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2021 Economic Outlook: Sunrise in a fractured world

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(see inside for contributor names)

Rays of sunshine are visible following dark times. The world economy begins 2021 still deeply depressed, but vaccines and policy interventions have raised hopes of strong growth. Inflation will likely rise in many countries, especially in the spring.

The interesting questions about 2021 are not whether growth and inflation will rise. On growth, the question is, following such an unusual, services-driven recession, what will recovery look like? On inflation, the question is whether the rise in inflation will be temporary, and whether low neutral policy rates will persist.

This outlook begins with five essays. First, we give a global roundup and discuss the central role of the services sector. Second, we dive into tail risks following the pandemic policy responses. Third, we examine where European integration stands. Fourth, we discuss China's opening up. Fifth, we describe the likely divergences in the performance of emerging market economies.

After the essays, we provide detailed analysis of our views for each economy we cover.

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Sunrise in a fractured world

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- **The world economy will likely grow strongly this year but output levels will still be mostly below long-term trends at the end of the year.**
- **Policymakers will likely be very patient in removing stimulus.**
- **The composition of the services rebound will be highly consequential for investors, and may fuel perceptions of an inflation resurgence.**

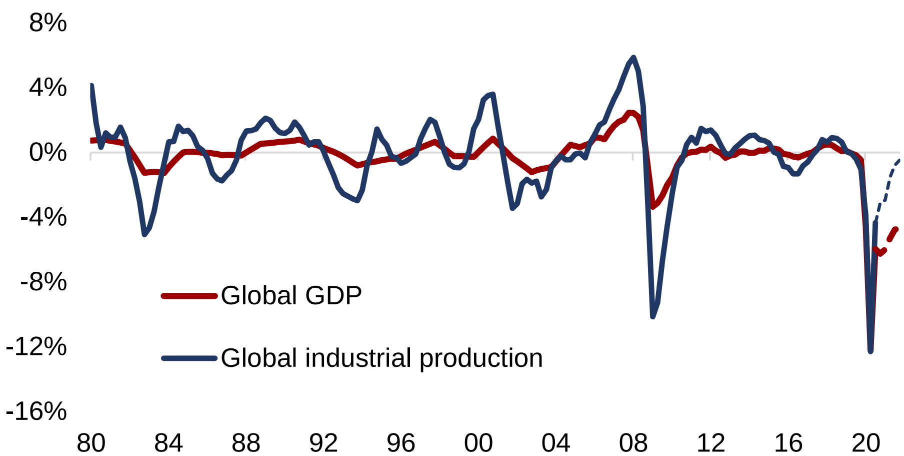
The world economy is in a deep pit. We foresee strong growth and easy policy because of the low starting point.

The recovery will be as unique as the preceding recession. Textbook business cycle descriptions hardly fit this case. Business activity was partly curtailed for public health. Profit was not always maximized and consumer utility faced new constraints. Policy norms were jettisoned.

The world economy's fracture is evident in your local restaurant, gym, or airport. Disrupted in-person services are heavy on employment and light on cyclicality. The output gap in industrial production is large but the one in services-heavy GDP is larger, due to social distancing.

Figure 1: Global GDP is currently further from trend than global industrial production

Cyclical component of an HP filter on quarterly global GDP and industrial production from 1980-2019. The pre-pandemic trend is extrapolated from the end of 2019 and used to calculate the deviation from trend in 2020 and 2021.



Source: Credit Suisse, Haver Analytics, Thomson Reuters Datastream

There is no precedent for the services part of GDP having a larger output gap than the goods-producing part in a recession. Uncertainty about 2021 is largely about how much services can recover. The latest vaccine news suggests that constraints on services could be gone in some countries, including the United States and parts of Europe, by the end of the year. That should lift GDP and employment sharply.

A more nuanced question is whether the supply of services can rebound alongside demand without notable price pressures. In other words, as vaccines permit safer social interactions, in which products might excess demand quickly emerge, generating price pressure for that product, and perhaps some overall inflationary pressure. This raises questions about jobs, inflation, future policy, and financial market implications.

Vaccinated individuals will demand restaurant meals, tourist experiences, and other services. Long before herd immunity is reached in any economy, vaccinations will reduce expected mortality risk from social interactions, leading to a jump in mobility. Because developed market governments have supported household cash flows and balance sheets, many consumers will resume strong spending on services as soon as possible.

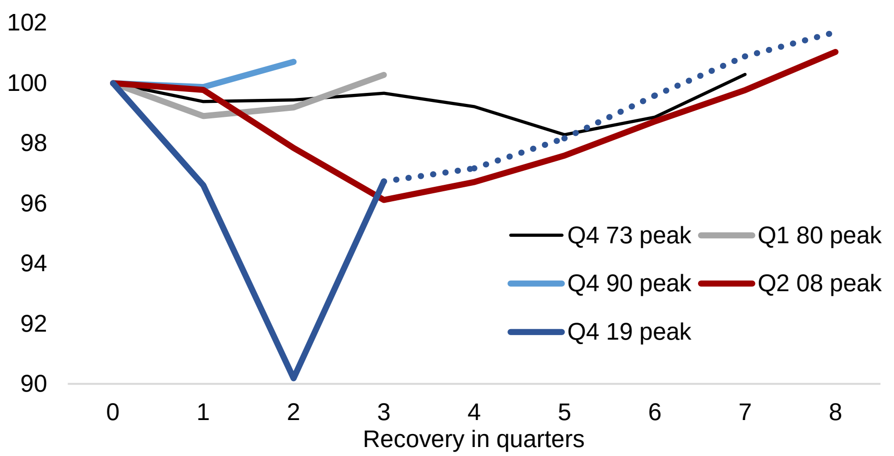
However, not all services will resume normal availability quickly. Supply elasticity varies along an extensive margin (how many businesses) and an intensive one (how much output for a given business). Many businesses have closed and new ones might take time to set up. Surviving businesses might face lingering problems and not be in a position to resume full operations soon.

We can guess which parts of the services sector will likely return quickly and which will not. Car services might reappear quickly as demand returns; that sector has a very elastic supply given the sharing economy. But high-end restaurants, hotels, or tourist destinations might not have supply elasticity. Tickets for popular sports events or concerts might see massive excess demand relative to fixed supply. In between the extremes of supply elasticity, there are sectors like airlines. If the world can go back on vacation next summer, will there be enough flights?

If demand returns strongly, car services activity, but not prices, might soar. Luxury services might see prices, but not activity, soar. Winners and losers next year might be quite different from 2020. The last shall be first and the first last.

Figure 2: Global GDP during past recessions

Pre-recession peak = 100



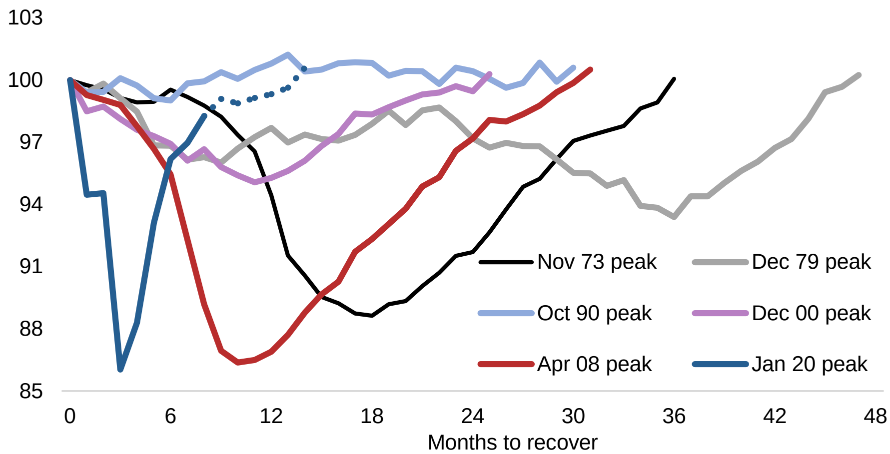
Source: Credit Suisse, Thomson Reuters Datastream

In the tradeable goods sector, a strong but incomplete recovery has occurred. It stalled in late 2020 due to another COVID-19 wave, but global industrial production growth is below its long-term trend level and is likely to grow strongly in 2021 overall, following a trough in growth momentum in Q1.

The demand for industrial production has seen another anomaly this year. Goods sales volumes to consumers have been phenomenal, returning to pre-pandemic levels by September in developed markets. The prior overshoot was driven by generous policy measures including low interest rates and direct subsidies, substitution from low spending on services, and strong demand for certain pandemic "winners" such as electronics and recreational goods. But a normalizing world economy is likely to see a pullback in consumer goods spending.

Figure 3: Global industrial production during past recessions

Pre-recession peak = 100



Source: Credit Suisse, Thomson Reuters Datastream

Industrial production involves not just consumers but also business investment, which is heavily driven by services businesses in developed economies. Although certain categories such as mining should show restrained spending, overall business investment is likely to be strong in most economies by the end of the year. Housing investment has already been strong in many countries, amplifying the need for physical products.

Another important question about 2021 is how fast workers can return. This is the typical intensive margin constraint for services businesses. Historically labor has returned quickly following recessions in the most cyclical sectors, such as manufacturing and construction. But services businesses take much longer to rebuild. We can say that goods sector business comes back to life like a slingshot, but services activity snowballs through an expansion. The best case for 2021 will be a rare services slingshot.

If demand for services picks up faster than supply can expand and workers can be rehired, wage pressures on services might rise quickly, even amid high unemployment. Matching frictions in the labor market could have downshifted the short-term labor supply curve in a way that can boost inflation and limit recovery.

A persistent overshoot in inflation is a risk worth considering, but it is not our base-case forecast. We expect US inflation to briefly overshoot 2% in core and headline terms in the second quarter, partly reflecting y/y base effects, but then to drop back below 2% in the second half of the year. European inflation will do something similar but at lower levels. Some investors, however, might observe rising growth, successful vaccinations, and overshooting inflation this spring, and make the argument above about possible inflation risks for the second half and drive an inflation scare that could be consequential for financial markets.

Central banks will remain obdurate under such conditions. They will mind the gaps, and not abandon their easy policies based on short-term wobbles or oddities in relative prices. We expect a steady hand from the Federal Reserve and other major central banks in 2021. They are far more likely to ease more, should rising long-term interest jeopardize the recovery, than become more hawkish in response to short-term developments.

This is because central banks understand how far the world is from acceptable and normal levels of activity. Returning to trend is the priority. This prioritization of the level, rather than the growth rate, is perhaps something that investors should keep in mind.

COVID-19 has been a synchronizing shock for the world economy. This means there are many similarities in our forecasts for countries and regions, but also some important differences. Similarities should be apparent in growth, inflation, and central bank behavior.

The US and Europe begin the year under the tight mantle of the virus, keeping economic activity subdued. But growth should surge around the middle of the year as vaccines nudge societies toward herd immunity and restrictions ease.

Inflation is set to rise in many economies in the first half of the year thanks to base effects.

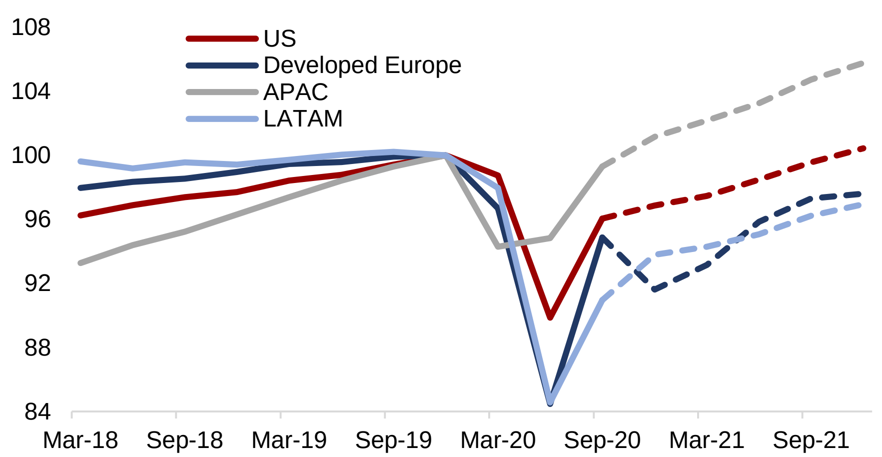
Central bank policy is set to be expansionary and undramatic. All the major central banks are committed to using their balance sheets generously to keep financial conditions supportive for recovery.

But there will be differences and divergences as well. As global economic output recovers toward trend, there should be a rotation of activity across economies and sectors.

Figure shows the expected pattern of recovery across a range of economies. Output in China and Asia has already fully recovered from last year's shock. Stalled at present, output in North America and Europe should surge again in a few months' time, returning to pre-pandemic levels around the end of the year. Some emerging economies, notably parts of Latin America, will lag.

Figure 4: Rotations in recovery

Real GDP levels, with Credit Suisse forecasts, for the US, Asia, the euro area, and Latin America; Q4 2019=100

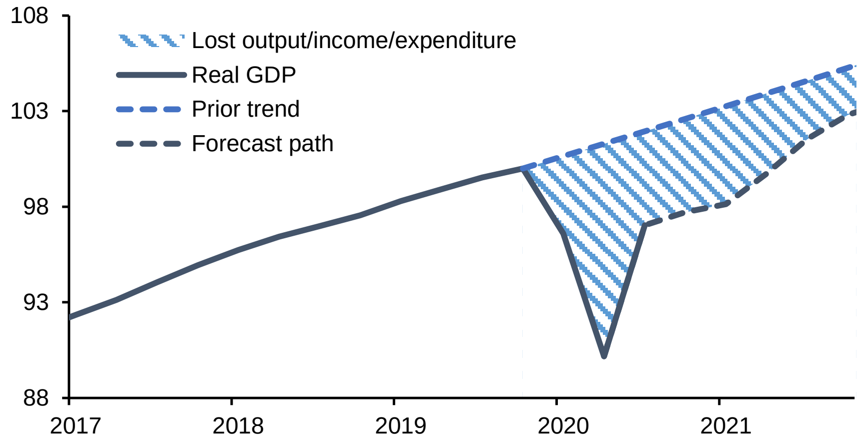


Source: Credit Suisse, Haver Analytics

Although supportive monetary policy should be fairly uniform, there are differences in fiscal policies. As Figure shows, the economic hurt from the pandemic in the form of lost incomes, and consequently damaged balance sheets, will persist through this year. The more that fiscal policy can provide an effective buffer to private incomes, the more vigorous the recovery should be.

Figure 5: The damage to real incomes from the pandemic will continue this year

Global ex-China real GDP, with Credit Suisse forecasts; index Q4 2019=100



Source: Credit Suisse, Haver Analytics

In the US, the new pandemic relief passed late in 2020 addressed several important risks and should help to boost growth. The recent Democratic victories in Georgia's Senate races, which will lead to Democratic control of both houses of Congress in additional to the presidency, raises the likelihood of further stimulus. This news means that the Biden administration will be able to pursue bipartisan legislation and craft a fiscal bill in the annual budget reconciliation process. Accordingly, we have raised our growth forecasts significantly, and there is further upside risk.

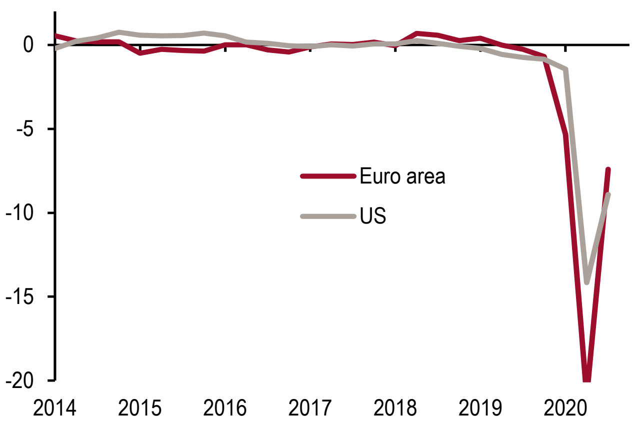
Fiscal policy will also remain supportive in Europe. National short-time and furlough schemes have limited the hit to corporate incomes while keeping workers attached to their employers. The EU's Recovery Fund should prevent financial fragmentation at the same time as providing a modest supra-national fiscal impulse.

Elsewhere, fiscal policies may be less supportive, out of necessity or by choice. We expect China to tighten fiscal policy this year, though it should not deliver much of a headwind. Moreover, in Latin America those economies willing or able to sustain fiscal support – Brazil, Chile, and Peru – should outperform those, such as Mexico, where policy is more constrained.

The qualities of fiscal policies, as well as their quantity, may drive further divergences. Europe's furlough schemes – where workers are still on firms' payrolls – could mean its service sector activity responds more elastically to recovering demand than in the US, leading to a period of relative outperformance. However, that may come at a price. Europe's preservation of businesses and jobs through the crisis may restrain any early-cycle surge in productivity and corporate earnings. And it may mean unemployment and business insolvencies creep up later this year in Europe while they are falling in the US.

Figure 6: Hours worked had collapsed by about the same amount in the US and Europe relative to trend by Q3 last year

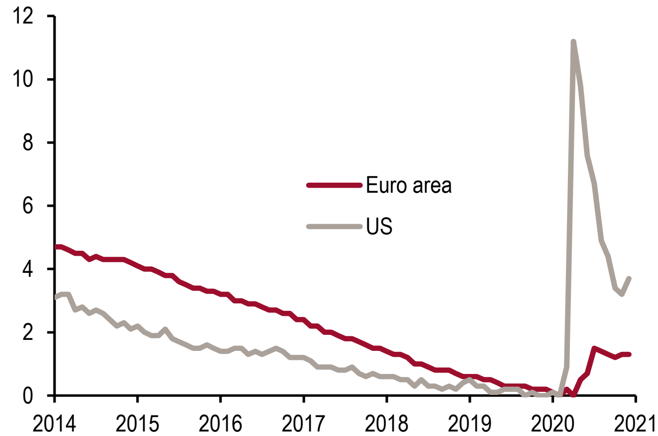
US and euro area hours worked relative to pre-crisis trend (2010-19 for the US and 2014-19 for the euro area,%)



Source: Credit Suisse, Thomson Reuters Datastream

Figure 7: But more workers have remained attached to jobs in Europe compared with the US

US and euro area unemployment rate relative to February 2020



Source: Credit Suisse, Thomson Reuters Datastream

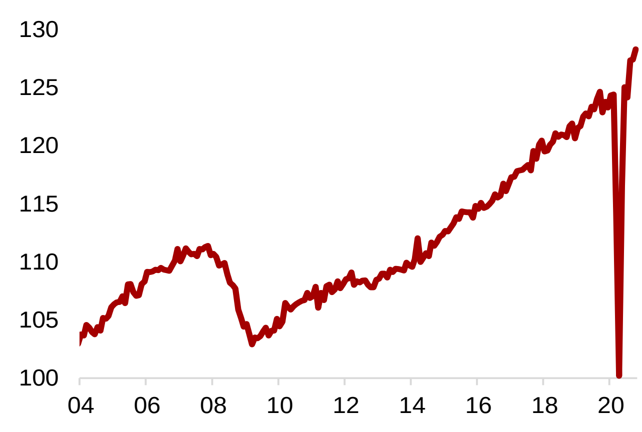
Another divergence in growth dynamics could be driven by the rotation of consumer spending from goods to services in developed economies. Developed market retail sales are well above their pre-pandemic trend (Figure 8), and so are goods exports from Asia to developed economies.

Resurgent demand for services in developed economies as social distancing ends may lead to a rotation in demand away from that excessive goods consumption. Slower retail goods demand in developed economies may then mean Asian exports slow. So the likely phase of much stronger growth in the US and Europe later this year may be associated with weakening industrial data in Asia.

And so harmony may start to fade into dissonance.

Figure 8: Real retail sales in developed economies have recovered above their pre-pandemic trend as spending was displaced from services

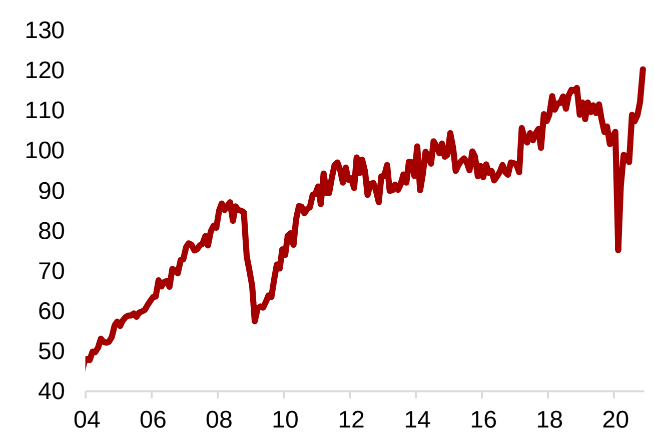
Developed markets real retail sales index



Source: Credit Suisse, Haver Analytics

Figure 9: Asian exports to the US and Europe have seen an equivalent surge

USD bn exports from Asia to the US and EU



Source: Credit Suisse, Haver Analytics

War on two fronts: Post-pandemic tail risks

- **Long-standing fiscal and monetary policy norms might be changing permanently.**
- **Investors and policymakers should consider a tail risk of rising neutral rates under difficult political conditions.**
- **The pandemic likely marks the end of the Great Moderation.**

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We now consider the longer-term tail risks of policy responses to COVID-19, including shifting norms in central bank and fiscal behavior. These introduce a strong human and political element into the post-pandemic risks.

A central banker and esteemed monetary theorist once walked into a room full of graduate students. "How are interest rates determined," he asked them, one by one. After hearing their answers, he replied, "You're all wrong. I set them."

A legislator could perhaps say the same about the budget balance. Goods markets and financial markets obviously shape yield curves and budget dynamics and influence policy decisions. The main driver of those decisions, however, is typically a set of institutional operating norms that officials obey.

In contrast to specific decisions, norms are not meant to be oversensitive to circumstances, but exceptional events can lead policymakers to change them. This is a feature, not a bug, of modern economies. It is meant to ensure independence and expert judgement, just like in modern military arrangements, where battle plans are made by seasoned generals.

Of course, politicians declare war, grant policy independence, and replace officials and generals. They can change the objectives, but policy implementers must sometimes ignore textbook rules, like those on interest rate setting and deficits. A century ago, gold standard norms and rules were often ignored or tweaked too. This is an escape clause for emergencies such as wars or pandemics.

Economic policy actions in 2020 were like war finance in that norms had to be abandoned, at least for now. Notions like "balance the budget," "do not politicize central banking," "let private markets allocate credit," and "plan for the worst" seemed to be thrown out. These have hardly bound behavior in recent years, but some popular ideas argue that these changes should be permanent.

One trendy idea is that today's apparent low neutral interest rates will persist for a long time. Neutral rates are not observable, and historical estimates of them show great variance when based only on backward-looking data. Most economists expect the primary forces holding neutral rates low to persist indefinitely. However, *it is a subtle but consequential switch to go from asserting a low neutral rate now to conducting policy as though it will stay very low for years*, especially considering the natural uncertainty around such a variable.

Policymakers or investors who fail to consider an early end to low neutral rates may not be giving fair attention to tails risks. Consider the (perhaps unlikely but still possible) dynamic of a sharply higher neutral rate without a strong pickup in *perceived* economic well-being among the public. Politicians and central bankers might not be willing or practically able to tighten conditions appropriately, leading to bubbles, inflation, or disruptive belated tightening. Any of those could lead to high financial volatility and eventual recession risks.

A jump in interest rates could also disturb fiscal dynamics, especially if government revenues were not robust as neutral rates rose.

Another trendy idea is Modern Monetary Theory, which argues that budget deficits do not matter for an economy with its own central bank and floating exchange rate. This is a strong form of the widely held view of debt stock irrelevancy. There are many reasonable arguments suggesting that policymakers have large fiscal space and a great opportunity to pursue expansionary policy while interest rates are low.

But knowledge of fiscal space is poor. Aggressive fiscal and monetary policy risks exchange rate and interest rate volatility that can bring about significant changes in financial market behavior without necessarily solving perceived underlying macroeconomic problems. Conversely, if some macroeconomic problems are solved, then higher financial volatility might be a small price to pay.

The notions of low neutral rates and irrelevant debt and deficits are supported by observations such as low stable inflation before the pandemic and low long-term rates in spite of rising public debt. If legislators or central bankers abandon norms and decide that they are unconstrained in setting budgets or short rates, then they would have enormous power to solve problems beyond the pandemic.

On a recent panel with Washington economists, one of us asserted that MMT removed the constraints from policymaking. This view was countered abruptly by a panelist who claimed strong connections with MMT theorists. He said, "… everyone knows inflation is the constraint on MMT." But inflation constrains policymakers like alcoholism constrains a heavy drinker. It is an implication, not a binding constraint on everyday behavior.

Ratiocination and rationalization

After the Global Financial Crisis it was commonly argued that countries with high debt would suffer sustained weak growth. That view's popularity has given way to its antithesis, the idea that debt levels do not matter. Both views are extreme.

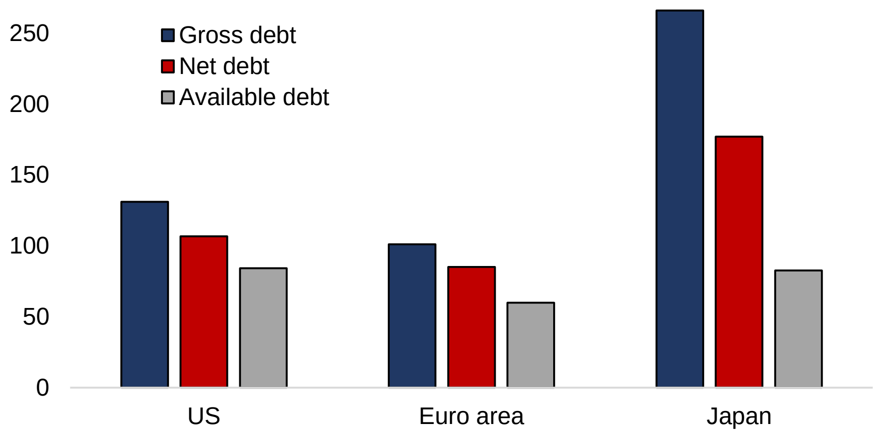
A government's debt sustainability depends on interest expenses, tax revenues, and the ability to cut spending. These are determined by actual and perceived economic well-being and, importantly, political flexibility. We highlight the difference between actual and perceived economic performance, because inequality among households can lead to serious political differences that hamper policymaker flexibility.

The US, UK, Canada, France, Italy, and Japan have gross government debt to GDP ratios above 100%. Germany is the only G7 country below the threshold but it plans a large multiyear fiscal expansion.

High debt-to-GDP levels might not do harm for many reasons. Debt could finance productive capital that boosts future growth. Debt-financed infrastructure is an example of this, but G7 indebtedness has mostly risen from persistent deficits and occasional emergencies, not well-planned investments.

Figure 10: Government debt to GDP ratios (%)

Projections for 2020 figures taken from the IMF World Economic Outlook. Consolidated debt of general government. Net debt is equal to gross debt minus government financial assets. Available debt is equal to net debt minus central bank holdings. % GDP



Source: Credit Suisse, Haver Analytics, IMF

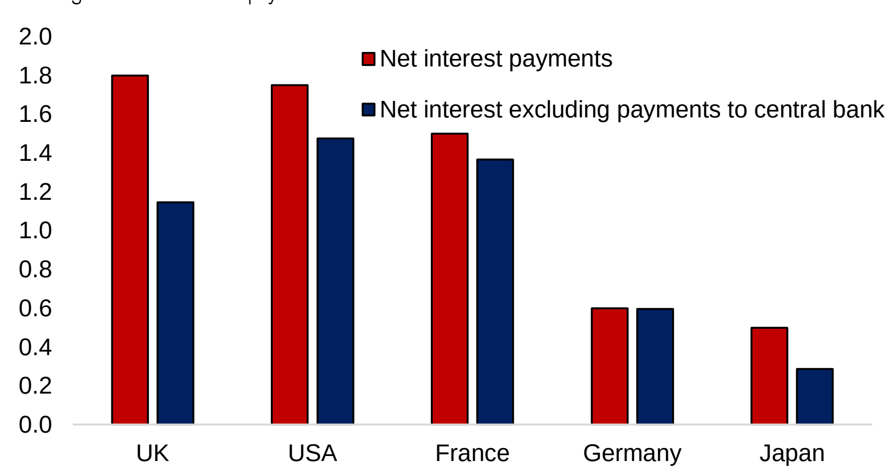
Gross debt measures are flawed. Governments often own financial assets such as student loans, and also government pension or trust funds, which hold their own debt. Net debt measures are therefore preferable.

Central bank purchases do not affect net debt statistics. Recent Fed, ECB, and BoJ bond buying has eviscerated the total supply of public debt available for private investors. We estimate that net "available" debt (gross debt minus financial assets minus central bank holdings) are 84% for the US, 83% for Japan, and 60% for the euro area.

Net or available debt measures look less alarming than gross measures for many countries, but some observers eschew these stock to flow ratios altogether. An alternative is to focus on interest payments.

Figure 11: Government net interest to GDP ratios (%)

General government interest payable minus interest receivable. % GDP.



Source: Credit Suisse, Haver Analytics, Eurostat, National Central Bank Financial Reports

Net government interest payments are manageable in all G7 economies, and even those figures are overstated in one important way. Interest paid to domestic central banks are included, but central bank profits remitted to government budgets are not. Of course, overall budget balances are composed of a primary balance and net interest, and these remittances raise the primary balance. Some developed countries that have historically run high interest costs have tended to run comparatively high primary balances (e.g., Italy).

If future interest costs rise across these countries due to rising market interest rates and/or large deficits, then politicians might seek smaller higher primary balances to offset this. If they do not, and deficits are larger than GDP growth as a share of GDP, then gross debt ratios will rise sharply.

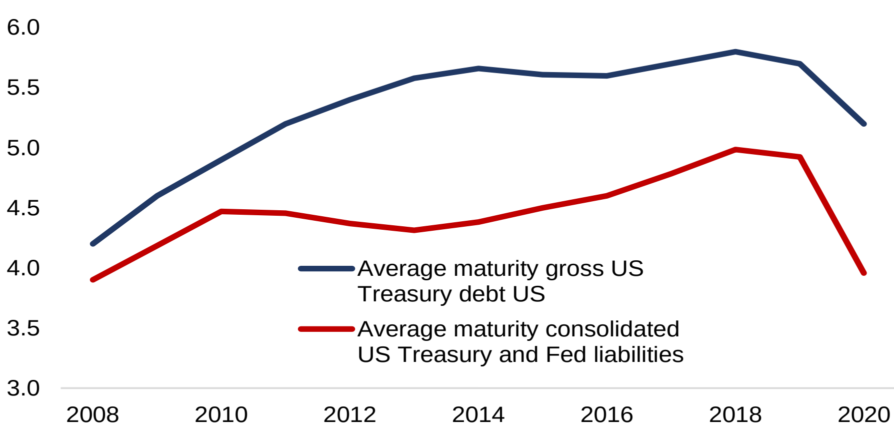
Large primary deficits are expected to persist for most G7 countries. Infrastructure needs and aging are two primary reasons, but emergencies come up too! The other problem is that interest rates could rise more than modestly. In the United States, net interest costs have recently been running near 1.6% of GDP. This is less than most estimates of potential GDP growth. The Congressional Budget Office assumes that rates will slowly trend toward 3% over the next decade, and many influential economists see this as a likely overestimate, because past forecasts have consistently overestimated future rates. However, errors can occur in either direction, and a larger increase is a risk.

Ultimately, the US's low tax revenues as a share of GDP compared with other developed economies offer a potential fix to debt worries even if Fed purchases stop, but that of course requires the political ability to do that. This is why our tail-risk scenario involves a surprising coincidence of rising neutral rates and political constraints. Both are needed for the scenario we are describing to arrive in full force.

G7 governments have not taken advantage of low long-term rates by increasing the average maturity of their debt. Pandemic finance has been skewed to the front end, and central bank purchases are financed by zero maturity reserve balances, so that the maturity of overall government liabilities (debt + money) has shrunk even more.

Figure 12: Average maturity of US government debt

To calculate consolidated average maturity, US government debt held by the Fed is given zero maturity. Average maturity shown in years.



Source: Credit Suisse, Haver Analytics, NY Fed

A high share of short-term debt increases the vulnerability of debt dynamics to rising short-term interest rates. This raises the costs of inflation fighting, a topic we discuss below. Central banks earn a spread on the “carry trade” their balance sheets represent, but paying interest on reserves means their non-cash liabilities no longer generate seigniorage.

Nothing stops a central bank from buying government debt if it chooses to do so. When this happens public holdings of central bank liabilities (currency, reserve balances, repo, or central bank bills) rise and public holdings of ordinary government debt fall. In Japan, this channel has worked wonders for reducing previously astonishing gross debt to GDP figures.

This dynamic might argue for a strong reliance on fiscal policy in managing an economy toward full employment, a view in-line with MMT-type thinking, which counsels governments to ignore the debt stock and reduce stimulus only when inflation is a problem, presumably when the economy is operating above its potential. Currency weakness, which might occur under strong stimulus, is seen as something helping the adjustment to full employment along.

With short-term interest rates at zero, there are strong arguments for fiscal reliance anyway, without going as far as saying this should be permanent. Such a view is reasonable in a pandemic. But important flaws of full-fledged MMT suggest that this is not a recipe for permanent new policy norms.

One is based on political realities. Legislatures prefer to hard code counter cyclical policy in fiscal automatic stabilizers and delegate discretionary actions to staid, norm-following central banks, which have massive expert staffs, apolitical orientations, and well-explained behavior. This keeps the burden of routine countercyclical policy away from legislatures and parliaments, whose actions will likely be so delayed relative to shocks as to be pro-cyclical, and will usually be contentious. Public support for stimulus ebbs and flows, and large actions often lead to backlash later.

MMT seems to assume omnipotent, forward-looking, non-partisan parliamentarians. The closest natural experiments of MMT have been done during major wars. MMT is indeed like war finance in crisis – when it may be appropriate – and a mere thought experiment the rest of the time, like something out of Plato’s Republic. The real world lacks fiscal philosopher kings.

Furthermore, fiscal policy may not be well suited for inflation management. Monetary policy can more precisely affect borrowing activity and money supply growth, asset prices, and exchange rates. Inflation is a meta-phenomenon arising from the relationship between a forward-looking private sector and public sector institutions that are now guided by operating norms established in the past thirty years. Under these conditions old notions such as Phillips Curves have not shown the same empirical relations with inflation as in earlier periods, and this is also very true for government budget balances.

There is also a problematic interaction between politics and inflation. What if inflation rises at a time of mass discontent by voters, perhaps because of high unemployment, inequality, or even overall stagflation? Elected legislators would have few incentives to cut government spending or raise taxes in order to counter an inflation problem that drives popular discontent. Central banks might face these same pressures, but less directly than elected officials.

Several senior members of the incoming Biden administration, including Treasury Secretary Yellen, do not embrace MMT, and neither do many policymakers in other G7 countries. But governments including the Fed are now committed to large fiscal deficits amid historically high debt levels and heavy central bank bond purchases until full employment and sustainable and satisfactory inflation are reached.

Is this policy orientation a temporary tool or a new norm? Will other features like direct checks to households become a regular feature of fiscal policy too? These types of questions are central to how market expectations will evolve this year and how future tail risks unfold.

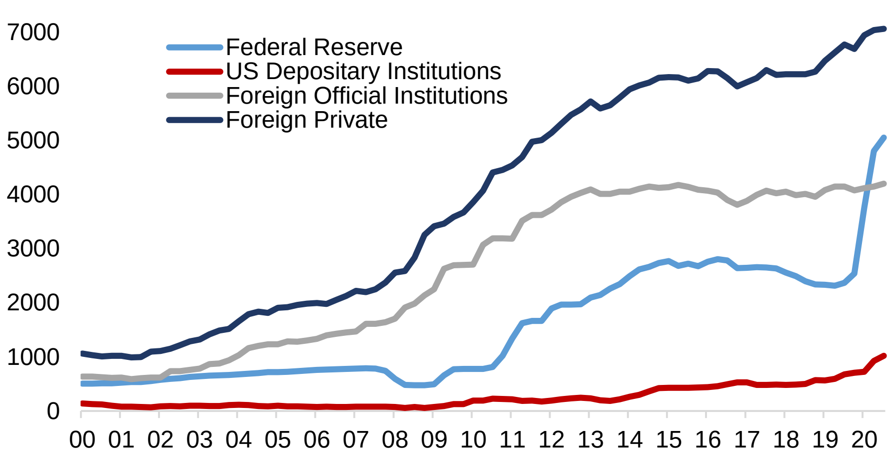
Central banks change the world

G7 governments are managing the jump in debt via central bank purchases and a shrinking maturity profile for government liabilities available to the public. This behavior suggests that they worry more about rising interest rates than deteriorating debt dynamics. Interest-rate-sensitive sectors such as housing and consumer durable goods have been important offsets to the pandemic-related collapse in services activity.

Policymakers are holding interest rates low by promoting the scarcity of long and medium maturity safe assets, signaling slow short rate normalization, and spreading the plausible but uncertain forecast that neutral rates will remain low for years. Ownership shares of government debt have shifted toward domestic central banks and away from foreign central banks. Domestic banks are increasing their holdings of government liabilities sharply, but mostly in the form of central bank liabilities.

Figure 13: Ownership of US government debt

USD bn



Source: Credit Suisse, Haver Analytics®

Central bank balance sheet expansion involved increased government debt (assets) and increased reserve balances (liabilities). Fed reserve balances roughly doubled in 2020 to $3.1tr. Total commercial bank assets rose roughly 14% on the year to about $20tr. Reserve balances now make up more than 15% of bank assets, and rising.

The counterpart of this asset increase is an increase in bank deposits (M2) of nearly $4 trillion, or nearly 25%. The US banking system has grown as a share of GDP, a consequence of the payments chains providing pandemic relief. It has acted as a release valve, a passive intermediary of a government injection of funds through the central bank purchase of new debt issuance.

The Fed plans to continue buying Treasuries and mortgages by $80bn and $40bn per month until its objectives are in sight. This could in theory add trillions more in reserve balances and deposits in the next few years, or rising inflation and improving growth this year could end purchases sooner than expected. Along the way the private sector is getting even more cash, the banks will grow further, and net government debt available to the public might not rise much in spite of deficits. Interestingly, the recent US pandemic relief bill does not require much new issuance due to overfunding by the treasury last year. As treasury deposits at the Fed fall to pay for new measures, Fed reserve balances and public deposits will rise.

So far, the surge in US M2 – which is echoed in many other economies – coincided with the disposable income jump that the US household sector experienced even as labor income fell. (We explained that dynamic in detail in a note last summer). A natural question is whether the private sector is content in holding these cash assets in their asset allocations, or will this incremental cash achieve decent velocity, which equates to accelerating transactions and nominal GDP.

Our base case calls for "normal" inflation in the US in the next few years amid a very slow normalization of short rates. Therefore, investors will see cash as yielding not much less than short and medium maturity safe fixed income securities, and so they will simply hold more cash assets. But in the spirit of asking "what if," we point out that a strong recovery with abundant investment opportunities, inflation pressure, and rising apparent neutral rates is precisely the environment where cash will circulate faster. Rising velocity and rising rates would not explain or forecast each other; if they occur forcefully, it will be together.

If that reflationary spiral does not occur, strong further Fed purchases could lift reserve balances far above the current 15% of bank assets, reshaping bank balance sheets to resemble in some ways the post-war period, when banks held large amounts of short maturity interest-bearing government debt. The full implications of this are difficult to fathom, but regulatory changes (such as excluding reserves from the Supplementary Leverage Ratio) would seem possible, especially if the balance sheet transformation constrains bank behavior and generates funding market anomalies.

In the best-case scenario, governments will have paid for the pandemic by allowing certain ratios to adjust, including government net and gross debt to GDP, central bank assets to GDP, bank reserve balances as a share of total assets, and total private bank deposits as a share of GDP (inverse money velocity). Because net available government debt remains well below 100% of GDP in major economies and interest costs remain low, this response is sustainable and fears of sharp interest rate increases are uncommon among macroeconomists and large fixed income market participants.

Immoderation

The US military has traditionally attempted to stand prepared for two major wars at once. In that spirit, consider the possibility of rising neutral rates amid public unrest, political turmoil, and disappointing economic activity. Supply-driven stagflation is one version of this, but let us assume major economies return to full employment amid higher-than-expected inflation while economic rebalancing has further exacerbated distributional tensions and led to strong public criticism of the policymaker behavior.

Would central banks tighten sufficiently? Many central banks are confident – even overconfident – that they could easily stop any inflation outlook. History suggests, however, that central banks often tighten insufficiently because of political pressures, miscalculated output gaps, and variable lags between churning economic dynamics and later inflationary results. These are all clear risks.

If bond investors' inflation expectations rise sharply this year without the offset of rising expectations of tighter monetary policy, the demand for many types of government liabilities might suffer. This would push up interest rates at the long end, and potentially lead to another leg of dollar weakness. It might further risky asset market performance, but promote bubbly behavior too.

Rising interest rates would increase debt service costs, but it would take years for such a change to meaningfully drive budget deficits. Two important unknowns are how sensitive economic activity will be to future interest rate increases, and how sensitive inflation dynamics will be to the profound changes in the composition of government liabilities and bank assets. We do not have strong views on these topics but they are clearly areas where some analytical humility is warranted.

In general, such a scenario would likely be a turbulent backdrop for debt and currency markets. Many businesses, financial firms, and governments today simply assume that low interest rates will persist. It is important that they are right. Rising debt service costs would be an unwelcome shock to many businesses and governments, especially if they come at a time of weak or badly distributed growth. It is possible that the economy's interest sensitivity has increased so that even a few hundred basis points of interest rate hikes can lead to a sharp slowdown in growth or falling asset prices.

Again, this dark scenario is not our base case, and the most sensible objection to this risk scenario is that yields and neutral rates don't rise sustainably without accelerating growth. But our "wars on two fronts" scenario reminds us that the objection is not a universal law but a key danger for financial stability in the post-pandemic global economy.

In our 2020 Outlook, we wrote about the extreme low GDP and inflation volatility that prevailed in the United States and other major economies in the 2010s. We argued that such tranquility was unlikely to continue, and we explored ways the Great Moderation – the period of low growth and volatility since the mid-1980s – might end. In brainstorming possible triggers for a major change, we mentioned the possibility of a pandemic.

Actual growth and inflation volatility in 2020 were so high that even if the rest of the decade looks like the 2010s; there will have been a huge jump in growth volatility. Given the policy uncertainties we have discussed above, it is likely that growth volatility will be much higher than the 2010s for years to come.

Part of the reason for this is the simple dynamics following such a large output perturbation with accompanying policy shocks. However, underlying political dynamics also appear to be trending toward a far less stable regime. This is true both of fraught domestic politics in major economies including the United States, and of geopolitics too.

Tensions between the US and China, the world's two largest economies, are unlikely to vanish, and could easily worsen. China is opening up and might before long have a current account deficit, a change that could upend the global savings glut. We wonder whether the structural relationship between the US and China, the world's largest manufacturer, could itself hold hints of a future neutral rate shock, if the West suddenly feels the need to expand local production capacity sharply.

Post-Brexit Europe, which faces turmoil from its east and is embarking on a new fiscal agenda in Germany, where popular opinion might not always be supportive, also has its risks. And emerging market economies face a wide range of difficulties starting with long lags to vaccine access and very different implications from policy measures used during the pandemic. Most of these themes are explored in other essays below.

In early 2020, we foresaw "fragile tranquility" but now everywhere we see fractures. Policy norms are being defenestrated, geopolitical tensions have intensified, and economic insecurity continues to plague everyday life for many. There is a strong consensus on a benign outlook for government finance, but wise investors will continue to be open minded to a range of possibilities.

Europe: Integration and disintegration

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- **Brexit and the pandemic have, surprisingly, revived the process of economically and politically integrating the European Union.**
- **Inadequate and unbalanced integration to date has led to distortions and weaknesses that need addressing. There are encouraging signs that they will.**
- **Further integration should lead to a better-balanced European economy and policy mix. But it may also cause tensions and stress.**

Acceleration

2020 should have been a signally bad year for the European Union; the UK seceded in January, and coronavirus delivered a catastrophic shock. The EU economy experienced a deep recession, while national fiscal policy responses raised questions over the sustainability of some governments' debt and the cohesion of the Union.

Such risks did not materialize. The EU, and particularly the euro area, start this year without economic, political or financial fragmentation. Quite the opposite. It emerged with greater political and financial capacity, capable of putting the economy on a stronger, better-balanced trajectory than before the virus hit. Coronavirus and Brexit gave impetus to European integration.

As per the pandemic proving an accelerator to integration, the exceptional and common nature of the shock required an exceptional and common response. In March and April, European policymakers failed to deliver that, threatening political and financial fragmentation. As a result, badly affected countries such as Italy and Spain saw their government bond yields rise sharply, as did anti-EU sentiment over a perceived lack of solidarity and support.

The Franco-German announcement in support of an EU Recovery Fund to provide funds to governments in May finally met that need for solidarity. Compared with past European crisis funding vehicles, there were two important innovations: the EU would issue significant amounts of debt in its own name, while some of the funds raised by that debt would be disbursed to governments in grants. The EU would be taking on debt rather than its member states.

A Rubicon was crossed. The EU now had a federal fiscal capacity. Bond markets calmed. Political stress abated.

The UK's membership of the EU was a suppressor of integration. Hostile to greater pooling of sovereignty, the UK resisted, blocked and slowed integration as a large and important member of the EU. For example, it negotiated an opt-out from membership of the single currency in 1991 and vetoed the Fiscal Compact in 2011. It is very unlikely that any UK government would have been politically able to support the EU Recovery Fund, so if the UK had remained a member, it would likely have blocked it.

The UK departure from the EU at the start of the year removed a stiff brake on integration just as the virus forced the need for it.

Consequently, we think 2020 marked a point when, after long period of inertia, EU integration gathered new momentum. That will have meaningful economic, political and financial consequences.

The price of negative integration

Why is further integration so important? Because the process of integration to date has been incomplete and flawed. That left the EU economy and financial system in an imbalanced, fragmented and unstable state which, uncorrected, would threaten the long-term viability of the Union and single currency.

EU treaties drove the economic integration of the EU in the 1980s and 1990s, launching the single market and single currency. That integration largely worked to remove market barriers between countries (for example, restrictions on state aid to companies). Furthermore, it codified in treaty the 1990s macro-economic consensus: fiscal restraint; independent monetary policy aimed at price stability; deregulation; and liberalization of trade.

That has been described as 'negative integration' [1]: integration driven by constraining governments' capacity to act in fiscal, monetary and regulatory policy.

In general, there was little 'positive integration' to compensate for those limitations on governments, in the form of common fiscal or social policies. Politically, such steps were hard to agree and implement. Their absence led to rising stresses and imbalances.

Risk reduction without mutualisation

Those stresses came to a head in the euro area crisis of 2009-13, in the words of one historian, "one of the worst self-inflicted economic disasters on record"[2]. Although the euro area survived, largely thanks to the ECB's credible threat to eliminate redenomination risk premia from sovereign bond markets in 2012, the policy response to the crisis at the governmental level furthered the imbalanced process of negative integration.

That response pushed for greater integration in fiscal policy (the European Stability Mechanism [ESM] and Fiscal Compact), the banking sector (Banking Union) and capital markets (Capital Markets Union), in order to address the financial fragmentation that occurred in the crisis. But it was not successful.

That's because the process was, again, grounded towards negative integration (or risk reduction) rather than positive integration (or risk mutualisation) in our view. It forced countries to reduce sovereign debt and banking sector risks, by running consistently tight fiscal policies and restructuring bank balance sheets. Unpopular, disinflationary policies.

And they were not accompanied by much greater risk sharing, for example in the form of an active common bank deposit insurance scheme or common fiscal stimulus. Attempts to develop the latter were constrained by the EU's lack of effective fiscal capacity. For example, the so-called Junker Plan (The Investment Plan for Europe, launched in 2014) was designed to stimulate infrastructure investment in the EU, but proved economically irrelevant because it required enormous private sector leverage on a nugatory EU financial contribution.

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[1] Europe After Coronavirus: The EU and a New Political Economy, Chatham House, 2020
[2] Crashed, Adam Tooze, 2017

Warped economy

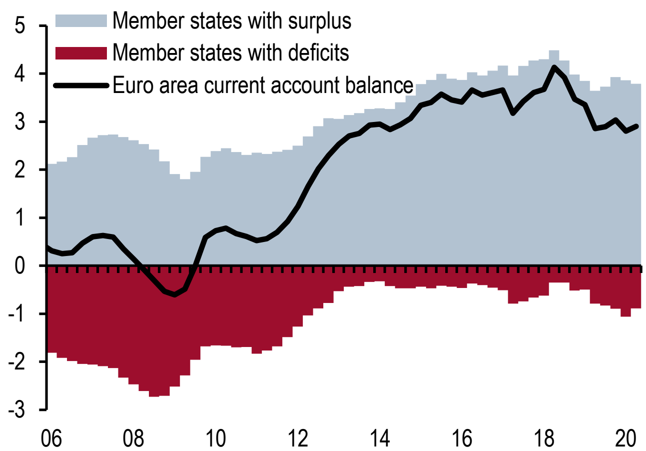
One legacy of the sovereign debt crisis and its asymmetric policy response was an equally unbalanced and fragmented economy and financial system. This had several important characteristics.

The most prominent is the euro area's large current account surplus, which has run consistently at 3% of GDP since the end of the crisis. As Figure 14 shows, a key reason for that was the sharp closure of peripheral economies' current account deficits in the crisis whilst Germany's large surplus persisted. This represents inadequate domestic demand, which contributes to global imbalances. And, as we will see, capital outflows associated with it have suppressed bond yields globally.

A corollary of that is a fragmentation of finance at the national level within the euro area. Private sector cross-border financial flows have diminished considerably. During the euro crisis it was this 'sudden stop' of cross-border financing that forced the rapid closure of external deficits in the troubled economies. In place of those private sectors, capital flows – particularly in the banking sector – are national central banking flows captured in rising TARGET2 balances.

Figure 14: An unbalanced economic adjustment

Euro area current account balance as % GDP, broken down into total deficits and surpluses at the member-state level



Source: Credit Suisse, ECB

Figure 15: A process of financial disintegration since the financial crisis

Euro area banks' cross-border lending within the euro area, €tn

Source: Credit Suisse, ECB

Another, related, imbalance was the economic policy mix. Fiscal rules prevented governments from increasing deficits (for example, Italy was forced to scale back its 2019 budget under threat of sanctions), but there was no mechanism to push governments running surpluses – such as Germany – to spend more. In the absence of a federal fiscal capacity, fiscal stimulus was impossible. That left monetary policy overburdened and incapable of generating significantly stronger domestic demand, despite negative policy rates and enormous bond purchases (see Figure 45 on page 55).

Puny geopolitics

The large external surplus and excessive dependence on exports also rendered the economy vulnerable to geopolitical shocks and trade wars. Russia's invasion of Ukraine in 2014 and increasing US protectionism in 2018-19 both precipitated slowdowns in euro area trade that policy could or would not offset through stronger domestic demand.

The EU was ineffective at dealing with these issues on a geopolitical, as well as an economic, level. That's because of another of the EU's asymmetries: puny geopolitical heft relative to its economic weight. Conflicting interests and foreign policy objectives at the national level have impaired a more coordinated and assertive EU foreign policy commensurate with its size and importance.

This impaired, passive approach to foreign policy does not seem sustainable in today's world. Europe's reliance on US military support in NATO was put into question in the Trump presidency. And although President-Elect Biden is likely to be far more constructive towards Europe, the focus of US interests has clearly shifted irrevocably to the Pacific. The EU may want to take its own approach to China. Threats and problems on the EU's borders – Syria, Russia, and Turkey – would be better addressed at the EU level.

In effect, there has been a growing need for the EU to assert greater 'strategic sovereignty'[3], otherwise it and its member states will further lose autonomy over their interests and, consequently, their economy.

2020: A turning point

2020 marked a turning point for the EU in addressing these many problems. As noted above, both the coronavirus and the UK's departure from the EU prompted renewed – and better – integration and co-ordination. These problems are by no means resolved. But rather than continued drift, there is momentum to address them.

A key development has been a confident and assertive European Commission, led by President Ursula von der Leyen. As well as driving greater fiscal and financial integration, the EU has better managed other issues at a European level.

In foreign policy, Brexit is a good example of a negotiation undertaken by the European Commission. That protected the EU's interests, particularly the integrity of the single market. The EU became more assertive in dealing with Turkey's controversial drilling operations in the eastern Mediterranean, imposing sanctions on Turkish officials.

Coronavirus vaccines have also been procured at the EU, rather than national, level. And as we discuss later, Europe's Green Deal, launched at the start of last year, is an EU-wide project that could be a catalyst for addressing some of the deficiencies discussed above.

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[3] Sovereign Europe, dangerous world: Five agendas to protect Europe's capacity to act, European Council on Foreign Relations, 2020

Hamilton: A process, not an event

The signal achievement of the von der Leyen Commission is the EU Recovery Fund. Although its size is not huge, at €750bn (5% of EU GDP) spread over seven years, it still marks a serious innovation in fiscal policy in the EU and euro area.

In particular, it is funded by the European Union issuing debt in its own name. And some of those funds (€390bn) will be disbursed in the form of grants, not loans. Consequently, it marks a material shift to mutualizing and federalizing government debt.

That has led some politicians and commentators to describe the Recovery Fund as the EU's 'Hamiltonian moment', referring to when the first treasury secretary of the United States, Alexander Hamilton, wrapped states' debts together into a federal debt.

To claim the EU is at such a transformative moment is to invite disappointment. That's because change in the EU tends to happen as a process rather than in a few key moments. We think a better description is that the Recovery Fund marks an important stage in the EU's 'Hamiltonian process'.

Taking a step back, a process of federalizing the EU's fiscal capacity, and mutualizing euro area governments' debts, has been slowly under way for some time.

At the governmental level, we can trace the start of this process to the launch of the bail-out vehicles of the euro crisis. The European Financial Stability Facility (EFSF) and the ESM started to issue debt in 2010 and 2012 to finance support packages for Greece, Portugal, Ireland and Spain. Euro area governments issued joint debt to support specific countries.

As we discussed above, this progress towards a common fiscal capacity was unbalanced.

There was considerable 'risk reduction'. The EU imposed strict conditionality on countries receiving support in the form of firm fiscal discipline, labour and product market reforms and bank restructuring. Politically challenging and economically depressing policies.

But 'risk mutualisation' was limited. Firstly, euro area governments were not jointly and severally liable for ESM debt. Instead, their liabilities were limited. And the support packages were in the form of loans, rather than grants.

However flawed, these crisis vehicles are an important part of the process of European fiscal integration. The ESM is now a permanent feature of the euro area's policy architecture, and as Figure 16 shows, its debt now amounts to nearly 2% of euro area GDP.

While the EFSF and ESM began an evolution towards a federal EU fiscal capacity, it is the European Central Bank where progress towards mutualizing member states' debts has been the most significant. Because in 2015, through its asset purchase programme, the ECB began consolidating member states' debts on its balance sheet and issued a safe, mutual, asset to replace them, in the form of ECB reserves.

The ECB has largely bought each sovereign's debt proportionately[4], according to the 'capital key'. Its holdings of government debt now amount to 27% of euro area GDP and 30% of the total outstanding amount. It is set to acquire more in the coming year, and has committed to reinvest maturing debt until at least the end of 2023. We think the ECB will sustain its holdings of government debt for longer than that.

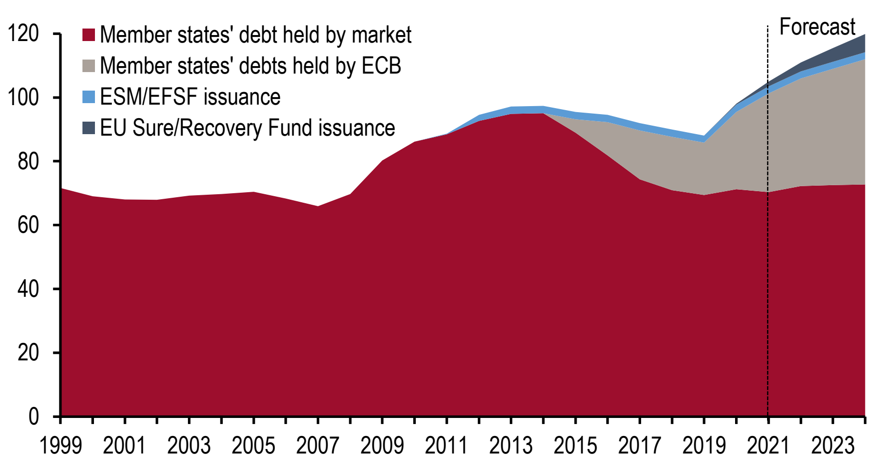
In short, a substantial amount of euro area governments' debt is now consolidated on the ECB's balance sheet. The joint liabilities issued in its stead – ECB reserves – currently bear an interest cost of -0.5%.

That transformation of governments' debt has helped reduce their financing costs. For example, for all that investors may be concerned about the sustainability of Italy's debts, its debt service costs as a share of GDP are at an all-time low.

As Figure 16 shows, once the ECB's actions are taken into account, Europe's 'Hamiltonian process' of fiscal federalization – past, present and future – becomes apparent.

Figure 16: De facto, all of the increase in euro area government debt since 2007 has been transformed into a mutual liability

Euro area government debt as % GDP, with Credit Suisse projections to 2024, euro area nominal GDP held constant from 2019



Source: Credit Suisse, ECB, European Commission

For us, the Recovery Fund marks clear progression in this process. There is greater risk sharing – the debt is a mutual liability – and the 'risk reduction' is far less onerous. Indeed, the crisis has freed – temporarily, at least – euro area fiscal policy from the constraints of the Stability and Growth Pact, which are suspended until at least the end of this year, allowing governments to spend freely to manage the pandemic and economic recovery.

[4] The ECB's Pandemic Emergency Purchase Programme is allowed to deviate from the capital key. In the early months of its operation it did so. But recently purchases have converged towards the capital key.

That has improved the economic policy mix in Europe over the short term, and there is scope for further reform this year as reviews of both the ECB's monetary policy strategy and the euro area's fiscal rules conclude (see page 53).

Issuing debt and disbursing funds – as the EU can do with the Recovery Fund – are vital elements of any fiscal capacity. A federal fiscal authority also needs its own tax revenues. Presently, the EU's budget is a negotiated set of net contributions and disbursements between member states. The EU has no revenue resources of its own.

That may also change. As part of its Green Deal the European Commission is proposing the eventual introduction of a carbon border tax to prevent carbon-intensive production from shifting offshore. It also proposing to finance the Recovery fund partly through a digital services tax (of 3% of gross revenues), and with a plastic tax implemented at the start of the year.

There is growing discussion that any, or all, of these taxes could be designated to the EU to allow it to finance its own debt. That would give the EU its 'own resources' and complete the creation of an EU fiscal capacity.

Consolidation

A more effective and integrated fiscal policy framework is necessary to reduce economic and financial fragmentation in the EU. But it is not sufficient. There is also a need for greater integration in the financial system, and at the broader corporate level.

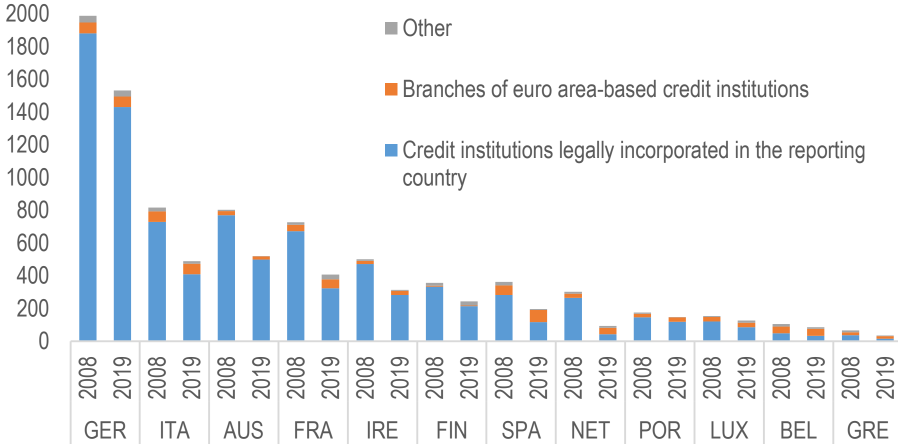
The UK's departure from the single market increases the urgency for a less-fragmented financial system. The City of London has remained an important provider of financial services to the EU, such as derivatives clearing, investment banking and securities and derivatives trading. In many of those cases, the UK is still responsible for over half of all EU financial activity.

The recent trade agreement with the UK does not cover financial services, so there is considerable political and regulatory pressure to shift some of these services into the EU. Although that would increase the EU's (and specifically, the euro area's) financial capacity, the challenge the EU faces is a highly fragmented financial system. If not London, where is the EU's financial centre?

As Figure 17 shows, the EU has multiple financial centres. Each member state has a large number of domestic banks servicing its domestic market. That was a particular weakness for the euro area in periods of financial stress, as domestic banking systems were vulnerable to redenomination risk. Since the financial crisis, cross-border banking sector financial flows have effectively been replaced by intermediation through the central bank network. Despite the best efforts of the ECB, the euro area still effectively has nineteen different banking sectors.

Figure 17: Single market, single currency, many financial centres

The number of credit institutions in euro area countries in 2008 and 2019



Source: Credit Suisse, ECB

An effective way to defragment the EU's financial structure would be through cross-border bank mergers. But bank merger activity in the euro area has been limited since the aftermath of the 2007-09 financial crisis. And what little activity there has been was predominantly domestic, rather than cross border.

Changing that is not easy. One clear obstacle is the high cost of capital for EU banks. That's partly a consequence of negative policy rates. But it will also require considerable regulatory change, for example treating the EU or euro area as one jurisdiction for cross-border merger capital requirements, rather than a multiplicity of jurisdictions. That, in turn, requires harmonization of rules at the EU level. And the completion of the Banking Union, with an EU-wide deposit insurance scheme, would likely help.

Given the more assertive European Commission, we would expect some progress on this in coming years. It will be slow, but the environment for cross-border bank mergers in the EU should become steadily less challenging as both the Commission and the ECB try to create a more supportive environment for them to take place.

That issue has also been addressed by the successful development of a broader credit market. Thanks to the ECB's corporate bond purchases encouraging issuance, businesses have steadily reduced their borrowing from banks and resorted to market issuance (Figure 18). Given exceptionally low yields, this is a trend that will likely continue, increasing financial integration through capital markets rather than through the banking sector.

Figure 18: Shifting towards credit-based corporate finance

Share of non-financial corporations' debt liabilities comprised by market issuance (%)

Source: Credit Suisse

Regulatory pressure for cross-border integration is also likely to build for the broader corporate sector. For the EU to remain competitive, competition rules are under pressure to adapt to a world of large-scale corporations. A review of competition policy is currently under way, with a conclusion likely later this year.

There could be changes on rules for state aid in specific sectors. For example, in 2019 state aid was approved for companies building electric car batteries. The rules could be made more flexible when innovation needs to be supported in certain sectors, such as healthcare following Covid-19 and renewable energy to achieve the climate change objectives of the Green Deal.

The latter aims to reduce carbon emissions (by 55% of 1990 levels by 2030). That links it with the process of fiscal integration (30% of the EU budget will be spent on environmental projects and infrastructure, and a carbon border tax, if implemented, could also provide the EU with its own revenue stream).

It also plays to one of the EU's few relative strengths at the global level: its ability to set regulatory standards that other regions have to follow, the so-called 'Brussels effect'. Given the importance of the European Single Market as an export market for the rest of the world, EU regulations have often been adopted by other countries in areas as diverse as chemicals and data protection. A shift towards decarbonisation may do the same. Indeed, other countries have already raised concerns that the EU will determine environmental standards globally[5].

By taking a lead in setting environmental regulatory standards in both industry and finance and effectively subsiding them through the Recovery Fund, the EU has the potential to develop a comparative advantage in those sectors.

[5] Japan warns against allowing EU to set emission rules, Financial Times, 6 December 2020

Consequences: Integration and disintegration

The political and economic developments of the past year or so suggest that the EU has passed an inflection point. The impetus for more – and better – economic, financial and political integration is under way, spurred by the pressures of the pandemic and Brexit.

The pace and form of the integration now under way mark a change with the inertia of the past 10-20 years. That will have consequences.

We think the process of integration should slowly diminish many of the economic and financial imbalances and distortions we discussed earlier. But there will also be points of tension and stress.

Better balance inside and outside the EU

Firstly, we expect a better macro-economic policy mix to emerge from the aftermath of this recession, compared with the crises of 2007-13. That means a slower process of fiscal consolidation. It is likely that the rules of the Stability and Growth Pact will be imposed with greater discretion, allowing deficits to be brought back below 3% of GDP over a long time.

Together with the creation of fiscal capacity at the EU level – which should begin to support public investment later this year – fiscal policy should be more supportive of euro area domestic demand in the coming few years than it was over the past decade.

As Figure 15 shows, some indicators of financial integration, such as cross-border lending flows, were starting to improve before this crisis. Greater fiscal and political coherence should encourage that further, as should the pressures from monetary and regulatory policy. Improved cross-border financial flows should also support stronger domestic demand, especially in southern Europe.

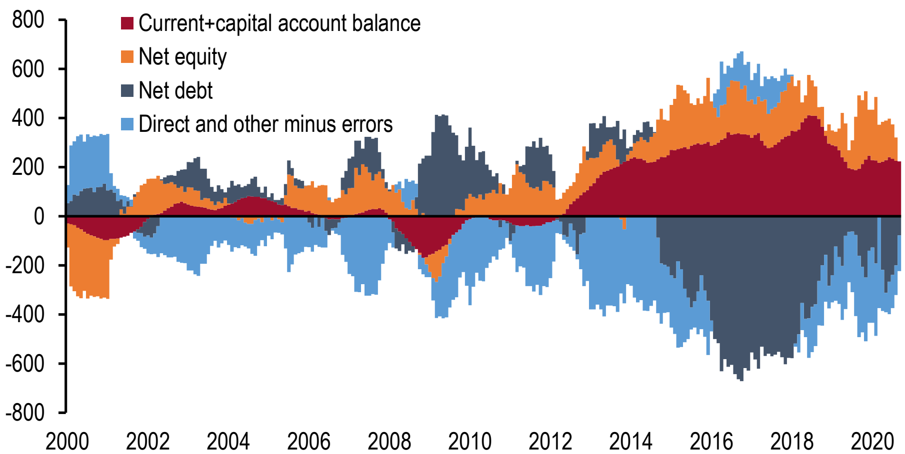
In turn, that means a better external balance. This process should steadily reduce the euro area's large current account surplus.

In the past five years or so the combined imbalances of weak domestic demand relative to external demand, and loose monetary relative to tight fiscal policy, had powerful effects on global financial flows.

Those effects are illustrated in Figure 19, which shows the key inflows and outflows from the euro area's balance of payments. The combination of a massive current account surplus, huge ECB bond purchases, negative policy rates and small government deficits provoked enormous foreign bond buying by domestic euro area institutions, totaling almost €2tn net in 2015-19. Consequently, the euro area's imbalances put serious downward pressure on yields around the world. So as those imbalances diminish, so should that pressure on yields.

Figure 19: A better-balanced euro area economy and policy mix should ease the downward pressure on global yields

Euro area balance of payments, €bn, 12m rolling sum



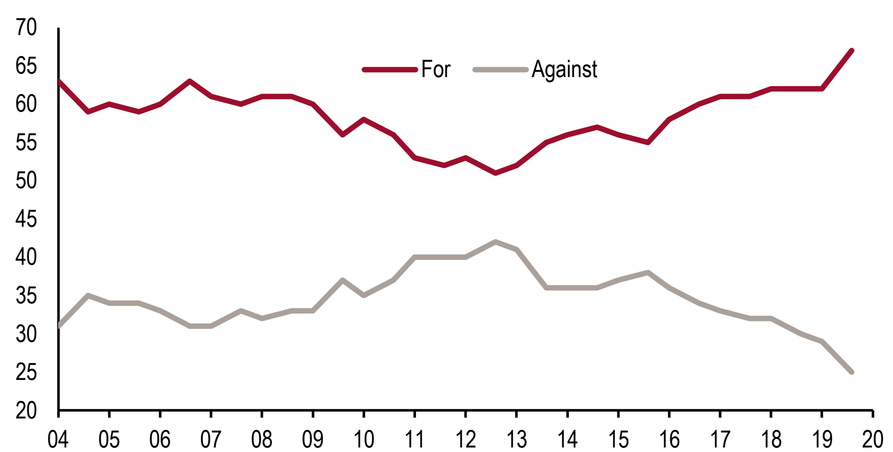
Source: Credit Suisse, ECB

An ebbing of anti-EU politics

The past decade also saw moments of political fragmentation, as elections delivered unexpectedly strong results for anti-EU parties and movements, for example in Italy in 2018. And most spectacularly in the UK in 2016. Here too the trends we discussed should reduce those risks. As Figure 20 shows, support for the EU and the euro has increased in the past year and is now at its highest level in many years.

Figure 20: Support for the EU and the euro has increased

What is your opinion on each of the following statements? A European economic and monetary union with one single currency, the euro (% EU)



Source: Credit Suisse, Eurobarometer

That may also provide further political momentum to integration. This autumn's German elections and next spring's French elections will be key in determining whether the recent Franco-German push for greater integration is sustained.

In particular, the complexion and leadership of the German governing coalition after the election will be critical. A coalition involving the Green Party is likely to be one that is engaged in implementing and extending the EU's Green Deal. Conversely, a more conservative government, albeit less likely, could interrupt that progress.

Frictions and disintegration of the periphery

As the process of integration proceeds, a change to the EU Treaty will at some point become necessary to deepen and codify these changes. As we have noted, the Treaty's rules currently constrain necessary policy flexibility. To address that, intergovernmental treaties (between subsets of EU members) and other fixes have been used to work around its deficiencies. We don't think that will be sustainable. For example, such 'fixes' are vulnerable to legal challenge.

But past Treaty changes have been difficult to achieve. Such pressures for integration will not be welcomed by all member states, and some may not wish to participate. In parts of Europe, there is limited enthusiasm for greater integration.

For example, some central European countries such as Hungary and Poland resisted aspects of the Recovery Fund, specifically the attachment of disbursements to compliance with the rule of law.

And some Scandinavian countries have an ambivalent relationship with the European Union. Sweden voted against joining the euro (despite it being a Treaty commitment) in 2003. Denmark voted against joining the euro in 2000 and voted against removing some of its EU Treaty opt-outs in 2015.

Politically, integration will be hard. And resistance to EU integration may lead to fracture. There are a couple of likely outcomes.

One way would be a deeper political and economic integration of countries in the euro area. That would mean detaching non-euro members of the EU (such as the Scandinavians and central Europeans) from the core.

Another – more likely – consequence of stronger integration is that pressure on non-euro EU member states to join the single currency will intensify. That would mean the euro area and the EU becoming the same thing.

But that could lead to other countries leaving the EU. As discussed above, the likely candidates would be in Scandinavia and central and eastern Europe.

Europe ranks senior

The process of fiscal integration is perhaps the most important for investors and markets. The constructive developments of the past year have been positive for financial conditions and the price of sovereign debt in countries such as Italy and Spain. Italian government bond spreads over Germany are approaching their lowest since 2007.

Although this 'Hamiltonian process' of debt mutualisation through fiscal federalization has been positive for bond markets, it is not without risk.

There has been a greater willingness to mutualise risks and debts of the present and future than there has been to sharing burdens of debts incurred in the past.

As Figure 16 showed, a slow process of mutualisation has been under way since the early 2010s. But it has been limited. The ECB has been accumulating sovereign debt since 2015. And the Recovery Fund will support reconstruction from only the pandemic. As Figure 16 demonstrates, there is still a considerable quantity of legacy national debt from the past.

That national legacy debt has benefitted from the process of mutualisation. But that process brings risk as well. We expect that legacy debt will rank junior to a growing quantity of EU mutual liabilities. If that's correct, there would then be a significant subordination of investors in several euro area governments' debt (Figure 21).

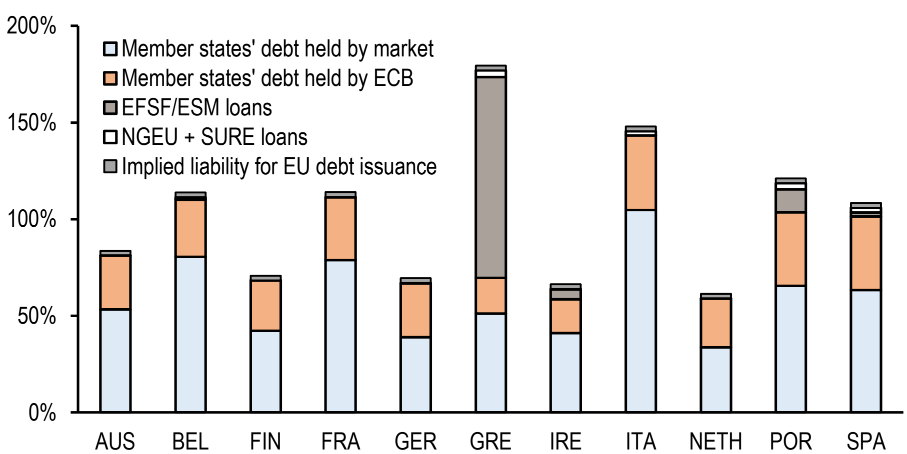
That may not matter. As noted, mutualisation has made servicing and rolling over that legacy debt easier and cheaper. But as the process of mutualisation advances – on the ECB's balance sheet and through the EU's growing fiscal capacity – so do tail risks in future episodes of stress.

For example, as we discuss on pages 8-17, greater volatility in inflation and real rates could lead to a material rise in ECB policy rates. That would immediately increase debt service costs for euro area governments through the large quantities of debt effectively mutualised on the ECB's balance sheet. If that raised questions of debt sustainability for some member states, the de facto seniority of the ECB's bondholdings would compound those fears for bondholders.

Or, perhaps, a 'grand bargain' to deliver a permanent federal fiscal capacity and debt mutualisation in an EU treaty could require restructuring of some governments' debts to reduce them to a common level. In which case, subordinate legacy debts would be the most at risk.

Figure 21: The mutualisation of euro area government debt may mean the effective subordination of legacy national debts

The ownership and structure of euro area governments' gross liabilities as a % of GDP



Source: Credit Suisse, ECB, European Commission

In conclusion, then, we think that the process of EU integration has been reinvigorated by the shocks of last year. That process will take time, but should help address many of the flaws and imbalances the EU and euro area have at present.

From a financial perspective, the reduction of those imbalances should reduce some of the distorting effects Europe has on the global economy and financial system. It should also lead to tighter financial integration within Europe.

But it will not be a smooth, orderly process. Integration may provoke disintegration. The tensions between members of the euro area and those outside it – in Scandinavia and central Europe – will increase and may lead to other countries in the EU's political periphery following the UK out of the EU.

And although the process of deeper fiscal integration has so far been very supportive for sovereign debt in the euro area's economic 'periphery', it too is not without risk. Mutualisation also means juniorisation.

Emerging markets: Is there a new normal?

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- **Fundamental divergences between emerging and developing economies, and across emerging markets, should start to surface as the discussion of policy normalization arises in coming quarters.**
- **Financing for fiscal and external sectors should be available amid low funding costs and abundant liquidity, but macro fundamentals will matter if negative surprises appear globally or domestically.**
- **EMs will likely lag DMs in the rollout of vaccines, deepening the divergence in the capacity of each group of countries to recover from the economic shock of the pandemic.**

We expect emerging market (EM) economies under our coverage to grow at an average annual rate of 5.8% in 2021, after contracting an estimated 0.3% in 2020. The impact of the pandemic was quite diverse among regions. Emerging Asia managed to post real GDP growth of 1.9% in 2020 and should accelerate to 6.7% in 2021 (a wider sample of countries suggests a contraction of 0.4% for the region). Meanwhile, we estimate a real GDP contraction of 7.2% in 2020 for Latin America, and a 3.3% contraction for EEMEA. This year, LatAm should rebound by 4.0% and EEMEA by 3.2%. But growth numbers are not the story. There are rich economic themes to explore in EM this year, as we navigate into the next phase of the pandemic.

Over the past few quarters, we saw a synchronized global story in terms of lockdowns, output decline, and the deployment of economic stimulus packages. In coming quarters, on the other hand, we may see fundamental divergences start to surface between developed and emerging economies. In previous reports, we noted that there was an inherent risk to eventual policy normalization in EM, as growth would likely suffer. We have also wondered how balance sheets would look in the aftermath of 2020's policy response and have highlighted that a time would come when investors may need to become increasingly discriminatory in the way they looked at EMs. We think that time is now.

Perhaps the most relevant thing to bear in mind this year, regardless of how obvious it may sound, is that EMs are not DMs. EMs do not have the ability to run stimulus measures for too long; their domestic markets are less deep, their labor markets are less flexible, and their infrastructure is less developed. Furthermore, DMs have greater resources and infrastructure to undertake their vaccine campaigns relative to EMs, and may reach herd immunity sooner. Hence, policy normalization may be forced to occur earlier in EMs than in DMs, regardless of the fact that the recovery of DMs, in terms of income, employment, output, and welfare levels relative to 2019, will likely be faster than in many EMs.

There is an overwhelming consensus among market participants that ample global liquidity and a weak dollar are the recipe for a good year for EM assets. However, fundamentals must not be lost from sight, especially as these tailwinds are completely exogenous to EM. What happens if the direction of policy in DMs, or market expectations about them, change abruptly? There are also EM-specific risks to bear in mind: will inflation remain so benign to allow EMs to keep interest rates at record lows for long? Once economic activity takes off, will external balances start to deteriorate rapidly, and if that happens, could currencies weaken, inflation start to pick up, and pressure increase for central banks to start normalizing their monetary policy stance? If so, can emerging markets continue funding large fiscal deficits, or will markets demand a faster fiscal normalization if they become more concerned with debt sustainability? What will happen to growth if policy shifts too fast, either in DM or EM? Will EM policymakers deliver the reforms needed to safeguard medium-term sustainability in the presence of large inflows?

Perhaps, the new normal is a world in which higher debt ratios will be tolerated, neutral rates remain lower for longer, and large fiscal deficits can be funded. If it is not, however, then the need to differentiate between EMs will be more important than ever, and we must keep these questions present in case any of these risks, or a sudden change in expectations, materializes.

The aftermath of an unprecedented shock

Over the past few months, most EMs deployed a policy strategy that mirrored, broadly speaking, that of developed economies. In fact, EM policymaking has been a function of DMs' policymaking, whether the latter intended that to be the case or not. Very accommodative monetary policy in DMs and, fundamentally, the Fed's actions to guarantee its role as the global provider of dollar liquidity helped EMs pursue a very lax monetary policy, which in turn created the conditions for fiscal policy to expand in order to mitigate the social cost of lockdowns. The question that we keep asking ourselves is how much damage could be inflicted in EMs if these dynamics were to reverse quickly. What is the aftermath of record high fiscal deficits, increasing public debt levels, central bank balance sheet expansions, and negative real interest rates in an EM country?

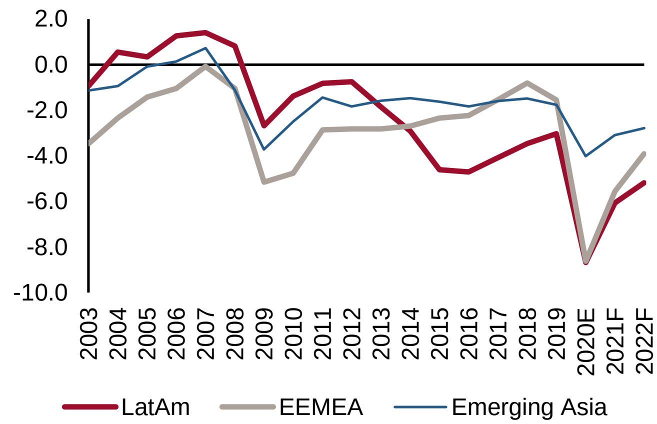
This new equilibrium in EMs does not look stable to us. Depressed economic activity, large fiscal deficits, increasing debt levels, low interest rates, and narrow external imbalances cannot coexist for long. Activity will eventually pick up, external balances may shift, interest rates may need to increase, fiscal deficits will be more difficult to fund, and debt sustainability concerns could surface in different countries. To be clear, this is not our baseline scenario for 2021: our forecasts tell a story of a moderate pickup in growth, stable interest rates, orderly fiscal consolidation, and healthy external balances. But in 2020, we faced a shock of unprecedented magnitude and witnessed unprecedented policy reactions. We must keep an open mind to how things could evolve in 2021 and beyond that challenge conventional wisdom.

In practical terms, the key question in EMs should be whether the fiscal sector and the balance of payments are transitioning to sustainable equilibriums, how fast, and if there is enough financing as these transitions materialize. The initial conditions of some EMs will surely be daunting, but financing should be available, at least in 2021.

On the fiscal side, public sector balance sheets in many EMs severely deteriorated in 2020. The average size of the 2020 fiscal deficit in the emerging market countries under our coverage likely reached 8% of GDP, up from an average of 1.8% of GDP between 2000 and 2019. Latin America stands out the most, where the average fiscal deficit last year reached 8.7% of GDP, followed by EEMEA at 8.6% of GDP, and finally EM Asia at 4.0% of GDP. The average size of EM fiscal deficits next year should narrow to 5.3% of GDP, the second highest in the past 20 years.

Figure 22: Average fiscal deficit in EM regions

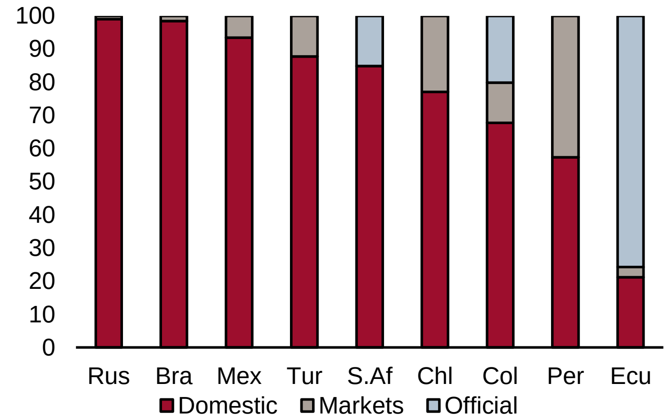
% of GDP, simple average



Source: National sources, Credit Suisse

Figure 23: Funding of 2020 fiscal deficits by source

%

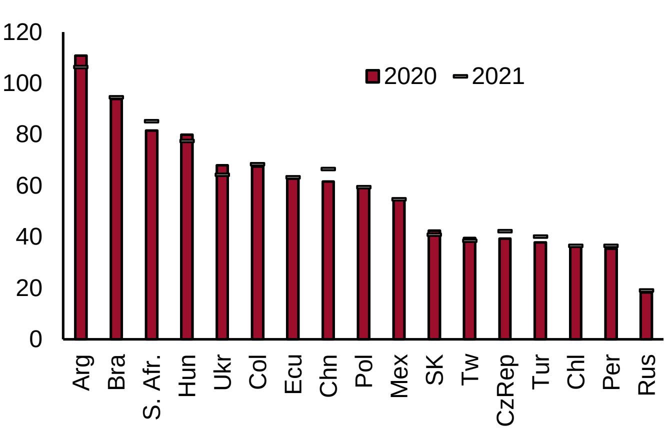


Source: National sources, Credit Suisse

Consequently, the size of gross government debt in EM rose substantially in 2020, to 58% of GDP from 50% of GDP in 2019. As a comparison, in the 2009 crisis, public debt in EMs rose by 7.4% of GDP. The median size of public debt in the countries we cover jumped to 59% of GDP in 2020 from 47% of GDP in 2019. We project public debt to continue increasing, reaching 62% of GDP in 2021 and 65% of GDP in 2022, while fiscal deficits shrink. We think markets may, at some point, demand greater fiscal discipline in some EMs, particularly as public debt ratios have reached very high levels. Countries like Brazil and Argentina now border or have breached a public debt ratio of 100% of GDP, South Africa and Hungary are at 80% of GDP, and Colombia, Ecuador, and Poland oscillate between 60% and 70% of GDP, for example.

Figure 24: Projected gross public sector debt levels

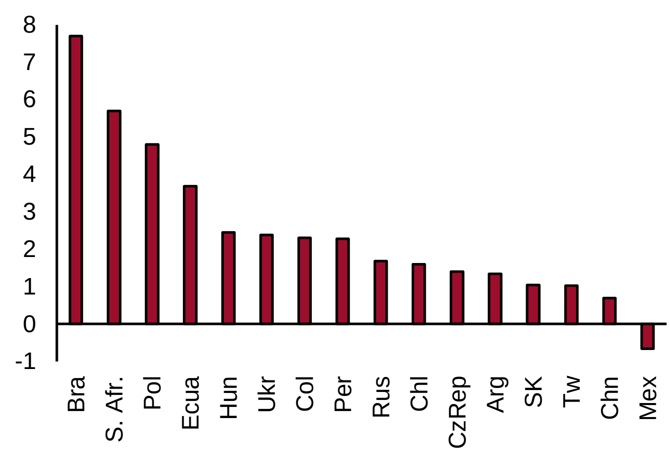
% of GDP



Source: National sources, Haver, Credit Suisse

Figure 25: Expected fiscal consolidation in 2021

% of GDP

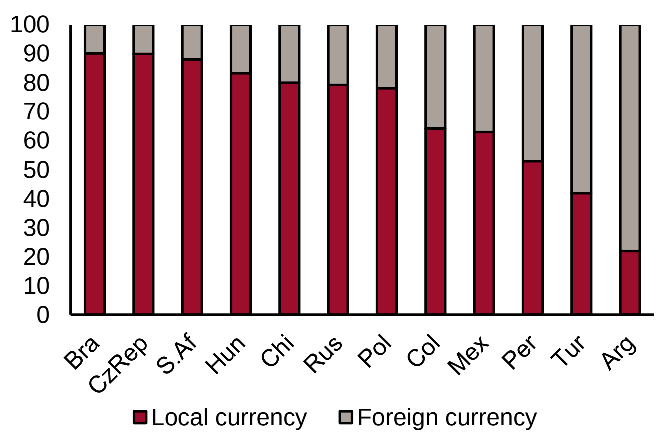


Source: National sources, Credit Suisse

The stock of public sector debt, by itself, is an insufficient indicator to gauge debt sustainability, but it nonetheless is a factor. Financing costs, maturity, and currency composition are also important factors to consider, alongside economic growth and the evolution of the primary fiscal balance. The structure of the holdings of local bonds is yet another source of vulnerability of which to be mindful. Most of the financing of last year's fiscal deficit came from domestic sources, but many countries also had access to international financial markets, and the official sector has also been active to a lesser degree in the countries we cover.

Figure 26: Currency composition of public debt

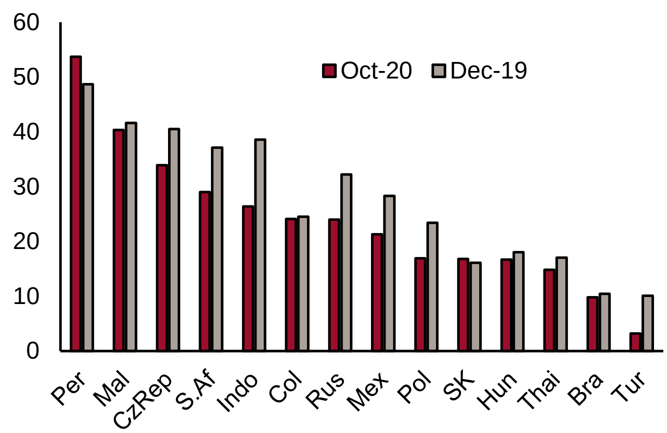
% of GDP



Source: National sources, Credit Suisse

Figure 27: Foreign holders of local bonds

% of total

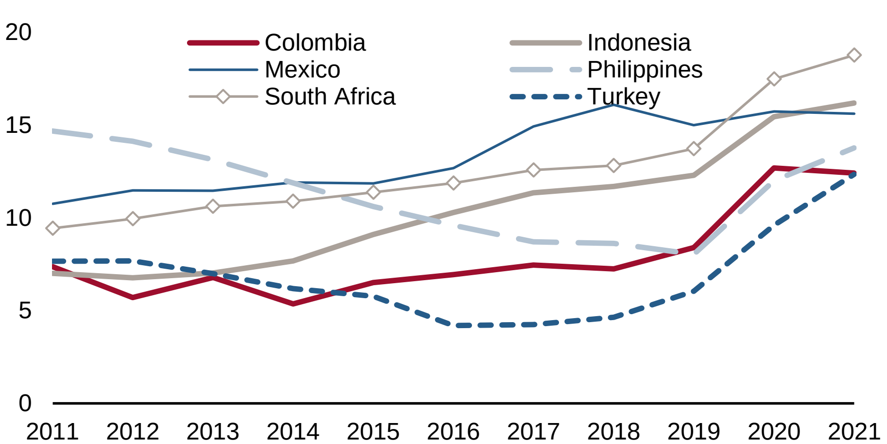


Source: National sources, Credit Suisse

Emerging markets have benefited from low interest rates both domestically and abroad, which has muffled, to a point, concerns about debt sustainability. However, these dynamics could be largely temporary. Eventually, funding costs may increase as governments start to roll over newly issued debt in both foreign and domestic markets, so we must be aware of how debt dynamics are changing and where. Brazil and South Africa are two countries where fiscal dynamics and reform implementation will become critical next year in order to keep investor appetite alive, we think.

Figure 28: Interest expense to revenue ratio

%



Source: IMF, Credit Suisse

At present, fiscal dynamics look manageable across the board, but the trend is clearly deteriorating in many countries. Several countries are already seeing the cost of servicing debt increase as a share of their revenues, for example. South Africa stands out as the place where this deterioration is more meaningful, and it should serve as a blueprint of risks for other EMs. Brazil stands out too, given a large and increasing debt to GDP ratio, coupled with concerns regarding the future of the fiscal sector. Both countries must implement important reforms to provide investors with credibility that there will be a fiscal anchor in coming years, which would prevent a further deterioration in debt dynamics. Countries like Colombia will also need to provide assurances to investors that their fiscal accounts can remain sustainable. In Colombia's case, the country risks losing its investment grade rating if it does not provide appropriate fiscal anchors in coming months. Turkey, despite having relatively low debt to GDP levels, has seen its gross government debt to GDP ratio and its cost of servicing debt increase as foreign-currency-denominated and short-term debt placements have increased.

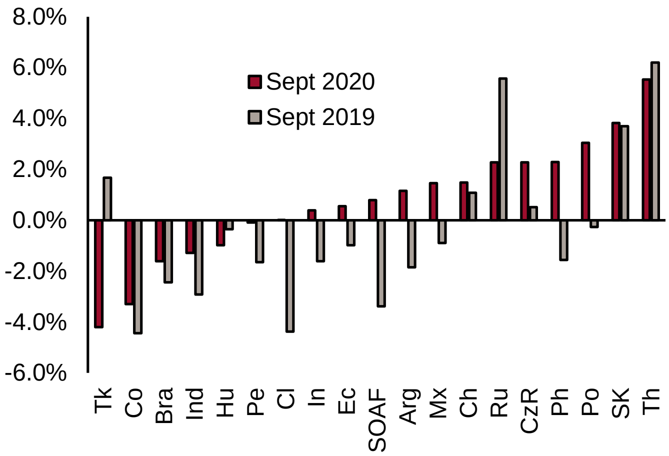
Sustaining investor appetite through sound fiscal reforms will be increasingly relevant in EM, as the presence of foreign investors in local debt markets is material in many countries. While this phenomenon has likely helped EMs in developing their local debt markets and shifting the composition of their public debt to local versus foreign currency, it also increases the risk of rapid outflows when investors lose confidence in the soundness of a country's macro fundamentals.

We expect fiscal imbalances to narrow across the board this year relative to 2020. Part of this fiscal consolidation will probably come from an organic recovery in revenues due to the normalization of economic activity. Another portion will need to come from the rollback of pandemic-related expenditures. However, fiscal consolidation efforts will need to continue in coming years in order to stabilize debt ratios and improve debt dynamics in many countries. Tax reforms and planned expenditure freezes or cuts are already in the pipeline in some of these countries, which will surely weigh on growth.

Meanwhile, external accounts have largely adjusted in EMs by virtue of substantial improvements in trade balances, many of these characterized by strong declines in imports. In some cases, lower income account outflows have been the main drivers of the improvement. This divergence likely underscores different degrees of damage to domestic demand. South Africa, Chile, Philippines, Czech Republic, and Poland have had the largest positive adjustments in their current account deficits, while Turkey remains an outlier in terms of its deterioration.

Figure 29: Current account balance

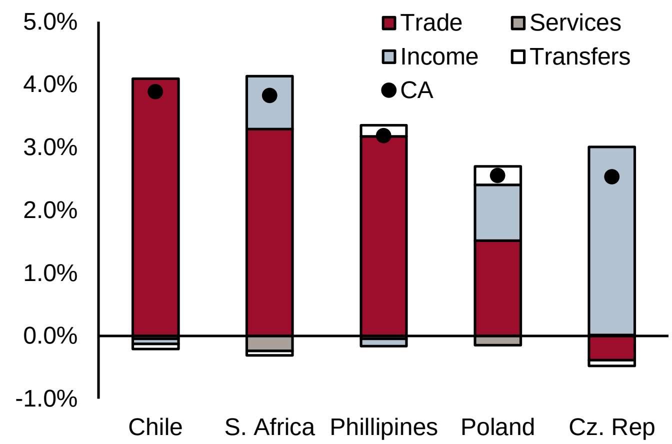
4-quarter rolling, % of GDP



Source: Haver, Credit Suisse

Figure 30: Composition of current account adjustment

% of GDP, 4-quarters accumulated, 4Q 2010 vs 3Q 2020



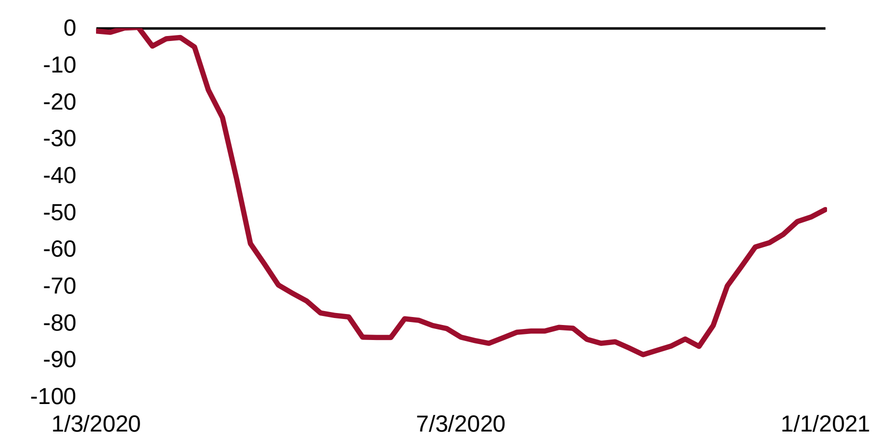
Source: Haver, Credit Suisse

The evolution of external balances will be linked to many factors, including the recovery in domestic demand, the strength of external demand, and commodity prices. At present, we do expect some countries to see their current account balances worsen this year (Brazil, Chile, Mexico, Poland, and South Africa are examples), and others may see marginal deterioration in 2022. A positive side effect of a quicker recovery in DMs' domestic demand should be to support commodity prices and external demand for many EMs, helping exports buffer the pickup in imports as economic activity normalizes in EM. The downside could be in terms of currency appreciation, which could hamper competitiveness, and in the fact that EMs will likely trail DMs in the recovery.

Narrower external deficits and the resurgence of external surpluses mean that policymakers may need to deal with capital inflows differently than in the past. IIF data suggest that flows to EMs have strengthened since November, which is consistent with the strong appreciation seen in EM currencies over the past few weeks. However, should EM currencies be stronger today than what they were before the pandemic?

Figure 31: Cumulative non-resident purchases of EM stocks and bonds

$bn, sample includes Indonesia, India, South Korea, Thailand, South Africa, Brazil, Philippines, Hungary, and Ukraine

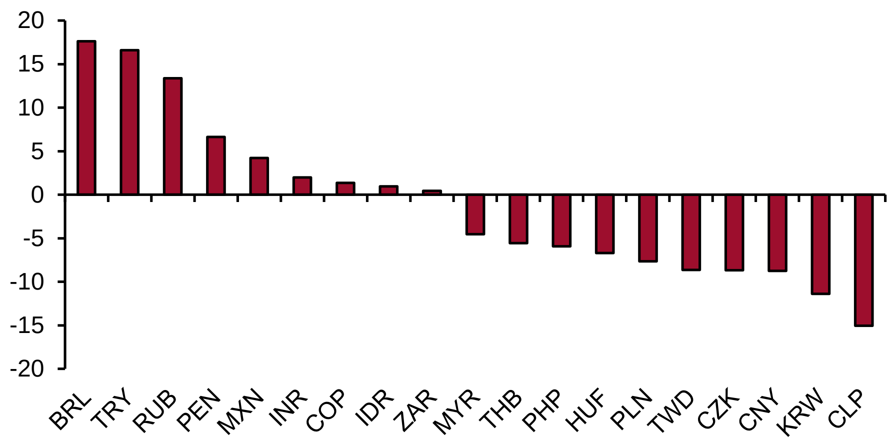


Source: IIF, Credit Suisse

Many EM currencies have indeed strengthened past their February 2020 levels. Markets have been quite differentiating, however. In general, Asian currencies recovered faster, followed by central European currencies, while Latin American currencies have generally remained weaker. This shouldn't be surprising, as in many Asian countries, in general terms relative to other EM, external accounts are stronger, fiscal imbalances are narrower, monetary sectors are deeper, and growth is more robust. The Chilean peso currently stands out as the currency that has appreciated the most since February 2020. A combination of factors, including higher copper prices, dollar sales by pension funds, a bounce back from negative sentiment given social unrest, and a new resolution to make the CLP fully deliverable offshore, are likely to have contributed to this dynamic.

Figure 32: Emerging market currencies

%, Spot depreciation (+) or appreciation (-) relative to 21 February, 2020, through 6 January 2021



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

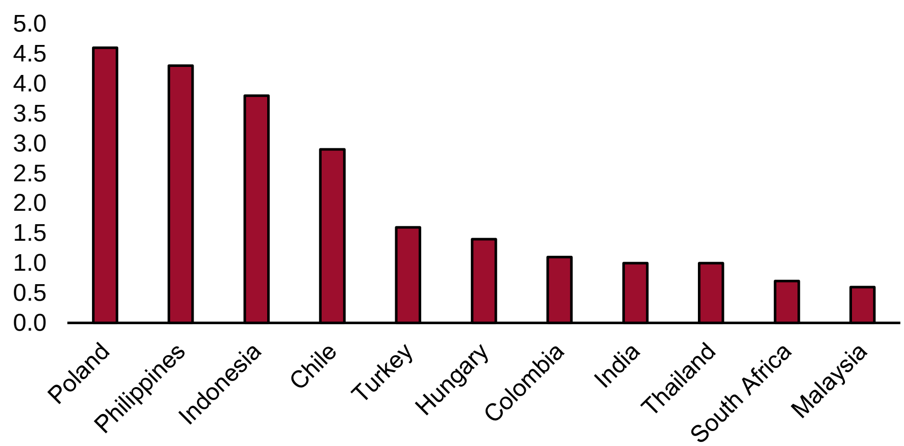
Turkey, Brazil, and Russia, on the other hand, stand out as the currencies that have recovered the least from the Covid shock. In every case, important idiosyncratic factors are present. Turkey faced a rapid deterioration of its balance of payments evidenced by a swelling current account deficit and international reserve drain, given overly expansionary monetary and credit policies in 2Q 2020. A newly appointed economic team and an incipient reversal in some of these policies have helped the lira regain some strength in recent weeks and could stabilize balance of payments dynamics. In the case of Brazil, record low nominal interest rates, coupled with record high public debt levels, may not yet be a combination that markets are comfortable with, at least until the government convinces investors that there is a fiscal anchor to its monetary policy scheme, which is necessary for debt sustainability to be ensured over the medium term. In Russia, rapid growth in domestic monetary aggregates and tax treaty initiatives from the government were a combination that was unfavorable for the rouble.

Meanwhile, other countries, such as Poland, have started to intervene in the currency market to mitigate the pace of appreciation. Poland reported one of the largest current account surpluses (on a four-quarter rolling basis) in EM during the third quarter of 2020, topped only by a few Asian countries. Will other EMs eventually follow Poland's example and intervene to prevent more appreciation of their currencies? During the spring, policymakers in EM largely refrained from intervening when currencies sold off. However, as capital inflows strengthen in the context of stronger external balances, policymakers will likely face the conundrum to either let currencies strengthen and allow capital inflows to fuel domestic asset prices, or build up reserve buffers and safeguard competitiveness.

Strengthening currencies is probably the result of a more aggressive (and expectations of a longer lasting) monetary stimulus in DM relative to EM. While interest rate differentials collapsed as interest rates in EM fell to historic lows, balance sheet expansion in DMs was orders of magnitude larger than in EMs. Several EM central banks adopted asset purchase programs, but none were very large and only few were aimed at providing direct financing to the treasury. IMF research suggests that these asset purchase programs did not have a negative impact on currencies, but did help domestic yields fall. If inflows into domestic markets intensify, central banks may find an exit strategy that should be largely harmless to domestic markets.

Figure 33: Size of asset purchase programs

% of GDP



Source: IMF, Credit Suisse

Some countries, like Hungary and Poland, may continue to use asset purchase programs as their main monetary policy tool. This may grant them degrees of freedom to keep their policy rates unchanged for longer than other countries or even lower them further in order to offset the negative growth impact from meaningful fiscal consolidation in 2021. However, these countries did not enjoy the disinflation momentum that LatAm and Asian countries went through this year. Actually, annual headline inflation in CEE3 countries has steadily picked up over the past few years. Resources from the EU Recovery Fund will be an important differentiator for CEE3 countries relative to other EMs. This should add further degrees of freedom for policymakers, as it may allow a faster pickup in economic activity and guarantee the flow of resources for the private sector during 2021.

We expect interest rates to remain low in EM. Some countries such as Mexico, South Africa, and those in Eastern Europe, for example, may still have room to deliver rate cuts at the margin. For the rest, incipient normalization is likely at the doorstep. We are penciling in modest rate hikes already in Brazil, Colombia, and Czech Republic in 2021, and Peru and Chile may follow in 2022. Inflation should not be a concern, according to our forecasts, as we expect annual headline inflation to remain contained in 2021 and 2022. As we mentioned before, our baseline scenario is not one of disorderly adjustments; it is the risks to that baseline that concern us.

The vaccine rollout should deepen divergences

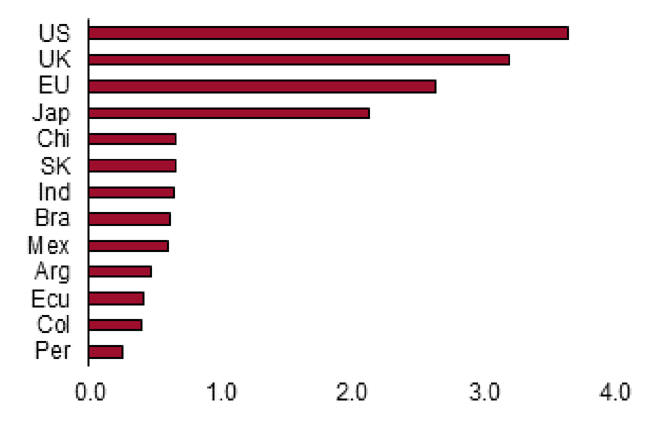
Vaccination campaigns have begun in many countries and should be more generalized in coming months. As mentioned in our opening section, DMs are probably better positioned to vaccinate a larger segment of their population faster than EMs. This means that herd immunity will likely be reached in DMs faster than in EMs. According to the information we have gathered, DMs have secured many times as many vaccines as EM countries, even when accounting for population and dosage. Admittedly, deals on vaccine purchases continue to be announced, so this information is constantly changing. Russia could be in a particularly better situation than most EMs, as it has managed to develop its own vaccines.

Seroprevalence estimates across EM are very heterogeneous, which means vaccine campaigns will likely differ. According to IHME data, seroprevalence in many countries of Latin America is very high when compared with other regions. If these estimates are accurate, some Latin American countries may need to vaccinate a smaller percentage of their population to reach herd immunity, although this means that a high percentage of the population contracted the virus. The seroprevalence estimates for emerging Asia are much lower, probably since outbreaks and contagion were in general more contained than in other regions.

We can be a bit skeptical about the magnitude of these estimates. Many country-specific conditions could have led to higher fatality rates than the ones estimated, for instance, or information sources may be deficient, particularly in some EM countries, leading to large estimation errors. However, we view these estimates as indicative of many countries' relative degree of contagion and their different capabilities and resources to obtain and (likely) deploy vaccines.

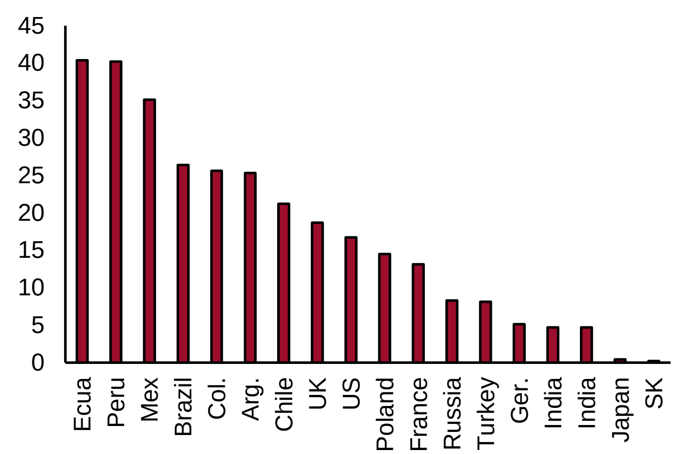
Figure 34: Covid vaccines announced deals

Vaccines per capita, dose adjusted



Source: Credit Suisse Pharma Equity Research

Figure 35: Seroprevalence estimates



Source: IMHE, Credit Suisse

The ability to reach herd immunity is the main determinant for social interactions and economic activity to go back to normal. The main challenge for EMs will be the capacity to roll out the vaccines to their population. It is impossible to forecast which countries will do this better than others, as it will depend on different factors that include infrastructure, weather, and logistics capabilities. What we do expect is that DMs will be more successful in obtaining herd immunity before EMs, which means their economies, and macro fundamentals, should also heal at a faster rate. On the positive side, this should support external demand for EMs. On the negative side, as we have argued in the past, EMs probably have less space to increase policy stimulus, and macro fundamentals will take longer to heal.

While everybody went 'into' the pandemic in a similar way (lockdowns, social distancing measures, job losses), the stark differences that distinguish developed from emerging economies, and EMs among themselves, will be intensified on the 'way out.'

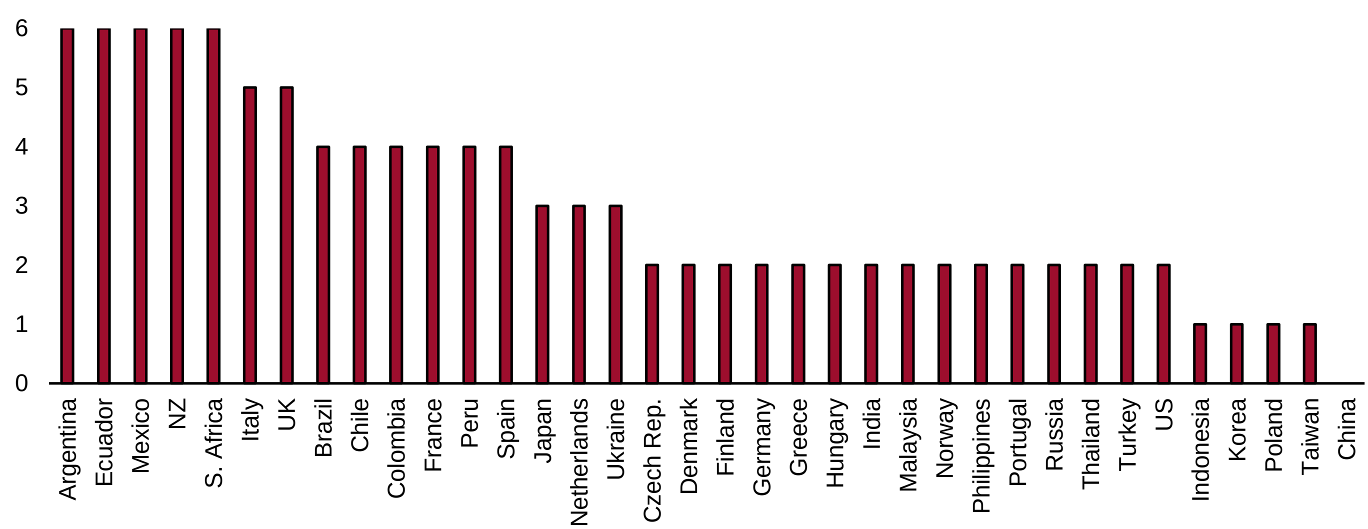
Rebound versus recovery

During a webcast organized by the Latin American Reserve Fund, World Bank Chief Economist Carmen Reinhart argued that "we should not confuse rebound with recovery." 2021 will likely be characterized by above-potential growth rates in many economies across the world (rebound). Output levels, income levels, and employment, however, may remain below 2019 levels in the majority of the world for a few years (recovery).

One standardized indicator that could help us visualize, to a point, the magnitude of the economic damage in many countries is per-capita GDP. IMF forecasts imply that many countries, particularly in Latin America, will take several years to recover the per-capita GDP levels of 2019. Argentina, Ecuador, and Mexico may take over six years to bring the indicator back to 2019 levels. Brazil, Chile, Colombia, and Peru, at least four years. Some developed markets also stand out for taking a long time to recover, such as Italy and the UK, at five years each, and France and Spain, which should take four. Recovery prospects in central European and Nordic countries look better, and Asia stands out as the region that will recover per-capita GDP levels faster.

Figure 36: Estimated number of years for per-capita GDP to reach 2019 levels

Based on forecasts through 2025 of IMF WEO



Source: IMF, Credit Suisse

A holistic recovery should be linked to the evolution of labor markets, we think. Countries that manage to generate formal employment faster, which in turn translates into permanent income, should foster better conditions for private investment to take off in order to ramp up production. Developed markets likely also have the upper hand relative to EM in this regard.

In this context, policy normalization in EM will need to be as careful and coordinated as the stabilization of a critical patient. Policymakers will need to calibrate their monetary, fiscal, and exchange rate policies to face challenges related with social welfare, labor markets, external balances, debt sustainability, capital flows, and growth, all at once. Many of these challenges may go unnoticed in the context of robust inflows in 2021. In fact, a negative side effect of abundant liquidity could be that it may enable policymakers to delay the needed adjustments for medium-term sustainability, as the social cost of the adjustment may be a difficult one for policymakers and politicians to bear.

Stark differences in the macro fundamentals among EMs should become increasingly visible in coming years. The skill of policymakers to deliver an ordered policy mix and the capacity of each country to overcome the challenges of the pandemic (linked to vaccination campaigns) will be the direct responsibility of each country. The largest exogenous risks that could accelerate disorderly adjustments will likely be sudden changes in the policy direction of DM's central banks, or at least in the markets' expectations on them. As long as liquidity remains abundant, yields remain compressed, and financing costs remain low, EMs will have time to create better conditions for when the status quo changes. The process starts this year.

A managed liberalization

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- **Opening up its economy is an essential policy solution to China's economic challenges, both externally and domestically.**
- **Capital account restrictions and import barriers will likely be lowered in a managed fashion.**
- **Such policies should result in disciplined monetary policy, greater RMB flexibility, smoother regional economic growth, and deepened global financial entanglement.**

As China embarks on its 14th five-year plan, it faces daunting economic challenges – trade skepticism from abroad and economic malaise at home due to its aging population.

The silver lining is that authorities have stepped up their efforts to confront these problems. The most pivotal policy innovation is to further open up China's economy to a freer flow of goods, services, and assets, in both directions. Such a stance will likely lead to profound changes in how the Chinese economy interacts with the rest of the world and how investors will adapt to it.

Success is not final…

While the evolution of China's economic liberalization has come a long way and generated great benefits to the country, the progress it has achieved thus far appears inadequate relative to the challenges that are mounting.

External challenges have intensified since the beginning of the US-China trade war. Not only did the conflict awaken ample resistance to China's trade practices, but it also led to the country's major trade partners demanding changes from it; one key demand was to open up its vast domestic market to more foreign participation, with fewer strings attached.

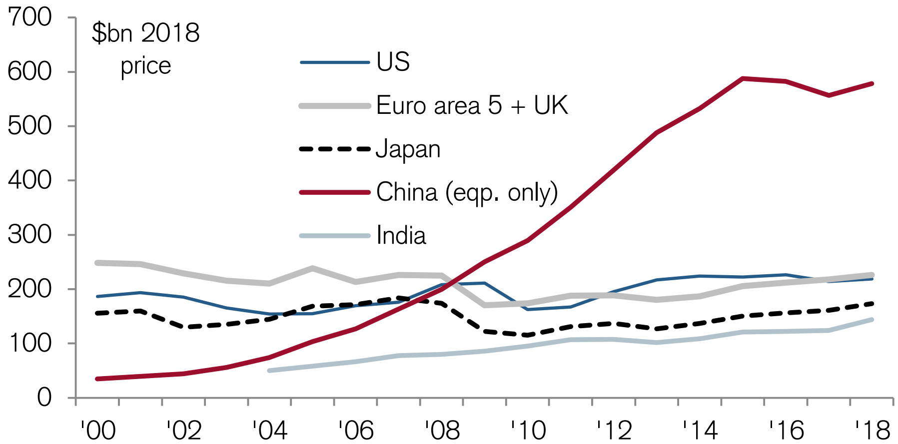
History has shown that China did not previously yield to this type of pressure provided it could shoulder the cost. The last time China's largest economic partner, the Soviet Union, turned away and left it isolated in the 1960s, the young nation embarked decisively on autarky and initiated domestic policies that proved to be counter-productive. It then had to endure over a decade of dramatic economic volatility[6].

Sixty years later, however, the cost of autarky would be prohibitively high. China has installed a spectacular amount of manufacturing capacity over the past two decades to serve global demand. During this period, China's real investment in manufacturing equipment grew almost twice as fast as its GDP. As of 2018, its manufacturing equipment investment was greater than the other seven largest countries combined (Figure 37). Almost 150 million Chinese factory employees work alongside these machines, representing 20% of the national employment. The cost of disintegrating supply chains would be equally high to the rest of the world, entailing moving humming factories elsewhere and displacing up to nearly one-half of the global manufacturing workforce.

[6] For the interrelation between the volatile diplomatic and domestic affairs, refer to Chapter 7 of *On China*, by Henry Kissinger.

Figure 37: Unmatched manufacturing capacity in China

Investment in manufacturing equipment and building except for China, which includes only equipment.



Source: Credit Suisse, Bureau of Economic Analysis, NBS, Eurostat, Cabinet Office of Japan, India Central Statistics Office, Haver Analytics

The good news is that China's political leadership has demonstrated a desire to embed the country deeper into the global economy. In a flurry of new treaty negotiations, China has offered greater market access and tried to improve the working relationship with its main trade partners. The US-China phase one trade deal pushed China's reforms forward to granting foreign firms access to the domestic market and reducing statutory discrimination against them[7]. Such progress is also a key building block for the ongoing negotiation of the EU-China investment treaty, which would be an essential step toward stronger trade ties. The recently signed Regional Comprehensive Economic Partnership (RCEP) agreement, while narrower in scope than a typical investment treaty, will remove non-tariff barriers for goods and services, unify rules, and integrate China closer with its neighbors[8]. Besides treaty negotiations, China has also strategically expanded its economic outreach through investments in overseas assets, including infrastructure, natural resources, and intellectual property. China's answer to the external challenges this time around is to reaccelerate its opening up.

In addition to these external challenges, a heavy load of domestic problems is also piling up. Deteriorating demographics, low credit allocation efficiency, and slowing productivity growth have dragged down economic growth in recent years. A central component of policymakers' solution to this has been to transition the country into more of a consumption-driven economy. In order that this transition continues proceeding, wage growth will need to be ensured by implementing policies that support labor productivity growth.

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[7] The newly enacted Foreign Investment Law of China inaugurates a legal framework that aims to reduce differentiated treatment of foreign firms. The law allows foreign access to most industries except those on the "negative list." The list has been shortening in recent years, with the notable removals of the energy (non-nuclear) and financial sectors. Limits to foreign ownership in the automaker industry have lessened and will be abolished next year. The law also prohibits forced technological transfer, a highly contested area with the US and the European Union.

[8] Trade among China, Japan, and Korea will likely benefit the most, as RCEP fills the gaps in bilateral free-trade agreements between some of these nations.

If this succeeds, incremental domestic demand would spill over the border, shrinking the current account surplus but raising the need for borrowing, including from overseas. Such borrowing is also crucial to finance China's capital deepening and self-reliant technology advancement, which are what will drive labor productivity growth over the long term. In other words, more openness goes hand in glove with an increasingly consumer-focused economy.

…failure is not fatal…

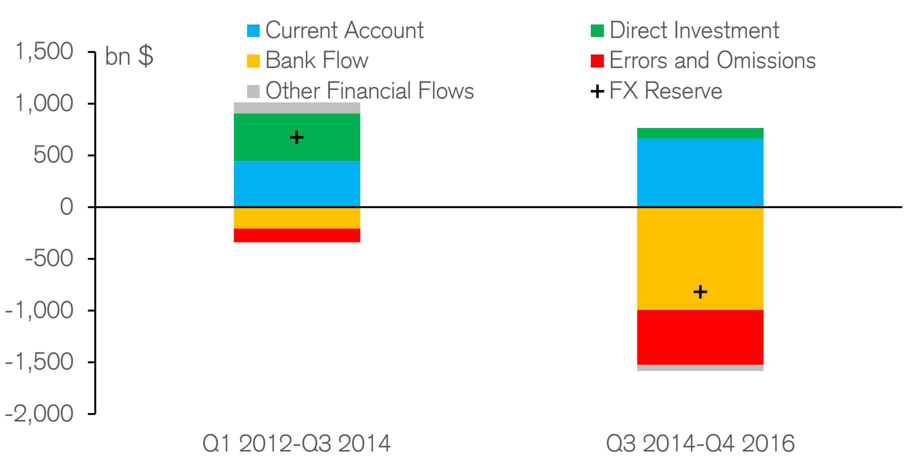
As a wider variety and larger quantity of cross-border transactions occur, existing capital account restrictions and import barriers in China should become obsolete. For going on two decades now, the basis for implementing these rules has been to bolster financial stability and encourage import substitution, particularly in the 2000s when the country was at an earlier stage of economic development. However, as China has grown into the second-largest trade nation globally, such rules are becoming difficult and costly to enforce.

For instance, disguised private capital flows flourished between 2011 and 2015 by circumventing the capital control measures at the time. Private financial capital flew into China through the current account, which had become completely liberalized. One simple way to achieve this effect was by an accelerated payment for products sold out of China or by simply disguising capital account transactions as current account transactions. During 2013, exports reported by Chinese custom officials significantly exceeded the mirroring import figures reported by China's trade partners.

Capital controls at the time were also becoming less effective in slowing down the outflow. Money started to leave China in 2014 amid Fed hiking expectations, and the exit was substantially accelerated by the surprise RMB devaluation in 2015. The majority of the capital flowed out through unidentifiable channels, captured only as "errors and omissions" in the balance of payment statistics (Figure 38). The remainder left mainly through banks, which had been deeply intertwined with the trade in cross-border goods.

Figure 38: Disguised capital inflows made a turbulent exit

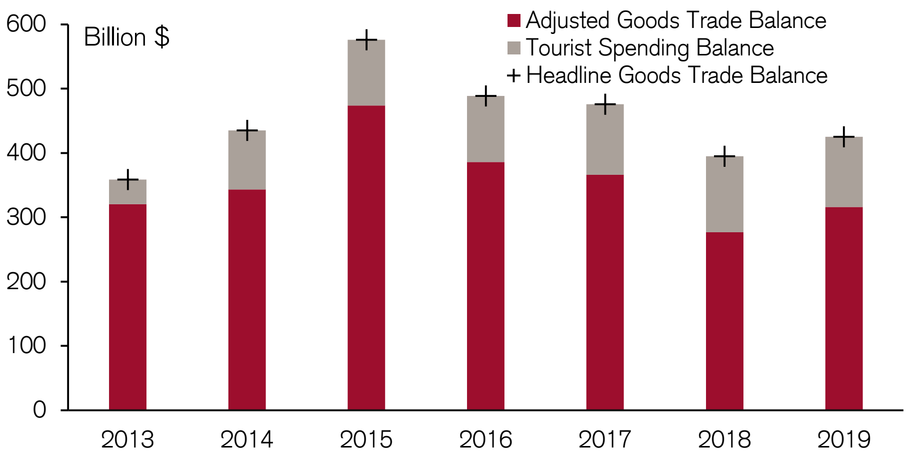
Cumulative cross-border transactions by type



Source: Credit Suisse, NBS, PBoC, CEIC

Import barriers have also been rendered less effective by the hundreds of millions of Chinese residents elevated above the middle-income threshold. Chinese travelers are among the highest spenders in the world. The travel service trade deficit currently stands at nearly half of China's goods trade surplus. Half of the travel spending takes place at flashy shopping malls in popular tourist destinations worldwide, especially Hong Kong. Due to the strong motivation to avoid import duties, the reported figure for the travel service trade likely understates the actual amount considerably. Once subtracting personal goods acquired overseas, the headline trade balance shrinks by a quarter (Figure 39). More interestingly, educational spending accounts for the other half of China's travel service deficit. In the US, the largest and most diversified exporter of higher education, Chinese students contribute half of its overall surplus. The majority of educational expenses are indeed on services, but they nevertheless illustrate the ballooning purchasing power of Chinese households.

Figure 39: Tourist spending overseas shrinks China's trade balance



Source: Credit Suisse, NBS, PBoC, CEIC

China's remaining capital controls and import barriers have lost effectiveness, increased regulatory difficulties, created economic discrimination, and encouraged rent-seeking behavior. These distortions can be substantially reduced without inflicting welfare losses to the economy.

…It is the courage to continue that counts

Acceptance of what is unsustainable is a necessary step toward repairing the economic structure. As long as Chinese authorities adhere to the opening-up strategy (which we expect that they will), the country's internally balanced and externally engaged economy will also change how it interacts with the rest of the world. That means future reforms to trade practices, currency policies, and cross-border capital rules will need to be compatible with this progression.

In addition, while opening up will likely be a years-long process, we expect policymakers to have to address existing vulnerabilities across all economic aspects immediately. Here are four imminent market implications we anticipate:

More disciplined monetary policy. To further the transition into a consumption-driven economy, more resources will need to be directed to households through multifaceted endeavors, including a higher labor share of national income, an improved social safety net, and easier access to credit. All of these efforts have started and will likely continue. Chinese monetary policy is expected to complement these distributional efforts by restraining the impulse to stimulate economic growth too early and too much by fiscal authorities.

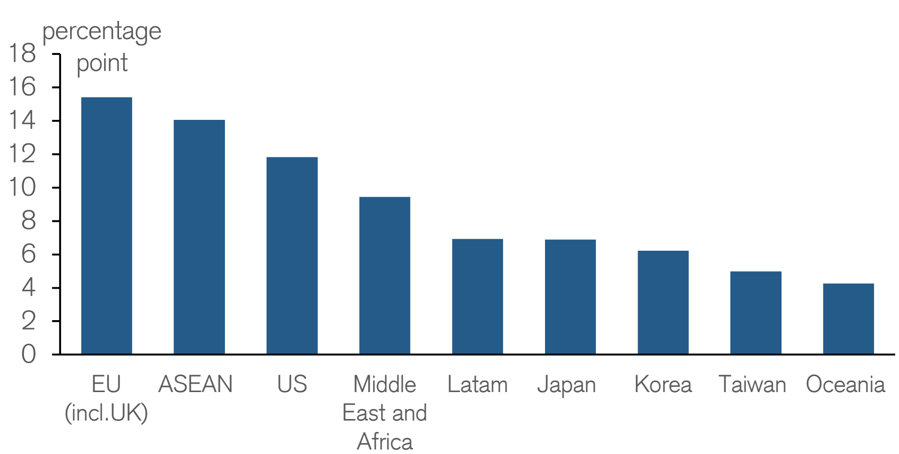
China's peculiar economic characteristics justify the counter-intuitive monetary cautiousness during the transition process. The existing mechanisms of credit allocation favor large corporates, local governments, and the housing sector, which have historically been the foremost beneficiaries of monetary easing but are now the sectors that authorities are transitioning away from. Thus, even when the COVID shock justifiably brought about the subsequent monetary stimulus, the scale and span were both restrained.

A more flexible exchange rate. From the perspective of policymakers, greater exchange rate flexibility will play a key role in reducing external imbalances. As bars of administrative controls are lowered, merchandise trades, asset returns, and the foreign exchange market will become increasingly important in determining the price of the RMB. Chinese authorities have overcome their long unbending obsession with exchange rate stability and become much more objective regarding the fluctuation in cross-border transactions. Going forward, heavy-handed intervention will likely be reserved only for extreme circumstances.

However, as China's reform process cultivates both the demand and supply of its currency, a multiyear price trend in either direction is not a foregone conclusion. In the past six months, the success in virus control measures, a record-high trade surplus, and an earlier withdraw of monetary stimulus compared with other major economies have pushed up the RMB against a trade-weighted basket of currencies, particularly the dollar. Momentum could continue over the coming 12 months, but it would mostly be due to cyclical forces instead of structural ones.

Figure 40: Country and regional share of Chinese total trade

ASEAN = Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Data as of 2019.



Source: Credit Suisse, China Customs, CEIC

Lower growth volatility in the region. By reducing the amplifying effects of a rigid exchange rate against the dollar, growth volatility experienced among the countries surrounding China should diminish. Moreover, China's growth idiosyncrasies such as an unexpected final demand acceleration can transmit across its borders more easily due to currency appreciation, and such shocks may offset growth impulses elsewhere.

Asia-Pacific neighboring economies are tightly linked to the Chinese economy through trade. ASEAN countries' share of China's total trade has climbed considerably in recent years (Figure 40). They also led the recent RCEP agreement that committed signatories, including China, Japan, Korea, Australia, and New Zealand, to further trade liberalization.

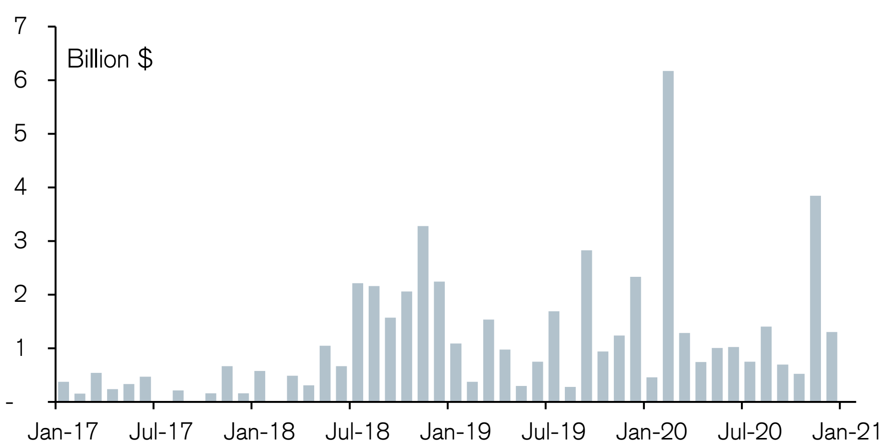
Growing intertwinement to the financial world. The marginal accumulation of China's foreign assets will focus on non-reserve alternatives that offer a more desirable intertemporal substitution for domestic consumption. The Belt and Road Initiatives (BRI) will continue to be at the forefront of such an outbranch, and sovereign wealth managers and private corporations will also advance in strategic acquisitions of receptive targets. Households' direct access to overseas assets will likely be admitted more gradually.

A richer menu of domestic financial investment opportunities will also be offered to foreigners. Licensing restrictions and ownership limits on banks, asset managers, brokerage firms, and insurers have been significantly relaxed since 2018. Foreign access to China's onshore capital markets (both equites and debt) has also increased from a low base. Early data showed net portfolio investment inflows reached record highs in 2020.

However, a deeper entanglement of financial markets brews contagion risks that spill both ways, which may disrupt the opening-up process. The financial robustness of illiquid overseas assets is harder to assess and monitor for China. Lending under the BRI has experienced a serious setback in the past two years due to the financial strains of borrowing countries from even before the pandemic. Sobering credit losses earlier last year have also suppressed Chinese investors' appetite for cheap global assets. These stings may take time to recover from amid the unusual economic conditions around the world.

Figure 41: Credit defaults reached a record amount in 2020

Defaulted bonds issued by China's private and state-owned enterprises



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

The vulnerability of China's capital markets and banks will also be exposed more than ever before as the participation of foreign institutional investors increases. For instance, over 70% of China's onshore corporate bond market is rated AA or above by local rating agencies, although China's sovereign rating is merely an A according to international counterparties. Such mismatches will need to be resolved. In addition, recent defaults among troubled state-owned enterprises (SOE) encouraged a reassessment of credit risk for SOE and local governments, which is a positive development. But it also cut into creditor confidence over the resilience of the banks, which are heavily exposed to SOE and local government debt.

Low-quality assets are among the key ingredients that lead to systemic stress in a financially open economy. If an influx of easy foreign money merely fuels reckless domestic bank lending, the eventual capital flight may trigger a banking crisis. Also, attractive returns from foreign financial assets may divert residents' investment portfolios and bank deposits, hindering domestic financial conditions. The tendency for outflows could be strong, and thus a gradual approach to liberalizing portfolio transactions is likely. Our past analysis found a strong presence of momentum-chasing behavior in the onshore equities market, evidence consistent with its valuation premium over other major economies supported by the trapped pool of saving.

The evolving geopolitical climate will also likely slow direct investment in both directions. China's major industrialized trade partners acknowledge its national ambition and consider it a competitor on multiple fronts. The US and the EU have led efforts to toughen the screening of inbound direct investment on strategic or national security grounds. China has enacted similar procedures of its own. While sponsors of greenfield projects that spawn local jobs in China should easily pass through the filtering, these companies will still need to stomach the high costs of being compliant with unfamiliar regulations to which their Chinese competitors are already accustomed. The Corporate Social Credit System[9] is one of the most prominent regulatory initiatives that all firms operating in China and their local employees will be required to follow.

A multifaceted challenge faced by the Chinese economy requires an overarching solution, which is what policymakers have offered. Parts of the plan may still fall short, but China will find it hard to turn back on opening up due to persistent economic pressures. The country's intended steady steps toward self-serving openness will bring economic opportunities for other governments, corporations, and financial institutions. However, the demand for transparency, sound governance, and diligent cooperation will also ascend accordingly. It will take courage from all parties to engage in this managed liberalization, and that is what counts.

[9] Refer to *The Digital Hand: How China's Corporate Social Credit System Conditions Market Actors* by the European Chamber of Commerce in China for an in-depth examination.

US: From stalemate to stimulus

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- **Growth is in a severe slump going into 2021, but spending should rise sharply once the current COVID-19 outbreak is under control. Widespread vaccination will drive a rapid normalization in services spending in the second half of the year.**
- **A large bipartisan relief deal was passed late last year, and more fiscal stimulus is likely early in the Biden administration. Renewed stimulus will drive household income and savings higher, adding fuel to the fire for the second-half recovery.**
- **Core inflation will likely overshoot the Fed's 2.0% target in the spring, but this is driven by temporary factors and base effects. We expect the Fed to look through this strength and keep policy accommodative through the year.**

2021 will be a volatile year for growth and inflation data. The ongoing wave of COVID cases will weigh on activity early in the year, but a sharp rebound is likely once the public health situation improves. Widespread vaccination will likely lead to even more acceleration in the second half of the year. We expect growth for the year to average 5.5%, with a rapid 6.8% pace in the second half of the year. The path will be bumpy, but we expect real GDP will have returned to its pre-COVID level by the end of the year.

The current surge in COVID cases is leading to renewed restrictions on businesses, and many households are voluntarily limiting activity. This will be a significant headwind to growth, but we do not expect the shock to be as severe as in the initial wave of the pandemic last year. Better understanding of COVID transmission will lead to milder and more-targeted shutdowns than last March and April. Discretionary in-person services will likely contract, but we expect retail and manufacturing businesses to remain open. Expectations for a vaccine and easy financial conditions will support business investment despite near-term weakness in growth.

Policy gridlock was a key risk late last year, but the recent COVID relief deal and the Senate run-off elections in Georgia ensure that fiscal policy will remain supportive through the recovery. The bipartisan relief deal provides crucial support to households, small businesses, and state and local governments. We expect another smaller round of fiscal easing early in the Biden administration. Disposable income will rise sharply early in the year. Importantly, unified government will allow for policy flexibility to deal with any new challenges that arise during the recovery.

Households' *willingness* to spend is going to be a more important driver of growth than their *ability* to spend. On top of the income support from stimulus, the collapse in services spending led to a sharp increase in the savings rate. Record-low mortgage rates and a wave of refinancing activity is providing an additional boost to cash flows.

A normalization in services will be the main driver of growth later in the year. Despite a rapid recovery, we expect services spending to end the year below its pre-pandemic level. There are three main reasons for this. First, many services don't experience much 'pent-up' demand. People may be eager to go on vacations or out to restaurants once COVID is no longer a risk, but there is no reason to expect anyone to suddenly increase the frequency of visits to a barber, dentist, or laundromat. These categories can normalize, but are unlikely to overshoot on the upside. Second, business closures and labor market turnover will create some supply constraints in the service sector. Finally, some lifestyle shifts from the pandemic may have lasting effects on demand. Even a small increase in employees working from home will reduce demand for transportation and food services in business districts. And people who invested in home-exercise equipment during the pandemic may be slow to renew their gym memberships.

Consumer spending on goods is likely to slow this year. Retail sales collapsed in the acute shutdowns last March and April, but surged higher soon after to well-above its pre-pandemic level. Some of this strength was likely temporary – driven by generous fiscal stimulus payments or one-off purchases to adapt to the pandemic. There was also a substitution effect where households spent more on goods because services were less available or desirable. This effect will likely reverse as service spending normalizes. We do not expect an outright decline in goods spending, but the strength last year is not sustainable and a slowdown is likely.

Housing has been a bright spot for growth and we expect the outperformance to continue through this year. Residential investment was gaining momentum even before the pandemic began and this has been aided further by falling mortgage rates and a surge of demand for single-family homes. Construction was sluggish for most of a decade in the wake of the global financial crisis, meaning there is plenty of room for homebuilding to run above-trend without leading to oversupply. Near-term supply constraints are likely to ease for building materials and broader labor market slack will limit wage pressure for the construction sector.

Business investment has stabilized and is likely to remain solid despite near-term COVID risks. However, the outlook is mixed going forward and we do not expect strong growth broadly. Equipment investment tends to be more cyclical and should accelerate along with the broader economy later in the year. Spending on structures is slower-moving though, and the first wave of pandemic weakness is likely to continue to play out for many quarters. Offices, hotels, and brick-and-mortar retail all face an uncertain future even after the pandemic resolves. Energy-sector investment has stabilized after a sharp decline last year, but growth is likely to remain subdued.

State and local finances have been stressed by the pandemic and this will be an ongoing headwind for public employment and investment. Weakness in tax revenues has not been as severe as pessimistic projections, but there are likely to be ongoing revenue challenges for areas, which are dependent on tourism or commuting workers. Meanwhile, states are responsible for unemployment insurance payments, and many have blown through their dedicated trust funds for this program. States have some flexibility with how they balance their budgets, but without fiscal support there will need to be spending cuts.

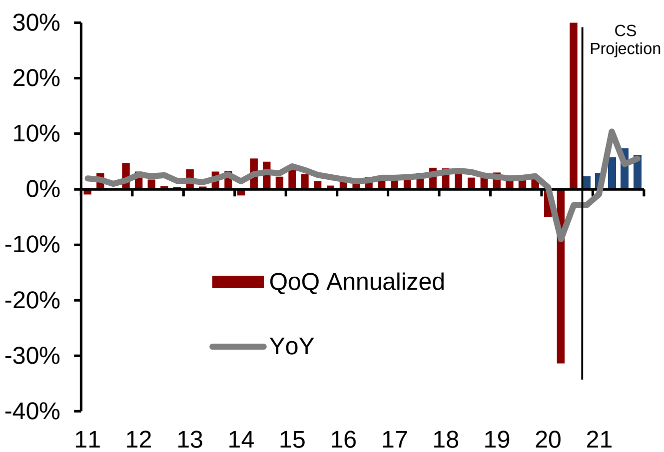
The labor market is likely to experience some weakness as the service sector contracts in the winter. However, the improvement in the unemployment rate should resume once the current wave of COVID infections is under control. Despite an impressive recovery in headline indicators, there are growing signs of long-term stress in the labor market. Permanent job losses are on the rise and an increasing share of the unemployed have been out of work for an extended period of time. Finding a job will be more difficult for these individuals even as demand recovers later in the year. We expect the unemployment rate to end the year around 5.5% - substantially higher than its pre-COVID level.

The pickup in growth this year will coincide with an overshoot in core inflation. YoY core PCE is likely to exceed the Fed's 2.0% target in Q2. This may appear to be a sign of an overheating economy, but the strength is likely to be temporary. Slower-moving disinflationary pressures are on the rise and we expect core PCE to drop back below target by the summer.

We expect the Fed to keep policy accommodative through the year. New easing measures are possible, but we would only expect these to be implemented if financial stress reemerges. Borrowing conditions are easy for households and businesses, and there is not much the Fed can do to support the parts of the economy that are struggling due to the pandemic. If longer-term real rates backed up significantly we would expect the Fed to adjust the maturity or size of their Treasury purchases. Several of the Fed's special credit facilities have been wound down, but it will be possible to create new lending programs if markets become stressed again.

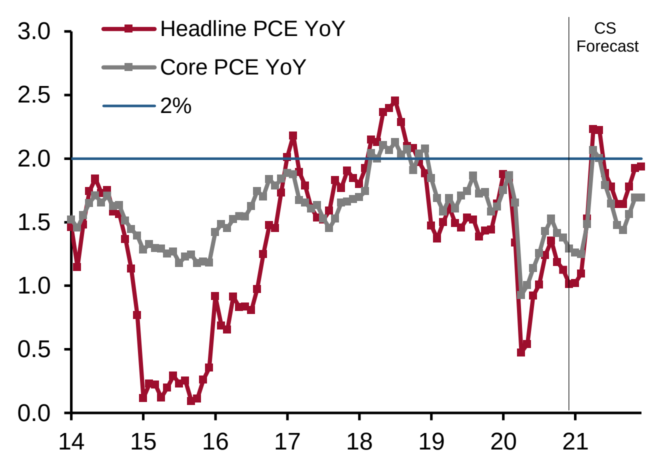
Overall, our outlook for 2021 is guided by a series of predictable shocks. The current resurgence of COVID cases will lead to a pullback in spending, but growth is likely to rebound once contagion is under control. Widespread vaccination will lead to even faster normalization later in the year. There will be lasting damage from the pandemic though. We do not expect a full recovery in services spending and unemployment is likely to remain elevated. The Fed will look past some temporary strength in core inflation and maintain easy policy through the year.

Figure 42: Real GDP growth will be weak to start the year, but a strong acceleration is likely to begin in the spring



Source: Credit Suisse, BEA

Figure 43: Inflation will rise above 2.0% as growth is rebounding. The overshoot will be short-lived though, and is not a sign of overheating



Source: Credit Suisse, BEA

Euro area: Fast recovery, thanks to policy

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- **Much of Europe is under lockdown again, leaving economic activity subdued. Once vaccines are distributed and restrictions are lifted however, we think the economy is capable of a fast recovery.**
- **An ongoing broad, substantial, and effective economic policy response should support that recovery. We expect that support to be sustained into 2022.**
- **After the resolution of the Recovery Fund and Brexit, political risks have eased. But German elections in September and French elections next year will be key in determining Europe's future path.**

The euro area begins 2021 under strict social distancing restrictions. Although lockdowns slowed the spread of the virus in recent months, new infections are still high and rising again. Consequently, governments may keep restrictions strict, or tighten them further, in coming months.

These lockdowns have dampened economic activity again, especially the consumption of services. We expect GDP to experience a shallow dip over the winter, after the sharp rebound in Q3 last year.

Vaccinations should soon be deployed. Many member states could attain herd immunity to the virus by the middle of the year. These developments would likely allow for a near complete easing of restrictions in the second half of the year, which should lead to a rapid rebound in demand and output. We expect the euro area economy to recover back to end-2019 levels of output by early next year. That would mean the economy grows 5.0% this year, and we forecast 4.2% GDP growth next.

That forecast may appear optimistic. But we think it is plausible.

While unusual for the euro area, the economic policy response to the crisis has been competent and effective, with a substantial and concerted easing of monetary, fiscal and regulatory policy. Enormous fiscal support – the euro area deficit increased by 9 percentage points of GDP last year – backed by monetary policy – the ECB's new asset purchases last year constituted over 10% of GDP – helped to strengthen corporate and household cash flows.

The widespread use of furlough and short-time work schemes reduced corporate operational leverage, sustaining employment and household incomes. That, along with forbearance in insolvency laws and procedures, meant that corporate liquidations were extremely low in 2020. Unemployment barely rose, at 8.4% in October, up from a low of 7.2% at the beginning of the year.

Consequently, the euro area will emerge from the period of depressed economic activity without a significant overhang of unemployment, insolvencies and non-performing loans. In the past, those have seriously impaired economic recoveries. This time, they should be less of a problem.

But these policies will be sustaining some unviable jobs and businesses as well as viable ones. Policy support will diminish as social restrictions end, meaning that corporate insolvencies and unemployment are likely to rise later this year. These increases should not be substantial however. For example, we do not expect the unemployment rate to climb much above 9%. Absent the policy support last year, we think unemployment would currently be around 11%.

That should not constrain a rebound in consumer spending. Savings rates are still high, which we attribute to restrictions on spending rather than consumer caution. The prolonged period of restrained spending means households will emerge from the recession with fairly high cash balances. Household bank deposits are likely to begin this year almost 9% higher than they began 2020, their fastest annual growth since the launch of the euro. Consumers can adjust both the stock and flow of their savings to deliver a solid recovery in spending this year once social distancing measures are eased, as we saw in Q3 2020.

Corporate spending should see a more restrained recovery. Firms also have sizable cash balances, but they also accumulated a meaningful amount of debt. Businesses are likely to use some of their excess cash holdings to retire some of that debt once the recovery is assured and are unlikely to have the appetite to boost spending. Surveys suggest that firms plan to raise investment only a little, after last year's drop. Those intentions may be raised over the course of 2021, but any growth in investment during the year is set to be insipid.

External demand should continue to recover quickly. Global goods demand has been less depressed than services, and swift economic recoveries in Asia and the US should help boost trade and industrial output. In the near term, it is possible that the shift to a new trading relationship with the UK and imposition of non-tariff barriers could weaken bilateral trade volumes with a major export market. A recovery in exports is likely to gather strength through the course of the year.

As a driver of the recovery, fiscal policy remains key. In addition to furlough and short-time work schemes, many governments implemented discretionary stimulus measures, such as temporary tax cuts and increased public spending.

Governments have the financial ability to provide ample fiscal support given extraordinarily low borrowing rates. Almost all euro area governments can issue debt of at least five years' duration at negative interest rates. That will keep government debt service costs low despite relatively high government debt to GDP ratios.

Moreover, there is no political pressure on governments to restrain fiscal policy. The rules of the Stability and Growth Pact are also suspended this year. It is likely they will be again next year.

Fiscal largesse at the national level should be supplemented by greater fiscal support at the supranational level, with the launch of the Next Generation EU fund. Although the size of the fund remains fairly small (5.8% of EU GDP), it should allow a shift in public spending away from mitigating the effects of the pandemic, toward outright stimulus through higher public investment – an area of considerable weakness over the past decade – particularly in green technologies.

This shift in fiscal policy means that the euro area will begin its recovery this year with a better balanced economic policy mix than has been the case for several years. As we discuss on pages 3-8, the euro area experienced a sub-optimal mix of tightening fiscal and loosening monetary policies in the past decade. That imbalance wrought others, such as the large external surplus.

The crisis forced a reset, with both fiscal and monetary policies now in a highly expansive setting (Figure 45). This year both the ECB's monetary policy strategy and the EU's fiscal rules are subject to review.

We expect the ECB to shift its definition of its inflation target in a slightly more inflationary direction. Instead of the current asymmetric and convoluted target of "below, but close to 2%", we expect a direct point target of 2%, with a symmetric intolerance of sustained deviations away from that target in either direction.

As core inflation is likely to remain low – we estimate it will end the year at 0.9% – the ECB will be compelled to maintain considerable monetary expansion into 2022. It has already committed to run its Pandemic Emergency Purchase Programme into early 2022, and we would expect that to be extended to the end of the year. However, we expect the 'envelope' of those purchases to remain capped at €1.85tn. We also think the ECB will maintain bond purchases at €20bn per calendar month in its regular Asset Purchase Programme until the end of 2022.

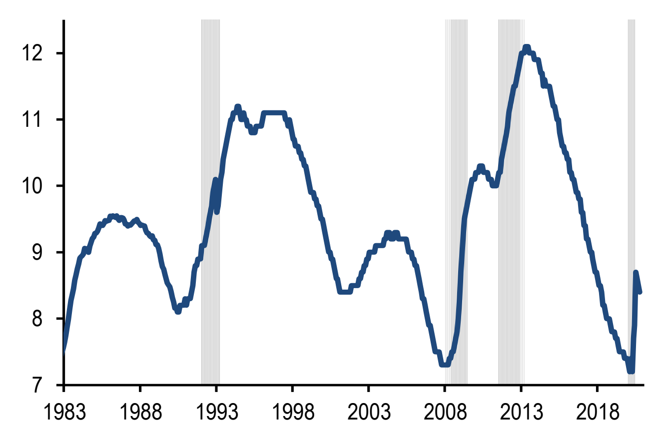
Another outcome of the ECB's strategy review could be a formal assertion of the need for better co-ordination between monetary and fiscal policies when policy rates are at the lower bound. That may synchronize well with the European Commission's review of the euro area's fiscal rules. And consequently could allow for fiscal policy to remain supportive for economic activity beyond the end of next year.

One problem is that fiscal policy is set at the national level, and Germany's constitution will require considerable fiscal consolidation at some point. That makes Germany's election in the autumn, which will mark the end of Angela Merkel's chancellorship, a key event.

Opinion polls currently suggest that the most likely outcome will be a coalition between the centre-right CDU/CSU and the Green Party, whose support has increased materially in the last few years. Whether such a coalition works will partly depend on who Merkel's successor is. But the Greens are likely to push for greater public investment in decarbonizing the economy, which may be compatible only with more borrowing or higher taxes. Inasmuch as the euro area's fiscal stance is to be determined by Germany, this election will be key to the path of economic policy for much of this decade.

Figure 44: Effective economic policy has prevented a large increase in unemployment that could impair the economic recovery

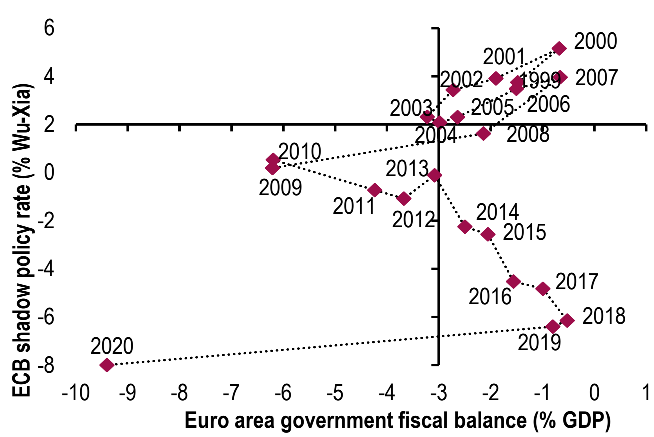
Euro area unemployment rate (%), recessions shaded



Source: Eurostat, Credit Suisse

Figure 45: After a decade of increasing imbalance in the economic policy mix, both fiscal and monetary policies are now very expansionary in the euro area

Euro area economic policy mix, 1999-2020



Source: ECB, Wu-Xia, Credit Suisse

China: Taming the overshoot

- **We expect GDP growth to improve to 7.1% in 2021 from 2.2% in 2020.**
- **Realized growth will likely overshoot potential growth in 2021, but from a policy perspective, we expect that the authorities would prefer to avoid an aggressive overshoot in one particular year in exchange for a smoother and more sustainable growth profile over the next five years.**

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The Chinese economy is coming out of the pandemic slump earlier than other economies, but the recovery has been uneven. Starting in Q320, production-side indicators have been rebounding faster than expenditure-side indicators. There has however been a noticeable unevenness on the expenditure side. The infrastructure and real estate sectors have disproportionately benefited from the stimulus, while in contrast, private manufacturing, services, and parts of the household sector have lagged due to fragmented credit allocation mechanisms. We anticipate the divergence between production and expenditure-side indicators to fade going into 2021, a process that recent indicators suggest is already under way. The fashion of the convergence is expected to rely more on the acceleration of the expenditure-side recovery, but it will also include a moderation to production momentum. Even with anticipated growth of 7.1% in 2021, the risk is actually skewed to the upside. For the unevenness within the expenditure side, we anticipate manufacturing fixed-asset investment (FAI) growth, which has been lagging other FAI components, to catch up (Figure 46). In addition, we also expect the ongoing rebound in services consumption to continue as disposable income growth recovers (Figure 47).

With the recovery already under way, a GDP growth overshoot in 2021 appears inevitable. From a policy perspective, we expect that authorities will likely avoid a pro-cyclical policy stance and, to the extent possible, rein in the overshoot in 2021. They would most likely prefer to avoid an aggressive overshoot in one particular year in exchange for a smoother and more sustainable growth profile over the next five years.

Specifically, we expect a moderation to M2 growth on the monetary front from 10.4% in 2020 to 9.3% in 2021. On the fiscal front, we expect a tighter fiscal stance. The one-time COVID-19 treasury issuance, which accounted for about 1% of GDP, will almost certainly not be repeated in 2021. Special purpose bonds will remain, but we expect their annual quota to decrease by roughly half a percentage point of GDP relative to that of 2020. There will likely also be modest downward adjustments to the official fiscal deficit target of about 0.3-0.5% of GDP in 2021 relative to the 3.6% target in 2020. Abstracting away from any multiplier effect, the fiscal drag in 2021 relative to that of 2020 would be approximately 2% of GDP.

To be clear, even with the tightening policy stance, overall GDP growth and its various key components are still expected to have above-trend growth in 2021. For example, we expect real estate investment (REI) to grow by 6.5% in 2021, faster than the anticipated growth rate for 2020 (4.1%) but slower than pre-COVID-19 growth in 2019 of 10.0%. REI growth in 2020 will likely fall below the implied growth rate based on macroeconomic factors such as M2 growth and house price inflation, predominantly attributed to the COVID-19-induced contraction experienced in Q120. Hence, despite the anticipated slowdown to

M2 growth in 2021 and authorities' ongoing effort to curb house price inflation, we expect REI growth in 2021 to be higher than the implied growth rate normally associated with such macro conditions.

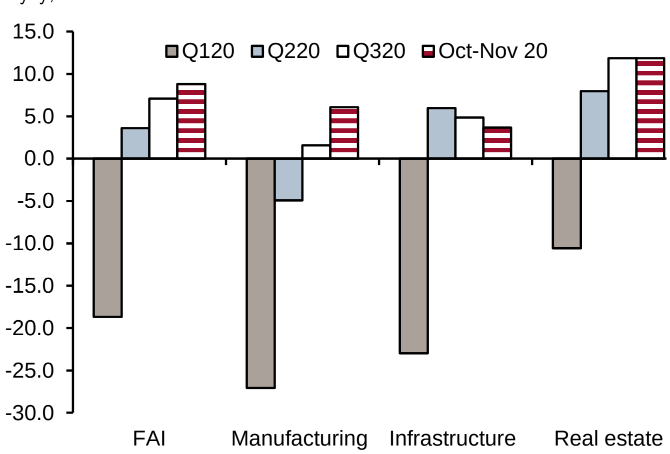
We revised our expectation for 2021 headline CPI downward, from 2.5% yoy to 1.1% yoy, mainly due to pork deflation. After looking at sequential price momentum instead of year-over-year numbers, which are distorted by the base effect, we believe that headline CPI is about to enter a reflationary cycle. As China continues to reduce its production-expenditure rebound gap, there might be a modest improvement to core inflation. We do not think that the PBoC will react to the disinflation in CPI with a more accommodating monetary stance. For the same reason that the PBoC did not tighten when pork drove up inflation during 2019, it will most likely not respond to pork-driven disinflation.
As per the exchange rate, the CNY is expected to experience additional appreciation over the coming 12 months. We forecast USDCNY to reach around 6.3 by the end of 2021.

Moving beyond 2021, we anticipate three key policy categories to be emphasized in the next five-year plan: technology advancement, labor productivity, and land reform. The technology category encompasses the ongoing efforts to establish "new infrastructure," innovate and enhance capabilities in the key strategic sectors, and secure essential inputs. The labor category aims to increase labor productivity, including labor market reforms to facilitate labor movement, educational reform to improve the quality of the labor force, and a further opening of Chinese markets to foreign participation and competition. Finally, the land reform category aims to clarify land usage rights and the transfer of usage rights. The scope of this reform would cover at least farm land and land used for residential and commercial properties. Land reform will directly affect the pace of urbanization, which in turn would provide ongoing support to sectors such as real estate and traditional infrastructure in avoiding cliff-like decelerations.

Finally, we view China's participation in the recently signed RCEP as a positive development for multilateralism and trade within the region. This should also slow down the decoupling forces between China and the rest of the world.

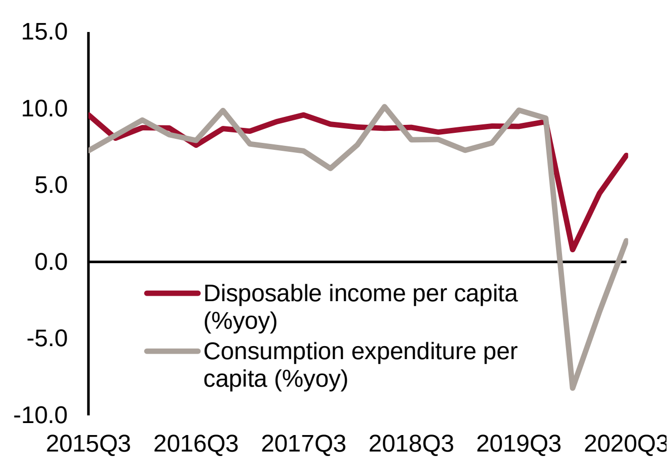
Figure 46: FAI growth by component

%yoy, 3mma



Source: Credit Suisse, Haver Analytics®

Figure 47: Disposable income growth



Source: Credit Suisse, Haver Analytics®

Japan: Shifting from stimulus to reforms

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- **A steady recovery in industrial production after 1Q, a pickup in personal consumption into the summer, and a re-expansion of public investments are contributing to growth in 2021.**
- **The Suga government appears more interested in structural reforms than the Abe government, acknowledging the diminishing impact of large-scale monetary and fiscal expansion on growth.**

Three focused growth dynamics

We are cautious about the near-term growth outlook. A third wave of the COVID-19 pandemic has prompted the national government to opt for suspending subsidies meant to boost domestic travel and dining. We expect consumer confidence to weaken again into the spring as the ongoing deterioration of business conditions for SMEs weighs on job markets. In seeing how the economy pans out over the coming 12-18 months, we focus on the following dynamics.

The first dynamic is a production and inventory cycle. While the pace of the recovery in industrial shipments is likely to decelerate as economic activity normalizes, industrial production should remain on a moderately rising path, as destocking has made progress. As seen in Figure 48, the industrial inventories to shipments ratio has declined to a level equivalent to that from autumn 2019.

The second is that of a corporate profits and capex cycle. The sharp contraction of corporate profits that began toward the middle of 2020 will likely continue to discourage corporate motivation for machinery investment in the coming 12-15 months. In addition, the still gloomy outlook for domestic tourism will also cap a recovery in construction investment.

The third is a consumer confidence and saving-dissaving dynamic. While household demand for precautionary savings appears strong (Figure 49), there could be a temporary upswing in consumption along with improved consumer confidence as households draw down their savings. A temporary containment of the COVID-19 pandemic into summer as the country hosts the Tokyo Olympic Games would lead to an expansion of household consumption, albeit one that is not likely sustained.

September will be the key month for politics in 2021

PM Suga's term as the president of the LDP is until September 2021. At present, we think it is possible for him to then step down, handing the premiership over to a new president of the party. Still, a new administration would adopt Suga's principles of economic policy management, defined by a gradual but steady shift in priority to structural reforms and away from monetary and fiscal reflation. A general election is likely to be held in September along with the LDP's presidential election.

The cabinet endorsed a third stimulus package in early December, which was mainly aimed at supporting the medical industry, local governments, and small businesses. With orthodox public infrastructure projects and credit enhancement measures included, about ¥19 trillion, or 3.6% of GDP, has been set aside as the third FY2020 supplementary budget. Much of the third package represents extensions of measures from the previous packages. Subsidies, local allocation tax grants, and other safety net measures will contribute to economic and social stability. Outlays with the potential to boost final demand seem to amount to ¥6-7 trillion (1.1-1.3% of GDP) for the coming 15-18 months. The government may opt for a fourth package of a smaller size by mid-2021. There appear no impactful tax measures in the pipeline to boost demand.

The BoJ looks to remain reluctant to lower the Tier 3 deposit rate, but we see a risk of a small rate cut in 1H 2021 if the JPY strengthens more substantially than currently envisaged. The bank has raised its pace of buying Japanese government bonds (JGBs) since March 2020, with the government emergency economic packages boosting JGB issuance. We estimate it will take 67-68% of the JGBs printed in fiscal 2020 and believe this accommodative stance will continue into 1H 2021. The 10-year yield target should be left unchanged at around 0% over the coming 12-18 months. Measures to support corporate finance, namely commercial paper and corporate bond purchases as well as the emergency fund supply operation with a total ceiling of 140 trillion yen (about 80 trillion yen left uncommitted as of end-November), are likely to remain available until autumn 2021.

Structural reforms in the pipeline

The Suga government appears more interested in structural reforms than the Abe government, acknowledging the diminishing impact of large-scale monetary and fiscal expansion on growth. There now appear three focus areas among the structural reforms, which are digitalization, regional banking, and energy.

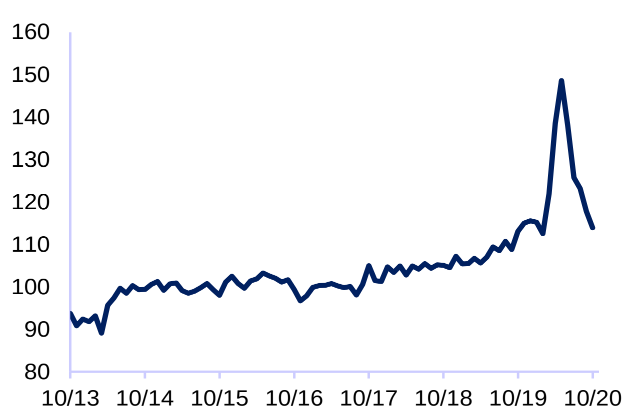
As per digitalization, the government plans to further build out an information infrastructure for the public sector, strengthen digital platforms, and improve the surveillance capacity that authorities have over individuals' personal information. The introduction of a central bank digital currency will be another centerpiece of this focus.

A potential outcome of regional banking reform could be a material consolidation of the sector through mergers and acquisitions over the coming two years. The BoJ is starting to pay extra interest to the current deposits of regional banks that plan to merge, while the government is subsidizing the costs of mergers.

Lastly, energy reform is designed to simply promote the production and consumption of alternative energy through a combination of deregulation and regulation measures. In raising the targeted proportionate share of renewable energy in total energy production into 2030 rather aggressively, the government will need to outline subsidy and tax measures to enhance investments for renewable energy into 2022.

Figure 48: Industrial inventories to shipments ratio

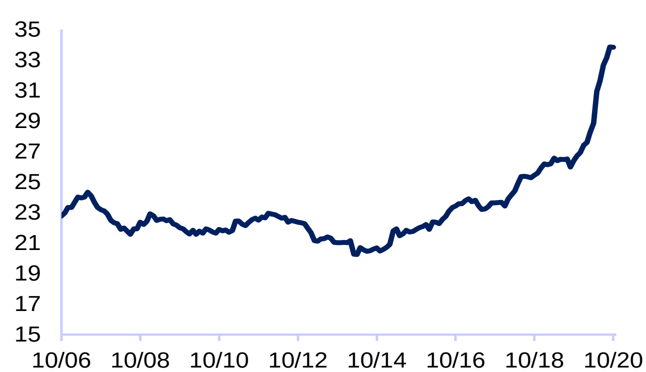
CY2015=100, seasonally adjusted



Source: METI, Credit Suisse

Figure 49: Financial surplus of households

% of disposable income, 12-month moving average



Source: MIC, Credit Suisse

Taiwan: Continuing outperformance while seeking growth through innovation and diversified investment

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- **We expect Taiwan to outperform in 2021 as it did in 2020, anticipating 4.0% GDP growth next year.**
- **External demand supported both by ongoing demand from China and international orders.**
- **Taiwan continues to seek sustainable growth through innovation and diversified investment.**

We expect Taiwan's growth to outperform regional peers going into 2021, just as it did this year; we estimate GDP growth in 2021 to be 4.0%. Tech exports have remained resilient, evidenced by another record high of semiconductor exports in Q320, while Q320 GDP regained all of its H120 losses and returned to its pre-COVID-19 level. We expect Taiwan's positive momentum to continue in 2021 and that it will continue to demonstrate its economic resilience, supported by external demand and its leading position in technology. Moreover, Taiwan will continue seeking sustainable growth through innovation and diversified investment.

Taiwan has significantly benefited from strong demand in semiconductors and upside from IT hardware over the past three years. Taiwan's exports to China (including Hong Kong SAR) rebounded 14.0% yoy YTD thanks to support from demand for tech products (e.g., semiconductors, info-communication products, and optical instruments). China (including Hong Kong) has been the largest export destination for Taiwan, accounting for around 40% of total exports in 2019. Going forward, we believe Taiwan will continue to enjoy the spillover demand from China owing to China devoting a significant amount of resources to new digital infrastructure and launching structural reforms to ensure the acquisition and development of advanced technology. Before China becomes entirely self-sufficient, the demand from it should continue to support Taiwan's export sector.

Meanwhile, given Taiwan's leading position in semiconductor foundries and diversified product types in tech manufacturing, semiconductor capacity was filled by a surge in international orders from trade partners other than China. Taiwan has a large share of global tech-related exports (e.g., semiconductors, consumer electronics such as laptops, and peripheral accessories including earphones and monitors). Taiwan's semiconductor industry has steadily moved up the value chain since the 1960s when it was the assembling destination for US companies. At present, Taiwan is heavily involved in semiconductor designing and manufacturing, which are R&D and capital-intensive (specialized equipment and tools). In integrated circuit (IC) designing, Taiwan ranks second in the world in terms of global market share, at nearly 20% and behind only the US, whereas in IC fabrication (manufacturing), Taiwan holds the leading position with a global share of close to 75%. Particularly in the past decade, Taiwan has been moving out of the relatively downstream "packaging & testing" part of the supply chain and gaining share in manufacturing (Figure 50). TSMC, Taiwan's largest chip producer, accounts for 54% of the global foundry market. The increasing demand for digitalization at a global scale should help sustain the future growth momentum of tech sector exports, especially in the medium term. In particular, we note that Taiwan's machinery exports showed a positive growth rate in November 2020, reversing its contraction trend over the past 24 months, suggesting there remains strong global demand for Taiwan's capex goods despite subsequent waves of COVID-19.

Taiwan's current inventory cycle also supports the manufacturing upcycle. According to an industry report, demand for 8-inch wafers currently appears to exceed supply, as the entire industry in Taiwan is reporting fully loaded capacity. This suggests that NAND and DRAM spot prices will keep rising well into 2021, boding well for Taiwan's export outlook.

While Taiwan is heavily reliant on manufacturing and exports, we expect it to continue to seek sustainable growth through innovation and diversified investments. The government has been highly supportive of boosting domestic capex, either by offering incentives to overseas Taiwanese firms to return home to invest or by encouraging domestic corporations to increase local investments. If we look at Taiwan's past investment and total factor productivity (TFP) based on the Penn World Trade data, we see it has shown continuously increasing growth rates of capital stock and TFP versus those of South Korea and Japan (Figure 51). The government appears committed to turn Taiwan into a high-end manufacturing hub for Asia, built out with an advanced and complete semiconductor processing supply chain and localization of material supplies. We believe the semiconductor industry will continue to lead Taiwan's investment cycle for the next few years.

Investment will also be allocated to other industries such as cybersecurity, green energy, and biotech, as the government is looking to diversify. We also see more business capex into non-China production capacity to cater to customers' cybersecurity requirements internationally. Taiwan's continuously increasing capital/investment and TFP/technology attest to our view that potential growth should remain high.

With regard to the Regional Comprehensive Economic Partnership (RCEP), Taiwan's exclusion from the trade treaty will likely have little impact. According to Taiwan's Minister of Finance, 70% of Taiwan's shipments (mostly tech products) to RCEP markets are already exempt from tariffs under the WTO's Information Technology Agreement, and many RCEP countries already had bilateral free trade agreements with Taiwan prior to signing the RCEP. While Taiwan's non-tech industries of petrochemicals, textiles, and machineries might be affected, as they face more competition from other economies, this development nevertheless does not affect our near-term outlook.

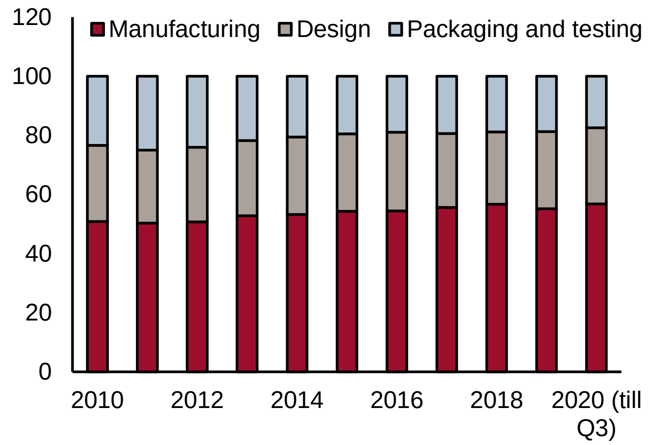
In addition, domestic consumption should continue to improve through Q420-21. The growth of imports accelerated in November 2020 alongside a recovery in demand for raw materials and consumer goods, which was contributed to by the result of the pandemic being well contained on the domestic side.

Taiwan achieved a small fiscal surplus of 0.1% of GDP in 2019. It adopted three supplementary COVID-19 budgets worth NT$2.1trn, of which NT$1.7trn was relief measures comprising financial aid, employment assistance, and tax breaks. Taiwan's monetary authority also enlarged its loan guarantee program for small and medium-sized enterprises. We estimate a fiscal deficit of 2.2% of GDP for 2020 and expect a lower fiscal deficit of 1.2% for 2021.

The temporary deflation is driven by low commodity prices this year and reductions in certain service prices. We expect headline inflation to recover from -0.2% in 2020 to 1.1% in 2021. On monetary policy, we expect the central bank to keep the policy rate unchanged through 2021, as the economy is expected to show a solid recovery.

Figure 50: Moving up the semiconductor value chain

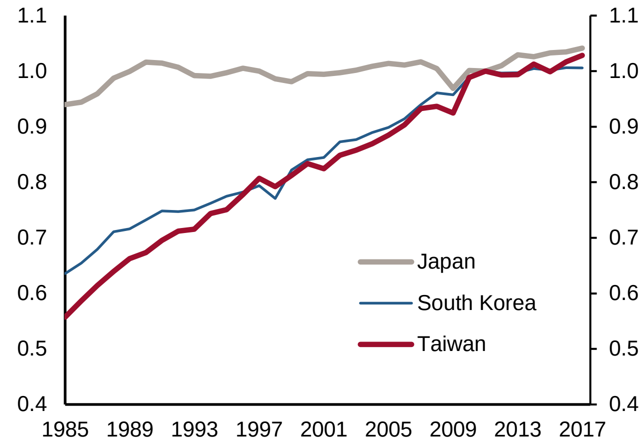
%share in Taiwan semiconductor industry revenue



Source: Credit Suisse, TSIA

Figure 51: Total factor productivity

At constant prices, 2011 = 1



Source: Credit Suisse, Penn Database

South Korea: A recovery fueled by external demand and investment

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- **We expect a sharp recovery in economic activity in 2021, with GDP growth improving to 3.6% throughout the year from -1.2% in 2020.**
- **Exports are likely to remain the key growth driver, and they are expected to remain on an upward trend in 2021.**
- **Strong business capex to support 2021 growth in new growth sectors such as 5G, cloud computing, electronic vehicles, and renewable energy, partially offsetting the fiscal contraction in 2021.**

We expect a sharp recovery in economic activity in 2021, with GDP growth improving to 3.6% in 2021 relative to -1.2% in 2020. The better-than-expected Q320 GDP led by a marked rebound in exports, which regained most of what it had lost in Q220, indicates that the worst may be behind. Much of the upside surprise was related to export orders production overseas that have not been being captured in custom trade data. We expect manufacturing to lead the recovery (mainly through exports). Exports are likely to remain the key growth driver and are expected to remain on an uptrend over 2021. While it is encouraging to see the Korean economy recovering, the domestic activity has been weighed down by tighter social distancing rules, and service sectors have been somewhat slower in their recovery. Abstracting away from any multiplier effect, the fiscal drag in 2021 relative to that of 2020 would be approximately 1% of GDP. However, strong private-sector investment growth fueled by Korea's "New Deal" could partially offset some of the growth slide resulting from the tighter fiscal stance.

At the early stages of the pandemic, the resultant worldwide shock had been a large threat to Korea's exports. The country is heavily reliant on global demand and a wide range of manufactured inputs from China (out of the total intermediate goods imports, approximately 40% are from China in the manufacturing sector). Fortunately, Korea's exports have proven to be resilient thanks to the increase in global investment in data centers and IT products. Increased digitalization and demand for IT products should continue to lead to demand for Korea's semiconductors. China's focus on productivity increases and the digital economy could generate demand for IT products from Korea in the near term (Figure 52; China accounted for 25% of Korea's exports in 2019, and semiconductors, memory chips, and chemicals remain with significant exposure to China). The non-tech sectors such as chemical and steel, which started to recover in H220, should recover at a faster pace in H221.

Alongside these developments, newer industries including electric vehicles and bio-health products are emerging as the new growth engines for Korea's exports, with respective growth rates of 36.8% yoy and 72.6% yoy in H22020. These products currently make up around 3.6% of total exports, up from 1.6% in 2018. We expect both to continue increasing their share of Korea's overall export growth by gradually replacing old economy products such as metals and petrochemical products. Moreover, exports will likely be boosted by a multilateral approach during the Biden presidency, which could help reduce uncertainties around supply chains in the region. A reduced risk of tariff escalation will also be broadly supportive to export-oriented economies.

On the production side, the strong growth in exports expected over the coming year will likely boost manufacturing. Strong manufacturing business confidence and PMI, healthy manufacturing operations, and inventory correction should all continue to support Korea's manufacturing and trade outlook.

In addition, we expect increasing business capex to support growth in 2021, particularly in new growth sectors such as 5G, cloud computing, electric vehicles, and renewable energy. A capex recovery should help lead to a more robust and sustainable economic growth rate by increasing the long-term productivity of Korea. To further this end, the government unveiled its "New Deal" program this year (at a total size of KRW160trn, or ~8.4% of GDP), a five-year state-driven economic policy that aims to shift the structure of the economy. Local technology firms have also recently been active in capacity expansion in their NAND and Foundry facilities, with production from the expanded plants expected to commence in 2021. The tech sector remains buoyant despite the near-term external uncertainties, and firms continue to invest in digitalization, with encouraging reading from data on facilities and construction investment.

We also expect accelerated capex in emerging growth drivers. The auto industry will likely increase investments by 10%, mainly for the production of electric vehicles. Renewable energy is likely to attract higher investment amid the transition toward a low-carbon and eco-friendly economy. With the "New Deal," we expect more public-private joint investment to increase future business capex and productivity.

The fiscal balance is likely to remain with a large deficit in coming years. However, even as the country's expansionary stance continues, no further stimulus will be likely in 2021. For the first time in its history, Korea has passed four supplementary budgets within one year, totaling a fiscal impulse size of 3.5% of GDP to combat against the COVID-19 shock. Government spending alone would contribute to around 1.6ppt to the economy in 2020E, when growth is forecast at -1.2% (2019: 1.1ppt). Fiscal expansion, targeted mainly on job creation and social welfare, will likely continue next year, especially for health care, education, and R&D. The 2021 budget proposed by the Ministry of Economy and Finance implies only a 1.6% increase in fiscal expenditure next year. We expect the fiscal balance to be at a deficit of 4.6% of GDP in 2021, down from 5.7% in 2020 and implying a fiscal drag of around 1.0% of GDP next year (compared with a 0.9% surplus over the past 10 years [2010-19]). Nonetheless, we expect the growth driven by the private sector will offset a portion of the growth slide from government spending.

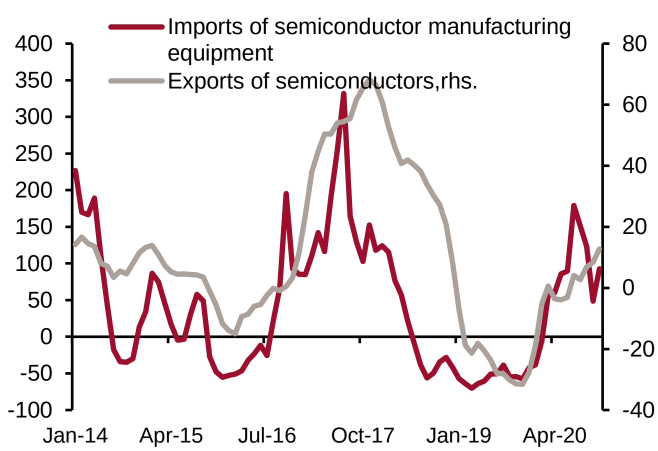
Overall consumption remains a drag, and employment has not returned to pre-COVID-19 levels. As for the labor market, the service sector (including hotels & restaurants, transportation, education, wholesale, arts & recreations, etc.) has neither fully recovered to pre-pandemic levels, and tighter social distancing measures could result in another dip in services consumption (approx. 35% of private consumption and employment; Figure 53). The labor market, particularly in the service sector, is likely to face a weak recovery as long as COVID-19 remains a threat, while the recovery in private consumption could be more gradual. On the other hand, online sales will provide a partial offset. Demand in the service sector should return once the virus is contained.

We expect inflation to rise gradually along with the recovery in economic activity, but it is likely to remain low. Core CPI (excl. agricultural products and oil products) rose to 1.0% yoy in November from 0.1% yoy in October, suggesting the demand side price pressure should gradually recover toward a mid-1% pace through next year. Service prices that were affected by COVID-19 (especially tourism) account for around 20% of the CPI basket, and they should be slow to come back, as international tourism will not likely normalize immediately next year. Headline inflation is still likely to remain significantly below the BoK's 2% inflation target.

We are not expecting any further easing by the BoK. Though the BoK acknowledged the elevated financial instability risks represented by household debt growth picking up and housing prices continuing to rise in all parts of the country, the BoK governor ruled out possibilities for a policy rate hike in the near term. The bank will keep an accommodative stance until the domestic economy returns to normal growth, with reduced uncertainties stemming from the pandemic. We continue to not expect any change to policy rates until late 2022.

Figure 52: Strength in semiconductor manufacturing

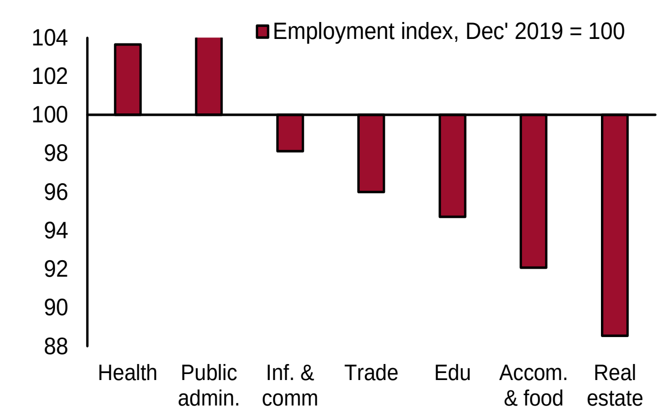
%yoy, 3mma



Source: Credit Suisse, Haver Analytics®

Figure 53: Employment level by sector

Data are seasonally adjusted and correspond to Nov-20



Source: Credit Suisse, Haver Analytics®

Latin America: Sluggish recovery

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- **We project that real GDP in Latin America will grow by 4.0% in 2021, after contracting an estimated 7.2% in 2020.**
- **We forecast annual regional inflation (excluding Argentina and Venezuela) of 3.6% by year-end 2021, after an estimated 3.3% last year**

We project that real GDP in Latin America will grow by 4.0% in 2021, after contracting an estimated 7.2% in 2020. Economic performance should be mixed this year in the countries we cover, with Brazil, Chile and Peru likely posting the highest growth rates. At the other end of the spectrum, we think that Mexico will recover only partially, given the lack of any meaningful policy stimulus in 2020, while Ecuador's growth is likely to be subdued given structural weaknesses.

We forecast annual regional inflation (excluding Argentina and Venezuela) of 3.6% by year-end 2021, after an estimated 3.3% last year. The majority of countries in the region showed, over the last few quarters, inflation prints within the target ranges of their respective central banks. We remain unconcerned on this front, particularly given the lack of demand-side pressures and the resilient behavior of EM currencies amid this crisis. We note that, as usual, Argentina and Venezuela will continue to be the high inflation outliers of the region, with central bank financing of fiscal deficits largely behind this.

Below we provide a summary of the highlights in the countries under our coverage.

In **Argentina,** the economic policy mix deployed in 2020 severely deteriorated the country's macro fundamentals. The monetization of fiscal spending by the central bank resulted in a massive swelling of monetary aggregates, pressures on the balance of payments and on prices, losses of international reserves, and a disjointed parallel foreign exchange market, despite exchange controls and domestic price controls. In 2021, Argentina will need to renegotiate its program with the IMF to smooth out the amortization payments generated by its previous Stand-By Agreement and which, in current conditions, are not possible to meet. A new IMF-sponsored program is an opportunity to revamp the policy mix into a more orthodox path, but we are not overly optimistic this will happen.

In **Brazil**, after an estimated real GDP contraction of 4.3% in 2020, the economy should post a recovery of 4.0% in 2021. Easing credit conditions and a recovering labor market should contribute to an acceleration in household consumption and investment in 2021 and 2022. Higher exports driven by stronger global demand should be partially offset by higher imports. Investor attention in 2021 will likely center on fiscal policy as Brazil was one of the countries that spent the most to fight the pandemic. Any additional fiscal stimulus poses a high risk to the public accounts and economic agents' expectations. In order to make room for higher expenditures under the spending cap, the government is likely to push for the approval of a constitutional amendment to reduce mandatory spending in the beginning of the year. The following measures may be included: salary freezes for public sector workers, layoffs, restricting salaries above the constitutional cap, and the de-indexation of welfare benefits from the minimum wage. This will be the main political challenge of 2021.

Aside from the fiscal concerns, the rise in inflation is another factor to watch closely. Consumer price inflation is expected to remain high at 4.0% in 2021, above the center of the target. In our opinion, the balance of risks to inflation in 2021 is to the upside due to the likelihood of strong FX pass-through, higher-than-expected commodity prices given the projected global recovery, and a potential de-anchoring of inflation expectations if there is a change in fiscal policy. In order to maintain anchored inflation expectations, we think that the reversal of the monetary stimulus will start this year. In our view, the process will likely begin with a 50 bps hike at the June meeting; we expect a 2021 year-end Selic rate of 4.5% versus 2.0% at present.

Chile stands out for the aggressive monetary and fiscal stimulus that authorities have deployed since the early stages of the pandemic. We think that this will pay off particularly in 2021, when we project that real GDP will grow by 5.5% after falling an estimated 6.3% in 2020. Aside from the pace of the recovery and the availability of the vaccines, we think that investor attention in 2021 will center on political developments. In the first half of the year, the focus will likely be in the selection on 11 April of the 155 members of the constitutional convention that will be in charge of drafting a new national constitution. Later in the year, market attention will center on the presidential race, as presidential elections take place on 21 November. Contrary to previous presidential elections, we think that the political rhetoric in 2021 of many candidates could sound more populist, or less pro-market, as they seek to capitalize on the social discontent that erupted in October 2019, as well as on recent short-sighted and populist reforms, like the one that allowed early withdrawal from pension accounts.

Meanwhile, we think that the main challenge for **Colombia** in 2021 will be to avoid losing its investment-grade status. Fitch and S&P currently have a BBB-rating with a negative outlook on its external debt, which may need to be resolved by the end of the year. The fiscal outlook looks highly complex to us given the combination of potentially lower-than-expected growth and a daunting task of approving a large tax reform before year-end. On the growth front, we project the economy will rebound 4.3% in 2021 after contracting by 8.0% in 2020. The rest of the macro outlook for Colombia looks in order, in our view. We expect inflation to remain in check, interest rates to increase slightly and only toward the end of the year, and the current account deficit to remain below 3% of GDP and largely financed by FDI.

Ecuador's macroeconomic performance during the pandemic has surprised us positively. Many of the risks we were fearful of did not materialize, and the resources obtained from the IMF helped soothe lingering concerns over the monetary sector. After contracting by an estimated 7.9% in 2020, we project real GDP growth of 2.9% in 2021. In our view, the outlook for Ecuador in 2021 will be highly dependent on its upcoming presidential election, whose outcome could potentially be binary if some of the leading candidates implement a change in economic regime. Our main concern in terms of policymaking would be if an incoming administration attempts to resume central bank financing to the treasury, which we think could be destabilizing for dollarization. We think it is too early to tell what the most likely outcome of the election will be, as polls suggest that the race is currently tight and the number of undecided voters remains high.

Mexico is one of the countries in the region that will likely post one of the lowest growth rates in 2021, even though its economic contraction in 2020 was close to 9% in real terms. We project real GDP growth of just 3.0% in 2021. We acknowledge that favorable tailwinds will likely come from stronger US growth, particularly in the second half of the year. Headwinds, however, will come from the net loss of over 340,000 firms in the formal economy in the past 18 months (and the close to 2.2mn jobs associated with them), subdued business confidence, a more risk-averse banking system given the lack of material official support throughout the pandemic, and the enormous challenge of securing and administering COVID-19 vaccines for a population of close to 130mn people.

Investor attention will likely center on any additional interest rate cuts the central bank may be willing to undertake. We think the central bank will have space to cut the overnight rate in its next two meetings (11 February and 25 March), as annual headline inflation will be close to the 3.0% target. On the fiscal front, however, the room for stimulus will be constrained by limited fiscal revenues and by the President's commitment to austerity. On the sovereign ratings front, we think that the risk of additional downgrades will persist in 2021. We think that this risk will come mainly from S&P and Moody's, which maintain a negative outlook on the country's long-term foreign currency debt. On the political front, investor attention will likely center on the June elections. Our central scenario is that ruling party MORENA and its allies will maintain more than one-half of the seats in the House that are required to enact secondary legislation in Mexico's Congress, although their voting totals will likely be below those in 2018.

In **Peru**, we think the GDP growth in 2021 will be one of the strongest in the region, partly due to a very favorable base effect. We forecast real GDP growth of 8.0% for this year and project that pre-pandemic output levels will likely be achieved by year-end 2022. Economic dynamism in recent months has surprised us to the upside, as government stimulus measures finally became apparent in domestic demand. The external sector has also contributed in the recovery, with the growth of exports outpacing that of imports, given sturdy global demand for mining output. Investor focus at the beginning of the year will likely be on the general elections on 11 April. At the time of writing, polls suggest that the presidential race remains wide open. An enhancement in governability, following years of political turmoil, will be key to improving the already complicated economic outlook.

In **Venezuela**, we expect real GDP growth of 3.0% this year, which would put an end to the streak of contractions since 2014. We think growth will be the result of an extremely low base of comparison and of certain positive changes in the economy's framework. The main hurdle for Venezuelan authorities will be to access and administer COVID-19 vaccines nationwide. We think Venezuela will likely be dependent on humanitarian assistance and vaccines deals with the governments of Russia and China. Our base case is that some sort of vaccination strategy will take place over 2021 and that authorities will continue relaxing mobility restrictions gradually. Lastly, we have no indication that the political crisis will be resolved any time soon, nor that there will be any improvement in the rule of law. An important factor, though, could be whether the incoming Biden administration in the US decides to take a different approach to the Venezuelan crisis.

UK: Robust recovery

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- **Despite a near-term contraction due to lockdowns, we expect a robust recovery in the UK from the summer. After falling by 10.7% in 2020, we expect the economy to grow by 3.2% in 2021 and 8.5% in 2022.**
- **The UK's departure from the EU single market and customs union at the end of last year, even with a deal, is likely to weigh on recovery.**
- **The Bank of England should increase its asset purchases by a further £150bn in response to the new lockdown.**

Covid restrictions continue in the UK as we enter 2021. The spread of a more infectious strain of the virus has led to a renewed lockdown, similar in stringency to that imposed in March last year. We expect restrictions to be tough until at least March. This means that GDP is likely to have contracted again over the winter months, but less severely than last spring.

Despite the near-term contraction, we expect a robust recovery in 2021 on the back of supportive policy measures and vaccine news.

After making several U-turns regarding its policy of job support, the government extended the furlough scheme until April 2021, whereby the government pays 80% of workers' wages. The presence of the furlough scheme and other fiscal measures allowed for jobs and corporate and household incomes to be sustained during the first lockdown in H1 2020. Household savings rates picked up significantly. Recovery from the Covid slump in Q3 2020, once the restrictions were eased, was more vigorous than expected. The Bank of England also announced an extension to its QE program until end-2021 to absorb the government's increased debt issuance and avert a tightening in financial conditions that increased fiscal support would imply.

Therefore, we think, like the first lockdown, policy measures have been put in place to prevent persistent damage to jobs, incomes and businesses. Savings rates are likely to be high, and these high cash balances could allow the economy to recover robustly from the near-term slump, once restrictions are eased. Of course, some job losses have already happened due to confusing policy U-turns and policy will not be able to mitigate all of the damage (we expect unemployment to rise to 6% by the end of 2020 and peak at 7.5% in Q2 2021, as the furlough scheme is set to end in April).

There has also been positive news on the vaccine, which raises the prospect of a return to more normal economic conditions during 2021. Vaccines are already being deployed in the UK, and it is possible the UK could attain herd immunity to the virus by the end of Q2 2021. That should allow for an almost complete easing of restrictions in the second half of the year and a rapid rebound in activity. The UK suffered the deepest contraction amongst developed countries in the first half of 2020. By the end of Q3 2020, GDP was 8.6% below pre-Covid levels, implying the UK has one of the biggest GDP shortfalls to make up for. The prospect of a vaccine and return to normality means that the UK, with its large consumer services sector hit hardest by the pandemic, is likely to see an outsize benefit.

These developments indicate the recovery from the impending Covid slump can be robust, as long as policy remains supportive. **We expect UK GDP to grow by 3.2% in 2021 and 8.5% in 2022.** At the end of Q4 2021, we think the economy would be around 3% below its pre-Covid levels and can return to pre-Covid levels by Q3 2022.

The UK has also left the EU transition period with a trade deal with the EU. The trade deal allows the UK to trade with the EU on a zero tariff zero quota basis. But the departure from the EU single market and customs union is likely to weigh on the recovery. There are now checks and non-tariff barriers on trade with the EU. Increased trade barriers will mean trade in both goods and services with the EU is likely to be lower as a result. This reduction in trade is expected to weigh on productivity and GDP. Moreover, the provision of cross-border services will become more restricted, given it is essentially a hard Brexit for services.

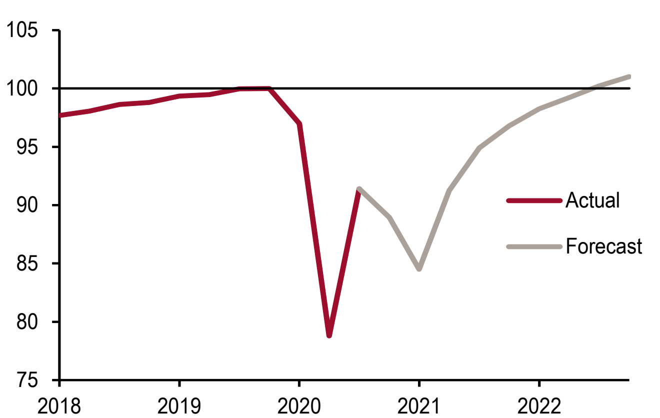
Other downside risks include the prospect of premature fiscal tightening, as well as persistent scarring from the pandemic in the form of elevated unemployment and business failures. Chancellor Sunak has announced supportive fiscal measures during the pandemic, and the UK deficit is set to rise to 19% of GDP, up from 2.5% in 2019-20. However, he also struck a cautious tone about the state of the public finances. Any pre-emptive fiscal tightening in the form of tax rises or spending cuts this year has the potential to slow the recovery.

The Bank of England is likely to respond to the new lockdown by increasing its asset purchase programme by a further £150bn in February, and keep policy unchanged thereafter. Those purchases will likely cover the government's financing needs for this year. There is a risk the Bank will cut rates, currently at +0.1%, to negative. It has not yet concluded its review on the efficacy of negative rates in the UK nor its assessment of the effective lower bound. While some in the MPC point to other countries' positive experience with negative rates, the concern remains the impact of negative rates on bank profitability. We expect rates to remain where they are.

Another political risk in 2021 are the Scottish elections in May 2021. If the Scottish National Party wins a majority in the Scottish Parliament, there are likely to be increased calls for a Scottish independence referendum. The Westminster government has so far denied holding another Scottish referendum, but increased calls could increase pressure for one.

Figure 54: UK GDP projections

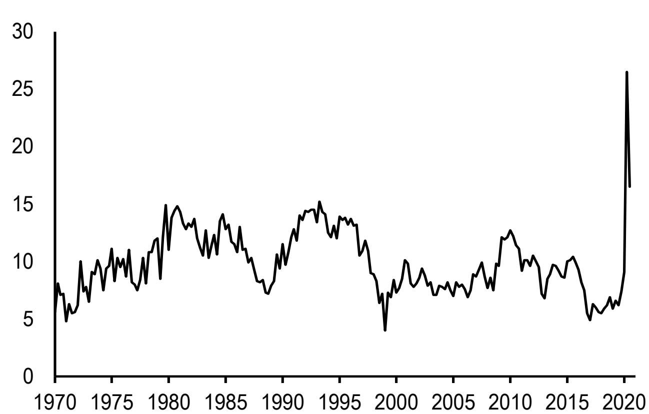
Q4 2019=100



Source: ONS, Credit Suisse

Figure 55: UK savings reached record highs, which enabled a robust recovery once restrictions eased

%



Source: ONS, Credit Suisse

Switzerland: Need for FX interventions should decline

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- **Growth should accelerate after the winter months, assuming the spread of the virus is under control.**
- **The rebound will likely push GDP growth above potential in 2021, but inflation should remain muted.**
- **Despite Switzerland being labelled a "currency manipulator" by the US Treasury, the Swiss National Bank (SNB) could still intervene in the FX market, but in a scenario of a global economic rebound, such intervention should be much less needed, in our view.**

Given the still high number of daily new COVID-19 cases in Switzerland, the government will maintain social distancing measures in place at the beginning of the year. These measures will dampen economic activity, in particular in the services sector. Moreover, we expect the unemployment rate to continue rising in the first half of 2021, despite the broad use of short-time work that has prevented a much worse outcome. As we expect vaccines to become more widely available over the course of the winter, it should allow the government to ease social distancing measures gradually, which would likely translate into a rapid rebound.

The outlook is more optimistic for the manufacturing sector. Surveys continue to point to solid demand for Swiss goods, in particular in cyclical goods, including metals, machinery and electronics. This trend should help support investments. Moreover, both the investments in IT infrastructure and strong investment activity of the pharmaceutical and chemical industries, which continue to exhibit robust growth, will likely support investment demand for some time. Even investments in construction should rise, despite growing evidence of oversupply in the rental apartment segment.

In sum, we expect GDP to rebound by 3.5% in 2021, after an estimated contraction of 3.2% in 2020. In terms of the growth trajectory, any acceleration should not be visible before Q2 2021, at the earliest.

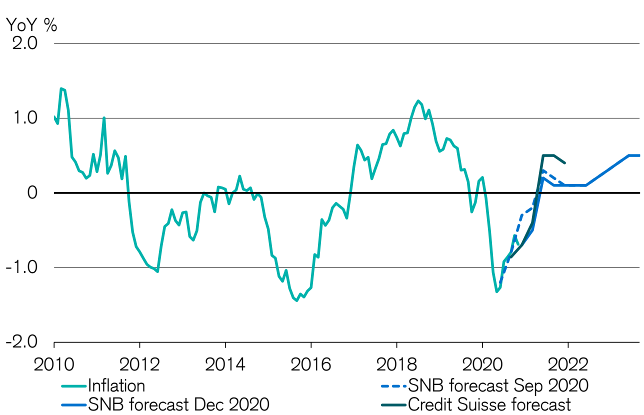
Inflation will remain subdued according to our forecast. Basis effects will help the inflation rate to turn positive again, probably in April, but structural factors should continue to prevent consumer price growth from accelerating. In particular, the growing oversupply of rental apartments is weighing on rents, the largest single item of the CPI. Moreover, health care prices, also one of the largest CPI items, have trended lower for years, and we hardly see this trend reversing in 2021. We expect inflation to average 0.3% in 2021, after –0.7% in 2020 (Figure 56).

On the monetary policy front, the US Treasury has officially labelled Switzerland as a "currency manipulator" due to Switzerland's large external surplus and substantial foreign currency purchases by the SNB, in particular in the first half of 2020. Being labelled a "currency manipulator" does not automatically lead to economic sanctions. However, the USA will "engage in negotiations" with the Swiss authorities to address some of the issues identified by the US Treasury. One of the issues raised – the large external surplus – will be difficult to satisfy. As the surplus is essentially due to pharmaceutical exports and commodity trading (merchanting), both of which have proved resilient to the appreciation of the Swiss franc, the surplus is there to stay, even if the Swiss franc were to appreciate.

Hence, if Switzerland wants to avoid diplomatic and trade tensions with the USA, the key change needed to satisfy the US Treasury would be for the SNB to clearly limit its foreign currency interventions. Reducing or even halting foreign currency purchases may in fact be possible. Between mid-2017 and end-2019 (Figure 57), the SNB did not intervene much, enabling the country to "escape" the currency manipulator label. More recently, the SNB has significantly reduced its foreign currency purchases since last summer. If the global economy continues to recover as we expect, the need for foreign currency purchases will likely diminish quite naturally, because appreciation pressure on the Swiss franc should then abate.

However, as the SNB has limited options to ease monetary policy (or to at least prevent monetary conditions from tightening), foreign currency purchases will remain part of its toolbox. Thomas Jordan, chairman of the SNB Governing Board, indeed said in December that being labelled a currency manipulator "has no impact on [the SNB's] monetary policy" and added that foreign currency purchases are "the result of the SNB's mandate (…)." We therefore expect the SNB to continue to intervene from time to time, in particular in the event of increased financial market volatility. In general, however, the need for FX interventions should be much lower in 2021, in our view. Lastly, we expect the SNB to maintain its policy rate unchanged at –0.75% in 2021.

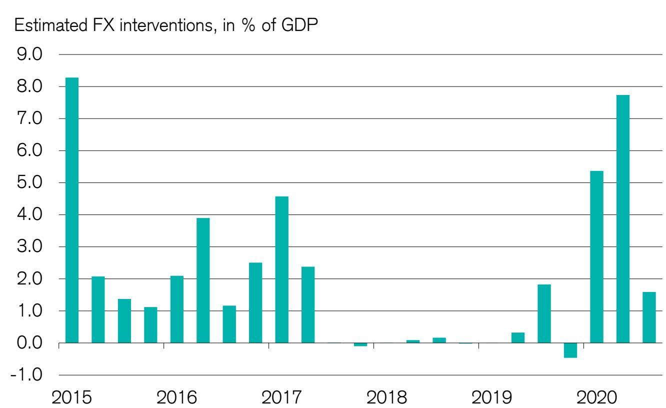
Figure 56: Inflation should remain subdued



Source: Datastream, SNB, Credit Suisse

Figure 57: Foreign currency purchases of more than 2% of GDP will attract the attention of the US Treasury

Quarterly data



Source: Datastream, SNB, Credit Suisse

Canada: A balanced recovery

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- **We expect Canada's GDP to expand by 6.2% in 2021 and 4.1% in 2022, driven by timely vaccine access, a broadening services rebound, and strong policy tailwinds.**
- **Moderation in the housing market is limited due to healthy fundamentals.**
- **Inflation pressure remains muted, allowing the Bank of Canada to stay accommodative.**

The Canadian economy likely contracted 5.5% in 2020, its worst year since the Great Depression. Economy-wide business closures depressed economic activity and a fast but uneven rebound has been led by goods-producing sectors. As the virus is now spreading rapidly and hospitals are filling up, restrictions may widen anew. Selective shutdown measures should be less harmful to the economy, as in European countries, but they will nevertheless disrupt the partial recovery.

Beyond the winter wave of COVID infections, a more balanced economic recovery will start as population immunity grows. Health authorities have begun inoculating high-risk groups, aiming to vaccinate most of the population by late March. Once senior citizens and health workers are less susceptible to contagion, the lethality of outbreaks will decline, a wider range of services sector activities can resume. The potential boost to economic growth is considerable, as services consumption constitutes a third of GDP and remains 12% below its pre-COVID peak. Badly impaired industries such as travel, restaurants, and hotels should normalize if the federal government executes its plan to vaccinate half of the population by June and reach herd immunity in Q3. A benign and predictable business environment will bring back firms' investment spending and hiring, resulting in a self-fulfilling economic recovery.

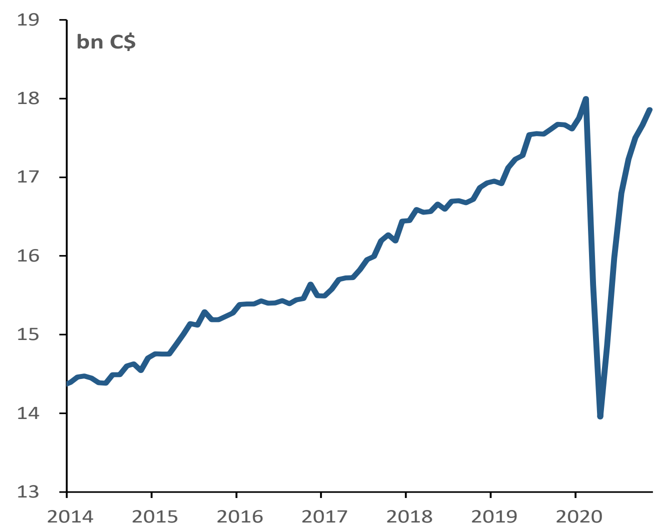
Continued fiscal stimulus should safeguard the recovery. The government has extended emergency wage subsidies, sustaining the robust gain in aggregate payroll income (Figure 58). Additional fiscal support worth 3-4% of GDP is also on the way to assist households and businesses in recuperating losses from the recession. A large share of the funds should be distributed within the fiscal year ending in March 2022. While Canada's fiscal stimulus has been the largest among industrialized nations, its budgetary position remains flexible. Despite the recent jump in public debt stocks, interest costs are lower than in 2019.

Continued fiscal support and income growth will limit the downside in consumer spending, but goods consumption growth should slow to a more sustainable rate. Real retail sales have overshot to levels almost 5% above the pre-COVID peak. The surge in demand for autos, home office equipment, and home improvement products are one-offs that are prone to a pullback. A presumably expanding array of discretionary services such as tourism, eating-out, and entertainment will also divert resources from household budgets.

The heated housing market should cool, but a sharp decline is unlikely, thanks to healthy fundamentals. Prime-age population growth has accelerated in recent years, spreading across metropolitan areas. Household formation and home upgrades will likely continue despite the pandemic-led search for space eventually fading. Interest rates near zero alongside a flat yield curve have also extended financing support to new and existing homebuyers. In addition, housing market excess appears to be limited, with regional speculative demand having been tame even prior to COVID, either by selective regulatory curbs or sluggish energy prices.

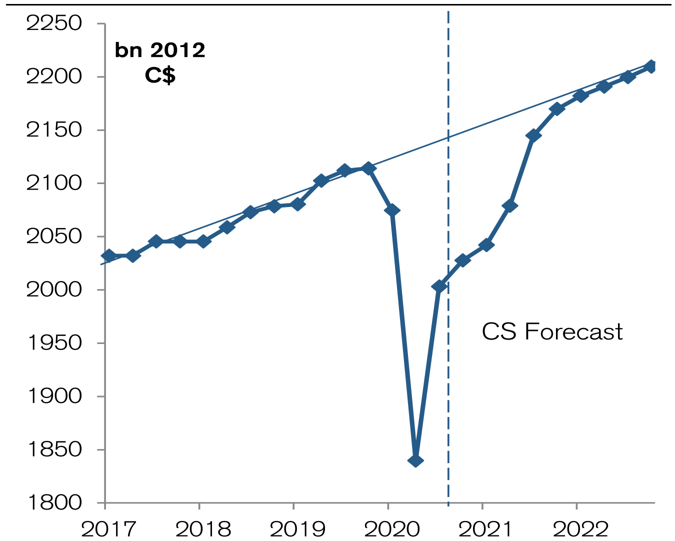
Despite the outlook for a broadening recovery, economic damage from the pandemic will take time to heal. Long-term unemployment should lead to exits from the labor force, and immigration has also slowed. GDP levels may not reach their previous trend before the start of next year (Figure 59). Until then, disinflationary pressure should persist, allowing the Bank of Canada to stay accommodative and downplay transitory inflation pressures.

Figure 58: Fiscal stimulus has pushed aggregate payroll income back to the previous peak



Source: Credit Suisse, Statistics Canada

Figure 59: Canada GDP to resume the 2% trend in 2022



Source: Credit Suisse, Statistics Canada

Russia: A sharp increase in inflation puts a halt to the central bank's easing cycle

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- **The pace of recovery in economic activity will depend on the revival of global demand and OPEC+ restrictions on oil output recovery.**
- **The rouble will strengthen to its fundamentally justified level, at 65-70 against the US dollar.**
- **Although CPI inflation may surprise to the downside in 2021, the central bank will refrain from a cut in the policy rate in 2021. (In an extreme-case scenario of an abrupt drop in inflation alongside a sharp contraction in economic activity, the CBR will cut just once, by 25bps, to 4.00% in 2021.)**

The Russian economy recovered moderately in 3Q following the COVID shock from the previous quarter. According to Rosstat, the contraction in real GDP narrowed to 3.4% yoy in 3Q from 8.0% yoy in 2Q. On our official seasonally adjusted estimate, real GDP was up 0.7% qoq in 3Q after declining 2.8% qoq in 2Q.

The recovery in real GDP was also boosted by an upside revision to the industrial output series since 2018. On our estimate, this revision narrowed the contraction in real GDP by roughly half a percentage point in 2020. Overall, the recovery in industrial output was mixed, being most visible in the manufacturing sector while remaining depressed in the mining sector output.

Despite a second, more severe wave of the COVID pandemic, the government was reluctant to introduce any meaningful restrictions in 4Q 2020 and seems unlikely to introduce any meaningful restrictions in 2021. The government has approved two COVID-19 vaccines that it will begin to roll out this year. Therefore, our outlook on the Russian economy will depend on the pace of the country's vaccination program and outlook on the recovery in global demand. The latter is crucial for Russian oil output, which has been reduced in-line with the OPEC+ agreement. We expect the economy will grow by 2.7% in 2021, after a 3.6% contraction in 2020.

The government will delay fiscal policy normalization by one year. According to the federal budget law for 2021-23, the government will reduce its primary structural deficit from 3.9% of GDP in 2020 to 1.4% in 2021, before a further scheduled narrowing to 0.5% of GDP in 2022. Therefore, the fiscal rule, returning to its pre-COVID shape, will be in place starting in 2022. The government will finance a wider structural deficit through a combination of borrowing in the local markets and a marginal increase in the tax rate for high-income households. Our readers may find additional details of the fiscal policy in the relevant note, CS House View Russia: Fiscal Policy 2020-23.

Fiscal policy normalization will put additional downside pressure on inflation that we project will drop to below the CBR's 4.0% inflation target by the end of 2021. However, the recent spike in actual inflation and households' inflation expectations has almost ruled out further policy easing. Headline CPI inflation accelerated to 4.9% yoy by the end of 2020, considerably above our and the central bank's forecasts, under the pressure of a weaker rouble and the side effects of a second wave of the pandemic (that pushed food prices significantly above all expectations). Headline CPI inflation will peak in 1Q, as the effect from the weaker rouble will be exhausted and fiscal policy normalization will take over. In our view, headline CPI inflation will fall toward 3.0-3.5% yoy by the end of 2021.

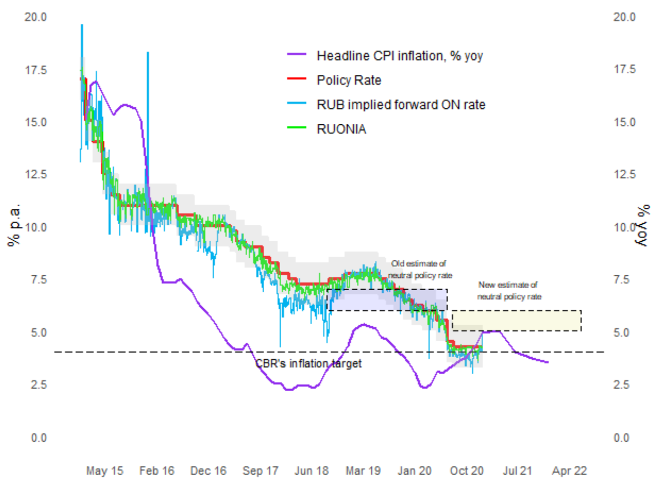
In our view, this scenario is widely expected by the central bank. However, since its most recent meeting in December, the CBR has become more concerned with the second-round effects from higher food prices that could affect the longer-term inflation expectations of households. Therefore, on 18 December, the central bank slightly tweaked its statement. It still sees room for the policy rate cut but no longer considers it an urgent step, in contrast to its previous guidance in which the central bank kept the door open to the cut at one of the upcoming few rate-setting meetings. We think in the current environment the central bank would refrain from further policy easing in 2021. A cut in the policy rate that we expected previously has now become a tail risk that could materialize under a unique combination of sharply lower inflation and a slowdown in economic activity, probably aggravated by a still-worsening pandemic. Our base case suggests the central bank has finished its easing cycle; therefore, we think the policy rate will remain at 4.25% through 2022.

We expect the rouble to return to its fundamentally justified levels in 2021. In our view, its weakness was driven by temporary factors. As we mentioned above, the rouble's weakness has also been behind the pause in monetary policy easing since September 2020. We believe the rouble's underperformance was a combination of several factors – the government's intention to revise tax treaties with offshore countries like Cyprus and a sharp increase in the money supply (M2 growth accelerated to 16.2% yoy in October from 10.2% yoy at the beginning of 2020). The former triggered front-loaded capital flight, while the latter created a favourable environment for such an outflow. The main sources of the increase in money supply were operations of the federal budget and special aspects of the deficit financing in 2Q, when the government received profit from the privatization of Sberbank (around 1% of GDP). Instead of offsetting this increase in RUB liquidity with FX sales, the CBR delayed its operations in the open market until 4Q, also netting it out with deferred FX purchases (from 2018). In our view, this created an additional misbalance in the local FX market. We think this misbalance was temporary and will be restored in 2021.

Our outlook on the current account remains favourable. In 2020, despite a sharp drop in oil prices and oil output, the current account surplus remained solid, at around 2.0% of GDP. We expect the current account surplus will widen in 2021. The recovery in global demand will push oil prices higher, which in turn will allow members of the OPEC+ agreement to increase their oil output. It could also contain a sharp increase in USD oil prices, but it will allow Russian oil producers to recover its oil exports in real terms. Should the global vaccination programs against COVID be successful, the demand for travel services will revive, creating additional demand for FX. However, we think a substitution effect will prevail among households. Due to the sharp decline in real disposable income in 2020, households will not be able to maintain the same demand for foreign goods and services at the same time. Therefore, we think a drop in goods imports will offset the increase in services imports. Last but not least, the current account surplus will improve on the back of lower primary income outflows due to the decreased profitability of the Russian companies. As a result, we estimate the current account will widen to around 3.0% of GDP this year before it starts narrowing back toward 1.0%-2.0% of GDP in 2022.

Figure 60: Key market and policy interest rates and headline CPI inflation

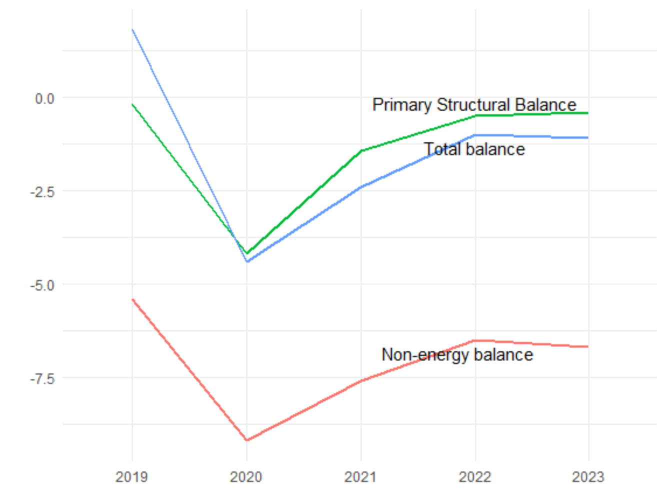
% p.a. / % yoy



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse, Rosstat, Bank of Russia, Credit Suisse estimate

Figure 61: Federal budget balance

% of GDP



Source: Ministry of Finance, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Turkey: Between a rock and a hard place

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- **Economic activity is likely to slow in the near term and the pressure on the balance of payments to ease, while the inflation outlook is challenging, particularly in 1H 2021.**
- **The recently appointed policymakers are reversing the interventionist and ad-hoc measures of the previous economic management team, but they still appear to be far from pursuing a coherent macro program that would address Turkey's vulnerabilities. We remain of the view that the rebuilding of confidence in Turkey's policies is a long shot.**

Economic activity is likely to slow in the near term and the pressure on the balance of payments to ease. We now estimate that full-year real GDP growth was probably 1.5% in 2020, although it was accompanied by significant imbalances, including a sharp loss of the central bank's reserves. The statistical carry-over to next year's real GDP growth is likely to be strong, at around 4.5-5.0pps, but the partial lockdowns that are now being imposed in response to a renewed wave of virus infections, alongside the tightening of monetary policy that has taken place since August, might lead to a contraction of domestic demand in 1H 2021. We are working with a real GDP growth forecast of 3.5% for 2021, which embeds a technical recession in 1H and a rebound in 2H. Against this backdrop, we expect the current account deficit to narrow in 2021, also supported by a potential turnaround in tourism receipts in 2H. As the positive market sentiment toward the recently appointed policymakers continues in the near term, cross-border capital inflows will also support the balance of payments.

Headline inflation will remain elevated in 1H 2021, and the risks to the outlook are primarily to the upside. These risks include the still-strong aggregate demand, lagged pass-through from the lira's past depreciation and the increase in international food and commodity prices. Given the challenging inflation outlook, we think that the policy rate should be higher than its current level of 17.00% (perhaps by 50-150bps) in order to strengthen the attainability of the MPC's interim inflation target of 9.4% for end-2021, but we do not think the MPC will deliver the required tightening in the absence of market pressure. In our view, the most likely scenario is that the MPC will keep the policy rate unchanged in 1H 2021 and ease gradually to 14.00% in 2H 2021.

The recently appointed policymakers are reversing the interventionist and ad-hoc measures of the previous economic management team, but they still appear to be far from pursuing a coherent macro program that would address Turkey's vulnerabilities. We think the steady implementation of a comprehensive macro program is required to address the lack of confidence in Turkey's policies and institutions, so that reverse dollarization could start and enough cross-border capital inflows could be attracted to replenish the central bank's FX reserves. In addition to reserves replenishment, such a program should, in our view, address the deterioration in the central government's balance sheet and comprise credible stress-testing of the banking sector following last year's rampant credit growth and the impairment in the non-bank corporate sector's balance sheet driven by the lira's depreciation. We remain of the view that the rebuilding of confidence in Turkey's policies is a long shot. More importantly, it still remains uncertain whether President Erdogan will tolerate the required austerity given the reported decline in voter support for his ruling alliance.

CEE3: Policy normalization delayed

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- **A full recovery from the COVID shock will be delayed until 2022.**
- **Apart from the Czech Republic, we do not expect any change to policy rates for the Central European countries.**
- **In our view, inflation risks are skewed to the upside, but stronger currencies may effectively mitigate them.**

The economies of Central Europe recovered strongly in 3Q, after a devastating COVID shock. The recovery is happening in a synchronized fashion. The main common feature of this recovery has been related to a significant increase in the final consumption expenditure and net exports, with only moderate growth in the gross fixed capital formation. In 4Q, the recovery in economic activity stalled due to the second wave of the COVID pandemic, which was much more severe than the first. That said, the governments refrained from imposing similar restrictions that were in place during 2Q. Therefore, although we expect a drop in real GDP in 4Q, it will be nowhere close to what Central European economies experienced during the first wave of the pandemic. Following the approval of the COVID vaccines, the sentiment around the economic recovery path has improved, although the actual pace of vaccination will be moderate, in our view.

For instance, in Poland, the government will be able to administer around 3.4 million doses of COVID vaccines per month. For a country with 38 million people, it will take a year to vaccinate the whole population. In Hungary, the government may consider importing the Russian vaccine Sputnik V, a relatively unpopular choice among the Western countries, and also a sign that it failed to safeguard early access to the alternative vaccines from Pfizer and AstraZeneca. In the Czech Republic, around half of the population should be vaccinated by October of this year. These guidelines suggest that vaccinations against the COVID will take some time, and therefore, most of the restrictions and social distancing measures may stay in place during 1H 2021. This, in turn, implies a longer period of recovery from the COVID shock. We expect the CEE3 countries will close the gap from the COVID shock by the end of 2022, longer than initially expected. In Hungary, we expect real GDP growth will be 3.9% in 2021, after a 6.5% decline in 2020; in Poland – the economy will expand 3.5% in 2021 after a 3.8% contraction in 2020; in the Czech Republic – real GDP growth will be 3.0% in 2021, following a 6.1% drop in 2020.

With that view, we do not expect any major change to monetary policy this year. All the central banks in the region reduced their policy rate to near zero, having exhausted conventional options. In Hungary and Poland, the central banks were engaged in the government asset purchasing programs, which will remain their primary policy tool before they consider normalization of their policy rate structures.

In Poland, during the second wave of the pandemic, the market was actively considering the possibility of reducing the policy rate to below zero; however, this option was decisively rejected by a majority of the Monetary Policy Council's members. It was even more so surprising when on 18 December, the National Bank of Poland intervened in the open FX market to weaken the zloty. Since the NBP refused to comment on this FX intervention initially, the market remained puzzled with its rationale and the timing. The comments from the majority of officials suggested the main aim of FX interventions was to help exporters, which is slightly perplexing, as exports had already recovered to their pre-COVID levels in October. According to Bloomberg, another reason for FX interventions could have been related to the NBP's desire to book higher profit from a revaluation of its FX reserves, a measure that would allow transferring higher profits to the central government's budget. Whatever the reason was, we would like to remind that the MPC had always expressed concerns over a stronger zloty and its ability to contain the recovery in economic activity. Also, this case with FX intervention shows how high the bar would be for the NBP to hike the policy rate until a complete recovery in economic activity. In his interview with local media on 30 December, Governor Glapinski did not rule out a further reduction in the policy rate in 1Q 2021. The comment surprised the market once again, although it effectively stressed all the above, which is that policy normalization will not be an option this year and nor will it be likely in 2022.

The reaction function of each central bank in the region remains different. For instance, the Czech National Bank (CNB) refrained from quantitative easing in 2020, thanks to the abundant room it had for reducing the key policy rate. Therefore, even though the central bank expects inflation to return to its 2.0% target in 2021, it does not want to delay policy normalization that should allow the central bank more flexibility in case of a future negative shock. The National Bank of Poland may delay policy normalization regardless of higher inflation risks. Having reduced its key rate to 0.10%, it does not seem to be concerned with the zero lower bound rate, as it relies heavily on its government asset-purchasing program (and potentially on its FX interventions).

Hungary's central bank (the MNB) faced the COVID shock without any room for reducing the policy rate, and therefore, its main reliance was on the government asset purchasing program, which will remain its main policy tool from now on. In light of the increase in inflation risks during summer last year, the MNB changed its approach to monetary policy, trying to target the market's expectations by setting the minimum rate at the one-week deposit auction, which has become its main sterilization tool. In 2021, we expect neither Poland nor Hungary would be willing to increase their policy rate. Should the economies start recovering faster, pushing inflation above the inflation target, the central banks may consider tapering their asset purchasing programs. In our view, monetary policy normalization may commence in 2022 in Poland and Hungary. In the Czech Republic, we expect the CNB may start adjusting its policy rate in 4Q 2021, even if there is no substantial increase in inflation risks. Unlike its peers, we believe the CNB is more concerned with a zero lower bound problem and would like to have at least some space for policy easing in case of a negative shock to the economy. We expect the CNB will increase its policy rate from 0.25% to 0.50% by the end of the year and to 1.25% in 2022.

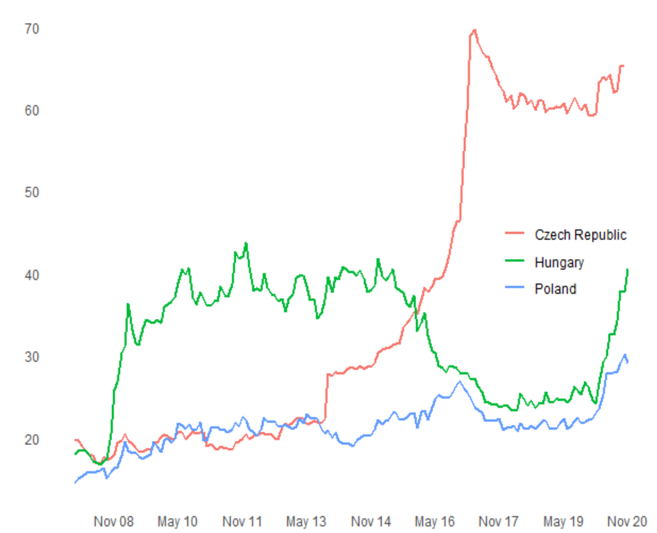
In Poland and Hungary, we believe inflation risks will be skewed to the upside in 2021. For most of last year, headline CPI inflation was either above the target or in the upper range of the tolerance band around the target, despite a sharp decline in the global energy prices. During all of 2020, the central banks observed a persistent increase in the various measures of underlying inflation. For example, in Hungary, demand-sensitive price inflation and sticky price inflation were 4.0% yoy and 3.0% yoy in 2H 2020, respectively (the MNB's medium-term inflation target is 3.0% ±1pp). While in Poland, official core inflation (net of food and energy prices) was at above 4.0% yoy in 2H 2020, substantially higher than its target of 2.5% ±1pp. In our view, the increase in core inflation was related to supply-side restrictions typical during the pandemic, aggravated by accommodative fiscal and monetary policy. In 2021, we expect the impact of supply-side effects will dissipate only gradually, while the recovery in consumer expenditure and higher energy prices will push headline CPI inflation higher.

The fiscal policy will be less accommodative in 2021 in all countries. In Hungary, the primary fiscal deficit will narrow from 5.0% GDP in 2020 to 1.0% in 2021, in Poland – from 7.5% of GDP in 2020 to 3.5% in 2021, and in the Czech Republic – from 5.6% of GDP in 2020 to 4.1% in 2021. Per these forecasts, we can conclude that the largest negative fiscal impulse will be in Hungary and Poland, with the smallest in the Czech Republic, yet another argument in favour of early policy normalization by the CNB. However, any fiscal normalization will be offset by support from the EU recovery fund that was approved by all member states on 14 December. According to the EC estimates, Poland may receive up to €25bn (or 5.0% of GDP) from the recovery funds in 2021, Hungary – 4.6% of GDP in 2021, and the Czech Republic – 2.5% of GDP in 2021.

Proceeds from the EU recovery fund will help the CEE3 currencies to strengthen. During 2020, the current account deterioration was limited, thanks to a decline in goods imports and lower primary income outflows. In Poland, the current account surplus widened most dramatically, to 3.5% of GDP in 2020, its highest level in more than a decade, mainly on the back of a sharp decline in the primary income outflows. In 2021, the current account surplus will narrow; however, capital inflows from the EU recovery fund will more than offset this deterioration. Therefore, we expect the HUF and CZK to strengthen in 2021, while the strengthening of the zloty would be contained by the NBP's interventions in the FX market.

Figure 62: Total assets of the central bank

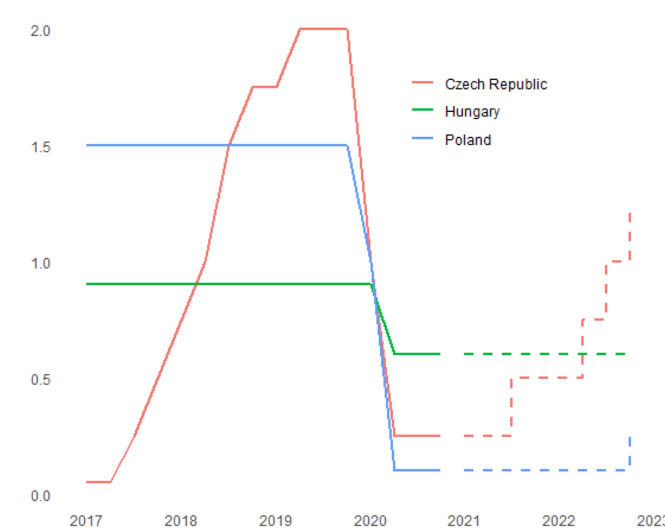
% of GDP



Source: NBP, MNB, CNB, Credit Suisse estimate

Figure 63: Forecast of key policy rates

% p.a.



Source: NBP, MNB, CNB, Credit Suisse estimate

South Africa: Attractive opportunities during crunch times

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- **A successful wage bill negotiation will open the door for debt stabilization and inflows into the local debt market.**
- **This will support the rand despite a marginal deterioration in the current account balance.**
- **We see downside inflation risks in 2021, mainly from aggressive fiscal consolidation and a stronger currency.**

The South African economy has entered into a crunch phase. The COVID shock has accelerated an inevitable deterioration of the country's fiscal position. Without fiscal consolidation, the general government debt will increase from 63.3% of GDP in March 2020 to above 135% in March 2029. The government's debt service costs had already approached 5.0% of GDP last year, or more than 20% of the main budget revenues. On 28 October, in its medium-term budget policy statement (MTBPS), the government outlined a plan to address the problem of rising debt. This plan boils down to structural reforms that should boost potential real GDP growth from 1.0%-1.5% to around 3.0% and a painful fiscal consolidation that rests on the shoulders of public sector workers, whose wages will be frozen for the next three years. The former includes a wide range of short- and long-term measures (e.g., building infrastructure, expanding electricity generation, supporting rapid industrialization, modernizing network industries, reducing barriers to entry, and increasing regional integration and trade) that cumulatively should add two percentage points to potential real GDP growth.

On the fiscal consolidation side, the focus will be on the government's efforts to strike a deal with the public sector unions on the wage freeze. The government did not implement the final year of the previous three-year wage agreement, aiming to limit annual wage growth to 0.8% in the period beyond 2021. Although the task is ambitious, there is no better time to negotiate with labour unions than this period when the government's finances are so stretched from the COVID shock. We cannot have a priori knowledge about the success of these negotiations, although investors gave the government the benefit of the doubt. In the financial market, investors' concerns over the rising public debt were well reflected in the steepness of the local government bond yield curves (investors demanded an additional premium for holding debt with higher maturities). Since the announcement of the MTBPS on 28 October, the SAGB yield curve flattened by up to 50bps at the long end of the curve (with maturities beyond 10 years). Also on 15 December, the government won a court case that allowed it to refrain from the indexation of public sector wages in 2020, the last year of the previous agreement between public servants and the government. We are cautiously optimistic about the ability of the government to limit wage growth in the public sector in the next three years.

A successful public wage bill negotiation is the main risk and the primary assumption of all our forecasts for the next two years. Alongside other fiscal reforms, which include a restructuring of fiscal spending, this would open the door to hopes for stabilization in the public debt at below 100% over the next decade. Obviously, success will also depend on the ability of the government to boost potential real GDP growth, although it will be difficult to gauge that in the coming years.

According to the MTBPS, the deficit of the primary main budget will narrow from 9.8% of GDP in this fiscal year (ending 1 April, 2021) to 5.0% of GDP next fiscal year. This implies a large negative fiscal impulse of around 5.0% of GDP, which would be devastating for households, in our view. It will have direct implications for households' actual spending and their expectations. Households' inflation expectations that were falling even before the COVID shock will deepen even more sharply after the new public sector wage agreement. In 2020, headline CPI inflation was hovering around the lower edge of the South African Reserve Bank inflation target range (3.0%-6.0%). In our view, headline CPI inflation may pick up toward the middle of this range in 2021, mainly due to higher energy prices that helped to contain inflation this year (however, a stronger rand could effectively contain this increase). Beyond this spike, disinflation risks should prevail in the coming years on the back of active fiscal consolidation.

The monetary policy of the South African Reserve Bank will remain accommodative for longer. As disinflation risks should prevail in 2021, accommodative monetary policy will be the only available option to offset tighter fiscal policy. Therefore, we do not expect the Monetary Policy Committee to hike the policy rate in the coming years. Moreover, we think the MPC has room to cut the policy rate at least once, by 25bps, to 3.25% in 2021.

The COVID shock led to one of the strongest improvements in South Africa's external balance in its history. According to the SARB's seasonally adjusted and annualized estimate, the current account was at a surplus of 5.9% of GDP in 3Q, the highest level in four decades. The improvement in the current account was the result of improvement in the goods and services trade balance. In real terms, imports of goods and services have been falling consistently since 3Q 2019, while they collapsed totally in 2Q 2020 during the COVID shock. Imports have not recovered since, although exports of goods and services (in real terms) rose by 201.1% qoq saar in 3Q. In 2021, we expect the current account surplus to deteriorate but remain in a surplus. In our view, a further recovery in economic activity following the COVID shock will push real imports higher, but not substantially. However, in nominal terms, it may pick up more notably due to higher oil prices.

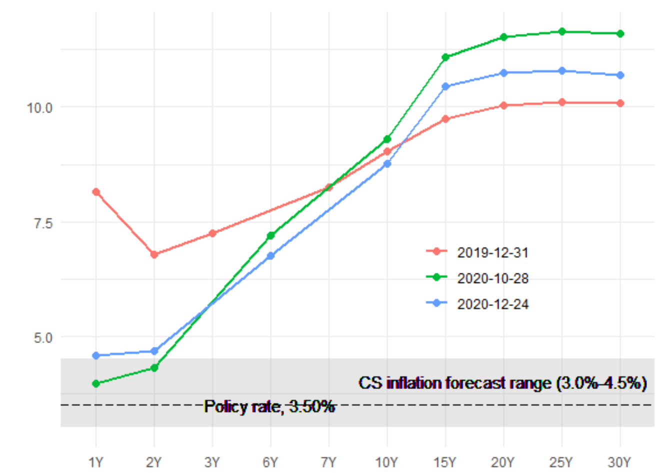
The improvement in the current account has helped the rand to strengthen since the COVID-19 shock, outperforming many of its regional peers. Despite our expectations of a deterioration in the current account balance, we think that the rand may continue strengthening, especially if the government succeeds on the wage bill negotiations. In our view, this may bring substantial inflows into the local bond market, especially at the long end of the curve that yields more than 10% in nominal terms and 6% in real terms, something that international investors rarely observe nowadays.

The economy of South Africa recovered strongly in 3Q. According to Statistics South Africa's seasonally adjusted and annualized estimate, real GDP growth was 66.1% qoq in 3Q after a 51.7% qoq drop in 2Q. The recovery registered across all sectors of the economy but mostly in the industrial sector. Net exports contributed positively to the real GDP growth recovery in 3Q. Although at a slower pace, the recovery extended into 4Q at least until December. A more extended recovery was supported by favourable weather conditions that contained a further spread of the COVID-19 virus in 4Q. However, in December, the pace of COVID infections started growing, thereby forcing the government to impose new restrictive measures. Since they are not as strict as those from April, we are not expecting any severe damage to the economy in 4Q.

With all the available data, we expect a full-year contraction in real GDP at 7.0% in 2020. This year, we expect the economy will continue to recover from last year's collapse, with the speed dependent upon the revival of global demand and implementation of structural reforms. In our view, fixed capital investment and net exports will be the main driving forces of economic growth in the next two years, while private consumer demand expenditures will remain suppressed. In our view, fiscal consolidation will contain any recovery in consumer demand for the next two years at least. We expect real GDP growth will be 4.7% in 2021 after a 7.0% drop last year.

Figure 64: Local sovereign bond curve

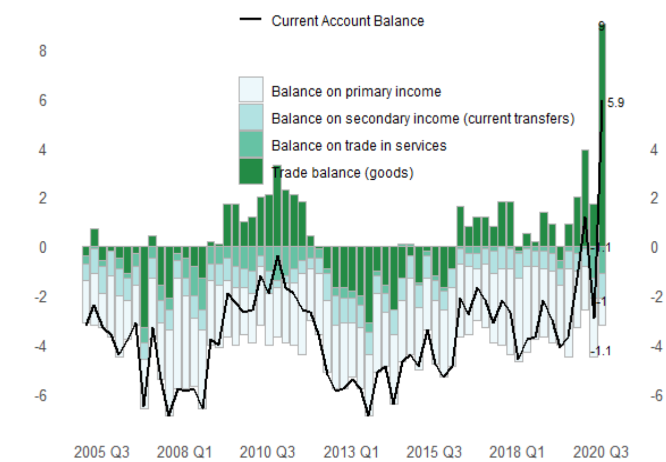
% mid yield / % p.a. / % yoy



Source: the BLOOMBERG PROFESSIONAL™ service, SARB, SSA, Credit Suisse

Figure 65: Current account

saar, % of GDP



Source: SARB, Credit Suisse

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Summary of Forecasts

Country/economy	Real GDP growth (y/y% avg)				Inflation (annual avg of y/y%)			
	2019	2020E	2021E	2022E	2019	2020E	2021E	2022E
Global	**2.6**	**-3.9**	**5.1**	**4.0**	**2.4**	**1.9**	**2.1**	**2.2**
Developed markets	**1.7**	**-5.3**	**4.6**	**3.6**	**1.4**	**0.7**	**1.3**	**1.5**
Emerging markets	**4.1**	**-1.8**	**5.8**	**4.5**	**4.0**	**3.6**	**3.2**	**3.3**
United States	2.2	-3.6	4.8	3.5	1.8	1.2	2.0	2.1
Canada	1.5	-5.2	6.0	4.1	2.0	0.8	1.3	1.9
Euro area	1.3	-7.2	4.9	4.2	1.2	0.3	0.6	1.0
Germany	0.6	-5.8	3.2	3.9	1.4	0.4	1.3	1.4
Italy	0.3	-8.9	5.8	3.7	0.6	-0.1	1.1	0.8
France	1.5	-9.0	5.8	4.5	1.3	0.6	1.2	1.1
Spain	2.0	-11.5	6.2	5.6	0.8	-0.3	0.6	0.8
United Kingdom	1.3	-10.7	3.2	8.5	1.8	0.9	1.4	1.8
Norway (CPI-ATE)*	2.6	-3.5	3.7	3.2	1.5	3.0	2.2	1.4
Sweden (CPIF)	1.2	-4.0	3.5	2.8	1.5	0.4	1.0	1.3
Switzerland	1.1	-3.2	3.5	2.0	0.4	-0.7	0.3	0.2
Japan (CPI ex fresh food)	0.7	-5.0	1.7	1.9	0.6	-0.1	0.1	0.3
Australia	2.0	-2.9	3.5	3.2	1.7	0.8	1.5	1.5
New Zealand**	3.0	-5.0	4.4	3.5	1.7	1.6	1.4	1.4
Non-Japan Asia	**5.2**	**-0.4**	**6.7**	**5.0**	**2.6**	**2.6**	**1.7**	**2.1**
China	6.1	2.2	7.1	5.2	2.9	2.5	1.1	1.7
India	4.9	-8.2	8.5	6.0	3.7	6.7	5.0	4.3
Indonesia**	5.0	-2.0	4.9	5.2	2.8	2.0	2.3	2.9
Singapore**	0.7	-5.8	5.5	3.7	0.6	-0.3	0.7	1.0
South Korea	1.8	-1.2	3.6	2.7	0.4	0.5	1.2	1.4
Thailand**	2.4	-6.6	3.9	3.5	0.7	-0.8	1.1	1.2
Malaysia**	4.3	-5.8	6.8	4.8	0.7	-1.1	1.8	2.1
Taiwan	3.0	2.5	4.0	3.0	0.6	-0.2	1.1	1.2
Philippines**	6.0	-9.0	7.5	6.4	2.5	2.6	2.9	3.2
EEMEA	**2.0**	**-3.5**	**3.2**	**3.9**	**6.2**	**5.3**	**5.9**	**5.3**
Czech Republic	2.3	-6.1	3.0	4.2	2.8	3.2	2.3	2.0
Hungary	4.6	-6.5	3.9	5.6	3.4	3.4	3.7	3.3
Poland	4.5	-3.8	3.5	6.9	2.3	3.5	2.6	2.8
Russia	1.3	-3.6	2.6	3.2	4.5	3.4	3.8	4.0
Turkey	0.9	1.5	3.4	4.1	15.2	12.3	14.5	11.3
South Africa	0.2	-7.0	4.7	2.3	4.1	3.2	3.7	3.5
Latin America	**0.8**	**-7.0**	**4.0**	**2.9**	**8.4**	**7.0**	**8.1**	**7.6**
Argentina	-2.1	-10.4	4.4	2.6	53.8	42.8	45.0	46.0
Brazil	1.4	-4.3	4.0	2.9	3.7	3.2	5.3	3.5
Chile	1.1	-6.3	5.5	3.0	2.3	3.0	2.8	3.1
Colombia	3.3	-8.0	4.3	3.6	3.5	2.5	2.3	3.1
Ecuador	0.1	-7.9	2.9	2.6	0.3	-0.3	0.0	0.8
Mexico	-0.1	-8.8	3.0	2.7	3.6	3.4	3.6	3.5
Peru	2.2	-12.0	8.0	3.5	2.1	1.8	2.1	1.9

Source: Credit Suisse * Indian figures correspond to fiscal year. Norway GDP figures correspond to mainland GDP

Central Bank Watch: Developed Markets

Central bank	Policy instrument(s)	Current	in 3M	in 12M	Comments/Expectations
US Federal Reserve	Federal funds rate (%)	0.00-0.25	0.00-0.25	0.00-0.25	The fed funds target range is 0.0%-0.25%, which the Fed considers the effective zero lower bound. The committee's statement indicates that they expect to maintain rates at this level until the labor market has reached full-employment and inflation has risen to 2.0% and appears likely to moderately overshoot. Our policy outlook is largely unchanged. High unemployment, low inflation, and a preponderance of downside risks will keep rates on hold for now and further easing is possible. Fiscal policy support has faded and colder weather increases the risk of a resurgence in COVID cases. Meanwhile, growth momentum is rolling over, which often coincides with financial market stress and turns in sentiment. The FOMC has laid the groundwork to adjust their asset purchases if financial conditions begin to tighten. Yield curve control remains a possibility if market panic reemerges.
European Central Bank (ECB)	Deposit rate (%)	-0.5	-0.5	-0.5	In December 2020, the ECB increased its Pandemic Emergency Purchase Programme by a further €500bn to €1.85 trillion, and extended the period the programme runs to March 2022 (from June 2021). The ECB also committed to reinvest any maturing bonds in its PEPP until at least the end of 2023. Additionally, the ECB will also continue to provide liquidity operations (both TLTROs and PELTROs), swap lines with other central banks, generous collateral requirements, as well as ongoing asset purchases, throughout next year. It also kept the deposit rate unchanged at -0.5%. We think these policies should be able to preserve favourable financial conditions in 2021.
Bank of Japan (BoJ)	Short-term policy rate	-0.1	-0.1	-0.1	The BoJ now pays 0.1% for newly deposited reserves in exchange for loans made to the private sector under the special lending scheme to deal with economic downturns due to the virus contagion. While we believe that the Bank remains rather reluctant to lower the Tier 3 deposit rate amid concerns about deteriorating profitability of commercial banks with their credit costs rising, we see risk of a small rate cut in 1H 2021 if the JPY strengthens more substantially than currently envisaged.
	10-year bond yield target (%)	around 0%	around 0%	around 0%	The BoJ has raised the pace of JGB buying since March 2020 as the government emergency economic packages boosted JGB issuance. It will take 67-68% of the JGBs printed for the FY2020 in our estimate and this accommodative stance will continue into 1H 2021. The 10-year yield target will be left unchanged at around 0% for the coming 12-18 months, but the Bank will allow a wider range of fluctuation in 2021. Measures to support corporate finance, namely CP/CB purchases and emergency fund supply operation with the total ceiling being 140 trillion yen (about 75 trillion yen left uncommitted as of end-2020); will remain available until end-September 2021.
Bank of England (BoE)	Bank rate (%)	0.1	0.1	0.1	The Bank of England kept rates unchanged and unanimously voted to increase their government bond purchase program by £150bn from £725bn to £875bn at its November 2020 meeting. The stock of corporate bonds was unchanged at £20bn. Going forward, we expect the Bank of England to respond to the new lockdown by increasing its asset purchase programme by a further £150bn in February, and keep policy unchanged thereafter. Those purchases will likely cover the government's financing needs for this year. There is a risk the Bank will cut rates, currently at +0.1%, to negative. It has not yet concluded its review on the efficacy of negative rates in the UK nor its assessment of the effective lower bound. While some in the MPC point to other countries' positive experience with negative rates, the concern remains the impact of negative rates on bank profitability. We expect rates to remain where they are.

Central bank	Policy instrument(s)	Current	in 3M	in 12M	Comments/Expectations
Swiss National Bank (SNB)	SNB policy rate (%)	-0.75	-0.75	-0.75	We believe that the SNB will address short-term appreciation pressures on the CHF with foreign currency purchases and expect the SNB to keep its policy rate unchanged at least until the end of 2021.
Bank of Canada (BoC)	Overnight rate (%)	0.25	0.25	0.25	The BoC will likely keep rates near zero as the economic recovery broadens. The GDP level should remain far below the potential in most of 2021, allowing the bank to look through temporary inflationary pressure. However, asset purchases will likely be revamped if economic growth or market conditions falter.
Reserve Bank of Australia (RBA)	Cash rate (%)	0.1	0.1	0.1	As we expected, the RBA cut the cash rate target, the 3-year yield target and the rate on new drawings under the Term Funding Facility from 0.25% to 0.1% and introduced a second quantitative easing package in November. The quantitative easing package is in addition to the purchases the RBA has committed to make under the 3-year yield target policy. It is a quantity-based package with a target to buy $100bn in Australian Commonwealth and state government bonds with maturities around five to 10 years over a period of six months. This is equivalent to 5% of GDP and will see the RBA's balance sheet grow to a size more commensurate with that of other major developed market central banks. In addition to these measures the RBA has, following a speech by the RBA Governor in mid-October, and in a formal statement on 4 November, strengthened the terms of their forward guidance considerably. At the initial stage of the outbreak, the RBA committed to maintaining the cash rate on hold until progress was made towards full employment and it was confident inflation could sustainably be within the 2-3% target band. Now, the RBA has stated that they will wait until actual inflation is sustainably in the target range and the labour market is tight. This effectively means the cash rate will be on hold for at least three years, likely much longer. We expect quantitative easing to be extended beyond six months and the adoption of additional measures, such as a negative official cash rate, depend in large part on the trajectory that monetary policy takes by the world's largest central banks, in particular the US Fed. This reflects the importance of the exchange rate channel through which monetary easing supports the economy.
Norges Bank	Deposit rate (%)	0	0	0	After cutting interest rates by 1.25% in March, Norges Bank has reduced the policy rate by 25bp during its meeting on 7 May, taking the rate to 0%. Norges has, however, also made it clear that "the policy rate will most likely remain at today's level for some time ahead. We do not envisage making further policy rate cuts". Additionally, Governor Olsen indicated that the Board sees "large uncertainties around the effectiveness of negative policy rates". As such, we think that 0% is the lower bound for Norges. Sizable fiscal stimulus packages have also alleviated the need for further immediate monetary easing. Overall, we expect the Bank to be on hold over the medium-term.
Swedish Riksbank	Repo rate (%)	0	0	0	The Riksbank has implemented various easing measures earlier this year, mostly through expanding its balance sheet, and the Executive Board now assesses that "The repo rate is […] expected to remain at this level in the coming years. As such, we think that the Riksbank will be on hold for the foreseeable future. Given the Board's sceptical comments around negative interest rates, we think that if the outlook were to deteriorate, a further easing in policy would most likely be implemented through expanding the Bank's balance sheet.

Source: Credit Suisse

Central Bank Watch: Emerging Markets

Central bank	Policy instrument(s)	Current	in 3M	in 12M	Comments
Brazil (BCB)	Policy rate (%)	2	2	4.5	The monetary authority indicated that intends to remove the forward guidance in the following meetings due to: (i) reversion of the downward path of inflation expectations and projections; (ii) increasing importance for the monetary policy of inflation in 2022 in comparison to inflation in 2021, owing to the evolution of the relevant horizon. We believe that Central Bank of Brazil is indicating that it might be necessary to start increasing interest rates in the next few months, as inflation expectation is within the target in 2022 and monetary policy is extremely stimulative. We expect that the Central Bank of Brazil will remove the forward guidance at its the next meeting in January and start withdrawing the monetary stimulus in June 2021, increasing interest rates 5 consecutive terms by 50 basis points until reaching 4.5% p.a. in year-end 2021.
Mexico	Policy rate (%)	4.25	3.75	3.75	The central bank left the overnight rate unchanged at 4.25% in its December 2020 monetary policy meeting. This was in line with median market expectations, but against our house-view that the bank would cut the policy rate by 25bps. The decision was split with two board members voting for a 25bps cut, while the other three members voted for holding the overnight steady. In the communique, the board stated that the decision accounted for the bank's inflation forecasts, the uncertainty surrounding them, and the convenience of consolidating a downward trajectory for headline and core inflation toward the 3% target. Benign inflation prints in the coming weeks, will likely result in annual headline inflation near 3.0%. Consequently, we think the board will likely cut the policy rate by 25bps, to 4.0%, in its 11 February meeting.
Russia (CBR)	Policy rate (%)	4.25	4.25	4.25	In its last rate-setting meeting of the year, on 18 December, the central bank left the policy rate unchanged, at 4.25%. The decision was in line with the market consensus but the statement was marginally more hawkish. In its statement, the CBR expressed concerns with the recent sharp increase in food price inflation and households' inflation expectations. Also, the CBR changed its wording about the next cut in the policy rate. Previously, the CBR's pledge to cut the policy rate was related to the closest meeting (one of the next few meetings), while in its last statement the CBR made a reference to some additional cut in the policy rate, in indefinite future. Therefore, even though we still optimistic about CPI inflation returning back to below the 4.0% target in 2021 (from 4.9% in 2020), we no longer expect the CBR to cut the policy rate.

Central bank	Policy instrument(s)	Current	in 3M	in 12M	Comments
South Africa (SARB)	Policy rate (%)	3.5	3.25	3.25	On 19 November, the Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) left the policy rate unchanged, at 3.50%, as widely expected. As in the previous rate-setting meeting, only three members of the MPC supported the decision to leave the policy rate unchanged, while two others voted for a policy rate cut. The decision was also against our expectations for 25bps cut in the policy rate. In our view, the SARB's forecast revisions were in favour of a policy rate cut. If we look through the MPC forecasts revisions, they were all in favour of the policy rate cut: headline CPI and core inflation were revised lower in the next 12 months; negative output gap was revised wider; current account balance higher; the rand's nominal and real effective exchange rates were revised marginally stronger. Despite further downside revisions to inflation forecasts the SARB's model projects no more cuts. Instead, the SARB's Quarterly Projection Model (QPM) implies two 25bps increases in the repo rate in 2H 2021, in line with its September projections. At the same time, beyond 2021, the SARB revised lower its longer-term interest rate projections (SARB revised lower its repo rate forecast in 2022 from 5.03% to 4.88%). Given the SARB's reluctance to cut the policy rate further, we believe investors' focus should shift on the policy normalization timeline. In our view, the SARB will not act on its QPM projections (will refrain from policy rate hikes in 2021) and will continue pushing back the start of policy normalization. If the government delivers on the front of fiscal consolidation, the SARB will refrain from policy tightening for an extended period of time. Such approach will offset the negative impact of tighter fiscal policy on aggregate demand and inflation. Overall, we think the SARB has room for policy easing, but its utilization depends on the government's success on fiscal consolidation front.
Turkey (CBRT)	One-week repo rate (%)	17	17	14	The MPC hiked the one-week repo rate by 200bps to 17.00% on 24 December. The magnitude of the rate hike was higher than the Bloomberg consensus forecast of 150bps and at the higher end of our expectation for 150-200bps. The MPC clarified in its statement that its interim target is to lower inflation to the central bank's forecast of 9.4% by end-2021 (compared to Turkey's official inflation target of 5%). Meanwhile, although the MPC stated that the risks to the inflation outlook are primarily to the upside, it refrained from adopting an explicit hawkish bias in its post-meeting statement, suggesting that it does not plan to tighten monetary policy further in the near term. It is worth highlighting that the inflation outlook for 1H 2021 (especially through April 2021) is challenging and that the government's decision to increase the minimum wage by 22% on 28 December will add 1.5-2.0pps to headline inflation in 2021. Accordingly, we think that the short-end rates should be higher than 17.00% if the central bank is serious about bringing inflation lower to 9.4% by end-2021, but we do not think the MPC will deliver the required tightening. In our view, the most likely scenario is for the MPC to keep the policy rate unchanged at 17.00% through mid-2021 and ease gradually in 2H 2021.
China (PBoC)	Lending rate (%)	4.35	4.35	4.35	We expect the authorities to rely on more targeted efforts to support the overall economy for the rest of the year. We expect another two RRR cuts for the remainder of 2020.

Central bank	Policy instrument(s)	Current	in 3M	in 12M	Comments
India (RBI)	Repo rate (%)	4	4	4	Amid the expectations for inflation to remain elevated in the medium-term (1-year ahead) with only gradual easing in its pace coupled with an improvement in estimates for growth, we believe the rate cut cycle has ended and expect the policy rate to stay unchanged at 4.00% through next 12 months in our baseline scenario. High inflation is a concern, and the uncertainty on the pace of inflation moderation amid supply-side disruptions makes the RBI cautious on another additional cut.
Indonesia (BI)	Policy rate (%)	3.75	3.5	3.5	Bank Indonesia reduced the policy rate by 25bps to 3.75% in its November meeting. The rate cut decision was likely driven by weaker than expected GDP growth in Q3, and low projected inflation amid weak demand, weak off-take in credit growth and limited transmission of policy rate cuts to lending rates. Positive news around vaccine has also reduced financial market volatility, thereby helping the currency through increased capital inflows. While the scope for larger cuts has been reduced by BI monetizing government issuances ($40bn, ~4% of GDP), we expect another 25bps rate cut in Q121 to support growth.
South Korea (BoK)	Policy rate (%)	0.5	0.5	0.5	We are not expecting any further easing by the BoK. The BoK acknowledged higher concerns on the recent pick up in household debt growth, the governor ruled out possibilities for a policy rate hike for the near term. The BoK will keep an accommodative stance until the domestic economy returns to a normal growth with reduced uncertainties from Covid19. We continue to expect the policy rate unchanged throughout 2021, with the liftoff in late 2022.
Taiwan	Policy rate (%)	1.125	1.125	1.125	We do not expect any more rate cuts for the rest of the year and expect the discount rate to stay at an historical low of 1.125%, as the economy will likely bottom in Q220 with the recovery of global growth and domestic policy support. The central bank is cautious on the second-wave infections and will likely use its limited tools when needed.

Source: Credit Suisse

House View forecasts

MSCI Regional Equity Indices

	Close on Jan 6, 2021	Expected absolute market direction	Relative view against benchmark	3M Forecast	12M Forecast
MSCI World	8718	↗	Benchmark	8640	9130
MSCI USA	16466	↗	Marketperform	16300	17250
MSCI EMU	470	↗	Marketperform	465	492
MSCI Switzerland	4950	↗	Marketperform	4880	5160
MSCI UK	15361	↗	Marketperform	15000	15900
MSCI Japan	2550	→	Underperform	2530	2610
MSCI Emerging Markets	173460	↗	Outperform	169500	180000

Arrows refer to expected absolute market direction, double arrow indicate stronger upside. Relative views are against benchmark index MSCI World

All indices are total return in local currency

MSCI Regional Equity Indices (Emerging Markets)

	Close on Jan 7, 2021	Expected absolute market direction	Relative view against benchmark	3M Forecast	12M Forecast
MSCI Emerging Markets	173460	↗	Benchmark	169500	180000
MSCI EEMEA	1040	→	Outperform	1020	1055
MSCI Latin America	28930	↗	Underperform	27800	29200
MSCI AC APAC	339	↗	Marketperform	335	355
MSCI AC Asia ex Japan	2400	↗↗	Marketperform	2360	2510
MSCI Russia	2848	↗	Outperform	2715	2820
MSCI Turkey	5579472	↗	Marketperform	5100000	5300000
MSCI Brazil	130514	↗↗	Marketperform	126000	136000
MSCI Mexico	80696	↗	Outperform	77000	79000
MSCI China	216	↗↗	Marketperform	213	230

Relative views are against benchmark index MSCI EM. All indices are total return in local currency.

Local Equity Indices

	Close on Jan 7, 2021	Expected absolute market direction	Relative view against benchmark	3M Forecast	12M Forecast
S&P 500	3748	↗	Marketperform	3710	3860
EuroStoxx50	3611	↗	Marketperform	3560	3690
SMI	10747	↗	Marketperform	10510	10900
FTSE 100	6842	↗	Marketperform	6600	6770
TOPIX	1796	→	Underperform	1780	1800
S&P ASX 200	6607	↗	Marketperform	6755	6940

Relative views are against benchmark index MSCI AC World

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MSCI Global Sectors (GICS)

	Close on Jan 7, 2021	Expected absolute market direction	Relative view against benchmark	3M Forecast	12M Forecast
MSCI World Energy	272	↗	Marketperform	270	285
MSCI World Materials	574	↗↗	Outperform	510	540
MSCI World Industrials	493	↗	Marketperform	473	500
MSCI World Cons Disc.	546	↗	Marketperform	504	533
MSCI World Cons Staples	466	→	Underperform	452	470
MSCI World Healthcare	486	↗↗	Outperform	472	500
MSCI World Financials	235	↗	Marketperform	223	236
MSCI World IT	545	↗	Marketperform	518	548
MSCI World Comm Services	208	↗	Marketperform	217	230
MSCI World Utilities	365	↗	Marketperform	358	378
MSCI World Real Estate	1186	↗	Marketperform	1205	1275

Relative views are against benchmark index MSCI World. All indices are total return in local currency.

10Y Government Bond Yields

	Close on Jan 7, 2021	Expected absolute direction	Relative view against global 7-10 bonds	3M Forecast	12M Forecast
USA	1.05%	↗	Short Duration	1.1%	1.3%
Germany	-0.52%	↗	Short Duration	-0.4%	-0.3%
UK	0.24%	→	Neutral Duration	0.4%	0.5%
Japan	0.035%	→	Neutral Duration	0.0%	0.0%
Australia	1.09%	→	Neutral Duration	1.1%	1.2%
Switzerland	-0.49%	↗	Short Duration	-0.4%	-0.3%

Relative views are the preferred positioning against the 1-10 year LC Index of the respective country.

Fixed Income Total Return Indices

	YTD on Jan 7, 2021	Expected absolute direction	Relative view against benchmark	3M exp. Return	12M exp. Return
Barclays Global Aggregate	-0.37%	→	Benchmark	0.0%	0.5%
Barclays Global IG Corp	-0.82%	↗	Outperform	0.7%	2.6%
Barclays Global HY Corp	0.18%	↗	Outperform	0.9%	3.5%
JPM EMBI Global Diversified HC	-0.65%	↗	Outperform		
JPM GBI-EM Global Divers. LC	-0.03%	→	Marketperform		

Relative views are against benchmark index Barclays Global Aggregate. All indices are total return hedged in USD

FX & Commodities

	Close on Jan 7, 2021	Expected absolute direction	3M Forecast	12M Forecast
EUR/USD	1.23	↗	1.24	1.25
USD/JPY	103	↘	102	100
GBP/USD	1.36	↗	1.43	1.45
USD/CHF	0.88	↘	0.87	0.88
AUD/USD	0.78	→	0.76	0.78
USD/CAD	1.27	→	1.26	1.23
Gold (USD / oz)	1917	↗	1900	2200
WTI oil (USD / bbl)	51.09	↗↗	45	52

2021 Global Calendar

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
CENTRAL BANKS												
North America												
FOMC meeting	27	-	17*	28	-	16*	28	-	22*	-	3	15*
FOMC minutes	6	17	-	7	19	-	7	18	-	13	24	-
Bank of Canada	22	-	4	15	-	3	15	-	9	28	-	9
Europe												
ECB meeting	21	-	11	22	-	10	22	-	9	28	-	16
BoE meeting	-	4	18	-	6	24	-	5	23	-	4	16
Risksbank	-	10	-	26	-	30	-	-	NA	-	NA	-
Norges Bank	21	-	18	-	6	17	-	19	23	-	4	16
SNB	-	-	25	-	-	17	-	-	23	-	-	16
CBRT meeting	21	18	18	15	6	17	14	12	23	21	18	16
CBRT inflation report	28	-	-	29	-	-	29	-	-	28	-	-
CBR meeting	-	12	19	23	-	11	23	-	10	22	-	17
SARB	21	-	25	-	20	-	22	-	23	-	18	-
Asia												
BoJ meeting	21	-	19	27	-	18	16	-	22	28	-	17
CBC meeting	-	-	18	-	-	17	-	-	23	-	-	16
BoK meeting	15	25	-	15	27	-	15	26	-	12	25	-
RBA meeting	-	2	2	6	4	1	6	3	7	5	2	7
RBNZ meeting	-	24	-	14	26	-	14	18	-	6	24	-
Latam												
Copom meeting	20	-	17	-	5	16	-	4	22	27	-	8
Mexico meeting	-	11	25	-	13	24	-	12	30	-	11	16
ELECTIONS												
Portuguese presidential election	24	-	-	-	-	-	-	-	-	-	-	-
Brazil - Election for Speaker of the House and President of Senate	-	1	-	-	-	-	-	-	-	-	-	-
Catalan regional election	-	14	-	-	-	-	-	-	-	-	-	-
Dutch General election	-	-	17	-	-	-	-	-	-	-	-	-
Israeli legislative election	-	-	23	-	-	-	-	-	-	-	-	-
Mexico (Legislative elections - Lower House of Congress)	-	-	-	-	-	6	-	-	-	-	3	-
Scottish Parliament election	-	-	-	-	6	-	-	-	-	-	-	-
Israeli presidential election	-	-	-	-	-	-	Summer 2021			-	-	-
Russian legislative parliamentary election	-	-	-	-	-	-	-	-	13	-	-	-
German federal election	-	-	-	-	-	-	-	-	26	-	-	-
Japan (Lower House Term Expiration; election will be held before the date)	-	-	-	-	-	-	-	-	-	21	-	-
OTHER POLITICAL EVENT												
ECB Strategic Review						Results mid-2021						
EU Economic Governance Review						Results in 2021						
China's National People's Congress	-	-	Early Mar	-	-	-	-	-	-	-	-	-
China Economic working conference	-	-	-	-	-	-	-	-	-	-	-	Dec
INTERNATIONAL MEETING												
World Economic Forum Annual Meeting	-	-	-	-	18-21	-	-	-	-	-	-	-
G20 (Rome - Italy)	-	-	-	-	-	-	-	-	-	30-31	-	-
G7 (United Kingdom)						TBD						
EU council	-	-	26-27	-	8 (informal)	24-25	-	-	-	14-15	-	16-17

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

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