Looking into 2021 and beyond...

Economic outlook

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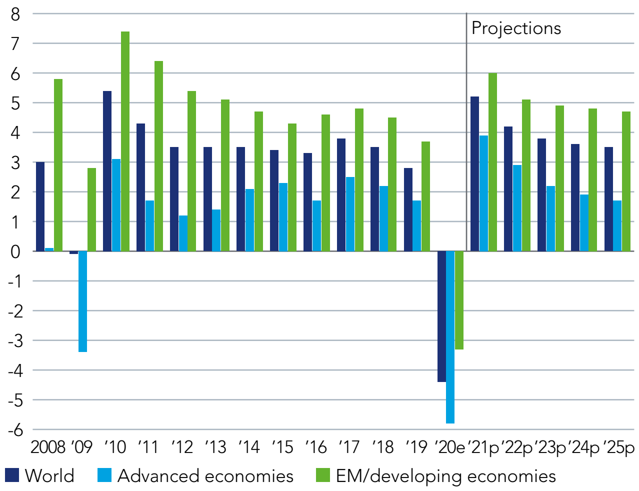
Main points

- Major economies blighted by Covid-19 are recouping their GDP, but it may be a slow grind getting them back to 'normal'. Vaccines are coming. But, with lockdowns repeating, and households and corporates tending as much to balance-sheet repair as re-leveraging and spending, extended 'W' or 'K'-shaped recoveries look likely.
- This leaves central banks, bereft of the inflation they crave, looking for variants of the tools that failed them. For markets, this should leave ultra-low rates distorting decisions, and QE's boost to asset prices counter-productive – widening disparities, stuttering demand, and stymying inflation.
- In this respect, 2021 offers more of the same, where, investors daren't miss out on reflation trades, even if they lack conviction. Governments, though, cannot patch up their balance sheets. In which case, the risk to elevated markets comes not from policy tightening, but protectionism and distrust, especially if the 'blame-game' for the virus intensifies.
- Amid these conflicting forces, our macro outlook is based on five core beliefs. First, securing vaccines will not, unfortunately, guarantee straight-line macro recoveries. Confidence may lift, but distributional and other challenges suggest 'normality' is unlikely before the Autumn. Labour scarring will also test how painlessly GDP levels can return to their pre-Covid-19 trends.
- Second, policy will stay abnormally loose. While central banks exhibit paradigm shifts, it's difficult seeing how fiscal stimuli can be reversed without unintended consequences. So, third, the legacy will be a relaxed approach to debt-build-up that's akin to the UK's post-War experience. Thankfully, G7 default-risk is next to zero. But, vulnerabilities lie with those emerging markets with high external-debt and foreign saving needs.
- So, fourth, with inflation craved by central banks *and* governments, QE will be harder to kick – reinforcing the dependence QE-governments have on their central banks. So, a challenge will be avoiding the impression (as in Japan) that central banks are effectively becoming the 'Monetary Departments' of government.
- And, finally, political distrust and beggar-thy-neighbour policies continue to build, despite a more collaborative US President-elect. Seeking favour in the Senate, he looks unlikely to unilaterally pull back restrictions on China into 2022. For markets, this may be more a 'crack-in-the-ice', than a 'cliff-edge', event. And, investors need to see the German Chancellor's successor keep the glue around the euro, and dissuade electorates watching the UK as it opens the EU trapdoor.
- So, vaccine-success and macro-recovery, yet political risk, protectionism, and new policy-thinking suggest volatility. The dilemma for central banks may be testing new tools, or letting fiscal expansion do the work. We expect both, with paradigm-shifts that prioritise growth and employment effectively changing mandates. Because, with governments in charge, setting anything other than growth-friendly ones, as debt and voter-enmity rise, would surely be like a 'turkey voting for Christmas'…

Chart 1. Major economies are expected to bounce back…

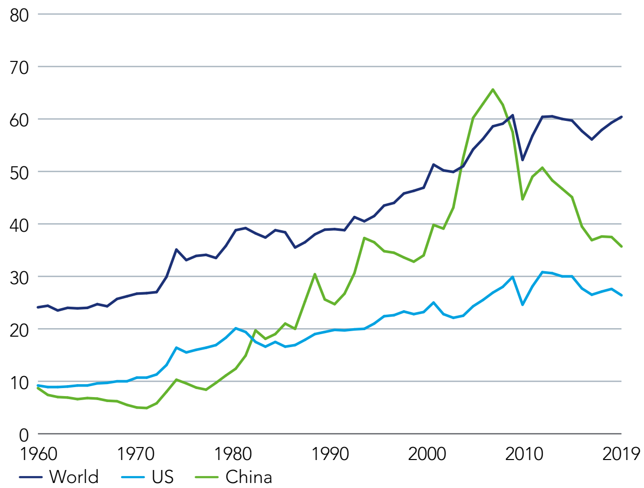
IMF's real GDP-growth projections: world; advanced; & EM/developing economies (%yoy)



Source: IMF's October 2020 world economic projections

Chart 2. On the assumption that world trade-growth is largely unabated

World, US, & China's trade (exports plus imports)* as a share of their respective GDP (all %)



Source: World Bank data (*goods & services)

Comment

Major economies blighted by Covid-19 are recouping their GDP, but it may be a slow grind getting them back to 'normal'. After Q2's 'eye of the storm' wiped out years of economic growth, some bounce, even on base-effect, has been inevitable. This has so far given back about half their real activity lost. But, with lockdowns repeating, vaccines yet to be distributed, and households and corporates potentially tending as much to balance-sheet repair as re-leveraging and spending, hopes for 'V'-shape recoveries have rightly morphed into an extended 'W' or more divisive 'K'.

This leaves central banks, bereft of the inflation they crave, looking for variants of the tools that failed them. None of these (see below) suggest tighter conditions further out. For markets, this should leave ultra-low rates distorting decisions (saving, buy-backs, 'zombies' *etc*), and QE's boost to asset prices counter-productive – widening disparities, stuttering demand, and stymying inflation.

Distrust & protectionism – a bigger risk than policy tightening…

In this respect, 2021 offers more of the same, where, lubricated by over a decade of cheap money, a $23trn sink of QE, and record fiscal stimulus, investors daren't miss out on reflation trades – even if they lack conviction. Governments, though, cannot patch up their balance sheets for risk of throwing out the baby (recovery) with the bath water (tax rises/spending cuts). So, their debt piles will amass. Differences, though, could include a step-up in geopolitical risk (US/China, European populism) – despite a less pugnacious US President – that's so far not been allowed to disrupt stock markets.

In which case, the risk to elevated markets comes not from central banks and fiscal tightening, but protectionism and distrust, especially if the international 'blame-game' for the virus intensifies. This could be heightened if employment-scarring, for example, becomes used as political capital.

The 1930s revealed few winners from trade conflicts. Should stagflationary forces build from such a stand-off, the cost-led inflationary flame will snuff itself out. This portends more to the inflation rises of the early 1980s/1990s recessions, than the late 1980s/mid-2000 overheating. Helpfully, ultra-cheap borrowing costs offer incentive to governments to keep fiscal boxes open. All this has precedent in deflationary Japan. And, while differences exist, these are not reassuring (see our 'Japanification' report, Q3 2019).

This, plus the contradiction of wanting to ease distortions, yet recapture GDP and be alert to geopolitical tensions, voter enmity, and climate change, is the starting point in 2021. But, it looks a wish-list that cannot please all. Our base-case is one where growth ebbs and flows in 2021 and 2022, channelled by both medical (vaccine success) and macro factors (stimulus, political distrust). The by-products being continued monetary accommodation (US/UK real rates stay negative), profligate governments, and yet, given international tensions, the shine taken off assets that overestimate the speed and duration of recovery (charts 1-2).

Amid these conflicting forces, our macro outlook is based on five core beliefs.

First, securing vaccines will not, unfortunately, guarantee straight-line macro recoveries. The apparent approach of effective vaccines sounds hugely encouraging, and should, in hard macro terms, lift consumer/business confidence, even before their distribution is underway. Current providers suggest next Spring before receipt by other than front-line workers and the most vulnerable, and warn that any sense of 'normality' seems unlikely before next Autumn. Obvious challenges include securing sufficient supplies (*e.g.* the UK government initially ordering five million doses, enough to reach 3.5% of the population), the time taken for more widespread use and, for less developed economies especially, efficiency of distribution for its widespread use.

Economic activity may, therefore, resume, but more telling will be how painlessly GDP levels can return to their pre-Covid-19 trend. After needing five-six years after 2008-09 to reclaim their real GDP, the virus at a stroke took the US's back to 2014 levels, and the UK's to 2003. It stole another 'growth decade' from Japan. The bounce since then has restored little more than half of these. Even before the virus, consumers in Japan (with deflation), and Italy and Spain (locked into the euro) had yet to recover their pre 2008-09 consumption. Even now, after Q3's improvement (latest data), their respective real consumption is having to start again from 2013 (euro-crisis) levels.

And critical to recovery will be the rapidity of labour's response. US job losses have been 'eye watering', having chimed with 1930s unemployment rates. The latest, 6.7% unemployment rate (November) is almost double February's. And, as in 2007-09, rapid downturns do not guarantee sharp recoveries. Thankfully, the labour data are improving as furloughed workers return. Yet, even if jobs continue to be clawed back at the current run rate, it would take 19 months for the near 10 million workers displaced to return. This delay may not be helpful to a new President seeking favour in a divided Congress (page 6), and it remains to be seen how spendthrift returning 'furloughers' can be.

Second, policy will thus stay abnormally loose. Central banks, long frustrated by inflation's absence, are starting to question their traditional reaction functions, such as CPI targets and Phillips Curves, which have remained 'inexplicably' flat relative to the business cycle (chart 3). Recent tilts, though – including the US Fed's move to average, rather than fixed, inflation targeting, the BoJ's explicit yield-targeting since 2016, and a BoE now considering negative rates and QT before eventual rate hikes – may all herald more widespread paradigm shifts. The ECB's review should conclude in H1 2021.

None of these would, meaningfully, tighten conditions. Based on the US Fed and BoE own metrics, we estimate the US and UK are already running *true* policy rates as low as -8% and -6% when QE is fully considered (-9.5% and -7.0% in real terms). Together with record fiscal packages, this confirms by far the loosest overall stance in nearly three decades of data, probably post-War, and points to even lower rates (-10.5% and -9% respectively) in 2021. It also questions the need for the US Fed and BoE to follow the ECB and BoJ onto negative 'headline' rates.

And, while fiscal expansions vary, it's difficult seeing how these can be reversed without unintended consequences. Front-runners have been the US, Japan, and UK, with packages equivalent to about 14%, 23% and at least 7% of respective GDPs; China favouring a more cautious 3.6% of GDP programme, to avoid the over-stimulation of 2008. The eurozone will near double its initial 4.3% of GDP if its Recovery Fund remains inoffensive to sceptics of 'debt-sharing'. This plus maintaining QE at the current, faster rate should avoid the macro divergence of 2010-13's funding crisis (page 10).

Third, the legacy will be debt build-up, which was amassing before the virus. Higher government debt ratios now look inevitable for 2021 and beyond. In 2020, the UK governments' net debt to GDP, at 102%, is three times Japan's was (34%) when it entered a lost-decade in the mid-1990s. Japan 'gets away with it' from having all its JGBs local-currency denominated, held predominately (97%) by a domestic investor-base less sensitive to yield/foreign-currency ratings. Thankfully, the US, eurozone, and UK's too are in local currency, also implying default-risk is next to zero.

This gives their governments (especially those facing voter enmity) time to put growth and inflation considerations ahead of more direct ways of addressing the debt. Such a relaxed approach would be akin to dealing with the UK's post-War debt burden that started at 250% of GDP. At the current rate of build-up, the UK could equal this ratio by 2030. But, an advantage this time is no longer having the USD-denominated obligations that contributed to our having to borrow from the IMF in 1976.

But, for many emerging markets (EM), the outlook may be less rosy than the IMF expects (chart 1). GDP-recovery may be delayed if vaccines are not widespread, for example, in densely-populated cities in Brazil, India, Mexico, and Russia. And, after that, in a potentially more protectionist, stronger USD, environment. Vulnerabilities lie with those non-commodity exporters with high short-term external debt and foreign saving needs, such as Argentina, Turkey, and Ukraine. But, for others, external debt-ratios are lower, with few currency pegs to have to protect. And, as their domestic debt climbs, they too can run QE.

Which means, fourth, with inflation craved by both governments and central banks, QE will be harder to kick. If it continues to boost asset prices over wages, this could further widen wealth disparities. With even more bond supply, Japan – after 23 years – will probably have to accelerate QE just to 'stand still' (page 8). In 1951, the US Treasury-Federal Reserve Accord was the reason for stopping US QE after 14 years. This will not be repeated, and could even be questioned, formalising the dependence QE-governments have on their central banks. So, in an even-higher-debt world, a challenge will be keeping clear the operational distinction between the monetary and fiscal authorities, thus avoiding the impression (as in Japan) that central banks are becoming the 'Monetary Departments' of government.

And especially if wage growth fails to recover. US inflation expectations anchored around pre-QE levels mean the Fed could easily tolerate faster wage-growth, and BoE officials admit forecast errors from having overstated the NAIRU. And even if green shoots show in the cluster of Spring pay claims (*e.g.* Germany's IG Metal, Japan's *shunto*), they may be trampled underfoot unless corporate pricing-power builds. As a guide, chart 4 suggests recent improvements in economy-wide inflation have reflected cost increases (Japan's tax hikes, sterling depreciation, and a statistical quirk in measuring the UK's public-sector deflator), more than demand.

Finally, political distrust and beggar-thy-neighbour policies will continue to build. In the US, the Senate would probably oppose a general approach to trade akin to the Smoot-Hawley reforms of 1929-30, which imposed up to 20% tariffs on over 20,000 US imported goods, covering as much as 60% of dutiable imports. That spread like 'bush-fire', with Europe finding new partners and Canada 'retaliating' even before they became US law. US President-elect Biden, seeking favour in the Senate, is unlikely to unilaterally pull back restrictions on China when both sides are looking to 'puff out their chests' into 2022's US midterms (page 6) and China's National Congress (page 14).

And, if needed, he could even invoke 'Super 301' to impose tariffs without approval on countries deemed to be engaging in "unfair" trade practices. Retaliation could include a reluctant China currency-depreciation, and dip into the PBoC's reserves that indirectly raises US mortgage rates. This, and depreciations elsewhere (*e.g.* S.E. Asia), could generate a deflationary return to the US.

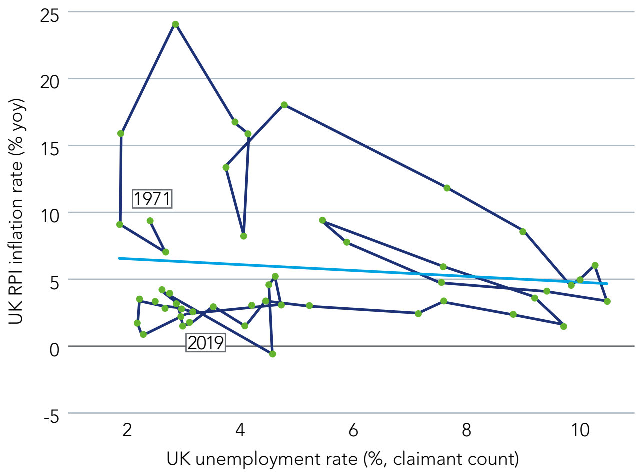
For markets, this may (like Brexit) be more a 'crack-in-the-ice', than a 'cliff-edge', event, with a disparity, at least initially, between goods and service sectors, and broadening out to countries whose 'cheaper' imports can fill the gap. In the UK, even if a Brexit deal can be struck, it would likely be a precursor to sorting out fully the various systems that extends well beyond 2020. And, ultimately, it could yet set the scene for a longer-term 'satellite' alignment with the EU (page 12).

While, in the eurozone, investors need to assess whether the German Chancellor's successor can quickly set the credibility needed to hold the glue around the euro, and dissuade electorates following the UK's progress as it opens the EU trapdoor. Encouragingly, euro-members' macro convergence is also holding in, albeit, in the wrong direction for economic wellbeing (page 10). And, in Japan, elections may be brought-forward, but will not alter the policy dials tuned for a third decade of deflation-fighting (page 8).

So, all in, the sensitivity of markets to vaccine-success and macro-recovery, yet political risk, protectionism, and new policy-thinking suggest renewed volatility. The dilemma for central banks may be between testing new tools, or letting fiscal expansion do the work. We expect both. For, while inflation remains 'yesterday's problem', paradigm-shifts that formally prioritise growth and employment over inflation-control could effectively change mandates. Because, with governments in charge, setting anything other than growth-friendly ones, as debt and voter-enmity rise, would surely be like a 'turkey voting for Christmas'.

Chart 3. Phillips curves will stay relatively flat

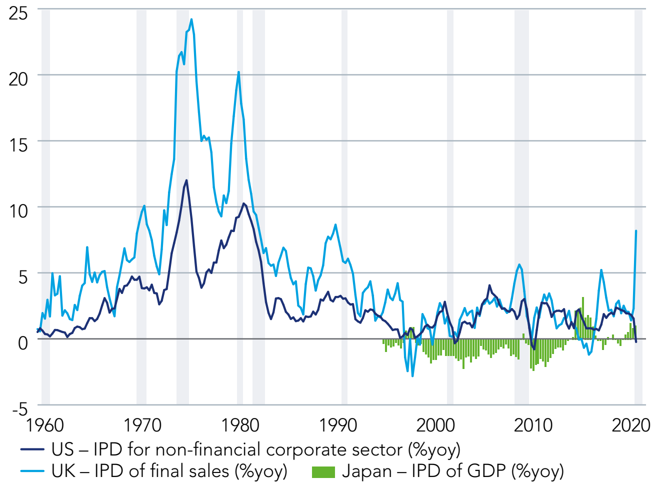
Fitted trade-off between UK unemployment rate (%) & CPI inflation (%yoy)



Source: Refinitiv Datastream, based on ONS data

Chart 4. Even US pricing-power is still modest

Implicit price-deflators (%yoy). US's is for private sector, non-banks. Grey denotes US recessions



Source: Refinitiv Datastream, based on national data

US

Passage of the election removes a major strand of uncertainty, but a divided Congress will leave doubt over President-elect Biden's ability to affect change this side of the 2022 midterms. In the near term, though, the conclusive result, and his pledges to promote recovery, and conciliate on international trade and climate change should be accommodating for growth, as should the Senate's likely push-back on his proposed tax increases. But, with obfuscation too over a third, a $1-3trn relief package, slower labour-market improvement, and unlikelihood of a swift unravelling of protectionism, hurdles still need to be cleared before restoring the economy to health.

On trade, Mr Biden should set a more collaborative tone, but looks unlikely to unilaterally roll back existing restrictions. This could include relying more on allies to help resist China, assuaging, though not removing, the global protectionism risks that keep us cautious on world GDP-growth. But, it remains to be seen how vehement Biden can be, given his need to hold onto and, nearer 2022, tap into, the Republican's core bases. And also how quickly allies' confidence in the US on trade/climate change rebuilds, following the highly visible, stand-alone approach under Mr Trump.

Hurdles still to clear…

Fiscally, though, even after 2020's record packages, neither Democrats nor Republicans express urgency for correction as an end in itself. In the short term, both sides advocate a third package of relief measures. Pre-election, the Democrats' passing in the House of a $3trn bill to extend extra unemployment benefits and boost state funding potentially looks more profligate than the Republicans' $1trn bill, that would extend benefits at a lower level ($200 p/week, vs $600). Yet, a compromising Senate may now deliver a smaller package and/or one that's staggered through 2021.

On the surface, Biden's pledge to thereafter raise both the main corporate (from 21% to 28%) and top personal tax rates (from 37% to 39.6%) made him look hawkish. Independent estimates suggest first-round revenue-increases from these centred on $3.6trn over a decade (1.4% of GDP). These would effectively take back three-quarters of this year's 'stimulus' if implemented from 2021. With a long-term GDP-hit of up to 1.5%point, though, this ignores redistribution effects.

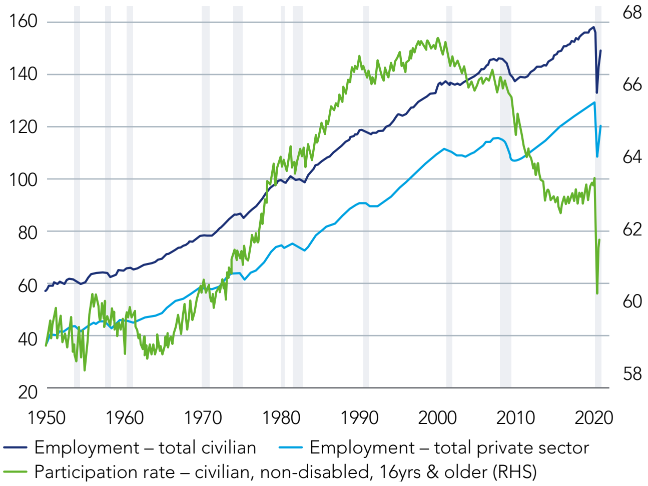
Thankfully, the labour data – that in Q2 chimed with the 1930s – are improving, albeit at a slower rate. April's (the hardest-hit month) 20.8 million payrolls collapse compares to the latest run rate (September to November average) 522,200 increase. Yet, even if jobs continue being clawed back around this pace, it would take another 19 months for the near 10 million civilian workers displaced to return (chart 5). This requires a full rehiring without further lockdown, and return of those disappearing from the workforce, but unregistered as unemployed. The 'under-employment' rate ('U6'), which includes those not searching but wanting to work/more (at 12% vs 7% in February) may be slower to fall. And as we know from 2007-09, rapid job losses do not guarantee the sharpest employment recoveries.

For this and other reasons (*e.g.* low inflation expectations), macro policy will stay abnormally loose. On the basis of last March/April's near $3trn package of tax, spending and liquidity measures and our assumed maximum $2trn to come, as well as the Fed's open-ended QE, our *Policy Looseness Analysis* suggests a *true*, QE/QT-adjusted funds rate currently closer to -8% (-9.5% in real terms). (See our *Tightening by doing nothing* report, May 2017.) While even lower next year (-10.5%, and -12% real), it shows how far short we'll be from taking the policy-mix back to pre-Covid levels. And, Senate willing, offers little policy-risk to the Fed's Powell when he looks to extend his Chair to 2026.

A bigger risk is that labour losses become used as political capital should the international 'blame game' for the virus intensify. This could pose an early test as the new Administration bargains to raise the US's $24trn (107% of GDP) debt ceiling by mid-year (chart 6). China has a $1.1trn claim on this, and looks unlikely to bow to US pressure as it prepares for its National Congress, also in October/November 2022. In practice, US 'default' here, of course, is only via inflation. But disruption (akin to August 2011's government shutdowns) will doubtless ensue if a divided Congress cannot raise it swiftly, especially if further relief packages are delayed. In which case, a protracted stand-off would surely affect both sides, with obstructive Republicans then risking their midterm prospects, much in the same way as they 'contributed' to President Clinton's re-election in 1996.

Chart 5. US – It's not just about employment losses

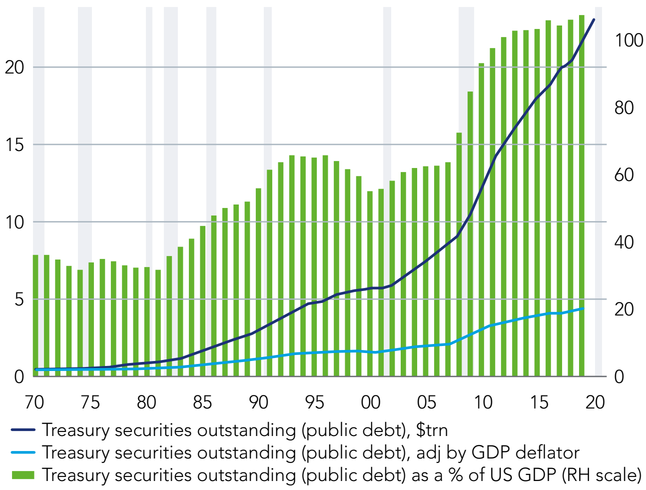
Civilian employment (millions) vs participation rate (%). Grey is recession



Source: Refinitiv Datastream, based on BLS & NBER data

Chart 6. US Treasury debt outstanding, in nominal & real terms

US securities outstanding ($trn), & as a % of GDP. Grey blocks denote recessions



Source: Refinitiv Datastream, based on US Department of the Treasury data

Japan

New PM, Suga has every reason for prolonging a policy-loosening entering its twenty-third year – extending Abe's pillars of monetary and fiscal loosening and furthering structural reform. And, while the monetary dials stay tuned to fighting deflation, expect a full carry-through, and likely extensions of, this fiscal year's three budget expansions totalling ¥127trn (23% of GDP).

Prior to CY18, a weaker yen and successive rounds of monetary/fiscal stimuli had been helping, with real GDP rising for two years. This was the second longest stretch since the 1990s' asset-price collapse. The output gap closed, suggesting a return, if growth could be sustained above its 1%yoy 'potential', to economy-wide inflation (positive GDP-deflator). But, these were losing their edge even before the virus. With personal consumption already lacklustre into October 2019's sales-tax rise – contrary to its *frontloading* into 1997 and 2014's tax hikes – and the yen buoyed by safe-haven flows, deflation's-end is not assured. Politically, this may frustrate ahead of October 2021's Lower House Elections. Yet, given his strong popularity, Suga may want to bring these forward to spring.

Elections could be brought forward...

Meanwhile, with the BoJ loathe to hurt banks by going further into negative-rate territory, QE will again have to do the monetary work. The BoJ's lifting of its commercial paper and corporate bond purchases, from ¥5.4trn to ¥20.4trn, now secures 23% coverage of those markets and should absorb new borrowing. And, given the MoF's latest estimate of ¥91trn new JGB issuance in FY20 (year ending March 2021), the BoJ would have to more than double its traditional ¥80trn annual purchases if it wanted to continue mopping them up at more than twice the pace of new supply.

Yet, depending on where global yields go, this ¥80trn will now vary, reflecting the need to meet the BoJ's near-zero 10-year yield-target set in 2016. Any QE rise at a zero/negative yield should, thus, be seen as a further loosening. For BoJ Governor Kuroda, there is no QE *"reversal"* until a +2%yoy CPI (latest -0.4%yoy) is the norm, presumably driven by demand, not costs. With the BoJ now assuming a return to deflation at least in its core-CPI (CPI ex fresh-food) of -0.6%yoy in FY20, its share of JGBs outstanding should surpass the current 55% (chart 7). This leaves institutions looking overseas, hopefully softening the yen.

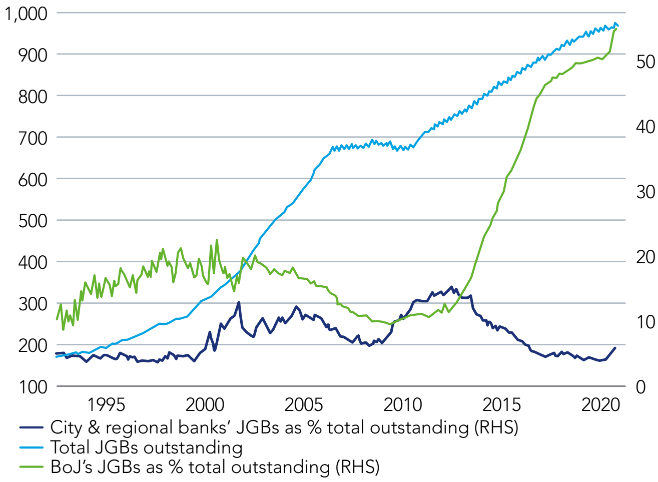
With the developed world's highest government liabilities-to-GDP, at about 250%, the MoF faces the biggest hit from deflation. With deflation raising the real value of debt, and deflation and recession eating into nominal GDP, debt-ratios are blown up. The MoF now strives to get nominal growth (-4.8%yoy in Q3) back above the long-term interest rate, to borrow without raising the debt ratio. This leads some officials to believe the BoJ will be the last to stop QE. Encouragingly, land prices – critical for balance sheets and collateral – are creeping back up, with an average +0.8%yoy since 2016. But, as the demographics crimp productivity and tax revenue, this also questions any scaling-back of QE.

Added to that, the authorities have long memories. Deflation-denial in the early 1990s, as the BoJ tightened, contributed to a correction that's still playing out. Tumbling asset prices from 1991 hurt banks' balance sheets and collateral, contributing to economy-wide deflation by 1995. This prompted banks to write off loans, and the BoJ in 1997-98 to mop up their commercial paper ('QE1'). However, it took until 2001 to get its key policy rate down to 0.1% and, with deflation expectations embedding and land prices falling, real rates stayed positive. This needed more unconventional tools, including government bond QE. A symbiosis thus started, where the MoF presiding over escalating government liabilities became reliant on the BoJ.

So, for inflation, the spring wage-round (*shunto*) will again be critical, and hopefully perkier than the 2.0-2.4% one-off wage hikes in each of 2014-20. Chart 8 suggests sustained wage-growth *would* probably lift the CPI, given the past 10 years' unemployment falls, and relative steepness of Japan's Phillips Curve. BoJ research concurs by identifying greater long-term wage responsiveness than in the US. (See chart 3 for the UK's.) Yet, deep in Japan's liquidity trap, it's doubtful easier money will prove any different, in terms of breaking the deflationary psychology – even with a likely demand-fillip from hosting the 2021 Summer Olympics and Paralympics.

Chart 7. The BoJ's overwhelming share of its domestic bond market

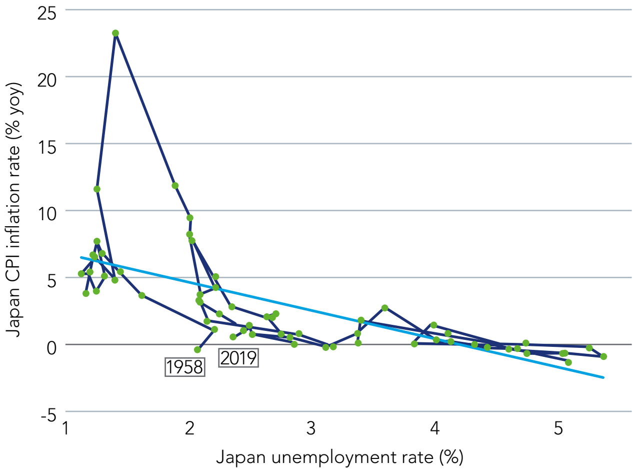
JGBs outstanding (¥trn) on LH scale, & BoJ & domestic banks' shares (%) on RH scale



Source: Refinitiv Datastream, based on BoJ

Chart 8. The outcome of the spring wage-round will again be critical

Fitted 'Phillips Curve', showing trade-off between unemployment rate (%) & CPI inflation (%yoy)



Source: Refinitiv Datastream, based on Ministry of Internal Affairs & Communications

Eurozone

After the zone's deepest recession (-11.8%qoq in Q2, vs 'just' -3.1% in Q1 2009) and lowest core inflation ever (just 0.2%yoy), the UK opening the EU trapdoor, and a successor sought for Germany's Merkel, the challenge will be to avoid political divergence, as populism and reform-fatigue build.

The ECB, doubting deflation will be beaten, will continue to raise QE. Intended initially at returning GDP to its pre-Covid trajectory, it will now be aimed at lifting headline inflation (latest -0.3%yoy) closer to its +2% target. While opposition to do more may persist in the Governing Council, QE's success hinges on capping long rates, and, with two thirds of private borrowing long-end driven, stimulating demand. This attacks the symptom: deflation. Yet, the solution – securing the economic union that a monetary union demands – may be years away (chart 10). After nine years of austerity, voters' enmity was visible before the virus, and a 'silver lining' of 2020 may be the fiscal box is now open.

Political, rather than economic divergence…

Budget expansions in Germany, France, and Italy suggest they're having to 'stomach' 2020 deficits close to 8.0%, 11.0%, and 11.5% of GDP. These could still be 4.0%, 8.3%, and 7.8% in 2021 (European Commission projections). Hopefully, implementation will be swift. EU Leaders' €540bn (4.3% of euro-zone GDP) of loan and guarantee recommendations last April were aimed at supporting governments, workers and firms. But, the later €750bn 'Recovery Fund', targeting grants averaging 2%-of-GNP toward the most affected states, remains controversial to those (*e.g.* Austria, The Netherlands, Sweden) wary of debt-sharing. In practice, though, highly-indebted members like Italy and Greece, vulnerable to rising debt-service costs, have especial interest in destabilising the euro.

It should also be easier for fiscally-prudent Germany to permit euro-wide fiscal largesse as a counterweight to QE 'conservatism'. Austerity from 2010 sliced the zone's budget deficit from 6.2% of GDP in 2009 to under 1%: easily below the 3% Maastricht test. Germany's own coalition had been eying a fiscal sweetener (infrastructure, childcare) before Chancellor Merkel steps down in 2021, on top of €54bn of climate-change measures by 2023. If debt-financed (which at negative yield must still be attractive), this helps an ECB nearing its cap of holding no more than a third of Germany's debt. Absence of a single fiscal-agency complicates the process, but as deficits rise broadly together, it shouldn't preclude autonomy within agreed, euro-friendly limits.

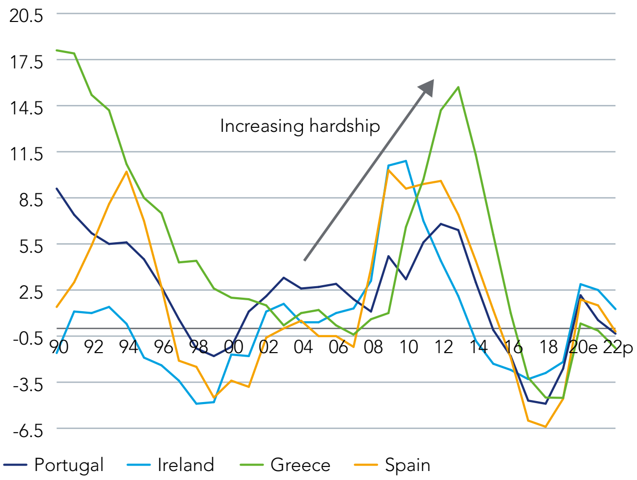
Nonetheless, regionalisation may increasingly be tested. Looking back, Italy's referendum back in December 2016, rejecting deeper government powers, probably set the political tone to come. In 2017, tensions with Turkey threw up a new risk: where one country's issues (Turkey's referendum) spill over into another's (Netherlands' election). Spain in November 2019 had to endure its fourth general election in just four years on regional-independence issues and budget failure.

But, the good news is Spain, Italy, and other peripheries' macro shortfalls versus Germany have been reducing rapidly. As an update, chart 9 uses our alternative 'Misery Indices' (MIs) based on relative CPI and unemployment shifts. (See our *Europe's highly-charged year* report, April 2017). It suggests that despite virus pressures, 2020 saw one of the largest degrees of *convergence* since the euro, albeit in the 'wrong direction' as far as economic wellbeing is concerned. A resumption of employment in 2021 with only modest inflation (as our consensus projections assume) would in theory cause our MIs to turn down again. Aspiring to this, though, probably rests on at least maintaining the ECB's faster QE run-rate (now over €100bn per month, up from €20bn pre-virus, and €80bn during 2015), and full implementation of the Recovery Fund.

Ideally, weaker strains in the periphery relative to the core members would ensure the harmful macro divergence during 2010-13's funding crisis is not repeated. Yet, with 15 years of GDP-growth lost through the virus, MI's off the bottom, Brexit looming, and the eurozone still lacking economic union, the challenge for leaders – including Germany's after next September – may be more political than economic.

Chart 9. The macro strains from the periphery had been easing…

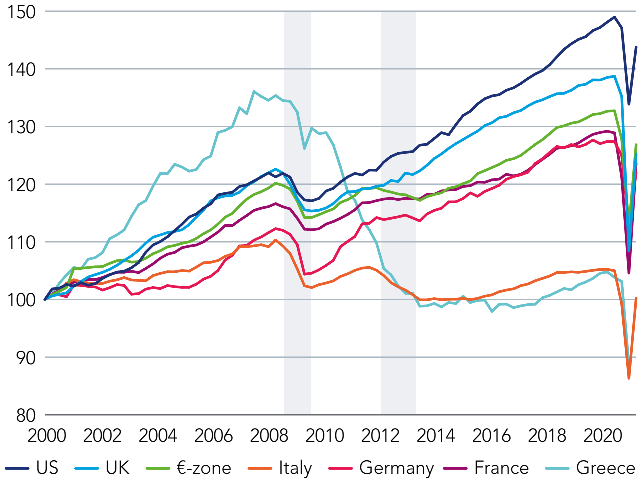
The lower the 'Misery Index', the greater the expected economic improvement



Source: Federated Hermes, based on Eurostat data, & Federated Hermes/ consensus projections (p)

Chart 10. But, it will be years before they reclaim GDP lost with the euro

Real GDP levels, re-based to Jan 2000 (= 100). Grey denotes eurozone recession



Source: Refinitiv Datastream, based on national data

United Kingdom

Though Brexit discussions remain fluid, with clarity needed on whether a trade deal can stave off WTO-terms tariffs, our base case is a 'sticking plaster' agreement can still be struck as a prelude to securing firmer arrangements down the line. And, while this may nominally be subject to concessions, such as deferring tariffs in exchange for 'unfair' state subsidies, dealing with the weight of Covid will take precedence over enforcing new measures.

And, even if a deal can be fast-tracked, it would likely be a precursor to sorting out fully the various legal, trade, and regulatory systems that extends well beyond 2020. These could ultimately still set the scene for some longer-term 'satellite' alignment with the EU (e.g. Norway's), and/or part-access to the Customs Union (Turkey) or Single Market (Canada).

No major economy has loosened more…

Meanwhile, economic repair will remain the priority. With a fifth of real GDP lost in Q2 – the biggest hit since 1709 – personal consumption back to 2002 levels, lockdowns prolonging uncertainty, and little more than half of the GDP-hit reclaimed (chart 10), assumptions of a 'V'-shape recovery have rightly waned. And with policy rates on the floor, onus will remain on fiscal expansion.

Chancellor Sunak's response to the crisis has been spirited, evidenced by his second extension, from October to next March, of furloughing. Temporary VAT and stamp duty cuts have been helpful, but, unless extended, it's doubtful they can launch our pent-up demand into something more lasting. Another fiscal 'jump-start' may thus be needed next spring (Sunak's sixth 'Budget' in a year), when hopefully he can focus more squarely on 'Green' ways to promote growth.

But, the legacy will be debt build-up. Second extension of the furloughing scheme could, even with firms' contributions, take 2020/21 job-retention costs through £100bn. Taking all measures together, the budget deficit balloons to £394bn (OBR projection). At 19% of expected GDP, it's easily a post-War high, and dwarfs the 2.4% expected in March 2019. This makes the net debt-to-GDP ratio, at a likely 105%, three times Japan's when Japan entered a 'lost decade' in the mid-1990s.

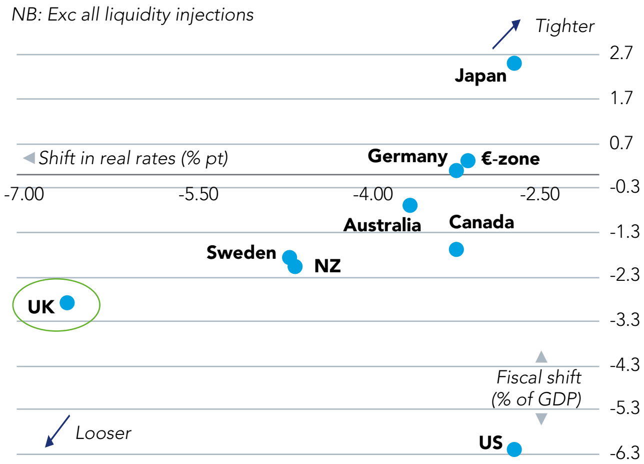
So, not to crowd-out growth, QE may be harder to kick, especially with the MPC wary of taking Bank rate into negative territory. Yet, this rate dilemma might be a 'red herring'. Using the BoE's 2009 simulations, we calculate the BoE is running a true policy rate as low as -6% (-7% in real terms), when QE is fully taken into account. Together with other measures, this confirms by far the loosest monetary-and-fiscal stance in 30 years of data, probably post-War, with lower rates (-7% nominal and -9% real) in 2021. This questions the need to follow the BoJ and ECB onto negative official rates.

And, even once the virus dissipates, the MPC should fall easily short of its 'Goldilocks' Bank rate of 2%. This equilibrium rate (r*), defined as that needed to deliver trend growth and anchor CPI to its +2%yoy target, is hoped later to rise to 2-3%, as better productivity spurs wages and leveraging picks-up. Yet (like Japan), the Holy Grail remains real-wage growth, which has for the first time since the 1860s been squeezed for a decade or more. Critical will be spring's cluster of pay settlements, and any impulse to the public-sector from the Budget.

But, it's not guaranteed. BoE staff believe it takes four years for higher import prices to be fully passed on to a CPI basket that's about one-third imported. Yet, the shortfall after sterling's 2016 post-referendum dive may still be being felt in exporters' margins. This may not be reversed, even if Brexit is resolved quickly. Chart 11 reminds us that, in 'more normal times', no major economy loosened policy more than the UK. And, given the inflation premium, there's probably little coincidence the pound has underperformed (chart 12). Which suggests, after an initial relief rally, little sustained upside for sterling, even once Covid and Brexit clouds lift.

Chart 11. No major economy had loosened its macro stance more than the UK…

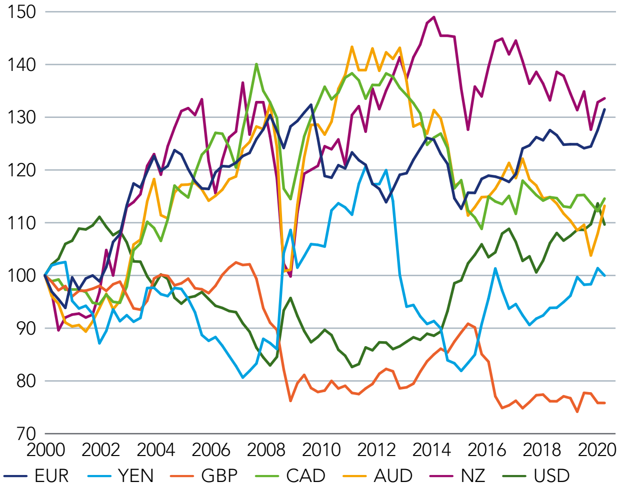
Shifts between 2000 & 2019 in real rates (using 3m Libor, CPI), & cyc adj budget balances



Source: Federated Hermes, based on OECD, national, & Bloomberg data

Chart 12. Which may help to explain the pound's relative weakness

Shows trade-weighted exchange rates, re-based to Feb 2000 (= 100)



Source: Refinitiv Datastream

China

The shift from the austere, supply-side reforms of 2016 and 2017 to an increasingly accommodative pro-demand programme should continue. In principle, President Xi's hand (he now looks entrenched even beyond 2022's National Congress) allows him to address the risks flagged at annual Central Economic Work Conferences, of limiting asset bubbles, taming debt, and managing shadow banking. But, with the economy slowing even before Covid-19, as 2017's credit tightening and 2018-19's trade-restrictions fed through, GDP targets missed, and trade negotiators needing to rebuff concerns about anti-globalisation, bolstering GDP will be the priority.

The virus provided a hit to H1 activity that the authorities have been loath to acknowledge. Q1's -6.8%yoy GDP – the first fall since 1976's ending of The Cultural Revolution – echoed private estimates, in a year when GDP-growth of at least 5.5%yoy was needed to double 2010's GDP level and *per capita* income. A core aim since 2015, its deferral was confirmed by May's omission for the first time of an explicit annual GDP-target. Encouragingly, Q1's GDP drop has been clawed back, led by direct State support. But, based on the NPC's +5.4%yoy *nominal* GDP and +3.5% CPI assumptions, little more than 2%yoy real growth looks likely for 2020, versus an 8.7%yoy average since 2000.

Ruffling the US Administration's feathers…

With key pro-reformers, such as President's Xi's Economic Adviser, Liu, having capped 2020's fiscal spending stimulus to 3.6% of GDP, there's room for more. But, it may be gradual. Officials believing China is ahead in the pandemic cycle are also wary of repeating 2008's 13%-of GDP (CNY 4trn) 'shock and awe' stimulus, which raised overcapacity and leveraging. Onus will thus remain on China's traditional levers for getting growth back on track, including agricultural subsidies and bringing forward infrastructure projects.

To make sure, Q2's measures may remain, including direct transfers and subsidies, unemployment insurance, tax reliefs and breaks, and banks being 'required' to use their lower reserve-requirements to purchase government Special Treasury Bonds. Fortunately, with GDP averaging +5.9%yoy since 2015, and Xi's inferred new growth ambition (of doubling current GDP and *per capita* levels) pushed out to 2035, there would be little political ignominy in recording lower, 4-5% growth rates.

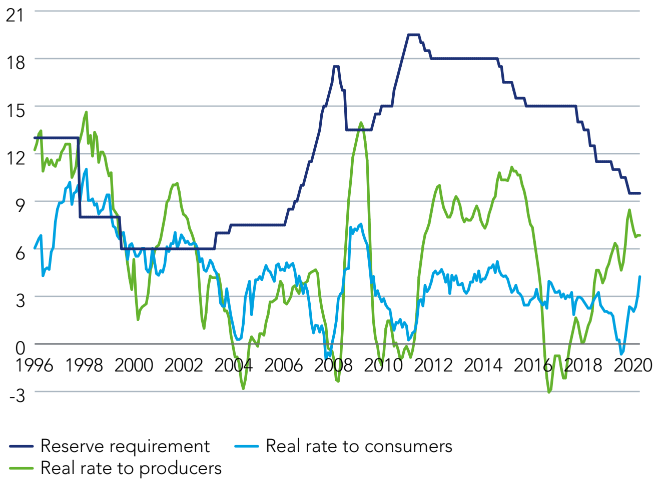
Either way, economic harm to China and the US looks inevitable. Politically, the virus increases need for 2019's 'Phase I' US trade deal to be reset, and lessened the prospect of a Phase II deal on industrial policy. China's concessions on IP and pledge to double US goods-purchases came as growth slowed. Yet, should trade tensions escalate, the PBoC may struggle to hold up the renminbi, adding to the burden of China's corporate and banks' balance sheets exposed to USD debt.

Tellingly, the RMB's been allowed to fall fastest during bouts of global influence, such as Brexit fears and rising US inflation-expectations in 2016, and trade spats in 2018-19. The persistence of these as China's/US surplus holds (chart 14) suggests downside risk for the RMB. Should this gain traction, the PBoC could again tighten capital controls and/or delve into its $3.1trn reserves. But, this would question China's commitment to buying US Treasuries (17% of international holdings), and unless offset elsewhere (US QE?) raise US mortgage rates. As unpalatable, though, might be higher domestic rates, adding to the strains on SMEs and consumers from real borrowing costs (chart 13).

And it remains to be seen how a Xi/Biden relationship widens differences over North Korea, Taiwan, Hong Kong, and the South China Sea. If fractious, currency depreciation, lower reserves, selective defaults, and a lower growth-target may be 'easier' for Xi if he can blame them on the US! And even if the two can agree on climate change, Xi's expansion of his 'Belt and Road' initiative, and call for China to be a *"leading global power"* may continue to 'ruffle the (new) US Administration's feathers'.

Chart 13. Further monetary loosening may yet be warranted…

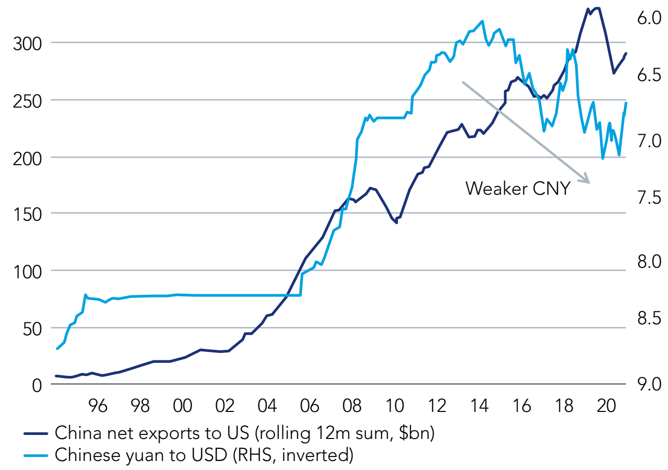
China's 3-5yr lending rate deflated by CPI/PPI, vs RRR for small banks (%)



Source: Refinitiv Datastream, based on NBS, & PBoC data

Chart 14. But, PBoC would only reluctantly weaken the renminbi

China/US bilateral trade surplus, 12m total, $bn. USD/CNY on an inverted axis



Source: Refinitiv Datastream, based on WM/Reuters, & IMF data

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