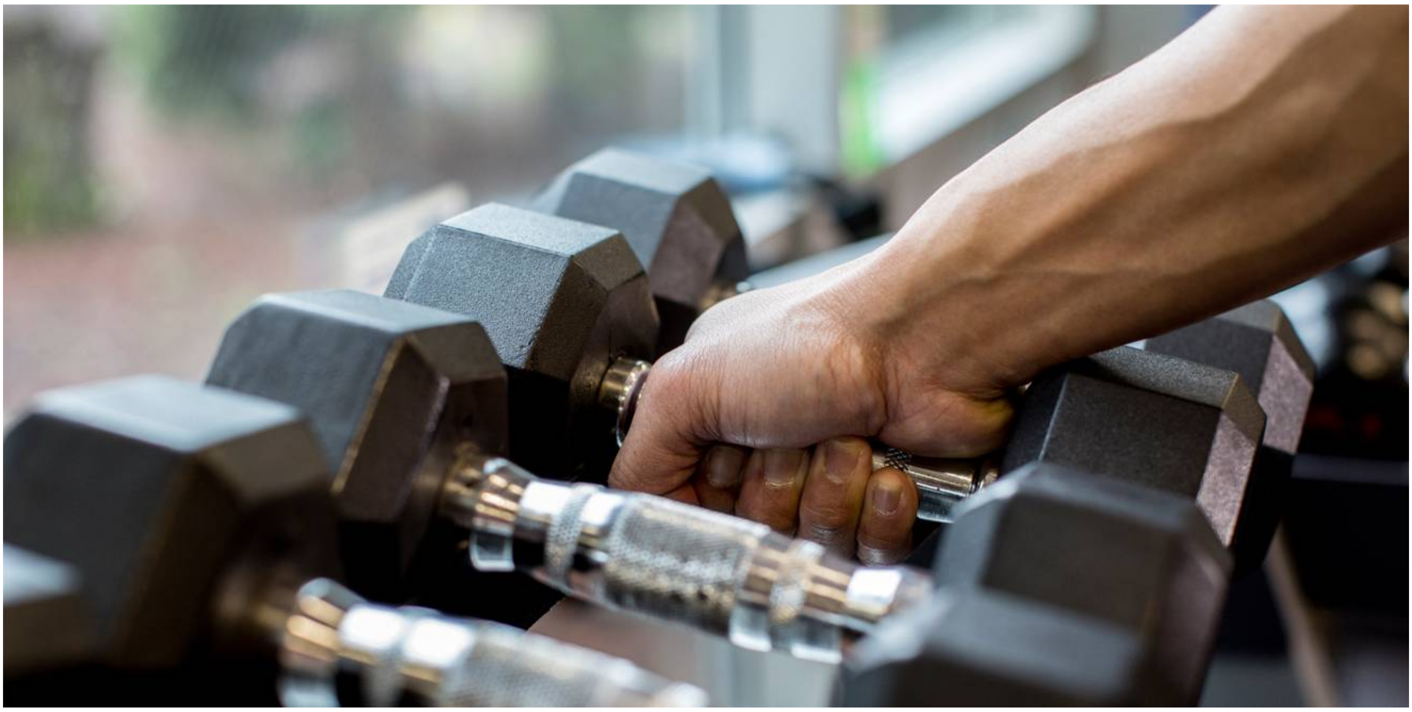


2021: The Strongest Growth in a Generation?

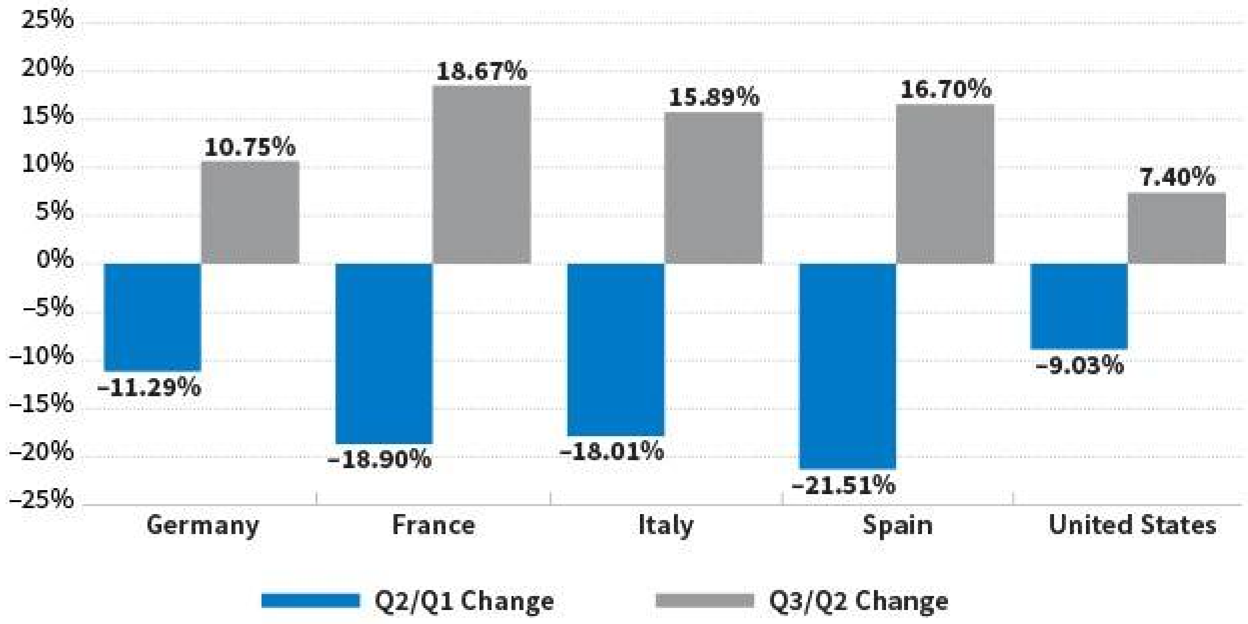
February 19, 2021

Charles Dickens's timeless quote—"It was the best of times, it was the worst of times"—may come to characterize the global economy of the early 2020s quite accurately.

The COVID-19 pandemic wreaked havoc on the global economy. The brunt of the decline occurred in the second quarter everywhere except in China, where activity declined mostly in the first quarter. However, the magnitude of the decline varied greatly, from 9.0% in the United States to 21.5% in Spain. By comparison, during the worst quarter of the Global Financial Crisis (GFC) recession, the U.S. economy lost 4.0% of output, annualized.

What is remarkable is that the subsequent snapback in activity in the third quarter of 2020 was commensurate with the second-quarter contraction: those countries where output declined the most in the second quarter posted the strongest growth in the third. The chart below, which shows gross domestic product (GDP) growth in both quarters, illustrates.

Real GDP Growth in Select Countries



Sources: Macrobond and WB analysis, as of January 2021.

Through the third quarter of 2020—the latest data available at the time of writing—the U.S. economy lost 3.9% of output relative to the end of 2019, and the EU-27 lost 7.0%.[1] This previews the magnitude of pent-up demand and economic force that is likely to be unleashed once the pandemic is finally behind us.

Last year was also one in which science came together with focused funding and state-of-the-art logistics and distribution to produce not one, but a series of vaccines in less than 12 months, a feat deemed all but impossible in February. The first quarter of 2021 is likely to prove challenging, with COVID-19 infections and deaths hitting new highs on both sides of the Atlantic and the subsequent curtailment of high-contact services provision.

At the same time, mass inoculation programs that are now being rolled out in Europe and the United States point to a decisive turning point in the fight against the COVID-19 pandemic.

Specifically, the United States aims to have approximately 100 million adults, about 30% of its population, vaccinated by the end of the first quarter of 2021. The European program is similar in scope and timing. If successful, more than 70% of the adult population in developed market economies may be vaccinated in the first half of 2021.

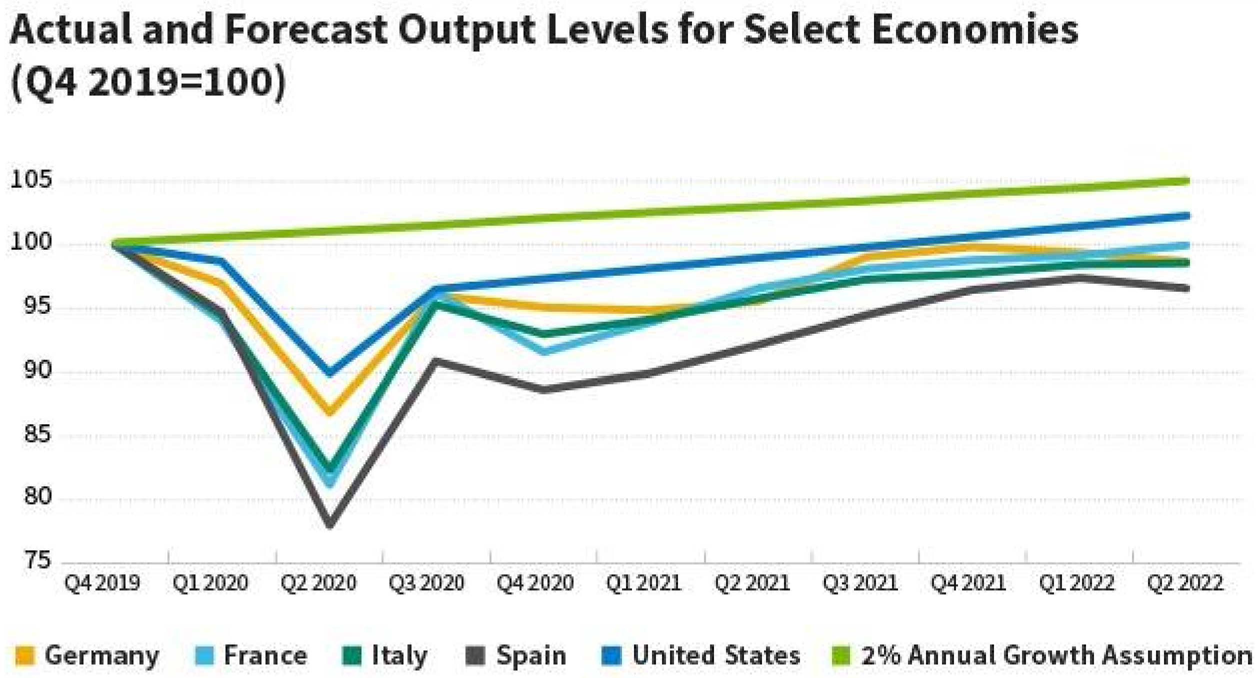
The experience in the third quarter, together with the vaccination rollout, points to the world economy starting out slowly, with growth remaining challenged in the first quarter of this year. However, this will likely be followed by strong sequential acceleration in economic activity as we head into the seasonally low period of respiratory infections and as mass inoculations further reduce whatever fear of vaccinations remains.

Consumer spending is likely to grow smartly across many developed markets as pent-up demand and high aggregate savings rates work in tandem. Indeed, retail sales volumes already surpassed their prior peak.

At the same time, industrial production, which enables the consumption of these goods, remains some 7% to 10%

below pre-COVID recession levels. So, even in the absence of further fiscal support—already approved in Europe and quite likely in the United States—major developed market economies may be firing on all cylinders come spring of this year.

Even with the strongest synchronized growth in at least three decades, major economies, with a notable exception of China, may not return to pre-crisis output levels before 2022. However, current forecasts of economic growth fall well short of regaining pre-crisis output levels on a multiyear horizon. The chart below provides a snapshot of the latest consensus estimates and the implied output trajectory for 2021 and beyond.



Sources: Bloomberg and WB analysis as of January 2021. Forecasts begin with Q4 2020.

The top baseline in the chart above reflects a conceptual output path for developed market economies, assuming a 2% annual growth rate—which is consistent with recent economic experience—in the absence of a COVID-19 recession. This assumed level of output indicates how much supply and labor is on hand.

Since the COVID-19 recession was short and fiscal measures provided the support necessary to keep supply more or less intact, this theoretical level of output is a reasonable approximation of the levels of activity developed market economies need to generate to truly recover from the 2020 recession.

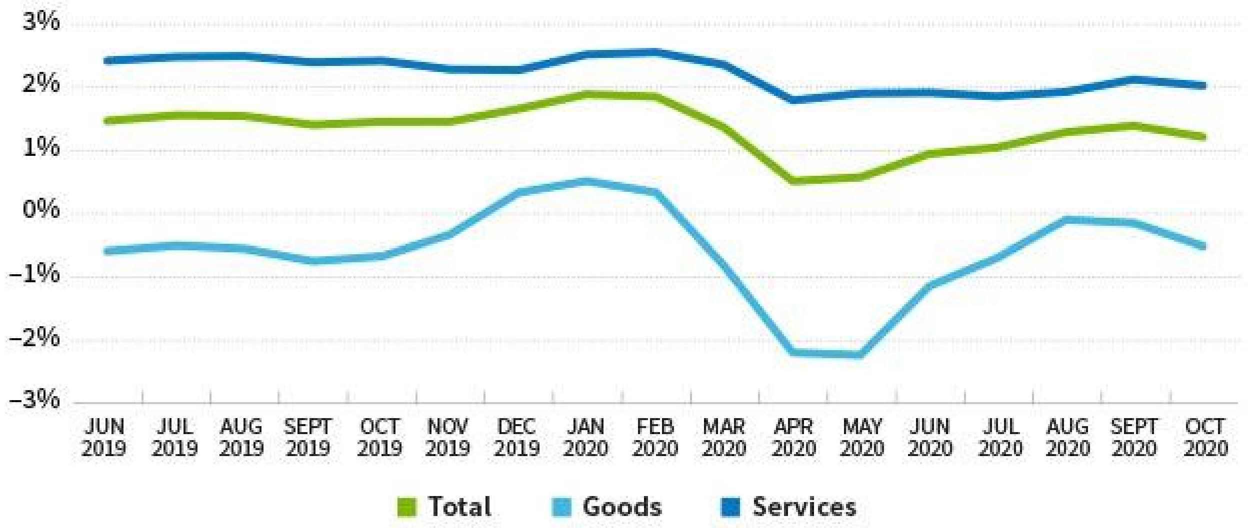
As can be seen in the chart above, current economic growth projections not only do not imply any convergence toward a pre-crisis growth trajectory, but actually imply further declines in output levels in select euro area economies in 2021. The third quarter 2020 economic rebound—together with ongoing concerted efforts of policymakers across developed markets—suggests that current forecasts are likely too pessimistic.

In short, high aggregate savings rates and strong acceleration in consumer spending, especially on services, together with still-depressed levels of industrial production, suggest that economic growth in 2021 is likely to be the strongest in many decades, and visibly above current forecasts.

If economic growth is to trend higher this year, so is inflation. The bulk of consumer spending in developed markets is concentrated in services, and the overall inflation baskets broadly reflect these weights. As with economic growth, 2020 provided a glimpse of what we might expect in 2021.

As the chart below highlights, during much of the summer, goods prices accelerated strongly while production was constrained by lockdowns and physical limits on personnel reduced supply and stretched logistics. As activity normalized and the supply side of the economy adjusted to the new, temporarily constrained work environment, goods inflation began to ease.

Annual U.S. Inflation Rate



Source: Macrobond, as of January 2021.

This episode highlights the elastic nature of developed market supply and logistics, both of which should adjust relatively quickly to the normalization of economic activity through 2021. Inflation of goods prices is likely to return to more subdued rates.

By contrast, services inflation declined sharply in 2020 as activity was largely curtailed. High-contact services inflation in recreation, travel, and related activities looks set to rebound strongly as pent-up demand is robust and consumers have plenty of income to support it, while supply can be delayed and in some cases is, by definition, finite. (It takes a while to return planes into service, and hotels once full, are, well, full. And, of course, they will adjust prices in response to surging demand.) Since the overall inflation rate is driven predominantly by services, inflation is going to be higher just due to base effects, precisely at a time when growth is getting stronger.

For now, any inflation “spike” beyond a 3% annual rate in 2021—if that can even be called a spike—looks likely to be transitory. Even if growth surprises to the upside and developed markets grow at well above the current consensus rates, our economies are unlikely to regain the pre-crisis trajectory of output until 2022 at the earliest.

For this reason—and to support domestic economies and fiscal authorities—central banks in developed markets will likely be in no rush to raise rates. Although 10-year U.S. rates have been inching up since the second half of 2020, at 1.12% they may not reach pre-COVID levels until well beyond next year.

In the remainder of this series, we discuss the outlook for emerging markets (EMs), the vast majority of which are small, open economies whose fortunes depend on what happens in the world’s three principal demand centers: the United States, Europe, and China.

Put another way, EMs are a high-beta play on developed market growth. Interest rates, exchange rates, and commodity prices are largely set by the economic and liquidity conditions in the three global demand centers.

At the same time, these prices—interest rates, exchange rates, and commodity prices—set binding constraints on economic outcomes in most EMs.

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Emerging Markets Series

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Part 6: 6 Themes Driving Emerging Markets Debt
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[1] The EU-27 refers to the 27 European Union (EU) countries after the United Kingdom left the EU.

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