Ten developments to watch for in 2021, and beyond

LlewellynConsulting's *Ten developments to watch for in 2021, and beyond* details what we judge most likely to happen; and pays particular attention to detailing what we see as the main risks and uncertainties.

1. There is growing recognition of the existential threat of climate change, but not all economies are set to cope well with the transition.
2. Nor will every country adequately manage the disruptive impacts of technological change, let alone turn them to their advantage.
3. Vaccines offer the hope of a sustainable recovery, but many uncertainties remain, and normality is likely some way off.
4. Inflation is likely to remain historically subdued in 2021, but the picture thereafter is less clear – with risks in both directions.
5. Monetary policy stands to become yet more unconventional, even if there is a reluctance to embrace more negative policy rates.
6. With interest rates so low there is no urgency for fiscal consolidation, but this may not prevent premature calls for budgetary consolidation.
7. The seemingly inexorable trend towards outright monetary finance need not necessarily lead to inflationary catastrophy.
8. Rarely have good supply side policies been so important, yet policy performance in this area is likely to vary considerably across countries.
9. Populism has burgeoned for powerful reasons, and it would be optimistic to expect a new incumbent in the White House rapidly to turn the tide.
10. A potential cascade of defaults in the non-OECD economies may require innovative solutions if serious consequences are to be contained.

Macro Series

Introduction

The consequences of big, unfamiliar, shocks are hard to forecast

Forecasters make their biggest mistakes – they least understand what is going on – when economies are hit by shocks that are both large and novel. It is thus inescapable, given both the novelty and the scale of the coronavirus pandemic, that there should currently be great uncertainty about the likely shape, timing, and pace of the hoped-for economic recovery. Naturally, this exaggerated uncertainty is a recurring theme in our *Ten things to watch for* in 2021 and beyond.

It is however just one facet of the prevailing challenging environment. The world faces at least two further, even more fundamental, issues: how to meet the exigencies of climate change; and how best to adapt to, and more importantly benefit from, today's rapid pace of technological change.

1. Climate change

Climate change is now recognised as posing an existential threat ...

Recognition is now snowballing that the world economy will have to decarbonise by around mid-century – only 30-odd years away. This recognition is bringing more, and increasingly stringent, policies to regulate, and impose a charge on, carbon emissions; progressively tougher attitudes on the part of managers of investment funds; and increasingly fundamental reappraisals of corporate strategies, not least where oil companies are concerned. No CEO can afford to ignore any of this.

Economies experiencing such forces for change are faced by a more fundamental test than merely restoring or maintaining aggregate demand: they also have to adjust their entire structure.

While recognition in the world as a whole is moving in a constructive direction, the pace of what is being done in response is currently too slow to limit the world's temperature rise to 2 degrees Celsius. One exemplar: the Paris '2-degree scenario' calls for global greenhouse gases to start falling, and keep doing so, until they reach zero around mid-century: yet in their rent COVID-19 fiscal support packages the G20 countries in aggregate committed more to 'brown' investment than to 'green' investment – a clear disconnect between word and deed.

… but not all countries will respond well to the challenge

Not all countries are going to handle this transition equally well. Simply adjusting passively to powerful, inexorable shocks is never sufficient. For an economy to grow sustainably in the face of structural change, its businesses have to be in front of that change, producing the goods and services that will be in growing demand in the new environment; workers have to be able and willing to move between activities, and be suitably trained in the requisite new skills; and governments have to facilitate these processes, through supportive policy frameworks and regulations that enable rather than restrict.

Accordingly, we shall through 2021 be monitoring countries' capacity to adjust to structural change with even greater attentiveness than we have in the past. We have already assembled a large body information and data, which we summarise in a heatmap, and we will be keeping a close eye on the evolution of these capabilities.

2. Technological change

Technological change stands to exert a huge impact on societies …

Not only are economies having to adjust to the requirements and exigencies of climate change; they are also having to adjust to today's rapid – some would say unprecedentedly rapid – pace of technological change. For the new technologies are not only altering, quite fundamentally, what is demanded, what is produced, how it is produced, and where it is produced: they are also affecting – through the social media that these technologies have spawned – the very functioning of society, not least the formation of opinion and the operation of political systems.

… but again, responses are likely to vary in their success

Many of these influences are as yet only poorly understood. Clearly, as with climate change, not all countries are going to handle the new-technologies transition equally well. One key influence will be gross fixed capital formation. In times of rapid structural change, a portion of the capital stock gets to be scrapped prematurely – in the sense of before the end of its physical life. This, in and of itself, reduces the economy's productive potential: for full employment and productivity to be maintained requires that the 'lost' capacity be replaced by new capital stock that is appropriate to changed patterns of demand and hence production. Moreover, investment not only provides requisite capacity: it is also the mechanism that brings the new technologies into play in the economy.

For all these reasons, we shall through 2021 be monitoring two variables with even greater attentiveness than we have in the past:

A close watch should be kept on investment and nominal GDP

- **Gross fixed capital formation**, as an overall indicator that, stands to be important both as a component of demand during the recovery and as a contributor to economies' ability to adjust structurally; and
- **Nominal GDP** and its split, as an indicator of the extent to which the growth of capacity is proving sufficient to keep inflation in check.

3. The shape of recovery

The hope is that in due course vaccines will speed recovery

After the unprecedented downturns of this year, the development of viable vaccines, together with considerable pent-up savings and demand, offer the hope of a sustained cyclical upswing taking hold over the course of 2021. That said, Europe is still in the midst of a second 'dip', the US is likely to experience a slowdown, if not a similar short-term set-back, and numerous uncertainties remain around the progress of the COVID-19 pandemic and more broadly. It is, for example, as yet unclear how quickly and efficiently vaccines can be distributed, and how many people will refuse to be vaccinated, not least in the US.

Meanwhile, the extent and timing of further government support for the recovery remains moot, as is the extent of enduring damage to productive potential, and the capacity of different economies to reallocate resources from permanently compromised sectors to those that stand to flourish in a post-pandemic world. Moreover, the underlying pace of economic growth prior to this year had for a number of powerful reasons, and not least demographic considerations, been slowing persistently for decades. And this despite the application of ever more unconventional monetary policy, and considerable asset price inflation.

But uncertainties abound, and normality is some way off

Overall our sense is that, perhaps after an initial burst of household sector-led growth, the pace of expansion will settle down to something altogether more pedestrian, and in many economies it could be some time yet – years, not months or quarters – before the pre-pandemic level of activity is consistently re-attained. Lingering uncertainties and unsatisfactory macro resource utilisation rates suggest that private sector business investment spending will probably continue to disappoint. All this is even more likely should fiscal and monetary policy support be withdrawn too soon, and government structural policies fall far short of what is required.

For now, there is little immediate reason to believe that China will not remain at the leading edge of the expansion, in the process drawing much of Asia along with it.

4. More 'lowflation'

Inflation has been the least of policymakers' worries over recent decades. In the advanced economies, it fell to uncomfortably low levels, and failed to pick up significantly in the long, shallow, cyclical upswing that preceded the COVID-19 pandemic. Even in the emerging and less developed nations, it registered historically depressed readings.

The dramatic recession and partial recovery that has characterised 2020 has seen a renewed decline in headline and core consumer price inflation rates, with near zero or negative figures increasingly common.

Excess capacity stands to keep inflation very low in 2021 …

Even allowing for significant supply-side damage, we judge it likely that abundant excess capacity, and in particular elevated unemployment and underemployment, will continue to weigh heavily on wage settlements and temper aggregate corporate pricing power. The IMF tentatively puts the output gap in the major economies at some 3.5% of potential output this year, 2.2% in 2021, and expects it to close fully only in 2025. Furthermore, to the extent that central banks retain their low-inflation credibility, and inflation expectations are adaptive, the latter are likely to remain restrained, and provide a further bulwark against significant price increases.

Against this kind of economic backdrop, inflation in the near-term – say two years – seems likely to stay historically subdued. Indeed, in the period immediately ahead, central bank targets will remain difficult to achieve, and some countries will continue to experience CPI inflation rates closer to zero than the typical 2% per annum goal. In short, the mutually-reinforcing interaction between excess capacity and well-behaved inflation expectations seems likely to be the dominant influence on wages and prices.

… but thereafter the outlook becomes much less clear

That said, the longer-term prognosis for inflation is more uncertain. Populism has not gone away. Globalisation and multilateralism could retreat further. Macroeconomic policy has become increasingly unconventional and is sliding into monetary finance. And with structural reform programmes stalled, the ability to cope with supply-side damage and structural change, including the exigencies of climate change and technological advancement, is enfeebled and differs importantly between countries. However, inflationary tendencies may in due course be limited by the fact that inflation is rarely, if ever, popular, particularly when population structures are relatively aged, as they increasingly are today.

5. More unconventional monetary policy

Monetary policy stands to become more unorthodox …

The combination of an extended, and perhaps hesitant and uneven, recovery process, enduring abundant excess capacity, and historically low inflation suggest that official rates in the advanced economies in 2021 will remain around the zero-interest rate bound, and monetary policy unorthodox. Indeed, if anything, unconventional monetary policy is likely to become more pervasive and unorthodox, including in the non-OECD economies – particularly should there be a further negative shock.

Not surprisingly, given the importance of credibility to successful monetary policy activism, central banks seem unwilling to admit publicly that they have in any way run out of ammunition. This is despite the fact that many policymakers are troubled by the diminishing returns and distortionary costs of their actions; and most recognise that fiscal policy should now play an increasing role in macro stabilisation.

Against this background, it is to be expected that asset purchase and funding for lending programmes will remain in place, if not continue to expand and evolve, and that forward policy guidance becomes longer-term and more 'state-dependent'. More central banks could also resort to explicit yield curve control, on the model of the Bank of Japan and the Reserve Bank of Australia or, like the Federal Reserve, formally embrace average inflation targeting, in an effort more actively to influence real borrowing costs.

… even if there is a reluctance to embrace negative policy rates

The likelihood of greater resort to negative policy rates is perhaps more debatable. To the extent that there is growing recognition of the negative side-effects of unconventional monetary policy, this is most acute in regard to negative central bank rates. That said, in the event of another serious setback to growth, there could be greater efforts to eradicate the zero-interest rate bound, whether by abolishing conventional currency and replacing it by e-money; the taxation or subsidisation of currency; or the imposition of a negative interest rate on bank deposits (but not on currency).

One further area of potential importance will be the extent to which governments start to impinge on central banks' operational independence in an effort to keep borrowing costs down at a time of historically-high peacetime debt burdens.

6. Fiscal policy taking up more of the slack

Aggressive fiscal activism was clearly warranted in 2020 …

With private sectors forced to retrench in unprecedented fashion and extent this year, it has been accepted, even in the most fiscally conservative countries, that the public sector should step in and act as a stabilising force for macroeconomies. There was little alternative but open-endedly to increase health spending and, through a range of benefit payments, transfers, temporary tax reliefs, subsidies, loans, and guarantees, for governments to attempt to put a floor under the income of households, individual firms, and entire sectors. More importantly still, however, it was hoped that these initiatives would sustain the complex network of economic relationships that underpins periods of more normal economic activity, such that it could subsequently be re-animated.

… but it has greatly swollen deficits and debt burdens

Tentative estimates are that the advanced economies have announced direct fiscal support measures equivalent some 10% of 2019 GDP, with loans and guarantees in some instances potentially stretching to an additional 30% of GDP. Such interventions are indeed unprecedented in modern times. They are likely to leave the average G7 broadly-defined budgetary shortfall in the region of 16% of GDP in 2020. Gross public debt, which at the onset of the Global Financial Crisis had been in the region of 90% of GDP for these economies, has been running some 20 ppts of GDP higher over recent years, and is now expected to jump towards 140% of GDP over the course of 2021 and 2022.

Governments are now confronted by huge budgetary shortfalls, and significantly increased indebtedness, even if in many cases much of the debt is now on the balance sheets of their central bank. Policymakers may well acquiesce in this for a period, and indeed embrace both further short-term measures to sustain aggregate demand and longer-term recovery programmes constructed around public investment and active labour market policies (ALMPs).

However, debt service costs are very low …

As such, it would make sense to seek to moderate the increased public sector liabilities only gradually, over a run of many years. With interest rates historically low, and central banks seemingly content to encourage this to continue, debt dynamics are relatively benign. And meanwhile fiscal multipliers, particularly on public infrastructure spending, are likely to be high – perhaps of the order of 2.5 to 3. On this reckoning, a broad-based fiscal stimulus, once employment is seen to start to rise sustainably, is likely to prove cost effective.

However, old habits often die hard, and some may feel compelled, for political reasons, to take early steps to tighten fiscal policy. The lesson from the post-GFC period is that initially-patient strategies to address public debt accumulations may come to be terminated prematurely. Debt conservatism may rapidly assert itself, especially if borrowing costs begin to rise, or should there be one or more high-profile case of a major sovereign debt default.

… suggesting early fiscal consolidation would be an error

What is clearer, however, is that the greater the emphasis on budgetary restraint, the shallower the immediate recovery stands to be, and the less the upward pressure on inflation. Much will depend on perceptions of the extent of supply-side damage, and the proportion of budget deficits that is perceived to be structural rather than cyclical.

7. The inexorable emergence of monetary finance

Widespread resort to monetary finance may not be far away …

Given the growing shortcomings of monetary policy, the various pressures for greater public spending, the political constraints on the tax burden, and high levels of public sector debt, macro stabilisation strategies may come to depend increasingly on outright monetary finance and financial repression, if not succumb to outright fiscal dominance.

The COVID-19 pandemic has already seen significant changes in the approach to economic management: in particular, monetary and fiscal policy have been more explicitly employed jointly. Such departures could easily burgeon, extending to central-bank-funded public investment spending; or cash transfers to households and/or companies – the so-called 'helicopter money' option. This is especially likely if the pace of recovery disappoints or suffers a severe setback.

Such initiatives, given their unfortunate history, much of it bound up with populist, if not autocratic, political regimes would doubtless generate significant concerns. They would raise the spectre of complete loss of budgetary discipline, central bank insolvency, currency collapse, runaway inflation, perhaps even general economic breakdown. At the very least, it is likely that, were it to be deployed widely, monetary finance would generate greater volatility in, if not a de-anchoring of, inflation expectations.

… but with the right constraints it need not be disastrous

That said, the risks with monetary finance may have been exaggerated. A central bank's balance sheet is very different from that of a commercial bank. Nevertheless, given the moral hazard involved, and the need not to frighten markets unduly, any such departure would have to be rigorously institutionally ring-fenced and time- and conditions-limited. It might be wise therefore to create a special emergency fund for the purpose.

It would make particular sense for there to be a pre-specified set of circumstances pursuant to which such joint fiscal/monetary action should be taken. In turn it would then be for the central bank, and/or the fiscal authority, rather than the government alone, to take the ultimate decision about monetary finance's deployment, albeit after suitable consultation.

8. The urgency of structural reform

Structural reform has slowed just when it is most urgently needed

Analysis by both the IMF and OECD suggests that with few, if any, exceptions, the pace of structural reform has slowed over recent years and, where progress has been made in the advanced economies and beyond, it has been uneven, and lacked coherence.

Yet it can be argued that seldom have policies that encourage flexibility in the face of shocks and more efficient resource reallocation been more important. The world is confronted not just by disruptions of the COVID-19 pandemic, but by huge technological change, and the need to alter energy supplies fundamentally in a bid to avoid existential environmental damage. And this at a time when aggregate investment spending and productivity growth have consistently fallen short of expectations and previous trends.

The menu of shortcomings is long and varied …

Perhaps the priority areas of reform over the period ahead are the development of better Active Labour Market Policies (ALMPs); improved financing arrangements for the dynamic SME sector; better bankruptcy procedures; increased public infrastructure spending; the encouragement of more intense competition in product markets; and the maintenance of an efficient and fair tax-based incentive structure. It could also be argued that more activist industrial strategies are needed in the context of climate change.

The problem, however, is, that many such policies involve significant additional public expense, at a time when governments' deficits and debt burdens are already historically high. They are therefore at the mercy of interest rate trends and of the burgeoning debate over fiscal policy priorities and space.

Structural reform also invariably involves costs that are immediate and narrowly focussed on certain (often politically vested) sectors and groups, whereas its benefits are spread thinly and accumulate only over periods of time that exceed a single electoral term. Hence, programmes are bound to be heavily influenced by the political environment.

…but again, not all countries will be able to deliver

Doubtless some countries will perform better than others in this area. Those that get it right will experience: comparatively strong growth of productivity and thereby of real incomes; rapid growth of exports; strengthening currencies in real terms; lower unemployment; and, in all probability, they will be less than averagely inflation-prone. And conversely.

9. The evolution of populism

Populism is grounded in much anger and frustration

Populism and nationalism have been on the rise for more than a decade. The emergence of more extreme views, and of the demagogues who proselytise them, follows an extended period of widening inequality, bouts of brazen financial excess, and two catastrophic recessions sandwiched between what was a shallow recovery marked by fiscal austerity and sluggish real income growth. Many of the economic certainties, previously taken for granted, have evaporated. Frustration, envy, even anger are manifest. Hence, people have looked for scapegoats; challenged the institutional status quo; and been attracted by those who promise to fight their corner, and offer sweeping change.

But the policies of populists rarely produce good results

Yet there are no easy answers to today's problems, and matters could get considerably worse were the rancorous myopia of populism to metastasise further. Populists typically view the world through what economists would term a partial, rather than a general, equilibrium framework. When they identify an unacceptable anomaly, their response is usually narrow and clumsy, often confusing symptom with cause. Broader ramifications of their actions may be ignored.

Furthermore, insofar as the consequences of the intervention prove inconvenient or intolerable, they are likely to be addressed with further heavy-handed initiatives. The net result, once this process has cascaded through the economy, is usually an outcome far more malign than the original issue. This applies to everything from migration controls, to rent controls, debt defaults, the destruction of existing domestic and international institutional arrangements, and government intervention to safeguard a particular industry or region.

The hope is that the imminent changing of the Presidential guard in the US will mark a turning point in the global political environment, and a return to a more liberal and multinational approach to policy. The tasks facing the new President are however onerous, and his country remains politically dyspeptic and riven. At the same time, the global recovery process will take time and is unlikely to be smooth or without setbacks.

A Biden Presidency is a beacon of hope, but don't expect too much

Risks will diminish only with a better balance of fiscal and monetary policy; a renewed focus on growth-enhancing structural reforms; greater efforts to address income and other inequalities; migration issues being eased by a clamping down on illegal immigrants, while at the same time ensuring that the inflow of legal foreign labour is widely spread, does not become ghettoised, and is actively equipped to enter the labour market; and stiffer penalties, extending to jail sentences, being imposed on those personally responsible for financial malfeasance, accompanied by greater efforts to make the financial sector work for society as a whole.

10. The potential for an Emerging market debt crisis

Most non-OECD economies are facing tough times …

The less-developed economies have been hit hard, if sometimes belatedly, by the pandemic. The emerging market (EM)s are forecast by the IMF to contract by some 3.3% this year, although this figure is inflated by China's early and relatively robust recovery. Ex-China, the likely decline in real GDP is put at 5.7%, a similar figure to that for the advanced economies. There is unlikely to be a return to the 2019 level of output before 2022. The low-income developing economies (LIDCs) are expected to contract by a less dramatic 1.2%, but rapid population growth, and a low starting point for incomes means that this is a more challenging outcome than it looks at first blush.

The global income convergence of recent decades is rapidly reversing, and inequalities and poverty, particularly extreme poverty, stand to rise sharply.

The real-economy traumas faced by many EM and low-income country economies have perforce led to large increases in budget deficits and surges in outstanding indebtedness, when public sector liabilities were already historically elevated. By the end of 2021, the stock of government debt in the EM and middle-income economies is likely to have risen by the equivalent of more than ten percentage points of GDP to some 60% of output, thereby exceeding the previous 1980s peak. For the LIDCs, which have latterly become more heavily reliant on commercial credit than on official financing, the average debt ratio is likely to end next year at close to 50%, also a new peak.

… including considerable debt distress …

Even before the pandemic, many low-income developing economies and frontier markets were considered to be in debt distress, or at least at high risk. Today, the IMF puts the proportion in these categories at well over one-half. Furthermore, the debt and debt service environment is complicated by these countries' growing reliance on non-concessional liabilities.

Although the recent weakness of the dollar has provided some respite, there is likely to be a requirement for much greater external assistance, and debt restructuring if a cascade of defaults is to be avoided. One useful initiative would be an allocation of new Special Drawing Rights (SDRs), the IMF's proxy reserve asset. Policymakers may well also have to go beyond liquidity provision to address solvency considerations. First and foremost, where debt is unsustainable, it will need to be recognised as such, and a comprehensive restructuring package put in place. Typically, the longer that a debt restructuring is delayed, the harder it is to complete, and the greater is the damage to GDP, investment, private sector credit and capital inflows.

… that requires brave and innovative solutions

The process of debt restructuring could also be enhanced by improvements in the international debt architecture, extending to enhanced and standardised CACs (collective action clauses) in international bonds. Potentially more important would be a movement towards the adoption of contractual clauses that reduce, or automatically suspend, debt service in the context of natural catastrophes and large economic shocks – GDP-linked bonds. Best of all, perhaps, would be the development of a sort of Marshall Plan for the non-OECD world, under which extended financial support could be supplied in exchange for the delivery of comprehensive development strategies worked out by individual countries in conjunction with the IMF and World Bank.

The key to any comprehensive solution to the non-OECD world's debt problems will be persuading the OECD nations to care sufficiently to take action. This may be difficult given the pressures on their own public finances, and that populism and nationalism remain ascendant in many countries.■