



ALLIANZ RESEARCH

'DEAR SANTA': OUR ECONOMISTS' WISH LIST FOR 2021

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EXECUTIVE SUMMARY



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And all the 'econo elves' at
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As 2020 draws to a close and we release our updated forecasts (see also: "2021-22: Vaccine economics"), our economists were caught daydreaming of a world where their boldest wishes would come true.

You may think we are a bit too old for a letter to Santa, or that policymakers are way too stubborn to abide by their New Year's resolutions, but the spirit of the Holiday Season seems to have nonetheless descended in each of our homes. *Webex*, *Zoom*, and *Teams*, the new red-nosed reindeers, did work their magic to bring to you what we think could make the global economy jingle all the way. From our work family to yours, our own Christmas carol playlist to sing loud in every policymaker's ear. So Santa, what are you waiting for?

- 1.** All I want for Christmas is...a return to normal before 2022
- 2.** Deck the halls with boughs of... smarter fiscal and monetary support
- 3.** Santa Claus (should) be coming to Emerging Markets town (too)
- 4.** Underneath the tree: Just the right amount of inflation
- 5.** Joy to the world's trade flows!
- 6.** All is calm(er)...for political risk
- 7.** A silent night...for corporate insolvencies
- 8.** Jingle bells (don't) rock too much for financial markets
- 9.** Do you hear what I hear? It's never too late to reform social protection
- 10.** Have yourself a merry (not so) little green revolution.

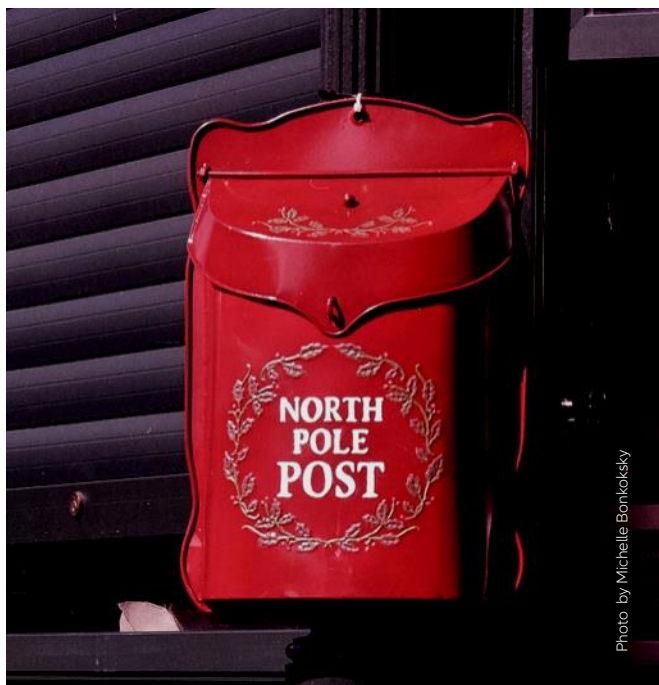


Photo by Michelle Bonkowsky



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All I want for Christmas is...a return to normal before 2022

After promising clinical trials for two Covid-19 vaccines, the start of a global vaccination campaign is the ultimate Christmas miracle. This could boost our 2021 GDP growth forecasts by around +1-2pps¹. We expect the vaccination of people at risk to be completed as soon as mid-2021 in developed countries and big Emerging Markets, which should ease the pressure on health systems and allow some Covid-19 restrictions to be lifted. But the battle for herd immunity depends on a vaccine acceptance rate of 70-80%, and skepticism is particularly widespread in Western Europe.



Deck the halls with boughs of... smarter fiscal and monetary support

Hey Europe, listen up! This message is for you: Don't be tempted to prematurely withdraw policy support, again. Because there is a vaccine light at the end of the tunnel, governments in developed markets can afford to put any debt sustainability concerns on the back burner – with the small caveat that the focus of fiscal spending should remain on (i) reinforcing safety nets for the private sector (short-work schemes & public state guarantees) particularly in H1 2021 as Covid-19 restrictions remain elevated, (ii) providing a springboard for the Covid-19 economic recovery (reduction in red tape and taxes) and (iii) building the foundation for higher potential growth (public investment / incentives for private investment in green & digital etc). After all, a full-fledged fiscal offensive in 2021 – if done right – could help reduce medium-term scarring effects to the economy. Not only would we like to see a sizeable U.S. fiscal package to the tune of USD900bn, but the EU recovery fund also needs to turn on the spending tap.

While fiscal policy remains clearly in the driving seat, monetary policy needs to leave no doubt that it will continue to provide a backstop to growing debt burdens in both the public and private sectors until the economic recovery is complete. This calls for another year of close cooperation between fiscal and monetary authorities. In our view, at a minimum the ECB will need to “threaten” – and not actually commit to - another EUR1.6bn in asset purchases in 2021, while the Fed should envisage a further easing of its monetary policy either via higher securities purchases or by

If governments can kick off a mass vaccination campaign in the second half of 2021, and herd immunity is visible before the end of the year, we could see a return to something resembling “business as usual” as early as Q4 2021, compared to around six months later in our baseline scenario.

maintaining the current USD120bn per month, albeit with a stronger focus on long-term maturities. Last but certainly not least, banks will also require special TLC in 2021 as the focus shifts from tackling liquidity risk to mitigating credit risk. Unmanaged banking sector problems could well jeopardize the economic recovery, particularly in Europe. Further regulatory forbearance to address the rise in NPLs as well as capital concerns could provide some breathing space. However, a more comprehensive strategy on NPL such as the setup of an EU marketplace would be a true game-changer.



1 Read more about our scenarios on allianz.com and eulerhermes.com

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Santa Claus (should) be coming to Emerging Markets town (too)

In Emerging Markets (EMs), additional spending to cope with the economic effects of Covid-19 has widened fiscal deficits and will markedly increase public debt-to-GDP ratios until the end of 2021 at least. But policymakers need to find the right balance and pay attention to debt sustainability. Lebanon, Argentina, Ecuador, Suriname and Zambia already defaulted on their sovereign debt in 2020, even if their financing problems were already evident before Covid-19 arrived. In 2021, not all EMs will be able to continue their stimulus programs as many could reach their border of public debt sustainability. While this may not

necessarily lead to the drama of a default, it could require restructurings and help from the IMF. Which countries are on the watch-list? Mozambique, Ghana, Sudan, Timor-Leste, Sri Lanka, Egypt and Pakistan, according to our Public Debt Sustainability Risk Score. Our wish is for policy makers and international institutions to help avoid a rude awakening with a wave of balance of payment crises in the emerging world.

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Underneath the tree: Just the right amount of inflation

Inflation could easily spoil the recovery post Covid-19. Should the massive fiscal and monetary stimulus morph into a significant overshoot of prices, central banks could have to prematurely exit their unconventional monetary programs. In this case, any unexpected shock on interest rates could disrupt the current fragile equilibrium in which governments have an apparently infinite capacity to issue debt, thanks to strong purchases of government bonds by central banks. The most credible economies, such as Germany and the US, could possibly escape the sanction of the market but structurally complacent countries could face severe restrictions via a significant increase of their risk premiums. Without the support of central banks, both the sovereign and private credit market bubbles could burst in a disorderly way with devastating consequences on the real side of the economy and much more long-lasting effects on growth compared with the Covid-19 shock.

On the other hand, an under-shooting inflation scenario is also plausible, should the huge amount of savings accumulated by households and companies not return fast enough to their pre-crisis levels. In this scenario, excess debt weighing on investment and a slow recovery on the job front could coalesce into a downward spiral, creating a scenario of deflation. Central banks in this situation would tend to increase their holdings of government debt and other types of assets, de facto leading to a further issuance of public debt alongside a progressive nationalization of economies. But we can still avoid a zombification or Japanification of the world economy.



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Joy to the world's trade flows!

Impressive growth in China and lighter lockdowns in Europe, which preserved manufacturing activity, led to a strong recovery of global trade in goods in Q3 2020. In 2021, we're wishing this continues as the recovery of global demand strengthens with further impetus provided by a rejuvenated multilateralism post US elections and swift normalization of trade relations post-Covid-19. We do see competing dynamics in global trade albeit not implying the comeback of a brutal isolationism but rather pointing toward a new definition of global supply chains. Less than 15% of companies we surveyed consider reshoring (bringing production back home). This confirms that

reshoring can happen only conditional on appropriate incentives, as it is not the most cost-effective resilience strategy. But we estimate around 30% consider near-shoring, i.e. bringing production to a nearby country. This is line with the renewed momentum for multilateralism, especially after the agreement of the RCEP and talks about the return of the U.S. to TPP negotiations. Multi-shoring or diversification is also on the agenda, as companies look for cost-effective supply and production solutions (notably still in China) after an unprecedented shock.

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All is calm(er)...for political risk

After a year marked by the tumultuous U.S. elections, we're hoping 2021 will make geopolitics boring again. Indeed, Biden's victory could represent a turning point after four years of President Trump's combative stance in trade and environmental policies. Despite a probable more cooperative stance adopted by Joe Biden, three factors invite us to be cautiously optimistic in respect of the international political climate. First of all, Joe Biden will continue to organize its foreign policy by following the precepts of the Pivot strategy, with the target of containing the growing influence of China.

Second, global political risk was at an extremely high level in 2019 independently of the US foreign policy and on the back of rapidly multiplying sources of social tensions, on the back of rising inequalities.

The Covid-19 crisis is likely to further exacerbate these tensions as the most fragile fringes of populations suffered relatively more both at economic and sanitary levels of the disease. At last, political risk is also likely to increase in a context where global public debts have reached unsustainable levels, putting at risk the long-term viability of social protection systems. Indeed, our Social Risk Index has identified several Emerging Markets with elevated social risk which also face high public debt sustainability risk: Angola, Mozambique, the Republic of Congo, Sri Lanka, Pakistan, Laos, Kenya, India, Kyrgyzstan, Côte d'Ivoire, Argentina, Lebanon, Venezuela, Zambia. The latter four are already in default. All in all, our wish is that the other countries can avoid such a scenario and that this risk does not evolve into a political crisis.





A silent night...for corporate insolvencies

Our first best wish for the corporate sector would be an early end to lockdowns, combined with a fast materialization of positive confidence effects on consumption and investment. This would boost revenues and profits, especially for companies in the sectors sensitive to Covid-19, including household goods, food and beverages, leisure activities and automotive. These account for one out of four jobs in Western Europe. A faster-than-expected return to 'business as usual' would also reduce the risk of second-round effects on other sectors, with positive implications cyclical ones such as construction, energy, metals and machinery equipment. This would strengthen global confidence and boost investment, notably of the green and digital kind, which could accelerate the roll out of much-awaited 5G networks. Our second best wish for the corporate sector would be a timely, targeted and fine-tuned phasing out of the support measures put in place by governments. Indeed, the massive injection of liquidity into financial markets, the direct and indirect financial support (partial unemployment schemes, tax deferrals, social security charges, mortgage repayment and rents rescheduling etc.) and the temporary adjustments made to insolvency frameworks have helped prevent a tsunami of insolvencies in the short term. But a premature and unprepared withdrawal of financial measures could cause a liquidity squeeze at a time when companies will have to finance a larger working capital requirements alongside the recovery.

At the same time, delaying the withdrawal for too long could see a massive increase in zombie companies, including both the pre-Covid 'zombies' (companies that were no longer viable before the crisis and temporarily took advantage of emergency measures) and the viable companies 'zombified' by the crisis (those companies weakened the excess of indebtedness after Covid-19). In this context, our third best wish would be to see corporates improving their resilience for the mid and long term, with more equity and less debt, and higher stocks with shorter or more diversified supply chains, along with closely monitored payment terms.



Jingle bells (don't) rock too much for financial markets

Competing scenarios of a post-pandemic economy are still reflected in the prices of safe and risky assets. U.S. equity prices, for instance, embody expected short-term earnings growth of +23% in the next two years and price in very ambitious expected long-term earnings growth of +16%. On the other hand, prices for safe assets embrace the still cautious stance of central banks, focusing on near-term economic risks linked to the second wave and possible longer-term scarring effects. Government bond yields in the major economies are kept in a trading range that is limited to the downside by already extremely low yield

levels and limited to the upside by large-scale asset purchases of central banks. So valuations are stretched on both edges of the risk spectrum, and this is a fragile balance. But if investors gradually abandon their extreme positioning and short-term trading behavior, valuations could reattach to fundamentals without a major market disruption, especially as monetary policy still acts as a credible backstop to a market meltdown. So our wish is for a narrowing of the differential between expected growth and interest rates for greater financial stability.



Do you hear what I hear? It's never too late to reform social protection

Never waste a good crisis. Covid-19 is not the first and will not be the last pandemic the world has to combat, and pandemics are not the only challenges. Our wish is for intelligent solutions for private-public partnerships in risk protection that would benefit long-term growth in two ways: by unleashing investments in resilience and by making the (inevitable) lows higher and shorter.

Our first wish is for an **ex-ante risk protection scheme** to strengthen resilience. The expectation that the state will always act as a safety net has rendered self-responsibility and own efforts to mitigate risks obsolete, leading to even bigger risks down the road. That is why it is so important to build an ex-ante risk protection scheme – for example by creating a pre-funded insurance fund or in the form of private insurance with a public backstop. If all participants retain skin in the game, they have a strong self-interest in taking preventive and preparatory measures. Private insurers could play a decisive double role in such a scheme: being a risk manager advising mitigation measures and being a kind of plumbing system, checking the claims and making the payments. Unlike the state, which is used to putting up protective umbrellas with guarantees but struggles to distribute funds quickly and directly, private insurers have the necessary know-how, processes and structures in place.

Our second wish is for **smarter saving behavior**. The low yield environment enters its second decade in Europe and with the Covid-19 crisis, zero interest rates will become entrenched for the time being. But most households still have a penchant for liquid and supposedly safe financial assets like bank deposits or cash, which is counter-productive: Not only are savers losing money as these instruments have negative real returns, the absence of investment income and value gains forces them to tap deeper into their earned income to reach their saving targets. Thus, aligning savings behaviors with the reality of low or negative yields is overdue. Concerted action is necessary: our wish is that policymakers find ways to raise financial literacy, for example by integrating the subject into normal school curriculums and that the finance industry doubles down on efforts for simple, cost-efficient and easy-to-understand capital market products. The gains would be threefold: savers would earn higher returns and find it easier to reach their saving targets; at the same time, earned income could increasingly be used for consumption, boosting demand and growth and finally, capital market development would be accelerated, leading to a more balanced financial systems in Europe (instead of a bank-dominated ones). This in turn, would benefit long-term growth in two ways: fostering financial stability and the green transformation.



Deeper capital markets imply a bigger role for long-term institutional investors, which are mainly real money investors, i.e., they have no leverage. They do not only take risks but also have the capacity to absorb risks. Thus, they foster financial stability by holding assets as contrarian investors, stabilizing markets, not rushing to the exit (as banks are prone to do). Key to success of the green transformation will be to mobilize trillions of euros of private investment in new technologies and infrastructure. This requires a comprehensive framework for the finance industry to make sure that capital is steered in the right direction. Deep, liquid, and innovative capital markets with their long time horizons are better equipped for the task than rather myopic banks.

Our last wish for the insurance and wealth markets is **pension system reforms** that reflect the aging of societies. Today, more than 727mn people are aged 65 or older and until mid-century this number is going to more than double to 1.5bn; 950mn of them will live in Asia. However, many countries are still ill-equipped to deal with the rising number of pensioners, lacking either a sustainable and adequate pension system at all or delaying necessary pension reforms.

Thus, in order to take the rapid aging of the population in many countries of the world into account, we wish for pension reforms that include the automatic adjustment of the retirement age to the changes in further life expectancy. What would also help is the introduction of a retirement age corridor, allowing each individual to choose the time of retirement according to the own physical condition. Persons with physically demanding jobs could choose to retire earlier, while white-collar workers might prefer to stay longer on the job. Old-age part-time work should also be a standard option and not the exception in order to enable a gradual transition into retirement.

By supplementing the state pension systems with a capital-funded element, one could take advantage of both worlds. And last but not least, occupational and private pension provision should be strengthened to distribute the financing burden on several pillars. Past experience shows that the

most difficult part in this respect is to reach low-income groups and incentivize them to save for old age. Measures like the introduction of a negative income tax could help to reach these income groups and allow them to build up sufficient capital for old age, while high enough income and tax allowances for pensioners could prevent them from being worse off than someone who relies solely on social welfare. Growth would benefit twofold: Directly from an expanded pool of skilled labor and indirectly from deeper capital markets, not to mentioning the positive effect of sustainable and adequate pension systems for social peace and cohesion.



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Have yourself a merry (not so) little green revolution

2021 will be a decisive year for climate change, marking the start of the sustainability wars in which Europe, the U.S. and China will fight for global leadership in green technology. But with more climate disasters likely to unfold, we will need to start implementing negative emission strategies, beginning with large-scale afforestation and reinventing the construction sector to transform buildings into carbon sinks. Infrastructure spending in green investment and the digital network is likely to create a virtuous circle by increasing the growth potential of our economies over the medium to long run. The expansion of digital platforms and the integration of digital services are also likely to boost productivity, especially for the SMEs.

Our wish is that central banks actively join the greening initiative by adapting their policy toolbox. For instance, the targeted liquidity allotment to banks (TLTRO) or the asset-purchase programs of the ECB could be re-calibrated to give priority to ESG criteria. In addition, revamping the collateral scheme by giving greater weight to ESG assets would encourage banks to finance 'green' investment. These new policy tools would make the balance sheet of the ECB greener down the road, and hopefully inspire other central banks (i.e. the Bank of England and the Fed).

We also wish that that governments will implement adequate policies to speed up and incentivize the development of sectors with strong growth potential. For instance, the development of a European-wide hydrogen sector could help to absorb idle physical and human capital from the aerospace industry. Effective labor force training and education policies would also be key to address the labor supply needs of the fast-growing sectors in digital and green industries. Finally, financial policies should seek to free the banking sector from the 'burden' of zombie loans and enable them to finance the new bloomers.



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