Ahead of the Curve

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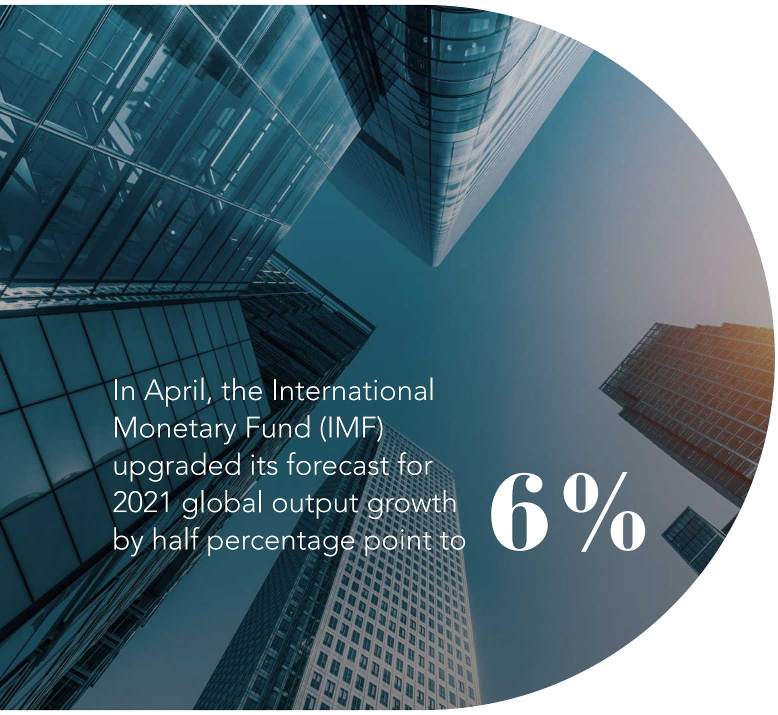
As Senior Economist, Silvia is responsible for providing macroeconomic analysis and commentary, non-standard macroeconomic modelling, and developing relationships with key central banks and monetary authorities.

Key points

- The global economy is bouncing back quickly from a sharp collapse in the first half of last year. What we are seeing now, therefore, is to some extent the mirror image of developments in 2020.
- Despite having increased somewhat over the last year, long-term inflation expectations are still low by historical standards.
- The growing bifurcation between emerging and developed markets is a source of fragility for the recovery
- Fiscal measures targeting longer-term issues have been more elusive and there is therefore a risk of going back to a pre-Covid-19 macroeconomic scenario.



Macro outlook: The economic scars of Covid-19

The economic picture has improved steadily as the year has progressed, the global recovery from the pandemic-related recession has gained speed, and the global economy is now on track for very strong growth for the next two to three quarters, underpinned by supportive fundamentals. Crucially, the vaccine roll-out – a pre-condition for the re-opening of the economy – has proceeded at a sustained pace in most developed economies, with the eurozone starting to catch up on the UK and the US over the last month. In addition, fiscal stimulus measures have been heavily front-loaded, which is boosting the recovery in the short term. That said, downside risk has not disappeared as difficulties in containing the pandemic in some Asian and Latin American countries suggest.

A mirror of 2020

In April, the International Monetary Fund (IMF) upgraded its forecast for 2021 global output growth by half percentage point to 6%, reflecting progress in vaccination roll-out programmes and new rounds of fiscal measures at the end of Q1 (most notably a $1.9tn package in the US). Recent hard data and surveys suggest that the global economy is on track to match that estimate. Most notably, the global composite Purchasing Managers' Index (PMI) increased by more than six points since the beginning of the year to 58.4 in May, a 15-year high (see figure 1). However, the speed of the current recovery needs to be put in context: the global economy is bouncing back quickly from a sharp collapse in the first half of last year. What we are seeing now, therefore, is to some extent the mirror image of developments in 2020.

Figure 1. PMI vs global growth (including latest IMF forecast for 2021)

Source: Refinitiv Datastream, IMF, JPM/Markit, as of June 2021.

In addition, the recovery has been uneven across and within regions, countries and sectors. Divergences have been particularly pronounced between emerging and developed economies, reflecting different abilities to tap the necessary resources to contain the pandemic and support the recovery.

A complex recovery

The US economy is now leading the recovery: it is expected to outperform the rest of the world in the next few quarters, going back to its pre-crisis trend by the end of the year. China, which experienced what looked like a V-shaped recovery in the second half of 2020, has slowed down somewhat this year, probably reflecting a prudent approach to policy support – indeed, credit impulse has likely peaked recently. The eurozone, that was lagging among advanced economies, has started to catch up and will likely accelerate in the second half of the year, as early disbursements from the €750bn EU Recovery Fund are set to start in coming months.

A wounded labour market

While the recovery in economic activity has proceeded apace, it will probably take longer for labour markets to heal. For instance, in the US, employment is still approximately 6.8m below its pre-crisis level. At the current run rate, it will take more than one year for employment to return to its pre-pandemic level. However, it might take longer, as current employment growth is unlikely to be sustained and sectors that were worst hit by the pandemic are likely to undergo transformations, implying reallocation of labour and some degree of friction.

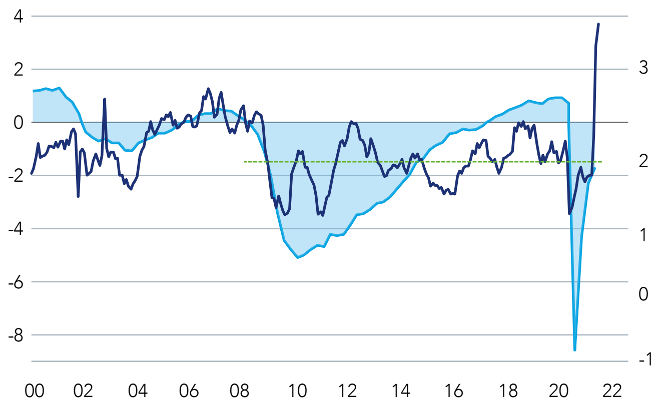
Accordingly, underlying inflationary pressures are likely to remain contained, despite a short-term surge in inflation largely driven by temporary factors. Base effects in energy, higher commodity prices and Covid-19-related supply constraints have already pushed inflation higher across the board. At one extreme, US headline and core consumer price inflation (CPI) rates surged to 5% and 3.8%, respectively, in May. This is the highest level seen since the early 1990s. By contrast, eurozone inflationary dynamics have been more subdued: while headline Harmonised Index of Consumer Prices (HICP) inflation came in at 1.9% in June, core inflation remained well below target at 0.9%. In emerging markets, inflation is also likely to come in strong in the months ahead, reflecting the impact of higher commodity prices and a larger weight of the food component in their CPI baskets. Current inflationary dynamics are probably largely temporary.

That said, as the economy strengthens, the Fed will have to think about tapering, i.e. reducing the pace of its asset purchasing.

Bottleneck effects should fade once both supply and demand normalise after Covid-19-related disruptions, while underlying inflationary pressures should remain contained as the labour market recovers, as suggested by development in wages.

Accordingly, central banks will likely look through inflation overshooting for now and maintain accommodative monetary conditions. In particular, the US Federal Reserve (Fed) will favour the employment aspect of its mandate, while its recently adopted average inflation targeting strategy means that it will tolerate above-target inflation for some time (see figure 2). That said, as the economy strengthens, the Fed will have to think about tapering, i.e. reducing the pace of its asset purchasing. The approach to tapering is likely to be gradual and very well telegraphed to markets: the Fed will conduct its discussion in coming meetings, with a view of providing a plan for tapering in Q4 and moving to actual implementation early next year.

Figure 2. US core personal consumption expenditure inflation vs slack in the labour market



Core PCE inflation, YoY (RHS)
Labour market slack (deviations of the u-rate from the CBO's estimate of NAIRU) (LHS)

Source: Refinitiv Datastream, US BEA, US BLS, CBO, as of June 2021.

Meanwhile, fiscal policy in developed economies will remain accommodative this year and, to a lesser extent, next, taking advantage of easy monetary conditions. The fiscal response to the pandemic has been much stronger compared to previous crises: over the last year, fiscal stimulus has amounted to about $16tn globally – mainly concentrated in developed countries and largely front-loaded. As the fiscal impulse starts to diminish across most developed economies between the end of this year and middle of next, growth rates will likely normalise. Fiscal stimulus has helped prevent a sharper output contraction in 2020. However, it is not clear that the composition of fiscal stimulus is apt to tackle some structural challenges that predate the pandemic. Whether existing policies will succeed in lifting medium-term prospects by boosting productivity growth and allowing for a greener and more inclusive expansion is yet to be seen.

Inflationary concerns

Drivers of high inflation are largely transitory and long-term inflation expectations are low by historical standards

Inflation has been a top concern for markets since it became apparent that a new policy paradigm (i.e. close coordination between fiscal and monetary accommodation) would dominate the policy response to the crisis. However, more recently, markets have reacted quite well to economic releases showing elevated realised inflation in the US. That's probably because, for the time being, drivers of high inflation seem to be largely transitory.

US inflation significantly surprised to the upside for two consecutive months in April and May. CPI inflation hit its highest levels since the early 1990s, coming in at 5% in May. Details suggested that most inflationary drivers were likely temporary and pandemic-related. Outsized price gains were concentrated in sectors that have been affected by bottleneck effects, i.e. autos, airfares and hotels. In addition, higher commodity prices played a role and base effects also flattered year-on-year rates of change.

Inflation will remain sustained for the next few months as the economy continues to re-open and demand for services and activities that were not available during the pandemic (e.g. tourism and leisure) outstrips supply. Favourable annual comparisons and higher commodity prices – although plateauing recently – will also help to keep inflation above target for the balance of this year. Yet inflation is likely to start to moderate in the second half of the year.

Fundamentally, cost-push price pressures (from bottleneck effects and higher commodity prices) are short-lived and self-adjusting, if they are not accompanied by demand-pull pressures i.e. higher wage inflation and/or higher long-term inflation expectations. As the labour market is recovering, wage dynamics are likely to remain well behaved. Cost-push inflation and the prospect of expiring unemployment benefits are likely to dampen consumption down the line, especially for items that recorded the largest price gains.

The main short-term inflationary risk relates to expectations: if realised inflation stays elevated for a long time, it might become ingrained in long-term expectations, in a self-fulfilling fashion. However, despite having increased somewhat over the last year, long-term inflation expectations are still low by historical standards.

The longer-term inflation picture will depend on the evolution of secular forces that have muted general price growth over the last decades. In particular, the labour income share has trended down in recent decades across advanced economies (see figure 3), likely reflecting a set of concurring secular factors compressing labour's bargaining power such as de-unionisation and the liberalisation of labour markets, globalisation, automation, and, possibly, demographics.

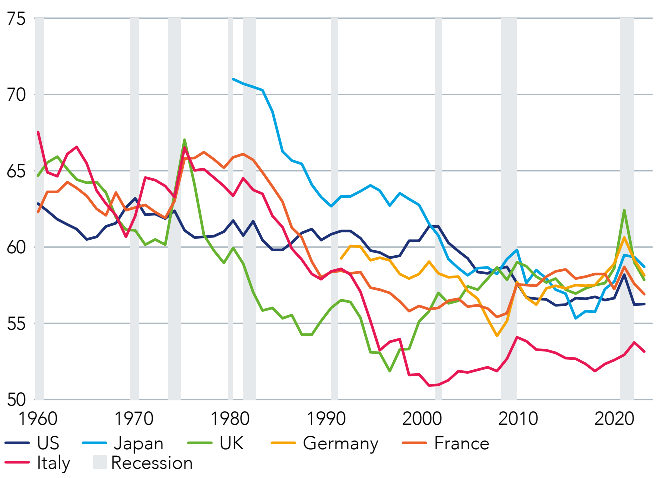
Inflation and the road to net zero

The transition to net zero – and, more generally, to a more sustainable world – is likely to have an inflationary impact, given that the price of most goods and services we consume does not currently reflect the negative externalities of production on the environment. Policymakers face the hard task of enabling a gradual and fair transition and need to focus on investment in research and innovation leading to lower costs of – and possibly gains from – the green transition.

Other factors have contributed to the containment of inflation, including central banks' independence, slower productivity growth, growing inequalities, zombification.

Going forward, some of those secular trends might change and new ones might emerge, with policies also affecting those evolutions. Fiscal policy can affect the inflation outlook profoundly: permanent and monetised fiscal stimulus could fuel runaway inflation, while targeted and productivity-enhancing fiscal spending could result in sustainable wage gains and healthy inflation down the line.

Figure 3. Labour income share has been on a downward trend



Source: Refinitiv Datastream, as of June 2021.

Divergences everywhere and scarring risks

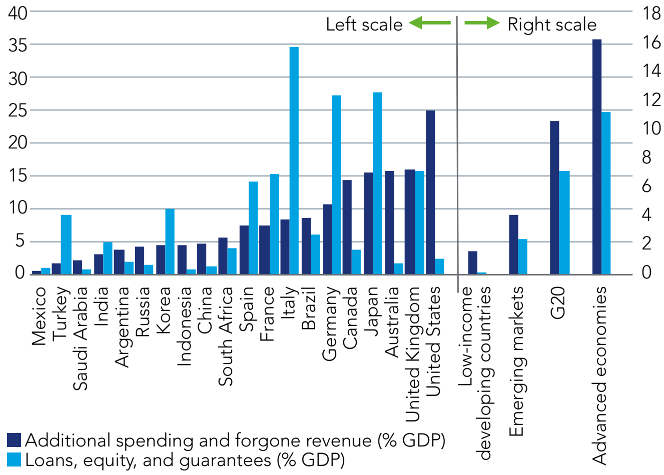
The most notable divergence has developed between advanced and emerging economies

The economic outlook has brightened significantly and the recovery from the sharpest recession in decades has made considerable progress. Yet divergences across and within regions, countries and sectors have persisted and, in some instances, widened. The most notable divergence has developed between advanced economies and emerging ones, with the latter lagging in the recovery, and reflecting a different ability to tap the necessary resources to manage the crisis (see figure 4). The growing bifurcation between emerging and developed markets is a source of fragility for the recovery in the short term and might lead to more pronounced structural imbalances in the longer-term. Emerging markets are a very differentiated universe, but they generally look vulnerable as they lack the resources to manage the pandemic in the short-term and to ensure an inclusive and sustainable recovery in the longer term.

Within advanced economies, the divergence between the US and the eurozone has widened. The US economy is set to accelerate sharply throughout the year, going back to its pre-crisis growth trajectory by the end of the year. In contrast, the eurozone experienced a double-dip recession, but it has just started to catch up and will probably go back to its pre-crisis level in the first half of next year. The divergence has reflected pre-crisis structural and institutional differences, differences in vaccine rollouts and in the implementation of fiscal packages. Upcoming elections in Europe (Germany in September and France in Spring 2022) will affect political balances and the institutional evolution of the block.

Meanwhile, the divergence between the manufacturing and the services sector – with the latter most severely hit by the crisis – has just started to close. As the economy re-opens, the services sector will catch up to manufacturing. The growth rotation from manufacturing to the services sector is key for the recovery to gain speed, given that the services sector accounts for about three quarters of advanced economies.

Figure 4. Government fiscal support in response to Covid-19, 2020-21



Source: IMF Fiscal Monitor, April 2021.

Building back better: where do we stand?

There is a risk of the global economy going back to a pre-Covid-19 macro scenario as fiscal measures have largely overlooked longer-term issues

'Build back better' has been the theme of the response to the Covid-19 crisis, yet it is unclear whether forceful policies are in place to favour a green and inclusive recovery.

Most fiscal measures have been short-term oriented and focused on the labour market. Such measures have averted a sharper contraction in the global economy – according to IMF estimates, global GDP would have contracted by 9% instead of 3.5% in 2020 if no fiscal response had been adopted – and it has protected the most fragile workers, at least in the short term.

Measures targeting longer-term issues have been more elusive and there is, therefore, a risk of going back to a pre-Covid-19 macroeconomic scenario, dominated by sluggish productivity growth (especially in advanced economies), rising inequalities and a looming climate crisis. For a start, it is unclear whether policymakers have worked out a long-term strategy for the labour market. The crisis has amplified inequalities in the labour market, disproportionately hitting already fragile categories, i.e. sectors with a prevalence of low-income and low-skilled jobs and women. While short-term measures have provided some temporary protection, it takes long-term policies of retraining and reskilling to avoid scarring effects, further productivity losses and persistent inequalities. Further, online learning and unequal digital access could result in long-term scarring of the labour market, hence there's an urgent need to address education gaps that the crisis has created.

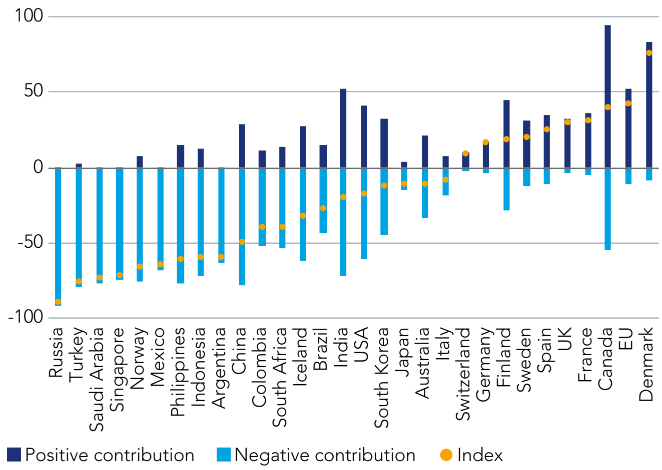
Fiscal stimulus in 2020-21 will have a net negative environmental impact, according to Vivid Economics.

Two recent reports by the UN and Vivid Economics suggest that policy efforts so far have largely missed the opportunity of building back better. In particular, Vivid's analysis (see figure 5) showed that fiscal stimulus announced up to February 2021 will have a net negative environmental impact in most analysed countries, including 15 of the G20 economies.

The EU Recovery Fund intends to devote about **30%** of resources to greening the economy and supporting the transition to net zero

However, there are some silver linings. First, the crisis has forced policymakers to put together a framework to deal with crises, crucially based on a coordination of fiscal and monetary policies. Going forward, the framework can be adapted and broadened to address long-term themes and projects. Second, announced or upcoming programmes include a focus on sustainability on a longer-term horizon. For instance, the EU Recovery Fund intends to devote about 30% of resources to greening the economy and supporting the transition to net zero – although early disbursements suggest the efforts will be largely backloaded. Furthermore, the infrastructure plan that the US administration is working on is set to include a strong green element.

Figure 5. Greenness of stimulus index



Source: Vivid Economics, as at 1 February 2021.

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