The future of currencies

How strong will the recoveries be in 2021?

In this paper

Hope for 2021, but uncertainty remains

The global economy is set to close out 2020 with overall economic activity down by around 5% on 2019. Economic downturns of this scale occurred during the Great Depression when, between 1929 and 1932, the global economy was estimated to have shrunk by around 15%. However, whilst the Great Depression was the aftermath of the greed and avarice that went before it, 2020's downturn was prompted by a pandemic, and the global response to it.

The good news is that, as we come to the end of the year, a number of vaccines are being rolled out across the globe, which may bring back a semblance of normality to much of the industrialised world, and could prompt a sizeable rebound in the major economies over the course of 2021.

So how strong will the recoveries be in 2021?

Table 1: Global economic growth (%)

	2020	2021	2022
World	-4,9	5,5	4,6
US	-5,0	4,1	3,5
Eurozone	-8,0	4,6	3,9
UK	-10,5	6,9	6,5
Japan	-5,3	4,0	3,2
China	2,2	8,0	6,9
India	-10,5	9,1	7,6
Canada	-6,3	5,2	3,5
Australia	-4,5	3,7	3,1
New Zealand	-6,4	4,9	2,9
Brazil	-6,0	3,0	3,4

UK economy – Embracing the future

The outlook for the UK economy in 2021 looks surprisingly robust, with growth expected to be close to 7%, but only after activity is predicted to have dropped by more than 10% in 2020.

The growth is expected to be driven by a recovering services sector, with hospitality, travel, tourism and leisure all forecast to have a sharp rebound after a disastrous 2020. The UK is set to benefit from a run down in the UK savings ratio, which hit a record 28.1% in Q2 2020, but is expected to quickly move back into its more normal 5-10% range.

It may be 2022 growth that proves more noteworthy, in terms of the UK's performance versus other major Western industrial economies. Helped by a rapidly recovering services sector, the UK should see domestic consumption growth comfortably outstrip growth in other economies, supported by a rebound in business investment and foreign direct investment also.

However, the stumbling block around Brexit remains. Even having agreed a deal, UK business will have to get used to very different ways of operating with regard to trade, customs and cross-border arrangements, and also potentially very different exchange rates. That might yet undermine the investment and hiring plans of businesses in 2021 and beyond.

The UK labour market is also expected to see slow progress back to pre-Covid-19 unemployment levels over the course of 2021 and 2022. In fact, a peak in unemployment is likely to be reached only in early 2022 at around 8%, based on the ILO measurement. It is unlikely to be much earlier than the back end of 2026 that unemployment is again as low as pre-pandemic. The lasting scarring, spoken at length about by Bank of England Chief Economist, Andy Haldane, will likely be felt most severely in employment surrounding the retail, leisure, travel and tourism and hospitality sectors.

It is not all bad news though. The UK remains a 'centre of excellence' in term of digital business development and usage. Consequently, that could propel the economy to a faster pace of expansion in the upturn versus its counterparts in the Western developed world, and also versus its pre-Covid-19 average, as the world turns more digital. The next couple of years are likely to focus on recovering as much lost output as quickly as possible, but beyond that, it will surely be about which economies can best adapt to the challenges ahead.

US economy – 'Biden' its time before recovery

On the face of it, the US economy has ridden out the storm of the coronavirus best out of the major economies, with economic output down only around 5% in 2020, compared with larger drops in the Eurozone, the UK and Canada.

The picture from the US labour market though is less rosy, with still close to 11m workers unemployed versus pre-pandemic levels.

Furthermore, with coronavirus infections continuing to run much higher than in other countries/economies, there could be a difficult start to 2021 for the US, versus a difficult end to 2020 for most of the other economies.

Indeed, even with the positive developments on the vaccine development and deployment, the need for more widespread restrictions in the early part of 2021 means the recovery might stall for the first quarter, or four to five months even, before gaining a lot of traction in the latter half of the year.

President-elect Biden's plans for spending to support growth and investment in the energy industry may be complicated by the make-up of the Senate. This will depend on the two run-off races for the Georgia Senate seats, due to be held in January. If the Democrats can win both, then the Senate will be 50 seats each, and the Vice President, Kamala Harris, will have the casting vote in the event of a tie.

The fiscal plans of the incoming President could slow the pace of recovery also, with money targeting a green revolution, moving away from carbon-based fuels to more sustainable energy. That may not pay dividends in terms of faster growth in 2021 or 2022, and as such the US economy sees its growth rate lower than that of its major rivals.

The labour market has already been mentioned, but it looks likely that further improvements in employment will be much tougher to achieve. This means that the unemployment rate is likely to remain elevated throughout 2021 and 2022. Although structurally the US labour market operates differently to those in the Eurozone and the UK, with support for the unemployed much less generous or long lasting, this time around it may prove a hindrance rather than energising the recovery.

Eurozone – playing for time

The Eurozone is faced with a deflation problem, again. It may be driven predominantly by the global pandemic that struck down the economy so forcefully in Q1/Q2 2020, but neither the UK nor the US are suffering deflation. So, what is unique about the Eurozone, and what can the European Central Bank do about it?

The European economy has been badly scarred by coronavirus, that much is undisputed. Economic output overall was down about 20% at the trough for the worst affected economies, and even after unlocking had fallen by 15% by the end of H1 2020, versus where we had begun 2019. However, the UK economy suffered a larger drop, and is set to recover more slowly to pre-pandemic levels of output, but hasn't had, and isn't expected to have, the same deflation problem.

Some of that can be explained by regulations around credit borrowing for consumers. This tends to limit the extent of any consumer led domestic expansions, and of course, generally higher gross taxation and larger state sectors, as a percentage of GDP are contributory factors. Therefore, the demand side drivers for inflation may not be as powerful as they are in the UK and US economies.

Whatever the reasons, Eurozone monetary and fiscal authorities have had trouble with a persistent undershoot of consumer price inflation versus target, which may now be ingrained within the economy. Consequently, the Eurozone recovery in 2021 may be lacking the same momentum and vibrancy of the UK's, and only bounce slightly more than the US economy in both 2021 and 2022, despite having seen output decline far more.

Table 2: Consumer price inflation (%)

	2020	2021	2022
World	2,9	3,0	3,2
US	1,3	1,7	1,8
Eurozone	0,3	0,7	1,1
UK	1,2	1,5	1,6
Japan	-0,1	0,0	0,2
China	2,7	3,0	3,3
India	4,7	3,5	3,7
Canada	0,6	1,2	1,8
Australia	0,6	1,2	1,4
New Zealand	1,6	0,4	0,9
Brazil	2,6	2,8	3,3

There are additional pressures also, prompted by an overly strong euro, at least on consumer price inflation purchasing power parity estimates. These could further slow a return of inflation to the Eurozone economy, and require additional monetary loosening in order to do so. Finally, the Eurozone has not been particularly successful in altering its business model to a more digital approach. In a post pandemic world, will this further slow the momentum behind recovery for this Europe?

2021 has another wrinkle for the Eurozone to navigate. Likely in late Q3/early Q4, Germany is set to go to the polls. The last time they did this, back in 2017, the CDU lost seats and had to form a super-coalition with erstwhile rivals the SPD. Since then, the SPD have been losing ground to the Greens in national polling, who now pose the CDU its greatest threat. With the pandemic problems growing in Germany, that could spell trouble for the CDU, and propel the German economy on a new course, driven by radical politics for the first time in well over half a century.

The Eurozone recovery is still likely to be solid, but even with smaller drops in output versus the UK, it probably won't be until the end of 2022 at the earliest before pre-Covid-19 levels of output are re-attained.

The Covid-19 vaccines – building momentum

The news on Covid-19 vaccines has continued to improve over recent months. From successful trial in the summer, the world finds itself with a fully-fledged, signed-off, and already being distributed UK-wide, vaccine, less than six months later.

Whilst this is positive stuff, a note of caution needs to be injected (pardon the pun). The long-term effects of Covid-19 are not known, how effective the vaccine programmes will be is still up in the air and there is the possibility the virus might mutate (already seen in the southeast of the UK). Such mutations could potentially make a vaccine less effective, or completely ineffective, and again, we'll only know this in the coming quarters and years. Even so, societies and economies have rapidly learnt to live with Covid-19, and have demonstrated a remarkable ability to adapt and recover despite repeated increases in restrictions and lockdowns.

The vaccines may offer a way out of the constant adjusting between eased and restricted public life, and as such allow the vast majority of society the ability to return to some semblance of normality fairly quickly. For the travel and tourism industry there is hope that, by the summer, holidays will again be enjoyed at home and abroad, whilst for leisure and hospitality, society will return to a greater degree of normality also.

A build-up of economic momentum, benefiting those sectors that disproportionately suffered during lockdowns and restrictions, may further be driven by a return of much of the gig economy employment lost during lockdown.

Rest of the World – China to lead the charge

The news on Covid-19 vaccines has continued to improve over recent months. From successful trial in the summer, the world finds itself with a fully-fledged, signed-off, and already being distributed UK-wide, vaccine, less than six months later.

Although China was the original source of the coronavirus outbreak, it has seemingly managed to prevent future outbreaks more successfully than many other major economies/populous countries. The outlook for the Chinese growth in 2020 is for it to be in the plus column, albeit that, at just a shade more than 2%, it represents a dramatic slowing in growth from the 6%+ of 2019.

A rebound of 8% in 2021 will still leave the economy around 4-4.5% smaller than it was expected to be by the end of '21, and growth is then expected to slow swiftly back to pre-crisis levels, suggesting some permanent damage will have been done. Unemployment rates, which dipped to record lows in mid-2019 have risen somewhat. Unemployment rates could rise further with export markets potentially less receptive given slumps in consumer incomes, and increases in unemployment also.

In terms of the other Asian powerhouse, India, it has suffered more significant damage to its economy in 2020, with output expected to have dropped by over 10%. While a strong recovery in 2021 will recover much of the lost output, the lasting scarring on this economy is likely to be far worse than in China.

Canada, Australia and New Zealand all seemed to deal more successfully with their Covid-19 outbreaks, but that hasn't prevented their economic output dipping sharply. Again, for them, 2021 and 2022 will be about rebuilding. Australia and New Zealand's worsening diplomatic relations with China over the course of 2020 could have long term ramifications for growth beyond 2022.

For the rest of the developing world, they will hope that growth in the developed world will elevate activity in their countries, via higher commodity demand, and prices. However, a lack of fiscal headroom for stimulus in most of these countries/economies leaves them exposed to potentially longer periods of lost output, and the consequences of that on their currencies.

Moreover, as has been demonstrated in recent weeks, there are other blockages to recovery. This includes the problems currently being experienced at ports in terms of the movement of goods, lack of containers and supply chain issues (raw materials etc). These could delay/slow the global recovery in the early phases of 2021, and have a disproportionate effect on those reliant on trade with the developed world for growth.

Monetary policy – Negative rates off the agenda

Negative interest rates are not expected to be forthcoming from any of the major economies/central banks over the course of 2021 and beyond.

Central banks have had ample opportunity to move interest rates negative in recent quarters. Despite being faced with one of the worst downturns in economic history over several hundred years, none have implemented negative interest rates. Without a significant worsening in economic conditions versus forecasts, there seems little prospect of any of the major central banks adopting negative interest rates over the coming months and quarters.

There is a good reason for this. Take a look at the Japanese economy, which has flirted with negative interest rates over the course of the past two decades. Has this led to a significant outperformance of Japan versus local competitors in Asia? Any cursory examination of Japanese data would indicate not. The same could also be said of Sweden, Denmark and Switzerland, who have negative interest rates, or have deployed them in recent years and have not materially outperformed the Eurozone or the UK.

Moreover, negative interest rates potentially undermine the core dynamics of well-run, cash rich businesses. These could be punished by negative interest rates, just for holding cash whilst waiting for the next opportunity to invest. It is hardly as if many businesses are doing this through choice, but rather because it is the prudent thing to do during such times of turbulence.

The Federal Reserve is likely to add to its asset purchase programme over the coming months, and then leave monetary policy on hold until the early part of 2023. By that point, the US economy should have recouped its lost output from the pandemic, but it is still likely to be several percentage point light of where GDP would have been without the crisis. Moreover, the Fed's average inflation targeting sets a high bar for when policy can start to be tightened. As a consequence, any tightening in monetary policy is likely to be slow going, and could begin with a reversal of the QE expansion, rather than interest rate hikes.

In Europe, **the European Central Bank** are likely to be on hold or looser for longer. The deflation issues already mentioned will mean the Eurozone's economy is expected to see growth rates slow more quickly than many others. It may be the very end of 2023, or even later than that, before a tightening of monetary policy ensues.

What of **the Bank of England**? Some further loosening could be expected in H1 '21, however this is looking less likely now the UK and EU have agreed a post-Brexit trade deal. The only realistic prospect of negative interest rates would have been in the event of a no deal Brexit. However, even then, it would have been unlikely that interest rates would go substantially negative, and they certainly would not have been expected to exceed the -0.75% that official Swiss interest rates currently reside at. The biggest tool in the Bank's box remains quantitative easing, and there is room for them to expand this by a further £500bn, if necessary, as well as broadening the asset purchase base also.

UK monetary policy is not expected to tighten until after the end of 2023.

The rest of the world is likely to follow the lead of the major central banks with a few notable exceptions. It is unlikely that we will see any tightening of monetary policy from the likes of China, India, Australia, New Zealand, Switzerland, Sweden, Norway or Brazil in 2021. China might look to tighten in the early part of 2022, if its recovery doesn't suffer a setback. However, for most central banks, the next few years are likely to be about ongoing adverse economic effects of Covid-19, which may require further shots of additional stimulus later into 2021, and then a prolonged period of no change.

Table 3: Key central bank interest rates (%)

	2020	2021	2022
US	0,25	0,25	0,25
Eurozone	0,00	0,00	0,00
UK	0,10	0,10	0,10
Japan	-0,10	-0,10	-0,10
China	3,85	3,85	4,60
India	4,00	3,75	3,50
Canada	0,25	0,25	0,25
Australia	0,10	0,10	0,10
New Zealand	0,25	0,25	0,25
Brazil	2,00	2,00	2,00
Switzerland	-0,75	-0,75	-0,75

FX markets – Don’t write off the dollar

It would be all too easy to jump on the band wagon that the US dollar is in a long term downward spiral, but we have been here before many times over the past three decades, and it feels as if the same naysayers are back to try yet another heave, to suggest the US dollar is finished.

First and foremost, the position that the US dollar is coming from is broadly the average of where it has been over the past three decades. On a dollar index basis (covering a broad range of currencies traded against), the dollar stands at a shade under 91. The average for the past 30 years is 91.16. During that time, we’ve seen the emergence of the euro, the Chinese economy grow to be the second largest economy in the world, several major market crashes/crises and monetary policy hit fresh record lows in each of the last 2 decades. Yet, even at the end of all of these major events, the dollar remains extraordinarily close to its 30-year average.

2021 will be about rebuilding, not the least in the US, where the President-elect Joe Biden, will spend much of his time rebuilding diplomatic and trade relationships around the world. After the America First programme of the current President, Donald Trump, there are many fractures to repair. Whilst some of the tough talking may remain from the US side, a more outward looking US government might be able to greater capitalise on the competitive advantages that many US businesses have regarding the digitalisation of business. That could put some pressure on the USD, but many are convinced it is already priced in.

For other currencies, such as the euro and sterling, persistent deflation risks and competitiveness issues could constrain additional gains. We could see both currencies dropping back against the US dollar, despite the UK and Eurozone economies having a little head start on the US in terms of their economic rebounds in the early part of 2021. 2021 might be similar to 2020, with H2 seeing more sustained economic progress, and that creating renewed US dollar weakness as risk appetite improves once again.

A recovery in oil prices, also at the back end of 2021 should help the likes of the UK pound, Canadian dollar, Aussie dollar, Brazilian real and Norwegian krone. However, there are some real difficulties in all of these currencies pushing on from here in terms of further gains, because of the undershoot of inflation in the vast majority of these economies.

Watch for the Indian rupee to also underperform. India's economic challenges would appear far greater than those of the China. As such, investors may take a dim view of economic underperformance.

US dollar index

The risks to FX markets

If there is to be a surprise, it is likely to be a further negative shock to the global economy. Under those circumstances, investors may find themselves in the same position that they have found themselves multiple times in the last decade, let alone the last 30 years; seeking the safety of the US dollar.

The received wisdom is that 2021 will see things return broadly to normal, but what if they don't? What do the markets do then? The dollar doesn't look cheap, but it certainly doesn't look expensive either.

As for the pound, with all the changes the UK economy will face, a further drop in its value against both the US dollar and euro is likely in the early part of 2021. In addition, a heavily services-dependent economy will require plenty of fair winds to propel it back towards a rapid recovery. There should be little prospect of outperformance for the pound, at least in the early phases of a new trading relationship with its major partner.

Table 4: FX forecasts (NB: forecasts are end of period)

	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
EUR/USD	1,16	1,16	1,18	1,22	1,25	1,24	1,20	1,17
GBP/USD	1,25	1,23	1,26	1,31	1,33	1,35	1,31	1,30
USD/JPY	103	100	101	105	108	110	111	112
GBP/EUR	1,08	1,06	1,07	1,07	1,06	1,09	1,09	1,11
EUR/GBP	0,93	0,94	0,94	0,93	0,94	0,92	0,92	0,90
USD/CHF	0,90	0,90	0,92	0,93	0,96	0,98	1,01	1,03
USD/CAD	1,29	1,27	1,25	1,25	1,29	1,31	1,33	1,35
AUD/USD	0,73	0,72	0,72	0,72	0,70	0,69	0,68	0,68
NZD/USD	0,69	0,68	0,68	0,68	0,67	0,66	0,66	0,67
USD/CNY	6,65	6,70	6,70	6,75	6,73	6,70	6,67	6,63
USD/INR	74,20	74,50	75,00	75,75	76,50	76,50	75,20	73,10
USD/BRL	5,35	5,65	5,40	5,35	5,30	5,30	5,25	5,25
EUR/SEK	10,15	10,10	10,10	10,00	9,95	9,90	9,90	9,85
EUR/NOK	10,30	10,20	10,20	10,05	9,90	9,80	9,75	9,65

The year ahead in summary

The outlook may be uncertain, the growth delivered in fits and starts amidst additional restrictions and lockdowns. Vaccine rollouts offer the route out of the pandemic for services-related businesses. It is highly unlikely to be as bad as 2020, and if it was that would prompt further drastic interventions from authorities.

But those predicting a smooth return to activity, as if on the 31st December 2020 we'll somehow press the reset button on a truly awful year, are sadly mistaken.

Businesses that have already invested in digital will perform far better than those that haven't, particularly within retail. The travel and tourism industry will likely enjoy a much better H2 than H1 of 2021. Global trade will have additional constraints to business to tackle.

There is room for optimism, but there are immense challenges ahead.

As for the FX markets, the dollar sees other currencies circling it, believing it to be wounded and vulnerable. It may prove to be both more resilient and more dangerous in a world of ongoing turbulence.

We will hopefully look back at 2020 as the worst of times, and hope that, particularly in the second half of 2021, that better times lie ahead for all global economies, and not just the majors.

Contact us

To find out more about how a customised foreign exchange strategy can help you save money:

For all corporate enquiries,
please call: +44 207 823 7800
or email: corporate@moneycorp.com

Alternatively, for personal enquiries,
please call: +44 207 589 3000
or email: enquiries@moneycorp.com