ECONOMIC BRIEF 08.01.2021

THE SPEED OF THE RECOVERY IN 2021
EU Policy Response

At the start of the New Year, we can look ahead with cautious optimism that the Covid pandemic will be brought under control. Even if that is the case, however, its economic effects will linger for a much longer time.

EU Member States continue to spend huge amounts of funds on health care, as well as on financial support for businesses and households affected by the crisis. EU fiscal rules were rightly suspended to allow for this large increase in government spending. This has been a necessary response to an external shock that threatened the lives and well-being of European citizens. That said, this necessary policy response comes at a cost: the higher deficits and lower GDP growth have pushed public debt-to-GDP ratios sharply higher. Euro area-wide, the ratio has increased to around 100% of GDP in 2020, from around 86% in 2019. Given varying pre-pandemic debt levels, some countries now face debt ratios significantly higher than that.

On 1 January this year, the EU’s €1.8 trillion recovery budget entered into force. Its centrepiece is the Recovery and Resilience Facility (RRF), offering ultra-low-cost financing and grants to EU Member States in support of reforms and growth-enhancing investment. The focus on reforms and investment, if well implemented, will improve the medium-term outlook for all European economies, and will also improve future debt dynamics.¹

1. World Economic Outlook

Although recent vaccine approvals have raised hopes of a turnaround in the pandemic later this year, renewed waves and new variants of the virus pose concerns for the outlook. Amid exceptional uncertainty, the global economy is projected to grow 5.5 percent in 2021 and 4.2 percent in 2022. The 2021 forecast is revised up 0.3 percentage point relative to the previous forecast, reflecting expectations of a vaccine-powered strengthening of activity later in the year and additional policy support in a few large economies.²

Following a collapse last year caused by the COVID-19 pandemic, global economic output is expected to expand 4 percent in 2021 but still remain more than 5 percent below pre-pandemic projections. In particular, the impact of the pandemic on investment and human capital is expected to erode growth prospects in emerging market and developing economies (EMDEs) and set back key development goals. The global recovery, which has been dampened in the near term by a resurgence of COVID-19 cases, is expected to strengthen over the forecast horizon as confidence, consumption, and trade gradually improve, supported by ongoing vaccination.

¹ Debt risks! after the pandemic crisis - speech by Klaus Regling
² World Economic Outlook Update, January 2021 – International Monetary Fund
2. Global Growth and Regional Outlooks

Although global economic output is recovering from the collapse triggered by COVID-19, it will remain below pre-pandemic trends for a prolonged period. The pandemic has exacerbated the risks associated with a decade-long wave of global debt accumulation. It is also likely to steepen the long-expected slowdown in potential growth over the next decade. In the baseline scenario, a decline in cases, a vaccine rollout that gathers pace in early 2021, and the eventual easing of pandemic control measures underpin a modest rebound. In the downside scenario, persistently higher caseloads, more stringent involuntary social distancing, and slow vaccine development markedly weaken the recovery. In the severe downside scenario, widespread financial stress and mounting firm bankruptcies trigger financial crises, causing a second year of global recession. In the upside scenario, effective pandemic management, coupled with prompt widespread vaccination, allows activity to recover faster.

Slower vaccine distribution leads to higher COVID-19 caseloads relative to the baseline, requiring additional voluntary and involuntary social distancing. On its own, the downside vaccine assumption is estimated to reduce global growth by 0.1 percentage point in 2021 and 0.8 percentage point in 2022.3

**East Asia and Pacific:** Growth in the region is projected to accelerate by 7.4% in 2021.

**Europe and Central Asia:** The regional economy is forecast to grow by 3.3% this year.

**Latin America and the Caribbean:** Regional economic activity is expected to grow by 3.7% in 2021.

**Middle East and North Africa:** Economic activity in the Middle East and North Africa is forecast to advance by 2.1% this year.

**South Asia:** Economic activity in the region is projected to expand by 3.3% in 2021.

**Sub-Saharan Africa:** Economic activity in the region is on course to rise by 2.7% in 2021.

3. A Policy Bridge to the Vaccine

Financial markets have looked beyond the global resurgence of COVID-19 cases. Announcements and rollout of vaccines have boosted hopes of a global economic recovery in 2021 and pushed risk asset prices higher. The speed of the recovery will depend crucially on production, distribution networks, and access to vaccines. Continued monetary and fiscal support remain vital to lessen lingering uncertainties, build a bridge to the recovery, and ensure financial stability. Risks to the baseline could threaten financial stability in some sectors and regions. A delay in the recovery would require prolonged accommodation, further fueling financial vulnerabilities. Uneven

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3 Global Economic Prospects, January 2021–World Bank
vaccine distribution and asynchronous recovery could imperil capital flows to emerging market economies, especially if advanced economies were to begin to normalize policy, and some countries could face daunting challenges. An asset price correction, should investors suddenly reassess growth prospects or the policy outlook, could interact with elevated vulnerabilities, creating knock-on effects on confidence and jeopardizing macro-financial stability.⁴

### 4. Fiscal Policy and Deficit

Additional fiscal policy support set to boost activity in some countries, but most are expected to experience lower deficits in 2021. The sizable fiscal support announced for 2021 in some countries, including most recently in the United States and Japan, together with the unlocking of Next Generation EU funds, will help lift economic activity among advanced economies with favorable spillovers to trading partners. However, as noted in the January 2021 Fiscal Monitor Update, fiscal deficits in most countries are projected to decline in 2021 as revenues rise and expenditures decline automatically with the recovery. About $900 billion in loans and grants should begin to flow to the EU’s struggling economies this year thanks to a December deal with Hungary and Poland, which had resisted conditioning recovery assistance on adherence to the rule of law. Germany brokered the agreement; with the U.K. cutting ties to the EU, Germany is more than ever its dominant member.

The euro area’s budget deficit will shrink by 2.5 percentage points. The budget deficits of the world’s governments will add up to about 8.5% of global GDP this year, according to new projections by the IMF.⁵

### 5. North Macedonia and Western Balkans

The World Bank expects North Macedonia's economy to expand by 3.6% in 2021, less than the 3.9% growth rate it forecast in June. Growth in the Western Balkans is expected to rebound to 3.5 percent in 2021, assuming that consumer and business confidence are restored as COVID-19 is brought under control and that political instability eases. Tourism-dependent economies, particularly Albania and Montenegro, are projected to experience a more robust rebound in activity than the subregion’s other countries. Rising fiscal liabilities in the subregion have reduced space for fiscal support, while at the same time, government budgets will be further stretched by additional spending necessary to counter the damaging economic effects of the COVID-19 outbreak. Despite these headwinds, medium-term growth and productivity in Albania and North Macedonia should be boosted by accelerating structural reforms in preparation for EU membership, assuming negotiations surrounding the accession process are not further delayed. The subregion is also expected to benefit from the EU’s recently adopted Economic and Investment Plan, which will mobilize funding to support sustainable connectivity, human capital, competitiveness and inclusive growth, and green and digital transition.⁶

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⁴ Global Financial Stability Report Update, January 2021 - IMF
⁵ Acting less big - Who is at risk from premature austerity? | Finance & economics | The Economist
⁶ Global Economic Prospects – January 2021