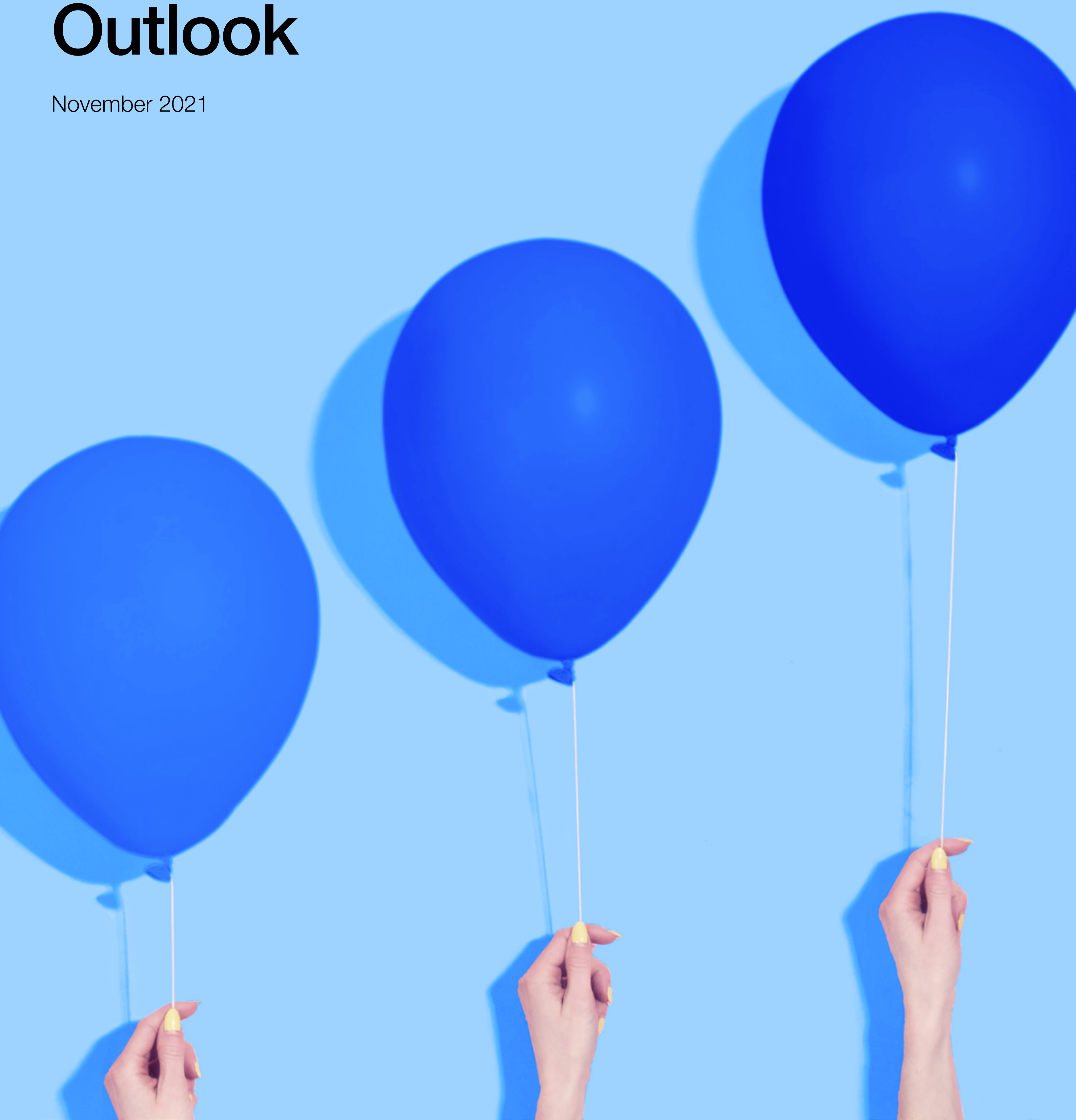
Centre for the New Economy and Society

Chief Economists Outlook

November 2021



Chief Economists Outlook

November 2021

This quarterly briefing builds on the latest policy research as well as consultations and surveys with leading Chief Economists from both the public and private sectors, organized by the World Economic Forum's Centre for the New Economy and Society.

It aims to summarize the emerging contours of the current economic environment and identify priorities for further action by policy-makers and business leaders in response to the global economic crisis triggered by the COVID-19 pandemic.

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Cover: UNSPLASH/Amy Shamblen

1. Monitoring fragilities

As we publish the November Chief Economists Outlook, COVID-19 is resurging in some parts of the world, the global economy still finds itself in major disequilibrium and the costs of fighting climate change are starting to come into view.

While a one-size-fits-all approach to fiscal and monetary policy was optimal across economies in the early stages of the pandemic, the ensuing disruption has evolved in such disparate ways across global markets and economies that national-level policy tools can no longer address the current challenges in homogeneous ways. Instead, policy-makers are faced with complex domestic and international trade-offs in their policy choices, with one exception: accelerating vaccinations.

The deepest fault line has emerged between economies with vaccine access and fiscal support and those without. Limited vaccine access is still forcing prolonged lockdowns and deepening the health toll in some parts of the world, while lack of fiscal resources is exacerbating economic and social scars from bankruptcies and unemployment. Workers and businesses in economies with large informal sectors have been particularly hard hit. Almost one year after vaccination campaigns began, only 3.7% of the population in low-income countries have received at least one dose versus 61% of the population in high-income countries.[1] Until the pandemic has been conquered everywhere, there continue to be major risks from the virus trajectory and therefore the global economic recovery for all.

On account of such a new, more aggressive variant that spread rapidly across the world, growth forecasts had to be revised downwards in the latest projections. The distribution of projections by Chief Economist Survey respondents has also shifted downward since the June edition and uncertainty has increased.[2] The IMF predicts 5.9% global growth for this year, down from 6% (with some major downward adjustments for individual countries); the OECD revised its 2021 forecasts down to 5.7% in its September Interim Outlook.[3]

Beyond the virus trajectory, the top risks to the recovery have started to change from a feared delayed wave of bankruptcies to policy mistakes in managing evolving inflation dynamics, especially the repercussions on financial markets in emerging economies.

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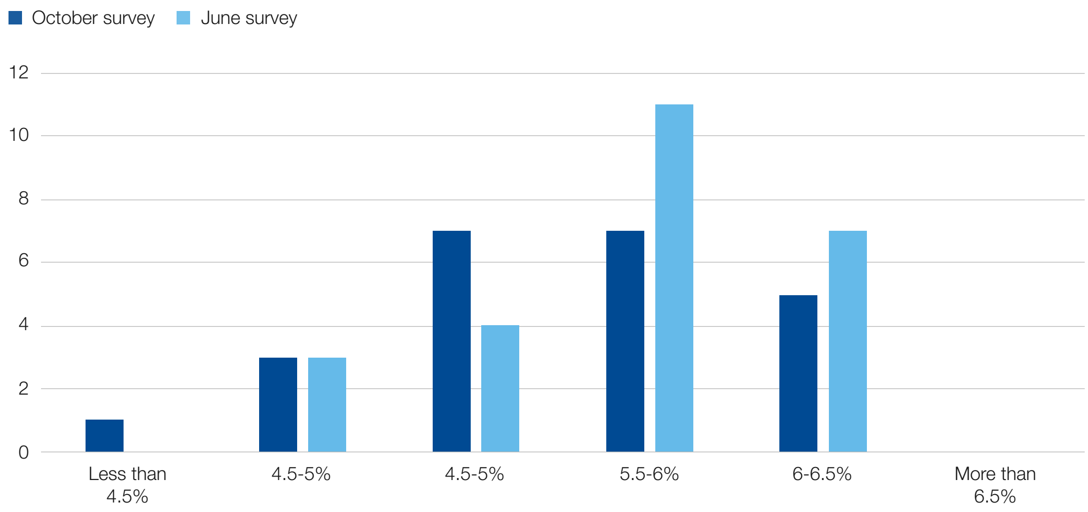
1 UNDP, data as of 6 October 2021.
2 World Economic Forum, 2021.
3 IMF, 2021; OECD, 2021a.

What is your global growth forecast for 2021?



Source: Chief Economists Survey, October 2021

Bankruptcies

Earlier this year, as noted in our June Outlook, potential sources of risk that might derail the recovery, but for which little data was available at the time, included a delayed wave of bankruptcies. At the same time, there was a fear that an overextension of government support would keep unviable firms artificially alive.

Five months on, there is new evidence on the number of bankruptcies and the effect in advanced economies of fiscal policy in containing the worst of the fallout. Recent empirical work suggests that fiscal measures were successful in treading the fine line between averting both bankruptcies and zombification of firms.[4] For small and medium-sized enterprises (SMEs), where the risk of failure was highest, the study finds that failure rates of SMEs increased by 4.3 percentage points, when they would have increased by 9 percentage points without government support (significantly more so in emerging markets). In advanced economies the failure rate even decreased. The counterfactual for business failures in 2021 without policy support further suggests that failures would have been only marginally higher than they were this year, implying that the initial emergency support did not lead to significant zombification of firms. Overall, the effect of stimulus packages was found to be concentrated on the domestic economy, with few positive spillovers internationally.

Even though the feared wave of bankruptcies has so far not materialized, and projections suggest that the number of failed firms being kept artificially alive is low, some central banks are said to be preparing additional backstops in the form of bond-buying programmes to safeguard against any potential troubles and further reduce the risk of a failed phase-out of emergency measures.[5]

4 Gourinchas et al., 2021.
5 Bloomberg, 2021.

Inflation

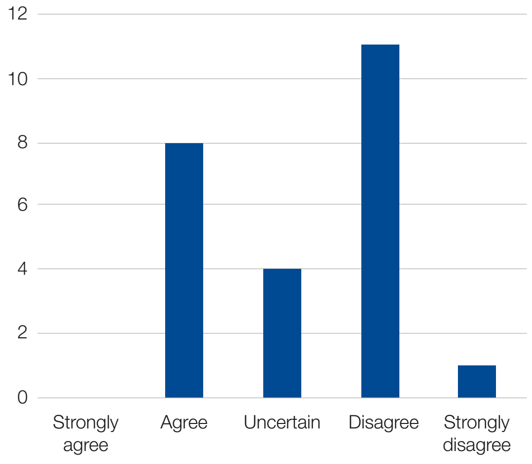
Price surges have emerged in many sectors of the economy, and the multiplicity of causes has led to diverging views on the most likely trajectory for inflation. There is disagreement over several dimensions of the evolving dynamics, which makes it challenging to find the optimal policy responses. Open questions include: (1) to what extent prices are driven by too much demand vs. rising costs (overheating vs. stagflation); (2) whether prices in isolated markets or the general price level are rising; and (3) how inflation expectations are likely to evolve.

Overheating or stagflation in advanced economies? Views among survey respondents are very much divided as to whether the greater risk in advanced economies is too much demand, leading to overheating, or rapidly rising costs on the supply side, leading to stagflation – increasing prices with simultaneously slower growth. Aggregate savings went up in most OECD countries over the course of the pandemic for various reasons, including build-up of precautionary savings, fewer opportunities to spend and non-targeted stimulus payments.

Similarly, in the corporate sector, companies built up large cash reserves. For larger firms, loose monetary policy and fiscal stimulus spending has led to unprecedented profit margins: in the US, the S&P 500 average operating margin is close to 13.55% in Q3 2021, up from 6% in 2020 and close to 3 percentage points higher than in Q4 2019.[6] Spending this household and corporate cash too quickly as economies fully reopen could lead to overheating.

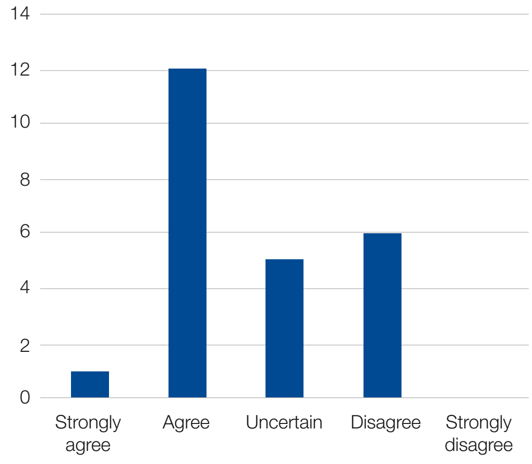
At the same time, costs have been rising with high pass-through rates to consumers. While some supply-side bottlenecks have been limited to specific markets, others affect a wide range of goods. First and foremost among the latter have been transport and shipping, as well as energy. Should these dynamics persist, there is a risk that they will choke off the recovery.

Overheating is currently a higher risk than stagflation in advanced economies.



Source: Chief Economists Survey, October 2021

The current situation is one of price increases in specific product markets rather than one of general inflation.



Source: Chief Economists Survey, October 2021

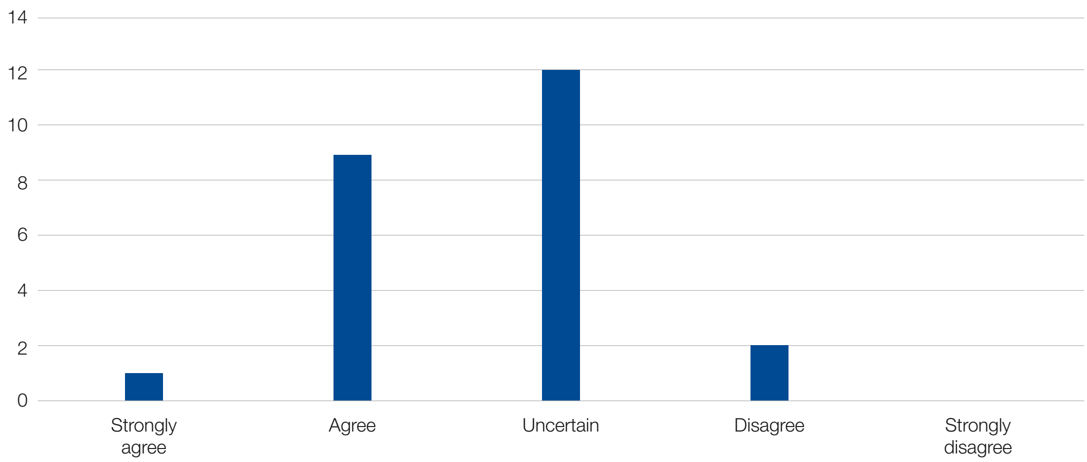
6 Armstrong, 2021.

Isolated price pressures or general inflation? Another point of contention among experts is whether we are seeing a general rise in the overall price level or whether price pressures are contained within specific product markets. Again, 2021 has had elements of both. The world economy is still marked by a multiplicity of disequilibria, which have been due to both supply and demand shocks. At the same time, there have been price surges in some important input markets, in particular energy, which could affect overall price levels and trigger wage-price spirals if they persist.

Whether or not isolated price rises will become general inflation will to an important extent depend on expectations. A number of survey respondents believe that inflation expectations will indeed remain anchored at around 2% (at least in countries with no recent hyperinflation experience), yet the majority are uncertain.

One important reason why inflation expectations have stayed anchored so far is the reputation independent central banks have built up over the years for sticking to their mandate of price stability. The June Chief Economists Survey confirmed the expectation that major central banks will continue to prioritize price stability, despite the addition of new mandates on employment and climate change for some.[7] Indeed, several central banks have started raising rates in response to price dynamics, including New Zealand,[8] Norway,[9] Brazil and Russia. In lower- and middle-income countries with less central bank credibility and less anchored inflation expectations, however, price pressures have been building more quickly and are at a greater risk of getting out of hand.[10]

Inflation expectations will remain anchored around 2% despite an intermittent period of higher inflation.



Source: Chief Economists Survey, October 2021

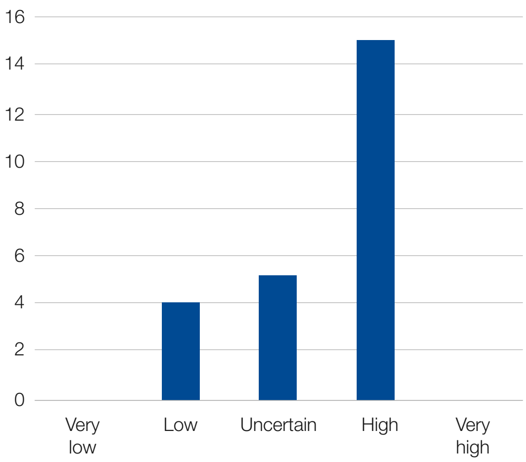
7 World Economic Forum, 2021.
8 BBC, 2021.
9 Reuters, 2021.
10 The Economist, 2021

Global financial market risks

As central banks in advanced economies, in particular the US Federal Reserve, are starting to tighten monetary conditions, the risk that such policy action triggers crises in low- and middle-income countries rises. Currencies weaken, creating even more inflationary pressures while making it harder to pay back dollar-denominated debt. In addition, current fluctuations in food and energy prices are hurting households more, since the latter take up a larger share of consumption baskets. This is an even bigger problem for countries that are net importers of food and energy. Overall, the growth outlook for emerging markets is weak. IMF projections suggest that the group of emerging and developing economies (excluding China) will still be 5.5% below the pre-COVID growth trend in 2024, while advanced economies are expected to be 0.9% above trend on average.[11] The majority of survey respondents regard the risk of capital outflows from emerging markets to be high, and especially so in markets where macroeconomic fundamentals are unsound.

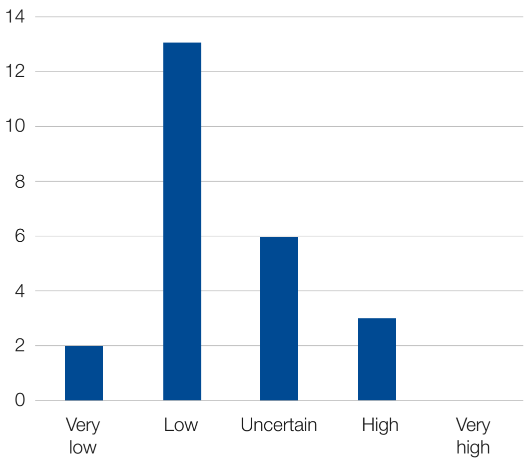
On the other hand, recent jitters in China's real-estate sector triggered by bond defaults of some major corporates are seen as less worrying for the global economy. The situation is assessed by survey respondents as one that can be resolved by domestic policy and that carries a low risk of international contagion.

The capital flow reversal risk for emerging markets is currently:



Source: Chief Economists Survey, October 2021

The risk of global contagion resulting from increasing default rates of China's corporate bond market is currently:



Source: Chief Economists Survey, October 2021

11 IMF, 2021.

2. Disentangling disruption from trends: the outlook for prices, wages and globalization

A number of powerful forces are pulling the global economy in different directions and seem to be reversing, at least for a brief post-crisis moment, long-standing patterns such as deflationary trends, a declining labour share of income and global integration. The question on many observers' minds is: how long will this last? Are we seeing true trend reversals or are inflation, labour shortages, wage increases and global disruption momentary phenomena marking the aftermath of one of the deepest economic crises of the past 100 years? Survey responses point to a wide mix of competing forces that are shaping post-COVID-19 dynamics.

The outlook for prices

Since the first upticks in inflation started appearing in price indices earlier this year, views have shifted from seeing such developments as a short episode to realizing that the green transition in particular could become a driver of long-term impacts on price levels.

Price pressures have arisen from sources as varied as pent-up demand, changes in behavioural patterns due to COVID-19 (in particular for goods enabling the digital economy), stimulus spending, shortages in building materials, supply disruptions due to renewed lockdowns and reduced shipping capacities or simply base effects. Products and services that have suffered such temporary price surges have included used cars, lumber and container shipping.[12] Lumber prices, for example, surged in the spring, but just as rapidly dropped back to their pre-pandemic levels over the course of June and July. A number of survey respondents further place energy price hikes in the temporary category.

In other cases, prices may be rising in the longer term. For some products, survey respondents expect longer-lasting supply pressures – for example, in the case of semiconductors and microchips as more of the global economy moves online. Secondly, the green transition can be expected to add resource and production costs to prices across the economy. Energy costs will have to increase by design and are expected to stay elevated while it takes time for demand to shift, renewables supply to expand and productivity gains from green investments and technology to come through. Some respondents also expect increases in housing prices as well as rent inflation to be longer-term phenomena. In addition, greater

12 Tooze, 2021.

protectionism can be expected to be a driver of inflationary pressures as can wages. The dynamics of the latter are discussed in more detail below.

On balance, survey respondents expect current levels of inflation to be a short-term phenomenon over the next 1–2 years, with the caveat that energy and housing prices might be on an upward trend for longer (but less steep than recent energy price hikes). Overall, there is confidence that central banks will remain determined and able to keep inflation in check.[13]

The outlook for wages

The COVID-19 crisis, together with evolving long-term trends, is shifting employees' bargaining power and has been lifting the wages of different groups of workers. More generous unemployment benefits and better protection for gig workers (e.g. in the US) have allowed low-paid service-sector workers to insist on decent pay as hospitality and retail businesses have started to rehire. Reservation wages (the lowest wage at which a person would accept employment) seem to be staying higher, even as unemployment support is being phased out. Many service-sector jobs remain unfilled to date, even though unemployment rates are still higher than before the crisis. In some cases, new immigration restrictions are contributing to labour shortages in the service sector.

In a different part of the economy, accelerating trends such as further digitalization and the net-zero transition are rapidly shifting skills demands while systems have not yet adapted to providing the right reskilling and upskilling opportunities. This has led to a war for talent, in particular in green and digital skills, which is driving up wages.[14] Wage pressures are thus forming across low- and high-skilled occupations, which are both experiencing labour shortages. Demographics in many advanced economies can be expected to be a compounding force.

New evidence is also emerging that productivity has been picking up post-crisis as companies have streamlined processes during the crisis and are battling post-COVID-19 labour shortages with more automation.[15] In addition, the pandemic appears to have led to workers moving from lower-tech, low-productivity firms to tech-savvy, high-productivity firms, which were able to expand during the crisis.[16] Projections for the US are 2% of total factor productivity growth in 2021 as opposed to close to 0% annual growth for the decade before the crisis.[17] OECD forecasts confirm a pick-up in labour productivity growth across high-income countries.[18] If this is indeed the case, workers will be able to bargain for a larger share of a growing pie as productivity is up and firms are competing for talent.

An upward pressure that will not bring gains in real wages to workers could be arising from de-anchored inflation expectations in economies with recent inflation experience.

At the same time, the automation of tasks that accelerated during the crisis will continue to put downward pressure on the wages of the middle-skilled workers it is (in

13 See also World Economic Forum, 2021.
14 Kimbrough, 2021a and 2021b.
15 Sandbu, 2021.
16 Andrews et al., 2021.
17 Ozyildirim and de Vries, 2021.
18 OECD, 2021b.

some cases partially) replacing.[19] In addition, the realization that some tasks can be done remotely with the same level of productivity will increase global competition for certain jobs. Shifts in activity away from certain sectors (e.g. business travel) will also lead to downward wage pressures. Overall, some strong forces curtailing workers' bargaining power remain.

Survey respondents in the majority see wage gains as a short- to medium-term phenomenon that is a welcome development in the battle against inequality, yet that may weaken in the longer term as automation and global competition for local jobs again dominate bargaining dynamics.

The outlook for global economic integration

Global integration is being pulled in many directions. As multilateralism and economic coordination are seeing a revival, economic linkages on the ground are fragmenting. Some of the fragmentation is expected to remain temporary and closely related to the crisis, yet other forces might drive disintegration in the longer term.

Global value chains: Global value chains have been experiencing a series of disruptions, beginning with emergency shutdowns and border closures and continuing with raw material and intermediate input shortages, staff shortages, missing containers and ships, and congested ports. Many of these bottlenecks should clear up as pent-up demand eases, lockdowns are lifted, workers return and ports become decongested.

There are also, however, forces likely to continue eating away at global integration via value-chain linkages in the longer term. Resilience considerations will be increasingly reflected in new production networks in the form of parallel supply chains (a "just in case" replacing the "just in time" production logic). Secondly, driven by much-needed environmental policy, production may be moved closer to markets to avoid more expensive shipping. Lastly, governments may be tempted to resort to protectionist measures in order to alleviate domestic pressures and geopolitical risks, driving fragmentation in supply chains for strategic industries such as semiconductors, electric vehicles, pharmaceuticals, microchips and batteries.

Geopolitics: Survey respondents expect to see continued rivalry between the US and China in the realm of technology developments and the further build-out of two competing tech hubs (and more generally between China and other Asian economies). Schisms in values between China, the US and Europe are expected to become increasingly apparent in a data-driven economy where issues of privacy and data ownership predominate.

At the same time, there is still demand for greater global integration, in particular from low- and middle-income countries. Business logic is further expected to continue to fall on the side of integration both on the production side and the market-access side. Global integration will to an important extent be helped by the progressing digitalization of working arrangements (allowing for greater integration of services industries) and platform-based distribution channels. The lockdowns of 2020 revolutionized working arrangements in white-collar industries by removing physical and psychological barriers to working in different locations and asynchronously. On the consumption side, it is hoped that digital

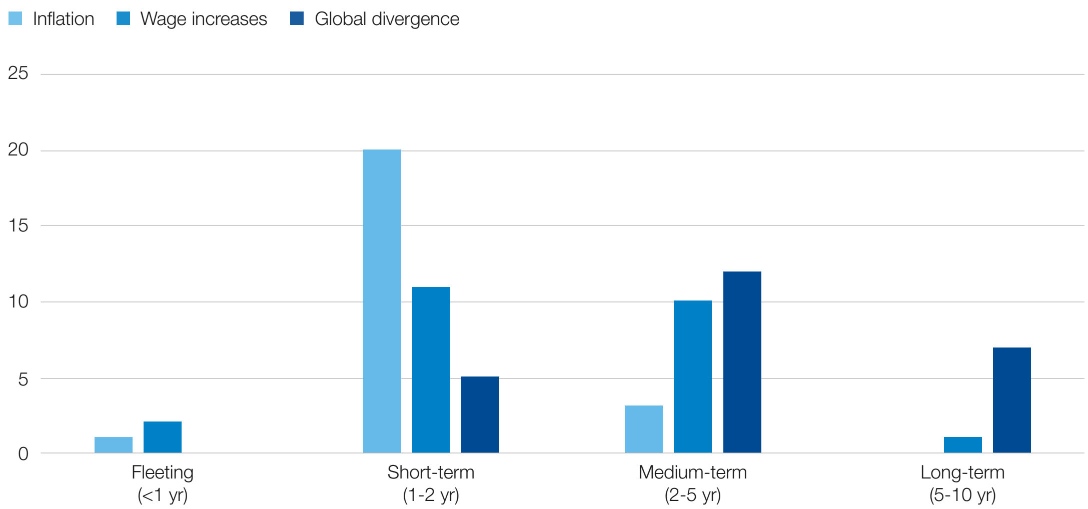
19 Autor and Salomons, 2018; Egglestone et al., 2021.

platforms will continue to drive integration by providing smaller firms with access to global markets. It was also pointed out that we are seeing a re-emerging interest in joining regional trade agreements, such as the Regional Comprehensive Economic Partnership (RCEP) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

When it comes to restoring the global economy to a functioning system, the first order of business will need to be finding a global approach to vaccine distribution. Failure to do so will be a major centrifugal force working against global integration. A multilateral approach to vaccine and recovery financing will go a long way towards stitching the global economy back together. Looking further into the future, nothing less than the survival of the planet will depend on global cooperation and coordination.

On balance, survey respondents view global fragmentation as a medium-term phenomenon, with the expectation and hope that the global challenges humanity is facing will eventually focus minds and force the adoption of a global mindset.

On balance, are the below dynamics more temporary or more permanent?



Source: Chief Economists Survey, October 2021

3. The outlook for policy

Managing inflation

There is a strong consensus that monetary and fiscal policy worked well together in advanced economies to soften the economic impact of the pandemic. Drawing on the lessons of the Global Financial Crisis in 2008–2009, governments acted swiftly to provide liquidity to markets and emergency funding to households and businesses. To different degrees, governments have been taking advantage of the opportunity to put their economies on a more sustainable and inclusive track, earmarking parts of the stimulus packages for more green and social spending.[20]

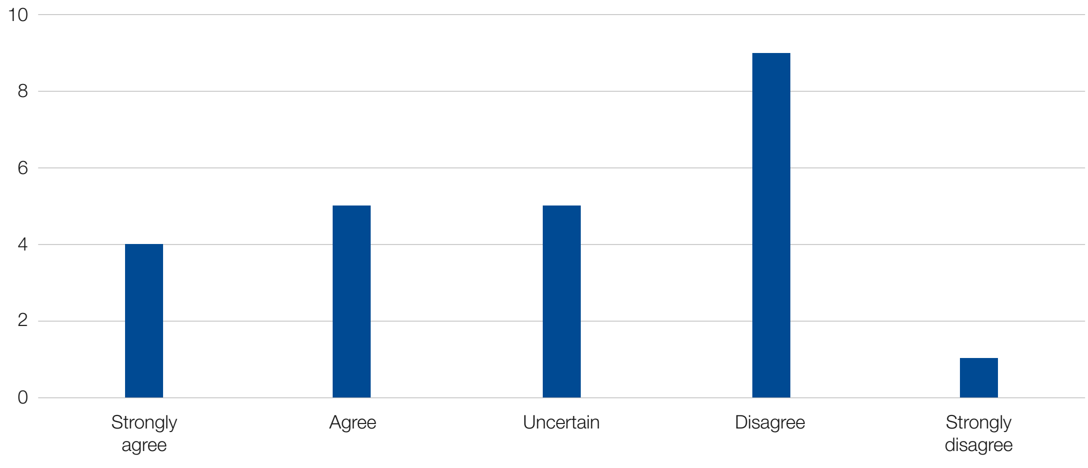
Monetary policy has been playing an accommodative role all along and worries about debt sustainability in advanced economies had all but disappeared in 2020, with interest rates close to zero. Yet the threat of inflation becoming entrenched is putting central banks in the situation of having to cool down price pressures while not abruptly choking off the recovery. While central banks' inflation-fighting credentials are still strong, there is a question about how potent monetary policy will be in dampening the mix of price pressures currently putting stress on the global economy.

Views among survey respondents on this question are very divided, with equal numbers (strongly) agreeing and (strongly) disagreeing on the statement that "monetary policy is an effective tool to deal with current price surges".

Should it turn out to be the case that overheating is the most important force driving inflation, monetary policy would indeed be the most effective tool to combat it. There are, however, also the elements of temporary disequilibria, including supply and shipping bottlenecks, as well as longer-term factors – such as the additional costs imposed by a green transition and fragmentation of global markets – that are driving price developments. In these cases, the best response seems to be a mix of rapid vaccine distribution to end lockdowns (and hence supply bottlenecks), protecting global integration by means of trade policy, and ensuring that price pressures arising from the green transition are borne by those who can most afford it. It was also pointed out, though, that there may be a case for normalizing monetary policy in order to rebuild resilience and policy space for future crises.

20 See World Economic Forum, 2021, for a discussion.

Monetary policy is the most effective tool to deal with current price surges.



Source: Chief Economists Survey, October 2021

Global coordination

Restoring international convergence will need to become a priority for multilateral action.

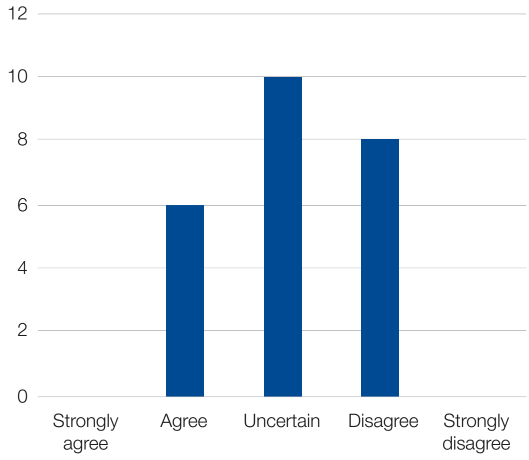
Recovery financing: In order to deal with the immediate aftermath of the global economic crisis and end the pandemic first and foremost, the IMF has proposed a $50 billion package to finance vaccine distribution to the poorest countries. In addition, there has been a reallocation of IMF Special Drawing Rights to low- and middle-income countries in order to support the crisis recovery. Despite this, expectations among survey respondents are divided over whether sufficient financing can be raised to rapidly end the pandemic everywhere. Other channels for international convergence will need to play an equally important role.

Global tax coordination: The OECD deal on a minimum level of corporate taxation for multinational enterprises (MNEs) represents a historical moment in global fiscal coordination, with 136 countries agreeing to a minimum global tax rate of 15%. The hope is that this will protect and boost countries' sources of revenue. Yet some observers have pointed out that the deal could be adapted to allow low- and middle-income countries to collect a greater share of the global tax take. A recent study, for example, has shown that gains in tax revenues for East Asian countries are negligible under the new deal.[21] The majority of survey respondents are uncertain as to whether it will be possible to make the recent deal a stronger force for convergence in the future. Yet a number do see room for such improvements.

Trade policy: Furthermore, global trade integration will continue to play an important role in fostering convergence across countries of different income levels. This will, however, increasingly require trade-offs with environmental goals and the desire to achieve greater resilience in value chains by bringing production closer to the final markets. However, there is an

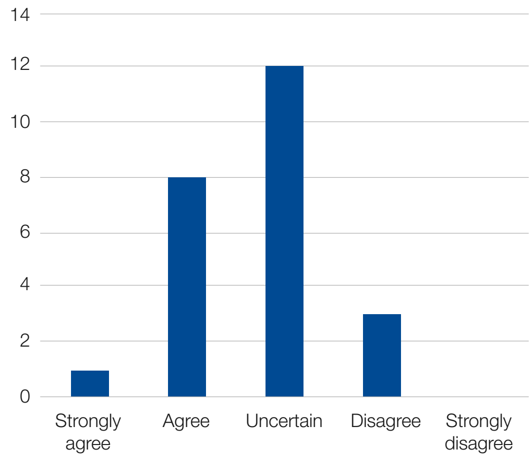
21 Dabla-Norris et al., 2021.

There is cause for optimism that sufficient financing will be raised to end the pandemic and narrow the global recovery divide (e.g. through reallocation of SDRs).



Source: Chief Economists Survey, October 2021

There is room to make the recent global corporate tax deal a stronger force for global economic convergence.



Source: Chief Economists Survey, October 2021

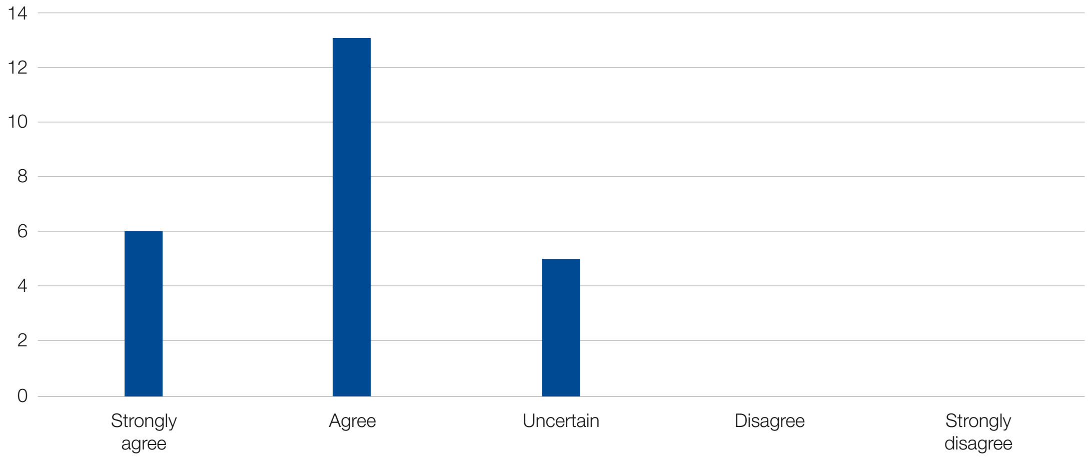
opportunity in the climate challenge to build a solution based on global cooperation and comparative advantage in tackling different parts of the problem.

Embedding the green transition: As this Outlook is published, leaders are gathering in Glasgow for the 2021 United Nations Climate Change Conference (COP26) to negotiate more stringent commitments on the road to net-zero carbon emissions. The latest report of the IPCC presented the strongest empirical evidence to date on the urgency of the situation.[22]

There is by now a strong consensus among experts that a carbon tax is the most efficient instrument to shift economies towards greater carbon neutrality, at least in theory. Indeed, the June edition of the Outlook showed wide agreement on this question among community members. However, implementation of such a price at the level and regional scope required to keep global warming below 2ºC is much less obvious. A majority of survey respondents believe that political economy obstacles are significant.

22 Intergovernmental Panel on Climate Change, 2021.

Political-economy forces will make it difficult to implement a carbon price of the level and coverage needed to keep global warming below 2°C.



Source: Chief Economists Survey, October 2021

The likelihood of achieving a realistic global price for carbon in the next few years seems low. For the immediate future, individual countries and regions will need to pioneer and drive domestic initiatives, combining forces where they can. Investors must play an important role in maintaining pressure for change.

It will be up to governments to give direction, develop taxonomies that can be replicated across borders, provide finance in a way that can be leveraged by the private sector and further encourage carbon trading. There is further a need for strong cooperation between the US and China across the entire spectrum of green transition issues.

Complementary reforms alleviating the impact of energy prices on poorer households with targeted policies will be critical. In economies where the trust in government to compensate vulnerable stakeholders is low, however, opposition is expected to be strong.

In addition, complementary policies will be needed to strengthen resilience (e.g. protecting biodiversity), even where they cannot directly reduce global warming.

Reflections on policy lessons from 2021

As 2021 is drawing to a close, we also asked the members of the Chief Economists Community for their biggest policy lessons of this second pandemic year. Responses covered a wide range of policy areas, from financial to social to public health, and highlighted the close interlinkages between them.

1. Fiscal and monetary policy are powerful allies when combined within a strong institutional framework.
2. It has proven easier to support demand than to restore supply, yet mechanisms for targeting fiscal support effectively are still lacking.
3. Short-term crises can be handled by government intervention, setting normal market forces aside; this is looking a lot more challenging for long-term crises.
4. Protecting the social fabric during crises has tremendous positive pay-offs for the subsequent recovery.
5. Digitalization can play a key role in helping vulnerable groups, such as small businesses and less educated workers, get back on their feet if policy-makers can tackle barriers to digital adoption.
6. Emerging market economies need better social safety nets and, first and foremost, data on vulnerable segments of the population.
7. Public health is an economic issue, and COVID-19 is the principal determinant of the recovery. Therefore, virus suppression should be a primary economic policy.
8. Effective public health strategies are very difficult to implement in the face of political polarization.
9. In emergencies, countries retreat to national self-interest (here, on vaccine distribution), but globalization and multilateralism are more alive than is commonly portrayed.
10. Successful public-private partnership models of the kind realized for vaccine development need to be better leveraged and deployed across borders for other global challenges such as the green transition.

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