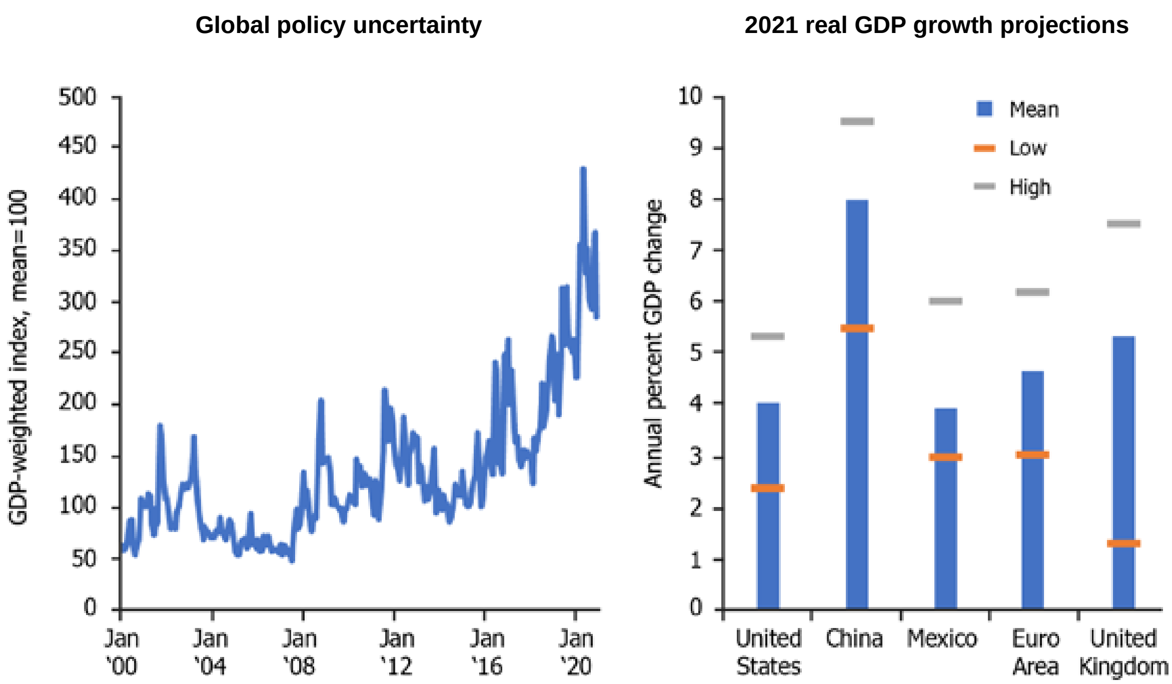
Office of the Comptroller of the Currency

ON POINT
ECONOMIC AND POLICY INSIGHT FROM THE OCC

2021 Economic Forecast Uncertainty Amplified by Global Pandemic

The global economic outlook for 2021 is highly uncertain. There are several sources for this uncertainty, but chief among them is the evolution of the COVID-19 pandemic and progress on vaccine rollouts across countries. The ultimate effectiveness of novel or aggressive fiscal and monetary stimulus measures are another source of uncertainty, as is the asynchronous nature of the global recovery—strong growth is projected in many Asian economies in 2021 while Latin American and European economies are projected to lag. The result is a very dispersed range of near-term economic forecasts and inflation expectations that could produce pronounced volatility in interest rates or financial asset prices as the year progresses.

Figure 1: Global Policy Uncertainty at a Two-Decade Peak, Consistent With Wide Dispersion in GDP Growth Projections



Sources: PolicyUncertainty.com, Haver Analytics, Consensus Forecasts (December 2020).

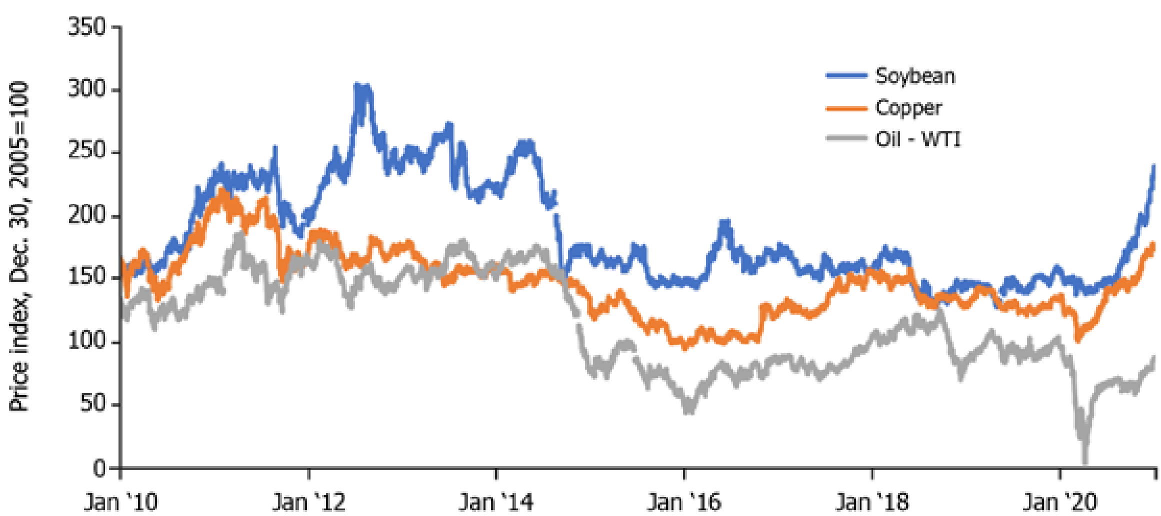
Containment of COVID-19 and the Asynchronous Global Recovery

The spread of the coronavirus is the main driver of global economic uncertainty. A second wave of the pandemic hit most countries in the fourth quarter of last year. New daily cases after September 2020 exceeded the first wave of cases in March and April of 2020 amid reports of the emergence of more transmittable COVID-19 variants. Even as the rollout of vaccines improved prospects for economic stabilization in the second half of 2021, the renewed spread of the virus resulted in a return of lockdowns around the turn of the year. While global consumers and businesses have adapted to local mobility and social distancing restrictions by varying degrees, the pace of economic growth in the first half of 2021 may be slower than once expected in several countries.

Pandemic dynamics are likely to reinforce the asynchronous nature of global growth. Asian economies experienced the pandemic first, early in 2020, and were very effective in containing the first wave in Asia. Thus, both 2020 and 2021 gross domestic product (GDP) growth (actual and projected) for Asia exceeded the weighted average of world GDP growth, with China as the main driver. Latin America is one region projected to lag world GDP growth this year. Latin American health care systems have been under significant stress from the pandemic. Among advanced economies, the euro area and the United Kingdom GDP growth in 2020 likely lagged that of the world, but their forecast growth for 2021 is set to track world GDP growth.

Commodity prices are closely correlated with the economic growth outlook. In April 2020, oil prices collapsed as global demand plunged and was expected to not recover for some time. The uneven recovery this year will likely be evident in commodity price patterns. For example, if growing demand for raw materials from Asia outstrips the ability of Latin American countries to ramp up supply, prices could spike. Transport fuel prices could rise further once the pandemic is under control and pent-up demand in global tourism is released, though more permanent shifts to telework could dampen fuel demand.

Figure 2: After Dropping Early in the Pandemic, Commodity Prices Rebounded Strongly

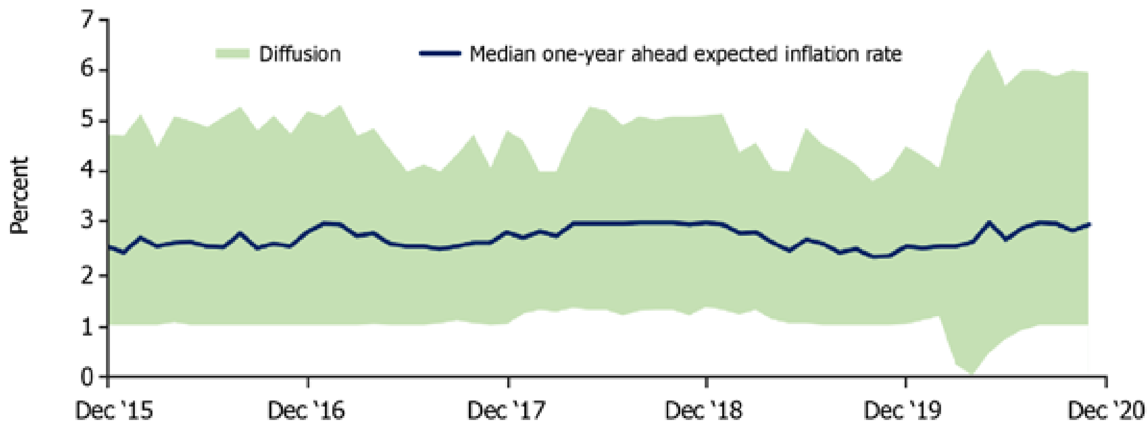


Source: Wall Street Journal (WSJ), Financial Times (FT), Energy Information Agency (EIA), Haver Analytics.

Note: Oil – WTI refers to West Texas Intermediate.

Surveys of inflation expectations show a wide dispersion in one-year ahead inflation, demonstrating the uncertainty around the growth outlook also extends to prices.

Figure 3: Dispersion of Survey-Based Inflation Expectations in the U.S. Increased Significantly Since the Start of the Pandemic



Sources: Federal Reserve Bank of New York Survey of Consumer Expectations, Haver Analytics.

Effectiveness of Fiscal and Monetary Stimulus

The worldwide fiscal response to the COVID-19 pandemic and ensuing lockdowns were massive and unprecedented. More than $12 trillion of fiscal actions representing 12 percent of global GDP[1] were taken, consisting of additional spending, foregone revenue, such as temporary tax cuts, and liquidity measures, including loans, guarantees and capital injections. Global central banks also acted swiftly and aggressively, easing monetary policy and expanding their balance sheets. G10 central banks[2] expanded their balance sheets by $7.5 trillion and 20 emerging market central banks deployed asset purchases for the first time.[3] Furthermore, authorities provided regulatory relief for banks and asked banks to grant forbearance to borrowers adversely affected by the pandemic.

These policy actions significantly eased financial conditions. Both governments and companies benefited from continued access to capital markets and bank funding, thus preventing liquidity pressures from turning into widespread insolvencies. Meanwhile, consumer incomes were sustained despite a sharp increase in unemployment. These policy actions propelled the global economic rebound in the third quarter of 2020.

If the pandemic subsides over the course of 2021 as projected, policy actions are expected to wind down; however, it is unclear exactly how economies and businesses will respond. Although financial markets have generally accommodated recent large increases in sovereign debt levels, governments without credible plans to reign in deficits may well face higher interest rates and re-

[1] *Fiscal Monitor*, International Monetary Fund, October 2020.

[2] The G10, or Group of Ten, is made up of eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), which consult and co-operate on economic, monetary, and financial matters.

[3] *Global Financial Stability Report*, International Monetary Fund, October 2020.

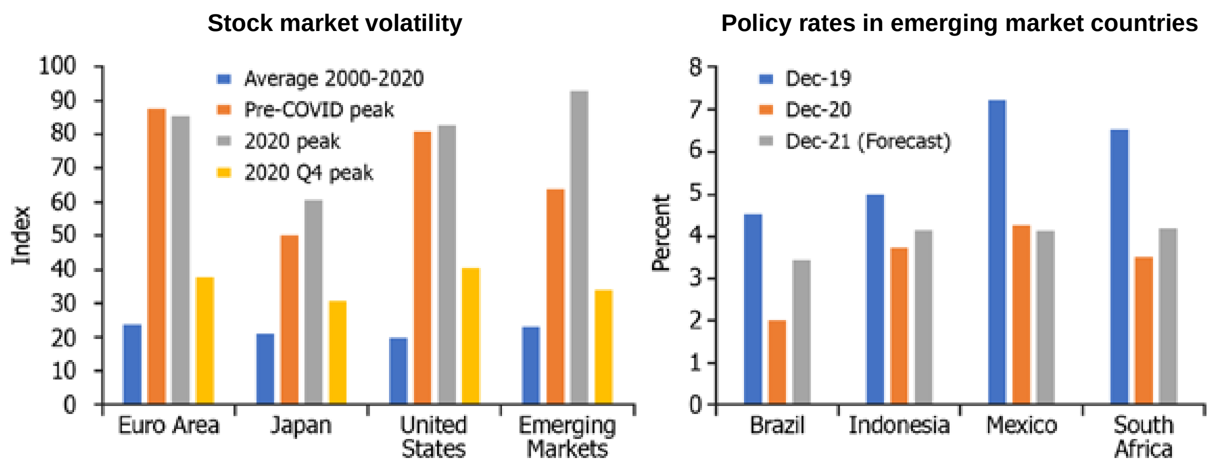
financing pressures. Similarly, forbearance helped otherwise healthy firms survive the pandemic, but at the same time, it probably also kept unhealthy zombie firms alive. Just how many of these zombie firms there are will only become clear when forbearance ends. As a result, while banks exhibited resilience last year, some of them may eventually recognize high levels of non-performing assets.

Impact on Economy and Financial Markets

Uncertainty about future growth could influence the economic outlook. Even as central banks seek to keep borrowing costs low, companies might delay investment plans, or capital could be diverted to zombie firms.[4] The recovery after the 2008 financial crisis was characterized by higher than expected growth in employment, but low productivity and wage growth, and the uncertainty of post-pandemic conditions could produce a similar pattern.

Economic uncertainty usually results in financial market volatility. The coronavirus pandemic and the ensuing lockdowns propelled stock market volatility indices to extremes not seen since the 2008 financial crisis. Stock market volatility equaled or surpassed pre-pandemic highs in 2020 and remained elevated at year-end (figure 4, left panel). Volatility often generates trading revenues for banking firms, but it also portends the possibility of large movements in asset prices or other financial market indicators. As noted earlier, the asynchronous recovery could affect commodity prices and it could even produce inflation pressures. The European Central Bank and the Federal Reserve System (Federal Reserve) may be able to tolerate inflation rates that temporarily exceed their targets. Central banks in emerging market countries with less well-established track records in combatting inflation, however, may be forced to raise rates when inflation rises (figure 4, right panel). Such central bank rate hikes might result in larger-than-expected adjustments in relative interest rates as well as exchange rate realignments.

Figure 4: Stock Market Volatility Remains Above Long-Term Average; Inflation Pressures Could Drive Higher Than Expected Increases in Emerging Market Policy Rates



Sources: Stoxx, FT, WSJ, Chicago Board Options Exchange, Banco Central do Brasil, Bank Indonesia, Banxico South African Reserve Bank, Haver Analytics, Consensus Forecasts.

[4] See, for example, Ahearne and Shinada, *Zombie firms and economic stagnation in Japan*, International Economics and Economic Policy; November 29, 2005; pp. 363-381, which shows evidence that productivity growth is low in industries with a heavy concentration of zombie firms, and that financial support from Japanese banks played a role in sustaining the zombie firms' market share.

The Point?

Until it is resolved, the COVID-19 pandemic will add to global forecast uncertainty and risk greater volatility in global financial markets.