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PowerTalks
2021: new dawn?

In the latest PowerTalks, Jim Power gives his personal assessment of the outlook for the Irish and global economy.

The Global Economy

The year that was for the Global Economy

2020 will be remembered as a truly extraordinary year for the global economy and society. At the beginning of the year, there was a widely-held sense of optimism that 2020 would be a better year, following a challenging 2019. This sense of optimism was based on a belief that a 'hard Brexit' would be avoided at the end of January; and that ahead of the US presidential election in November, President Trump would seek to soften his approach to China, and lessen the possibility of a very damaging all-out trade war between the US and China.

By the middle of February, both of those prognostications were looking valid. A 'hard Brexit' was avoided, as the UK left the EU on 31st January and then entered into an 11-month transition period. Furthermore, the US and China adopted a more conciliatory approach to each other and we witnessed some drawback from the trade dispute that had caused so much fear, uncertainty and disruption in 2019.

However, any positive impact from those developments was quickly swept away as the novel coronavirus, COVID-19, first took hold in China and then spread with rapid ferocity across the world. From the moment that COVID-19 was declared a global pandemic in early March, most countries around the world were subjected to varying levels of lockdown and restriction, and this arguably created the most severe economic and humanitarian crisis since the second world war. Unfortunately, as we enter 2021, this crisis is ongoing.

The economic performance of different countries in 2020 was heavily driven by the path of the virus; the structure of the economy, with those countries with a heavy dependence on tourism most adversely affected; and the manner in which the authorities restricted economic and social activity. It is still too early to reach any definitive conclusions about which countries handled the virus best, because the relative performance of different countries has ebbed and flowed. It is probably the case that more authoritarian regimes like China, found it easier to shut down economies and societies, than more libertarian countries like the United States. Even within the United States, the performance from state to state varied. Likewise, across the EU. Other countries such as South Korea and Taiwan had more experience of dealing with such a health crisis, and to date have coped better.

The prospects for 2021

As we move into 2021, there are grounds for greater optimism, once we get through what will be a difficult first quarter as serious restrictions have been put in place to deal with the latest surge in virus infection rates.

Notwithstanding the basis for optimism, the level of uncertainty about the future is still very high. There is no doubt that the outlook for the global economy will be primarily dictated by the path of the virus, and the likelihood of a successful global rollout of safe and effective vaccines. The new strains of the virus that was highlighted in the days leading up to Christmas is obviously a source of concern.

The speed at which the various vaccines are being developed and approved is very impressive. The hope is that the new strain, or indeed any subsequent mutations, will be susceptible to the various vaccines that are being delivered. The early indications are positive in that regard.

If the virus is gradually brought under control in the first half of 2021, the world economy is likely to experience a significant rebound in business investment, global trade, consumer spending, and international travel. In other words, the economic activity that has been artificially put-on hold since the early part of 2020, could

rebound very quickly. There is undoubtedly a high level of pent-up or dormant demand in the global economy – it just needs an excuse to be released.

As we ended 2020 and entered the new year, serious restrictions were being re-imposed all over the world, and this is likely to remain a recurring theme until the vaccines are safely and effectively delivered in sufficient quantities. In other words, the early months of 2021 could be very challenging and uncertain. The various vaccines represent a source of optimism, but there are still considerable grounds for uncertainty, and there is still some distance to go.

Another source of optimism in 2021 is the fact that the very divisive President Trump will be replaced by Joe Biden on 20th January. The platform on which Biden built his 2020 election campaign was titled 'Build Back Better'. This basically revolves around fostering economic recovery; improving infrastructure; bringing broader benefits to lower income communities and minorities; improving education, increase spending on R&D, and the skills of the workforce; and creating a greener economy and society. If delivered, this would be a very positive agenda for the US economy and its very divided and unequal society.

Of perhaps greater relevance is the fact that Biden is likely to have a much more global and internationalist perspective. He is likely to adopt a much more positive approach to global international relations, and particularly to seek to rebuild the somewhat damaged relationship between the US and the EU. The future relationship with China is a different matter, because the more confrontational approach Trump adopted towards China has understandably a high level of popular and political support within the US. One way or another, President Biden is likely to represent relatively good news for global co-operation, global trade, and multilateralism. In addition, he is likely to get the US to re-engage with the climate change agenda, which is absolutely essential.

Notwithstanding the uncertainty around the immediate path of the virus, and the uncertainties around the various vaccines, there are grounds for hope that from a global perspective, 2021 will be a better year. Just before Christmas, the Organisation for Economic Co-operation and Development (OECD) forecast that the global economy would grow by 4.2% in 2021, having contracted by a similar margin in 2020. Basically, the hope is that by the end of 2021, the global economy will be close to where it was prior to the health crisis. This would represent a very good outturn.

The policy environment

On the policy front, one of the potential challenges for policy makers is that if there is a relatively strong rebound in global economic activity later in 2021, and given all of the stimulus that has been injected into the global economic and financial system through very expansionary fiscal policy; aggressive Quantitative Easing (QE); and zero or near-zero official interest rates almost everywhere; inflation could start to pick up.

However, in an environment where Governments everywhere are borrowing and running up significant budget deficits and debt, it is essential that long and short-term borrowing costs are kept as low as possible for as long as possible. In terms of debt sustainability, the last thing the world needs is any uptick in borrowing costs. Central banks will just have to suck it up and accept a bit of much-needed inflation. Whatever way one looks at it, COVID-19 has been deflationary rather than inflationary, and so policy accommodation will be required for the foreseeable future.

It is reassuring that policy makers everywhere seem to recognise that policy will have to remain very accommodative throughout 2021. The Federal Reserve and the ECB have committed to ongoing significant monetary support. On the fiscal side there is still no suggestion virtually anywhere that the time to start restricting fiscal policy is appropriate or near. Indeed, just before Christmas the US Senate voted overwhelmingly to approve a fiscal stimulus package of almost $900 billion (€745 billion), which is the second largest economic relief bill in US history. The biggest was in March. This sort of fiscal reaction is common to many countries around the world, and will have to continue. It represents a totally appropriate counter-cyclical fiscal policy. Many countries will build up significant levels of deficit and debt, but there is no choice in the circumstances. Getting sustainable economic growth back on track as quickly as possible represents the most effective way of bringing public finances back under control. Fiscal austerity must not become a policy option.

The markets

2020 was a roller-coaster year for markets. When COVID-19 was declared a global pandemic in early March, panic ensued briefly and markets fell very heavily in the first half of the month. Then in the third week, markets bottomed out and subsequently made very strong gains.

There have been 27 Bear Markets since the late 1800s, with an average decline of 38 per cent, and once they bottomed out, it took an average of 60 months to reach new highs. Global markets fell by 34 per cent from February into March, but it took just 5 months to hit a record high. As an example of the extent of the rebound, the MSCI Global Index gained 12.2% in November, which is its best month on record.

During 2020, the S&P index gained 14.7%; the German DAX gained 2.5%; the Japanese NIKKEI gained 18.3%; the ISEQ gained 3%; and the UK FTSE 100 lost 15%.

In the circumstances that prevailed during 2020, these market outturns are impressive, with the notable exception of the UK market, which was affected by Brexit uncertainty. The strong performance of global markets has continued into 2021.

The equity market performance has been driven by the aggressive fiscal policy response from governments, and the monetary policy response from central banks, which entailed aggressive quantitative (QE) and historically low official interest rates. In addition, money was easy to borrow and was put into stocks.

In an environment of historically low short and long-term interest rates – which looks set to persist for the foreseeable future – investors are being pushed into equity markets by default. There are few other worthwhile investment options.

Brexit

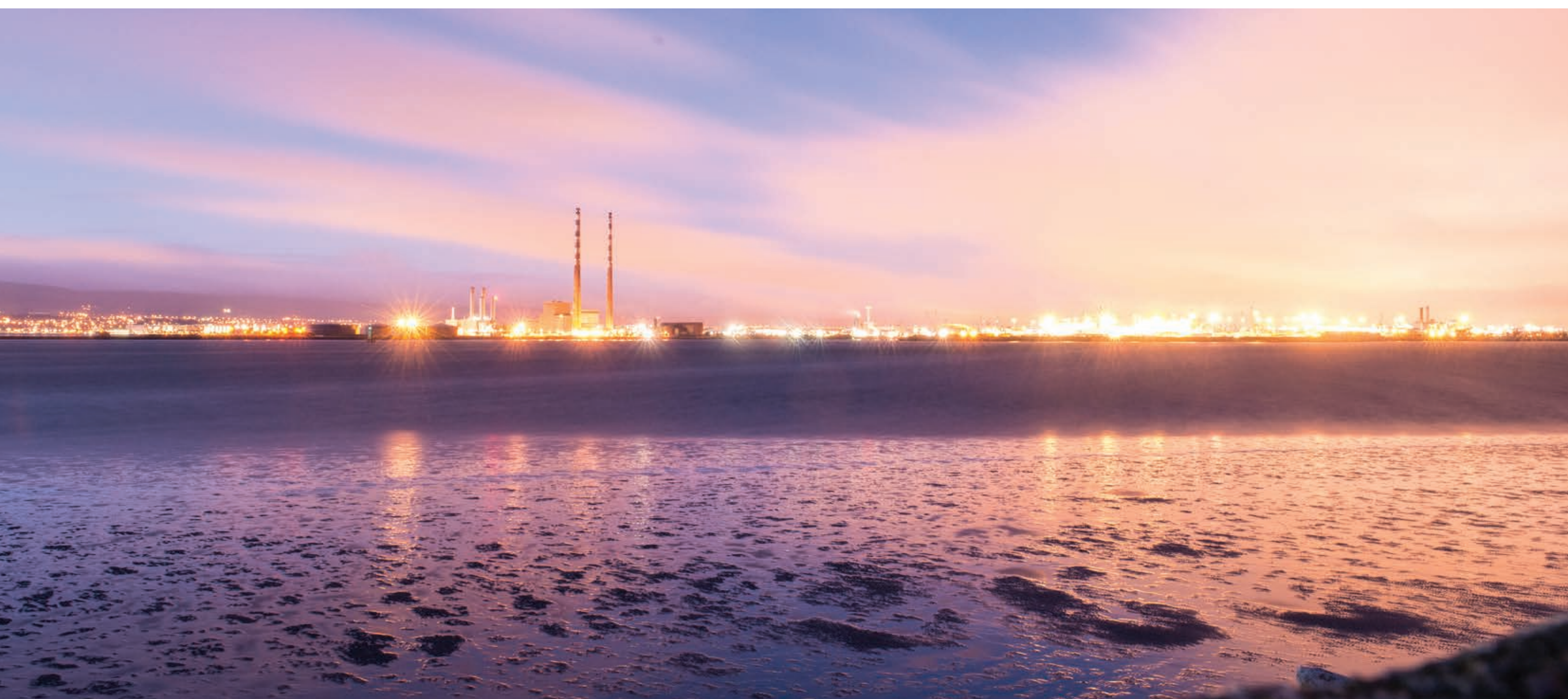
The UK exited the EU transition mechanism on 31st December 2020, thereby formally leaving behind the Single European Market trading environment. Thankfully, on 24th December, a trade deal of sorts was agreed between the EU and the UK, which avoided the so-called 'hard Brexit', and the imposition of a WTO tariff regime that would have ensued in the event of no deal being agreed.

While the most negative 'hard Brexit' scenario was avoided, it must be recognised that the 'bare bones' trade deal agreed will still have significant implications for Ireland's trade relationship with the UK market, which is vital for indigenous Irish SMEs in particular.

The deal agreed relates to goods, with the consequence that tariffs or quotas will not apply to trade in goods between the EU and the UK. However, the UK decision to leave the single market and the customs union, will necessitate border, customs, rules-of-origin, and veterinary checks and controls that will cause delays and increased bureaucracy, and will increase the cost of trade. In addition, the deal does not cover services to any extent.

The UK is now gone from the EU, but the future will be characterised by negotiations and haggling in relation to many aspects of relations between the EU and the UK, which is pretty much the situation between the EU and Switzerland. This implies significant uncertainty ahead on many aspects of the relationship between the EU and the UK.

Brexit as delivered is not good news for Ireland, the EU or the UK, but it could have been considerably worse.



The Irish Economy

Economic performance in 2020

2020 was a very strange year for the Irish economy. In the first nine months of the year, gross domestic product expanded by 3%, and it looks set to be one of only a very few countries globally that is set to deliver positive growth. However, as is always the case, GDP needs to be treated with extreme caution in an Irish context.

Ireland in 2020 was very much a story of two economies. The FDI part of the economy continued to perform very strongly. Exports of Chemicals and Pharmaceuticals expanded by 11.9% in the first 10 months of the year, and accounted for almost 66% of total merchandise exports. This sector along with other parts of the multinational sector provided a very solid base for economic growth, employment, and the public finances.

At a more general level, if one works in the FDI sector, the public sector, professional services, or financial services, then 2020 was a relatively good year financially. However, if one is involved in accommodation and food services, non-essential retail, personal services, or any tourism related activity, then 2020 was a very difficult year.

At the end of December, the total number of persons on the Live Register or Pandemic Unemployment Payment stood at 517,347. This will increase in January as the more stringent Level 5 restrictions impact across many sectors of the economy. This is indicative of the challenge facing policy makers over the coming months in dealing with the stringent restrictions, and later on in trying to restore normality to the labour market.

The Public Finances

The COVID-19 crisis had a serious impact on the public finances in 2020. An Exchequer deficit of €12.3 billion was recorded for the full year, which is a deterioration of €13 billion on the previous year. Total gross voted Government expenditure increased by 26.5%, with health and social protection growing very strongly.

On the revenue side, taxation held up very well in difficult circumstances. Overall tax revenues were down by just 3.6%. The multi-national corporation tax take was very strong, with the overall tax take from the corporate sector increasing by 8.7%. VAT declined by a large 17.8%, reflecting the impact on overall consumer spending. Income tax held up remarkably well, with a decline of just 1%. Given the sharp increase in unemployment as a result of COVID, the income tax take is very resilient. This reflects the fact that lower paid workers in sectors such as accommodation and retail were worst affected by the crisis. On the other hand, workers in sectors such as the FDI sector, the public sector, financial services, and professional services continued to deliver strong earnings during the crisis. In addition, the pandemic payments to employers in respect of employees supported the labour market.

For the full year 2020, the Department of Finance is projecting a General Government Deficit of around €19 billion, equivalent to around 5.5% of GDP. At the beginning of 2020, the Department of Finance was projecting a General Government surplus of around €2.5 billion. COVID-19 has had and continues to have a dramatic impact on the public finances. However, there is nothing that can be done about this, as it is essential that households and businesses are given as much financial support as possible during these extraordinary times, and that spending on health is ramped up as required.

	€ (M)	% OF TOTAL	YEAR-ON-YEAR (%)
Income Tax	22,711	39.7%	-1.0%
VAT	12,424	21.7%	-17.8%
Corporation Tax	11,833	20.7%	+8.7%
Excise	5,448	9.5%	-8.3%
Stamps	2,090	3.7%	+38.0%
Capital Gains Tax	951	1.7%	-11.5%
Capital Acquisitions	494	0.9%	-7.3%
Customs	276	0.5%	-20.9%
Motor Tax	939	1.6%	-2.4%
Total	57,165	100.0%	-3.6%

Source: Department of Finance, Fiscal Monitor, Jan 5th 2021.

The year ahead

Looking ahead to 2021, it is possible to be optimistic, subject of course to all of the same caveats about the mutating virus and the vaccines. The very stringent restrictions in place in January, which could last well into the first quarter, will obviously have a very significant impact on economic activity. There is not a lot that can be done about that. It is necessary to bring infection levels down, but Government will have to continue to provide strong financial support to households and businesses for the foreseeable future. The hope is that an effective vaccine programme will be rolled out as quickly and efficiently as possible, and restore some semblance of normality to the economy and society in the second half of the year.

One of the interesting features of the Irish economy in 2020 was that in the first 11 months of the year, household savings increased by €13.1 billion to reach a record high of almost €123.6 billion. At some stage, most probably later in 2021, much of these savings will be unleashed in the economy, along with pent-up business investment. This should set the scene for a decent rebound in the economy.

The multi-national segment of the economy is also a source of optimism. The end-year results from the IDA show that IDA supported companies increased net employment by 8,944 during 2020 to reach 257,394 jobs in the FDI component of the economy. This is really important in the current challenging environment.

Notwithstanding the current stringent restrictions in place, there are grounds for optimism about Ireland's economic prospects later in 2021. Much of this optimism is obviously contingent on a successful rollout of the vaccine programme. We will also have to mindful of the Brexit impact, and the fact that it will take some time for tourism-related activities to recover. Businesses in these areas will need to get as much ongoing financial support as possible. Apart from the evolving COVID-19 situation and the implications for the health service, housing is likely to dominate political discourse, as it should.

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Economist

The views expressed in this article reflect those of Jim Power and are for informational purposes only. They do not represent the views of Aviva. Jim Power's views may change.

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