

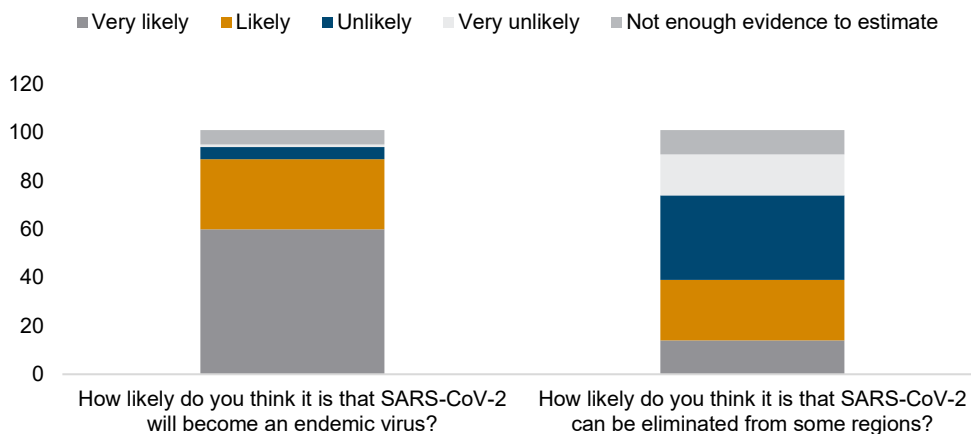
1. Global overview: Divergence, with Europe lagging behind

BY RICHARD GRIEVESON

1.1. PUBLIC HEALTH BACKDROP: HOW DO PANDEMICS END?

We will probably never reach zero COVID, but it will gradually become just another virus (Gross, 2021). In a survey of specialists conducted by the journal *Nature*, almost 90% of respondents said that they expected the virus to become endemic (Figure 1.1). The four coronaviruses that already exist, along with influenza, are all endemic and kill people every year.¹ However, acquired immunity and vaccines have brought the number of deaths down to a level that societies can tolerate (seasonal flu is estimated to kill 650,000 people per year). That is the most likely future for COVID-19 as well. It is highly unlikely that the pandemic will have a single end point; rather it will peter out differently, depending on age groups and regions of the world, and its ending will be a political and social decision, rather than a medical observation. A pandemic or epidemic ends when it becomes an 'accepted, manageable part of normal life in a given society' (Charters and Heitman, 2021).²

Figure 1.1 / Survey of scientists on the future of SARS-CoV-2, %



Note: Survey of 119 immunologists, infectious disease researchers and virologists from 23 countries.

Source: Nature survey.

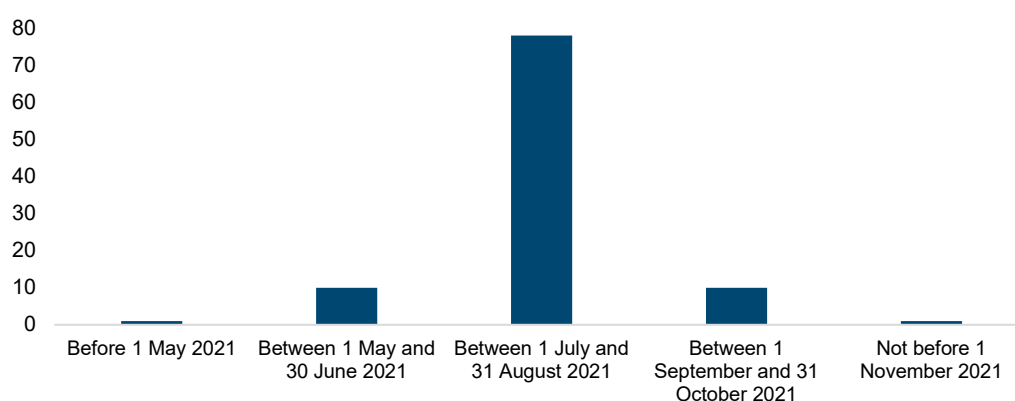
¹ These are OC43, 229E, NL63 and HKU1. It is likely that at least three of these have been circulating among human populations for centuries. Children typically get these viruses before they are six, with mild symptoms. They do not then build up a life-long immunity, but re-encountering these coronaviruses in adulthood tends also to produce mild symptoms. It is too early to say if COVID-19 will behave in the same way. Studies suggest that for those who have had it, levels of neutralising antibodies start to decline after 6-8 months. However, cases of reinfection are so far rare. This apparent waning immunity would make the virus more likely to become endemic.

² The Spanish flu was a pandemic from 1918-1920, but outbreaks continued until 1922 (historians disagree on whether that pandemic ended because the population reached herd immunity or because the virus mutated into a less deadly variant).

The key to returning to (something like) normal life as quickly as possible is vaccination, and here the signs are promising for 2021 – at least in the developed world. Studies from countries with advanced vaccination programmes, such as Israel and the UK, suggest that vaccinations dramatically reduce the number of people who get seriously ill from the virus (Reuters, 2021; *British Medical Journal*, 2021). One model produced by Imperial College London showed that vaccines with 90% effectiveness need to reach 55% of the population in order to achieve at least temporary herd immunity, so long as certain measures (wearing masks and working from home, for those who can) remain in place (Hogan et al., 2020). Although vaccine scepticism is widely reported in the media, a poll by Gallup showed that two thirds of people will take an available vaccine that has been deemed safe and effective (Gallup, 2021), while another survey in the US showed a similar two thirds for/one third against split (AP, 2021). It is reasonable to expect that, as vaccines continue to be rolled out, this number will rise (albeit missteps by both certain vaccine producers and politicians could continue to affect people's willingness to get vaccinated). That is a feasible scenario for much of the developed world by the summer; but clearly not for developing countries (or at any rate not for most of them).

Our best guess in terms of timing and severity is that – at least for the major global economies and the developed world in general – the worst is now over, even if a full return to normality will not happen this year. A ramping-up of vaccination efforts, plus better weather in the northern hemisphere, will allow a substantial easing of restrictions by late spring. In the developed world, a majority of the adult population may well have been vaccinated by the end of the summer. The Good Judgment Project attaches around a 90% probability that 75m doses will have been administered in Germany by the end of August (Figure 1.2). The EU did not tackle the initial phase of the vaccine roll-out well, but it now seems to be getting its act together. Mass vaccination alone does not mean normal life, but it does promise something much closer to normal life than we currently have. It should, for example, mean a better tourism season than last year. However, in much of the developing world, vaccination programmes have barely started. Travel restrictions between rich and poor countries may last for some time.

Figure 1.2 / When will Germany report that 75m cumulative vaccine doses for COVID-19 have been given?



Source: Good Judgment Project, accessed 19 March 2021.

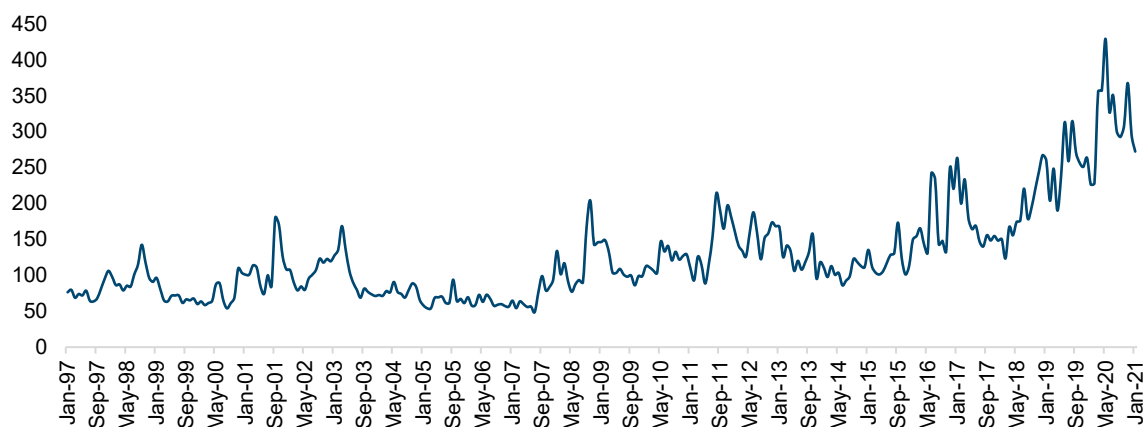
There are risks to this outlook in both directions, but it is human nature to focus more on the downside. It is very unlikely that the current mutations will be the last (Osterholm and Olshaker, 2021). Each new strain may be more easily transmissible and more deadly than the last, and may be resistant to existing vaccines. We may never reach herd immunity, meaning that we will constantly need new vaccines that work against the latest mutation – a rather daunting process to repeat 1-2 times per year for the whole global population (Murray and Piot, 2021). One mathematical modelling exercise found that even very successful vaccination roll-outs will need to be accompanied by quite stringent restrictions on economic life (Moore et al., 2021).

Some of the doom-mongering seems to be overdone, though. Initial trials suggest that existing vaccines can protect people from serious disease, and even against 501Y.V2 (the ‘South African’ variant; Ledford, 2021). Despite the B.1.1.7 strain (the ‘British’ variant) being widespread in the UK, vaccination there has had a dramatic impact on the number of cases. The human immune system is also capable of adapting to new variants (Phillips, 2021). Moreover, the early signs are that the new variants have common features, which will make it easier for scientists working on updated vaccines to react to them (*Economist*, 2021). A combination of partial immunity (from either having had the virus or having been vaccinated) and a shot of an updated vaccine each year will make SARS-CoV-2 into another virus that we live with. We will also probably have to get used to living with masks for some time. Those who decline the vaccine will naturally face a much bigger risk to their health.

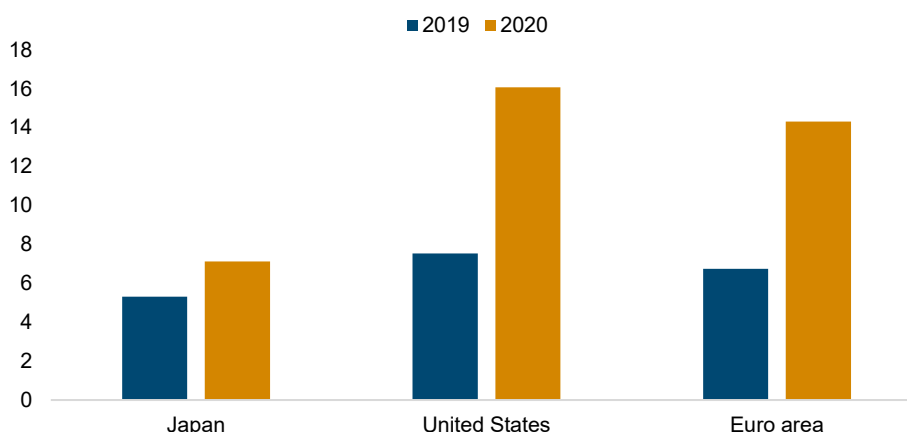
1.2. US/EURO AREA DIVERGENCE: GROWTH AND FISCAL POLICY

The worst of the public health crisis may be over by the middle of this year in the world’s major economies, but there is huge uncertainty about the shape and speed of the recovery. The pandemic has created unprecedented economic uncertainty, reflecting the range of possible outcomes and the extreme difficulty in attaching probabilistic estimates to each of them (Figure 1.3). Forecasters should all be especially humble in this environment. At the time of writing, it would seem that end-April or early-May is the most likely time for the major European economies to take the next step in reopening, with this date having been pushed back in many countries (including Germany, France and Italy) due to rising rates of infection in the early part of the year. All such projections, however, are hedged around with huge uncertainty.

The prospects for the global economy as a whole are fairly positive, reflecting in particular the performance of the US and China. Based on the assumptions outlined above regarding public health and the timing of reopening, the global economy is likely to grow quite strongly this year. The Organisation for Economic Co-operation and Development (OECD) expects the global economy to grow by 5.6% in 2021, a strong recovery after last year’s 3.4% downturn (OECD, 2021). The two big motors of the global economy – the US and China – both look to be in fairly robust health. According to the OECD, the US will grow by 6.5% and China by 7.8% in 2021, and the global economy overall will return to pre-pandemic levels by the middle of the year. Considering that the global economy has been hit by its biggest negative shock since the end of the Second World War, this is a very positive outlook. Household savings rates have risen markedly in many key global economies (Figure 1.4), which could unleash a tidal wave of spending as sentiment improves in 2021.

Figure 1.3 / Global Economic Policy Uncertainty Index

Source: Economic Policy Uncertainty; see also Davis (2016).

Figure 1.4 / Net saving rates of households and non-profit institutions serving households, %

Source: OECD.

Unfortunately, over much of the past 15 years the euro area has underperformed, and this is likely to continue during the forecast period – bad news for the countries of Central, Eastern and Southeastern Europe (CESEE). The OECD expects the single currency area to grow by 3.9% this year and by 3.8% in 2022. In contrast to the global and the US economy, the euro area will not get close to pre-crisis levels in 2021. This underperformance reflects a weaker and slower fiscal reaction and a disastrous start to the vaccine roll-out. The OECD has put total US fiscal support during the crisis at the equivalent of over 13% of GDP, while in the euro area the figure is around 7%. Although the fiscal reaction will come, and vaccination rates should pick up, it is unrealistic to wait for and expect the euro area to somehow perform like the US. However, while mobility in the euro area will certainly still be somewhat restricted during at least the second quarter, other factors will support growth, including spill-overs from the massive US fiscal stimulus and the uptick in world trade. Even as Europe's economy remains in a state of semi-lockdown, Germany's manufacturing Purchasing Managers' Index (PMI) is at one of its highest levels for decades. Moreover, people and businesses have adapted, and reduced

mobility is no longer having such a negative impact on GDP performance as during the first wave of the pandemic, in early 2020 (OECD, 2021).

1.3. US/EURO AREA DIVERGENCE: MONETARY POLICY

The very different fiscal and growth trajectories of the US and the euro area will also result in a continued divergence in monetary policy. In March, the US Federal Reserve said that it planned to keep rates on hold until 2024, and to continue buying USD 120bn of bonds per month to support the economy. However, given the size of the US fiscal stimulus and the expectation that the economy will grow by more than 6% this year, and with inflation currently above target, the bond market in particular has started to move. The yields on 10-year treasuries have regained their pre-pandemic levels, implying a tightening of monetary policy at the longer end of the curve. The market expects 'tapering' – a drawdown in the amount of bonds that the Fed buys each month – by the second half of the year.

The first important implication of developments in US interest rates is that pressure will increase on emerging markets reliant on dollar funding. All else being equal, as US rates rise, so emerging markets will also have to tighten policy, in order to continue to attract capital flows. Even if the Fed itself does not hike rates during the forecast period, tapering and market moves ahead of a rate hike will deliver effective tightening, at least at longer maturities. This matters, in particular, for Turkey, which is reliant on short-term dollar funding and has again recently changed the head of its central bank, causing further jitters on the market.

The second key implication of rising US rates is increased divergence from rates in the euro area, where weaker growth, a larger output gap and, consequently, a more dovish central bank will keep even longer-end rates much lower. While the market is betting on Fed tapering within months, the European Central Bank (ECB) announced in March that it is going in the opposite direction, increasing its monthly bond purchase to keep yields down. As a result, the euro has weakened recently, and we expect it to weaken further this year against the dollar. Growth and monetary policy divergence with the US will keep the euro weaker than it has been recently against the dollar throughout our forecast period.

1.4. SHOULD WE BE WORRIED ABOUT INFLATION?

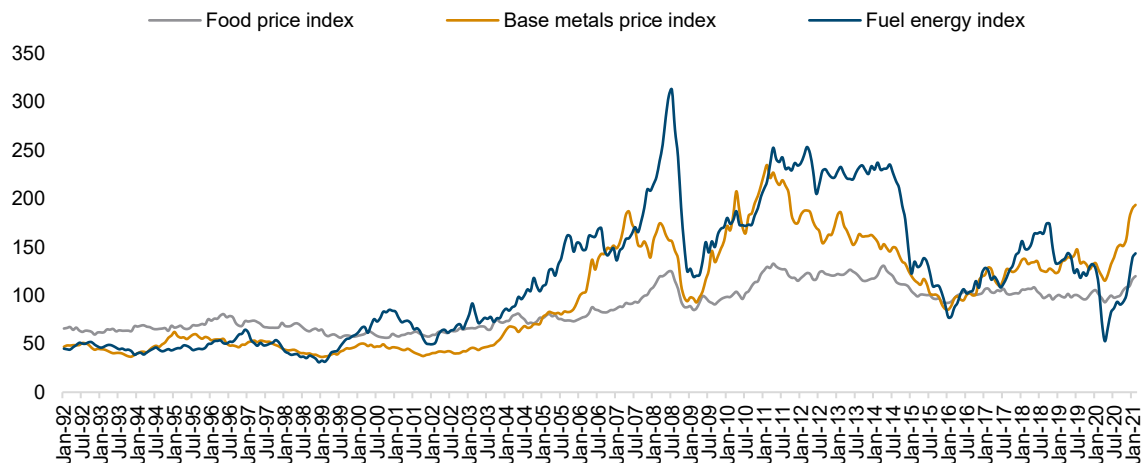
The pandemic has prompted a sharp increase in commodity prices on global markets. Food, energy and metals prices are going up (Figure 1.5). These increases appear to have been driven by supply bottlenecks related to the pandemic, as well as by increased demand owing to the global recovery. With many prices – not least of energy – having fallen off a cliff when the pandemic hit, the base period for commodities will be much lower from around March. As a result, a spike in headline inflation is quite likely for many economies in the coming months; but this will likely mean in the range of 2-3% for the US and major European economies, which is not especially high in historical terms.

Whether or not this lasts will depend on the country and the strength of demand-pull factors.

Inflation in the US is already above target. However, it is much weaker in the euro area: the harmonised index of consumer prices (HICP) in February rose by 0.9% year on year in the euro area, less than half of the ECB's target. This relied, though, on a 1.7% decline in energy prices, which will reverse as lower base effects arrive from March. While this will bring higher headline inflation, we expect high commodity

prices in the euro area to lead also to a margin squeeze, with firms struggling to pass the full impact of higher input costs onto consumers amid fragile demand. Even by the end of the year, the euro area is still likely to have a sizeable output gap. Over the forecast period, we expect oil prices to fall back from their current levels, reflecting the effective cap on prices created by US shale.

Figure 1.5 / International Monetary Fund commodity price indices, 2016 = 100



Source: International Monetary Fund.

1.5. MAIN TAKEAWAYS FOR CESEE

Based on the above assumptions, the main takeaways for CESEE are as follows:

- › The euro area – CESEE’s most important market and the source of foreign demand, tourists, remittances and investment – will recover, but not boom. This will generate positive extra demand for CESEE economies. However, the euro area’s recovery will be weaker than that of the US, and it will not recover to pre-pandemic levels of economic activity this year.
- › Western Europe seems to have got over its bad start with vaccines, and a large share of the adult population will have been vaccinated by the end of the summer. This should help tourism inflows in the parts of CESEE that need them.
- › The Fed may start to taper its asset purchases this year, while the ECB is going in the opposite direction. This will keep rates across Europe and much of CESEE low, but those reliant on dollar funding will face higher borrowing costs.
- › This policy divergence will weaken the euro against the dollar, increasing imported inflation in the euro area and those economies of CESEE that are linked to the single currency.
- › Global inflation will rise this year, especially as the much lower base period for commodity prices kicks in with the March data. However, large output gaps in the euro area mean that this is unlikely to generate permanently higher inflation.

Table 1.1 / wiiw spring 2021 global assumptions

	Spring 2021		Changes since autumn	
	2021	2022	2021	2022
Euro area real GDP growth, %	3.8	3.7	-2.0	1.2
USD/EUR exchange rate, average	1.15	1.15	0.00	0.00
USD per barrel Brent oil, US\$, average	65.0	60.0	15.9	10.0

Source: forecasts by wiiw. Cut-off date: 25 March 2021.

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