OXFORD ECONOMICS

Global Scenarios Service: Q3 2020

The Second Wave

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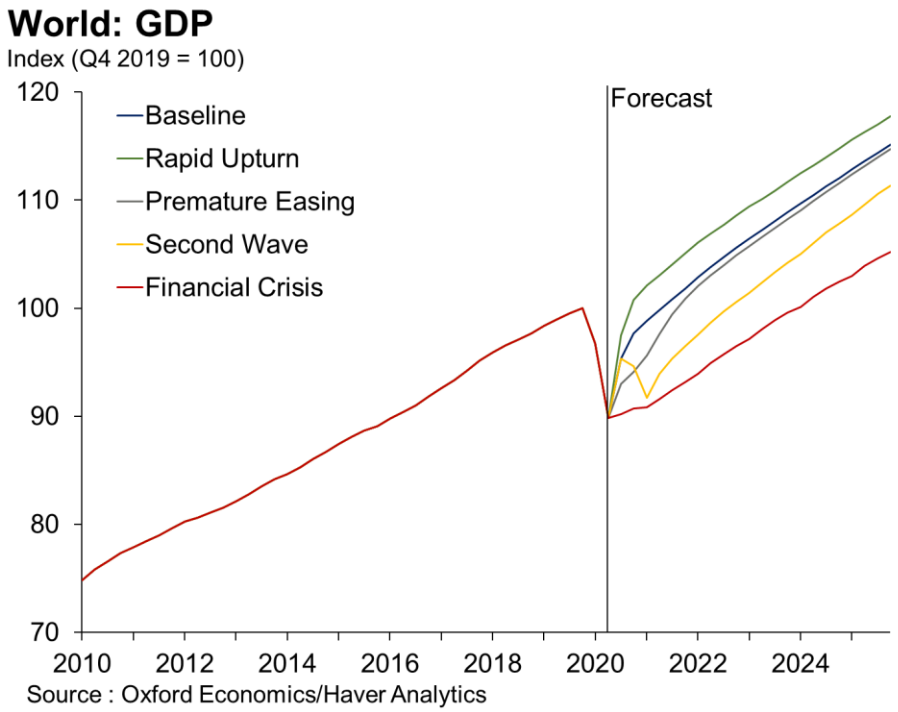
Executive Summary

The outlook for the global economy has stabilised since our previous report. Our baseline forecast shows a 4.4% contraction in world GDP in 2020, a smaller fall in activity than anticipated three months ago. But risks remaining skewed to the downside. As highlighted by our latest Global Risk Survey, business fears are increasingly focused on risks to the global economy stemming from a second coronavirus wave and a potential financial crisis.

In this Global Scenarios Service, we examine these key economic risks:

- **Baseline** (section 1; GSS weight=40%): While output remains significantly constrained in the near term by continued social distancing, a major worldwide second wave of Covid-19 is avoided and world GDP rebounds strongly in the second half of 2020 and into 2021.
- **Premature easing: Pandemic accelerates where economy prioritised over health** (section 2; GSS weight=25%): As lockdown fatigue leads to a premature easing of social distancing measures in some parts of the world, infections surge again and severe public health restrictions return in the most vulnerable countries in the latter part of 2020.
- **Second wave: W-shaped recovery as global infections spike again in early 2021** (section 3; GSS weight=15%): A second coronavirus wave results in renewed lockdowns globally, peaking in early 2021, and a further period of severe economic weakness.
- **Financial crisis: Deep downturn creates credit crunch** (section 4; GSS weight=5%): The post-pandemic period is characterised by limited credit supply, private sector deleveraging and public sector austerity, resulting in tepid productivity growth and anaemic growth.
- **Rapid upturn: Scientific advances mean reduced social distancing this year** (section 5; GSS weight=15%): A more optimistic upside for the global economy in which recovery is more rapid and less permanent damage is inflicted on the global economy.

Figure 1: World GDP level in Q3 2020 global scenarios



Baseline forecast

In our August 2020 baseline forecast, the global economy contracts by 4.4% this year, with output remaining significantly constrained in the near term by continued social distancing. But a major worldwide second wave of Covid-19 is avoided and a fair degree of activity resumes in H2, as governments around the world build large-scale reliable track and trace networks and testing capacity expands rapidly. World GDP rebounds strongly in 2021, by 5.7%, supported by a full relaxation of social distancing on the back of widely available medical advancements.

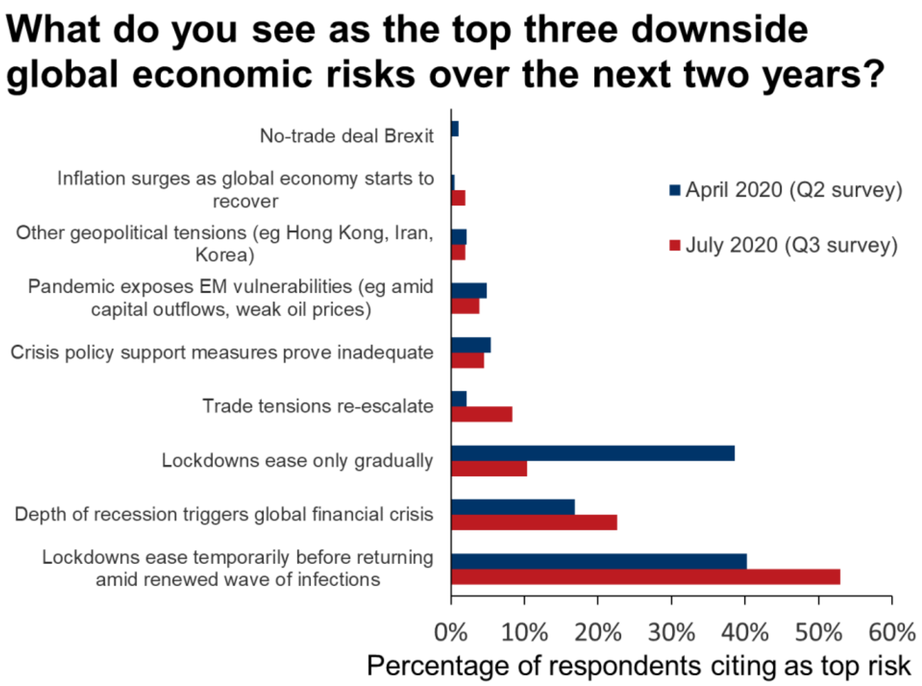
Among the major advanced economies, we now expect a contraction of 4.0% in the US in 2020. While GDP fell by a record 33% annualised in Q2, the latter part of the quarter featured a rebound in the economy and fiscal stimulus should help the economy recover further in H2 and into 2021. In Europe, the EU recovery fund is expected to support recovery and ease divergences across economies in the eurozone after an anticipated 7.9% contraction in 2020. But, in Japan, we expect a 5.6% fall in GDP in 2020 and a very gradual and protracted recovery thereafter as concerns about a resurgence in Covid-19 cases weigh on domestic and overseas spending.

In Emerging Markets, the rebound has been uneven across economies and normalisation is much less visible where progress in containing the pandemic has been sub-par. While household spending has been slow to pick up in China, a robust, business-led recovery appears underway and we have raised our 2020 Chinese GDP growth forecast to 2.5%.

Global inflation is expected to fall further, troughing at a 2.3% annual rate by the end of year, before picking up in 2021 as the world economy recovers. With price pressures subdued, we do not expect the US Federal Reserve or the ECB to raise policy rates before 2024. In financial markets, recent US dollar weakness is expected to persist.

The risks around this baseline view are substantial, however, and appear skewed to the downside. This is reflected in the results from our latest Global Risk Survey, which highlight increased business pessimism and heightened concerns over the potential for a second wave of infections after restrictions ease (**Figure 2**).

Figure 2: *Oxford Economics Global Risk Survey* – downside risks



Source : *Oxford Economics Global Risk Survey*

Risks to our baseline forecast

In this Global Scenarios Service, we explore the uncertainties around our baseline forecast, both to the downside and the upside. Using the Oxford Global Economic Model, we quantify four scenarios that examine key risks currently facing the global economy. Each relates to the spread of the virus, associated public health measures and longer-term economic consequences.

Key risk 1: Premature easing – Infections surge and lockdowns return in economies where restrictions are relaxed too early, at the same time as other countries are forced to impose additional measures such as localised lockdowns. The measures heavily impede global recovery in the very near term, before an easing in public health concerns supports an improvement in business, household and market sentiment.

Key risk 2: Second wave – A second coronavirus wave is assumed to result in renewed lockdowns globally in late-2020 and early-2021. While central banks resort once more to extraordinary measures, governments are reluctant to embark on new support measures against a backdrop of rising public debt levels. Risk aversion increases among households and businesses and is slow to dissipate.

Key risk 3: Financial crisis – The global economy struggles to recover from the pandemic, amid a slower than anticipated relaxation of social distancing measures, a persistent squeeze on financial conditions and households' desire to build up precautionary savings over the medium term. Limited credit supply amplifies private sector deleveraging, at the same time as governments introduce austerity measures in the face of unsustainable public debt levels.

Key risk 4: Rapid upturn – Scientific advances facilitate a swifter easing of restrictions than in our baseline forecast. Activity recovers more quickly than in our baseline forecast, fostering increased confidence among businesses and households.

The key characteristics of these scenarios, as well as the differences between them, are summarised in **Figures 3 and 4** below.

Figure 3: **Summary of Q3 2020 global scenarios**

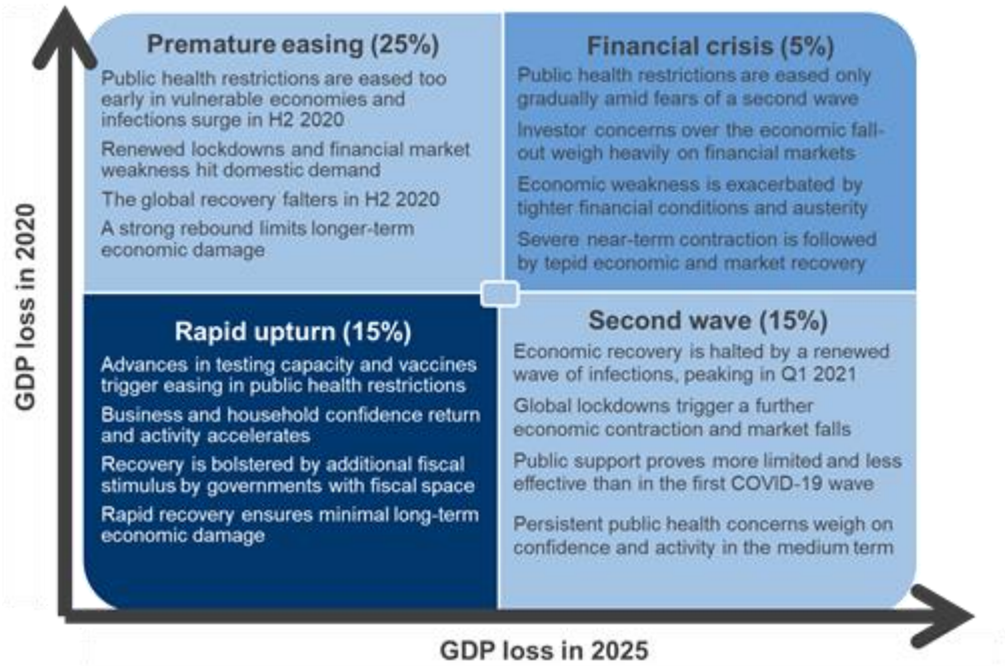


Figure 4: Overview of key assumptions and impacts in the Q3 2020 global scenarios

	Baseline	Premature easing	Second wave	Financial crisis	Rapid upturn
Infections	Globally, the number of new infections falls steadily	Infections are more elevated in H2 2020 than in the baseline, especially in vulnerable countries in which restrictions are relaxed too soon.	Globally, infections initially fall, but a second wave materialises in Q4 2020 and Q1 2021.	Infections are more elevated in H2 2020 and 2021 than in the baseline.	Infections fall more sharply than in the baseline in H2 2020.
Public health restrictions and social distancing	Social distancing remains in place in the remainder of 2020, albeit with an easing of public health restrictions, and continues to weigh on the pace of recovery. The global economy rebounds further in 2021 as widely available medical advancements make it possible for social distancing to fully relax.	Tighter public health restrictions mean greater social distancing than in the baseline in H2 2020, especially in vulnerable countries.	Tighter public health restrictions mean greater social distancing globally in Q4 2020 and Q1 2021 than in the baseline.	Tighter public health restrictions mean greater social distancing globally in H2 2020 and 2021 than in the baseline. Medical advancements only permit social distancing to fully relax after 2021.	Looser public health restrictions result in less social distancing than in the baseline in the near term. Widely available medical advancements make it possible for social distancing to relax fully a quarter earlier than in the baseline.
Monetary policy	Monetary policy is gradually tightened in the major advanced economies. Policy rates begin to rise in Q3 2024 in the US and the UK and Q1 2024 in the eurozone, but remain on hold in Japan throughout the 2021-2025 period.	Looser monetary policy than in the baseline. While policy rates remain broadly in line with the baseline in the major advanced economies in the near term, the UK cuts Bank Rate further; further ahead, US and eurozone policy tightening is delayed by a quarter relative to the baseline. Central banks with existing QE operations expand their purchases in line with the size of the shock to their economies.	Looser monetary policy than in the baseline. The Fed responds to the shock by keeping policy rates at the effective zero lower bound until 2025. The ECB cuts its deposit rate to -0.6% throughout the scenario and the BoE cuts rates to 0% until 2025, while policy in Japan remains at baseline. Central banks with existing QE operations expand their purchases in line with the size of the shock to their economies.	Looser monetary policy than in the baseline. The Fed keeps policy rates at the effective zero lower bound throughout the scenario, the ECB cuts its deposit rate to -1% and the BoE takes Bank Rate negative for the first time; in Japan, policy in Japan remain on hold. Central banks with existing QE operations expand their purchases substantially, in line with the size of the shock to their economies.	The path of central bank policy rates remains broadly in line with that seen in our baseline forecast for advanced economies. However, modest monetary tightening is brought forward in some EMs in response to mounting inflationary pressues.
Fiscal policy	Fiscal policy provides substantial support in 2020, particularly in advanced economies. But fiscal policy is then tightened significantly in 2021.	Broadly in line with the baseline. Substantial support in 2020 is followed by significant tightening in 2021.	Broadly in line with the baseline. Against a backdrop of rising public debt levels, governments are reluctant to embark on new support measures in the face of a second wave.	Tigher than in the baseline. Governments introduce austerity measures in an effort to contain the sharp rise in public debt seen during the recession. Vulnerable eurozone economies see sharp decreases in government consumption.	Looser than in the baseline. Governments with policy space provide greater fiscal stimulus, with spending boosted by up to 3% of government spending relative to baseline.
Global GDP	The severe H1 global recession is followed by a strong rebound in H2 2020. By end-2025, world GDP lies 2.2% below the level envisaged prior to the pandemic.	The global economy recovers more weakly in H2 2020 than in the baseline forecast, before a solid recovery takes hold. By end-2025, world GDP lies around 2.5% below the level envisaged prior to the pandemic.	The severe H1 2020 global recession is followed, as in the baseline, by a strong Q3 rebound. But the global economy then contracts in Q4 and Q1 2021. By end-2025, world GDP lies 5-6% below the level envisaged prior to the pandemic.	The global economy recovers much less strongly in H2 2020 and Q1 2021 than in the baseline forecast, before a relatively sluggish recovery takes hold. By end-2025, world GDP lies 10-11% below the level envisaged prior to the pandemic.	The severe H1 global recession is followed by a very strong rebound in H2 2020. By end-2025, and indeed throughout much of the scenario, the level of world GDP lies close to the level envisaged prior to the pandemic.
Global equity markets	Global equity prices over the next five years remain 7-8% below the level envisaged prior to the pandemic.	Global equity prices fall in H2 2020 to a level roughly 13% below baseline; stock markets then begin to recover from Q1 2021. By end-2025, global equity prices lie around 11% below the level envisaged prior to the pandemic.	Global equity prices fall in Q4 2020 and Q1 2021 to a level roughly 16% below baseline; stock markets then begin to recover from Q2 2021. By end-2025, global equity prices lie around 15% below the level envisaged prior to the pandemic.	Global equity prices fall in H2 2020 to a level roughly 20% below baseline; stock markets then recover only sluggishly. By end-2025, global equity prices lie around 20% below the level envisaged prior to the pandemic.	Rising global equity prices rise from current levels. By Q1 2021, stock markets are only 1% down from their pre-crisis peak. By end-2025, global equity prices lie slightly above the level envisaged prior to the pandemic.

Key transmission channels in the Q3 2020 global scenarios

In our scenarios, the assumptions outlined above affect the global economy through a number of key channels (**Figure 5**). In the three downside scenarios, public health restrictions directly limit activity in the near term, with the shock amplified by deteriorating household and business sentiment. Meanwhile, weaker market sentiment also weighs on activity as stock markets fall to around the lows seen in the March trough. Against this backdrop, major advanced economies see sharp falls in government bond yields and their currencies appreciate against the most vulnerable Emerging Market currencies. Policy actions are only partially able to offset the economic fall-out.

Figure 5: Transmission of Q3 2020 global scenarios

Assumption	Transmission	Key differences across scenarios
Pub;ic health restrictions and their impact on household and business confidence and potential supply	In our downside scenarios, public health restrictions entail greater direct disruption to economic activity in the near term than in our baseline forecast. Discretionary consumption is particularly badly hit by continued labour markets weakness and elevated precautionary saving, while recovery in investment is delayed. Potential output is also adversely impacted by the impact of restrictions on the supply of labour and capital accumulation. In our upside scenario, a quicker easing of restrictions has the opposite effect.	The scenarios differ in the timing of public health restrictions, their global scope, and the persistence of impacts on confidence. Restrictions are tighter in H2 2020 in our downside scenarios and looser in our upside scenario than in our baseline forecast; full relaxation of social distancing is also delayed in 'Financial crisis' and brought forward in our 'Rapid upturn' scenario. Near-term tightening of restrictions varies markedly across countries in 'Premature easing', based on the latest epidemiologoical evidence. Impacts on household and business confidence are more persistent in 'Financial crisis' and, to a lesser extent, 'Second wave'.
Investor sentiment	In our downside scenarios, equities fall sharply in the US and globally, generating adverse wealth effects and raising the cost of capital. In our upside scenario, equity price rises have the opposite effect.	Substantial near-term falls are assumed in all three downside scenarios, with the deepest falls and most protracted weakness seen in 'Financial crisis'. Equity prices rise above baseline in 'Rapid upturn'.
	In our downside scenarios, higher risk premia raise corporate borrowing rates, exacerbating the rise in the cost of capital and weighing further on demand. In our upside scenario, lower risk premia have the opposite effect.	The change in corporate spreads is again greatest and most persistent in 'Financial crisis'.
	In our downside scenarios, as investor risk aversion increases, capital flows from Emerging Markets to safe-havens. Sovereign spreads rise among vulnerable EMs amid the flight to quality, driving borrowing rates higher. The US dollar appreciates, weighing on US competitiveness and putting further downward pressure on global commodity prices. In our upside scenario, investor risk appetite increases, which has the opposite effect.	The change in risk premia and exchange rates is again greatest and most persistent in 'Financial crisis'.
	In 'Financial crisis', lenders curtail the supply of credit to the economy as the deep recession triggers a financial crisis. With household and business confidence already depressed, this amplifies de-leveraging in the private sector.	This additional transmission channel operates in the 'Financial crisis' scenario.
Fiscal policy	In 'Financial crisis', fiscal tightening compounds the weakness in private sector demand. In our upside scenario, fiscal stimulus (relative to baseline) has the opposite effect.	Differences from our baseline fiscal assumptions (of substantial support in 2020 followed by significant tightening in 2021) are most significant in 'Financial crisis', as governments attempt to contain rising public debt through austerity measures. Fiscal policy is more stimulative in 'Rapid upturn' than assumed in our baseline.
Monetary policy	In the downside scenarios, looser monetary policy than in the baseline helps to offset some of the adverse demand shock and support a recovery in demand in the latter half of the scenario. In our upside scenario, monetary policy generally remains in line with baseline in major economies.	Monetary policy support in the major advanced economies is greater than in the baseline in all three downside scenarios, including through the expansion of existing QE programmes. Later in the scenarios, policy rates begin to rise in 'Premature easing' and then 'Second wave'; by contrast, policy rates remain on hold at the effective lower bound throughout the 'Financial crisis' scenario.

There are, however, some notable differences in the importance of the different transmission channels. In ***Financial crisis***, financial market impacts are larger in the near term and more protracted than in ***Second wave***, while the impact of the pandemic and associated lockdowns on household and business confidence also proves more persistent. These shocks are, in turn, more persistent in the ***Second wave*** scenario than in ***Premature easing***. In part, this reflects the less global nature of the latter scenario, for which restrictions vary markedly across countries with the most severe lockdowns reserved for the most vulnerable countries.

In addition, some channels only operate in ***Financial crisis***. The fall-out from the pandemic is amplified by deeper fiscal tightening and by lenders curtailing the supply of credit, unlike in the other scenarios.

Key global scenario results

As a result, there are major differences in scenario impacts, both in the near term and over the medium term.

Near-term impact: In ***Second wave***, a pick-up in Q3 this year proves a false dawn. As lockdowns return, a double-dip for the global economy ensues, accompanied by renewed equity market falls. Global GDP in Q1 2021 lies more than 7% below the level in our baseline forecast; at its peak, the hit to our baseline forecast is around half that seen in the first wave. Those hit badly in the first wave are severely impacted in the second, with open economies hard hit more generally.

In both ***Premature easing*** and ***Financial crisis***, the impact is even more immediate. In the former scenario, the global economy expands more slowly than anticipated in both Q3 and Q4, particularly in economies vulnerable to a spike in infections based on recent epidemiological data. In the latter scenario, recovery fails to materialise at all in the first year of the scenario and world GDP lies around 8-9% below the baseline level in 2021.

A much stronger recovery is achieved in ***Rapid upturn*****,** although a large contraction in 2020 proves unavoidable. By 2022, global GDP has rebounded to a level a little above that envisaged prior to the coronavirus outbreak, reflecting in part the release of pent-up demand.

Medium-term impact: In ***Premature easing***, near-term economic weakness is followed by solid recovery as public health concerns ease and confidence returns. The rebound limits the scale of longer-term economic damage. In the US, the Federal Reserve edges the policy rate higher towards the end of the scenario, albeit modestly, reflecting the improvement in economic conditions. Globally, stock markets and economic activity remain below baseline throughout the scenario.

Recovery proves more sluggish in our other downside scenarios. In ***Second wave***, persistent public health concerns weigh on confidence in the medium term and monetary policy tightening is delayed a few quarters relative to the previous scenario. By the end of the scenario, world GDP is still around 5-6% below the level envisaged prior to the coronavirus outbreak.

In ***Financial crisis***, tighter financial conditions, private sector deleveraging and government austerity drive world GDP some 10-11% below the medium-term level forecast at the start of the year. Stock markets are down even more, ending 2025 some 20% below the pre-pandemic trend. Reflecting more persistent impacts, exceptionally loose monetary policy remains in place in the major advanced economies throughout the scenario and government bond yields are more depressed than in the other downside scenarios.

In contrast, damage to the supply side of the economy is minimised in ***Rapid upturn***. The level of global GDP ends the scenario close to the level anticipated prior to the crisis. The severity of the 2020 global recession does, however, mean that the pandemic entails a large cumulative loss for the global economy over 2020-25 even in this upside scenario.

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