ALLIANZ RESEARCH

RACE TO THE POST COVID-19 RECOVERY: 7 OBSTACLES TO OVERCOME

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- **The global recovery is on the right track albeit conditional on key differentiating elements across countries.** Global GDP is expected to rebound by +5.1% in 2021, with one fourth of the recovery being driven by the US, while China should contribute less to growth by progressively adopting a less accommodative economic policy. In 2022, world GDP growth should reach +4.0%. Europe should recover its Covid-19 losses only at this horizon against H2 2021 for the US. The race to recovery will hinge on seven key obstacles.
- **Obstacle 1: Formula 1 race on vaccination.** Execution risks will remain a key differentiator between countries, with the pace of vaccination campaigns driving a multi-speed recovery and keeping divergence at high levels. At the current pace of vaccination, the US and the UK will reach herd immunity in May. While Europe should be able to vaccinate its vulnerable population by the summer, herd immunity is not likely to be reached before the fall at the current pace. On the other hand, most governments (France) are speeding up the vaccination pace to reach herd immunity during the summer.
- **Obstacle 2: Excess savings will still hover around 40% above pre-crisis levels at end-2021.** In a relatively optimistic scenario, excess savings from households should provide a tailwind to consumer spending to the tune of +1.5% of GDP in Europe and more than +3% in the US in 2021. Close to the same amount could be added on top for investment or consumption abroad purposes should confidence effects play a positive role. We calculate that around EUR163bn could be transformed into private consumption in the Eurozone, equivalent to 30% of the Covid-19 excess savings. However, in the US, we expect 50% of the current excess savings to be spent in 2021 as an earlier loosening of restrictions and more powerful fiscal impulses should boost the confidence effect. The US household savings rate should be back to a normal level at close to 7% of gross disposable income at end-2021.
- **Obstacle 3: Phasing out assistance mechanisms is not a zero-sum game and the risk of policy mistakes remains high.** After the "whatever it takes" consensus in 2020, fiscal policy will march to the beat of national drums going forward. In 2021, the consensus to do "whatever it takes" is already giving way to more heterogeneous policy prospects. In China, the path towards a policy normalization has already started, with official targets implying a clear withdrawal of policy support in 2021, even if some flexibility will be kept to manage credit risk if needed. The global demand torch will pass to the US, with its gigantic USD1.9trn fiscal stimulus (9% of GDP) and a new gigantic infrastructure plan to come. Europe's fiscal response pales in comparison: the Next Generation (NGEU) fund will only extend a helping hand from H2 2021 onwards and the growth impact (a cumulative +1.5pp until 2025) should prove moderate and delayed, given its focus on the supply side – 2/3 of the EUR313bn grants are likely to be used for investment – and drawn-out payments. It will be difficult to operate a smooth phasing out of job retention schemes, transfers to the most impacted sectors and public credit guarantees, without adding to difficulties of non-financial companies. Corporate bond redemptions will increase by more than 70% in 2022 and double in the US.
- **Obstacle 4: Crowding-in vs. crowding-out effects on investment are not yet resolved.** Joe Biden's "Build Back Better" in the US (potentially USD2.3trn), the EU Next Generation of EUR725bn fund and China's infrastructure plan totaling more than USD1.5trn by 2025 will all contribute to support demand and the global economy's growth potential over the medium-term. But their success depends on whether governments can channel excess savings to productive projects and boost private sector. We find a positive impact of excess savings on business investment in the US, Germany, France and the UK, but much of this will depend on future tax policies and the funding conditions (e.g. recovery state-guaranteed loans).

- **Obstacle 5: Bottlenecks in the global supply chain are as high as during the peak of the pandemic and should push global trade into a borderline recession in Q2.** Global trade growth will rebound to +7.9% in 2021 in volume terms, but excluding the positive carryover effects from 2020 will stand at +5.4%. More importantly, we expect a temporary slowdown in Q2 2021 due to prevailing supply -chain disruption: for the full year 2021, we estimate that the impact of supply-chain disruptions could weigh on global trade growth by -1.7pp. In addition, trade in services will remain impaired by the delayed reopening of sectors most impacted by Covid-19-restrictions and continued barriers to cross-border travel.
- **Obstacle 6: Temporary overshoot of inflation.** A temporary overshoot of inflation is likely to be driven by temporary base effects. Hence, companies' pricing power is likely to remain limited, given subdued demand dynamics: (i) excess savings from households and NFCs that act as a drag on money velocity; (ii) persistently negative output gaps due to lower capacity utilization and (iii) rising unemployment rates that will keep a lid on wage growth (below 3%). Therefore, we don't expect central banks to stage a policy U-turn as a reaction to inflation temporarily overshooting in the US at 3.5% by mid-2021 and hitting the 2% target for a few months in the Eurozone.
- **Obstacle 7: Not putting an end to the sweet music of market's reflation.** Risky assets are operating under the assumption that what is good for them – unconventional monetary policy and fiscal profligacy – is necessarily good for the real economy, which will ultimately validate their optimism. For the time being, however, what we see is a widening divergence between asset prices and their underlying value. Amplified by various investment management techniques (ETFs, risk-parity) that put asset allocation on automatic pilot, this divergence is a vulnerability. An inadvertent escalation in geopolitical tensions between the US and China, surging inflation that wrong-foots the subdued inflation expectations held by central banks or nationalistic impulses prevailing over the common good in Europe are all exogenous triggers that could put its widening in reverse. But exogenous sources of risk are always easier to identify than endogenous ones: the danger is more likely to come from within capital markets. As shown by the rise of options trading and margin debt, leveraged investing is pervasive, and so is the confusion about liquidity: especially in capital markets, the velocity of money (the flow of liquidity) is far more volatile than its quantity (the stock of liquidity). In the presence of leverage and overtrading, risk-taking is prone to running amok and even a minor shock to confidence can lead to a sudden drying up of liquidity, forced liquidations and/or default.

+5.1%

Forecast for global GDP growth in 2021.

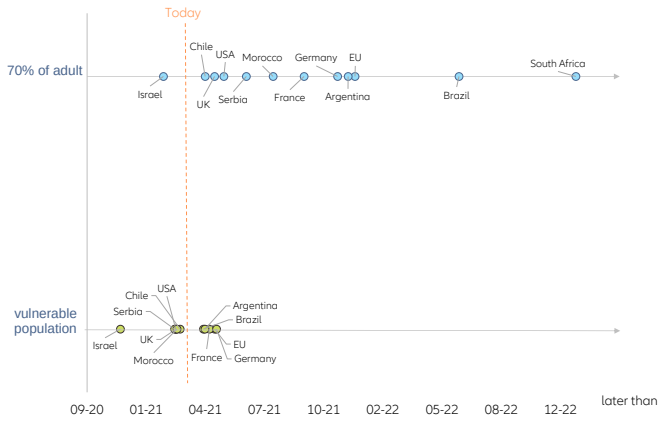
A MULTI-SPEED RECOVERY, SEVEN OBSTACLES TO OVERCOME

From China saving the world to the US. Global GDP is expected to rebound by +5.1% in 2021, with one fourth of the recovery being driven by the US, while China should progressively adopt a less accommodative economic policy. In 2022, world GDP growth should reach +4%. The over-expansionary stance of the global policy mix explains this rebound in 2021 and 2022, compared with the contraction of –3.6% in 2020. However, execution risks will remain a key differentiator between countries, with the pace of vaccination campaigns driving a multi-speed recovery and keeping divergence at high levels.

Obstacle 1: Formula 1 race on vaccination.

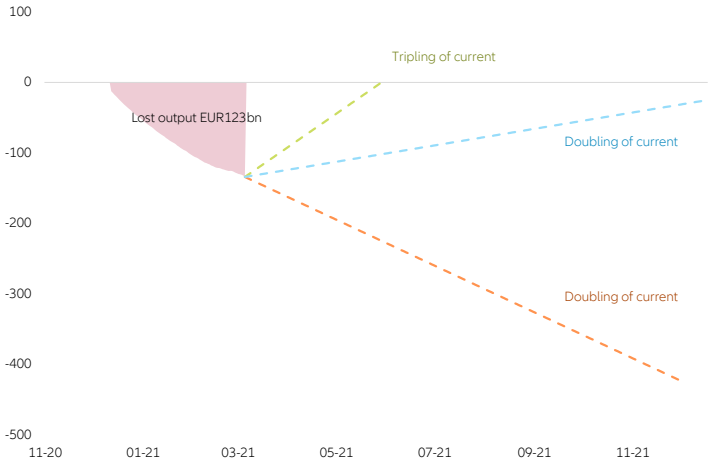
At the current pace of vaccination, the US and the UK will reach herd immunity in May (see Figure 1). While Europe should be able to vaccinate its vulnerable population by the summer, herd immunity is not likely to be reached before the fall at the current pace of vaccination. Overall, the seven weeks of vaccination delay in Europe is equivalent to EUR123bn of economic losses (see Figure 2), or more than twice as much as the EU Generation Fund's planned disbursement for 2021. Asymmetries will be also be the result of dis-synchronized economic policies. The US will remain at the forefront of fiscal initiatives, while delays in execution will be visible in Europe. The early positioning of China in the current cycle will allow the central government and the PBoC to start a reining in of their expansionary policies.

Figure 1: Expected date of herd immunity



Sources: Our World in Data, Duke University, Euler Hermes, Allianz Research

Figure 2: Cost of vaccination delay

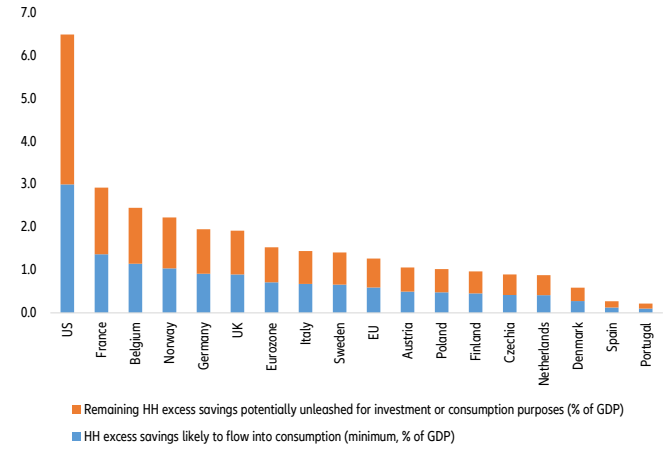


Sources: Our World in Data, Duke University, Euler Hermes, Allianz Research

Obstacle 2: Excess savings will still hover around 40% above pre-crisis levels at end-2021.

Excess savings from households should provide a tailwind to economic growth to the tune of +1.5% of GDP in Europe and more than +3% in the US in 2021. In 2020, Eurozone household savings increased by EUR530bn or +40% compared to pre-pandemic levels. Out of this, and taking into account the pace of dissaving from 2020 during deconfinement periods, we expect EUR180bn to be unleased in 2021 in the Eurozone, equivalent to 1.5% of GDP (see Figure 3). At end 2021, this would mean a fall of a bit more than 50% in excess savings compared to end -2020. Looking at the structure of savings by income level and the propensity to spend, we calculate that around EUR163bn could be transformed into private consumption, equivalent to 30% of the Covid-19 household excess savings, and to half of the depleted household savings in 2021. This is equivalent to around half a point of GDP this year. Overall, at end-2021, we expect Eurozone savings to still remain 37% above pre-pandemic levels (or close to EUR350bn, 2.9% of GDP). In the US, we expect 50% of the current excess saving to be spent in 2021 as an earlier loosening of restrictions and more powerful fiscal impulses should boost the confidence effect. The US household savings rate should be back to a normal level at close to 7% of gross disposable income at end 2021.

Figure 3: US and European households' savings, % of GDP (expected unleashed in 2021)



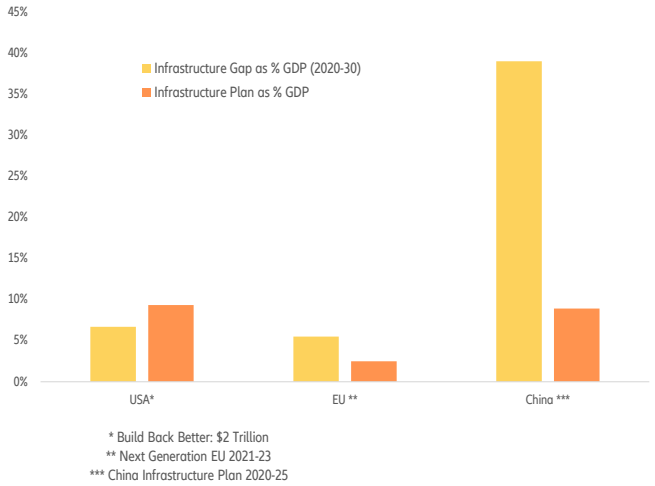
Sources: : FRED, Eurostat, Euler Hermes, Allianz Research

Obstacle 3: Phasing out assistance mechanisms is not a zero-sum game and the risk of policy mistakes remains high.

In 2020, unprecedented monetary and fiscal stimuli to the tune of 20% of GDP helped cushion the economic blow to global GDP. By early 2021, the consensus to do "whatever it takes" is giving way to more heterogeneous policy prospects. In China, for instance, policy stimulus has already passed its zenith in line with the advanced economic recovery. In fact, the path towards policy normalization has already started, with official targets implying a clear withdrawal of policy support in 2021, even if some flexibility will be kept to manage credit risk if needed. The global demand torch will pass to the US, where the gigantic fiscal stimulus to the tune of USD1.9tn (9% of GDP) will provide a much-welcomed boost to global exports (USD362bn in 2021-2022, 2% of total nominal trade).

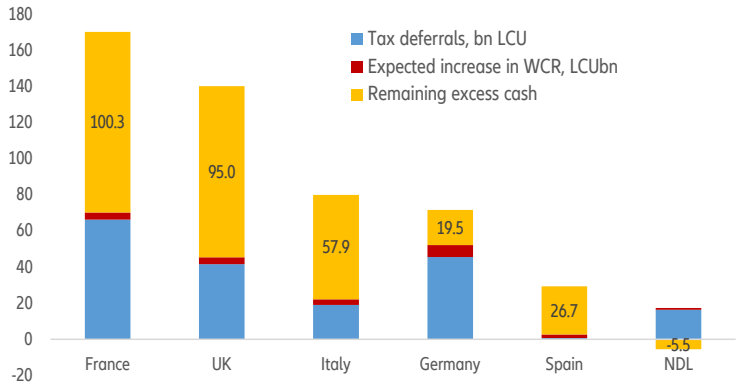
Europe, meanwhile, has learned from its 2011-12 policy mistakes, when it pursued a pro-cyclical fiscal stance, but its Covid-19 fiscal response still pales in comparison to the US. On the surface, the story is one of the US doubling down with an unprecedented fiscal bazooka at a time when a recovery is already starting to unfold, while Europe has spent all its political capital on a stimulus that is too small, too drawn-out and subject to heightened implementation risk. However, headline figures are deceiving: we estimate Europe's stimulus to be closer to 2/3 of the US response when factoring in automatic stabilizers in 2020-21 (see Figure 4). For now, national fiscal policy continues to lead the show in Europe via ongoing targeted support measures aimed at keeping a lid on economic scarring i.e. job retention schemes, transfers to the most impacted sectors and public credit guarantees. We expect most EU flagship fiscal policies to be phased out no sooner than fall 2021, given the delayed recovery prospects, which is bound to trigger a rise in unemployment and insolvencies. Fiscal stimulus may even surprise on the upside as Eurozone governments underspent in 2020, as the sharp rise in government deposits suggests (we estimate excess deposits at 3% of GDP). The EU's Next Generation fund will only extend a helping hand from H2 2021 onwards and the growth impact (a cumulative 1.5pp until 2025) should prove moderate and delayed, given its focus on the supply side – 2/3 of the EUR313bn grants are likely to be used for investment – and drawn-out payments. Nevertheless, with NGEU funds not counted under national deficits, they will help cushion the normalization of fiscal policy. This is particularly true for recovery laggards, including Spain and Italy. In any case, we expect EU fiscal rules to remain suspended until 2023.

Figure 4: Infrastructure spending vs estimate gap, % of GDP



Sources: Various, Euler Hermes, Allianz Research

Figure 5: Increase of working capital requirements and tax deferrals vs. NFC "excess cash", bn LCU, as of February 2021



Sources: Various, Euler Hermes, Allianz Research

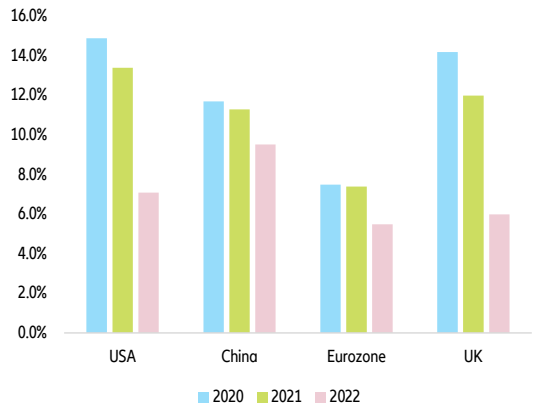
Most countries will continue to inject liquidity and support companies and jobs to avoid the sanitary and economic crisis morphing into a financial and social crisis. Hence, the risk of policy mistakes is high, negative externalities are visible (disconnect between financial markets and the real economy; lack of price for credit risk, inequalities) and rolling back state and central banks' support will prove complicated. The risks are further protectionism, disorderly exists (taper tantrum for example), scarring effects (private debt levels) and more entropy across countries (especially as the political calendar is heavy in Europe).

2022 will bring an (economic) reality check for companies. Higher interest charges for non-financial corporates are likely from next year onwards and we forecast a cumulated impact of close to -2pp at end-2023 for Eurozone NFCs' margins on average. An increase of low bank interest rates offered by the state-guaranteed loans will push NFC interest payments on the upside as soon as 2022. An incremental increase of at least +50bp per year for the new loans given in 2020 is expected and would be equivalent to an increase of close to close to EUR15bn in the Eurozone as a whole or a rise of +0.8pp of the operating surplus to close to 4%. In terms of the impact on NFC margins, for the Eurozone countries on average it would go from -0.3pp in 2022 to close to -2pp in 2023. The impact is expected to be above Eurozone average in Belgium, Italy and Spain. Another credit market risk: corporate bond redemptions will increase by more than 70% in 2022 and double in the US.

Obstacle 4: Crowding-in vs. crowding-out effects on investment are not yet resolved. The multiple initiatives in terms of infrastructure projects, including Joe Biden's "Build Back Better" in the US (potentially USD2.3trn), the Next Generation EU EUR725bn fund and China's infrastructure plan totaling more than USD1.5trn by 2025, will all contribute to support demand and the global economy's growth potential over the medium-term (see Figure 5). In this respect, their success will also rely on the efficacy of governments in channeling excess savings to productive projects. In addition to potential growth, we estimate that in advanced economies, households' financial assets (i.e. excess savings) are a key long-term determinant of the investment cycle (see Figure 6). The positive impact of excess savings on the durability and the magnitude of the new investment cycle is significant in the US, Germany, France and the UK.

Besides the question of capital allocation, tax policies will also play a decisive role in funding these long-term projects. In the US, Biden's administration aims at increasing the corporate income tax from 21% to 28% and taxes on capital gains and the incomes of the wealthiest households. One of the probable long-term legacies of the Covid-19 crisis, alongside the significant jump in public debt, relates to a probable redefinition of the value-added sharing, less in favor of profits and more in favor of salaries. The long-term success of the new upcoming investment cycle will certainly hinge on the progressiveness of these new fiscal orientations.

Figure 6: Fiscal deficit, % of GDP



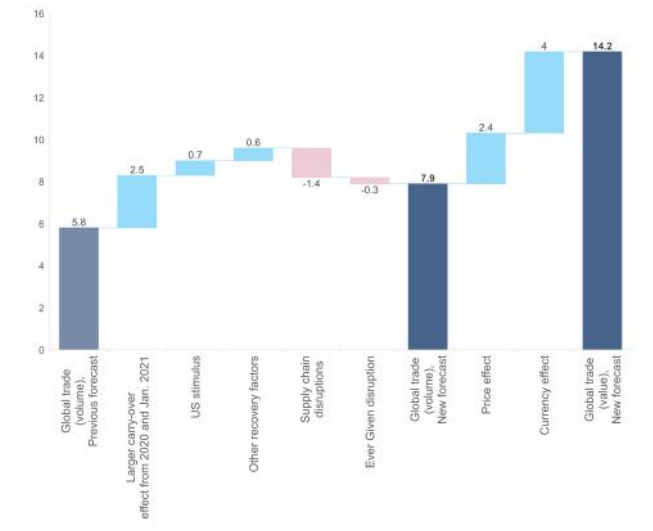
Sources: Various, Euler Hermes, Allianz Research

Obstacle 5: Bottlenecks in the global supply chain are as high as during the peak of the pandemic and should push global trade into a borderline recession in Q2. Global trade growth will rebound to +7.9% in 2021 (+5.4% excluding positive carryover effects from 2020) and +6.0% in 2022 in volume terms, but a temporary slowdown is expected in Q2 2021 due to prevailing supply-chain disruption (estimated to cut 2021 volume growth of global trade in goods by -1.7pp). Trade in services will remain impaired by the delayed reopening of sectors most impacted by Covid-19-restrictions and continued barriers to cross-border travel. In 2020, trade in goods fell by -8.1% in volume terms and -10.8% in value terms. This was less than previously expected, thanks to the rapid recovery in Asia and China. However, the temporary supply-chain disruptions in H1 2021 (container shortages, higher transportation costs, shortages of some inputs such as semiconductors and raw materials, as well as the temporary blockage of the Suez Canal) are likely to slow the flow of trade in goods. More specifically, we expect sequential growth in trade to be only slightly positive in Q2 2021 and at risk of turning negative if disruptions linger. For the full year 2021, we estimate that the impact of supply-chain disruptions could weigh on global trade growth by -1.4pp, and by -0.3pp for the one week of immobilization in the Suez Canal. On the positive side, positive carryover effects should boost global trade growth by +2.5pp more than previously expected, while the US super stimulus and other recovery factors could add +1.3pp. Overall, we expect global trade to grow by +7.9% in 2021 in volume terms (see Figures 7 & 8 and here for more details). In value terms, strong price and currency effects should push growth to +14.2% in 2021.

Figure 7: Global trade growth, goods and services, % y/y

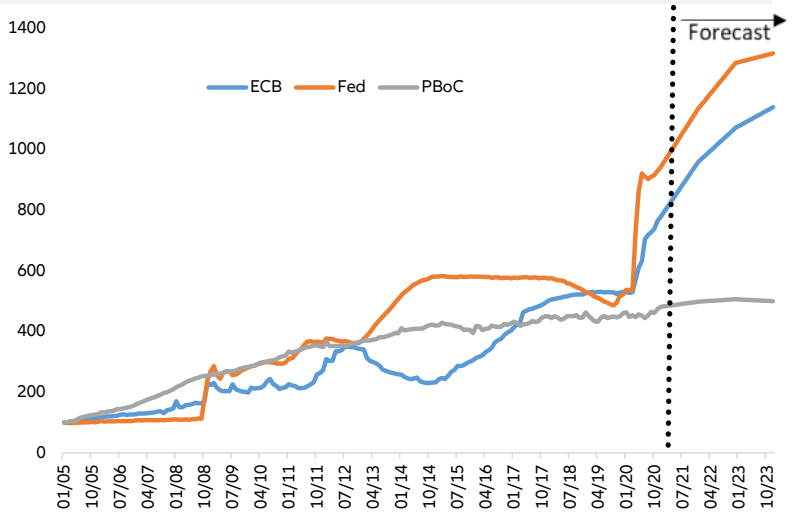
Sources: IHS Markit, Euler Hermes, Allianz Research

Figure 8: 2021 global trade forecast, % y/y



Sources: IHS Markit, Euler Hermes, Allianz Research

Figure 9: Central bank's balance sheets (Index Jan2005=100)



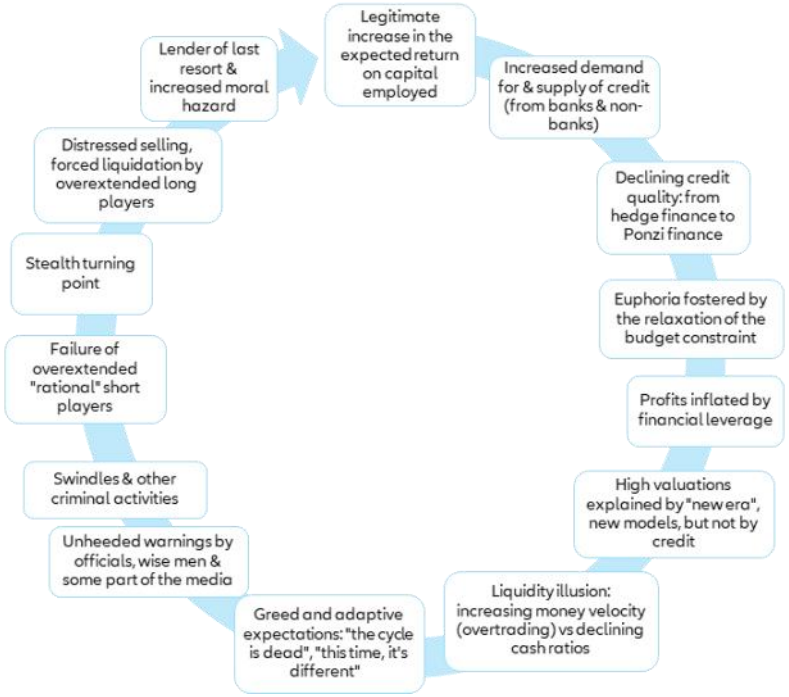
Sources: Refinitiv, Euler Hermes, Allianz Research

Obstacle 6: Temporary overshoot of inflation. Inflationary pressures will continue to increase notably in 2021, thanks to (i) the recent input cost bonanza, driven above all by strained supply chains and the oil price recovery; (ii) higher services inflation along with the economic reopening in H2 and (iii) strong pandemic-related roller coaster base effects. But we do not see inflation embarking on structural upside trend as subdued demand dynamics point to a potential head fake: (i) excess savings from households and NFCs that act as a drag on money velocity; (ii) persistently negative output gaps due to lower capacity utilization and (iii) rising unemployment rates will keep a lid on wage growth (below 3%). Therefore, we don't expect central banks to stage a policy U-turn as a reaction to inflation temporarily overshooting in the US at 3.5% by mid-2021 and hitting the 2% target for a few months in the Eurozone (see Figure 9).

In fact, we expect policy normalization to proceed at a very gradual pace in the US, kicking off with a first tapering step in H2 2022, while China will take credit growth lower very gradually. Meanwhile, the ECB will continue to "walk the talk" in 2021 by boosting the pace of asset purchases made under the PEPP in line with its stepped-up verbal intervention to protect favorable financing conditions. In 2022, the ECB may get away with a slower pace of monthly QE purchases without endangering the strengthening recovery but in terms of active normalization steps it will clearly lag the Fed as inflation will remain subdued at 1.2% in 2022 after 1.4% in 2021. In contrast, in many Emerging Markets, inflation has already staged a meaningful comeback, which central banks are unlikely to ignore. In Africa, countries such as Angola, Ethiopia, Nigeria and Zambia now boast double-digit inflation rates because of FX depreciations and food shortages. In LatAm, we see Brazil most at risk, with high input price pressures driven by supply-chain disruptions and FX depreciation now passing through to CPI. Inflation in Turkey, the Philippines and India have also exceeded central bank targets.

Obstacle 7: Not putting an end to the sweet music of market's reflation. The market frothiness following the Covid-19 shock has sparked claims of a fundamental change in the functioning of capital markets. But have capital markets really detached from traditional market cycles thanks to cryptocurrencies and retail trading? The outreach, speed and amplification of market rallies have certainly changed by the extensive use of new social networks, new online platforms and new digital assets. However, the underlying market patterns seem all but new to us. The recent rallies unite all patterns of a classical "late" market cycle boom: reliance on leveraged investing to quickly multiply gains, stretched return expectations, appearing signs of market manipulation/fraud and overtrading due to Fear of Missing Out (Figure 10). These are worrying signs, but for the time being the expansionary monetary and fiscal policies shield risky assets from negative shocks. As long as this protection is in place, risky assets will be supported, even though late cycle phenomena will occur more frequently and trigger episodes of increased volatility.

Figure 10: The Fisher-Minsky-Kindleberger model



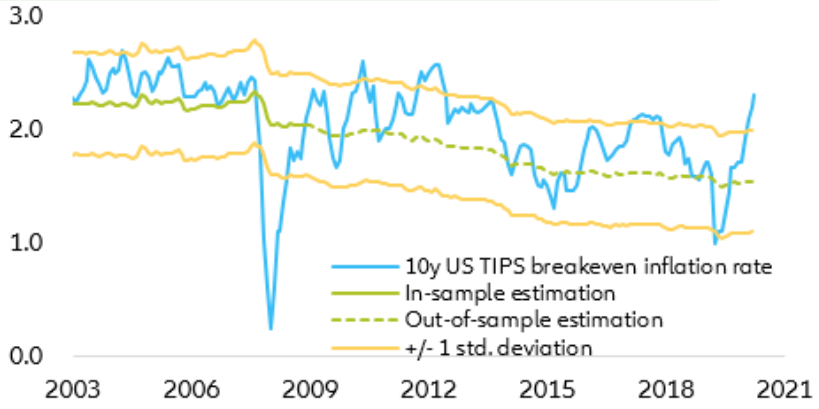
Sources: Adapted from Charles Kindleberger's Manias, Panics and Crashes a history of financial crises, 1978

Is it a game of chicken or a tea party?

However, on the bond markets, notably in the US, expectations have built up that central banks could withdraw their support sooner against the backdrop of stronger confidence in the global recovery and rising inflationary pressure. Yields on 10y US Treasuries have already risen 70bp since the beginning of the year to 1.6%. So far, the pressure on equity valuations has not been sufficient to cause major market turbulences, also because valuation metrics might count less in such late cycles. But is it possible that rising inflation expectations drive up US yields to an extent where they destabilize risky assets? From a fair value perspective, the upside for US long-term market-based inflation expectations (breakeven rate) seems limited. At currently 2.3% they trade more than 1 standard deviation above our fair value estimate (2.3% vs 1.6%) (Figure 11).

Indeed, the recent rise in breakeven rates is in fact not due to a shift in long-term expectation. It is rather due to a repricing of the uncertainty about the Fed policy timeline (tapering) and the extent of inflation overshoot tolerated within the Fed's "Average Inflation Targeting" (AIT) framework. When correcting breakeven rates by its risk components (term and liquidity premia) - which is recommended to obtain satisfactory predicting power on future inflation[1] - we can see that inflation expectations already peaked at the end of December (Figure 12).

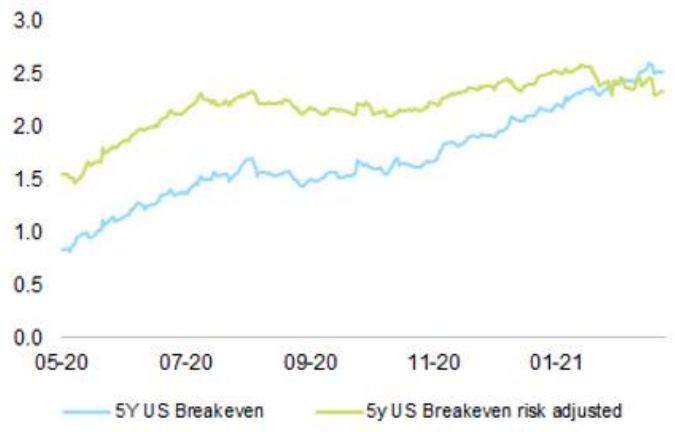
Figure 11: US 10y breakeven inflation rate model (in %)



Sources: Refinitiv, Euler Hermes, Allianz Research

[1] Andreasen, Martin M., Jens H. E. Christensen, Simon Riddell. 2020. "The TIPS Liquidity Premium," Federal Reserve Bank of San Francisco Working Paper 2017-11

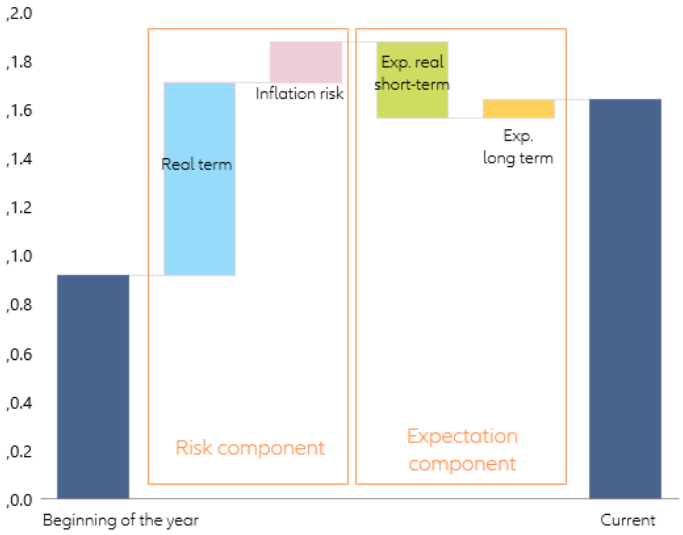
Figure 12: Uncertainty not expectations are repriced in breakeven rates (in %)



Sources: Euler Hermes, Allianz Research

Accordingly, the recent rise of long-term US nominal yields is not due to higher expectations for short-term rates or long-term inflation, but to a higher risk component (Figure x). The strong contribution of the term premium in the recent increase indicates an expected change in the supply-demand dynamics in US long-term treasuries. This means many market participants are betting on an early tapering. This expectation could be further reinforced in the coming weeks when high CPI figures heavily distorted by base effects seemingly support this narrative. We could then see a test of the 2.0% or even 2.5% level (equal to FOMC long-term rate target and current 10y10y forward) for 10y US Treasuries

Figure 13: Decomposition of recent US yield rise (10y maturity)

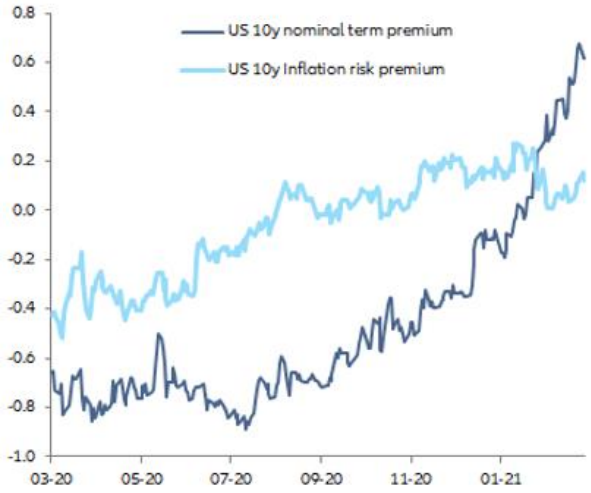


Sources: Refinitiv, Euler Hermes, Allianz Research

If such a movement occurs quickly with erratic jumps it could cause a serious self-enforcing downwards spiral for risky assets. However, our decomposition shows that the Fed exerts full control over the financial cycle. It can manage the uncertainty on tapering, inflation or rates by targeted statements without affecting long-term expectations – at least for now. In case of a major market turmoil, it would certainly make use of this. There are indeed no signs indicating the Fed might be tempted to put an end to the current cycle. It seems thus overly risky to bet on an early tapering, especially when monetary and fiscal policy seem to be having a tea party instead of playing a game of chicken over dominance. Despite a volatile episode in the coming months, we expect 10y US Treasuries not to exceed current yield levels at the end of the year. In the range around 1.6%, some air seems to go out of hot market segments without creating major disruptions which the Fed may not dislike. But with the cooperation of expansive fiscal policy and loose monetary policy, we will have to live with a stretched US curve prone to volatility.

The question is whether the financial cycle could be stalled this or next year and whether the cause will lay inside or outside the Fed's sphere of influence. A major risk from inside is a relapse to a mechanistic inflation targeting policy, including rapid rates hikes and early tapering. To gauge that risk, interventions of FOMC members must be watched closely. Currently we would consider this risk to be rather low. The risks from the outside could be related to a market accident (liquidity, default or fraud related), excessive regulatory tightening or strong taxation of profits and/or transactions. In the current high volatility environment, we see a market accident as the biggest source of risk.

Figure 14: Markets are testing the Fed on early tapering

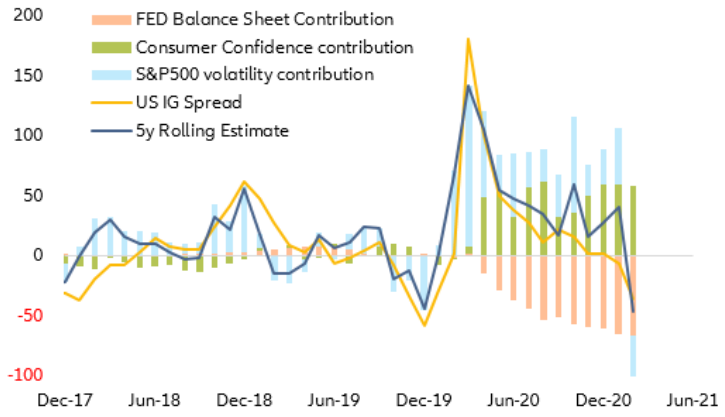


Sources: Refinitiv, Euler Hermes, Allianz Research

In the Eurozone, long-term market-based inflation expectations have recently converged towards our fair value estimate of 1.3%. We believe that 10y EUR inflation breakeven rates could still rise by around 20-30bps as the reflationary pressures are yet less present in the Eurozone. However, we believe that a significant pricing out of the QE effect (strong increase in term premium) is very unlikely. In fact, the risks here are currently more oriented in the other direction. Accordingly, we expect yields of the 10y German Bund to remain broadly unchanged over the year and only rise moderately in 2022. European risky assets could even find themselves in a favorable position, offering more upside potential than their US counterparts due to the delayed recovery.

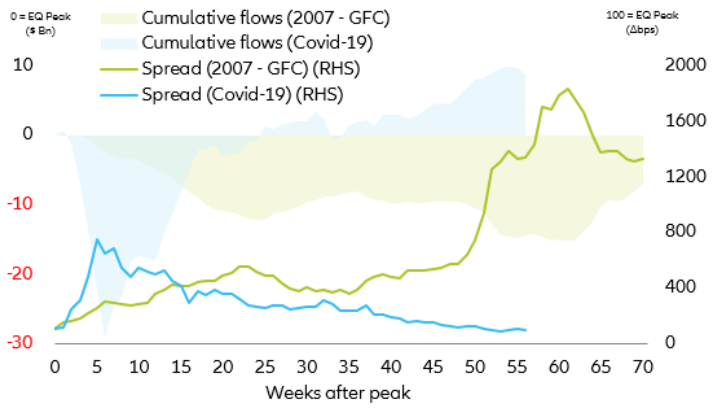
Corporate credit remains strongly dependent on monetary policy. Like their sovereign counterparts, corporate bond yields also remain under the control of central banks. In the near future, the balance of risk might be skewed towards higher spreads. However, central bank market intervention allows corporate spreads to navigate through pockets of equity volatility. We expect investment grade spreads to widen timidly in the US and Eurozone as QE compensates for extra volatility and sentiment deterioration (Figure 15). High-yield bonds, however, have been under pressure recently, experiencing substantial outflows and widening spreads. The Covid-19 exposed sectors (eg. energy and travel & leisure) seem to have been the most targeted. (Figure 16). For the moment, this is a correction after a strong rally, but the US high-yield sector in particular remains a fragile spot, especially given the large refinancing needs in the course of 2022.

Figure 15: US y/y change in IG corporate spreads decomposition (in bps)



Sources: Bofo, Refinitiv, Euler Hermes, Allianz Research

Figure 16: US high-yield long-term fund flows



Sources: Bofo, ICI, Refinitiv, Euler Hermes, Allianz Research

Equity returns still a function of money supply.

Equity returns also remain strongly related to monetary conditions. Our US equity model shows that the monetary component of equity returns remains the biggest contributor. Since the beginning of 2021, the inflation component has been gaining some traction, but the composition of equity return still shows that central banks cannot withdraw monetary support without creating a strong equity market correction that would spill over into credit markets and deteriorate the financing conditions for the whole economy (Figure 17). In this context, we expect equity markets to close the year with timid single digit returns but to accelerate in 2022 on the back of a palpable economic recovery and still accommodative monetary policy.

What is happening with the USD?

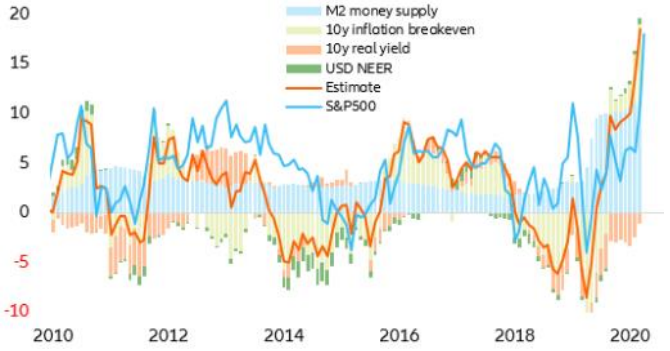
The USD is on appreciation trend vs the EUR on the back of faster-than-expected US economic growth and an acceleration of foreign investment inflows int. But is this USD strengthening trend here to stay? Speculative positioning is now USD long. But the market-implied interest rate differential has yet to confirm the USD appreciation. Currently money markets still price in a flat interest rate differential until 2024. The current trend direction could well turn out temporary. As fundamentals do not give much leeway for a quick repricing of monetary policy, we still believe in a range trading EURUSD for 2021 (1.22 with upside volatility pockets) with a mild structural (+2 to +3% yearly) appreciation of the USD in 2022.

What about Emerging Markets?

After a great divergence between Asia and other regions last year, some convergence among EMs could be expected. However, in the first quarter of the year two key markets - Turkey and Brazil - are experiencing high volatility due to political turbulence.

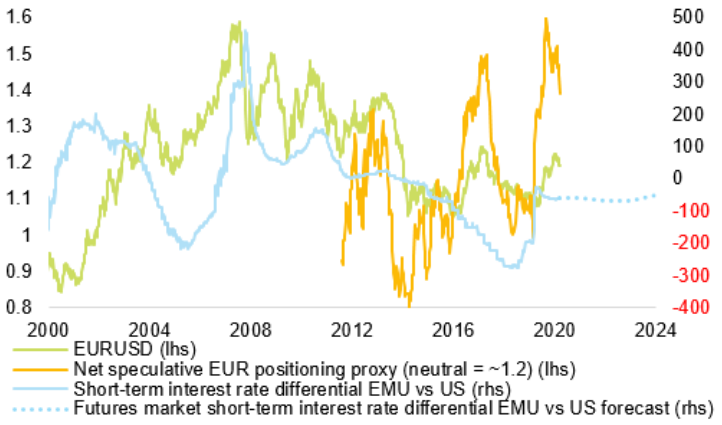
In line with recent yield movements in the US, yields on local currency sovereign bonds have been rising, especially for longer maturities. However, we do not think that this is a repeat of the 2013 tantrum. Growth forecasts are well oriented and yield changes are contained so far. What remains the same is that in EMs the Fed still largely determines the financial cycle. So if a bumpy 2021 unfolds on US and European markets, EMs might see quite some agitation also, especially since more than USD1trn of debt will have to be rolled over in 2021 and 2022.

Figure 17: US equities yearly return decomposition (in y/y%)



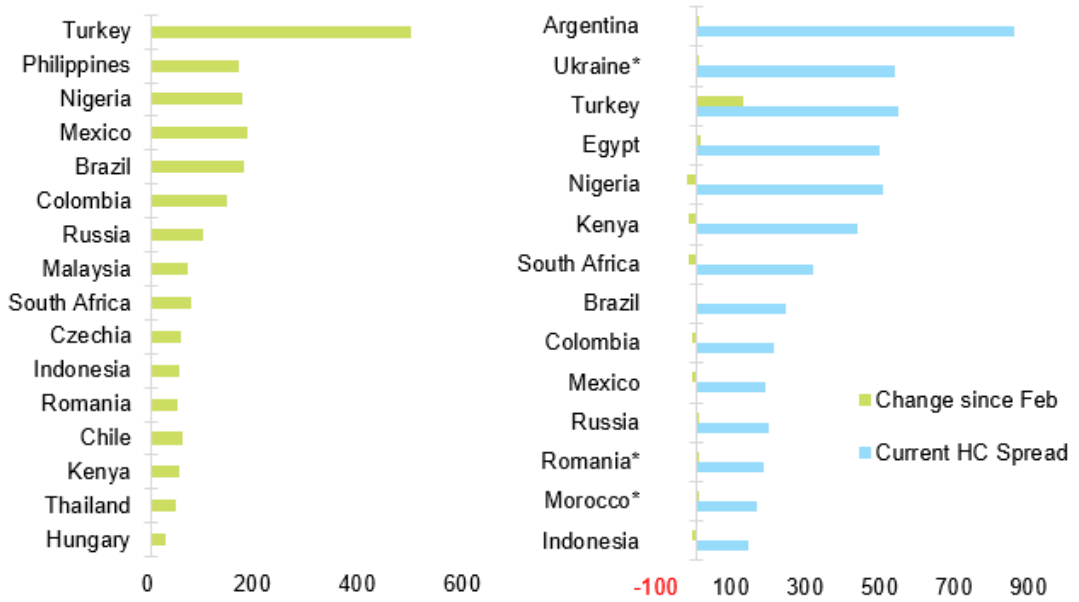
Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 18: EURUSD and the interest rate differential



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 19: Movements in EM yields. Bps change in the 10Y local currency bond since 01.02.2021 (LHS). Spreads in the HC sovereign bonds (RHS)

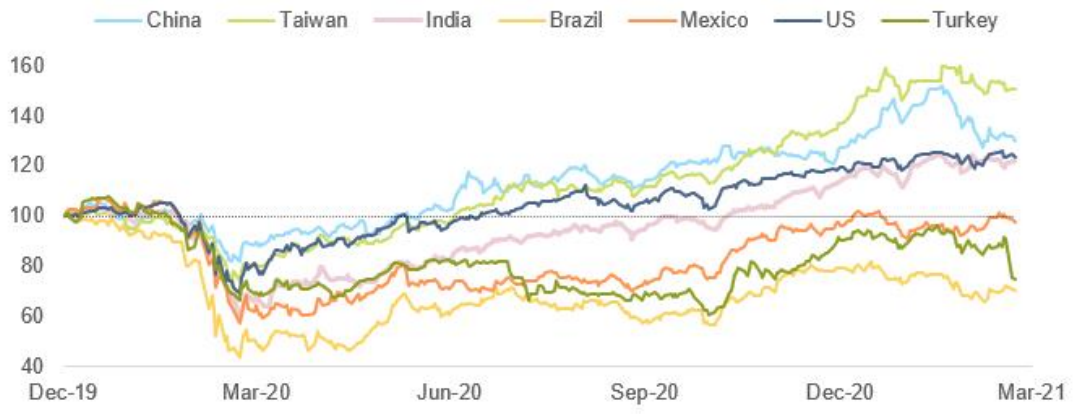


*Sources: Refinitiv Datastream, BofA, Allianz Research. Only the biggest increases (LHS), and widest spreads (RHS) are displayed. In the RHS, the * indicates the Hard Currency is the EUR, otherwise USD. The spread in the RHS accounts for Asset Swap Spread.*

USD vs EM currencies. The USD has strengthened against most EM currencies recently. Some Asian currencies such the Thailand Baht or the Indonesian Rupiah still have room for further depreciation, while others already corrected strongly in 2020 and could recover some ground lost. However, idiosyncratic risks will remain high in the latter, making this recovery fragile and unstable. Like in the US, inflation expectations are also on the rise in EMs. The usual suspects Turkey and Brazil are leading this trend. But there have been also some other movements in Eastern Europe and Asia. We think that in the current context slightly higher inflation will not harm and could even support the recovery, but a cocktail of stimuli and unconventional monetary policies could trigger a dangerous spiral if the economic recovery disappoints.

Asian equities, the rally continues? Since the return from Chinese New Year holidays and the release of official economic targets, Chinese equities have been correcting by more than 10%. We now see signs of stabilization. Those signs are also observed in Taiwanese equities, which have been the clear winners of the equity rally in the EMs so far. However, as the sector composition is quite different, sector rotation in an economic recovery could play in favor of the Chinese equity market instead of the heavily tech-concentrated Taiwanese market.

Figure 20: Evolution of MSCI$ indexes since 31.12.2019 (rebased). Selected EM + US



Sources: Refinitiv, Euler Hermes, Allianz Research

REGIONAL OUTLOOKS

In the US, President Biden's stimulus packages are set to create a strong confidence effect on domestic demand. In January 2021, the household savings rate reached 20.5% of gross disposable income. The success of the vaccination campaign and the strength of the US fiscal stimulus, as well as a healthy progression of housing prices, will boost consumer confidence, which for now remains below pre-crisis levels. On the back of this confidence effect, accompanying steady progress on the job front, we expect excess savings to be unleashed, generating a strong impetus for consumption. All in all, we expect household consumption to grow by +5.5% y/y in 2021 and +4.1% y/y in 2022 against –3.9% y/y in 2020.

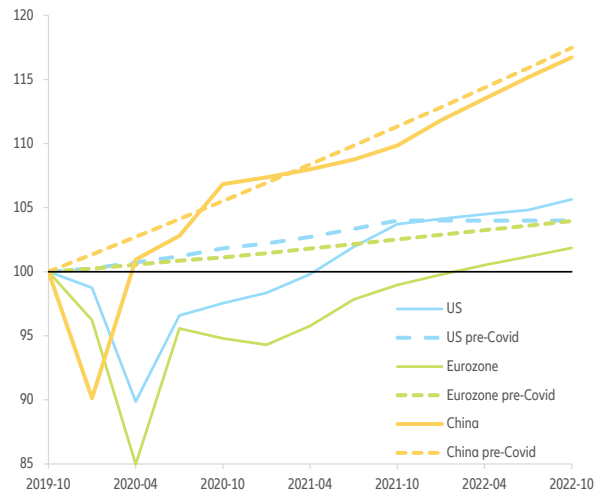
Fiscal policy will turbo-charge growth. On top of the recently announced USD1.9trn fiscal package, the US government wants to add another round of stimulus with a USD2.3trn infrastructure program to renovate roads and bridges and develop new types of digital infrastructure, while continuing to invest in health and education to reduce inequalities. The first leg of this infrastructure program would be funded via an increase of the corporate tax rate from 21% to 28%. The second social leg of this program would have to be financed via higher capital gains taxes and higher tax rates on wealthy households. There is a good chance that this will face political opposition, including from moderate Democrats. Given the fact that the government will have to compromise, we consider a USD2.3trn infrastructure plan has a higher chance of being passed. Should the second leg of the plan be voted, it has the potential to boost growth significantly above +6% y/y in 2021 and +4% y/y in 2022 compared to the +5.3% y/y and +3.8% y/y we expect in our current scenario.

Positive externalities for US trade partners. The stimulus will also boost business confidence, supporting non-residential investment. This increase in domestic demand will not be fully absorbed by US producers. We expect the US trade deficit to widen to -4.5% of GDP on average over 2021-2022, compared with -2.9% on average over the past five years. More precisely, we estimate that a +1% increase in domestic demand leads to a +2.6% rise in imports in the US. *The wage–inflation loop will not be re-activated as the doubling of the federal minimum wage was not voted in the Congress*. We calculated that this initiative had the potential to install CPI inflation durably above 4% y/y. The government will give the priority to fiscal incentives targeting small- and medium-sized companies in particular in order to encourage the business sector to envisage a revaluation of salaries. Increasing salaries in a too rapid manner would have been a too large burden for the supply side of the US economy, especially if the government targeted tax increases to fund its announced infrastructure program. In the current circumstances, we expect the US CPI inflation to reach 2.5% y/y in 2021, 2% y/y in 2022 and 2.1% y/y in 2023.

The Fed in a wait-and-see mode does not mean an absence of volatility. Taking into account the new fiscal impulses of the US government, uur estimate of the Fed's reaction function suggests that a phase of monetary policy normalization could take place much earlier. However, despite this mechanical reaction suggested by the model and a rapid disappearing of an output gap at -3.6% of potential GDP in Q4 2020, we continue to believe that a first tapering phase will only be visible starting in H2 2022. The current proximity between the Fed Funds target rate and the natural rate of interest (point below which the monetary policy exerts significant inflationary pressures on the economy) shows that the Fed, in line with the recent communication stance of Chairman Powell, has some time before really envisaging a tightening in US monetary policy. We don't expect a rate hike before H2 2023.

Europe remains the eternal recovery laggard compared to other economic heavyweights. In 2021, we expect the European economy to race at a rapid pace through the entire economic cycle, from a double-dip recession at the start of the year to a consumption-led catch-up growth spurt in the second half of the year. The third wave of Covid-19 infections, which saw several Eurozone heavyweights including Germany, France and Italy prolong and/or retighten lockdown measures, will postpone the expected economic resurrection until mid-Q2, when progress on the vaccination front should allow for a gradual, and most importantly sustainable, economic reopening. Thankfully, strong export demand – driven by the ongoing Chinese recovery and supercharged, stimulus-induced US GDP growth – will extend a helping hand to European economies in 2021, in turn exacerbating the divergence between manufacturing and services. But it cannot fully compensate for the delayed reopening as 20% of economic activity remains heavily impacted by Covid-19 restrictions. From mid-2021 onwards, all eyes will be on the strength of the consumption-led reopening rebound following an extended period of economic hibernation. We expect pent-up demand to supercharge growth in 2021, with around one third of the EUR530bn in excess household savings to be unleashed. At the same time, policymakers will continue to do "whatever it takes" to safeguard the recovery and shore up public support ahead of key elections in Germany (September 2021) and France (April 2022). Flagship fiscal measures including furlough schemes (which will see the unemployment rate peak below 9%) and public guarantees will be extended at least until fall 2021, whereas the ECB will continue to lean against rising yields by front-loading PEPP purchases to ensure favorable financing conditions during the early phase of the recovery. Nevertheless, in comparison to other economic heavyweights, Europe's recovery looks set to disappoint, with key drivers being its delayed vaccine rollout and its smaller and more drawn-out fiscal response. Even though base effects should prove favorable for Europe, given that it recorded a larger GDP contraction in 2020 than the US, growth prospects for 2021 are notably lower. We expect Eurozone GDP to expand by +4.0% in both 2021 and 2022, while acknowledging elevated downside risks for H1 2020 should the lockdowns be tightened further and/or be prolonged and for thereafter should the vaccination rollout fall behind our expectations. Overall, we expect the Eurozone economy to recover to pre-crisis GDP levels in H1 2022, almost a full year after the US, whereas some member states, including Spain and Italy, will need an additional year to heal.

Figure 21: Real GDP, Q4 2019 = 100, pre and post Covid-19



Sources: National sources, Euler Hermes, Allianz Research

Figure 22: Global GDP growth, %, for 2021 and 2022

	2019	2020	2021	2022
World GDP growth	**2.4**	**-3.6**	**5.1**	**4.0**
United States	2.2	-3.5	5.3	3.8
Latin America	**0.2**	**-7.1**	**3.9**	**2.9**
Brazil	1.4	-4.4	2.8	2.3
United Kingdom	1.4	-9.9	3.7	5.9
Eurozone members	**1.3**	**-6.6**	**4.0**	**4.0**
Germany	0.6	-5.3	3.4	3.8
France	1.5	-8.2	5.4	3.6
Italy	0.3	-8.9	4.1	4.0
Spain	2.0	-11.0	4.8	5.7
Russia	2.0	-3.1	2.5	3.0
Turkey	0.9	1.8	6.6	4.1
Asia-Pacific	**4.1**	**-1.1**	**6.6**	**4.7**
China	6.0	2.3	8.2	5.4
Japan	0.3	-4.9	2.8	1.9
India	4.1	-7.5	10.7	6.4
Middle East	**0.1**	**-5.2**	**2.8**	**2.2**
Saudi Arabia	0.3	-4.1	2.5	2.3
Africa	**1.7**	**-3.2**	**2.4**	**3.4**
South Africa	0.3	-7.1	1.9	2.1

** Weights in global GDP at market price*
NB: fiscal year for India

Sources: Various, Euler Hermes, Allianz Research

Germany's GDP will expand by +3.4% in 2021 and +3.8% in 2022 as external tailwinds make up for the delayed recovery in domestic demand, allowing for a return to pre-crisis GDP levels by early 2022. With Germany moving into its third lockdown just ahead of Easter, its domestic economic resurrection will face another delay until mid-Q2 2021. However, strong extra-EU export demand should once again help Europe's largest economy weather this renewed setback for private consumption better than its European peers. After all, supercharged, fiscal stimulus-induced US import demand, together with resilient appetite from China – German exports to both countries tally up to a combined 15% – should provide a further tailwind to already booming industrial production, in turn exacerbating the divergence between buoyant industry and depressed services. In the short-run, supply-chain strains including long delivery times and input shortages could weigh on activity but we don't expect widespread production disruptions to derail the manufacturing upswing.

Meanwhile, private consumption meanwhile is ready for take-off as soon as late -Q2 when sufficient progress on the vaccination front will allow for a gradual easing of Covid-19 restrictions. Services activity should further shift into overdrive in H2 2021 as excess savings to the tune of at least 1% of GDP are unleashed till year-end, helped by the relatively solid labor market outlook (unemployment rate forecast at 5.5% in 2022 after 6% in 2020).

Fiscal policy will remain very supportive in 2021 and unspent funds earmarked for 2020 (around 3% of GDP) pose an upside risk to fiscal stimulus. The sharp acceleration in consumer prices towards 3% y/y in H2 2021, due to the marked pick-up in growth momentum, rising energy prices and strong base effects from the H2 2020 VAT reduction should prove to be temporary and any calls for monetary policy tightening at that stage would be clearly premature. The unusually uncertain September election outcome will set the course for fiscal policy in the coming years. The still most likely scenario of a CDU-Green party coalition will probably see higher investment and social spending in the coming years to support the green and digital transition, with a return to the debt brake not before 2023.

We expect the French economy to grow by +5.4% in 2021 and by +3.6% in 2022, thanks to recovering demand (both domestic and external). A return to a nation -wide confinement, with school closures for four weeks in April, is expected to reduce growth by -1.5pp in Q2. On the other hand, the speeding up of the vaccination pace (with herd immunity to be reached in June instead of in October) will enable a stronger economic rebound in July and August. Strong state support (EUR30bn has been spent for the partial unemployment scheme) helped preserve household incomes and build excess savings to around EUR130bn. After a slight increase (+0.6%) in 2020, we expect households' purchasing power to decline only marginally (by -0.6%) in 2021 on the back of accelerating inflation (1%). Pent-up demand after the easing of sanitary restrictions will boost consumption in the second half of 2021. If 50% of it consumed, excess savings accumulated could add up 3pp to GDP growth this year. The government will most probably extend the partial unemployment scheme for Covid-sensitive sectors as hidden unemployment and under-employment may become an important issue ahead of the Presidential elections in 2022.

The recovery of corporate investment proved to be resilient in France as of the second half of 2020. The need to adapt to the Covid-19 environment, the liquidity support from state -guaranteed loans and the normalization of demand will continue to support the new investment cycle in 2021. Covid-19 state support measures to non-financial companies (Empowered Solidarity Fund, state-guaranteed loans, social contribution and tax deferrals/cancellations) continue to support businesses' cash positions. We expect business margins to recover moderately to 31.1% in 2021 (after a sharp decline of 3.8% in 2020) on the back of recovering demand and the easing of sanitary restrictions (i.e. higher productivity).
We have revised our international trade forecast upwards. In 2021, we expect exports to grow by +9.4% in 2021, which will translate into a positive net trade contribution to GDP growth of 0.3pp. The Biden stimulus plan will give a significant boost (9 bn EUR) to exports in pharmaceuticals, transport equipment and agrifood in 2021 and 2022.
France's corporate debt overhang will certainly become a long-lasting issue. Already high, French corporate debt soared to 86% of GDP (+12pt) in Q3 2020, well above the Eurozone average of 68% of GDP (+6pt). The repayment of state-guaranteed loans will start as of March 2022 but these loans are only a small part of the indebtedness problem. In order to sustain the new investment cycle and the solidity of the banking sector, the French government ought to provide a comprehensive roadmap. Consolidating all corporate debt (regular loans + state-guaranteed loans + unpaid tax and social contributions) under a single umbrella and restructuring it over a longer period could be a viable solution.

Itay's GDP contracted by -1.9% q/q in Q4 2020, driven primarily by lower private consumption and a reversal in net trade. However, manufacturing still runs at full speed, driven by the production of intermediate goods, confirming Italy good position in global value chains. Industrial production stands at only 2.4% below the level one year before. Services and retail continue to bear most of the recessive effects of the restrictions. This divergence is going to intensify as Italy entered a third lockdown in mid-March. The speed of the 2021 economic recovery will therefore be even more dependent on the pace of vaccinations. Italy is in the European average here (11% of population vaccinated). In this context, we expect another GDP contraction of -0.6% in Q1 2021. However, with the recovery picking up speed in mid-Q2, Italy's GDP should still grow by +4.1% this year and +4.2% next year. Private consumption will be the main driver of this recovery as the short-term work scheme and the redundancy ban continue to stabilize employment and disposable income. The priority for the Draghi government is the completion and implementation of the Italian recovery plan. The current draft includes expenses of EUR310bn over six years (EUR210bn comes from the EU recovery fund), of which 70% should be allocated to investments.

If invested wisely, it has the capacity to lift potential output by up to 8% over the next 10 years. This would also make public debt more sustainable (topping close to 160% of GDP). The main levers for achieving this remain structural reform in institutions (juridical system, red tape) and increasing the participation rate, especially among women.

In Spain, four in 10 companies ended 2020 subjected to great financial pressure, as measured by the Bank of Spain, a +27pp increase compared to 2019. Despite the new EUR11bn plan to bolster solvency, the risk of high insolvencies this year and in 2022 remains elevated. Renewed targeted sanitary restrictions and a fall in mobility could lead to a renewed GDP contraction in Q1 2021, delaying the recovery. On the other hand, a slow vaccination rollout should allow Spain to only gradually remove restrictions in Q2. We thus expect a stronger recovery in the second half of the year, with real GDP growing +4.8% this year after falling -11% last year, followed by growth of +5.7% in 2022. We expect the unemployment rate to peak at 16.5% this year before gradually decreasing but remaining at an elevated level (15.2% in 2022). The government's stimulus should focus on public investment, which could lead to a higher fiscal multiplier. In 2021, the government is looking at EUR25bn of measures, mostly in public infrastructure investment (green and innovation). However, the previous take-up of EU funds is low (34%) in Spain and public sector effectiveness also relatively low (lower than France, Portugal but higher than Italy): this means Spain risks missing out the full potential of the EU-led recovery.

In the UK, the fast vaccination campaign is counterbalancing negative effects from Brexit: We have revised on the upside our GDP growth forecast for the UK from +2.5% to +3.7% in 2021. This is driven by the additional fiscal spending announced within the 2021 budget (3.2% of GDP), which will provide a tailwind of up to +1.1pp to real GDP growth in 2021. Support measures have been prolonged to three months beyond the date of all restrictions being lifted (until end-September) and should continue to protect companies' excess cash (GBP101.4bn at the end of January, or 4.5% of GDP). The hyper-amortization scheme at 130% coupled with excess cash and the state-guaranteed recovery loan scheme should help business investment recover fast in 2021 (we expect +12.5% vs. the +17.2% needed to catch up with the fall in the capacity utilization rate). In addition, positive confidence effects linked to the vaccination campaign (herd immunity expected in May) and to the reopening of the services sector should feed into a strong depletion of excess savings from households (1.9% of GDP).

On the other hand, Brexit is expected to cost growth around 1pp to 2pp in 2021. In January, UK exports of goods fell by more than GBP5.6bn and we expect between GBP12bn and GPB24bn of losses in 2021 depending on how long-lasting the disruption at the border will be. Additional downside risks to the scenario are linked to potential tariff increases from the EU side as a retaliation to the UK's unilateral decision to extend the transition period for full border checks in Northern Ireland. Finally, negotiations have started on the equivalence for financial services, on which both the EU and the UK maintain a hard stance.

In China, the post-Covid-19 recovery is well underway, and 2021 will focus on policy normalization. The 2020 rebound was mostly a story of policy-driven areas such as the real estate and infrastructure sectors. In 2021, household consumption and business investment could become the growth drivers. The external environment will continue to be supportive as many of China's trading partners are still battling the pandemic and their policies are in full easing mode. We expect the Chinese economy to grow by +8.2% in 2021 (after +2.3% in 2020) and +5.4% in 2022. Should China's quarterly GDP in 2021 be unchanged from Q4 2020, growth in 2021 overall would still land at the relatively high level of +6.2%. This means that the official target of "above 6%" will be very easy to achieve, allowing policymakers' focus to shift away from short-term stimulus to financial vulnerabilities and asset price bubbles (in real estate and capital markets). We don't expect a policy cliff and normalization should be done in a flexible and gradual manner. On the fiscal side, we estimate that after 7.1% of GDP in 2020, support will decline to 4.6% of GDP in 2021, with less infrastructure spending. But this remains relatively generous compared to the past (2.9% on average in 2018-2019). On the monetary side, the policy stance already started to tighten in Q4 2020, and this should continue in 2021 through liquidity and regulation (see more details here). In this context, there is room for further appreciation of the renminbi, although most of it may already be past. We expect the USDCNY onshore rate towards 6.3 at the end of 2021 (vs. 6.5 at end-2020 and 7.0 at end-2019).

In Asia-Pacific as a whole, we expect GDP to expand by +6.6% in 2021 (after -1.1% in 2020) and +4.7% in 2022. These solid rates of growth mask uneven recovery speeds, given different states of the pandemic, external exposure and policy reactions. While the pandemic is overall under better control in Asia-Pacific than in other regions, India and the Philippines are showing signs of renewed outbreaks. Vaccination is lagging (except in Singapore), with some economies not in a sanitary urgency (eg. Taiwan, China, Vietnam, Australia etc.), while others more in need face supply and distribution issues (eg. Indonesia, Malaysia, the Philippines and India to a lesser extent). Policy space for further economic support is also more limited in some of these latter countries, given debt sustainability concerns and inflation pressures. Externally, the environment will drive growth for economies exposed to the early recovery of China, the electronics value chain and the US super stimulus (in particular for Taiwan, Vietnam, South Korea and Singapore), while the Philippines and Thailand's strong exposure to tourism will weigh on their economic recovery. The Regional Comprehensive Economic Partnership should further foster regional trade integration after it enters into force likely in 2022. Overall, upward revisions to the 2021 economic outlook in the Asia-Pacific region are mostly led by Singapore, Vietnam and Taiwan, while Malaysia, Thailand and the Philippines were revised on the downside.

Emerging Markets (EMs) are heading for a multi-speed recovery amid vaccination hurdles as well as diverging space for fiscal stimulus to boost growth. The UAE, Chile and Bahrain are top performers in the vaccination rollout, with 26%-76% of the populations having received at least one dose. However, vaccination rollout is progressing very slowly in most EMs, including Brazil, Mexico, Colombia, Peru, Saudi Arabia, most Central European countries, Indonesia, Malaysia the Philippines and a large part of the African continent. Less developed and poor countries relying on the COVAX initiative for vaccine supply are very unlikely to reach her immunity this year.

Besides the speed of vaccine roll out, fiscal leeway for stimulus is another key determinant of EM growth prospects in 2021-2022. We expect a K-shaped recovery in EMs as larger countries in Emerging Asia and Central Europe as well as Turkey manage to provide relatively strong fiscal support to their economies, while there is more limited fiscal space in Argentina, Brazil, Russia, the GCC and most African countries struggling with debt. On the positive side, the recovery of commodity prices and sustained Chinese demand should be a tailwind for exporters such as Nigeria, Algeria, Angola, Chile, Peru and Brazil in 2021. Economies that are dependent on trade in goods (particularly electronics/ technology goods) or have strong trade links to China are set to continue to perform better (e.g. South Korea, Taiwan, Vietnam).

However, the return of inflation, after a few quiet years, is bad news for the post-Covid economic recovery. In Latin America, Brazil is most at risk of high inflation, with high input price pressures due to supply-chain disruptions and the currency depreciation now passing through to consumer prices. Turkey has exceeded the central bank inflation target for many years and the Philippines has done so since the beginning of 2021. Inflation already returned to Africa in 2020: Angola, Ethiopia, Nigeria and Zambia are struggling with double-digit inflation on the back of strong currency depreciations in 2020 and food shortages due to adverse climate events.

The Covid-19 shock has also accelerated the ongoing debt accumulation trend in EMs. The time bomb of record-high public debt is ticking ahead of substantial debt refinancing needs in 2022-2023. Overall external financing requirements are very high for Turkey, Romania, Hong Kong, Pakistan, Argentina and Chile, while debt sustainability is at risk in Brazil, Argentina, India, Malaysia, Angola, Tunisia and Ethiopia.

After a tumultuous 2020, currency pressures eased in early 2021, except for Argentina, Brazil and Turkey. Although current account balances are in better shape than in 2013, a repeat of the taper tantrum in the event of the eventual tightening of US monetary policy cannot be excluded for EMs. Turkey, Nigeria, Ukraine, Argentina, Kenya, South Africa and Chile are currently the weakest spots in this context, owing to still relatively large current account deficits, moderate to low FX reserves, elevated inflation rates as well as currency volatility and high sovereign bond spreads. Looking ahead, EMs over-relying on short-term foreign financing and having poor growth prospects (i.e. large real interest rate-economic growth differentials) will be more vulnerable to the changing appetite of global investors.

Finally, rising unemployment is a key area of concern that could feed political and social tensions. Official unemployment rates rose to record high levels in most EMs (South Africa 30.8%, India 10.6%, the Philippines 10.3%, Indonesia 7.9%, Colombia 17.3%, Brazil 13.8%, Chile 10.2%) yet these numbers are only the tip of the "hidden unemployment" iceberg.

In the Emerging Europe region as a whole, annual real GDP growth is forecast to recover to +3.7% in 2021 (from -2.7% in 2020), followed by +3.4% in 2022. Third waves of Covid-19 infections are underway, especially in Central Europe, and lockdown measures have been raised to relatively stringent levels in the major economies towards the end of Q1 2021, except for Russia. Since the progress on vaccination is slow, we expect the lockdown measures to be relaxed only gradually in the course of Q2, pushing the recovery of Covid-19-sensitive services sectors to H2 2021. Accordingly, consumer sentiment has remained subdued. However, the outlook for the industrial sector is fairly positive as reflected in solid growth rates and manufacturing PMIs. Occasional supply-chain disruptions will make the recovery bumpy but not affect the full-year performance. Meanwhile, accommodative monetary and fiscal policy will continue to support most economies over the next two years or so. Ukraine and Russia, however, have already began a monetary tightening cycle as inflation exceeded central bank targets but we expect policies to remain credible.

The same cannot be said for Turkey, which fired its central bank governor in March after six months of appropriate interest rate hikes that had calmed financial markets. Turkey will most likely revert to its known unorthodox monetary policy style, which could maneuver the economy once again close to the next currency crisis. We also identify Hungary, Romania, and to a lesser extent Poland and Czechia, as facing increased inflationary pressures in the next two years, though rising unemployment should moderate wage growth and mitigate these pressures in 2021 at least. Fiscal policy leeway is diverse amid rising public debt levels. Czechia and Poland are stimulating their economies the most, while elevated public debt in Croatia, Hungary, Romania and Ukraine require close monitoring.

In Latin America, external tailwinds (exports, remittances) will support the recovery but domestic headwinds (limited fiscal space, high unemployment, social and political risk) will prevail and put a lid on it. We therefore expect a partial recovery in 2021 (+3.9% GDP growth after -6.8% contraction in 2021), extended into 2022 (+2.9%). Shocks were uneven in the region, and now recoveries will diverge. While Brazil is walking a fiscal tightrope and struggles to advance its reform agenda, exports of commodities could help, along with a moderate pandemic stimulus check. The country benefits from external buffers against financial crises. However, pandemic mismanagement, a slow start of the vaccination rollout, inflation pressures and political and social risk put the recovery at risk and should create some stress on the currency, raising borrowing costs for companies and leading to double-digit insolvency growth: we expect +2.8% growth in 2021, +2.3% in 2022 after a -4.4% contraction in 2020. In Mexico, increased exports over the next two years (USD+45bn) due to the US super-stimulus could boost growth by +1.5pp in 2021 (to 4% in 2021) and +0.5pp in 2022 (to 3%). However, a deteriorating business environment, erratic policymaking, slow vaccination rollout and a reluctance to stimulate the economy with fiscal spending mean the domestic economy will continue to struggle. Peru, Uruguay and Chile should reach pre-crisis levels the fastest. In Chile, the impressive vaccination campaign will make it the best performer but the busy political calendar still poses risks to the outlook. In Colombia, we expect a solid recovery, but unemployment is at a record high (17.3%), raising social risk and putting a lid on consumption, in addition to fiscal pressure. Argentina's consumer remains squeezed between high inflation and sanitary restrictions. While we expect the government to strike a new deal with the IMF, companies and consumers will suffer from continuous currency FX depreciation and the recovery will be the slowest in the region.

The Middle East region as a whole is forecast to experience a sluggish recovery of real GDP growth by +2.7%, after the sharp contraction by -5.4% in 2020, followed by +2.2% in 2022. Second or third waves of Covid-19 infections are underway in many countries in the region, though not in Saudi Arabia, but lockdown measures are moderately stringent, especially in the GCC member states. They are more stringent in Israel still but are set to be relaxed rapidly in Q2 as the country's swift vaccination progress should soon ensure herd immunity and an above-average pace of recovery. In the GCC economies, however, low oil prices since 2015 (as compared to the 2011-2014 boom period) have dramatically worsened the public and external debt positions and will, combined with ongoing output cuts agreed by OPEC+, continue to constrain fiscal stimulus and limit annual growth to +2.5% in 2021-2022. Currency pegs to the USD will limit the leeway for monetary policy, which usually follows the US Fed. It will thus remain accommodative for now but some tightening is expected from 2022 onwards. Subdued demand will keep the GCC in deflationary territory, except for Saudi Arabia where the VAT increase to 15% will keep inflation at 5-6% until mid-2021. Meanwhile, still large FX assets, including SWFs, held by Saudi Arabia, the UAE, Qatar and Kuwait provide a buffer against potential external financing disruptions for at least five more years, but Bahrain and Oman are the weak spots in the region and depend on the support and strength of their neighbors in order to avoid a default.

In Africa, the second wave of the pandemic has been very severe as of end 2020. Vaccination progress on the continent is very slow as most governments are relying on the COVAX facility for vaccine supply, enabling only 20% of the population to be vaccinated so far. We expect GDP to rebound by +2.4% in 2021 and +3.4% in 2022. The recovery will be driven by the resumption of tourism activity, the increase in commodity prices and sustained domestic demand after the rollback of sanitary restrictions. More diversified African economies such as Kenya, Senegal, Egypt and Ghana proved to be more resilient to the crisis and will to rebound faster going ahead.
The Covid-19 economic shock has eroded two decades of progress in poverty reduction in Africa. It has also accelerated the mounting public debt trend by increasing debt to GDP ratios by 10-15pp in some countries. While most governments have barely any leeway for stimulus spending to reignite growth, disorderly defaults and long-lasting debt resolution processes may hamper the post-Covid recovery. Addressing looming debt distress, implementing bold governance reforms and improving domestic resource mobilization should be on policy agendas to avoid a "lost decade" in Africa.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