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Simon BAPTIST

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29 Jan 2021

The Economist Intelligence Unit is keeping an eye on inflation despite expecting interest rates to stay near zero. But don't expect COVID-19 to be gone anytime soon

Back in September 2020, the German government announced plans to take on nearly €100 billion in new debt in 2021 to bolster a COVID-stricken economy. Taking into account earlier debt provisions for €218 billion that had shattered the country's renowned commitment to a balanced budget, Europe's largest economy has pumped in, as a percentage of GDP, more than six times it did during the 2009 Great Financial Crisis.

Germany's actions mirror much of the rest of the world's, with the IMF estimating governments worldwide to have forked out some US$12 trillion to keep economies going amidst COVID-19 lockdowns and related knock-on effects.

"Debt has risen massively through this crisis," notes **Simon Baptist**, Global Chief Economist at The Economist Intelligence Unit (EIU). "But it doesn't matter as long as interest rates stay low. In fact, in many countries the cost of servicing their debt has gone down because the decline in interest rates has been bigger than the increase in the level of debt.

"[Countries will be] very keen to keep interest rates low to keep those sovereign bond interest rates low even at the expense of building up other risks in the economy, such as bubbles in the stock market or at the risk of higher inflation."

LOW INTEREST RATES, HIGH STAKES

Baptist made those observations at a recent webinar by SMU Libraries titled "The World in 2021" where he noted the difference in governments' fiscal response between the 2009 Great Financial Crisis and the current pandemic.

"Back then, there was widespread acceptance amongst governments that fiscal deficits should be kept under control, that you would limit how much spending you had. Interestingly, that was in opposition to the advice from most economists, which was that even though your debts are going to go higher, as long as interest rates are low, and you have a lot of spare capacity in your economy – which you did when you have a lot of unemployment – that fiscal spending should have been higher in 2009 and 2010.

"That message of economists', and the experience of the world's slow post-2009 recovery, have fundamentally changed the perspective of policymakers and we've seen a lot of countries…really go all out on fiscal spending. Places like Germany, like Singapore that never used to have fiscal deficits now have their biggest ones ever.

"I think that governments' fiscal support is going to stay around for a long time. I wouldn't expect too much of a roll back in that."

With much of that fiscal stimulus fuelled by debt, the fear of inflation that could result in higher interest rates and costs of servicing that debt becomes a real worry.

"It looks likely to stay low but an uptick in inflation is the biggest economic risk that we're facing in 2021," Baptist points out. "Should inflation rise faster than expected, particularly if it starts going substantially above those 2 percent thresholds that most central banks have, that could lead to rise in interest rates, which could be quite damaging."

He adds: "Another source of uncertainty that we're really thinking about is financial markets and stock market valuations. Valuations are very, very high at the moment. There's been a divergence between underlying earnings of shares and in the valuations in the market.

"This is related to our first risk, the very low interest rates that are happening where interest rates are very low, the returns you get from dividends from stocks are more attractive. So people are more inclined to buy shares and willing to pay more for them in order to access that dividend stream."

With most major central banks operating at or near zero interest rates, it is unsurprising to see the Dow Jones Industrial Average hitting all-time highs of over 30,000 points, recent tumbles on stock valuation concerns notwithstanding. Baptist thinks the equities bull run could have some legs left.

"I think Japan is very reconciled to…a zero interest rate environment but I don't think the European Central Bank psychologically is there yet. The current head Christine Lagarde was talking about things like risk from inflation because of a stronger Euro but I think they need to continue to adjust their monetary policy to adjust to the zero interest rate world.

"We think the Bank of England is going to raise rates first but not till the end of next year, and with U.S. not raising rates until 2023. So our baseline is that the low-interest rate environment will stay with us and that's going to mean that market valuations should stay pretty high."

RECOVERING FROM COVID-19

Given the stock markets' performance, one might be tempted to think it could trigger a wider economic recovery, or at least view it as a harbinger of it. Baptist points to the elephant in the room: COVID-19. Specifically, the time-consuming nature of vaccination to achieve herd immunity.

"We're now seeing the light at the end of the tunnel with vaccines starting to be rolled out, although we're not expecting those to be rolled out in a way that protects more than 80 percent or so of a country's population, which is what you need to reduce distancing measures, until the second half of this year," Baptists elaborates. He adds:

> *"The general optimism around the vaccine is probably running a bit too high. I do believe ultimately we will get vaccinated and that will be a solution to the pandemic but it will take a long time. Even in rich countries like the U.S., Europe and Japan, we're not expecting widespread vaccination until really September this year, running into March next year. So a return to for global normality is still going to be some way off."*

Simon Baptist was the speaker at the SMU Libraries webinar "The World in 2021" that was held on 22 January 2021.

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