

January 25, 2021

# GLOBAL ECONOMIC HIGHLIGHTS

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## ECB on Hold in January Amid Second Eurozone Downturn; a Global Double-Dip Recession Could Be Underway

**EUROZONE:** The Eurozone is one of between three and five major economies that are contracting in early 2021, the others being the United Kingdom, Canada, Brazil, and possibly Japan. Collectively these economies are about a quarter of global GDP valued at market exchange rates. The U.S. economy also may contract in early 2021 but its contraction should be short-lived, given the boost of the December round of fiscal stimulus, and the boost to sentiment from vaccine distribution and expectations of even more stimulus later in 2021. Even so, with a significant portion of the global economy already contracting, the risk of a global double-dip recession is elevated in early 2021.

January's early indicators confirm the Eurozone's contraction. The Markit services and manufacturing PMIs for the Eurozone both fell in the January flash releases, to 47.5 from 49.1 and to 54.7 from 55.2, respectively. The European Central Bank likewise warned that the Eurozone's economy contracted in the fourth quarter of 2020 and likely continues to contract in early 2021 at their January 21 Governing Council decision. Despite this contraction, the ECB saw fewer downside risks to the 2021 to 23 growth outlook in January than they did at their December monetary policy decision, due to vaccine distribution and Brexit's resolution—while Brexit is a headwind to EU-UK trade, Brexit without a trade deal could have been much worse. The ECB's economic outlook is essentially unchanged from December 2020 when they last published formal forecasts, which anticipated a slow multi-year recovery from the 2020 crisis, during which inflation would average markedly below the ECB's target of below-but-near 2 percent.

The ECB's monetary stance stayed unchanged in January as virtually assured following December's increase in stimulus. They held the benchmark negative deposit rate steady at -0.5%. The ECB will continue to purchase up to €1,850bn euros in assets under its Pandemic Emergency Purchase Program or PEPP, the name for their crisis QE program, at least until the end of March 2022 "and in any case until the Governing Council judges that the coronavirus crisis phase is over"; the ECB increased the budget or "envelope" for the program by €500 billion euros at the December decision. However, the ECB does not commit to use the PEPP's entire €1.85 trillion budget; if financial conditions stay supportive of growth without the ECB using the full amount, they could use less. "Equally," they may expand the program if conditions worsen again. The ECB will continue to use its other unconventional monetary stimulus tools as well. These include PELTROs, negative-rate loans the ECB makes to Eurozone commercial banks, and the APP, an open-ended QE program that buys €20 billion euros of assets per month on top of the emergency QE program. The open-ended program will continue after emergency QE ends, and stay active until shortly before the ECB raises benchmark interest rates, which would presumably be once headline and core inflation get back to their target of below but near two percent.

The ECB reiterated that they are closely monitoring the exchange rate. The euro appreciated to the strongest since early 2018 in late 2020 as rising U.S. inflation expectations pushed down ex-ante real U.S. interest rates and weakened the U.S. dollar. But the ECB's exchange rate jawboning is an empty threat: German central bankers are highly resistant to more accommodative monetary policy, setting an extremely high bar for the ECB to use monetary policy to push back against a strong euro.

The ECB serves as a cautionary tale for the Federal Reserve and U.S., where multi-year economic and interest rate trends are tracking the euro area's but are not yet as far along. Inflation slipped below the ECB's target in

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the mid-2010s, and since then the ECB has found it devilishly difficult to raise inflation back to target. This was even true before the crisis struck, when the Eurozone economy was relatively strong. The Eurozone economy now generates much less inflationary pressure than twenty years ago. Most of its labor force growth is among older and part-time workers, who receive smaller raises than younger workers. Several Eurozone member states deregulated labor markets after the 2011 to 2013 sovereign debt crisis, weakening workers' power to command wage increases and create inflation. And manufacturing employment is stagnant, lessening pressure on service sector employers to raise wages and compete for workers the way they did in the 20th century. The ECB is trapped in extremely accommodative monetary policy with no visible prospect of a return to the old normal. This problem is much more common for central banks in developed countries than inflation, and affects not just the Eurozone but also Japan and now the UK. If the U.S.'s future is like the Eurozone's present, inflation undershooting the Fed's target in coming years and prolonging the current low-rate environment is a larger risk than inflation overshooting the target.

**UNITED KINGDOM:** The UK is back in a double-dip recession. The Markit/CIPS services PMI for the UK plunged to 38.8 in the January flash estimate from 49.4 in December, and the manufacturing PMI fell to 52.9 from 57.5. The economy's second contraction began in November, when real GDP fell 2.6% from October. January's drop in services activity is principally due to the second lockdown imposed by the British government January 5 to control the more infectious coronavirus strain spreading in the UK; Brexit is a secondary and much smaller contributor to the downturn, through increased tariffs, costs and delays caused by customs clearance, and related supply chain disruptions.

**CANADA:** The Bank of Canada announced at its January 20 monetary policy statement that it expects the Canadian economy to contract "roughly 2½ percent" in the first quarter of 2021 due to renewed restrictions on activity in response to the winter coronavirus surge. At the same time, like the European Central Bank the Bank of Canada is more confident about "the prospects for a strong, sustained recovery through the second half of this year" as vaccines allow the economy to reopen. The BoC is so confident they are starting to discuss tapering their QE program: "If the economy and inflation play out broadly in line or stronger than we projected, then the amount of quantitative easing (QE) stimulus needed will diminish over time." The Bank of Canada could taper QE in the second half of 2021 if vaccine distribution proceeds quickly.

**BRAZIL:** Brazilian consumer spending is likely to contract in early 2021 due to the expiry of emergency cash transfers to households which expired at the end of 2020; Brazil's weak sovereign credit rating gives it less latitude to finance fiscal stimulus than developed countries. The Central Bank of Brazil held its policy Selic rate unchanged at 2.0 percent as expected at its January 20 monetary policy decision.

**JAPAN:** The Jibun Bank services PMI for Japan fell to 45.7 in the January flash release from 47.7 in December, and the manufacturing PMI dipped to 49.7 from 50.0. The PMIs are not so low to be sure the Japanese economy is contracting in the first quarter of 2021, but the risk has sharply increased since the Tokyo area entered a state of emergency on January 7.

As expected, the Bank of Japan held its monetary stance unchanged at its January 21 Policy Board decision. The short-term policy rate remains -0.1%, the target for the 10-year government bond yield zero percent, and purchases of ETFs and REITs continue at unchanged rates. The BoJ modestly revised down their forecast of growth in the April 2020 to March 2021 fiscal year (fiscal 2020), with larger upward revisions to growth in the 2021 fiscal year. The BoJ forecasts for CPI inflation excluding fresh food to average under 1 percent through the end of the 2022 fiscal year, seriously undershooting their 2 percent target.

**UNITED STATES:** Bucking the trend of other developed economies, the flash estimates of the Markit manufacturing and services PMIs for the U.S. rose in January from December. The manufacturing PMI rose to 59.1 from 57.1 and was the strongest since the survey began in 2004, and the services PMI rose to 57.5 from 54.8 and was near its 5-year high of 58.4 reached in November. The University of Michigan Consumer Sentiment Indicator pulled back modestly to 79.2 in the January preliminary release from 80.7 in December.

Weekly economic data continue to be mixed in mid-January and point to a slowdown or pause in the U.S. recovery in the month. Initial claims for unemployment insurance fell to 900,000 in the week ending January



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16 from 926,000 a week earlier, which was revised down from 965,000 in the prior week's report; however, Pandemic Unemployment Assistance claims rose even more on the week, to 424,000 from 285,000. The Federal Reserve Bank of New York's Weekly Economic Index fell 2.0 percent from a year earlier in the second estimate for the week ended January 16, slightly worse than the 1.7 percent year-ago decline in the previous week.

Even so, the strength of recent housing data suggest that the early 2021's soft patch is concentrated in high-touch sectors, and that the rest of the economy continues to recover. Housing starts jumped 5.8% to the highest level since September 2006 in December, and housing permits rose 4.5% to the highest since August 2006. Existing home sales rose 0.7% to the second-strongest (after October) since March 2006.

The Federal Reserve will hold its monetary policy stance unchanged at its decision January 27; the Fed committed in December to continuing its quantitative easing program at its current rate of \$120 billion in purchases per month until the U.S. economy makes "substantial progress" toward maximum employment and inflation of modestly above the Fed's 2% goal; the Fed's interest rate guidance points to the FOMC delaying a first federal funds rate hike until 2024.

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