1. Global overview: A long and bumpy road back to normality

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- **The Northern Hemisphere winter looks set to be tough, with the renewed spread of the pandemic leading to increased restrictions on economic life.**
- **However, by the end of Q1 2021, the restrictions should again be relaxed, allowing economic activity to rise.**
- **Major players will continue to engage in ultra-loose fiscal and monetary policy, providing an important source of stability and demand to the whole global economy, including CESEE.**
- **The economic recovery at the global level will be slow and bumpy, with a general upward trend punctuated by periods of weakness. Nevertheless, the trough of the downturn is likely to have been in Q2 2020, and the global economy should post positive growth in 2021 and 2022.**
- **Risks to global projections remain unusually high in both directions, albeit at present weighted quite heavily to the downside. The future path of economic recovery is heavily dependent on the pandemic and any future vaccine.**

1.1. ECONOMIC RESTRICTIONS: A TOUGH WINTER AHEAD, FOLLOWED BY ZIGZAGGING BACK TO NORMALITY

Various media reports suggest that a vaccine for COVID-19 is getting closer. However, this is only one of several important steps, and will not in itself lead to a sharp economic rebound. The testing, manufacture and distribution of any vaccine will take time. There is a great deal of uncertainty about the timing of all those steps, but it seems unlikely that there will be a successful mass immunisation programme before the middle of 2021. However, mass inoculation is not necessary for large parts of the economy to get back to something like normal, especially once the Northern Hemisphere winter has passed.

The most likely scenario is that there will be a difficult few months over the winter, with the return of lockdowns in at least some regions of Europe. There will be a general zigzag pattern of restrictions, with specific conditions at any given time dictating whether the constraints are tightened or loosened. However, nobody knows how bad the second wave will be, or to what extent it will be exacerbated by the winter weather. Nevertheless, by next summer, even without a vaccine, our baseline scenario is that economic life will be much closer to normal than is currently the case.

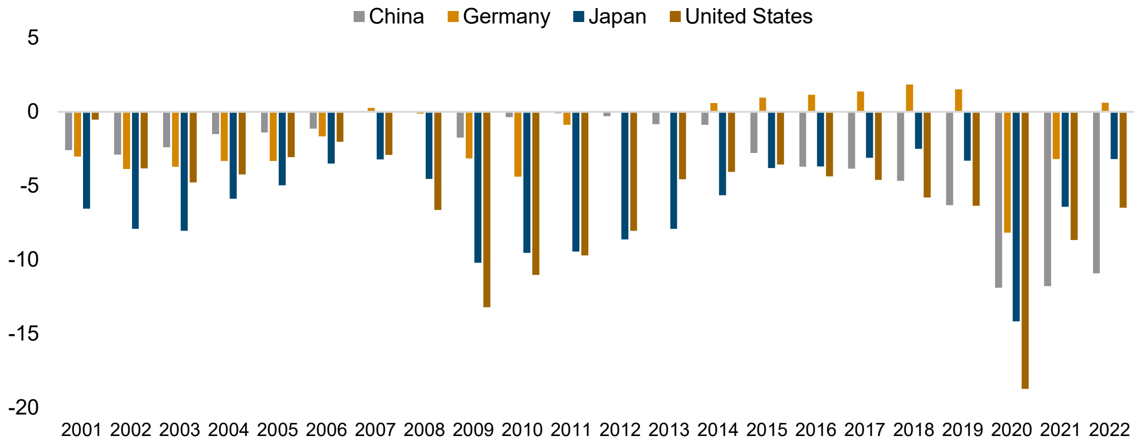
1.2. POLICY RESPONSE: EXTRAORDINARY STIMULUS

The impact of the current pandemic on the real economy is much greater than after the global financial crisis of 2008. According to the IMF, the global economy will contract by more than 4% in 2020, compared with basically flat growth in 2009. However, for large parts of the economy, the fallout this time does not seem as dramatic as post-2008. The main reason for this is the unprecedented scale of monetary and fiscal loosening this time. In 2009 and thereafter, especially in Europe, the fiscal and monetary authorities trod especially cautiously, in constant fear of the impact of looser policy on inflation and public debt. This time, such a debate is (for now at least) quite marginal.

The scale of the fiscal response to the pandemic in 2020 is unprecedented in peacetime: according to the latest IMF Fiscal Monitor, the world will run a budget deficit equivalent to 12.7% of its GDP this year (compared to 3.9% in 2019).[1] The shortfall will be 18.7% of GDP in the US, 14.2% in Japan, 10.1% in the euro area and 11.9% in China. These numbers dwarf those of the 2008 crisis and its aftermath (Figure 1.1), testifying both to the gravity of the current situation, and also to a much more 'Keynesian' consensus in economic policy making than a decade ago (the IMF's October 2020 Fiscal Monitor notably urged countries to spend during the acute phase of the crisis). The EU's Recovery Fund of EUR 750 billion is remarkable not only for its scale, but also for the fact that over half of the money is in the form of grants, rather than loans (see Regional Overview Box 2.1). This is a serious step forward for EU fiscal integration, and indicates a game-changing shift in thinking on this issue in Germany.

The outcome of the recent elections in the US suggests that fiscal policy in the world's major economy is not going to be especially loose in the coming years. At the time of writing, the final results of the US presidential, senate and house elections have not yet been confirmed. However, it seems likely that the outcome will be a Democratic presidency and a Republican-controlled Senate. This probably means that there will be frequent stalemate in US fiscal policy, with President Joe Biden pushing for an expansionary policy to aid recovery, but being thwarted by a fiscally conservative Senate.

Figure 1.1 / Budget balance, % of GDP, big four global economies



Note: 2020 data onwards are IMF October 2020 World Economic Outlook projections.
Source: IMF.

On the monetary side, the response so far has been more like business as usual – only more so. Big central banks – specifically the US Federal Reserve, the ECB and the Bank of Japan –have dramatically increased the amount of liquidity in the global economy since 2008 (albeit the ECB started rather later). Unlike in 2008, the current crisis is not financial, and nor is there a desperate shortage of dollar liquidity. Capital outflows from emerging markets reached an all-time high in Q1 2020, according to the Institute

1 https://www.imf.org/en/Publications/FM/Issues/2020/09/30/october-2020-fiscal-monitor

of International Finance, but 'big bazooka' responses from the Fed and ECB at the end of March stabilised the situation. With nominal rates already close to or below zero, central banks may not be able to do much more to stimulate economies. However, their commitment to keeping rates low for years will help to underpin macro-financial stability until the recovery takes hold.

Especially (but not only) in Germany, the debate about the riskiness of such massive fiscal and monetary loosening in the medium term remains prevalent. The criticisms voiced include the observations that so much of the monetary loosening appears to have ended up in the property and stock markets, rather than consumer prices and wages, and that paying back the large piles of public debt will constrain growth far into the future (and put huge pressure on a shrinking working-age population in much of Europe and Japan). Once the acute phase of the current crisis passes, this debate will probably come back more into focus.

In terms of monetary policy, it would seem that central banks are effectively trapped: so much of the economy (for example, the property market) is now based on the assumption that real rates will stay low or negative for decades, and therefore central banks cannot really hike their rates without causing a deep recession. Moreover, the impetus to raise rates may never come if inflation stays well below target. Although the reasons for such low inflation remain disputed, it does seem that structural factors (such as demographic trends), competition from online retail and a persistent shortfall in demand in many developed economies (exacerbated massively by the current crisis) are central to the story. As such, a change in inflation dynamics will only come about slowly, if at all.

Regarding public debt, it is true that current levels are high, and that this crisis will certainly push them higher. Global public debt is projected by the IMF to rise to 98.7% of GDP this year, an increase of 15.7 percentage points relative to 2019. This includes levels of 131.2% of GDP for the US, 134.8% for Italy and 238% for Japan. However, debt/GDP loads can only be considered in the context of the real cost of borrowing for governments, which for the big global economies is at a historically very low level. In the US, for example, although real rates on long-term debt have been lower in the past – around the Second World War, for example, or during the stagflation of the 1970s – those were times of heightened volatility in prices and interest rates. What is so notable about the current period, and indeed most of the last decade, is the persistent stability of real interest rates at or close to zero across the developed world.

1.3. SHAPE AND SPEED OF RECOVERY: SLOW AND BUMPY

Taking into account the assumptions about the future path of the pandemic, government responses, and the fiscal and monetary backdrop, we think that the recovery will most likely take a zigzag path, with alternating waves of tighter and looser restrictions on economic life. From next spring, the recovery should firm up, but it will take at least a couple of years to regain 2019 levels of output in most major economies.

Nevertheless, the downturn itself seems not to have been as bad as many expected during the summer. Reflecting this fact, in its October World Economic Outlook the IMF made some serious upward revisions to its 2020-2021 economic projections. In particular, it improved its 2020 projection for the US by 3.7 percentage points relative to June, and for the euro area by 1.9 percentage points. The IMF now expects the US and euro area economies to decline by 4.3% and 8.3%, respectively, in 2020 as a whole, and for the Chinese economy to grow by 1.9%. In 2021, it expects robust growth in all three key pillars of the global economy: 3.1% in the US, 5.2% in the euro area and 8.2% in China.