



Positive Payback

An eerie calm has descended on financial markets, even though major risks to economic activity continue to swirl about. The number of new Covid cases continues to rise rapidly, especially in Europe, with countries re-imposing restrictions to try and rein in the second wave of the virus. Lockdowns are now being talked about in some countries.

Meanwhile, Brexit trade talks remain on a knife-edge. Political uncertainty continues to rise in the US creating difficulties on agreeing a new fiscal stimulus package. There are also concerns that the outcome of the Presidential election could end up being contested in the courts.

Meantime, although economic data for the third quarter have generally printed ahead of expectations, there are signs that the recovery is losing momentum. Service sector activity softened in September in most economies. Jobs growth in the US also slowed a lot in September, with little more than half the 22 million jobs lost in the recession recovered so far.

UK GDP data for August also disappointed to the downside, leaving the level of output more than 9% below its pre-Covid levels. The recovery in global economic activity could well stall in the fourth quarter, especially where fiscal supports for the economy are being scaled back, most notably in the UK and US.

Markets, though, don't seem to be phased. Stock markets have regained significant ground over the past fortnight having suffered losses during most of September. Bond yields remain within narrow ranges, with peripheral Eurozone markets outperforming. Currency markets have returned to stable range trading, after first sterling and then the dollar wobbled in September.

It would appear that the ample liquidity being provided by central banks through QE, combined with a surge in private sector savings, is helping to shield markets from what seems an elevated risk environment. Investors may also be comforted that central banks will continue to maintain very accommodative monetary policies over the next number of years.

However, it is also critical that fiscal policy remains supportive of activity in the near-term. Ongoing supports for the labour market and those sectors of the economy most impacted by Covid restrictions will be required until next spring at least. Funding costs are very low and private sector savings have gone through the roof, helping to finance public deficits. So fiscal policy can and should remain supportive.



A vaccine for the coronavirus is also critical to economic prospects. Such a vaccine is expected to start to be rolled out early next year, but it is likely to be the second half of 2021 before it becomes widely available. The rebound in activity seen over the third quarter was much stronger than expected, but it has been cut short by the second wave to the virus. It suggests that a sustained rebound in activity can take root next year if a successful vaccine becomes available.

What's more, there is every chance it can be a very robust recovery given the build-up of private savings and the extent of pent-up demand. What fiscal policy needs to do in the near-term is limit the scarring effects of the recession that could hamper a recovery, such as permanently high unemployment, high numbers of business failures and rising bad debt levels.

Budget deficits won't be long in coming down if the world economy rebounds strongly. There is every prospect that if fiscal policy continues to support economies now, it will pay dividends for public finances in the long term.

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