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ALLIANZ RESEARCH

GLOBAL ECONOMY: A CAUTIOUS BACK-TO-SCHOOL

17 September 2021

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- **Global growth remains strong but increasingly uneven amid evolving virus dynamics and the gradual removal of policy support.** Growth momentum softened over the summer despite a positive impulse from trade. The delta-related uncertainty and soft stops will cost (only) -0.2 to -0.5pp of GDP growth in advanced economies in 2021. Overall, while we expect global growth to remain strong at +5.5% in 2021 and +4.2% in 2022 amid significant monetary accommodation and fiscal impulse, economic slack remains sizable with significant variation across countries. Vaccination rates, unwinding of supply bottlenecks and policy choices will critically influence the scale of catch-up. Output will remain below its potential level until the end of 2022, and the output loss relative to the pre-crisis trend is likely to be considerable, especially in Emerging Markets, where scarring tends to be higher. Their recovery continues to lag because of undervaccination, less room to manoeuvre for additional policy support, as well as the Chinese slowdown. Inflation is likely to accelerate this year as the recovery becomes entrenched, mainly reflecting transitory factors that are likely to wane early next year. While inflation expectations remain well-anchored, pockets of elevated inflation are visible in some sectors with stronger pricing power (automotive, building materials, and, to some extent, in retail and warehouse services). Overall, we expect inflation to reach 2.2% in 2021 and 1.5% in 2022 in the Eurozone and 4.1% and 2.2% in the US, broadly in line with the respective inflation targets.

- **Price and capacity pressures on global trade are likely to persist going into 2022, albeit less acutely.** The reopening boost to services has eased, while labor and materials shortages are weighing on manufacturing and construction. Supply-chain disruptions worsened over the past few months and triggered a more visible manufacturing slowdown during the summer, which could amplify adverse spillover effects to Emerging Markets. The rush for restocking amid historically high domestic production shortfalls and low inventories continues to accelerate the recovery in volumes and prices. While restocking should become less of a driver for trade flows in 2022, companies are likely to operate in a "just-in-case" environment as the normalization in shipping capacity is unlikely to occur before 2023. Hence, on the back of the frontloading in 2021 (+0.3pp to +8% in volume), we have revised slightly on the downside our 2022 forecast for global trade growth: -0.2pp to +6%.

- **Risks to the outlook are broadly balanced, but pandemic-related uncertainty remains high.** Higher vaccination rates, together with a stronger release of pent-up demand and a faster than-expected global recovery, could provide a stronger growth impetus. However, as long as vaccination rates remain below the coverage required to reach herd immunity and continue to differ significantly between most advanced and Emerging Markets, virus mutations will raise the prospects of renewed lockdowns and keep the recovery uneven. In addition, tighter financial conditions or a premature withdrawal of policy support could undermine the recovery and increase private and public sector vulnerabilities, with the potential for cliff-edge effects in some countries and further adverse distributional effects. China is providing an early example of the risks of policy normalization in a still uncertain environment. Despite an expected pause in monetary tightening, the regulation drive is unlikely to ease, which could lead to further credit events among the most fragile cases. We continue to believe that a systemic crisis remains a tail risk as authorities have room for policy support if needed.

- **Unwinding policy support requires a careful balancing act to ensure an effective rotation towards private demand and sustainable growth.** The fiscal impulse in most countries remains positive, with both China and the US expected to remain expansionary while the Eurozone has delayed structural tightening due to the supplementary spending in France and Germany. While several Emerging Markets have already started tightening their monetary stance, most central banks in advanced economies have remained accommodative, though normalization is on the horizon. The US Federal Reserve is likely to gradually pivot towards dialing back its accommodative stance, with stronger inflation and growth outturns suggesting economic slack diminishing more quickly than anticipated. Tapering is likely to commence later this year but uncertain virus dynamics and inflation pressures make it difficult to pin down the scale and timing. Capital markets have been unfazed by reemerging uncertainty about the pace of recovery, but risk sentiment underpinning historically high valuations remains crucially dependent on continued policy support. The existing pre-positioning by market players has reduced the downside risks of market disruptions and dislocations in capital flows, especially in Emerging Markets. Against the backdrop of a stabilizing recovery, we expect asset prices to move sideways over the near term as we enter a consolidation phase. Besides accelerating the vaccination rollout, the key policy priority is to calibrate support to the pace of the recovery, while gradually shifting to more targeted measures focusing on growing firms and sectors. Another important challenge is to identify the potential size of the reallocative needs and the role that policy should play in facilitating reallocation in response to the scale of structural transformation.

+5.5%

Forecast for global economic growth in 2021

MACROECONOMIC CONDITIONS AND OUTLOOK: SOFT LANDING

Extensive policy support has cushioned the pandemic's impact on growth, but economic slack remains sizable as growth momentum softened over the summer. While massive job losses and bankruptcies have been prevented, labor participation has declined and private consumption and investment have only partially recovered, leaving output in Q2 2021 more than -2.5% below its pre-pandemic level in the Eurozone vs. -0.3% in the US. Unlike during the Global Financial Crisis, economic scarring has been greater in most emerging economies, most notably those dependent on international trade and tourism, and where policy space for support was limited. However, declining leverage from the rising cash holdings of both corporates and households augurs well for a rebound in investment and consumption once the outlook improves.

While global GDP growth is expected to remain strong at +5.5% in 2021 and +4.2% in 2022, the recovery is likely to be partial and uneven. Most countries will restore pre-crisis output, but it will remain below potential by the end of 2022. The cumulative output loss relative to the pre-crisis trend is sizeable and larger in countries with low vaccination rates. Especially in Europe, there is an increasing divergence across countries (Figure 1). Inflation is likely to accelerate this year as the recovery becomes entrenched, mainly reflecting transitory factors that are likely to wane in early-2022. Inflation expectations remain well-anchored.

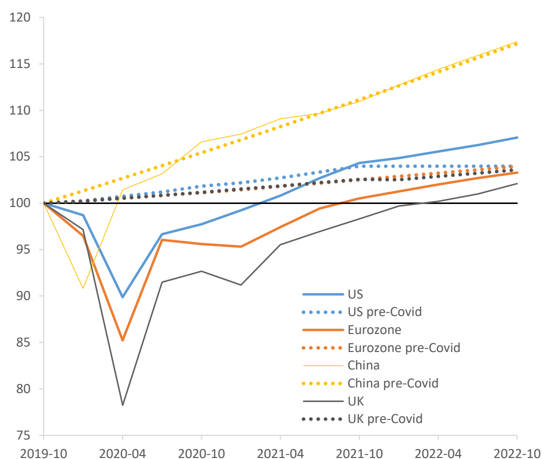
The reopening boost to services has eased, while labor and materials shortages weigh on manufacturing and construction, most notably in China, which is experiencing a significant slowdown of its manufacturing sector. This adds on to the supply-chain disruptions since the start of the year, which have kept input prices and supplier delivery times at record high levels.

Figure 1: Real GDP growth forecasts

	2019	2020	2021	2022
World GDP growth	**2.5**	**-3.5**	**5.5**	**4.2**
United States	2.2	-3.5	6.1	4.1
Latin America	**0.2**	**-6.9**	**5.3**	**2.7**
Brazil	1.4	-4.1	5.1	1.4
United Kingdom	1.4	-9.9	6.3	5.4
Eurozone members	**1.5**	**-6.5**	**5.0**	**4.2**
Germany	1.1	-4.9	3.0	4.0
France	1.8	-8.0	5.6	3.4
Italy	0.3	-8.9	6.0	4.8
Spain	2.0	-10.8	6.2	5.6
Netherlands	1.9	-3.8	4.4	3.7
Belgium	1.8	-6.3	5.3	3.1
Emerging Europe	**2.6**	**-2.6**	**5.6**	**3.8**
Russia	2.0	-3.1	4.5	3.3
Turkey	0.9	1.8	9.4	4.1
Asia-Pacific	**4.1**	**-1.0**	**6.1**	**4.8**
China	6.0	2.3	8.2	5.4
Japan	0.3	-4.9	2.5	3.2
India	4.1	-7.5	7.9	6.4
Middle East	**0.2**	**-5.0**	**3.1**	**3.3**
Saudi Arabia	0.3	-4.1	2.4	3.5
Africa	**1.7**	**-2.7**	**2.9**	**3.6**
South Africa	0.3	-6.4	3.8	2.4

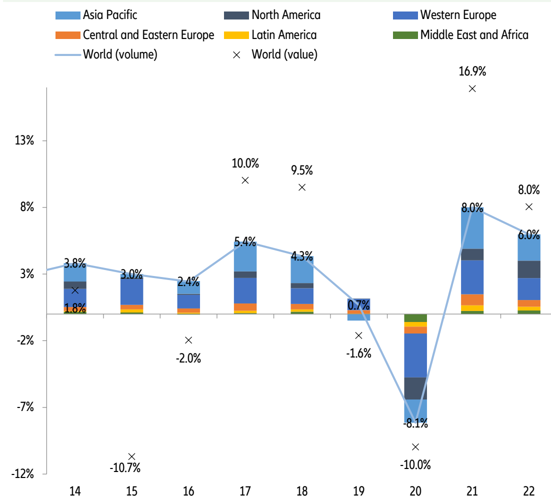
Sources: Various, Euler Hermes, Allianz Research

Figure 2: Real GDP level



Sources: Various, Euler Hermes, Allianz Research

Figure 3: World trade growth forecast

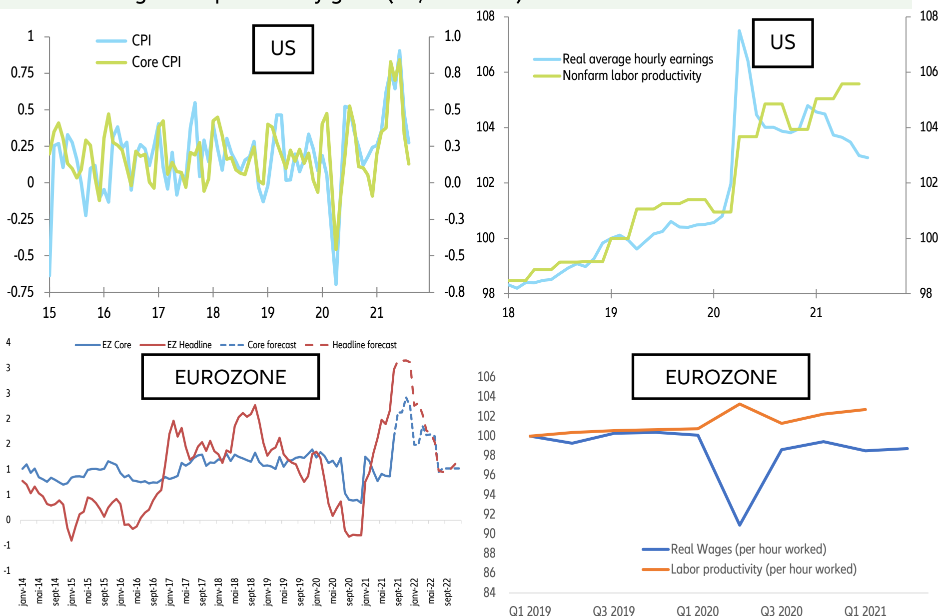


Sources: Various, Euler Hermes, Allianz Research

We have upgraded our global trade forecast for 2021 (+0.3pp to +8.0% in volume, and +1.0pp to +16.9% in value). The rush for restocking amid historically high domestic production shortfalls and low inventories continues to feed into the acceleration of both volumes and prices. We expect price and capacity pressures to remain going into 2022, albeit less acutely, and no normalization in shipping capacity before 2023. Hence, on the back of the frontloading in 2021, mainly driven by supply-chain disruptions, we have revised slightly down our 2022 forecast by -0.2pp to +6% in volume and by -0.4pp to +8.0% in value terms[1].

Most of the recent strong rebound in inflation is likely to be temporary and largely explained by supply-side constraints and base effects. However, the re-opening of economies after a series of lockdowns has increased the uncertainty about the scale and duration of the current surge of headline inflation. In advanced economies, labor shortages may increase inflationary pressures, notably if partial unemployment schemes are not withdrawn completely by year-end and labor participation remains depressed due to some structural transformation resulting in prolonged resource reallocation during the recovery phase. In Europe and the US, some wage pressure could be building as real wages have not kept pace with productivity gains (see Figure 4), suggesting that the non-labor unit cost of businesses is causing inflation as firms cope with higher input prices by preserving mark-ups. However, a sustainable revival of the wage-price loop seems unlikely amid considerable economic slack. Unemployment rates are expected to rise by year-end and money velocity struggles to accelerate despite the strong rebound in growth. Overall, we expect inflation to reach 2.2% in 2021 and 1.5% in 2022 in the Eurozone and 4.1% and 2.2% in the US, broadly in line with the respective inflation targets. In fact, month-on-month, price pressures have started declining already.

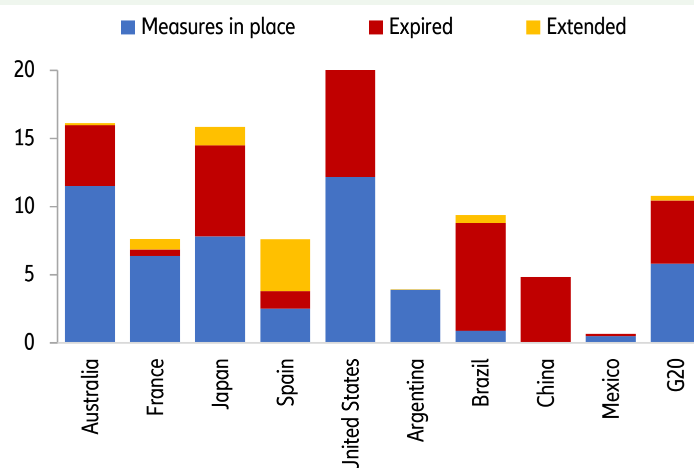
Figure 4: Real wages and productivity gains (US, Eurozone)



Sources: Various, Euler Hermes, Allianz Research

[1] See our report *Global trade: Ship me if you can!*

Figure 5: Expiration and extension status of fiscal measures



Sources: IMF, Euler Hermes, Allianz Research

While some Emerging Markets have started tightening their policy stance, monetary conditions in advanced economies have remained easy. Several central banks in Latin America and Emerging Europe have begun tightening through rate hikes and reduced asset purchases; however, some emerging Asian economies have become even more accommodative. The ECB is likely to remain even more patient following tweaks to its strategy, which saw it adopt a slightly higher inflation target. The US Federal Reserve is likely to start tapering later in the year (and sooner than expected) in response to a quickly closing output gap and strong employment growth. The Jackson Hole meeting also confirmed that the end of tapering would be decoupled from a possible interest rate lift-off. The probability of a taper tantrum shock is thus clearly reduced. This raises the question of spillover effects on Emerging Market currencies, with leverage and debt levels reaching record highs, especially for non-financial corporates.

Some of the largest economies have provided further fiscal impulse. China is expected to increase fiscal stimulus to fight the growth slowdown while Germany and France have adopted supplementary budgets this year to boost additional spending on crisis-related initiatives. In the United States, the large-scale social protection and infrastructure plan is nearing completion. While many countries have extended their balance sheet support, such as credit guarantees and unemployment benefits, until the end of this year, which has helped limit the vulnerabilities of households and firms to the reductions in earnings and consumer spending. This helped prevent a surge of loan defaults and bankruptcies without altering the underlying deterioration of credit risk. The normalization in business insolvencies is expected to be slow as most of the policy measures are due to expire in early 2022. Pockets of risks are higher in some markets where pre-crisis fundamentals were already weak. The Covid-19 corporate debt could become a true hurdle for companies in 2022 as most of the grace periods end, while cash buffers will diminish significantly amid the strong rise in working capital requirements and significantly less state support.

Financing conditions remain favorable, but downside risks are building. Banks remain broadly well-capitalized, with capital buffers likely large enough to absorb loan losses. They have been able to slowly absorb rising impairments without a significant change in their capital ratios, thanks to continued borrower support and effective capital-conservation measures. However, deteriorating asset quality as support measures expire could test the adequacy of current loan-loss provisioning, especially in countries where private sector leverage is high and banks are heavily exposed to hard-hit sectors. In some countries, there has been excessive risk-taking in a context of low interest rates, heightened competition and rising house prices. Looser lending standards combined with high growth in residential real estate prices suggest that vulnerabilities might be building up.

Risks to the outlook are broadly balanced, but pandemic-related uncertainty remains high. Rapid vaccine production and delivery, together with a stronger release of pent-up demand and a faster than-expected global recovery, could provide a stronger growth impetus. A better external environment, notably in the US, is also providing a meaningful tailwind. Recent high-frequency indicators, including for business and consumer sentiment, suggest significant recovery momentum. This is particularly noteworthy in services, which have shown increasing adaptation to mobility restrictions. However, as long as vaccination rates remain below the coverage required to reach herd immunity and continue to differ significantly between most advanced and Emerging Markets, virus mutations raise the prospects of renewed lockdowns and keep the recovery uneven and incomplete. In addition, tighter financial conditions or a premature withdrawal of policy support could undermine the recovery and increase private and public sector vulnerabilities, with the potential for cliff-edge effects in some countries. A slower recovery would mean additional scarring, with further adverse distributional effects. Over the medium term, expectations of an incomplete recovery could become entrenched. Divergence across countries could be disruptive to international trade and cause adverse spillover effects to Emerging Markets.

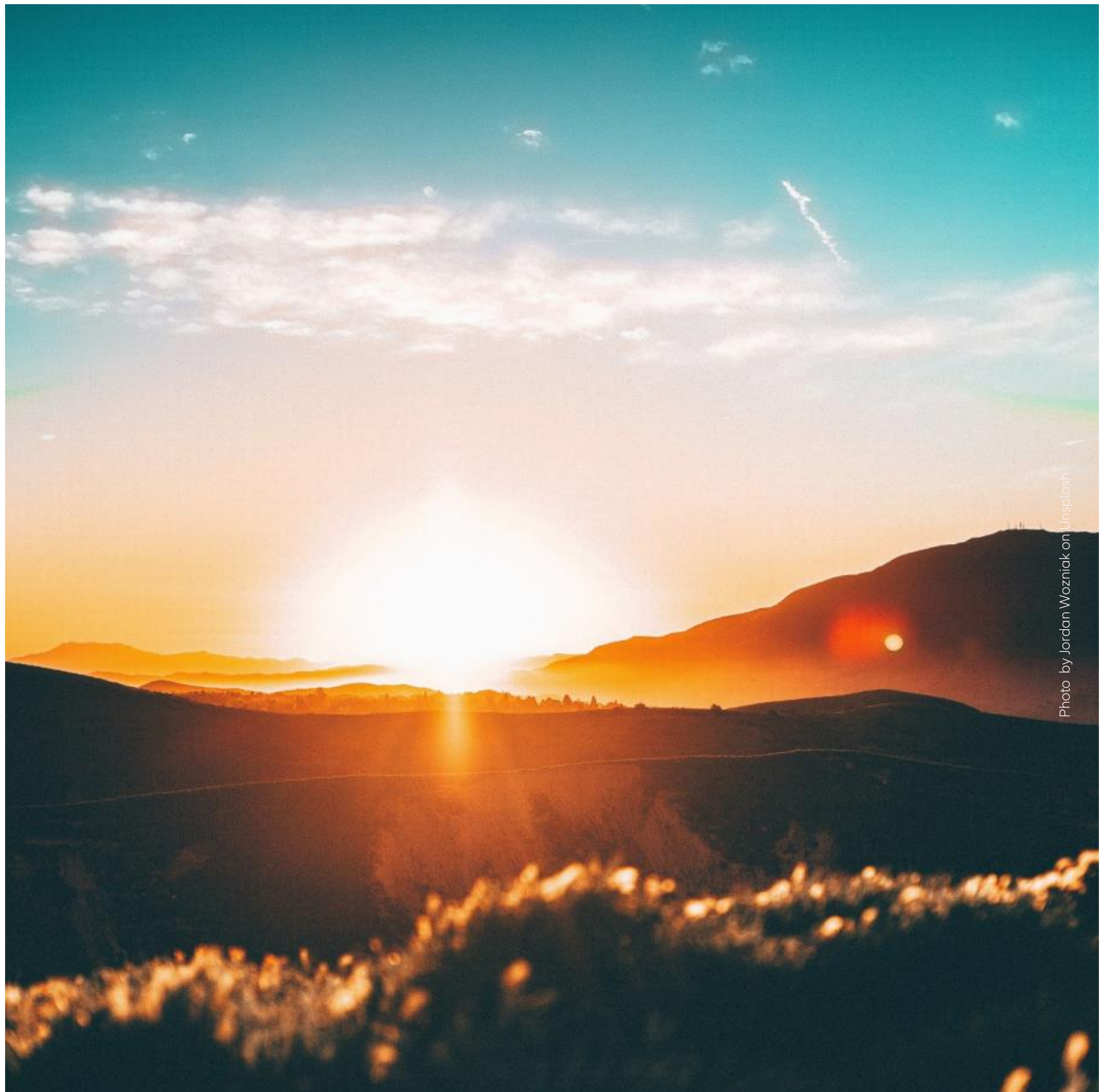


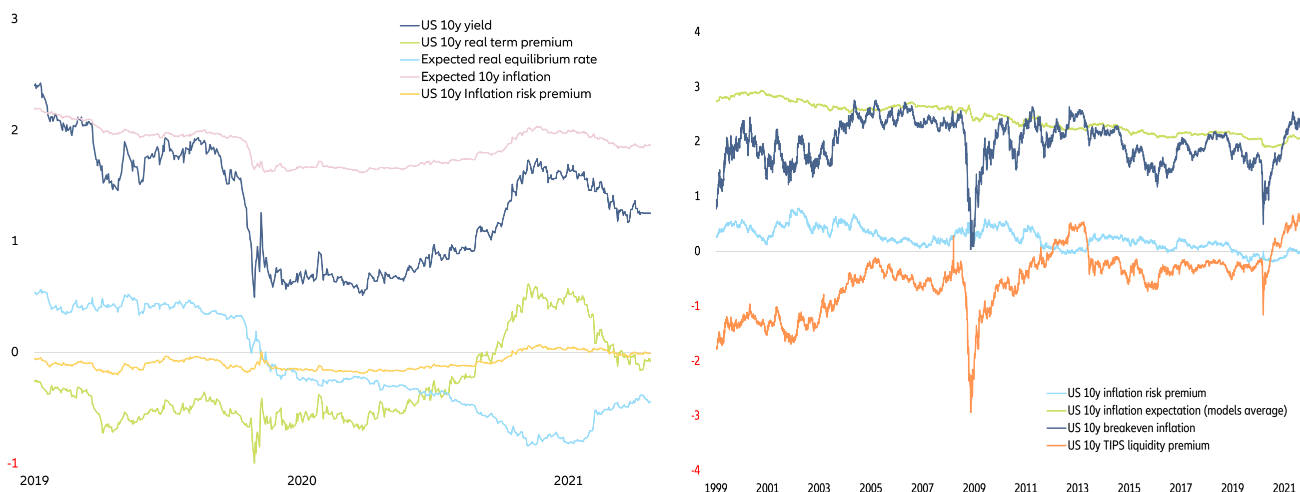
Photo by Jordan Wozniak on Unsplash

CAPITAL MARKETS: STILL GOING STRONG

Capital markets have been immune to the potential downside risk of the unexpected acceleration in Covid-19 cases. In Q3, equity markets recorded further increases, with US and Eurozone equities up by 5.2%/4.0% QTD and 20.3%/18.9% YTD, respectively. At the same time, sovereign yield curves have flattened again on the back of declining term premia after a short episode of an inflation-induced surge of long-term rates. For the US 10-year rates, the risk component (nominal term premium) has fallen back to the level seen at the beginning of the year (-70bps since the May peak). This decrease was only partly compensated by an increase of the expected short-term rates. Interestingly, this increase was based on a higher expectation for the real equilibrium interest rate rather than higher inflation expectations. US 10y yields and 10y Bund yields are now at around 1.3% (+40bps YTD) and -0.3% (+24bps YTD), respectively. Corporate credit spreads have timidly widened in Q3 with US and EUR investment grade credit spreads at 90bps (+4bps QTD, -13bps YTD) and 84bps, respectively (+0bps QTD, -9bps YTD). US and EUR high-yield corporate spreads, on the other hand, are currently at 308bps (+4bps QTD, -78bps YTD) and 288bps (-8bps QTD, -67bps YTD), respectively.

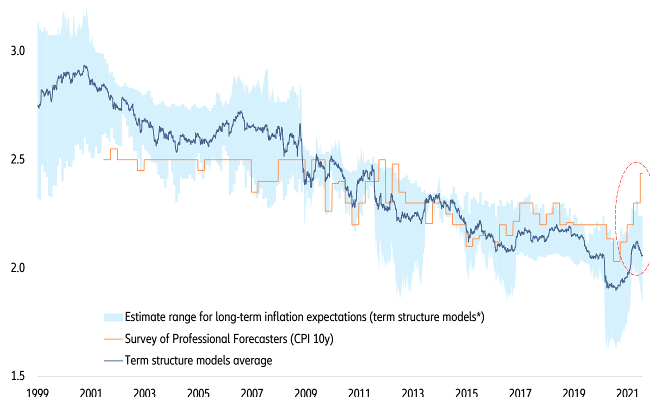
Market-implied inflation expectations remain well-anchored (in marked contrast to consensus forecasts). While the yield curve of inflation-indexed US Treasuries suggests little persistence in the current surge of headline inflation, professional forecasters have raised their inflation expectations for the next 10 years to 2.5%. Consistent with our characterization of rising inflation as being temporary, we give greater weight to market signals and continue to see 10y US Treasuries yields in a range of 1.3% to 1.5% until year-end as the inflation risk premium remains muted. In our view, long-term US yields could only return to levels last seen during the spring episode if inflation expectations become unanchored. However, so far, the inflation risk premium has proven to be largely insensitive to fluctuations in realized inflation.

Figure 6: Decomposition of US 10y nominal Treasury yield and 10y inflation expectations



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 7: Markets vs forecasters: long-term US Inflation expectations (10y, in %)



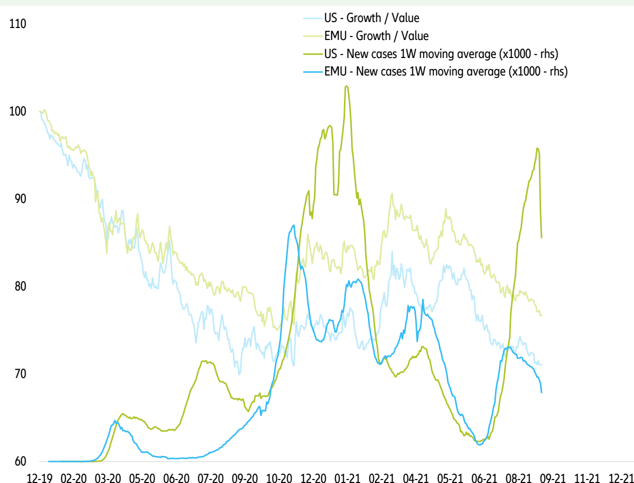
* models used: Adrian, Crump & Moench (2013), D'Amico, Kim & Wei (2018), Christensen, Lopez & Rudebusch (2010) and proprietary model

Sources: Refinitiv, Euler Hermes, Allianz Research

Equities have continued their bull run and remain richly valued relative to fundamentals. Despite the bearish rotation in long-term yields, equity markets recorded solid gains in Q3. Nonetheless, the drivers of this performance have dynamically changed, with growth (especially "stay at home" sectors) being now in the lead at the expense of the Q1 reflation/reopening trade (Figure 8). Most fundamental valuation metrics remain at the upper range of historical distributions, continuously raising questions about the structural sustainability of this bull run. Along these lines, earnings expectations remain extremely optimistic, with 2021 revisions exceeding any other earnings revisions path since 1987 for the US and the Eurozone (Figure 8). However, dividend yields have recently converged to yields available on 10-year Treasuries (which has never happened before), suggesting that bonds are even pricier than equity by historical standards.

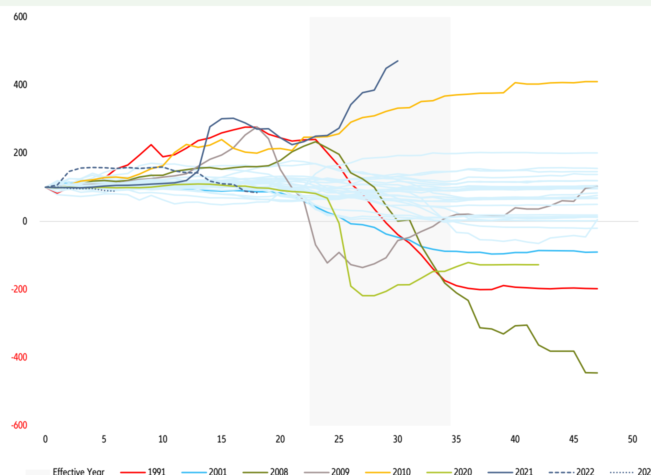
However, recent market moves suggest a period of consolidation. This stabilization, although detrimental for momentum trading, should be positive in the medium-term as it will allow market expectations to adjust to a series of consecutive missed earnings and prevent a sharp market meltdown. Because of that, we do not expect 2022 and 2023 to be as benevolent as 2021 for equity investors. Instead, we expect a return to average yearly historical returns (5% to 6%) both in 2022 and 2023. While a sudden deterioration in investor sentiment remains a material downside risk, a massive market correction seems doubtful considering the very supportive monetary and fiscal policies. Policymakers are still offering an implicit put protection, with money supply and inflation expectations as the biggest contributors to the current equity performance. However, as monetary policy starts normalizing over the medium term, the inflation contribution remains key for the stabilization of the market.

Figure 8: Equity performance (indexed, 100 = end-2019)



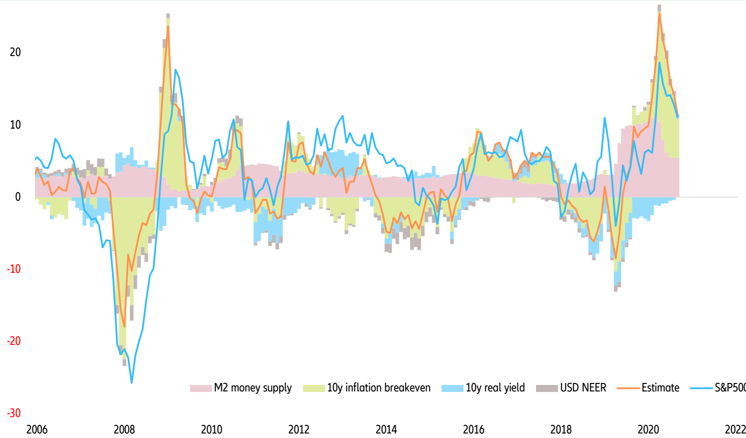
Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 9: Changes in US EPS growth expectations (100 = beginning of the forecasting period)



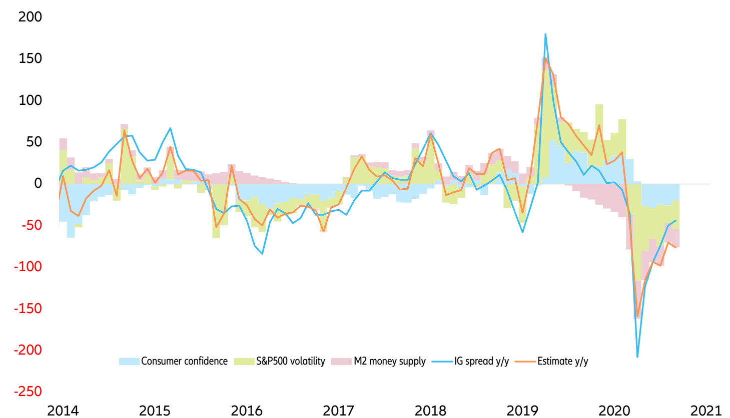
Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 10: US equity return decomposition (in y/y % changes)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 11: US investment grade corporate credit spread decomposition (in y/y changes bps)

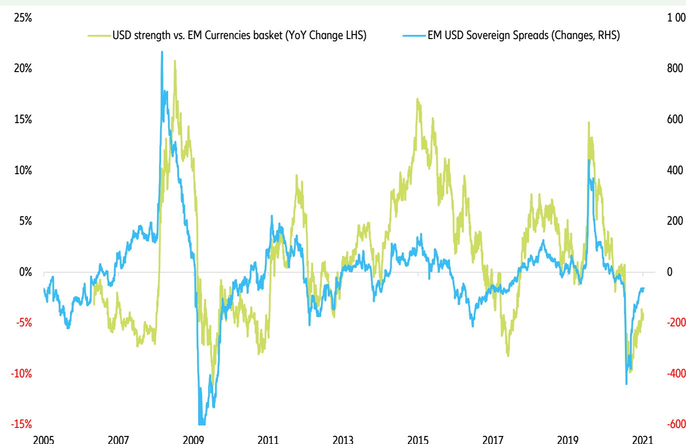


Sources: Refinitiv, Euler Hermes, Allianz Research

Corporate credit markets have seen some volatility but remain on the optimistic side. In Q3, spreads have timidly widened across the rating buckets. However, the initial sell-off has quickly reverted, anchoring at wider levels (~90 bps). We do not expect further recompression of spreads as the combination of a worse-than-expected economic outlook paired with high leverage and earnings stabilization in 2022 and 2023 is likely to prevent a reversal to previous levels. In this context, as in the case of equities, we do not expect any broad-based corporate credit underperformance, but we do envisage a gradual consolidation of the credit market, with spreads slowly returning to pre-crisis levels, adjusting by between +10 and +20 bps each year.

Emerging Markets will be in wait-and-see mode until there is greater visibility on the Fed's normalization path. Local yield curves in the main Emerging Markets have flattened since March. Equity markets, on the other hand, have underperformed, remaining flat (-0.4% in the benchmark MSCI EM $) largely due to drag from China. The first signs of US monetary policy normalization are likely to be felt in the hard-currency-denominated bonds environment – together with the exchange rates. That this is not fully priced in by markets can be seen in the movements that surround the echoes of tapering (i.e. a more hawkish Fed meeting). Nonetheless, the policy normalization carried out by some Emerging Markets due to rising inflation – mainly in Latin America and Eastern Europe – should help mitigate pressures on capital flows.

Figure 12: Evolution of EM hard currency sovereign spread index vs.nominal USD index

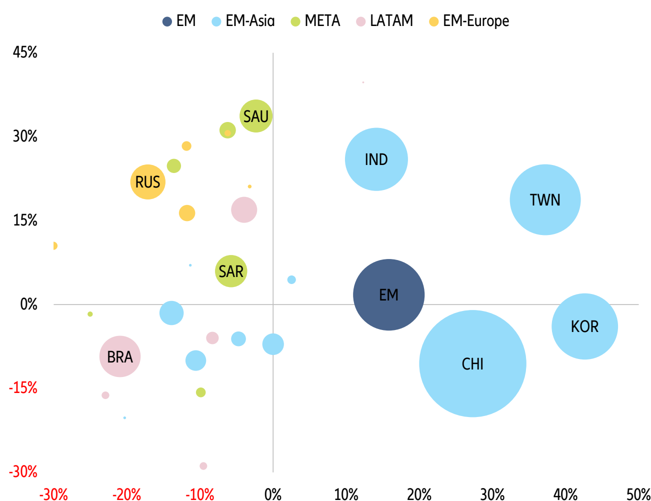


Sources: Sources: Bloomberg, Refinitiv, Euler Hermes, Allianz Research.
The nominal USD index measures the strength of the dollar vs a basket of EM currencies.

The USD is waiting for the Fed to move. After a bumpy 2020, and with some localized exceptions (Turkish Lira in March, certain Latin American economies after political events), the year has seen a generalized appreciation of the USD. Two resembling exceptions have been the GBP – correcting after Brexit did not turn into a total disaster – and the CNY, although the trend was halted in June after a regulatory adjustment on foreign exchange reserves. The prospects for the future will be determined by the different tapering paths for developed markets, and how well Emerging Markets control inflation.

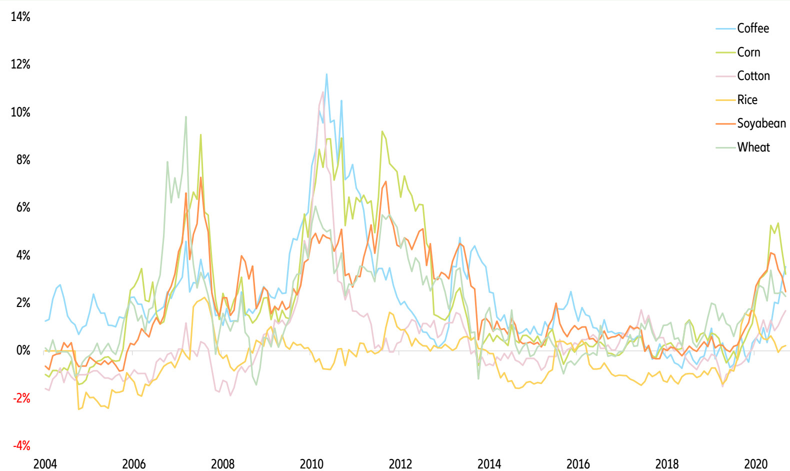
The rally in commodity prices has lost some steam in Q3. After the surge in commodity prices at the beginning of the year, fueled by anticipated pent-up demand, inventory building and supply-chain constraints, we are starting to see some trend changes. As we anticipated, there are temporary elements pushing for higher prices that once the world learns to live with Covid-19 will gradually dissipate. In Figure 14 we can observe how this trend is visible in the agricultural segment.

Figure 13: Performance of MSCI $ Index of the individual EM markets. 2020 vs 2021



Sources: Refinitiv, Euler Hermes, Allianz Research.
Size of the bubble measured by the current weight of the respective country in the MSCI EM $ index except for the EM index for which the size is standard.

Figure 14: Perceived annual rate of appreciation of selected agricultural commodities



Sources: Refinitiv, Euler Hermes, Allianz Research.

Figure 15: Forecast table for capital markets

year-end figures	Last Value (15.09.2021)	Unit	Scenario	
EMU			**2021**	**2022**
Rates				
Policy rate (depo)	-0.5	%	-0.5	-0.5
10y yield "risk-free" sovereign (Bunds)	-0.3	%	-0.3	-0.1
10y Swap Rate	0.0	%	0.0	0.2
Italy 10y sovereign spread	101	bps	90	90
France 10y sovereign spread	33	bps	20	30
Spain 10y sovereign spread	65	bps	55	60
Corporate Spreads				
Investment grade credit spreads	84	bps	90	110
High yield credit spreads	288	bps	325	375
Equity				
MSCI EMU: total return p.a.	18.8 (ytd)	%	15-20	6
US			**2021**	**2022**
Rates				
Policy rate (mid-rate)	0.125	%	0.125	0.125
10y yield "risk-free" sovereign (Treasuries)	1.3	%	1.5	1.8
Corporate Spreads				
Investment grade credit spreads	90	bps	100	110
High yield credit spreads	308	bps	350	400
Equity				
MSCI USA: total return p.a. in USD	20.0 (ytd)	%	15-20	6
FX			**2021**	**2022**
USD - EUR	1.18	%	1.19	1.19
Emerging Markets			**2021**	**2022**
Rates				
Hard Currency Spread (vs USD)	281	bps	300	330
Local Currency Yield	4.7	%	4.8	5.3
Equity				
MSCI EM: total return p.a. in USD	1.6 (ytd)	%	5-10	7

Sources: Refinitiv, Euler Hermes, Allianz Research

POLICY EXPECTATIONS

Unwinding policy support requires a careful balancing act to ensure an effective rotation towards private demand and sustainable growth. Besides accelerating the vaccination rollout, the key policy priority is to calibrate policy support to the pace of the recovery, while gradually shifting to more targeted measures that focus on growing firms and sectors. Another important challenge is to identify the potential size of the reallocative needs and the role that policy should play in facilitating reallocation.

Fiscal policy should remain supportive until a robust expansion is firmly in place. As demand for emergency support wanes, the fiscal policy mix should shift toward measures to aid resource allocation and hence further reduce output loss while enhancing the efficiency of public spending. In a few, mainly Emerging Market, economies where the recovery is well underway and/or fiscal buffers are more limited, the time to embark on a gradual but steady path of fiscal adjustment will come earlier.

Advanced and Emerging Markets are facing different monetary policy challenges. In most advanced economies, monetary policy should remain highly accommodative and projected inflation is set to remain below central banks' inflation targets over the longer term. Some Emerging Markets, however, are grappling with overshooting as they are further into the recovery phase. Central banks should maintain monetary support and allow for temporary price increases, unless sustained inflationary pressures pose a significant risk of de-anchoring inflation expectations.

Maintaining regulatory flexibility and government loan guarantees will be important to avoid a sharp tightening in financing conditions. Credit growth has remained favorable during the crisis. However, a gradual tightening of bank lending standards in the first half of this year has coincided with the phase-out of borrower and income-support measures.

Labor market policies would have to consider the extent of structural transformation and associated reallocation needs. A scenario of a high degree of structural transformation and a permanent shift in labor demand across sectors and occupations would require a substantial reallocation. Policies would have to support job-to-job transitions, including through reskilling and upskilling workers while still under the job-retention schemes, enhancing the job search and incentivizing hiring. In a scenario of a low degree of structural transformation, viable work relationships should be preserved, including by maintaining job-retention schemes as necessary and protecting the income of uncovered workers.

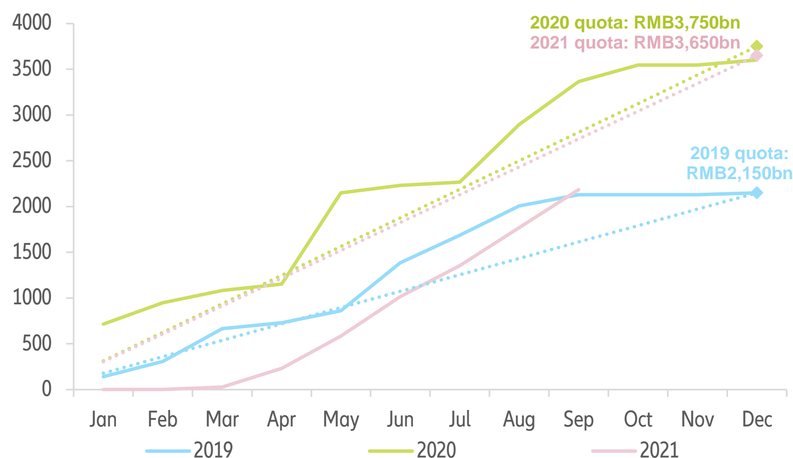
REGIONAL OUTLOOKS

Despite the rapid propagation of the delta variant, we expect a solid US recovery. The recent rise in infections, notably in the southern states (characterized by a below average vaccination rate) has raised uncertainties, especially given the return to schools and the upcoming winter season. High-frequency indicators confirm that services-driven activities have been hit the most by the recent surge of cases. In September, more than 7.5 million Americans have lost a USD300 per week top-up payment. The combined impact of these factors suggests a slowing of consumption growth to an average of 1% q/q annualized in Q3 and Q4 2021, compared with a pace close to 3% q/q annualized in Q1 and Q2 2021. Consumer and business surveys confirm an erosion of confidence among economic actors, albeit coming from an extremely high level before. Despite a deceleration in consumption growth, we do not expect the pace of the recovery to change as the need to replenish inventories and higher export performance alongside Europe's rebound should lead to a higher net positive contribution to growth. All in all, we expect US GDP growth to be close to +7% q/q annualized both in Q3 and Q4 2021. More tangible signs of deceleration should be visible in H1 2022 pending the approval of the new fiscal package for infrastructure and social programs in October only. The implementation of this program (estimated in our central scenario at USD2.3trn to be spent until 2030, including USD550bn of supplementary spending for infrastructure projects) is likely to have a more positive influence on growth starting in H2 2022, while the positive impact of the recent urgent social programs will progressively diminish. We expect a downward revision of our GDP growth scenario to +6.1% in 2021 (from +6.3% before) and an upward revision of our scenario to +4.1% in 2022 (from +4% before). Current policy guidance after the Jackson Hole gathering suggests that the Fed will leave all options open for the timing of a taper announcement, while there is broad consensus now in the FOMC that the time is coming for a rollback of asset purchases. While the September meeting remains the base case for an announcement, disappointing data releases on payroll and inflation developments could delay the announcement to November or even later. A first rate hike is not expected before mid-2023.

The normalization of the Chinese economy is proving bumpier than expected due to a strong regulatory drive and the materialization of downside risks. Systemic risks should be avoided. It was clear since H2 2020 that a tighter policy mix, along with an emphasis on regulation (in the real estate and the financial sectors), would be key themes in 2021. While some slowing of growth was expected, renewed Covid-19 outbreaks and adverse weather conditions have further weighted on growth with knock-on effects business and household confidence. The recovery of the private demand is thus likely to pause over the coming quarters. In reaction, in contrast to H1 2021, the policy mix has turned accommodative in the past few months and is likely to keep providing support. The very latest policy communications indicate that fiscal spending will accelerate, and local government bond issuance will increase, supporting infrastructure investment. On the monetary side, the PBOC unexpectedly cut the reserve requirement ratio by 50bp in July and another decline is likely by the end of the year to support liquidity in the banking system and overall credit growth. This change in the policy stance also aims at mitigating the negative impact of regulation – a drive that is unlikely to be dialed down. In particular, restrictions in the real estate sector (e.g., purchase restrictions in some cities, more intense oversight of household loans for housing, and financial rules for real estate developers) will remain in place, with some even possibly strengthening. This means that further defaults in the sector are likely in the coming quarters, although we expect them to be limited to the most fragile cases with limited contagion. Furthermore, the focus on technological autonomy (from the dual circulation strategy) and "common prosperity" in the medium term is announcing additional potentially

disruptive changes in sectors that carry structural risks and/or exacerbate social inequalities. Macroprudential regulation and rules regarding data privacy, labor conditions and welfare sectors (in the same vein as private tutoring) should continue to be put in place and could potentially weigh on the economic cycle. Overall, downside risks have become more prominent, but we continue to believe that a systemic crisis remains a tail risk and that authorities have room for further policy support if needed. We expect the Chinese economy to grow by +8.2% in 2021 and +5.4% in 2022.

Figure 16: Local government special bond issuance, year-to-date (RMB bn)



Sources: Ministry of Finance of China, Euler Hermes, Allianz Research

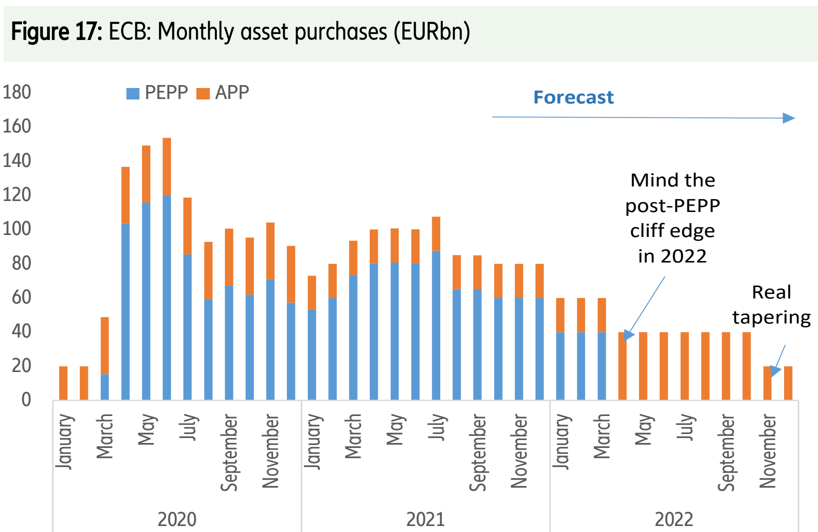
By end 2022 the Eurozone economy will have largely caught up with its pre-crisis GDP path, one year earlier compared to previous expectations. The "grand reopening" kicked off in Q2 2021, driven by buoyant catch-up growth in social spending and a strong recovery in spending. Even though reopening tailwinds will continue to prop up GDP growth in the coming quarters, momentum looks to have peaked over the summer as data surprises have declined. Private consumption will remain in the driving seat of the economic recovery even though the days of supercharged pent-up demand have passed. After all, consumer confidence continues to fly high (France is an exception) despite persistent Delta concerns, thanks to a buoyant labor market recovery. Meanwhile, industry continues to face notable supply bottlenecks, which is keeping a lid on the near-term recovery. Thankfully, fiscal policy should remain supportive throughout H1 2022, when we expect the normalization in public finances to gain more traction in the big Eurozone countries. Overall, we expect the Eurozone economy to grow +5.0% in 2021 and +4.2% in 2022, with pre-crisis levels of economic output reached before the end of the year. As a result of the swifter-than-expected recovery, the Eurozone economy will have largely caught up with its pre-crisis GDP path by end 2022. The very contained economic scarring – for instance we see the unemployment rate return within touch of its pre-crisis level by end 2022 – is unprecedented and in sharp contrast to the experience of the GFC or the Eurozone debt crisis. In turn, Eurozone divergence should remain under control. The only large economy that we see somewhat lagging is Spain, given higher insolvencies and larger job losses amid a delayed tourism recovery. A delta dip at the turn of 2021/22 cannot be completely ruled out, but in view of the good vaccination progress, which has significantly decoupled new infections from hospital admissions and deaths, renewed hard lockdowns are not currently expected. Nevertheless, even a slight tightening of restrictions and a renewed increase in uncertainty amid a sharp increase in new Covid-19 cases could be enough to dampen investment activity and private consumption. Going forward, several key elections amid increasing political polarization, diminishing policy space at national levels and a fraying consensus at the EU level of key architectural reforms could increase the downside risk to the forecast.

The ECB is scaling back its crisis support this year while remaining accommodative. At its September meeting, the ECB committed to a "moderately lower" PEPP purchase pace going forward (our best interpretation is EUR65bn-70bn per month). However, this announcement should not be confused with the beginning of monetary policy normalization, with the ECB insisting that the calibration of PEPP is neither policy tightening nor tapering. Meanwhile, the focus has already firmly shifted to "life after PEPP" even though a definite retirement confirmation will only come at the December meeting at the earliest. After all, the ECB will opt to wait for more visibility on the potential downside risks of the delta virus threat to the recovery and the Fed's tapering plans, as well as a fresh set of macroeconomic forecasts. To manage a potential cliff-edge effect from the likely expiration of PEPP, we expect monthly asset purchases under the APP to be doubled to EUR40bn to ensure favorable financing conditions and a smooth monetary transmission. As a result, total net asset purchases will drop from around EUR1.1trn in both 2020 and 2021 to EUR500bn in 2022.

A concern is that the ECB is likely to have difficulties staying within the confines of self-imposed constraints (e.g., issuer limit and capital key). We calculate that monthly APP purchases of between EUR20bn and 60bn would only allow for the general QE program (APP) to continue for seven to 20 months after March 2022. As we have learnt in the past, the ECB tends to have another trick up its sleeves, i.e., some self-imposed limits can be amended (or smoothed over time). This could include rolling over some of PEPP's features to its older cousin APP, in particular the flexibility around how much is spent in which jurisdiction, or via a temporary QE envelope that can be spent flexibly on an as-needed basis to better target its remaining firepower. Tapering – as concerns the traditional QE program APP – will only start in earnest in late 2022 while we expect no rate hikes to be implemented before 2024. Hence the ECB (together with the Bank of Japan) remains a clear late bloomer with regards to policy normalization among major global central banks.

The current Covid-19-induced surge in inflation is unlikely to change the monetary stance and the projected path of asset purchases. We still see the strong acceleration in headline inflation in H2 2021 as a temporary overshoot, rather than consumer prices galloping out of control. Key drivers include (i) a surge in input prices driven above all by strained supply chains and recovering commodity prices; (ii) higher services inflation along with the economic reopening and (iii) strong pandemic-related technical effects (base effects as well as on-offs such as the temporary VAT reduction in Germany). But these are largely transitory and their impact should fade as the economic recovery advances and supply catches up with demand. At 2.2% for 2021 as a whole, Eurozone inflation should hence only briefly rise above the ECB's 2-percent-target - peaking at +3.3%y/y in November – before still-subdued core inflation and reversing base effects push headline inflation back towards 1.5% in 2022.

Figure 17: ECB: Monthly asset purchases (EURbn)

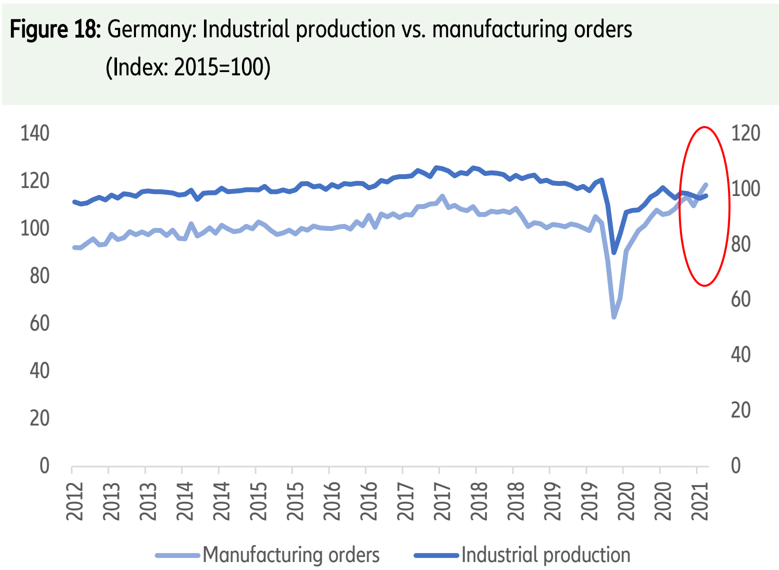


Sources: Ministry of Finance of China, Euler Hermes, Allianz Research

The fast-tracked German economic recovery unfazed by elevated political uncertainty. The German economy is still enjoying an economic summer high, but the zenith of the current upturn is probably behind us, with leading indicators clearly pointing to an autumnal slowdown. The economic record chase is over but despite weakening catch-up effects, cooling foreign demand - especially from the US and China, where 17% of exports are destined - continuing supply-chain bottlenecks and persisting delta concerns, above-average GDP growth can still be expected in the coming quarters. Overall, the economy is expected to grow +3.0% in 2021 and +4.0% in 2022. This means that the pre-crisis level of economic output will be reached before end 2021. The swift recovery has also supercharged the healing of the German labor market. By end 2021, almost two in three workers who lost their jobs in the wake of the Covid-19 crisis should find new employment. The unemployment rate will, however, remain elevated at 5.7% in 2021 and 5.3% after 6% in 2020. The outcome of the German general election on 26 September remains highly uncertain amid volatile polls that allow for a wide array of party coalitions. Notable differences across party programs will need to be overcome, suggesting that we will see more policy evolution than revolution over the coming four years. Hence, while change will come – a new chancellor, an unprecedented coalition government (a three-way party coalition for the first time looks likely) – the question remains whether it will be enough for Germany to tackle the looming triple-whammy of the digital, green and demographic transitions.

In France, the services catch-up occurred at the expense of goods, while consumer confidence is losing steam. The impact of the delta variant on France's economy is limited when we consider developments in services activity. On the other hand, consumer confidence declined in July and August to reach 99 (slightly below its long-term average of 100). The dramatic drop in the "future economic outlook" (-19pp) is the main driver of the overall decline.

Figure 18: Germany: Industrial production vs. manufacturing orders (Index: 2015=100)

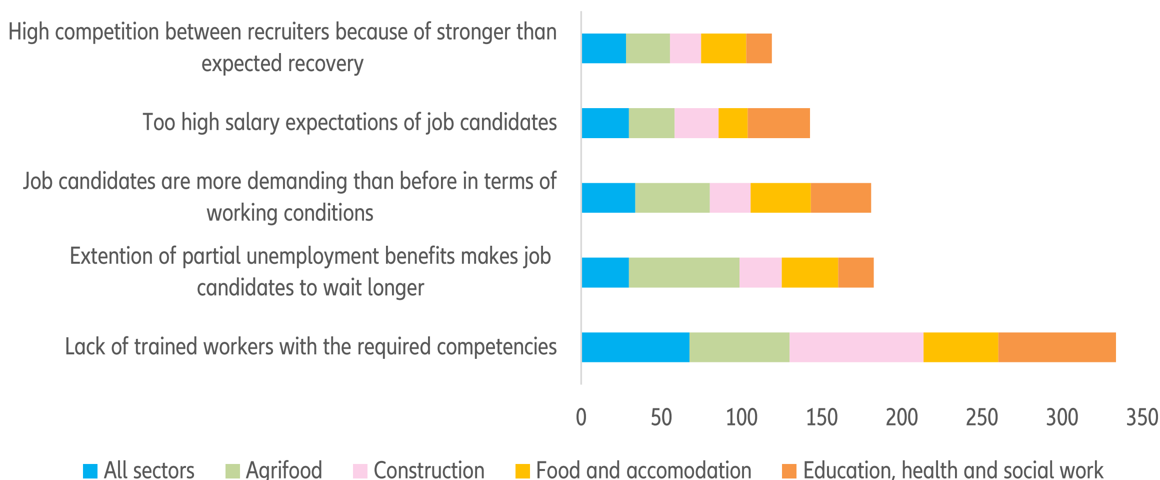


Sources: Refinitiv, Euler Hermes, Allianz Research

This is somehow paradoxical as the government is not at all keen on implementing a sudden withdrawal of support measures before the elections in April 2022. In addition to a potential rise in unemployment from a low level of 8% in Q2, households might be worried about the accumulation of public debt and potential tax increases after the elections. Although likely to become more "targeted", we expect ample state support to SMEs and households to remain in place until the second half of 2022. Consequently, the budget deficit is expected to reach -8.4% of GDP in 2021 and -5.2% in 2022, and progressively moderate thereafter. In France, the materialization of "pent-up demand" disappointed as the rebound of services after the reopening occurred at the expense of goods consumption, which fell -2% m/m in July. Morever, high-frequency data do not suggest any strong recovery of goods in Q3. On the other hand, the recovery in services was sustained, but accommodation and services activity remained below its pre-crisis level in Q3. Robust domestic demand will continue to drive the recovery next year, while exports will certainly struggle to pick up (especially in the transport sector) in comparasion to other European heavyweights. All in all, we have revised our growth forecast for France slightly up (+0.2pp.) to +5.6% for 2021 and to +3.4% in 2022 (-0.2pp.).

Labor market shortages could also weigh on recovery perspectives in the most affected sectors such as agrifood, food and accommodation, health and education: More than one in four businesses report facing severe labor shortages, mainly due to a lack of suitable candidates. In view of France's longlasting labour market rigidities and weak track record in skills training, we expect labor shortages to last longer. Therefore, moderate wage increases are likely in 2022 as workers' bargaining power regains some strength after decades of wage moderation and high employment.

Figure 19: Main reasons explaining labor shortages in France



Sources: DARES, Euler Hermes, Allianz Research

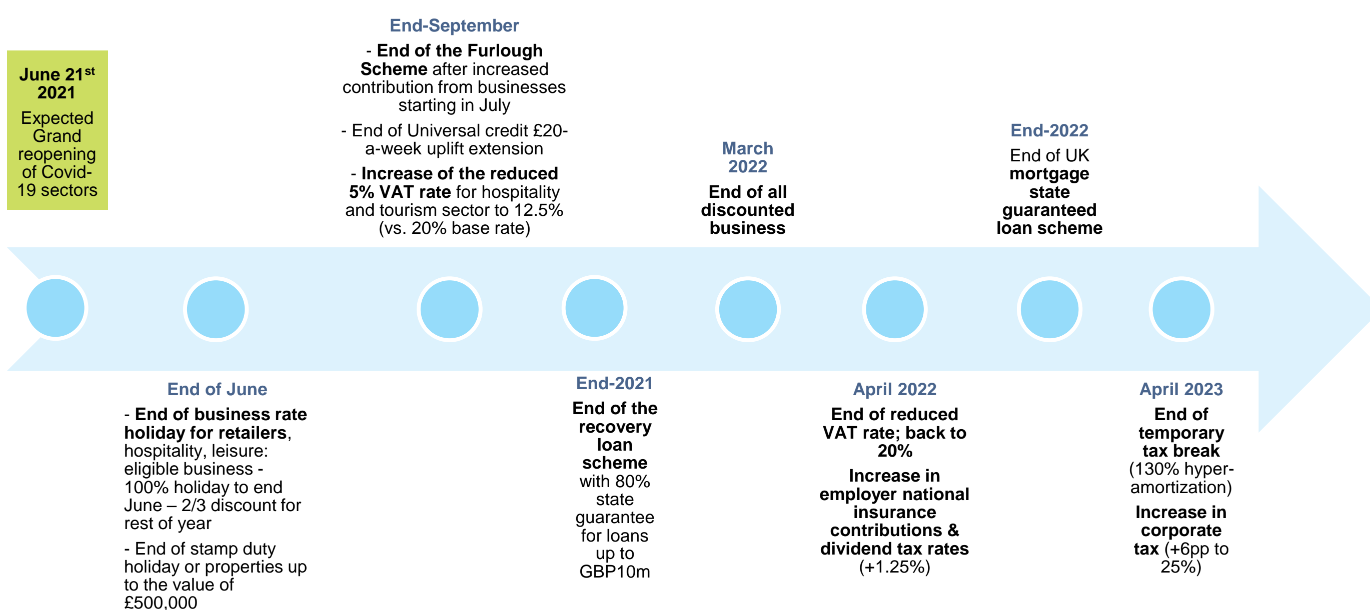
The gradual unwinding of emergency short-term work schemes and government guarantees on loans to firms is the biggest risk for the short-term outlook in Italy. After a strong GDP increase of +2.7% q/q in Q2, Italy closed the gap with France and Germany in terms of the distance from pre-pandemic output levels. The growth dynamic is broad-based but private consumption remains a major driver. Weaker restrictions and a lower unemployment rate (10.2% to 9.7% in June) have increased consumer confidence and lifted retail sales above pre-crisis levels. The manufacturing sector also remains very dynamic. Despite supply shortages, industrial production still finished Q2 on a strong +1.0% m/m increase, outperforming France and Germany, thanks to strong export performance and recovered external competitiveness. We expect the manufacturing recovery to continue in Q3 as orders have been coming in strong. This momentum should prove supportive for investments, especially as capacity utilization nears pre-crisis levels. In addition, in contrast to the euro crisis, public investment has not fallen after the Covid-19 shock and should be further supported by the Next Generation EU (NGEU) fund. We have revised up our GDP growth forecast to +6.0% this year and +4.8% in 2022. This implies Italy will have recovered its output loss from the crisis by mid 2022. In the short-term, we see the biggest risk to this forecast coming from the gradual unwinding of Italy's emergency short-term work schemes and government guarantees on loans to firms. This could delay the reduction of increased private savings as well as put pressure on the banking sector. In addition, a sticky fiscal deficit might complicate the budget negotiations, while rating agencies and markets are still somehow cautious regarding Italy's creditworthiness. Despite the good economic performance and current political stability, the 10y spread to Germany remains at around 100bp. But political risks are never far away. The party landscape continues to become fragmented, with the right-wing Fratelli d'Italia now at 20% of voting intentions. For the medium-term, the implementation of the NEGU-funded recovery plan is key. Italy has made a respectable start: The plan is approved by European institutions, over 100 projects are in the pipeline and Italy has launched a long-awaited judicial reform.

Spain's robust recovery in 2021 (+6.2%) will be mainly driven by strong base effects, higher private consumption boosted by the gradual re-opening of the economy and moderate residual household savings. Performance in Q2 (+2.8% q/q) proved more resilient than initially anticipated and we expect continued growth in the following two quarters – albeit at a slower pace. At this stage, the spread of the delta variant represents a moderate risk to the recovery. Spain has made strong progress on the vaccination campaign, with around 75% of its population fully vaccinated, and it is on track to reach 80% of the population in October. In addition, containment measures have been moderate and targeted. High-frequency data point to a moderate recovery in the tourism sector, affected in part by travel and mobility restrictions across Europe this summer, and we do not expect the sector to return to its full pre-pandemic performance before 2023. Upside risks to economic activity stem from the fiscal stimulus envisaged in the 2021 budget, with an allocation of 2.3% of GDP of the grant requested under the Next Generation EU facilities. Spain will maintain an expansionary fiscal stance in 2021, with a gradual phasing-out of support measures. However, political and social pressure may push the government to extend the furlough scheme that should expire at the end of September 2021, especially in the tourism and restaurant sectors. Insolvencies increased in the first half of 2021 in all sectors, especially in the transportation (+124% compared to H1 2020), accommodation and food services (+320%) financial and real estate (+165%) and social (+212%) sectors. In addition, the government is planning to increase the minimum wage, which may put additional pressure on spending in the medium-term. We expect the government to further cut support measures in 2022 and bring the fiscal deficit to -5.8% of GDP in 2022 from -8.9% of GDP. Emergency measures helped limit the impact of the crisis on the job market, but Spain did not resort to furlough schemes as much as other European countries. Unemployment increased to 15.5% in 2020 from 14.1% in 2019. The recovery should contribute to reactivate employment in 2021 but we expect unemployment to decline only slightly to 15.4% in 2021 and 14.7% in 2022.

Despite strong growth in 2021, the UK's economy will return to pre-crisis levels at the end of 2022 at the earliest as Brexit is lowering the post Covid-19 catch-up effects. Q2 GDP increased by +4.8% q/q, the strongest growth rate among G7 economies. Private consumption has been the main driver of growth: +7.3% q/q and 30% of the pent-up demand has already been absorbed in Q2. Despite the super-amortization (130%) scheme and prevailing high corporate cash holdings, business investment performance was in line with other European peers (+2.4% q/q). From a sector perspective, food and accommodation and transportation remained in catch-up mode in June (but still below pre-crisis levels at -7.2% and -10%, respectively). Activity in wholesale & retail has flattened since June but stands +4.6% above the pre-crisis level. Global supply-chain disruption and Brexit hurdles are putting a drag on manufacturing activity, which also seems to have plateaued while remaining -1.9% below the pre-crisis level. Construction is floating around the pre-crisis level. Exports in volume terms remain more than -20% below pre-crisis levels. The real effective exchange rate has acted as a cushion for the rise in input prices (+4.8% since the start of the year against +3.6% for the U.S. and -2.1% in the Eurozone), but has been a drag on export competitiveness. Since 2001, the U.K. lost more than -2pp of its global market share, one of the biggest losses worldwide, with one third of losses registered since the Brexit referendum. At the same time, the dependency of UK companies on Chinese suppliers has doubled since 2015 to 16% of total imports. Indeed, Brexit is a hurdle for exporters and importers when trading with the EU. Currently more than 50% of companies still experience significant challenges due

to additional paperwork, transportation costs, custom duties, reduced demand, and lack of haulers. Since mid-August, one in five firms in the manufacturing industry has changed suppliers, mainly in the manufacturing and construction sector. This points to a more dynamic investment momentum by year-end, also ahead of the fiscal cliff edge expected in 2022 with the end of most state-support measures and the rise of the social contribution tax. However, the post Covid-19 lockdown disruption in labor markets has been exacerbated by Brexit. The highest shortages prevail in transportation services, construction, health, financial services and to a lower extent in retail & hospitality. Wage growth registered above +8% y/y in June, one of the highest growth rates in the advanced economies. While we think this is temporary and disturbed by the furlough scheme-related base effects, we do believe wage growth will remain around +2.5% on average in 2021-22, which should keep inflation above its 2% target, warranting a progressive start of monetary policy tightening by the Bank of England by summer 2022. Delta is lowering growth prospects for Q3 and Q4 to around +1.5% q/q. In addition, the closer we get to 2022, the more financial services will be back on the agenda as the transition period is planned for March. The UK has been the only one among the top 10 major economies to lose global market share for financial services since 2017 (-2pp to less than 15%). Overall, we expect GDP growth at +6.3% in 2021 and +5.4% in 2022.

Figure 20: Planned end dates for state support in the UK following the Covid-19 crisis



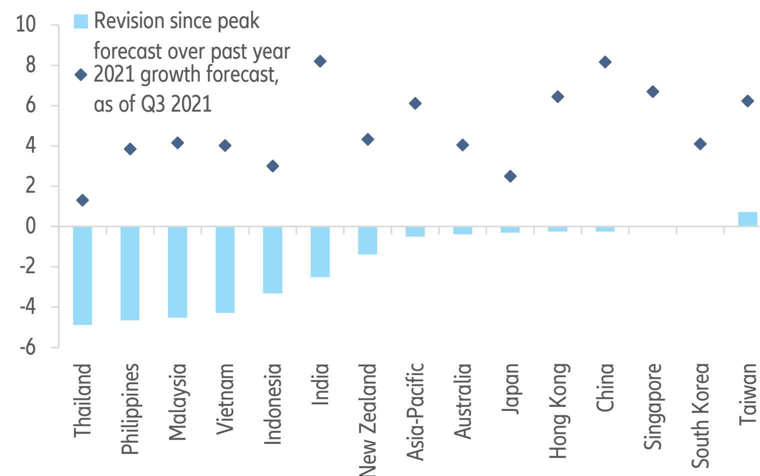
Sources: Various, Euler Hermes, Allianz Research

In the Emerging Markets (EMs), economic recoveries are divergent amid varying vaccination rollouts, diverging space for fiscal stimulus measures and desynchronized monetary policy normalization. Varying degrees of Covid-19 vaccination progress among EMs mean that the prospects and stringencies of potential new lockdown measures in response to the delta or other variants do also differ. In this context, many high- and middle-income EMs are for now relatively well positioned, but for low income countries, notably on the African continent, herd immunity is still far away. Moreover, large differences in their fiscal leeways for stimulus have contributed to a multi-speed recovery while increased public debt levels pose substantial debt refinancing risks for some countries[2]. Meanwhile, inflation is back in many EMs and various central banks in Latin America and Emerging Europe have begun tightening through policy rate hikes and tapering, even as the monetary stance in several emerging Asian economies have become even more accommodative.

[2] See our report *Emerging Markets debt relief : Kicking the can down the road*.

The Asia-Pacific region was probably the most badly hit by delta outbreaks, which are exacerbating divergence across economies. The spread of the more contagious variant in a region that often exhibits a lower immunity rate (due to a low infection rate and slow vaccination) has led to authorities implementing strong restrictions that have weighed on economic activity. The zero-Covid strategy worked well in 2020 and resulted in the overall outperformance of the Asia-Pacific region. However, it may have become a lagging choice against the more sustainable option of fast vaccination (when available) as the global economy reopens. More reassuringly, the worst of the delta hit may be past for some economies, exports prospects are still supported by strong demand from developed markets (less so by China) and accelerating vaccinations bode well for their recoveries to restart soon. This is the case in particular for Singapore, South Korea and Taiwan. This lays the ground for slowly normalizing policy mixes, with notably the Bank of Korea delivering the first rate hike in the region in August. On the other hand, Thailand, the Philippines, Vietnam and Indonesia have struggled more to ramp up vaccination progress. The delta outbreaks and ensuing halt in their recoveries are thus delaying the path towards policy normalization, with central banks (e.g. in Thailand and the Philippines) delivering more dovish messages. Malaysia could see increased fiscal stimulus as a proposal to raise the statutory debt ceiling has been put forward. The divergence in the paces of recovery across Asia-Pacific has thus been exacerbated in the past months, with south and southeast Asia seeing the largest downward revisions for 2021 expected growth rates, while north and eastern Asia are more resilient and even seeing upward changes in some cases. Overall, we expect Asia-Pacific regional GDP to grow by +6.1% in 2021 (revised on the downside by -0.2pp) and by +4.8% in 2022 (unchanged). Risks to this outlook remain closely tied to pandemic developments.

Figure 21: 2021 GDP growth forecasts and revisions from peak over past year

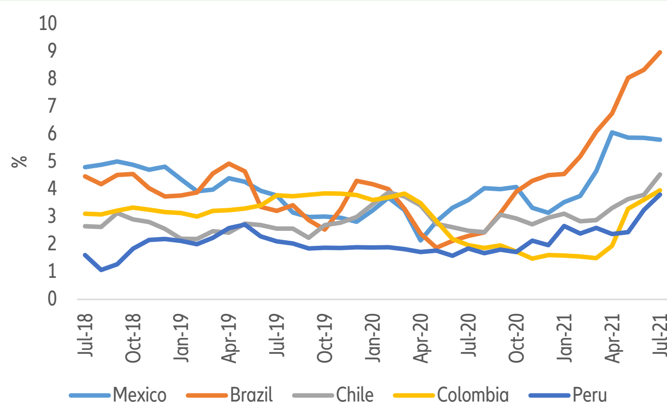


Sources: Various, Euler Hermes, Allianz Research

The Emerging Europe region has surprised on the upside and is rebounding strongly, with annual real GDP growth forecast at +5.5% in 2021 and +3.8% in 2022. The impact of renewed waves of Covid-19 infections has been much smaller this year than in 2020 and has mostly been limited to vulnerable services sectors. Industrial output has continued to rise, thanks to strong investment activity, especially in EU member states that will also benefit from EU funding programs in the coming years. The impact of global supply-chain disruptions on output appears to be moderate in the region, except for highly trade-dependent economies such as Czechia and Slovakia, which will experience the comparatively slowest recoveries in 2021. We expect only a limited tightening of lockdown measures in response to the delta variant towards the end of year since vaccination has gained traction in the region in Q3, except for Russia, Romania and Bulgaria, which, however, have been relatively lenient with regard to restrictions anyway. Overall, the economic recovery will remain robust. Inflation has accelerated across the region, in part owing to base effects (related to higher commodity prices this year) that will fade by early 2022. However, higher input prices due to supply constraints and labor shortages have also contributed to upward price pressures and could last longer. Several central banks in the region have begun monetary tightening through policy rate hikes (Ukraine, Russia, Czechia, Hungary) and the tapering of government bond purchases (Hungary). We expect tightening to continue and expand to further countries, and we forecast inflation to fall back to the countries' respective target ranges in the course of 2022. Yet, the tightening should not imperil the recovery path since monetary policy will remain accommodative overall in the region, especially in the EU member states. Unemployment rates peaked in Q1 2021 and have since gradually fallen. However, they are unlikely to fall back to pre-crisis levels before 2023.

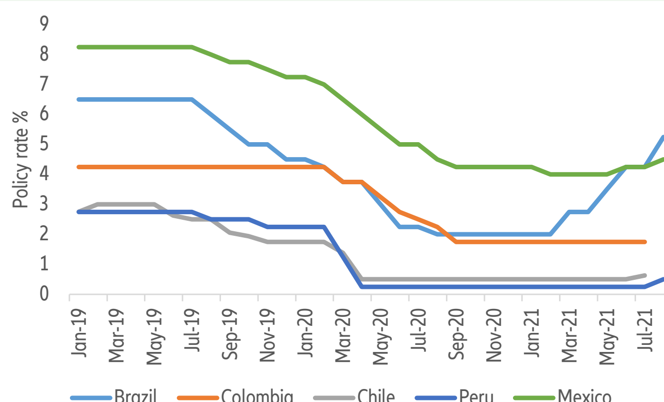
Prompt monetary tightening, deteriorating public finances, fragile growth prospects and rising political instability weigh on the recovery path in Latin America. Rising inflation across the continent and pressures on local currencies have prompted central bankers to tighten monetary policy quicker than initially anticipated. Since the beginning of the year, consumer prices have increased substantially in Latin America, mainly because of higher food and energy prices. The acceleration has been especially marked in Brazil, Mexico and Colombia, although at around 4% in July 2021, the levels remain contained in the latter. As a result, Latin American central bankers, especially in Brazil, were some of the earliest in emerging economies to raise interest rates, and we expect further hikes before the end of the year. Higher borrowing costs will put further strain on already deteriorated public finances in some countries. Fiscal responses to the pandemic were heterogeneous in Latin America, with, for example a substantial stimulus in Brazil widening the deficit to -13.4% of GDP whilst Mexico's conservative approach contained the deficit at -4.6% of GDP. As a result, paths to return to pre-pandemic fiscal stances will diverge substantially and rising borrowing costs will put pressure on countries with wider deficits as they will have to choose between consolidating or deteriorating public debt dynamics. This issue will weigh mostly on countries such as Brazil, Argentina and to a lesser extent Colombia and Mexico, which were already grappling with higher levels of public debt prior to the shock. Limited fiscal space, higher interest rates and political uncertainty in the medium term will exacerbate the fragile growth outlook. In the medium term, key structural measures, such as revamping pension systems or tax reforms, will be key to preserve confidence in some countries' fiscal rules, attract FDI and boost growth prospects. However, they may face backlash in a context of rising political and social tensions. The electoral agenda is heavy in the coming years, with many upcoming legislative or presidential elections that could lead to substantial policy shifts. In addition, high inflation levels and the long-lasting scarring effects of the pandemic have exacerbated inequality, increasing social demands from the fringes of the populations.

Figure 22: Latin America - rising inflation



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 23: Latin America - monetary tightening



Sources: Refinitiv, Euler Hermes, Allianz Research

In Africa, unprecedented fiscal and monetary policy challenges are weighing on the recovery outlook. We expect African GDP to rebound only by +2.9% in 2021 and +3.6% in 2022 in view of slow vaccination progress (less than 10% of the population has received one dose) and limited space for fiscal stimulus. In Q2, South African growth surprised on the upside (+1.2% q/q), mostly driven by buoyant farming and mining activity. At the same time, the unemployment rate reached a record high of 34.5% as these sectors failed to create much-needed new jobs. We expect economic growth in Q3 to be muted, undermined by the ongoing third wave of the pandemic, coupled with a week of violent unrest in July that caused significant economic damage (-0.8pp of GDP). In most African frontier markets, monetary policy is set to play a greater role in supporting the economic recovery because of tight budget conditions. After the unexpected -100bps reduction in May, Ghana's central bank has kept interest rates at a historically low level (13.5%) to help boost bank lending and sustain the economic recovery. On the other hand, the central bank of Angola has had to give in to inflationary pressures and raise policy interest rates by +450bps in Q3. Upward pressures on food and energy prices continue to fuel inflation in Kenya (6.5%) and Ghana (10%), while Nigeria's naira has hit record low levels in the black market in Q3 due to continued foreign liquidity shortages. The Common Framework needs to be tested to tackle debt distress and allow for an economic recovery in debt-ridden African countries. Chinese creditors in Zambia and Ethiopia and private creditors in Chad make it difficult to reach timely and deep enough debt-restructuring agreements. In a context of a fragile socio-economic situation, we identify Nigeria, South Africa, Ethiopia, Guinea, Mozambique and Tunisia as political and social risk hotspots.

The overall outlook for the Middle East region has improved, with real GDP growth forecast at +3% in 2021 and +3.3% in 2022. Oil exporters in particular are expected to gain from higher average global oil prices and the reduction of OPEC+ production cuts. Moreover, most countries in the region are set to benefit from stronger external demand, low rates of new Covid-19 infections, the advanced vaccine rollout and the rollback of lockdown measures. However, geopolitical tensions, pandemic-related uncertainty in the context of the delta or potential new variants, as well as fragile fiscal positions pose downside risks to the outlook. In the GCC economies, markedly worsened fiscal and external positions will be the legacy of the 2020 Covid-19 and oil price crises. Fiscal breakeven oil prices currently standing at above 80 USD/bbl for Oman and Bahrain and above 65 USD/bbl for Saudi Arabia, Kuwait and the UAE will continue to constrain fiscal space and jeopardize the structural reforms needed to move to more diversified economies. Most GCC economies have returned to positive but low inflation after two years of deflationary trends. We expect monetary policy to remain accommodative overall as it usually follows the US Fed due to the currency pegs. Hence, some tightening is likely from 2022 onwards. Meanwhile, still large FX assets, including Sovereign Wealth Funds, held by Kuwait, Saudi Arabia, Qatar and the UAE, provide a buffer against potential external financing disruptions at least until 2025, but Bahrain and Oman are the weak spots in the region and depend on the support and strength of their neighbors in order to avoid default. Meanwhile, Israel is on a strong recovery path, thanks to a broad-based rebound of domestic and external demand, with GDP projected to rise by +6% in 2021 and +3.5% in 2022. In contrast, economic conditions will remain dire in Lebanon, which continues to be adversely affected by ongoing protests, surging inflation and severe shortages of fuel and basic goods, as well as the inability to form a new government.

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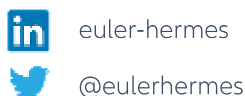

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