Research Reports

A dark tunnel with faint glimmers of light

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Dark tunnel, faint lights
A world no one imagined

The COVID-19 crisis has caused major losses of human lives and jobs. Extreme economic changes have taken place in a very short period. Global production, demand and trade have collapsed, with unprecedented GDP declines. It is hard for traditional forecasting methods to capture the short- and long-term consequences of this crisis, so today many of us are fumbling in the dark.

But exceptionally large-scale economic crisis packages, totalling nearly 20 per cent of global GDP, are helping to bolster health care, create "lifelines" for businesses and households, support future recovery efforts and ensure financial stability and well-functioning markets.

Right now the world is inside a dark tunnel, surrounded by big unknowns. Financial markets are facing a toxic mix of unpredictability, anxiety and uncertainty that is fuelling volatility. Yet faint glimmers of light are discernible. For example, crisis packages continue to be rolled out and the spread of the virus is showing early signs of being under control in some countries. This will enable countries and regions to join forces in earnest and make plans to cautiously and gradually restart the world's economies and manufacturing activity.

The crisis has also fostered creativity and global competition in medicine and technology, boosting hopes for the economic world that is waiting at the end of the tunnel, as well as near-term hopes. New virus-related reversals may be lurking around the corner. To reliably restore production and demand, businesses and households must feel safe. Medicine and technology can ensure the "infrastructure" this will require.

The question is: How long is this dark tunnel, and how strong are the lights? What awaits us when the tunnel ends? This new *Nordic Outlook* analyses the global consequences of the COVID-19 crisis. The issue includes four in-depth theme articles:

- Historic crisis policy
- Fighting COVID-19
- The EM economies
- How locked down?

We hope the May 2020 *Nordic Outlook* will provide you with some new insights about today's challenging global prospects. Take good care of yourselves, and let us all help each other get the world back on its feet!

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The global economy

Unprecedented halt despite record stimulus

The United States

Unemployment will climb rapidly to 17 per cent, in line with the customary American crisis dynamic. Aggressive stimulus measures will contribute to a recovery in 2021 but also leave behind a heavy debt burden for the future.

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The euro area

The EU is being hard hit by the pandemic as the single market is side-lined. A deep recession and a sluggish recovery can be expected. Although the economic policy response has been rapid, north-south divisions are apparent once again.

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China

First closed, first reopened. China is recovering quickly, but new outbreak risks and international weakness will hold back growth. Other Asian countries are lagging, and overall EM economies will shrink for the first time in 75 years.

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The United Kingdom

With low savings and the approach of Brexit, the consumption-driven British economy was being squeezed even before restrictions were imposed. The UK lockdown is broader than elsewhere, so the GDP decline will be deeper.

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The COVID-19 pandemic has brought the world economy to an unprecedented halt. In our main scenario, we expect GDP in the developed countries to shrink by 7 per cent in 2020. Record-sized government and central bank stimulus measures will have their main impact a bit later. This autumn, unemployment will climb to levels not seen since the 1930s and – despite a more V-shaped recovery than in earlier crises – it will remain high for the next few years.

Unique forecasting environment in recent months. As recently as late February the International Monetary Fund (IMF) presented a main scenario where the negative impact of the coronavirus epidemic on global GDP growth would be limited to a marginal 0.1 per cent. In the *World Economic Outlook* published in mid-April, global GDP growth had instead been revised by more than 6 percentage points downward from the IMF's January forecast. The IMF is thus predicting the deepest economic downturn since the Second World War. There are reasons behind this radical shift. For a long time most epidemiologists, including those at the World Health Organisation (WHO), underestimated the spread of the virus and thus the risks of a pandemic. Even at a later stage – once the disease had begun spreading – it was nearly impossible for economists to predict the far-reaching economic and social lockdowns that have now been imposed.

Exceptional forecasting challenges. At first, the economic consequences were mainly associated with the broken supply chains that arose at the time of the first Chinese lockdowns. Now that country after country has imposed dramatic lockdowns, the main task has instead become to try visualising how large a proportion of the economy is affected, and to what degree various sectors are locked down. Traditional statistics are often outdated by the time they are published, and forecasters are largely dependent on alternative short-term observations – such as debit card usage, electricity consumption or traffic density. It is also hard to draw conclusions based on historical comparisons of leading sentiment indicator levels, since the situation is unique in most respects.

Similarities with natural disasters and a wartime economy? Parallels with other emergency situations may have some relevance, even though such comparisons are inapplicable in important respects. Market forces are now largely side-lined. Economic developments are mainly determined by the overarching objective of stopping the spread of the virus, which is reminiscent of war-like conditions. This is also true of the political climate, with normal conflicts between the government and the opposition – or between different ideologies – ending up on the back burner. The big difference is that the available production resources, especially labour, are utilised to the breaking point during wartime, while today we generally have a diametrically opposite situation. No natural disaster in modern times has had economic consequences that can be compared to the COVID-19 pandemic. However, there are similarities that are important when discussing the design and purpose of economic policy. Many businesses and entire economic sectors risk being wiped out, even though it is obvious that the problems are not primarily due to market conditions such as overcapacity or lack of demand once the situation normalises.

Impressive economic policy responses. Generally speaking, today's combination of supply and demand crises – with large parts of both production and consumption paralysed by lockdowns – presents unique challenges to the design and effectiveness of economic policy measures. They have little chance of influencing the level of economic activity in the short term. Instead the task of crisis policy is to minimise the destruction of productive capacity and jobs as well as to ensure financial stability. In the next phase, fiscal policy makers need to lay the groundwork for a sustainable recovery. Economic stimulus measures have been launched at a substantially faster pace than during earlier recession outbreaks. Our estimate is that globally, the crisis packages launched by governments, central banks and regulatory authorities total USD 17.5 trillion. Our theme article "Historic crisis policy" (p 12) analyses the design of these policies in various countries and the long-term consequences of rising public sector debt. It also discusses the impact of central bank promises about unlimited asset purchases, which in practice create an increasingly unclear boundary between fiscal and monetary policies.

The economic outlook is still very uncertain, but gradually more bits of evidence are emerging that can be used in order to quantify various forecasts and scenarios. Estimates in Western European countries such as France and Italy indicate that 30-35 per cent of economic activity had ceased when the lockdowns were at their broadest in April. This would mean that each month of this situation leads to a GDP loss of nearly 3 per cent for the full year 2020. The OECD has presented estimates in which the corresponding effect

in advanced economies as a whole is more than 2 per cent. Our estimate for Sweden is that about 20 per cent of the economy was locked down in April. We believe accumulated GDP loss during Q1 and especially Q2 will be 10-20 per cent, depending on the degree of lockdown in various countries.

Each month of lockdown will lead to a GDP loss of more than 2 per cent for the full year 2020

The chronology of the pandemic and lockdown strategy will remain crucial to economic growth. The theme article "Fighting COVID-19" (p 19) analyses various factors that determine the path towards normalisation in each economy – such as immunity, testing capacity, a vaccine and effective medicines. In our main scenario, economies reopen gradually and cautiously starting in May. This implies that in Q3 there will be a relatively clear economic recovery as the pattern of consumption in some areas normalises and industrial production that depends on functioning cross-border supply chains can restart. But in many other areas, it will take time before the situation normalises. Travel restrictions, both domestic and international, will remain in place and greatly reduce tourism. Continued social distancing rules will inhibit large parts of the service sector.

Global GDP growth
Year-on-year percentage change

	2018	2019	2020	2021
United States	2.9	2.3	-6.5	5.6
Japan	0.3	0.7	-5.3	3.0
Germany	1.5	0.6	-7.7	5.8
China	6.8	6.1	2.0	9.0
United Kingdom	1.3	1.4	-11.6	4.3
Euro area	1.9	1.2	-9.6	6.2
Nordic countries	1.9	1.4	-8.0	5.9
Baltic countries	4.1	3.6	-9.0	5.9
OECD	2.3	1.7	-7.0	5.1
Emerging markets	4.7	4.1	-0.6	6.1
World, PPP	3.6	3.0	-3.3	5.7

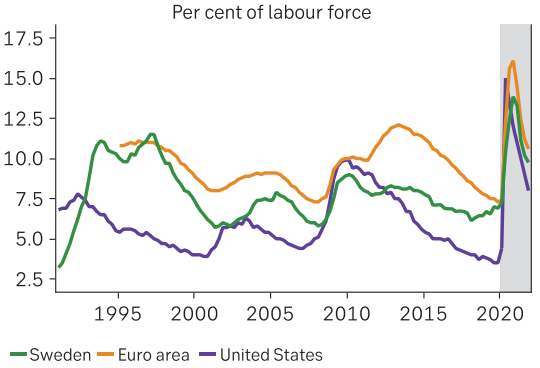
Source: OECD, IMF, SEB. *Purchasing power parities

The difference in GDP growth between countries will largely depend on how severely they are affected by COVID-19 and what lockdown strategy they have chosen. In countries like Italy, Spain and the UK, we expect full-year 2020 GDP to fall by more than 10 per cent. Meanwhile the US, Germany and Sweden will manage slightly little better, with downturns of around 6-7 per cent. Our forecast is based on the assumption that the degree of lockdowns in different countries will converge in the course of 2020, but contrasting views in the epidemiological debate indicate that a number of scenarios are possible. This is especially true of Sweden, which has attracted attention with its strategy of trying to keep large portions of society open. A higher degree of immunity in the population could conceivably allow increased future economic activity. But it is too soon to rule out a shift in Sweden's strategy in a more restrictive direction in the near future.

Chinese recovery, but threats of new outbreaks. China's GDP fell by nearly 7 per cent year-on-year in the first quarter of 2020 after large-scale lockdowns in February. The country's recovery has now begun and is most apparent in manufacturing, where we estimate that production now totals 90-95 per cent of its pre-crisis level, but the risk of new virus outbreaks and negative impulses from other countries will continue to hamper the economy. We expect full-year 2020 GDP to increase by only 2 per cent.

Varying conditions in EM economies. Most other emerging market (EM) economies are now in an early phase of the epidemic, making its impact difficult to estimate. Many EM countries have younger populations than more developed economies, which suggests milder economic consequences. Because of lower income levels, their inhabitants travel less: one reason why the spread of the virus is slower. The transport sector – which is now hard-hit in all countries – also accounts for a smaller share of their economy. But other factors pull in the opposite direction. High population density, lower-quality health care, crowded living conditions in major cities and a larger share of multi-generational households in rural areas may increase the spread of the virus. Because of low trust in the authorities in many countries, especially in Africa, official restrictions may be hard to implement. In the EM sphere as a whole, we expect GDP in 2020 to fall for the first time since the Second World War.

Highest unemployment since the 1930s
Per cent of labour force



Source: Macrobond, SEB

Second wave of indirect effects this autumn

During the second half of 2020, we will enter a crucial phase with regard to the indirect consequences of lockdowns. Capital spending will be hampered by low capacity utilisation. Unemployment in various countries is expected to peak at 10-15 per cent. This will exert downward pressure on home prices, which in turn will decrease household consumption. The commercial real estate market will also be hard hit, due to permanent closures of some shops and a reduction in the need for

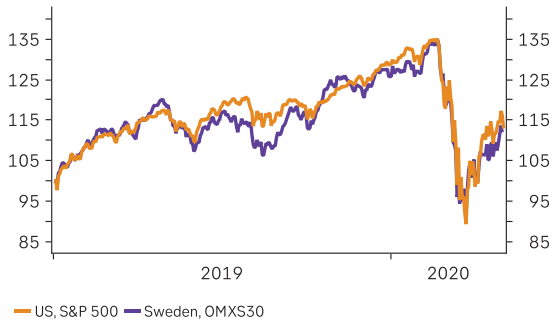
office space. Even though GDP growth in 2021 will look impressive, largely because of these forces we expect the GDP level at the end of the year to be well below our earlier forecasts. In the Organisation for Economic Development and Cooperation (OECD) as a whole, the gap is about 5 percentage points. This is one reason why unemployment will also remain far higher than we have become accustomed to in recent years. A combination of plunging nominal GDP and fiscal stimulus measures will lead to large budget deficits and cause public sector debt levels in many countries to climb by 15-20 per cent of GDP.

This autumn we will enter a crucial phase with regard to the indirect consequences of the lockdowns

Strains in banking systems. Developments in the commercial real estate market will be instrumental in determining the size of credit losses in the banking system. How much crisis-hit businesses can and should increase their debt may lead to tensions between commercial banks and economic policy makers. Some form of credit crunch behaviour – where the banking system, voluntarily or involuntarily, becomes more cautious about lending – is an oft-recurring feature of economic downturns. In this respect, the risks are currently largest in the euro area, where banks were already weakened at the outset of the pandemic. Hopefully we will see the launch of new mechanisms for saving crisis-hit businesses that will be attractive to both business entrepreneurs and sources of fresh venture capital. Such solutions would ease the burden on the banking system, but could also reduce the degree of business nationalisations.

What does the stock market rebound tell us?

Index 100:Jan 2019



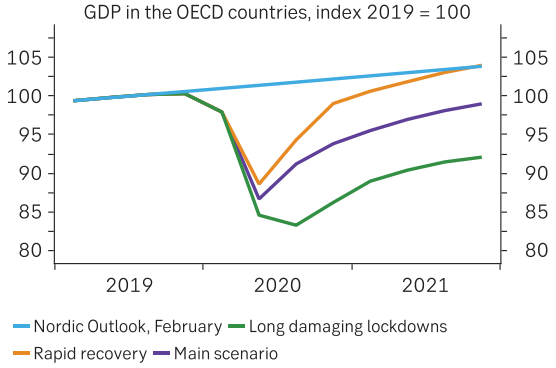
Source:Nasdaq OMX, S&P Dow Jones Indices, Macrobond, SEB

Tensions between real-economy and financial market signals. The stress in financial markets culminated in late March. Since then, yield spreads between corporate bonds in various risk classes and government bonds have fallen somewhat, but above all we have witnessed a robust stock market recovery. Central bank liquidity injections and the expansion of quantitative easing (QE) programmes to include corporate bonds have certainly played a major role. Another reason behind the stock market rebound is that the market has already made allowances for a sharp economic downturn this year and is now looking ahead towards better corporate earnings in 2021. During crises and recessions, share prices often show a W-shaped curve. In the middle of a crisis, the market experiences a relief rally, which proves unsustainable, followed by a renewed downturn in share prices. In light of this, there are strong reasons to ask whether the stock market is being a bit too optimistic about the consequences of a second wave, which macroeconomists are now very concerned about (see also “The stock market”, p 18). Once it has arrived, hopes of a favourable long-term earnings trend will be put to the test in many sectors.

Good chances of avoiding policy disappointments. Meanwhile there is nothing predestined about the W curve. A positive interpretation is that the second wave of falling share prices has often been triggered by market disappointments about economic policy responses. One example is that during the global financial crisis, the Fed and the US administration tried for a long time to strike a balance between keeping the financial system functioning while avoiding major rescue actions, out of concern for “moral hazard”. It was not until October 2008, when the financial system was on the brink of total collapse, that aggressive measures began to be launched. The policy response during the euro crisis of 2011-2012 was hampered for a long time by trench warfare mainly between Germany and southern European countries. This time around, when the economic crisis is a direct consequence of drastic medical and political decisions, there is no corresponding dilemma, at least not initially. There are also other arguments that may justify today's share prices and reduce the risk of major declines. Investors have probably extended their discounting horizon and are now seeing prospects of good earnings increases over a longer period. They are also becoming increasingly convinced that extremely low interest rates and yields will persist during the foreseeable future, justifying historically high valuations

Various scenarios

GDP in the OECD countries, index 2019 = 100



Source: Macrobond, SEB

Downside risks connected to new outbreaks. Because of the exceptional uncertainty now prevailing, it is natural to work with various alternative scenarios. The main kind of uncertainty concerns how rapidly economies will actually reopen. This, in turn, may depend both on strategic trade-offs between medical and economic aspects, but also to what extent we will see setbacks in the form of new COVID-19 outbreaks when restrictions are lifted. Our negative scenario assumes that economic recovery is significantly delayed compared to our main scenario and that important parts of the economy do not restart during the second half of 2020. In that case, full-year GDP in the 37 mainly affluent OECD member countries will fall by about 12 per cent in 2020. Unemployment will climb to around 20 per cent both in the US and Western Europe. Permanent business closures will occur on such a large scale as to put severe pressure on the financial system. In this scenario, economic policy makers will need to resort to dramatic actions that we have not seen so far during peacetime. Public sector debt will explode, climbing in 2020 and 2021 by an accumulated 35-40 per cent of GDP in most countries.

Negative scenario
GDP growth, per cent

	2020	2021
United States	-11.0	4.0
Euro area	-13.5	3.5
Sweden	-11.5	3.0
OECD	-12.0	3.0
World	-8.0	4.0

Source: OECD, SEB

Rapid recovery when stimulus gets a chance to work? Our more positive scenario may assume that the virus spread situation turns out to be more favourable than expected or that for other reasons, economies reopen earlier than in our main scenario. Looking a bit further ahead, it is also possible to imagine that economic stimulus measures begin to have a significantly better effect as the general social environment normalises. In such a scenario, it is difficult to foresee governments and central banks acting especially quickly to withdraw their stimulus due to fear of overheating. We foresee a roughly symmetrical probability for these alternative scenarios and are setting a 60 per cent probability for our main scenario and 20 per cent each for the positive and negative scenarios, respectively.

Positive scenario
GDP growth, per cent

	2020	2021
United States	-4.0	8.0
Euro area	-6.5	7.5
Sweden	-4.0	8.5
OECD	-5.0	7.8
World	-2.0	8.5

Source: OECD, SEB

Oil prices add risks in a nervous world

Low energy prices are normally positive for global growth, due to cheaper production costs for businesses and increased purchasing power for households. Today's low oil prices are instead a destabilising factor for oil-producing emerging market economies, the US credit market and the security policy situation.

Plunging Brent crude oil prices since January – from USD 70/barrel to a low of USD 16 – have mainly been due to sharply falling demand during the pandemic. Early in March, Saudi Arabia also chose to start a price war. In April this led to an agreement by the hard-pressed OPEC+ countries to reduce their production by about 10 per cent, but many observers believe that the COVID-19 crisis has lowered near-term demand by as much as 20-30 per cent. This is likely to require additional production cuts.

A combination of overproduction by the US oil industry and limited storage capacity led to negative prices for West Texas Intermediate (WTI) oil for delivery in May. Since then, prices have stabilised at higher but still depressed levels. Brent oil prices have also been affected.

Oil prices, USD/barrel – break-even levels

	Production	Budget balance
Saudi Arabia	10-20	83
Russia	20-40	42
United States	30-50	
Norway	30-40	

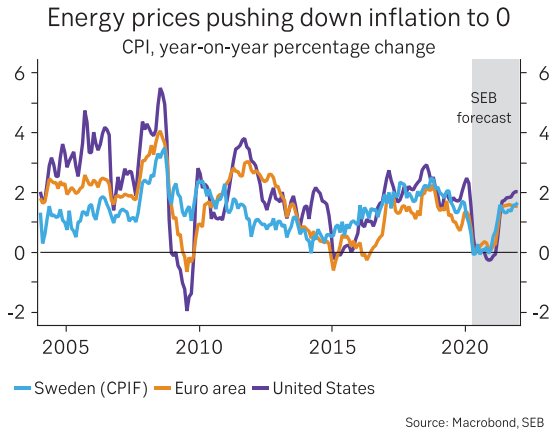
At today's prices, Saudi Arabia, Russia and the US cannot produce oil without a major adverse impact on public finances or on the industry's profitability. The growing US oil industry has developed into an economically strategic sector that is important to national security. This has irritated other oil-producing countries like Russia and Saudi Arabia. The stock market's negative reaction to the oil price collapse is partly due to worries about increasing credit and job losses among oil companies.

The US Congress is expected to grant capital support to the country's critical oil sector, but overproduction is a concern. Our price forecast for 2020 is an average of USD 40/barrel. During the second half, prices will be around USD 30 and then gradually rise toward year-end as the economic outlook stabilises. Our forecast for 2021 is USD 50/barrel.

Challenges to a stable inflation environment

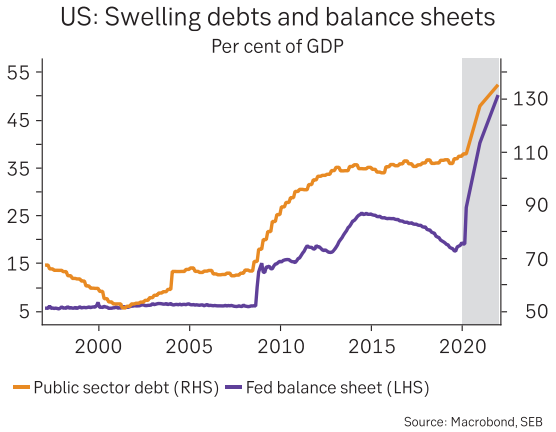
Over a long period, we have become accustomed to the dominance of disinflationary forces. Despite high resource utilisation and historically very low unemployment, central banks have had difficulty nudging up inflation to their own targets. Nor have setbacks to globalisation – due to trade wars and Brexit – had any major impact on the inflation environment. But because of the pandemic, we are now seeing closed borders on a larger scale and forceful monetary expansion, which more clearly raise questions about the stability of the inflation environment.

Falling energy prices will dominate in the short term. In the immediate future, however, it is clear that inflation will be driven lower. Falling energy prices will make a 1-2 percentage point negative contribution to Consumer Price Index (CPI) inflation during 2020. Weak demand and rising unemployment will also push down underlying inflation. Price hikes due to decreased supply – a result of food and pharmaceutical export bans in some countries – will pull in the opposite direction. So far, however, world market prices for agricultural products have not climbed and the wave of hoarding we saw at the beginning of the lockdown process generally appears to have faded. Overall, we now expect inflation to fall to zero as early as May and then remain there for about a year. The subsequent upturn will also be largely driven by energy prices, as the effects of price declines vanish from 12-month figures and oil prices gradually recover. Also worth noting is that over the next few months, producers of statistics will face special technical problems since consumption in some areas has fallen so dramatically that it is not possible to make any reliable price measurements.



Risk of major setbacks to globalisation. Given lingering high unemployment and low resource utilisation, it will take some time before traditional cyclical inflationary forces make themselves felt. Indirect effects of earlier energy price declines will also hold back inflation during the next couple of years. But changes caused by the coronavirus crisis may pull in the other direction. Supply chains that become more local or regional, and less global – for example as a consequence of increased demands for national control of pharmaceutical and food production – are factors that may drive up inflation in important areas. If this trend is far-reaching, the disruptions may be severe.

Are economic policy makers playing with inflation fire? The long-term consequences of exceptional stimulus measures will also raise questions. Once we approach normal resource utilisation, central banks are likely to accept and even approve of inflation that overshoots their targets. The mandates of the Fed and other central banks will probably also be revised in such a way that they may try to achieve their inflation target "on average" over time. After a long period of bias towards excessively low inflation, this consequently represents a need for a period of overshooting. A less strict interpretation of inflation targets and a suitable degree of "irresponsibility" by central banks may help keep inflation expectations up and ensure that real interest rates do not climb.



A period of higher inflation would thus arrive at a time when both government debt and central bank balance sheets have soared. The Fed has declared that it is now prepared to buy government securities with no limits. European Central Bank (ECB) purchases of government securities during 2020 appear sufficient to finance most budget deficits in the euro area. There are many indications that current central bank purchases of government securities will not be phased out in the foreseeable future, in line with the Japanese example.

There are many indications that current central bank purchases will not be phased out in the foreseeable future

In practice, this represents a monetisation of public sector debts, even though central banks firmly deny this. Our theme article "Historical crisis policy" on p 12 discusses this new situation, in which the boundaries between fiscal and monetary policy are blurring in a way that may undermine central bank independence. In spite of this, there is not an especially great risk that inflation will skyrocket. Swelling debts and balance sheets may generate inflation to the extent that they

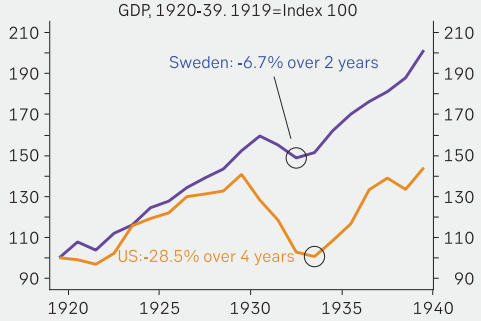
contribute to demand exceeding supply in the economy. But governments and central banks have time to withdraw their stimulus and liquidity measures, and inflation expectations are about to rise. It seems a bit far-fetched that developed countries would deliberately want to use inflation as a way of sharply reducing their real-term debt burden, but individual countries may be affected by trust issues that lead to sizeable inflation impulses via weaker exchange rates We also believe that central banks in some less developed countries are refraining from large-scale QE programmes in order to ensure that governments will not to be tempted into inflationary money-printing policies.

Far from the 1930s Depression

Today there seems to be a great need for historical comparisons. With the downturn – at least in the short term – likely to be worse than during the 2008-2009 global financial crisis, we have to go back to the Great Depression of the 1930s to find a deeper downturn. In many ways, the Great Depression was so severe that the comparison is misleading, but some aspects are worth highlighting. After the Wall Street crash of October 1929, American GDP fell four years in a row by a total of nearly 30 per cent before hitting bottom in 1933. Unemployment rose from 3 to 25 per cent during the same period, and the stock market completely collapsed, losing 90 per cent of its value (S&P 500).

1930s crisis in the US much deeper

GDP, 1920-39. 1919=Index 100

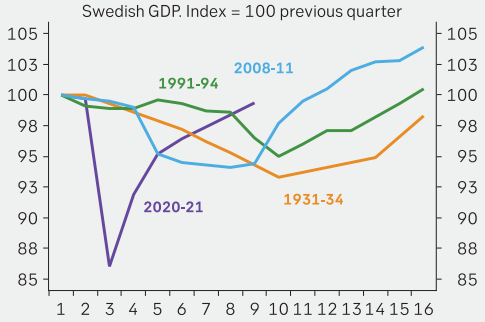


Source: Lund University, Maddison Historical Data, Macrobond, SEB

Sluggish policy response was disastrous. The policy response was delayed for such a long time that this is usually cited as one reason for the catastrophic downturn. Economists argued for years about the proper medicine. The Republican administration of President Herbert Hoover remained passive and mainly relied on the "self-healing powers" of the economy to bring out a recovery. Not until 1932-33 did Keynesian concepts of active fiscal policy become fashionable. In the US this took the shape of President Franklin D. Roosevelt's New Deal programmes. Sweden's economic downturn was much milder, totalling an accumulated 6.7 per cent. Fiscal stimulus began somewhat earlier in Sweden, but perhaps a more important difference was that in the autumn of 1931, Sweden followed the United Kingdom's example and abandoned the link between its currency and gold. The gold standard was replaced by the world's first "price-level targeting" regime, but the result was a clear devaluation that made Sweden's recovery easier. Countries like the US and France instead lost competitiveness by sticking to the gold standard. Exchange rate movements due to uncoordinated global retreat from the gold standard later resulted in a wave of protectionism that lasted for the rest of the 1930s.

COVID-19 recession different from others

Swedish GDP. Index = 100 previous quarter



Source: Macrobond, SEB

Many-facetted Swedish 1990s crisis. In Sweden, the crisis of the early 1990s is also interesting as a comparison. Viewed from a GDP standpoint, it was a bit milder than the 1930s downturn, but it unfolded in a rather similar way. The crisis arrived in successive waves. The first phase consisted of a cost crisis, in which Swedish exporters were hard-pressed due to employee pay increases that were many times higher than in competitor countries for a number of years. In a second phase, the international real estate crisis swept across the country, brutally revealing excesses in the financial deregulation of the mid-1980s in the real estate market. The consequences of this were also amplified by certain features of the big 1990-91 tax reform. The crescendo then came when the European Exchange Rate Mechanism collapsed in 1992 and Sweden tried desperately to defend its peg against the European Currency Unit (ECU) by means of sky-high interest rates. As the above chart indicates, the recession path we are seeing today presents a V-shaped pattern that is completely different from the other three comparable crises. One precondition for its realisation is that new policy conflicts or dilemmas do not appear during the complicated phase that we will go through over the next couple of years.

How will the "post-corona" world look?

Even though we are only at the beginning of the coronavirus crisis, there is already a lively public conversation about its long-term consequences. Aside from purely macroeconomic consequences like rising public sector debt and expanded central bank balance sheets, we can highlight several other possible trends:

National governments will be strengthened, for better or worse. There are many indications that the crisis will lead to a stronger role for national governments. There are obvious risks that this process will go too far and that we will see widespread setbacks for free trade and the climate of international cooperation. But in some areas, there may also be a sobering realisation that people had been unrealistically hopeful about what could be achieved by international cooperation and by restricting the manoeuvring room of national governments in harmful ways. In Sweden, this shift may be larger than in other countries, since we have implemented especially far-reaching deregulation and phased out various forms of emergency stockpiles. For a long time, Sweden has also paid little attention to the ownership of strategic companies in various key sectors. In a world of increased tensions between China and the West, this issue may end up being a higher priority.

Stronger incentives for technological development. Less labour mobility, combined with more regional and fewer global value-added chains, may persuade rich countries to take less advantage of cheap labour in other parts of the world than in recent decades. This may push inflation higher, but further ahead it will also probably lead to increased pressure for technological development as well as stronger incentives to use existing technology. This would make it more likely that we may finally experience a new surge of productivity, in the form of the "Fourth Industrial Revolution" that has been discussed in recent years.

We are more likely to finally experience a new surge of productivity, a Fourth Industrial Revulotion

A green transition will be easier to achieve. The coronavirus crisis broke out at a time when "green" issues enjoyed a strong tailwind. At the moment these issues occupy less space in the public conversation, but it is reasonable to imagine that the crisis may lead to lasting changes that will benefit the trend towards a fossil fuel-free society. In spite of obstacles, so many things have worked smoothly in the contact-free environment during the lockdowns. This will probably lead to increased use of digital technology, thereby decreasing travel. Governments can also take the opportunity to give a green profile to the programmes they must now implement in order to soften the economic downturn. At EU level, ambitions to launch a Green New Deal may gain stronger momentum.

Earlier crises have often changed the playing field, but there are also reasons to be cautious about predicting major changes due to the crisis. Experience suggests that most people will return to business as usual, unless institutional conditions change. After earlier crises, people also managed to reach a consensus on some useful lessons. The experience of the 1930s Depression led to a lasting breakthrough for more active stabilisation policies, with governments assuming greater responsibility. The collapse of the Bretton Woods system and the oil crisis of the early 1970s led to institutional changes that made it necessary to devise new solutions. The experience of the early 1990s crisis in Sweden led to various changes, for example related to wage formation, the government budget process and monetary policy – including a floating exchange rate supplemented by inflation targeting, to be administered by an independent Riksbank. In the aftermath of the global financial crisis, there was a wave of regulation aimed at increasing the stability of the financial system.

Will ideological conflicts return? We can always hope that the crisis will increase the chances of breakthroughs related to structural policy reforms. In Sweden, a number of important fields – such as taxation, labour market and housing policies – have been plagued by major gridlock for many years. But the question is whether political leaders can reach very many shared conclusions this time around. At present, commentators representing a wide range of viewpoints seem to be using the coronavirus crisis as an argument for the need to enact their particular ideas. Once the crisis is over, there are many indications that the ideological conflicts that underpin Sweden's political gridlock will flare up again.

Theme:

Historic crisis policy

Record-high government debts, swelling balance sheets

The official policies announced to ease the economic crisis caused by the COVID-19 pandemic are unprecedented. These fiscal and monetary policy measures are equivalent to 20 per cent of global GDP. Government debts and central bank balance sheets are swelling to record levels, and the line between fiscal and monetary policies is becoming ever blurrier. Crisis policies have addressed the right main problems but have lacked global coordination. They raise questions about what debt levels are sustainable, and thus what manoeuvring room will be left for supporting growth when the crisis fades. Central bank independence will also be in focus as we approach a monetisation of national budget deficits.

The task of crisis measures is to offset lost production capacity and jobs as well as ensure financial stability. Political leaders and central bank governors have promised to do "whatever it takes" to manage an acute crisis situation, but their actions have unfortunately revealed a lack of coordination and solidarity between countries, for example in the European Union. But the fact that such measures have been launched in most countries during an extremely short period means their overall impact at global level is strong, as countries largely utilise the same fiscal and monetary tools.

Combined **fiscal measures** so far have delivered stimulus equivalent to 11 trillion US dollars (13 per cent of global GDP). These measures can be divided into three categories: 1. direct costs for health care, tax cuts or cash payments, public programmes etc.; 2. postponed payments of corporate tax, fees and so on, which has a temporary adverse effect on government borrowing requirements; and 3. government loan guarantees and support to certain sectors, which are expected to be budget-neutral in a long-term perspective. Aside from these active decisions, the economy is also supported by automatic stabilisers: systems that are activated when GDP falls, such as expanded unemployment insurance benefit payments.

Total **monetary stimulus measures** are estimated at USD 6 trillion (7 per cent of GDP) as central banks have financed their purchases of securities and lending to businesses (via the banking system) by "printing" new

money. Central banks with room to do so have lowered their key interest rate to nearly 0 per cent. Those CBs that initially had negative key rates have abstained from lowering them further. Using negative interest rates in today's crisis environment seems counterproductive, since this would generate further uncertainty. It would also squeeze banking systems with low profitability and high percentages of troubled loans, thus increasing the risks of financial instability.

To help more businesses gain access to loans, central banks and regulatory agencies have also lowered capital adequacy requirements in the banking system. This is making possible a lending capacity of about USD 500 billion. But banks must still assess the credit-worthiness of potential borrowers – even though government loan guarantees make things easier – to ensure that new risks are not built into the financial system. Before businesses are prepared to increase their debt levels, however, they must also discern the prospect of improved demand for their products and be confident that they can repay their loans in the future.

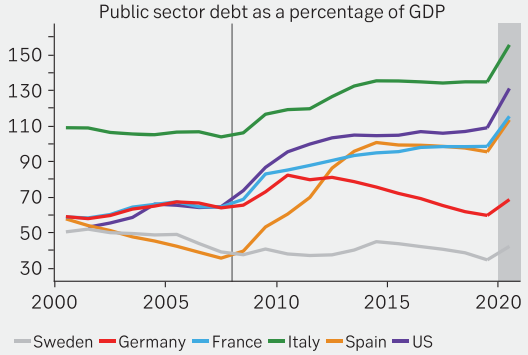
Central banks have limited ability to influence the kind of collapse in real economic growth we see today. Unlike the Swedish recession of the 1990s or the global financial crisis of 2008-2009, the problems do not have their epicentre in the banking system. Yet the actions of CBs may reduce the risk that today's pandemic – which has caused a collapse in production, demand and global trade – will evolve into a full-scale financial crisis.

Warnings about debt even before COVID-19

The world entered the COVID-19 crisis with record-high debts (see "Theme: A world full of debt", *Nordic Outlook*, February 2020). This growing debt mountain has been a source of great concern among economists and investors, among other things due to risks that growth may eventually collapse under its weight.

Heavy debts are getting even heavier

Public sector debt as a percentage of GDP



Source: International Monetary Fund (IMF), Macrobond, SEB

Public sector debts are now growing to new record levels. It is hard to estimate how much these debts will increase relative to GDP, due to greater uncertainty about both the GDP decline and the need for new fiscal rescue packages., but we estimate that in 2020 combined public sector debt in the OECD will increase by about 20 percentage points to an average of about 125 per cent of GDP. This will decrease manoeuvring room for fiscal stimulus in the aftermath of the crisis and boost vulnerability to strains from ageing populations and future crises. Faster-rising public debt may also leave less room for green investments.

However, the new low interest rate environment that has been established will substantially ease this situation. Interest expenses as a percentage of GDP are at historically low levels, despite sharply rising debt levels since the global financial crisis of 2008-2009. During the euro crisis of less than 10 years ago, some observers opined that public sector debt above 125 per cent of GDP risked becoming destabilising. Yet the fact that structural factors will keep interest rates low for a lengthy period is raising the pain threshold for how high public sector debt can be. In addition, the world's central banks have shown their willingness to buy government securities and prevent an upturn in interest rates and bond yields that is not primarily driven by inflation, thereby also making higher debts possible.

Discretionary fiscal policy – COVID-19 crisis
Selected countries, April 20, 2020. Per cent of GDP.

	Direct effect	Liquidity boosting	Guarantees, grants etc.	Total
US	9.1	2.6	4.9	16.6
Germany	6.9	14.6	38.6	60.1
France	2.4	9.4	14.0	25.8
Italy	0.9	13.2	29.8	43.9
Sweden	3.0	6.4	4.4	13.8
Norway	4.6	1.9	3.7	10.2
Denmark	2.1	7.2	2.9	12.2

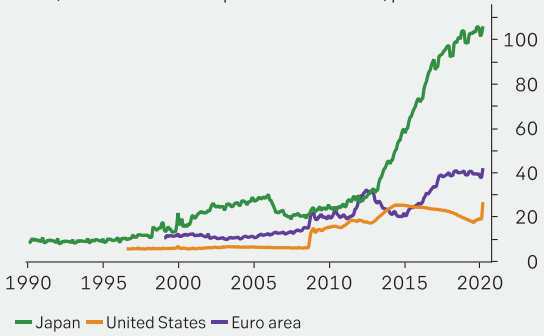
Source: SEB, Bruegel

Is monetary "subordinate" to fiscal policy?

Monetary policy by itself, focused on key rates and long-term yields, is fairly powerless in the prevailing crisis. Further lowering the price of money (interest rates) will hardly help to boost consumption and capital spending. Instead fiscal policy will play the main role by extending a lifeline to businesses and households and by supporting the post-crisis recovery. The task of monetary policy will be to hold down the funding cost for growing government budget deficits and debts.

Central bank balance sheets growing again

Fed, ECB and Bank of Japan balance sheets, per cent of GDP



Source: SEB, Macrobond

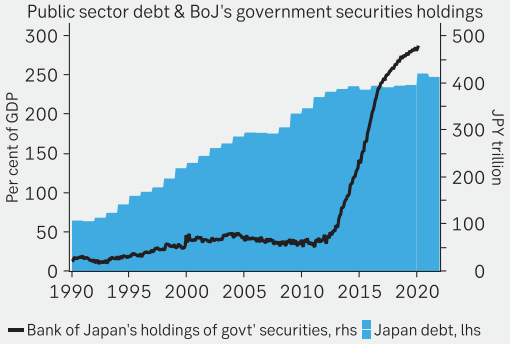
Fed buying unlimited government securities

Reacting to the pandemic, the **US Federal Reserve** has announced that it will buy unlimited quantities of

government securities. This year the **European Central Bank (ECB)** will buy more than EUR 1 trillion worth of securities, while the **Bank of England (BoE)** intends to buy USD 250 billion in British government paper. The **Bank of Japan (BoJ)**is pursuing a policy similar to the Fed's in volume terms, but has focused on yield level; it will make purchases in such a way that the yield on a 10-year government bond will be close to 0 per cent. In Japan, where 25 years of large budget deficits have been matched by big CB purchases of government securities, it is clear that the BoJ's sizeable bond holdings will never return to the fixed income market.

Heavy public sector debt is owned by the BoJ

Public sector debt & BoJ's government securities holdings



Source: International Monetary Fund (IMF), Bank of Japan (BOJ), Macrobond, SEB

Line between CBs & governments blurring

A combination of rapidly growing budget deficits and large-scale central bank purchases of government and other securities (quantitative easing = QE programmes) – funded by the "printing" of new money – means, in practice, monetary financing (MF) of a portion of government debt. The strict definition of MF is that a CB buys debt securities directly from the government – or credits the government's account at the central bank – in an amount that covers the government's current expenditures. In this way, monetary policy can thus be used for fiscal purposes.

Bank of England opens Pandora's box

In early April the British central bank announced that it will let the government borrow directly from the bank without first issuing government securities. Via its BoE account ("Ways & Means"), which is not new, the government can now obtain direct funding in "unspecified amounts". Although the BoE emphasises that this arrangement is temporary, the borderline between the government and central bank balance sheets has undoubtedly become more unclear. According to EU treaties, for example, the European Central Bank is prohibited from monetising budget deficits. The question is whether the continued crisis will force changes in the EU as well.

Many countries explicitly prohibit their government from obtaining direct financing from the central bank. One of the main reasons is that MF hurts the credibility of inflation-control measures when the CB is deprived of its operational independence. It may ultimately also mean that changes in the CB's balance sheet become unpredictable, thereby coming into conflict with its inflation-targeting policy and independence.

Timing and future signalling are important

Central banks maintain that money is created as a consequence of their government securities purchases – not for the purpose of financing the government's budget deficit. In addition, such actions are temporary, according to CBs: these securities have a maturity date and once they fall due, the system is drained of money.

The purpose of MF is to provide a permanent supply of nominal purchasing power. Such an injection must not be considered reversible. This also applies to fiscal stimulus; governments that would like to begin talking about debt restructuring even now run the risk of reducing the effectiveness and impact of their crisis stimulus. Nor does MF increase the need for future tax levies that might give the private sector incentives to save the expanded purchasing power provided by crisis stimulus, for example to pay for future tax hikes.

The effectiveness of monetary policy is also weakened if there is a risk that economic players will interpret central banks' purchases of government securities as temporary while CBs also maintain strict inflation targeting policies. In the prevailing crisis situation, effectiveness may also be weakened by an overly clear division of responsibility between government and central bank.

CBs ensure that governments have access to capital at a low funding cost. Experience from Japan's 25-year "crisis policy", as well as the Fed's attempts to trim its government securities holdings, suggest that we may regard CB holdings of such securities as essentially perpetual. Over the next couple of years, they are also totally necessary and beneficial. Putting Italy's debt in the hands of the ECB rather than the market represents a crucial difference compared to the 2010 euro crisis. In 2020 the ECB is expected to buy nearly EUR 940 billion worth of government securities. In practice, this is probably enough to finance this year's euro area budget deficits, totalling around 10 per cent of GDP.

The risks of monetary financing

When CBs buy government securities or otherwise expand their balance sheets, this also increases the monetary base and thus the money supply, thereby boosting the risk of unwelcome inflation. But the risk of hyperinflation and the desire to merely generate a monetary transfer and higher demand can be managed by imposing reserve requirements (forcing banks to keep a certain amount in their accounts at the CB) equivalent to the higher money supply. Of course this is not needed at present, but it may be considered later.

MF involves operational, legal and institutional issues and to some extent also implies a return to political influence on monetary policy, after many years of efforts to draw a clear line between fiscal and monetary policies. In practice, it also means the disappearance of national debt policy. Monetary financing of budget deficits is not good, but the alternative is worse. MF is taking us into uncharted but perhaps necessary new territory.

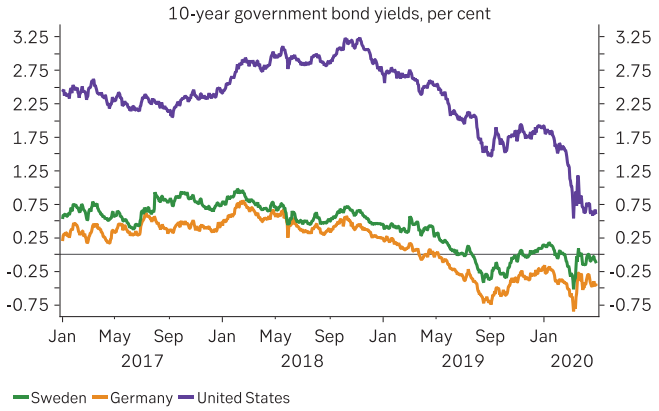
Fixed income

Tug-of-war between greater supply and QE

The "whatever it takes" strategy of central banks (CBs) is dampening the upward pressure on long-term government bond yields due to historically large budget deficits. Production disruptions and shrinking global trade will eventually justify higher inflation expectations – suggesting somewhat higher future long-term US and European yields. But low yields will persist; the market foresees that 60 per cent of all bonds will be traded at 0-1 per cent over the next three years.

US Treasury yields on new all-time lows

10-year government bond yields, per cent



Source: Macrobond, SEB

10-year government bond yields
Per cent

	May 4	Jun 2020	Dec 2020	Dec 2021
United States	0.64	0.70	0.90	1.20
Germany	-0.54	-0.40	-0.40	-0.10
Sweden	-0.08	0.15	0.15	0.35
Norway	0.58	0.70	0.70	0.90

Source: National central banks, SEB

US Treasury yields have reached new lows. Like other financial market prices, yields have shown large movements in recent months. The Federal Reserve's key rate cuts and quantitative easing (QE) programmes caused yields to fall early in the COVID-19 crisis, but in mid-March long-term US yields climbed due to increased stress in the credit market, as investors were forced into "fire sales" of Treasuries to free up liquidity. After new crisis packages from the world's CBs, including unlimited bond purchases by the Fed, the situation has stabilised. In early May, 10-year US Treasury yields are near the lows of recent months: around 0.60 per cent, or some 80 basis points below their previous lows in 2016. Credit spreads on risky assets ("high yield" bonds) remain well above pre-crisis levels: in the US, 300-400 bps higher.

European and American yield trends are diverging. After initially falling to new lows in early March due to increased expectations of key interest rate cuts, 10-year German and Swedish government bonds are trading at essentially the same yields as in early February. European credit spreads have widened, however. For example, the spread between 10-year Italian and German government bonds has climbed about 100 bps since late February.

There is great uncertainty about future long-term yields. Short-term interest rates are easier to predict. Although central banks might favour key rate cuts due to the COVID-19 crisis, negative rates may adversely affect the stability of the financial system. Nor is it likely that CBs will want to hike key rates in the next couple of years; there will be widespread acceptance of above-target inflation. The trend of long-term yields is more uncertain. In the near term, news about the spread of the virus and changes in risk aversion will dominate market movements. Considering the dramatic drop in US yields, our assessment is that 10-year Treasury yields may climb somewhat during this year, while we foresee more sideways movements for their European equivalents.

The tug-of-war between supply and QE purchases will determine the future level of long-term yields. The supply of government securities is now increasing dramatically. Meanwhile CBs have promised large-scale QE programmes and are prepared to do more if higher yields jeopardise growth and financial stability. In principle, a monetisation of government budget deficits is under way (see "Theme: Historic crisis policy", p. 13), which may have consequences for future inflation risk premiums. A combination of better economic performance and larger bond supply will lead to somewhat higher yields in both the US and Europe during 2021.

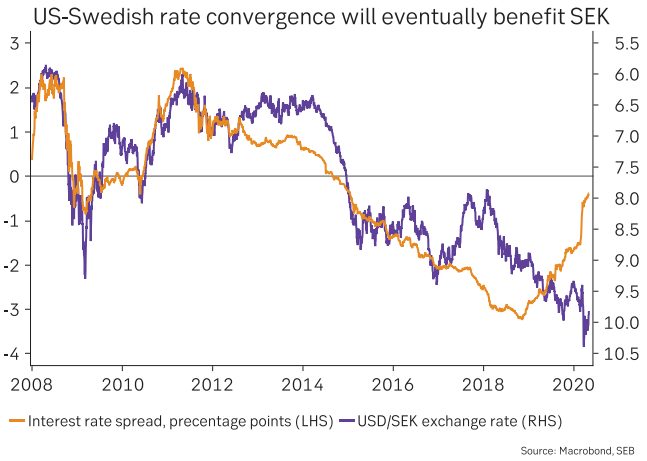
The market's inflation expectations have fallen dramatically in recent months as economic growth and oil prices have plunged. In the US, the market is pricing in inflation averaging 1 per cent over the next ten years. We believe that the risk of production disruptions and decreased global trade will lead to somewhat higher inflation further ahead and that inflation expectations should climb somewhat. But we consider it unlikely that inflation will soar and justify clearly higher inflation expectations. A reasonable estimate is that inflation expectations should be about 1.5 per cent in the next couple of years, which is the average core CPI in the OECD countries since 2000 (for more about our estimate of long-term US yields, US, see *Nordic Outlook*, February 2020, p. 17).

Wider spread. The spread between Swedish and German 10-year government yields has widened and is now 45 bps, at the upper end of its recent years range. We believe the spread can continue to widen as the Riksbank has announced relatively small purchases in government bonds while supply will increase dramatically. Our forecast is that the spread can increase to 60 bps in coming months but then tighten some again when the Riksbank announce more QE.

The FX market

Headwinds facing the krona have dwindled

The COVID-19 crisis has contributed to greater foreign exchange market turbulence, after a lengthy period of unusually small movements. In keeping with traditional patterns, defensive currencies have risen at the expense of less liquid ones. Converging key interest rates will help undervalued currencies regain lost ground as risk appetite normalises. We thus believe the USD will weaken while the SEK gradually climbs, no longer weighed down by a negative Swedish key rate.



Exchange rates

	May 4	Jun 2020	Dec 2020	Dec 2021
EUR/USD	1.09	1.08	1.14	1.20
USD/JPY	106	108	111	113
EUR/GBP	0.88	0.90	0.86	0.82
EUR/SEK	10.75	11.00	10.30	9.85
EUR/NOK	11.29	11.25	10.35	10.00

Source: Bloomberg, SEB

Greater volatility due to the crisis. After a lengthy period of unusually small exchange rate movements, FX market turbulence rose sharply in response to plummeting stock markets, as the coronavirus gained a strong foothold outside China. To a great extent, the market followed a classic pattern, where defensive currencies appreciated at the expense of smaller, less liquid currencies. In April, the situation stabilised amid rising hopes that official restrictions may slowly begin to be lifted, but short-term exchange rate movements remain larger than before the crisis broke out and are likely to remain so for as long as uncertainties about the economic consequences of the pandemic persist.

Temporary USD depreciation as the outbreak began. The US dollar weakened as the crisis began, but since then it has gradually risen against other major currencies. In times of sudden major stress, investors often need dollar liquidity and liquid instruments. The latest trend has made the dollar even more overvalued than before, but the US Federal Reserve's aggressive key interest rate cuts have meanwhile contributed to rapid key rate convergence with other leading central banks. This has almost eliminated one dollar-positive force, and we expect broad USD depreciation in the second half of 2020 as the situation slowly continues to normalise and as risk appetite returns. Our EUR/USD exchange rate forecast is 1.14 at the end of 2020 and 1.20 at the end of 2021.

The pound risks a decline, due to continued Brexit uncertainty. After recovering last autumn and winter, the pound plummeted in response to stock market turbulence during March. This reaction was probably connected to a sharp cutback in pound positions – acquired after EU withdrawal in January – as the COVID-19 crisis escalated. Since then the pound has recovered. We believe it will continue to strengthen, with the EUR/GBP exchange rate falling to 0.86 at the end of 2020 and 0.82 at the end of 2021. Risks to the pound are on the downside, however, and are mainly related to the Brexit process. It is still uncertain whether a trade agreement with the EU will actually be in place by year-end. There is thus a risk that trade between the EU and the United Kingdom may be saddled with tariffs. The UK's economic situation was also under stress even before the outbreak, and there is a risk that the UK will be affected more severely than other countries, for example in the euro area.

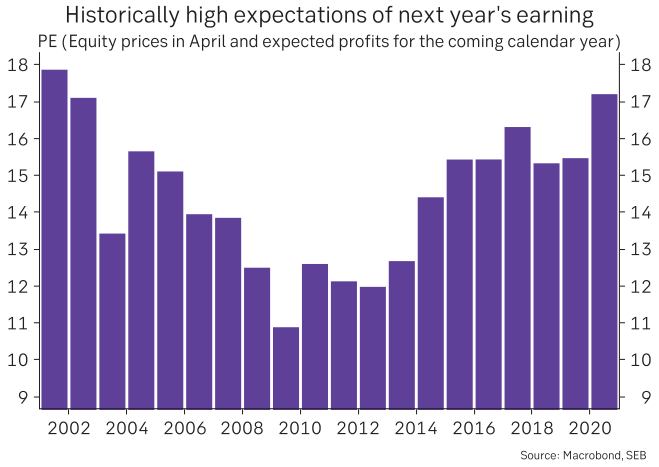
SEK will climb as risk appetite returns. The uncertain economic environment of recent months has not been beneficial to the Swedish krona, yet the SEK has been more resilient than during previous crises. This is probably because the Riksbank's key interest rate has been negative. A zero rate today and with falling rates in other countries have contributed to a fading of the headwinds from key interest rate spreads. Long term, the krona is undervalued. Assuming a stabilisation of the global economic environment, we expect the EUR/SEK rate to fall to about 10.30 at the end of 2020. This trend will continue during 2021, when the EUR/SEK rate will fall below 10 for the first time since February 2018. The risk to the krona is mainly tied to a possible policy reversal by the Riksbank with regard to a negative key rate and the possibility that the COVID-19 crisis may be more prolonged than in our main scenario.

The NOK continues to be squeezed by low oil prices. The Norwegian krone plunged when the bottom fell out of the oil market. Weak NOK liquidity regularly amplifies exchange rate movements, and the EUR/NOK exchange rate peaked above 13.00. In fundamental terms, the NOK is greatly undervalued, but as long as Brent oil prices – now at around USD 20/barrel – remain depressed, the Norwegian currency is likely to stay at historically low levels. As risk appetite returns and oil prices normalise, we expect the krone to appreciate: with the EUR/NOK rate reaching 10.35 at the end of 2020 and 10.00 at the end of 2021.

The stock market

A roller coaster ride, due to the pandemic

Not surprisingly, prices of various types of corporate risk have climbed after their dramatic plunge earlier this spring. Stimulus packages and the prospect of reopening economies justify lower risk premiums – especially for corporate bonds, due to reduced risk of credit losses. Stock markets are now approaching their previous peaks, indicating that the market is already discounting more normal earnings levels. We share this long-term view but see risks of disappointments along the way.



Rapid stock market plunge. It is not surprising that the outbreak of the COVID-19 pandemic triggered one of the biggest stock market downturns of modern times. Large-scale lockdowns of societies and economies will naturally lead to a broad decline in corporate earnings. This also happened in a situation where share valuations were at or above earlier peaks (except the millennium bubble). The downturns that followed were in the 30-35 per cent range: close to the historical average for "bear markets" (defined as periods when the stock market falls more than 20 per cent).

Followed by a quick rebound. There are also good reasons why stock markets started climbing again in late March. Flattening COVID-19 infection curves shifted the political conversation about the pandemic from the scale of necessary lockdowns to how and at what speed reopening would occur. Together with unprecedented stimulus packages, which are still being expanded today, this allows investors to assume that within a reasonable period the ongoing obliteration of corporate earnings will be replaced by earnings growth, propelled by the recovery. But it seems a bit optimistic to expect the fastest economic rebound of modern times, as the speed of the recent stock rally implies. More than half of the downturn has now been recovered, as measured by America's S&P 500 index.

Broad-based decline. The market downturn was also different from earlier crashes in other ways. Since it was triggered by a non-economic factor with broad impact on the entire economy, it affected all stock market segments in fairly similar fashion. At the sectoral level, energy stands out with the biggest declines by far, driven by the oil market drama. Otherwise the differences are relatively small, with cyclical sectors on the weaker side while IT and health care shares are largely back where they started. But one exception is that small business shares have fallen more than the rest of the market: possibly more an effect of liquidity risk than anything else. If so, this suggests that the rebound potential is especially big for these companies.

Earnings forecasts may fall further. One thing that makes it harder to judge whether today's share prices are reasonable – based on normal factors like earnings growth and valuations – is the great prevailing uncertainty about future economic developments. Since everyone assumes that earnings will fall sharply this year and then recover strongly in 2021, the question is naturally what earnings levels to put into our calculations and what multiples can reasonably be assigned to them. Forecasts of the MSCI World index indicate that corporate earnings will fall by nearly 20 per cent this year, with a risk of further downward revisions. Looking at 2021, consensus forecasts indicate a rather large earnings upturn. Analysts expect the 2021 earnings of S&P 500 companies to be somewhat higher than they were in 2019. This seems a bit optimistic, since economic growth forecasts indicate a clearly lower average in 2021. Also keep in mind that 2019 was a year when everyone had a job and companies were operating at full speed. These high 2021 levels can probably be explained by the current focus on adjusting the forecasts for this year downward. Meanwhile there is still room for 2020 earnings forecasts to fall further.

2020 a lost year, and high valuations based on optimistic 2021 forecasts. It is hardly meaningful to study valuation metrics such as price/earnings (P/E) ratios on the basis of forecasts of 2020 earnings decreases. If we instead use 2021 forecasts, the market's P/E ratio based on today's share prices turns out to be 18. The bar graph shows valuations (P/E) using a 12-month forward-looking earnings forecast (April-April) for each year since 2001. The result is a bit discouraging. Despite exceptionally uncertain earnings forecasts, with large downside risks, the market is applying the highest valuations since the IT (dotcom) bubble. It will thus require

a stronger economic recovery than we have forecast, a longer discounting horizon on earnings and/or an acceptance of higher valuations long-term (for example, justified by lower interest rates and yields) for today's share prices to be justified by fundamentals. Discounting a long period of earnings increases may be reasonable, since the economic slump creates idle resources that might make a long period of growth possible once the crisis is over. Low interest rates and yields over a long period will support higher valuations. Combining these factors, today's historically high valuations may well be justified, thus creating a new valuation standard.

Low interest rates and yields over a long period will support higher valuations

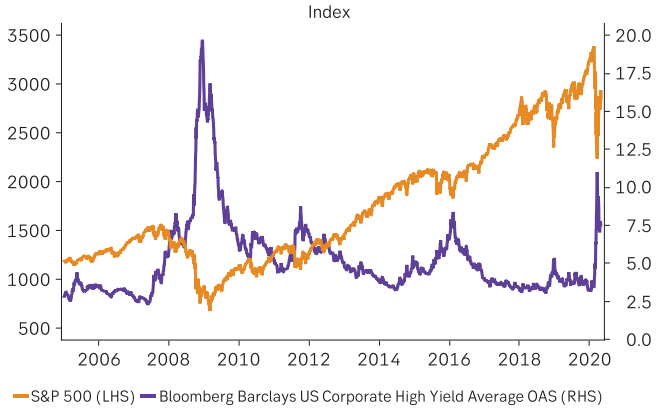
Large price decline for HY bonds, too. The corporate bond market has reacted in the same way as stock markets. Bond prices fell when credit spreads (the differential between corporate and government bond yields) widened rapidly during the recent downturn. The recovery also followed the stock market pattern when risk appetite returned. For natural reasons, movements were larger for bonds with lower credit ratings (high yield, HY) than for less risky investment grade (IG) bonds. Credit spreads are now substantially wider than the historical average, especially for HY bonds. This is justified by the increased risk of credit events, when companies are unable to repay their bonds. From normal spreads for HY bonds of around 300-400 basis points in the US, spreads peaked at more than 1000 bps. Today they are at about 700. Given today's low government bond yields, this means that American HY bonds are trading with current returns of around 7.5-8 per cent.

The market has now made allowances for increased credit losses. A return forecast needs to be adjusted for expected credit losses. At present, market forecasts indicate about a 10 per cent default rate, compared to 13 per cent during the financial crisis. Assuming asset recoveries maintain their historical level (50 per cent), this reduces return potential by 5 percentage points. However, we expect credit spreads to shrink when the economy stabilises, enabling the risk premium to be adjusted downward. It would suffice if spreads shrank halfway towards historical norms for the price increase this creates for bonds to more than offset expected higher credit losses.

High yield bonds often outperform during recovery periods. It is natural for corporate credits to follow a pattern similar to equities, since they both essentially involve taking a risk on the same company. But while share prices are driven by a company's income statement and potential to generate future earnings, bonds are driven by its balance sheet. As long as debts can be repaid, bonds deliver their returns. This is one reason to buy bonds when the earnings outlook is uncertain. In fact, during post-crisis recovery periods HY bonds have often delivered better returns than corresponding stock market investments, despite lower risk. Another argument for credits as opposed to shares is that large-scale programmes aimed at supporting the corporate sector are likely to reduce the risk of credit losses. Several central banks, including the Fed, have announced that they are now buying corporate bonds, including some HY bonds, in order to support the market and decrease liquidity risk.

Low interest rates and yields will continue to help the stock market. For those who expect a faster recovery in economic growth and earnings than we are forecasting, equities appear to have the biggest potential. But even in our main scenario, there are many indications that the market may be prepared to discount earnings further ahead (and thus accept higher valuations than in traditional models) – thus explaining rising share prices in this otherwise gloomy environment. Because of the rapid upturn in prices, however, further weak economic statistics may generate new uncertainty and new stock market disappointments during the coming months: a common pattern following major downturns. The TINA (There is No Alternative) argument nevertheless suggests that any market dip will quickly attract buyers who have a lack of alternatives; if the growth situation holds up, the stock market has probably passed its lowest point.

Equities and credits have reacted in similar ways



Source: S&P Dow Jones Indices, Macrobond, SEB

Theme:

Fighting COVID-19

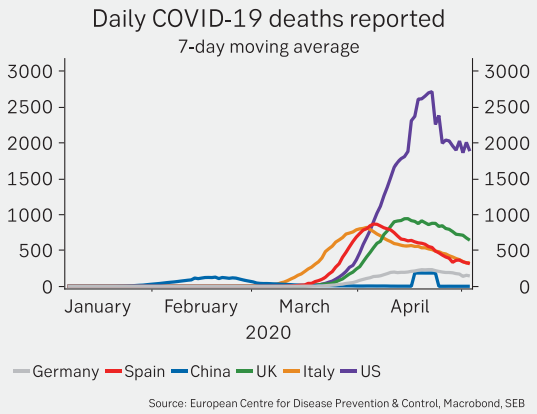
Critical factors in order to start the wheels turning again

There are positive signs that the spread of the coronavirus has stabilised in many countries and that the outbreak is past its peak. Governments in Europe, the US and Asia have thus begun planning to safely restart their economies. Mass testing and new technology will be vital tools – and part of an "infrastructure" – to prevent new outbreaks and allow steps towards normalisation. There are many indications that time, and this infrastructure, will enable the world to be better prepared for the next virus wave. Manufacturers need global coordination of exit plans in order to safeguard production and make sure that certain companies are not given advantages by being the first to restart.

Signals from various parts of the world indicate that the COVID-19 pandemic has entered a more stable, if not calm, phase. The number of daily new infections, as well as deaths, is slowly falling in a number of countries.

The spread of the disease has followed similar patterns in many countries, although there have been significant differences in how officials have chosen to manage the outbreak. The number of new COVID-19 diagnoses shows clear similarities between countries, but with major differences in such matters as how many – and which – people they have chosen to test. Over time, testing strategies have also changed. Yet statistics show that in countries like China, Italy, Spain and the US, it took about a month after aggressive measures aimed at stopping the spread of the virus were imposed before the number of new infections seems to have peaked. China and South Korea were the first countries hit by the virus, and the first to apparently succeed in stabilising the situation. After them came Italy, closely followed by Spain.

Once the spread of COVID-19 shows signs of fading, governments also begin the process of trying to find various ways of restarting their economies by gradually easing all the restrictions that are currently holding back economic growth around the world.



Because of major differences in the number of tests and how they have been administered, many observers prefer to look at the number of COVID-19 deaths when comparing countries (although such statistics are not entirely reliable either, since the degree of underreporting varies). But the overall picture is consistent with the approach that focuses on new cases. So far, the statistics clearly indicate that we have passed the peak of the virus outbreak.

The battle against COVID-19 continues

Despite improvements in the statistics, the battle is not yet won. The risk of new outbreaks is considered high and remains a cause for concern. To prevent a second or third wave, countries like China and South Korea have continued with rigorous observation of their populations, using a variety of new technological solutions.

In China, anyone who wants to move about freely must be able to show a kind of health certificate in their mobile phone. Using a mobile app, people answer a series of questions about their own health and to what extent they have been in contact with others who have been sick. With the help of an algorithm, the app then determines whether a person may move about freely or must stay home. For example, in order to ride the metro or go to a restaurant, people must be able to show a green code in their app.

Personal privacy vs battling the virus

Some countries also employ a rigorous system of following the movements of individuals via the mobile phone network in order to keep track of where the risk of new outbreaks is biggest. These methods may be perceived by many people as invasions of privacy. For that reason, they cannot be used to the same extent in places like Europe and the US. Yet it is worth recalling that one lesson so far during the COVID-19 crisis has been that Western governments have also been prepared to intervene very aggressively in people's normal freedoms and rights in order to prevent the spread of the disease.

Considering the enormous economic costs resulting from economic lockdowns, it is likely that a number of countries will follow the methods being employed in Asia and elsewhere – if they prove effective – and use technology both to combat the ongoing spread of the virus and to prevent a second wave. There are also many indications that their citizens are prepared to pay a high price in terms of lost privacy for the chance to return to a somewhat more normal everyday life.

While awaiting a vaccine: mass testing

Another tool that will help governments to gradually reopen their economies without risking major reversals is mass testing of their citizens. This method has successfully been used by South Korea. The Seoul government initially focused on retesting people who had had the virus. Over time, the focus has shifted to testing for antibodies, i.e. whether a person has already had the virus and can thus be regarded as immune.

Mass testing has definite potential to become an important part of enabling people to return to their workplaces. Testing all employees at a factory daily is obviously an effective way to resume production with few risks. So far, however, shortages of simple, reliable tests have made mass testing difficult. But quick and reliable tests already exist, and within the not too distant future these tests may become a key element of efforts to restart economies.

Global preparedness is improving

It is promising that more and more governments are making plans for how their economies can return to a more normal situation. Many industrial companies will welcome having dates to work with. But if it was difficult to decide on locking down large parts of society, decision to reopen are even harder. Restarting too early may lead to another major virus outbreak, forcing the economy to shut down again. In that case, the potential for managing the new wave of disease would be even more limited.

Many industrial companies will welcome having dates to work with

The risk of reversals should be taken very seriously, but it should not be exaggerated either. Around the world, governments are now under pressure from citizens to reopen their economies – or at least plan for this. Countries can learn from each other. Most countries are well aware of the risks and will probably intervene quickly if developments move in the wrong direction. In addition, every day we are increasing our knowledge of both the virus and the methods that are most effective in combating it.

Testing capacity is already high and is being expanded continuously. The populations of all countries have learned a lot about the virus, how it spreads and what we should do to avoid being infected. All countries have also sharply expanded their health care capacity to take care of those who will become infected in a second wave.

Herd immunity and vaccines are the paths forward to eliminate the COVID-19 problem in the long term. The experts disagree on which of these will arrive first. A global race is nevertheless under way, with huge resources being mobilised to develop a vaccine as soon as it is scientifically possible. Most observers believe it will take one or two years before a vaccine can be ready for large-scale use. This suggests that all countries will have to learn to live with the virus for a long time to come.

Making producers and consumers feel safe

The COVID-19 crisis has generated creativity and global competition in medicine and technology that is encouraging, both in the near term and further ahead. Government exit plans will enable various parts of the economy to restart. For manufacturers, the timing of these exit plans will have to be fairly well synchronised at the national and global levels. Otherwise some production will stop due to subcomponent shortages.

Being able to feel safe amid the new "infrastructure" of technology and medicine will determine how rapidly normalisation can occur

The first step is to restart production. After that, consumption will also have to resume. Households must feel that it is safe to go to work and spend their money on goods and services. Businesses need to know that they will not face new production shutdowns. Being able to feel safe amid the new "infrastructure" of technology and medicine will determine how rapidly normalisation can occur.

The Chinese economy is estimated to have reached 90 per cent of normal status. This has occurred 2½ months after the lockdown in Wuhan, the city where the spread of the virus apparently began. Worth keeping in mind is that China's economic recovery is now being adversely affected because the rest of the world has entered a deep recession.

The EU and the US are expected to gradually reopen their economies in May. Although it is uncertain how fast this will happen, there is already heavy pressure on governments to speed up the reopening process. This pressure can be expected to increase further as unemployment accelerates in most countries.

Pressure will also come from manufacturers, based on growing concerns about loss of competitive neutrality and about buy-out risks. Companies and countries that restart fastest may enjoy big advantages and opportunities to gain market share at the expense of countries – and thus companies – that have decided to keep production closed for longer. Governments are likely to carefully monitor what others are doing, in order to ensure that their own manufacturers are not put at a competitive disadvantage.

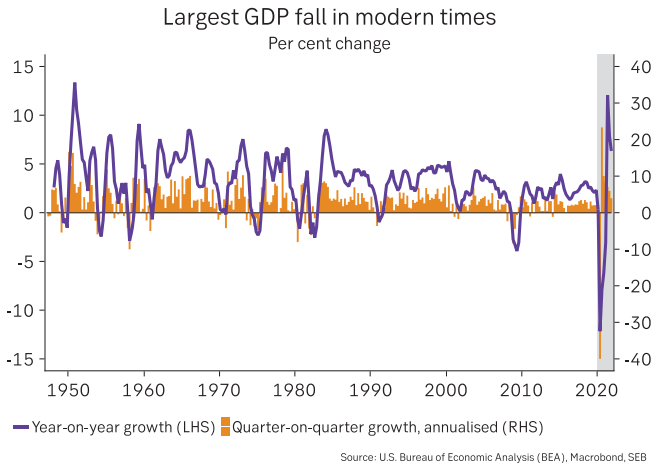
The competitive aspect and buy-out risk will provide an incentive to launch the restarting process as fast as possible

When countries emerge from the crisis at different rates, there is also a greater risk of undesired buy-outs. There is already a debate under way about how China, for example, views acquisitions of companies in other countries that have been temporarily weakened and are thus cheaper because their share prices have fallen. This dynamic – the competitive aspect and buy-out risk – will provide an incentive to launch the restarting process as fast as possible. It may thus happen quickly.

The United States

Explosive increase in public sector debt

The COVID-19 crisis is subjecting the US economy to major challenges. Despite record stimulus, we expect GDP to fall by 6.5 per cent this year, then gain 5.6 per cent in 2021– not enough to restore its pre-crisis level. Unemployment will peak at 17 per cent this fall and drop by only about half the increase by year-end 2021. Public sector debt will set new records, and cooperation between the Fed and the administration will deepen. Yield curve control may be the Fed's next policy tool.



Key data

Year-on-year percentage change

	2018	019	2020	2021
GDP	2.9	2.3	-6.5	5.6
Unemployment*	3.9	3.7	13.7	11.9
Wages and salaries	3.0	3.3	2.4	1.5
Consumer Price Index (CPI)	2.4	1.8	0.5	1.4
Core PCE (the Fed's target variable)	2.0	1.6	1.7	1.8
Public sector balance**	-5.7	-5.9	-17.5	-9.0
Public sector debt**	106.9	109.0	133	136
Fed funds rate***	2.50	1.75	0.25	0.25

* Per cent ** Per cent of GDP *** At year-end. Source: Macrobond, SEB

Historic GDP declines, big changes from earlier trend

The US economy began the year strongly, with solid household consumption, a red-hot labour market, a fresh start for home construction and signs that manufacturing sentiment had recovered after last year's trade-related uncertainty. But the lockdowns in late March dramatically changed this situation. The most radical change is in the labour market, with 30 million people – almost 19 per cent of the workforce – applying for unemployment benefits during six weeks. The crisis has left its mark on other data as well: in March, retail sales and industrial production fell by 6 and 5.4 per cent, respectively. This was the fastest retail sales drop since the series began in the 1990s and the deepest production decline since 1946.

GDP fell some 1 per cent in Q1 2020 (4.8 per cent annualised). During Q2 we expect an additional 12 per cent decline, equivalent to an annualised 40 per cent. This is 4 times more than the previous post-war record of -10 per cent in 1958. Question marks about the spread of the virus, including the risk of new outbreaks, as well as how fast the economy can be restarted, make forecasting highly uncertain. There are also differences between states in terms of COVID-19 caseloads and policy responses. Georgia and a few other states began reopening in late April, while restrictions in Florida, Texas and several other states expired soon afterward.

Our main scenario is that the US economy will gradually restart during May and that a recovery will begin in the second half. Full-year GDP will fall by 6.5 per cent, followed by a 5.6 per cent upturn in 2021.Only late next year will GDP approach its late-2019 level, and we now expect the 2021 GDP level to be nearly 5 per cent below our February forecast. Unemployment will peak at 17 per cent around mid-year and fall to 10 per cent by the end of 2021: 6.5 percentage points above its pre-crisis level. The reason why the jobless rate will not climb more is that a relatively large proportion of people on temporary furlough are expected to get their jobs back as the economy gradually reopens. Some groups will also leave the labour market completely, given its prevailing weakness. The number of temporarily jobless rose from less than 30 per cent of all the unemployed to nearly half in March. This pattern more closely resembles the millennium ("dotcom") crisis than the 2008 financial crisis, with its widespread labour market softness. Yet lower wage and salary incomes, as well as higher precautionary saving, will hold down consumption in the recovery phase. Business investments will continue to fall this year due to lower capacity utilisation. Sharply lower oil prices will severely limit oil sector activity (more than 1.5 per cent of the US economy). The upturn in residential construction will fade as the weak labour market puts renewed pressure on home prices, although lower interest rates will ease its impact. Falling imports initially strengthened the trade balance, but exports will also decelerate in the weak international economic environment. Extremely low energy prices will push down total inflation this year, while underlying inflation is more balanced.

The US was ill-prepared for the pandemic and the response it required. Jobless benefits are worse than in other advanced economies. This explains the historical pattern where limited upturns in unemployment (more than 0.5 percentage points) were enough to trigger an economic vicious circle, with weakened consumption in turn driving unemployment even higher. Worse public health than in Japan and Western Europe makes people more susceptible to the virus. In addition, as of 2018, 8.5 per cent of the population have no health insurance at all, and employer-sponsored policies dominate the rest of the market (55 per cent of the total population). This means that those who lose their jobs also risk losing access to affordable health care.

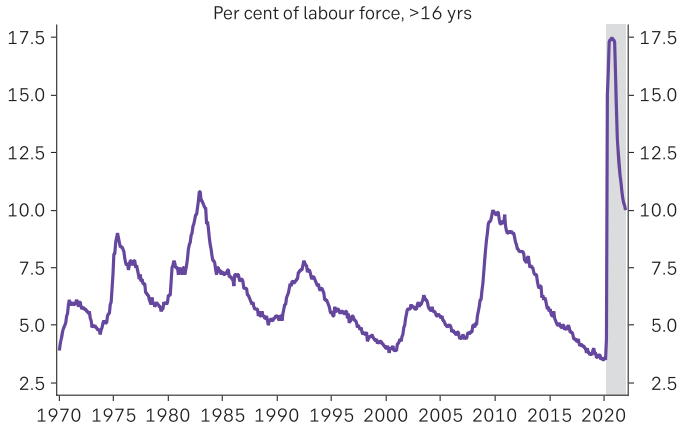
Congress has reacted both more rapidly and more aggressively to this crisis, enacting programmes partly designed to offset the weak social insurance system. Unemployment benefits have been expanded to "gig workers" and self-employed individuals. In some cases, benefits have been raised to levels that exceed regular working income. Households will receive cash payments of USD 1,200 per adult (USD 300 billion, nearly 2 per cent of disposable incomes). Small businesses can borrow money through the Paycheck Protection Program (PPP) to cover wage costs for 8 weeks; businesses that keep their employees on the payroll need not repay the loans. There are also extra grants to hospitals and state governments, as well as special funding through various Fed programmes to increase lending.

17.9%

The Congressional Budget Office's forecast of this year's federal budget deficit as a share of GDP.

Sharply higher unemployment followed by partial reversal

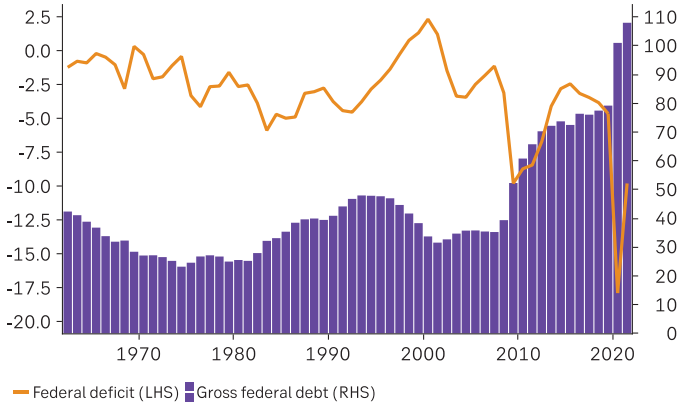
Per cent of labour force, >16 yrs



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

Highest deficit since WWII and record debt

Per cent of GDP



Source: U.S. Congressional Budget Office (CBO), Macrobond, SEB

The stimulus packages approved so far total nearly USD 2.8 trillion or 13 per cent of GDP, excluding Fed credit lines, but are probably not big enough. For example, the first round of PPP loans was quickly oversubscribed, and the latest expansion of loan volume does not appear likely to meet demand either. These programmes thus seem less capable than European wage subsidies of preventing terminations. Overworked systems and bureaucratic obstacles are meanwhile delaying disbursement of unemployment benefits and federal cash grants to some households. Congress will thus need to approve new recovery support packages, but its ability to achieve bipartisan agreements will diminish once the acute phase is over.

These stimulus packages will cause soaring deficits in a situation where federal finances were already stretched after tax cuts and several expansionary budgets. The Congressional Budget Office (CBO) now expects a federal deficit of nearly 18 per cent of GDP fiscal year 2020 (the largest since the 21.5 per cent deficit in the war year 1945). The federal debt is now expected to reach 108 per cent of GDP by the end of our forecast period: a new historical record. We believe overall public sector debt will exceed 135 per cent of GDP, with public sector deficits reaching 17.5 and. 9 per cent of GDP in 2020 and 2021, respectively. Given today's low interest rates, the economy can bear higher debt, but increased borrowing abroad will worsen the current account deficit. Increased coordination between fiscal and monetary policy makers is also blurring the line between the executive branch and the Federal Reserve (see page 13).

Swelling Federal Reserve balance sheet

The coronavirus crisis highlights a question that the Fed struggled with last year: How do you design monetary stimulus when your key interest rate is already zero? The Fed has applied lessons from 2008, relaunching programmes aimed at stabilising markets and preventing the battle against the pandemic from triggering a new financial crisis. The Fed has slashed its key rate to nearly zero but has made clear its intention not to go into negative territory. It has resumed QE and is now buying as much government and mortgage-backed bonds as needed to ensure that the market is functioning and that the effects of monetary policy will help the economy. The Fed has also launched entirely new programmes for purchasing corporate and municipal bonds and for onward lending to the business sector. Altogether, we expect these programmes to expand the Fed's balance sheet to a record USD 11 trillion, or some 50 per cent of GDP: up from about 20 per cent at the end of 2019. The Fed has gradually slowed its pace of bond purchases from a total of initially USD 100 billion per trading day to around USD 15 billion. This is still equivalent to a monthly pace of around USD 300 billion, far higher than its QE programmes after the financial crisis. We expect the Fed to keep lowering its daily purchases but to retain a market presence. Although its QE programme has no upper limit, the Fed will need to guide the market in the future. One alternative to a new quantitative target for QE might be to follow the example of the Bank of Japan and the Reserve Bank of Australia by adopting "yield curve control". In a February speech, Fed Governor Lael Brainard described how such an approach may strengthen the Fed's communication, with the Fed capping yields within the time horizon required to achieve its unemployment and inflation targets. We believe that the Fed will announce such a policy this autumn.

Next autumn's presidential election has ended up in the shadow of the COVID-19 crisis. President Donald Trump's approval rating is up slightly, as usually happens during national crises, but given the weak economy and widespread criticism of his handling of the virus crisis, he cannot count on beating Democratic candidate Joe Biden.

Theme:

The EM economies

The sharpest slowdown since the Second World War

The COVID-19 pandemic will have a very negative impact on the emerging market (EM) sphere, whose overall GDP looks set to shrink for the first time since the Second World War. Most large EM countries have imposed economic lockdowns and strict social distancing rules. There will also be adverse effects from lower commodity prices, decreased global trade and weaker capital flows. Fiscal and monetary policy manoeuvring room is also generally smaller in EM economies, with China as a big exception. Yet Beijing has chosen to be cautious about stimulus measures. A recovery will come in 2021, but before a vaccine is available growth will be hesitant.

In the last two issues of *Nordic Outlook*, we have highlighted signs of an approaching recovery among EM economies after more than two years of sub-par growth and market gloom. Although some sources of concern remained, various indicators such as purchasing managers' indices, international trade and industrial production figures had bottomed out and had begun to rise gradually. Seldom has the outlook changed so radically in only three months.

Our previous forecast of a slight acceleration in the EM GDP growth rate to 4.2 per cent in 2020 has now been revised to a downturn of 0.6 per cent. This implies a main scenario in which the economies of the EM countries shrink for the first time since reliable statistics began to be kept after the Second World War. A recovery will occur next year when GDP in the EM sphere appears set to grow by just over 6.0 per cent, which is nevertheless insufficient to compensate for this year's losses. The EM economies will not recover as rapidly as they did after the 2003 SARS epidemic, since restrictions on travel and large gatherings will remain in some form – at least until a vaccine is generally available, which will probably take at least one year.

Exactly how the COVID-19 pandemic will affect the EM economies is hard to predict. Many of these countries have populations that are younger on average than in more advanced economies, which suggests a milder effect on the economy. Because of lower income levels, their inhabitants travel less than people in more industrialised countries, which should make the spread of the virus occur more slowly.

Other factors pull in the opposite direction. Because of high population density in many large cities, multi-generational households in rural areas and a shortage of health care resources, the crisis may affect EM economies more severely, especially compared to Western Europe and North America. Low trust in the authorities in many countries – especially in Africa – also means that restrictions may be hard to implement.

GDP growth, BRIC countries and EM sphere
Year-on-year percentage change

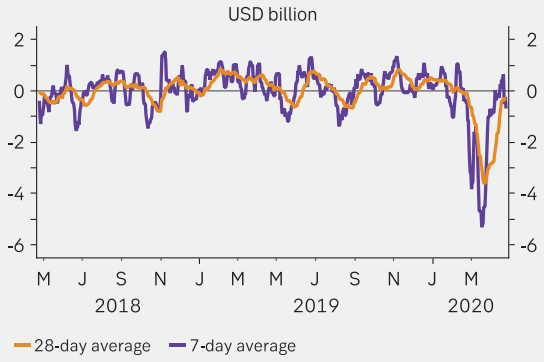
	2018	2019	2020	2021
China	6.7	6.1	2.0	9.0
India	6.1	4.3	2.0	5.3
Brazil	1.3	1.1	-5.2	3.0
Russia	2.5	1.3	-5.6	3.7
Emerging markets, total	4.7	4.1	-0.6	6.1

Source: IMF, SEB

There is some room for monetary policy easing, with inflation being pushed down by falling oil prices and weak demand. Central bank stimulus measures in the United States, Europe and Japan will also increase the room for manoeuvre. Hence, we expect additional rate cuts by EM central banks. However, monetary policy stimulus in the form of quantitative easing (QE) will only be possible in a limited number of countries in Central Europe, Chile, Singapore, Taiwan and South Korea. The threat that governments might be tempted to monetise their debt and thereby drive up inflation expectations and market interest rates mean that central banks in other EMs will not be able to use QE.

Limited monetary policy options, with the use of QE being unfeasible, circumscribe the use of fiscal policy measures. Gross government debt in EM countries has increased to 53 per cent of GDP in 2019 from 34 per cent of GDP in 2008, which implies that several economies have now reached the limit for how much they can borrow without pushing up interest rates to unsustainable levels. Several governments, especially among the very poorest countries, have already turned to the IMF for support. Countries like South Africa and Turkey are also likely to need IMF support.

Foreign purchases of EM bonds and equities
USD billion



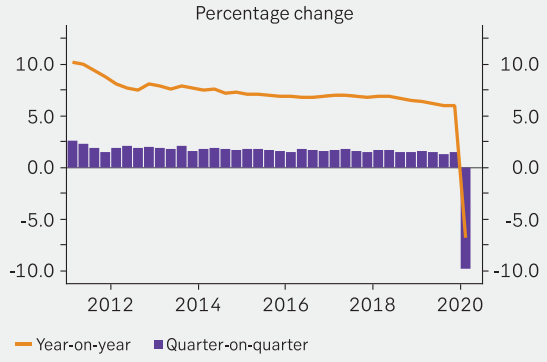
Source: Institute of International Finance (IIF), Macrobond, SEB

EM economies are generally dependent on an influx of foreign capital, but the flare-up of the COVID-19 crisis caused record-sized outflows. Although the situation has stabilised in the past month, capital flows will be weak as long as there is a risk of further waves of infection and lockdowns. A complicating factor for some countries is that remittances from workers abroad will likely fall sharply due to furloughs and rising unemployment especially in the services sector. Lebanon is highly dependent on such flows and is in a class of its own, but countries such as Ukraine, the Philippines and Mexico also rely on remittances.

China – first to lock down and to reopen

Since China was the first country hit by the coronavirus outbreak, its economy was greatly affected during the first quarter, when a nearly complete lockdown of some regions in February contributed to a GDP decline of 6.8 per cent year-on-year. This interrupted the pattern of recent years, with suspiciously stable official GDP statistics showing only insignificant deviations from official growth targets. During Q2, activity has begun to recover as the authorities have gradually eased restrictions imposed in order to stop the virus from spreading. The upturn is being driven mainly by manufacturing, while the service sector and consumption have rebounded more slowly. We estimate that April industrial production reached 90-95 per cent of its volume before the COVID-19 outbreak.

Decline in GDP growth will have lasting effects
Percentage change



Source: China National Bureau of Statistics (NBS), Macrobond, SEB

Two factors suggest that the recovery will be slow. Lingering risks of a new infection wave are generating headwinds for the Chinese economy. The authorities have already been forced to re-impose partial restrictions in some regions, especially along the northern border with Russia. World economic deceleration is also hampering recovery by lowering China's exports. Preliminary statistics on South Korea's exports can be regarded as a leading indicator. They show a 24 per cent year-on-year decline in April. Combined with rising unemployment and continued restrictions on travel, this means global trade may shrink by around 20 per cent in 2020. Beijing has also been relatively cautious about stimulating the Chinese economy, since it wants to avoid a large increase in an already high debt level, but monetary policy has become more expansionary. We expect further monetary easing in the coming months, since inflation looks set to drop below the 3.0 per cent central bank target. This easing will mainly be aimed at small and medium sized businesses, but China's main key interest

rate (the one-year loan prime rate, LPR) will be lowered to 3.75 per cent from its current 3.85 per cent.

Overall, we expect the economy to grow by 2.0 per cent this year and by 9.0 per cent in 2021 as treatments and a possible vaccine against COVID-19 become available and the global economy begins to revert to its normal level of activity. Yet, growth may turn out lower than forecast. Daily statistics cannot be directly translated into quarterly GDP numbers. Nevertheless, judging by among others real estate sales, coal consumption, container freight, traffic congestion, air pollution and box office admissions in April, total economic activity may have been 15 to 20 per cent lower than in the same period of 2019.

One provision of its Phase 1 trade agreement with the US, which was signed in January, states that China undertakes not to manipulate its currency in order to gain export advantages. In any case, the yuan looks set to weaken to 7.20 per US dollar in Q3 before recovering to 7.18 late this year and 7.10 at the end of 2021.

India – World's biggest stay-at-home order

India abruptly shut down almost all production on March 22. Restrictions were initially supposed to run for three weeks, but they have been renewed until May 17. The authorities nevertheless have begun a gradual easing of their stay-at-home rules and certain sectors and some regions are permitted to resume production in order to avoid an economic and humanitarian catastrophe. Millions of people who were largely living on what they earned day by day are now dependent on emergency aid from the government or from other organisations. However, restarting production is being made difficult by a labour shortage. Many migrant workers returned to their home regions when the restrictions were imposed and have not yet received permission to travel back to their workplaces.

Of the BRIC countries, the risk of social conflict and violence is greatest in India and Brazil

The Reserve Bank of India has lowered its key interest rate and has tried to inject liquidity into the fixed income and foreign exchange markets. But it has failed to prevent market disruptions, for example the closure of bond funds, which may ultimately contribute to capital flight from the fixed income market. The central bank has also eased credit regulations in order to facilitate lending and enable banks to offer a moratorium on loan repayments. More monetary easing will be needed. We expect the key interest rate, which is currently at 4.40 per cent, to end 2020 at 3.90 per cent and remain at that level until late 2021, when it will be raised to 4.15 per cent.

India's fiscal stimulus measures have been limited, amounting to less than 1 per cent of GDP and mainly consisting of food and cash handouts to the very poorest. One obstacle is budget rules that are intended to prevent excessive deficits, but Prime Minister Narendra Modi and his government will probably be forced to relax these rules and approve additional fiscal stimulus. But room for this is limited, with central government debt approaching 70 per cent of GDP.

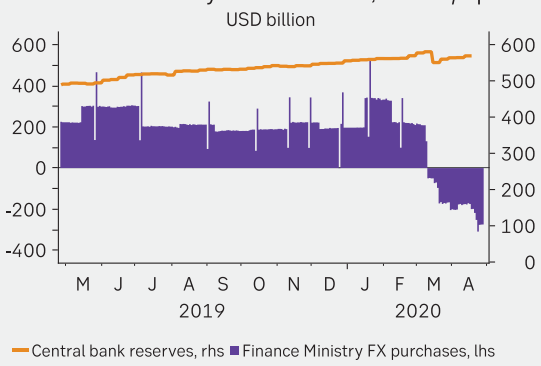
The COVID-19 crisis hit an Indian economy that was already weak. The authorities estimate that economic growth reached only 5 per cent during the budget year that ended on March 31, 2020: the lowest level in 6 years. We expect GDP growth of 2.0 per cent this year and 5.3 per cent in 2021. However, India is one of the countries where the risk of social conflict is greatest.

When the restrictions are lifted, there is a major threat of violence aimed at the Muslim minority as well as at migrant workers from other regions. Social conflict thus poses a risk to economic recovery.

Russia – Early but insufficient steps

The COVID-19 pandemic is affecting the Russian economy both because of lower oil revenues and because the authorities – as in other countries – are being forced to impose economic lockdowns in order to slow the spread of the virus. Russia was one of the first countries to stop visitors from China, but its leaders waited before taking further steps. Moscow was the first city to impose a stay-at-home order in late March. In early April, President Vladimir Putin declared a work-free month, which was subsequently extended to May 11. Although some sectors will begin to see an easing of restrictions, getting everyone back to work even by that date looks unrealistic.

Russian currency interventions, March/April



Source: Central Bank of the Russian Federation (CBRF), Macrobond, SEB

So far, the Kremlin's response to the crisis has been relatively cautious compared to Western Europe and the US. The fiscal stimulus measures that have been announced total 2-3 per cent of GDP, but it is unclear how much of this sum represents new expenditures and how much consists of reprioritisations. Meanwhile the government has announced tax increases for high income earners in order to finance part of the stimulus measures: a strategy probably being driven by Russia's economically orthodox finance minister, Anton Siluanov. This caution reflects an unwillingness to increase government debt, which might lead to

dependence on foreign investors in particular; these, in turn, might be influenced by American or European sanctions. It also reflects a willingness to prioritise President Putin's national projects to boost productivity and growth, launched after the 2018 presidential election. Giving up these projects might weaken Putin ahead of a referendum on constitutional changes that would allow him to remain in power after 2024. The referendum was planned for April 22 but has been postponed for now due to the COVID-19 crisis.

The Russian central bank (CBR) left its key interest rate unchanged in March to avoid further weakening the rouble, which by then had lost more than 20 per cent against the US dollar since the beginning of 2020. After the rouble had recovered somewhat, the CBR lowered its key rate by 50 basis points in April to 5.50 per cent, while leaving the door open for further rate cuts totalling 100 bps. Inflation appears likely to climb above the 4.0 per cent CBR target in the coming months, mainly due to the weakening of the rouble, but underlying inflation pressure is weak. The CBR's assessment seems realistic, and we believe that its key rate will end up at 4.50 per cent in 2020 before being hiked to 5.00 per cent late in 2021 as the economy begins to grow and inflation rises.

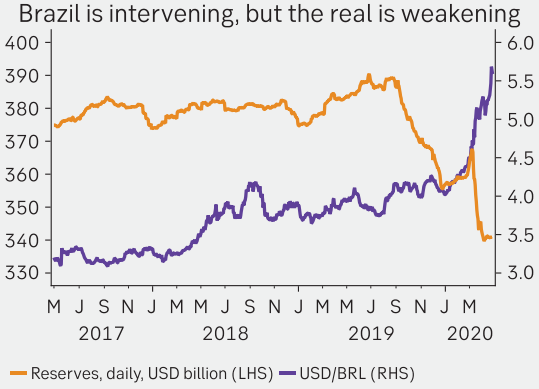
Overall, we expect GDP to fall by 5.5-6.0 per cent this year, mostly due to the effects of the lockdown and stay-at-home orders. Low oil prices and the production cut that Russia reluctantly agreed on with the OPEC oil cartel will also hold back the economy. This downturn will be partly offset because the Kremlin is likely to use the National Welfare Fund, which totalled nearly 7 per cent of GDP at the end of 2019.

Brazil – Sinking back into a political brawl

Like India, Brazil entered the COVID-19 crisis from a weak position – with growth of only 1.1 per cent in 2019. President Jair Bolsonaro has been unwilling to acknowledge the severity of the threat from the coronavirus outbreak and has criticised regional authorities for what he views as their overly aggressive and far-reaching restrictions. The COVID-19 crisis has accentuated an underlying conflict between the president and the National Congress. It has also worsened internal tensions in the Bolsonaro administration. After a lengthy period of public disagreements, Bolsonaro replaced his respected health minister in April. More recently, the popular and respected justice minister Sergio Moro (who led the "Car Wash" corruption investigations) resigned after accusing the president of trying to influence an ongoing police investigation and lying about why he fired the federal police chief. For the moment, economy minister Paulo Guedes seems to be safe, but as Bolsonaro's position weakens there is a risk that fiscal discipline will be sacrificed once the COVID-19 crisis has faded.

Because of political infighting, Brazil acted late and there was poor coordination between national and local authorities. The direct fiscal stimulus measures that despite all have been approved total only around 1 per cent of GDP. Bolsonaro's unwillingness to stimulate the economy has led groups of National Congress members to start taking matters into their own hands, with populist proposals like forcing companies to finance increased expenditures by lending money to the federal government. Since government debt is more than 90 per cent of GDP, there is not much room for fiscal stimulus measures. But inflation has remained at historically low levels (3.3 per cent in March 2020, which is below the official 4.0 per cent target). This allowed the central bank to lower its key rate to 3.75 per cent, the lowest ever. We expect a further rate cut to 3.50 per cent at the May 6, 2020 policy meeting.

Brazil is intervening, but the real is weakening



Source: Macrobond Financial AB, Central Bank of Brazil, Macrobond, SEB

Exports have not fallen as much as feared in March, but in light of the global economic slowdown their downturn is likely to accelerate in the coming months. As in other countries, large portions of the Brazilian economy are locked down at present, and many restrictions look set to remain in place at least until the end of the second quarter. We expect GDP to fall by 5.0-5.5 per cent in 2020. The recovery will remain slow next year, with growth averaging 2.5-3.0 per cent – due among other things to political paralysis.

The Brazilian real recorded a new record low of 5.65 per US dollar after Moro's resignation. Since pressure on oil and other commodity prices looks set to persist in the coming months, new record lows are likely to be reached before the economy and the real slowly stabilise. We expect the real to reach 5.40 per dollar at the end of 2020 and 5.90 at the end of 2021.

The euro area

The crisis reveals north-south tensions

The spread of COVID-19 and resulting lockdowns are pushing the region into deep recession. We expect a recovery in the second half of 2020, but it will take time to repair the damage. Numerous fiscal and monetary stimulus packages are aimed at protecting euro area businesses and consumers. Brussels is pretending not to see widening budget deficits. But as during the euro crisis, north-south tensions are emerging. GDP will fall by 9.6 per cent in 2020 and then regain 6.2 per cent in 2021.

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.9	1.2	-9.6	6.2
Unemployment*	8.2	7.6	11.9	12.2
Wages and salaries	2.2	2.0	1.0	2.0
CPI	1.8	1.2	0.4	1.3
Public sector balance**	-0.5	-0.6	-11.4	-6.5
Public sector debt**	85.8	84.1	103.7	114.2
Deposit rate***	-0.40	-0.50	-0.50	-0.50
EUR/USD***	1.15	1.12	1.14	1.20

* Per cent **Per cent of GDP *** At year-end. Source: Eurostat, SEB

Stimulus helping but not stopping downturn

Early 2020 was unexpectedly strong, but the lockdowns since then have caused the euro area economy to seize up. Indicators such as PMIs have plunged to unprecedented lows – far below those of the financial and euro crises – but their collapse is hard to translate into growth forecasts since these sentiment indices only tell us a downturn is under way, without stating its magnitude. More frequent data, like electricity use and credit card sales, are thus needed to help analyse the impact of sectoral lockdowns. Such observations are among those used by the French national statistics bureau to estimate that each month, given the current lockdowns, will result in a decline of 3 percentage points in full-year growth.

The policy response has been much faster this time around than during the financial and euro crises. Numerous crisis packages have been launched, with a focus on supporting household incomes and ensuring the survival of affected businesses, regardless of whether they were hit by shutdowns in production or demand. Some measures provide a direct stimulus effect, but the emphasis is on enabling businesses to take out guaranteed loans or postpone certain tax payments. Brussels bureaucrats have also put their debt and deficit regulations on hold. Germany, which had been criticised earlier for an overly cautious fiscal policy, has announced reforms costing more than 4 per cent of GDP plus loans and guarantees totalling well above 10 per cent of GDP. Countries including Italy and Spain have unveiled direct stimulus measures totalling around 1 per cent of GDP, despite being harder hit than others. The difference in manoeuvring room between Germany and southern Europe is likely to become even clearer when exit policies are formulated, although it looks as if the EU may agree on joint stimulus measures mainly targeted to the countries most deeply affected by the crisis.

Tensions emerging among EU members. Once the most acute phase of the crisis is over, exit policies and EU-wide responses will be more in focus. EU countries continue to disagree about how much Brussels can do. Just as during the euro crisis, conflicts about the shape of joint assistance to the hardest-hit countries are leading to questions about the survival of the EU and the euro area. We will probably see plenty of rhetorical excesses again. The EU project will probably continue to move ahead, slowly but steadily. The ultimate outcome is likely to be more support, both in the form of grants and loans to the worst affected. The euro area deficit is expected to climb to over 10 per cent of GDP this year. This deficit and the drop in GDP will push public sector debt above 100 per cent of GDP in 2020. The debt ratio will climb more slowly in 2021, as the deficit falls towards just over 6 per cent and nominal GDP rebounds sharply. Several of the hardest hit countries had not yet shaken off all their euro crisis-related problems. This weakens their starting position. Italy is again in the spotlight due to large public deficits and debt, and there are concerns about rising borrowing costs. European Central Bank (ECB) interventions are a large piece of the crisis management puzzle, including bond purchases that will ignore worsening credit ratings – something very important to countries like Italy.

Sharper GDP declines in the south than in the north

All euro area countries will be severely affected by the crisis, with major after-effects in the labour market, public sector finances and society at large. There are differences in timing and the scale of COVID-19 cases and in the resulting lockdowns, but they are not huge. The sectoral structure of each economy is also of some importance. In southern European countries that are highly dependent on tourism-related income – such as Spain – travel

restrictions will hit especially hard in a somewhat longer perspective, but differences in fiscal manoeuvring room and underlying growth potential will probably be more important to their recovery process. Overall, this means that the downturn in Italy and Spain will be deeper than in Germany. France will end up somewhere in the middle. Although we expect GDP to begin rebounding as soon as the end of Q2, the full-year 2020 GDP decline for the euro area as a whole will set a record of nearly 10 per cent. In the four largest economies, the GDP decline will range from 8 to 12 per cent. Due to the lingering effects of the coronavirus pandemic – social distancing, lower business investments and hesitant households affected by rising unemployment – the euro area will regain only about half of this GDP decline in 2021.

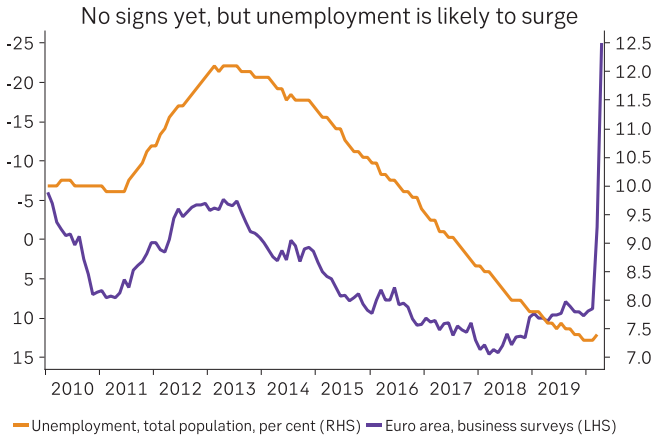
The ECB will focus on quantitative easing and abstain from cutting its key rate for as long as possible

GDP growth forecasts

Year-on-year percentage change

	2018	2019	2020	2021
Germany	1.5	0.6	-7.7	5.8
France	1.7	1.3	-9.5	6.2
Italy	0.8	0.3	-11.5	6.5
Spain	2.4	2.0	-11.7	6.6
Euro area	1.5	0.6	-7.7	5.8

Source: Eurostat, SEB



Source: European Commission (DG ECFIN), Eurostat, Macrobond, SEB

Indirect effects will slow the recovery

The long-term effects of the COVID-19 crisis on demand will also be important to the recovery process. The mood of households has sharply worsened, and business investments are likely to decrease due to falling capacity utilisation. Service businesses live with narrow margins, and labour is a large cost item. They must reduce their headcounts, before re-hiring as demand returns. Unemployment will thus climb rapidly even though we already see signs of restarting economies. We estimate that the jobless rate will peak at 15-16 per cent this autumn, compared to a peak of around 12 per cent in the aftermath of the financial and euro crises. Although many people can be rehired fairly fast, in 2021 unemployment will remain about 3 percentage points above the level of February and March this year. Even once the lockdowns have largely been lifted, the indirect effects of COVID-19 will be prolonged in the hardest-hit economies. The question of a joint "recovery fund" will thus remain important in order to help sustain these economies.

Low inflation, despite conflicting forces

Inflation has been stuck at around 1 per cent for years, but last winter it showed initial signs of climbing. The COVID-19 crisis will affect inflation in several ways. In the near term, we will probably see large-scale discounts and price cuts aimed at luring back consumers. We may also face a new kind of measuring problem, because a number of sectors have shut down their operations. Since the labour market is weakened, this will also generate downward pressure on inflation in a slightly longer perspective. But other forces will pull in the opposite direction. Despite lower demand for food due to restaurant shutdowns, food prices will probably climb as supply and delivery chains are interrupted or reshaped. Difficulties bringing in seasonal workers may contribute to problems with planting and harvesting, and some crops will simply be binned. Upward pressure on food prices will probably last for a long time. In addition, it cannot be ruled out that the EU will reassess some of its strategic production rules and call for more production within the union despite expected higher costs. Lifting our gaze to a longer time horizon, it is not out of the question either that massive monetary policy stimulus measures may ultimately cause global inflation to climb (for more, see "International overview").

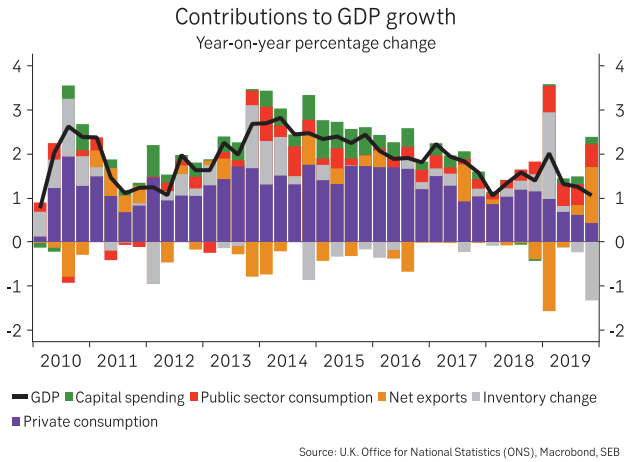
Focus on asset purchases as ECB tackles crisis

For the ECB, inflation targeting will now take a back seat as the bank focuses on combating the crisis by supporting real economic growth and avoiding major disruptions in the financial system. Since key interest rates are already record-low, the ECB must use its balance sheet to stimulate the economy. After some hesitation compared to other central banks such as the US Federal Reserve, in late March the ECB announced expanded asset purchases and a special "corona package". It also eased strict requirements for activating its European Stability Mechanism (ESM). One important decision – and a departure from earlier principles – was that at least in the short term, asset purchases will not be restricted by the usual country allocations (proportionately based on economic size). This enables the ECB to buy a disproportionate share of assets from economies with bigger problems. But the decision was controversial – showing that tensions related to crisis policies are also found within the ECB. Further key rate cuts cannot be ruled out, but we believe that the ECB sees strong reasons to avoid them. Their stimulus effects would be small and uncertain, while extending key rates further into negative territory would squeeze the euro area banking system. Banks in Germany, Italy and elsewhere are already hard-pressed, and at present it would be unfortunate if the situation worsened in a way that would severely hamper their lending capacity.

The United Kingdom

Slowdown began even before the virus struck

The UK is one of the countries that have chosen to impose large-scale restrictions to decrease the spread of the coronavirus. Of course this hurts growth a lot. Meanwhile the economy was already in a clear slowdown phase, partly related to Brexit (withdrawal from the EU). The British economy will thus be harder hit than that of comparable countries, with GDP falling -11.6 per cent in 2020. On December 31, the transitional period expires and a trade agreement with the EU must be in place.



Source: U.K. Office for National Statistics (ONS), Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.4	1.5	-11.6	4.3
Unemployment*	4.1	3.8	11.0	8.0
Wages and salaries	2.9	3.5	2.2	1.6
CPI	2.5	1.9	0.9	1.4
Public sector balance**	-2.2	-2.1	-8.3	-5.5
Public sector debt**	85.7	85.4	95.7	95.8
Key interest rate***	0.75	0.75	0.10	0.10
EUR/GBP***	0.90	0.85	0.86	0.82

* % of labour force ** % of GDP *** End of period. Source: Macrobond, SEB

Indications of a slowdown in the British economy were in place even before the coronavirus took over the stage. As in the US, growth is mainly driven by household consumption, which has gradually cooled in recent years. In Q4 2019, GDP stagnated completely and consumption contributed only 0.4 per cent: the lowest since the financial crisis. Household demand began to cool, even though unemployment was record-low and pay hikes had been decent over a long period. We have emphasised the vulnerable position of British households, especially since their low savings ratio leaves narrow margins if something unpredicted happens. Now the coronavirus has created such a situation, and the UK is one of the countries that have chosen to impose large-scale restrictions to decrease its spread. Given this difficult starting position, there is a great risk that the UK will be harder hit than other countries.

The service sector is being squeezed by lockdowns. While the more export-oriented manufacturing sector has long been hampered by Brexit-related uncertainties, the domestically oriented service sector has been resilient. With lockdowns now mainly hurting services, the economy is especially vulnerable. Service sector confidence fell from well above 50 (neutral) in February to 34.5 in March, plunging to 12.2 in April. GDP is expected to fall by 5.6 per cent during the first quarter, but a more dramatic downturn is expected in Q2. The rapid decline in sentiment indicators during March and April is much deeper than during the financial crisis, which suggests a significantly sharper drop in GDP now. We expect GDP to fall by almost 12 per cent in Q2, compared to Q1. A significant share of the downturn is likely to be recovered during the second half of 2020, but the GDP decline is still likely to be larger than in countries like the US and Germany. We expect full-year GDP growth to end up at -11.6 per cent. The recovery will continue during 2021, and the year's growth will total 4.3 per cent. The government has launched various rescue packages in an attempt to soften the downturn in household demand and ensure that businesses will survive the crisis. We expect the public sector deficit to climb to 8.3 per cent of GDP during the current budget year.

The British labour market has been record-strong for several years. As recently as December, unemployment stood at 3.8 per cent. Signs of cooling were discernible even before the economic lockdown. Unemployment will now rise rapidly. We expect it to reach 11 per cent this summer. Although many people can return to their jobs during the second half of 2020, the jobless rate will remain higher than before throughout our forecast period as businesses take advantage of the opportunity to streamline their operations. Meanwhile demand will not bounce back completely.

The British central bank (Bank of England) has reacted quickly and decisively during the COVID-19 crisis. It has used essentially its entire arsenal, with cuts in the key interest rate to 0.10 per cent, bond purchases and a number of programmes to ensure the supply of liquidity to businesses and financial institutions. Given the recovery we expect during the second half, these measures should be sufficient, and the BoE may be able to scale back the size of some assistance programmes towards year-end. But we expect the key rate to remain at its current level throughout our forecast period. The pound took a beating in March, and we remain negative towards the British currency. The reason is that transitional rule connected to last January's EU withdrawal will expire in December 2020, which means the UK risks leaving the EU system without a new trade agreement in place. As long as that risk continues, it will spill over into a weaker pound. However, we expect that in the end this will not be allowed to happen, so the pound should recover late this year. Our forecast for the GBP/SEK exchange rate is 12.00 at the end of 2020 and 12.00 at the end of 2021.

The Nordics

Sweden

A relatively gentle lockdown strategy will limit this year's GDP decline to 6.5 per cent. Employment will seize up, but job losses will be milder than in the early 1990s. The Riksbank will expand QE but not resume negative key interest rates.

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Norway

Aside from COVID-19, plummeting oil prices have hurt the economy. Petroleum investment will fall nearly 25 per cent in 2020-2021, and household fundamentals look weak. The krone will improve but remains weak.

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Denmark

Despite a comparatively mild virus outbreak, the GDP downturn will be the worst in the Nordics. Solid government finances allow major stimulus, however. As in 2008, Denmark was forced to hike its key rate to defend the EUR/DKK peg.

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Finland

The downturn had already started in late 2019. ECB and Finnish government stimulus measures are helping, but more will probably be needed to ensure that the economy avoids a long period of stagnation like after the financial crisis.

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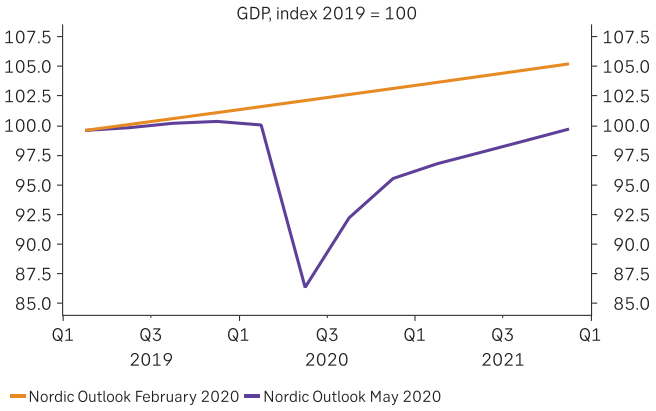
Sweden

Smaller decline in GDP due to gentler strategy

Because of Sweden's gentler lockdown strategy, the decline in its economy will be smaller than in other countries, but the drop in GDP – nearly 7 per cent in 2020 – will be the largest in modern times. Despite economic stimulus, at the end of 2021 GDP level will be nearly 5 per cent below our February forecast. Job losses will not be as dramatic as during the 1990s crisis, but unemployment will still hit a record-high 14 per cent this autumn. Government debt will climb to 50 per cent of GDP.

GDP far below normal level, despite recovery

GDP, index 2019 = 100



Source: Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	2.2	1.1	-6.5	5.0
Unemployment*	6.3	6.8	11.0	11.0
Wages and salaries	2.5	2.5	1.2	2.0
CPIF (CPI excl. interest rate change)	2.1	1.7	0.3	1.3
Net lending**	0.8	0.5	-7.5	-5.2
General government debt**	38.8	35.1	45.1	50.8
Repo rate***	-0.25	0.00	0.00	0.00
EUR/SEK***	10.13	10.51	10.35	10.00

* Per cent ** Per cent of GDP *** At year-end. Source: Eurostat, SEB

Record drop in GDP during second quarter of 2020

GDP in Q1 declined by only 0.3 per cent in Q1 but is predicted to plunge by almost 14 per cent in Q2. Despite a recovery in the second half, full-year 2020 GDP will fall by almost 7 percent: the largest decline in 150 years, aside from the world wars. We then expect GDP to rebound by 5 per cent in 2021. Yet Sweden's downturn is likely to be milder than that of neighbouring countries that have imposed more extensive lockdown orders. We estimate (see theme article, p 35) that 20 per cent of Swedish GDP disappeared at the peak of the lockdown in April, compared to 30-35 per cent in countries like Italy and France. Sales data based on household debit cards suggest a gap of about the same size between Sweden and neighbouring Denmark and Norway, but our forecast assumes that the degree of lockdowns in different countries will converge during 2020. This is naturally difficult to predict, and judging from public discourse on epidemiology, we can imagine a scenario in which a larger share of the Swedish economy may be open in the long term, since the population will have achieved a higher degree of immunity to COVID-19. On the other hand, it is too early to rule out a reassessment of Sweden's pandemic strategy that might force the country to adopt a more restrictive stance in the near future.

The economic downturn is primarily driven by more or less locked down service sectors that are mainly very labour-intensive. This is in contrast to the financial crisis of 2008-2009, in which capital-intensive export companies were hardest hit. Job losses are expected to peak at 7 per cent this autumn, followed by a gradual recovery. We foresee unemployment peaking at nearly 14 per cent late in 2020 (see theme article), then falling to 9.5 per cent by late 2021. During the early 1990s crisis, the downturn in employment was both deeper and more long-lasting, but Sweden did not reach levels of open unemployment as high as we are now predicting. This was because at that time, we started from a record-low unemployment level just over 1 per cent, but also because labour market policy programmes were more extensive at that time.

Long-term impact on demand is hard to estimate

Most Swedish manufacturing sectors have been able to maintain production, and the vehicle industry has now partially restarted after a production halt due to component shortages. But demand has plummeted both in Sweden and abroad. Exports of both goods and services will fall sharply in the near term. As demand regains speed, new challenges will arise due to disrupted supply chains and bottleneck risks. We may possibly see increased demands to keep some production in Sweden for emergency preparedness reasons – including pharmaceuticals and food. We expect total exports to fall by 15 per cent this year and then rebound by 11 per cent in 2021.

Capital spending and consumption will also be hampered by indirect effects related to lower capacity utilisation, rising unemployment and falling home prices. After a time lag, construction of commercial properties will fall significantly. Residential construction will hold up in the short term, but the number of housing starts has already started to fall. This will lead to roughly a 15 per cent decline in residential investments until mid-2021, followed by a stabilisation. Rising public sector investments will help to soften the downturn, however. Further ahead, changed supply chains and relocation of strategic manufacturing may also contribute to higher investments. We expect capital spending to fall by 15 per cent this year, then recover by 8 per cent in 2021.

We expect household consumption to fall sharply this year. In the short term, the dominant trend is that lockdowns will reduce people's opportunities for consumption, though it is hard to estimate

to what extent this may be offset by other consumption. To some extent, domestic travel is likely to compensate the tourist industry for the lack of foreign visitors during the rest of 2020. Further ahead, consumption will be hampered mainly by lower incomes and precautionary saving due to rising unemployment and falling home prices. But the downturn in household purchasing power will be softened by more generous rules in the social insurance system and by low inflation. When unemployment begins to fall in 2021, we foresee potential for a downturn in saving, allowing a 3 per cent increase in consumption after a 5 per cent decline in 2020.

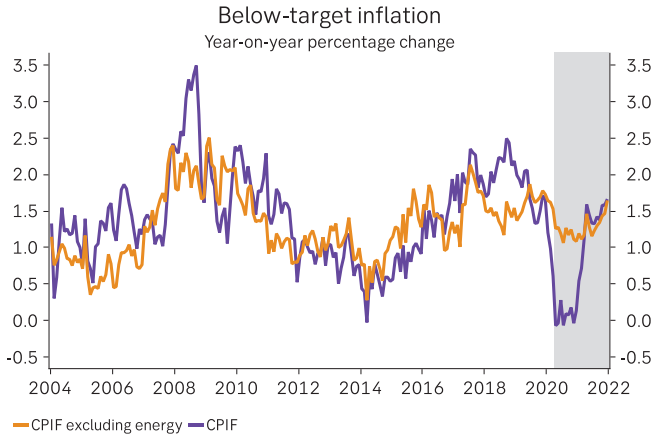
Household incomes and savings ratio

Year-on-year percentage change

	2018	2019	2020	2021
Real disposable income	2.8	2.6	-1.8	1.0
Private consumption	1.7	1.2	-5.0	3.0
Savings ratio, per cent of income	15.4	16.6	18.3	16.9

Source: Statistics Sweden, SEB

Source: Macrobond, SEB



Source: Macrobond, SEB

SEB's Housing Price Indicator reported its largest-ever drop in April and actual home prices fell late in March. Preliminary estimates suggest that home prices in Sweden's three largest cities had fallen by 4-6 per cent by mid-April. These declines are likely to continue, and we expect a downturn totalling 15 per cent in 2020. This would bring down prices to 7-8 per cent less than their lows in late 2017. In 2021 we expect home prices to be largely unchanged.

Fiscal stimulus measures so far in line with peers

Fiscal programmes unveiled so far have been largely in line with comparable countries. Direct stimulus measures are equivalent to about 3 per cent of GDP. However, as during the financial crisis, the biggest item is loan guarantees for businesses, which are also being allowed to postpone tax payments. Overall, we expect further stimulus equivalent to nearly 2 per cent of GDP during the rest of 2020 and in 2021. Together with relatively strong automatic stabilisers, this will push the public sector deficit to 7-8 per cent of GDP: higher than during the financial crisis but not really on a par with the 1990s crisis. Next year the deficit will fall to about 5 per cent of GDP. The deficit and the drop in GDP will push up the debt ratio 15 percentage points to about 50 per cent of GDP by the end of 2021. Rising public sector consumption will partly offset the decline in GDP growth. Health care capacity has been expanded as a direct result of the pandemic, and we are likely to see continued investments in the health care sector. This suggests increasing consumption in 2021, when we foresee an upturn of nearly 5 per cent. Higher government grants will enable local authorities to expand their operations, despite shrinking local tax revenues.

Below-target inflation. The national wage round has been put on hold until October, and rising unemployment will probably also contribute to lower wage and salary hikes than we had previously expected. We now believe that pay will rise only 1 per cent in 2020 and 2 per cent in 2021. Inflation has fallen steeply so far this year, driven mainly by plunging energy prices. Record-cheap oil and electricity will push CPIF inflation close to zero during the rest of 2020; in some months, negative inflation is likely. In the near term, downward pressure will dominate other sectors too. CPIF excluding energy will fall from 1.5 per cent in Q1 towards 1 per cent. Further ahead, the inflation outlook is more mixed, with downward pressure from low pay hikes, while the risk of bottlenecks as economies restart will pull in the other direction. Structural shifts due to disrupted international supply chains and protectionist tendencies in some sectors also suggest slightly higher inflation.

More Riksbank QE. The Riksbank left its key rate at 0 per cent and did not change the plans it approved in March to buy SEK 300 billion worth of bonds during 2020. The central bank is signalling a continued unchanged key rate until the end of 2020. Beyond this it has no forecast, since it considers the situation too uncertain. It has left open the possibility of a key rate cut, but at present a majority of Executive Board members seem worried about the downsides of negative interest rates for households. The April policy meeting thus confirmed our view that the repo rate will stay at zero in the foreseeable future. We also still believe that the Riksbank will expand its bond purchases by another SEK 300 billion. Slow economic growth and inflation indicate that monetary policy must become more expansionary, and due to sharply rising public sector borrowing requirements the Riksbank will need to expand its government bond purchases in order to keep yields low.

Theme:

How locked down?

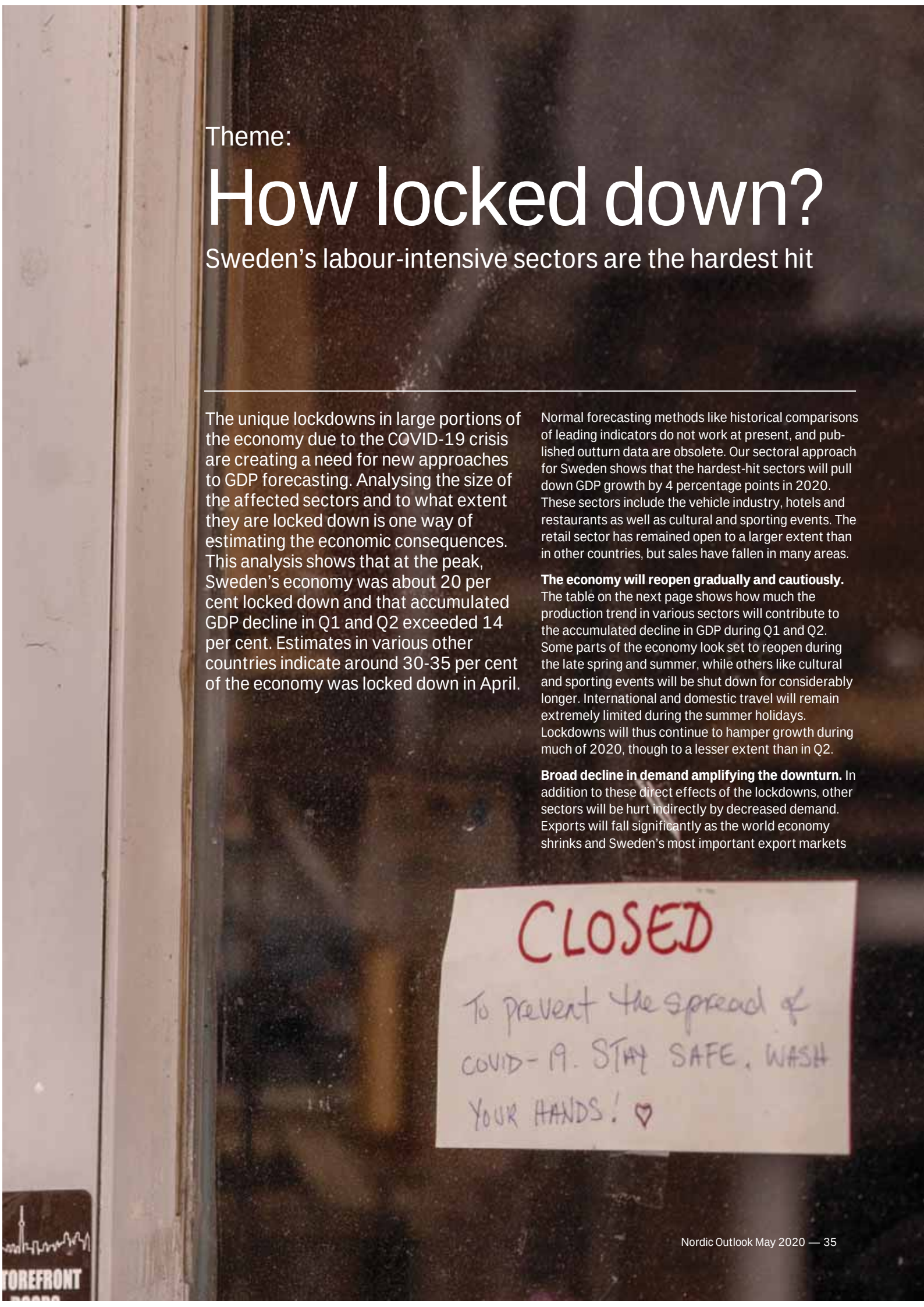
Sweden's labour-intensive sectors are the hardest hit

The unique lockdowns in large portions of the economy due to the COVID-19 crisis are creating a need for new approaches to GDP forecasting. Analysing the size of the affected sectors and to what extent they are locked down is one way of estimating the economic consequences. This analysis shows that at the peak, Sweden's economy was about 20 per cent locked down and that accumulated GDP decline in Q1 and Q2 exceeded 14 per cent. Estimates in various other countries indicate around 30-35 per cent of the economy was locked down in April.

Normal forecasting methods like historical comparisons of leading indicators do not work at present, and published outturn data are obsolete. Our sectoral approach for Sweden shows that the hardest-hit sectors will pull down GDP growth by 4 percentage points in 2020. These sectors include the vehicle industry, hotels and restaurants as well as cultural and sporting events. The retail sector has remained open to a larger extent than in other countries, but sales have fallen in many areas.

The economy will reopen gradually and cautiously. The table on the next page shows how much the production trend in various sectors will contribute to the accumulated decline in GDP during Q1 and Q2. Some parts of the economy look set to reopen during the late spring and summer, while others like cultural and sporting events will be shut down for considerably longer. International and domestic travel will remain extremely limited during the summer holidays. Lockdowns will thus continue to hamper growth during much of 2020, though to a lesser extent than in Q2.

Broad decline in demand amplifying the downturn. In addition to these direct effects of the lockdowns, other sectors will be hurt indirectly by decreased demand. Exports will fall significantly as the world economy shrinks and Sweden's most important export markets



in Western Europe and North America are hit hard. Rising unemployment and falling home prices will make households cautious about buying cars and other durable goods. As a result, the savings ratio will increase from an already record-high level. With a slight time lag, this will also hamper capital spending as demand and capacity utilisation fall.

Lockdown effect in vulnerable sectors
Per cent, percentage points

Sector	% of GDP	% change, Q1 & Q2	p.p. GDP contrib.
Vehicle industry	3.2	-80	-1.9
Hotels, restaurants	1.7	-40	-0.7
Retail, wholesale	11	-25	-2.3
Travel, transport	4.0	-30	-1.8
Culture, sport	2.0	-35	-2.2
Total	**21**		**-7.9**

Source: Statistics Sweden, SEB

Export decline on a par with the financial crisis. To assess the decline, some guidance can be obtained by putting the declines in PMIs or the National Institute of Economic Research tendency index in a historical context. But adjustment must be made to ensure that effects are not counted twice. We expect exports to fall by 15 per cent in the first half, roughly on a par with the decline during the financial crisis, but the latter occurred over one year. On the consumption side, vehicle sales are expected to be hardest hit, falling by 70 per cent, but other durable goods and services will also see major downturns. Grocery sales, however, are expected to rise by 4 per cent. Public sector consumption will also increase, mainly due to higher health care spending. Overall, GDP during Q1 and Q2 2020 will decline by a historically high 14.2 per cent, with 13 per cent of this total occurring in Q2.

GDP and its demand components
Per cent, percentage points

	% of GDP	% change Q1 & Q2	p.p., GDP contrib.
Private consumption	44	-3	-0.5
Exports	47	-15	-4.5
Capital spending	25	-5	-1.2
Public consumption	26	+2	0.5
Total indirect effect			**-6.1**
Direct effect			-7.9
Total GDP, Q1 & Q2			**-14.0**

Source: Statistics Sweden, SEB

Pressure on labour-intensive sectors

It is clear that labour-intensive sectors are hard hit. One fourth of Swedish jobs are found in the most adversely affected sectors. But historically, employment has fallen at a slower pace than GDP during economic downturns. One reason is that employers retain employees ("labour hoarding") in order to more easily restart operations when the economy rebounds. This tendency may now be stronger than usual if the downturn is regarded as temporary due to measures such as wage subsidies for shorter working hours.

Rapid rising unemployment

Employment indicators have weakened at record speed in recent months, including more than 40,000 lay-off notices in March. Although the pace has slowed somewhat, the number of lay-off notices in April was 26,800. This can be compared to the earlier record for a single month: just over 20,000 during the early 1990s crisis. So far, the number of people affected is equivalent to less than 1.5 per cent of all employees, but is very unevenly spread among sectors. We estimate that employment in these vulnerable sectors will fall by a maximum of 290,000 (5.5 per cent of total jobs). Overall employment will fall by a maximum of 7 per cent in 2020, which is more than twice as much as during the financial crisis.

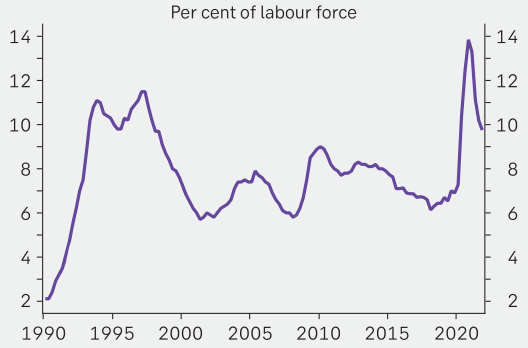
Employment in vulnerable sectors

Sector	Total, 000s	Change, 000s	Change, per cent
Vehicle industry	87	-40	-57
Hotels, restaurants	192	-90	-45
Retail, wholesale	271	-40	-22
Travel, transport	250	-70	-48
Culture, sport	173	-50	-45
Total	**1,300**	**-290**	**-6.5**

Source: Statistics Sweden, SEB

Unemployment will peak at around 14 per cent. Looking ahead, the government's wage subsidies will help lower the number of terminations, enabling employment to recover relatively fast. But at the end of 2021, the number of jobs will still be 3-4 per cent (equivalent to 170,000 people) lower than in 2019. One major difference compared to the global financial crisis is that this time around, labour-intensive service sectors are being affected. This has a significantly larger impact on the labour market than downturns in the manufacturing sector. The upturn in unemployment is being partly offset by a cyclical downturn in labour force participation, but the jobless rate will still climb by about five percentage points to nearly 14 per cent by the end of 2020. After that, we expect unemployment to decline gradually to 9.5 per cent at the end of 2021.

Unemployment will peak at nearly 14 per cent
Per cent of labour force

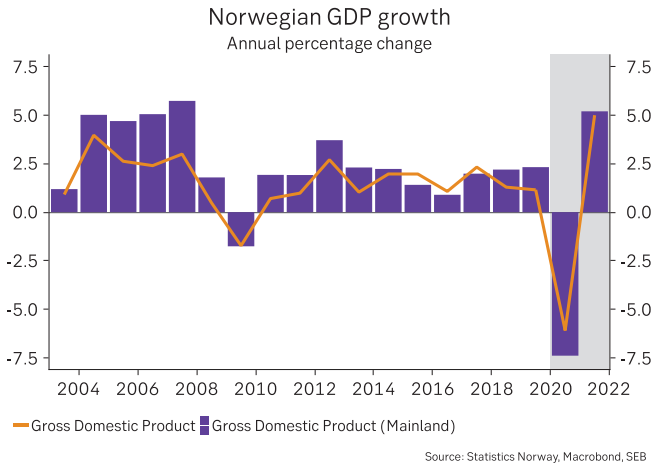


Source: Macrobond, SEB

Norway

Low oil prices hamper the economic recovery

The outbreak of COVID-19, combined with the collapse in oil prices, will have a major negative impact on the Norwegian economy. Mainland GDP is expected to contract by 7.4 per cent in 2020, assuming a reversal of containment measures during the spring. Despite an unprecedented policy response, the economic recovery will be slow – hampered by falling petroleum sector demand and high unemployment. Uncertainty is high, and risks are tilted to the downside.



Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.3	1.2	-6.1	5.0
Mainland GDP	2.2	2.3	-7.4	5.2
LFS unemployment*	3.9	3.7	6.2	5.8
Annual wage and salary increases	2.8	3.5	2.0	1.8
CPI-ATE inflation	1.5	2.2	2.3	2.5
Key interest rate*	0.75	1.50	0.25	0.25
EUR/NOK***	9.90	9.84	10.35	10,00

*Per cent ** Year-end. Source: Macrobond, SEB

An instant shutdown of the economy

Growth in the mainland economy (excluding oil, gas and shipping) reached its cyclical high in the third quarter of 2019. Momentum was thus already slowing when the pandemic outbreak hit Norway. Weakening petroleum sector demand, moderation in mainland investment and cautious consumers were projected to result in trend-like growth in the coming years. The outlook has changed drastically since February's *Nordic Outlook*. The government responded quickly to the virus outbreak by implementing extensive measures to contain the virus, including travel restrictions, social distancing, closing of schools and preschools and suspension of certain services. This resulted in an almost instant shutdown of the economy in mid-March, with the activity level in mainland GDP falling 14 per cent during the month. A gradual reopening of society started on April 20. The most extreme containment measures are likely to be reversed during the second quarter, but it will probably take time for both domestic and external demand to recover.

The initial impact on the Norwegian economy lacks any historical parallels. According to Statistics Norway's preliminary data, growth in the mainland economy fell 6.4 per cent in March, resulting in a sequential drop of 1.9 per cent in the first quarter (the national accounts will be published on May 12). Activity has fallen the most in the service sector, which accounts for 39 per cent of GDP. Tourism, travel, entertainment and food service activities are the most heavily affected. Activity in the public sector (19 per cent of GDP) is slowing due to such factors as the closing of schools and preschools. The immediate impact on the manufacturing sector (17 per cent of GDP) has been milder, but businesses are very pessimistic about the near-term outlook as the collapse in external demand and oil prices weigh on order bookings.

Mainland GDP growth is expected to post its largest decline in the second quarter, before recovering gradually in the second half. We expect a full-year decline of 7.4 per cent substantially larger than the 1.8 per cent fall in 2009. Fiscal stimulus and the weaker exchange rate should support the economic recovery once activity resumes, but repercussions from the containment measures and the collapse in oil prices will dampen the upturn. Although we forecast a 5.2 per cent rebound in mainland GDP next year, the level will be around 6 per cent lower than our February forecast. We expect total GDP to fall by 6.1 per cent in 2020, before climbing by 5.0 per cent in 2021. There is great uncertainty about the pace of the recovery. New virus outbreaks as containment measures are being reversed, or an extended period of low oil prices, may lead to large second-round effects and a prolonged economic downturn.

A sharp fall in investment

Petroleum investment has increased by 36 per cent since the trough in early 2018, but the outlook was gloomy even before the virus outbreak due to the completion of several major projects on the Norwegian continental shelf. Infection control measures have halted most investment activity, and the collapse in global oil prices will accelerate the spending downturn. Despite the fiscal support package to the oil industry, we forecast a cumulative decline of 23 per cent in petroleum capital spending during 2020-2021. Oil companies have maintained a strong cost control focus in recent years, and only 40 per cent of the jobs lost after the last oil downturn in 2014 have been recovered. The sector only accounts for 2 per cent of total employment, but the share of petroleum-related jobs via supply sectors is higher. Lower investment activity will thus create strong negative demand impulses in the broader economy. Statistics Norway's quarterly manufacturing survey

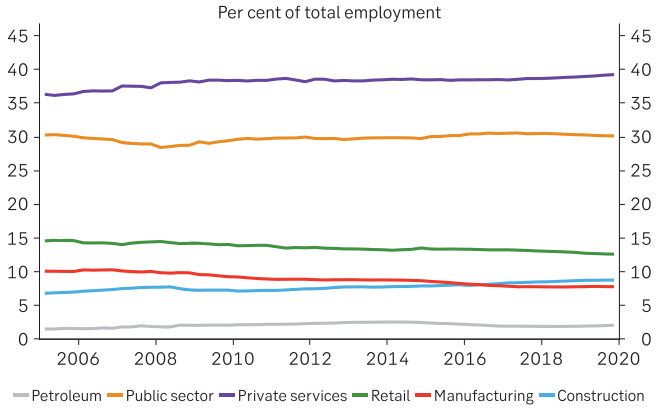
showed that petroleum industry suppliers were especially pessimistic. Low capacity utilisation, substantial uncertainty about future demand and sturdy growth in recent years will weigh on business investment. We forecast gross fixed capital spending to subtract nearly 3 percentage points from GDP in 2020.

Weak fundamentals constrain consumption

Private consumption has moderated over the past two years, due to weaker goods consumption and higher savings. Household fundamentals have deteriorated greatly in the wake of the pandemic outbreak. Registered unemployment showed an unprecedented 8.4 percentage point increase to 10.7 per cent during the last two weeks in March. Almost 90 per cent of the increase reflects surging lay-offs in sectors directly impacted by restrictions and containment measures. It is assumed that a large share will be re-employed when activity resumes, suggesting a reversal in the jobless rate. Labour Force Survey (LFS) data are lagging, since laid-off people are counted as employed for the first 3 months. LFS unemployment should start to increase in late summer and we forecast an average jobless rate of nearly 6 per cent in both 2020 and 2021. Weak business profitability and high unemployment will lower annual pay increases from 3.5 per cent in 2019 to below 2 per cent. Household consumption will thus be constrained by negative real wage growth in 2021. This contributes to our assessment of a moderate economic recovery, since private consumption accounts for 50 per cent of mainland GDP.

Employment in various sectors

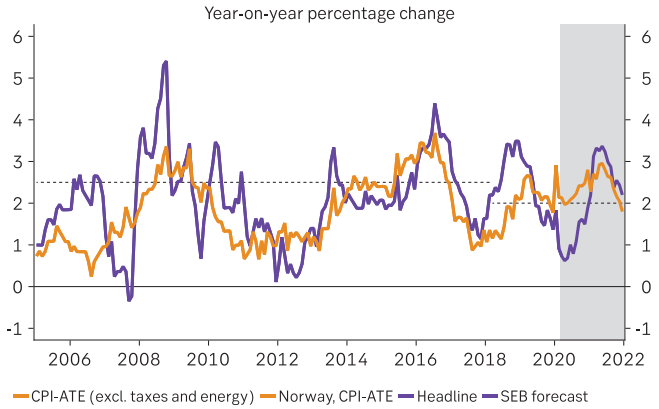
Per cent of total employment



Source: Statistics Norway, Macrobond, SEB

Norwegian inflation

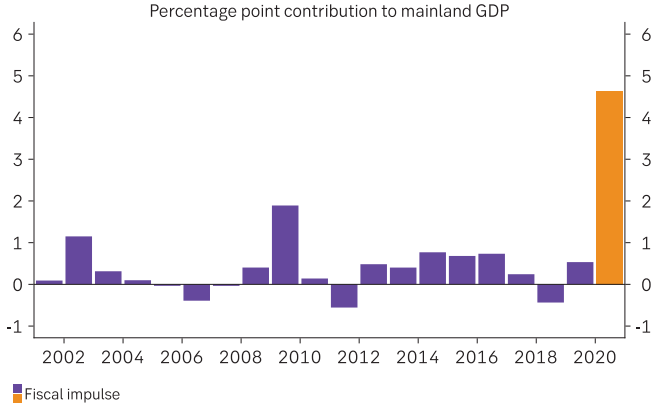
Year-on-year percentage change



Source: Statistics Norway, Macrobond, SEB

An unprecedent fiscal policy response

Percentage point contribution to mainland GDP



Source: Ministry of Finance, Macrobond, SEB

Mixed inflation outlook

The outlook for inflation is more mixed in Norway than for other countries. Low international price pressure and slower wage increases will dampen inflation throughout our forecast period, but the 10-15 per cent krone depreciation will work in the opposite direction. We believe the exchange rate will dominate and CPI-ATE will rise to near 3 per cent in early 2021, before falling below target by the end of the year. Sharply lower electricity prices will keep CPI down this year, but futures indicate some normalisation next year.CPI inflation will then rise temporarily to nearly 3.5 per cent.

An unprecedented policy response

There has been an unprecedented policy response following the shutdown of the economy. The government has introduced measures aimed at safeguarding jobs and the survival of viable companies. They include postponement of tax payments, extension of unemployment benefits and compensation for companies. In addition, a government loan guarantee scheme and the re-establishemnt of the Government Bond Fund will provide NOK 100 billion in liquidity support to businesses. The government will release its spring budget on May 12, but preliminary estimates suggest the non-oil deficit will grow by NOK 201 billion. Spending of petroleum revenues will thus equal 3.9 per cent of the Government Pension Fund Global. The fiscal contribution amounts to 4.6 percentage points of mainland GDP, double the dose implemented in 2009, but fiscal policy is likely to become even more expansionary. Broader measures to stimulate economic activity will be announced in late May once the most extreme containment measures have been reversed.

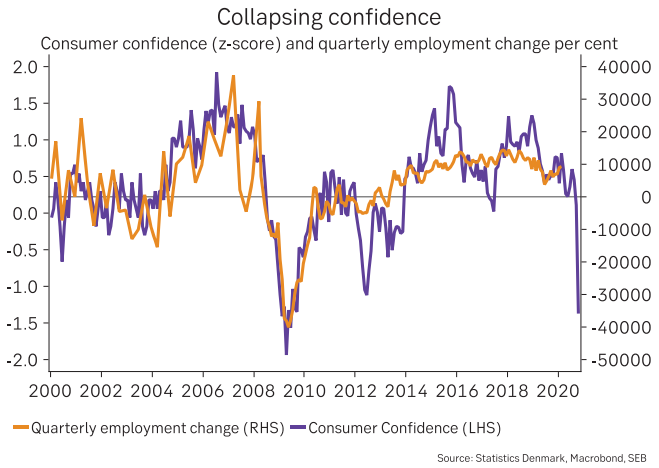
Norges Bank has broken new ground in this crisis with a record-low key rate and a commitment to defend the NOK. The central bank has reduced its benchmark rate in two steps, from 1.50 to 0.25 per cent. It does not rule out a further rate cut, but we believe it will refrain from cutting to negative rates, since this risks harming the transmission mechanism and increasing mortgage rates. The policy mix also favours letting fiscal policy assume a larger role in case of a more pronounced downturn. However, Norges Bank will maintain banks' access to funding via its liquidity operations.

The Norwegian krone crashed completely in mid-March as liquidity dried up. It remains vulnerable in the short term, since uncertainty about global growth and oil prices is still high. Norges Bank's readiness to intervene in the market should, however, limit the risk of a further excessive NOK depreciation. Moreover, increased fiscal spending is creating a positive krone flow, since the deficit is funded via transfers from the Government Pension Fund Global. The EUR/NOK exchange rate is out of synch with the fundamentals of the Norwegian economy and is unsustainable in the long term. We forecast an EUR/NOK rate of 10,00 by the end of 2021.

Denmark

Mild outbreak, sharp downturn

Our forecast for Denmark was revised sharply lower after the pandemic triggered lockdowns both locally and in major export markets. The Danish lockdown began on March 11, and the country has avoided a major outbreak, but the economic consequences have been grave. We now expect a GDP decline of 10 per cent in 2020, followed by a 9 per cent increase in 2021. The recovery will depend on the speed of the reopening and on how fast global demand picks up. Our forecast is highly uncertain, since the duration of COVID-19 and likelihood of a second surge in cases remain unknown.



Key data

Yearly change in per cent

	2018	2019	2020	2021
GDP	2.4	2.3	-10.0	9.0
CPI	0.8	0.8	0.3	1.3
Wages and salaries	2.2	2.0	2.0	1.0
Public sector fiscal balance*	0.6	2.0	-15.0	-7.0
Public sector debt*	34.3	33.5	48.0	50.0
Current account*	5.7	8.0	6.0	8.0
Key interest rate (CD rate), per cent	-0.75	-0.75	-0.60	-0.60
EUR/DKK	7.47	7.47	7.46	7.46

*Per cent of GDP. Source: Statistics Denmark, DØRS

Highly uncertain economic outlook

GDP growth has been cut to -10.0 per cent in 2020, followed by an increase of 9.0 per cent in 2021. As with SEB's forecasts of other European economies, we do not expect a full recovery immediately, but rather a more gradual return to pre-crisis GDP levels. Consumption will take a large hit, falling by 7.7 per cent in the first half of 2020, but the outlook is even worse for capital spending and exports. Consumer confidence has collapsed, declining to an index figure of -11.4 in April from 4.5 at the beginning of the year, and with confidence worsening across all components. This is the lowest confidence level since October 2008. Surprisingly, manufacturing sentiment surveys held up well in March, but we think that will change as the impact of the shutdown in big European export markets kicks in.

Recent statistics show that nearly 91,000 people had registered as unemployed since March 9, an increase of around 50,000 compared to the same period of 2019. The official unemployment rate has risen from 5 per cent a year ago to 7 per cent. Not surprisingly, the hotel and restaurant sector and the transport sector have been hit the hardest. However, it would have been a lot worse without a swift reaction from the Danish government. An additional 175,000 people have signed up for a furlough scheme in which the government pays 75 per cent of wages and salaries in return for companies not laying off employees. Adding a further 36,000 self-employed and freelance individuals, total unemployment could potentially reach 10-15 per cent.

Solid fundamentals facilitate large stimulus

There will be substantial costs to combat the crisis. The current fiscal response by the Danish government will require about DKK 250 billion in additional funding, or more than 10 per cent of GDP. The total cost will not emerge until later, since the stimulus packages are partly based on loans and guarantees. There will be a major impact on the public sector deficit and debt, but with solid fundamentals as its starting point, the Danish government can afford this. After budget deficits of 15 per cent of GDP in 2020 and 7 per cent in 2021, gross public sector debt is expected to reach 50 per cent of GDP in 2021.

Painful hike in acute crisis situation. While central banks around the world have been cutting key interest rates, Danmarks Nationalbank (DNB) responded to the DKK/EUR peg coming under pressure by increasing its deposit rate by 0.15 basis points on March 20. Prior to this, the DNB bought DKK 65 billion in March to reverse outflows. Due to the peg, the central bank cannot engage in QE directly, but the government has shifted parts of its short-term deficit funding to international markets, supporting the local liquidity position. Spot DKK was already under some pressure prior to the crisis, since negative bank deposit rates had led savers to shift into mutual funds with exposure outside Denmark. Hiking interest rates during a crisis is a painful way of demonstrating one's commitment to a fixed exchange rate system, but the same thing happened in 2008. At that time, it did not take long before superior fundamentals led to a reversal – with upside pressure on the peg and a rising currency reserve bolstering the domestic liquidity position.

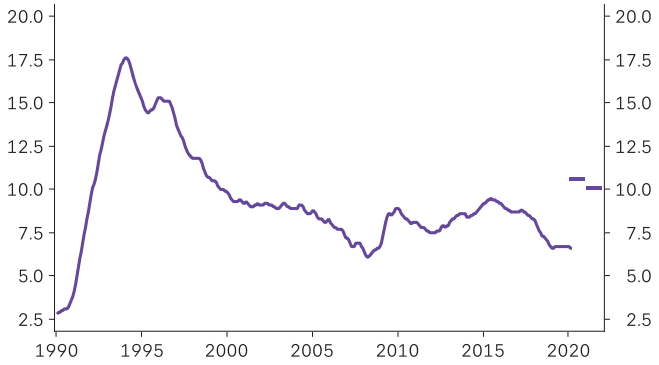
Finland

Downturn already began in late 2019

Finland was already noting negative growth in late 2019. Large-scale lockdowns and their secondary effects are now amplifying this downturn. GDP will fall by 9 per cent in 2020. Shrinking GDP, combined with stimulus measures, will put pressure on public sector finances and push up public sector debt to 75 per cent of GDP by 2021. More actions will be needed in order to keep the Finnish economy from lagging behind during its recovery phase, as it did after the global financial crisis.

Unemployment heading higher than the financial crises but lower than in the 1990ies

Procent av arbetskraften



Source: Statistics Finland, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.6	1.0	-9.0	5.0
Private consumption	1.7	1.0	-6.0	6.0
Unemployment*	7.4	6.7	10.6	10.1
Wages and salaries	1.5	1.6	1.0	1.5
HICP inflation	1.2	1.1	0.5	1.0
Public sector fiscal balance**	-0.9	-1.1	-9.0	-6.0
Public sector debt**	59.6	59.4	72.0	75.0

* Per cent ** Per cent of GDP. Source: Eurostat, SEB

The Finnish economy was already starting to shrink in late 2019. Unlike neighbouring countries, GDP fell in the fourth quarter. This 0.6 percentage point drop was broad-based, with negative GDP contributions from all parts of domestic demand, while net exports softened the decline. Today's measures to prevent the spread of COVID-19 are dramatically intensifying the GDP downturn. Finnish lockdowns have been far-reaching. GDP is likely to fall by more than an accumulated 15 per cent during Q1 and Q2 2020. Although we are now seeing signs of attempts to restart the economy, we expect GDP to fall by 9 per cent in 2020 as a whole. The downturn thus appears likely to be about as large as during the 2008-2009 financial crisis but less than in 1990-1992, when GDP fell by 13 per cent. In the latter case, Finland was especially hard hit because the general international recession was amplified by the abrupt disappearance of important exports to the Soviet Union. On both occasions, GDP fell during a more extended period: 6-11 quarters. Now the same nosedive is happening within a few months.

Rapidly rising unemployment. The labour-intensive service sectors are hardest hit by lockdowns. This will have an impact on the labour market and lead to a surge in unemployment. Even though labour force participation will be pushed lower by a weaker employment outlook, the jobless rate will climb to 13-14 per cent by late 2020. This can be compared to peaks of 17.5 per cent during the early 1990s crisis and 9 per cent during the financial crisis. Low inflation will provide some support to real incomes, but household consumption will still decline sharply this year. Exports will also fall significantly in the near future. Weak demand and falling capacity utilisation will hamper business investments throughout our forecast period.

Sizeable stimulus programmes will create big deficits. Like other countries, Finland has unveiled various stimulus packages to prop up businesses and households. These measures are a mixture of fiscal stimulus and guarantees, which the IMF estimates at 30 per cent of GDP. Direct fiscal stimulus is equivalent to 2.5 per cent of GDP, and businesses are also being given the option of postponing tax payments equivalent to 2 per cent of GDP. Finland can also take advantage of the ECB's large-scale support packages, for example a lowering of bank capital requirements to make lending easier. Meanwhile the government has issued guarantees for airlines and other companies. Stimulus measures and the economic downturn will put heavy pressure on public sector finances. The public sector deficit, which was about 1 per cent of GDP last year, will swell to nearly 10 per cent this year, then narrow to 6 per cent in 2021. The deficit and the big GDP decline this year will push the debt ratio from less than 60 per cent of GDP in 2019 to 75 per cent in 2021.

Further stimulus programmes will be needed in order to get the economy moving. We expect additional measures ahead in order to support the recovery that will start in the third quarter of 2020. After the financial crisis, Finland fell behind its peers and the economy suffered recurring disappointments and "mini-recessions" for a fairly long period. There is a risk that this will be repeated, due to such factors as strained competitiveness because of the euro's strength against the Russian, Swedish and Norwegian currencies. We are making a relatively cautious forecast of the recovery process and predict GDP growth of 5 per cent in 2021. This implies that the level of 2021 GDP will be a full 7 per cent lower than according to our forecast in the February issue of *Nordic Outlook*.

The Baltics

Lithuania

First quarter GDP decline was less than expected, but this year the economy will shrink by nearly 9 per cent. The government's stimulus packages are relatively small, and exports will be the key to a fast recovery.

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Latvia

Rapid lockdowns are contributing to a major drop in GDP, but it will be far milder than during the financial crisis. Funding measures totalling 13 per cent of GDP will soften the downturn, but unemployment will climb to 11 per cent.

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Estonia

Fundamentals have improved since the financial crisis, when GDP fell by nearly 20 per cent. This year's downturn will be half as big. The EU's lowest public sector debt, 8.4 per cent of GDP at the end of 2019, allows room for stimulus.

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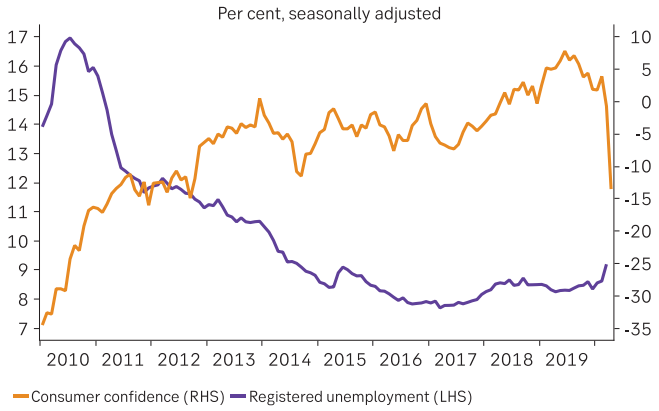
Lithuania

Upturn in exports key to recovery

The year 2009, when GDP dropped by 17.6 per cent, is still remembered and some lessons from the mistakes made then are not forgotten. The economic downturn in 2020 will be closer to the average euro area level. The relatively small role of tourism in the economy and healthy household and business finances before the COVID-19 outbreak are helping to mitigate the decline. But government support is relatively small and lagging. This is expected to contribute to a slow recovery.

Rise in unemployment has already started

Per cent, seasonally adjusted



Source: Lithuanian Labour Exchange, European Commission, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	3.6	3.9	-8.7	6.1
Private consumption	3.9	3.2	-8.0	6.0
Exports	6.3	9.3	-10.9	8.2
HICP inflation	2.5	2.2	0.8	2.2
Unemployment	6.2	6.3	9.9	8.8
Wages and salaries	9.9	8.8	0.3	3.0
Public sector fiscal balance*	0.6	0.3	-9.5	-3.5
Public sector debt*	33.8	36.3	49.5	51.5

* Per cent of GDP. Source: Statistics Lithuania. SEB

GDP will drop by 8.7 per cent in 2020 but recover by 6.1 per cent in 2021. In order to limit the spread of COVID-19, a nationwide lockdown started on March 16. The containment measures introduced were slightly stricter than in the other Baltic countries. In the first quarter, the GDP decline was only 0.2 per cent – not that miserable, due to a solid economic performance in the first two months. New infections moderated in the second half of April and allowed the government to announce a four-step plan to reopen the economy. In mid-May the country is forecasted to enter the third phase of reopening. The second quarter fall in GDP will be double-digit, with hopes of recovery in the third quarter if our assumptions regarding the rebound in Lithuania's major export markets are right.

Registered unemployment increased by 1.7 percentage points to 11.5 per cent in April. The rise was rather muted as employers did not hurry to lay off staff, preferring to reduce employee working hours. The government compensates employers for up to 90 per cent of labour costs, depending on the maximum state subsidy level chosen. However, unemployment will keep on rising in the months to come as employers in the most vulnerable sectors face low demand while activities are being restored after the lockdown. We forecast that unemployment will peak in the fourth quarter and start falling next year. Average unemployment will increase from 6.3 to 9.9 per cent in 2020 and then drop to 8.8 per cent in 2021.

Average pay is forecasted to increase by 0.3 per cent in 2020 and 3 per cent in 2021. This year the wage and salary bill will be supported by higher pay in the public sector, which accounts for around one third of total employees. However, next year we expect the opposite to happen. Pay levels in the public sector may be frozen, while they recover in the private sector. Banks have agreed to a moratorium allowing private individuals to defer mortgage payments for up to one year, easing household financial stress. A similar moratorium applies to business loans.

In Lithuania, tourism accounts for only 3 per cent of GDP. The loss of foreign tourists starting in mid-March will thus have a smaller impact than in some other EU countries. So far, manufacturers have been able to get through this crisis with smaller losses than the service sector. Industrial production excluding oil refining was up 1.3 per cent in first quarter. However, we believe that the worst months for manufacturing companies are just ahead and that recovery to pre-COVID levels will take time. Construction companies have continued working during the lockdown, but their outlook is also bleak. Although the government plans to increase its investments, the private sector is already suspending new projects. A downturn in residential property construction is unavoidable, since sales of new apartments will fall in the coming months.

Inflation will decelerate to 0.8 per cent this year, mainly due to lower fuel prices. Regulated prices for household electricity and natural gas will also be cut from June 1 by around 10 and 20 per cent, respectively. Despite the drop in global agricultural prices, we do not expect lower retail food prices in Lithuania.

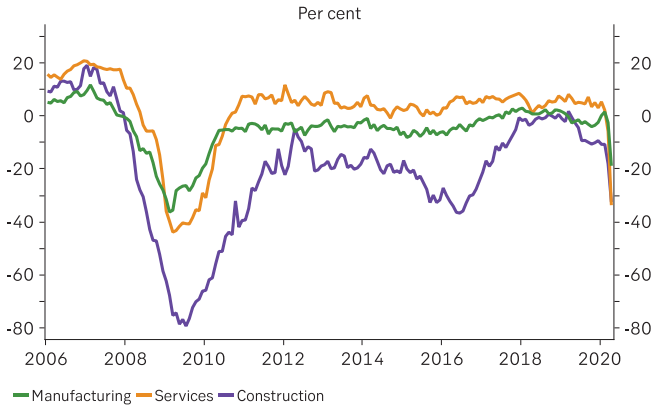
The government has already increased its net borrowing limit by EUR 5 billion (~10 per cent of GDP). Unlike during the 2009 economic downturn, the country is a member of the euro area and has no problems in borrowing. However, the government's fiscal response is lagging, especially guarantees and direct loans to small and medium sized businesses. In the first quarter, national budget revenue was still 1.6 per cent higher than planned. But public finances will be hit hard, and we expect that the government budget will end up with a deficit of at least 9.5 per cent of GDP this year.

Latvia

Focus on exit strategy

Timely introduction of COVID-19 containment measures has worked well and allowed a liberal restriction regime. However, this has not spared the economy entirely from a slump. Although we expect the economy to contract less than during the global financial crisis, GDP will decrease by 9 per cent this year. It will rebound by 5 per cent next year. Unemployment will peak by the end of this year at just above 11 per cent.

Falling demand, but better than in 2009



Source: Eurostat, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	4.3	2.2	-9.0	5.0
Private consumption	4.4	2.9	-12.5	6.0
Exports	3.9	2.0	-8.0	6.5
Consumer price index (CPI)	2.5	2.8	0.3	1.8
Unemployment*	7.4	6.3	9.8	8.8
Wages and salaries	8.4	7.2	1.0	3.0
Public sector fiscal balance**	-0.7	-0.2	-8.0	-5.0
Public sector debt**	37.2	36.9	48.0	50.5

* Per cent of GDP. Source: Statistics Latvia. SEB

Bad, but better than 2009. The uncertainty Latvia is facing is huge, but at the same time the scale of economic damage seen during the global financial crisis just over a decade ago will be avoided. The current account deficit last year was -0.5 per cent of GDP, compared to -20.8 per cent in 2007, and this time the government has more tools available to face the challenges. In March, economic sentiment dropped sharply (to 96.1 from 100.6 in February) but is widely expected to plunge further, as in practically all other European economies.

Big drop in consumption. Latvia managed to escape a surge in coronavirus cases by timely introduction of containment measures in an effort to save the economy. Despite this, we expect GDP to decline by up to 20 per cent in the second quarter. Data so far suggest a substantial drop in activity. In March consumption of diesel and petrol fell by 12.5 and 45.5 per cent respectively on a month-to-month basis. A recent SEB survey shows that 50 per cent of small and medium-sized businesses have experienced a drop in turnover; 17 per cent reported that their business has completely stalled. Only 30 per cent of respondents reported that their business has not experienced any changes at all, while 3 per cent reported an increase in turnover. Not surprisingly, the most affected sectors are tourism, transport, manufacturing, real estate and trade. In March the number of foreign and resident visitors decreased by 62.7 per cent. On the other hand, agriculture is regarded as relatively well positioned, despite changes in supply chains and market conditions and a shortage of seasonal workers.

GDP to decline by 9 per cent. The state of emergency is set to run until May 12, with gradually eased restrictions after that but social distancing measures in place until the end of 2020. We expect GDP to decline by 9 per cent this year before gaining 5 per cent in 2021. Consumption is down by 13 per cent, and capital spending is being dragged down as well. The global recovery profile depends on how well countries will succeed in re-opening their economies. As in many countries, Latvia's goods exports were surprisingly strong until February, but export indicators will turn negative and a 10-15 per cent drop may not be the worst-case scenario.

Unemployment peaking at 11 per cent. Funding measures to contain the crisis have reached 13 per cent of GDP. Cash reserves at the Treasury stand at EUR 2.6 billion, and EUR 1.5 billion is reserved in credit lines. Announced and planned stimulus measures total around 6 per cent of GDP, including direct support from the budget, tax deferrals and credit lines. However, the weakest point could be the efficiency of the programme. This could hamper Latvia's ability to achieve an agile recovery and to avoid a surge in unemployment. From the beginning of March to mid-April, registered unemployment rose from 6.3 per cent to 7.3 per cent. In the absence of any support measures, unemployment would have exceeded 10 per cent already. Instead it will peak at just above 11 per cent by year-end.

Low inflation and slower wage growth. In the second half of 2020, wage and salary growth will slow sharply. At many companies and institutions, pay increases for this year have already been set. We can expect wage growth of 1 per cent in 2020. In March, inflation dropped to 1.4 per cent. Due to falling energy and food prices, CPI rate will slow further and in some months negative inflation (deflation) is possible. This year we expect inflation to average 0.3 per cent, before rising to 1.8 per cent next year.

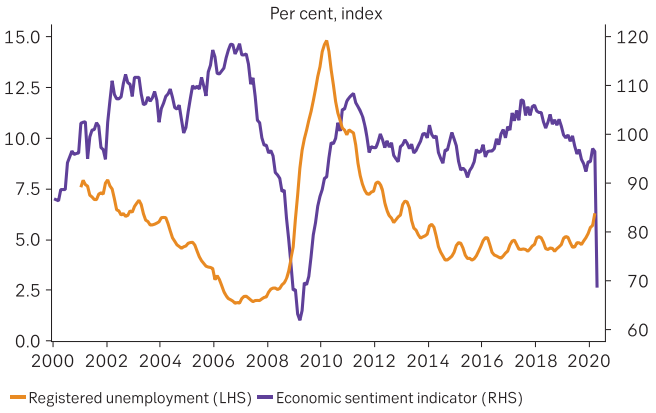
Estonia

Will it be as bad as the 2009 recession?

Instead of the previously expected gradual slowdown in economic growth, the coronavirus will now push Estonia into a severe recession. Despite being able to avoid a full scale lockdown, Estonia is highly dependent on exports and tourism, and GDP will plummet by 9.8 per cent in 2020. However, under current assumptions, the economy should rebound by 6.5 per cent in 2021. Unlike many countries, this represents a better outcome than during the global financial crisis of 2008-2009.

Labour market not as bad as in 2009

Per cent, index



Source: Estonian Institute of Economic Research (EKI), Estonian Labour Market Board (TTA), Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	4.8	4.3	-9.8	6.5
Private consumption	4.3	3.1	-9.5	5.4
Exports	4.3	4.9	-11.2	7.8
Consumer price index (CPI)	3.4	2.3	0.4	2.8
Unemployment*	5.4	4.7	10.2	6.2
Wages and salaries	7.3	7.4	0.3	3.5
Public sector fiscal balance**	-0.6	-0.3	-5.8	-3.3
Public sector debt**	8.4	8.4	13.8	13.6

* Per cent ** Per cent of GDP. Source: Statistics Estonia, SEB

Estonia very different from 2009. After three years of very strong economic growth, averaging 5 per cent annually for GDP, the Estonian economy was bound to slow. The coronavirus has now unfortunately answered the question of whether the slowdown would be caused by supply-side limits in the labour market or by weak demand among Estonia's main trade partners. As elsewhere, many observers are wondering how the inevitable recession will play out compared to the global financial crisis (GFC). Warnings about the worst economic downturn since the 1930s sound hollow in a country that saw its GDP drop by 5.1 per cent in 2008, followed by a 14.4 per cent plunge in 2009. Such analyses also have limited value because of the very different nature of today's economy. While pre-GFC Estonia was characterised by large credit inflows, a negative savings rate and a real estate bubble, hardly any imbalances can be found in recent macroeconomic data.

No total lockdown. The death toll from COVID-19 per inhabitant has been slightly higher in Estonia than in neighbouring Finland or Latvia. However, the worst predictions have luckily not materialised. The government response to counter the virus has been to close schools, gyms, theatres, cinemas and large shopping centres. Unlike many countries, there has hardly been a discussion of a full-scale lockdown.

Exports and tourism are key. It is debatable whether this slightly softer approach will actually prevent a slump in the economy, since many businesses are closed because of a lack of demand, not government measures. The contribution of tourism to GDP has been estimated at 8 per cent, and there are few hopes of seeing significant inflows of foreign tourists this year. In addition, the economy is very dependent on exports, which plummeted by a fifth back in 2009, much more than household expenditures. Exports might be helped somewhat by the fact that Estonia's main trade partners – Finland, Sweden and Germany – have fared relatively well during the coronavirus crisis, but that is of marginal importance. Our assumptions suggest that exports will fall by 11.2 per cent in 2020, followed by a 7.8 per cent recovery in 2021.

Households in a better situation. So far it seems plausible that household demand will hold up better than foreign trade. Today's social safety net is a world apart from the one Estonia had during the GFC. In addition to comprehensive unemployment insurance, similar to many countries, a wage compensation scheme was put in place by the government to prevent mass redundancies. Registered unemployment increased to 7.5 per cent from 5.7 per before the crisis started. It could be worse, given the scale of the crisis. We currently estimate that unemployment will average around 10 per cent in 2020. Under those assumptions, household spending will fall by 9.5 per cent this year, before bouncing back by 5.4 per cent in 2021. Private consumption will be cushioned by low inflation, since the combination of low energy prices and a cut in excise duties will result in a modest rise in consumer prices of only 0.4 per cent.

Strong public sector finances. Also very different from the GFC is Estonia's fiscal ability to fight the crisis. Back then, even euro area countries were paying exorbitant prices for borrowing, not to mention a small country at the eastern edge of the EU with its own national currency. This time, Estonia may be one of the countries best positioned to stimulate its economy. Estonia limited its public debt to 8.4 per cent in 2019. Balancing the budget is required by law. There is thus plenty of room to increase borrowing. We foresee that the debt-to-GDP ratio will increase to 12.6 per cent of GDP in 2020, while the budget deficit will widen to 2.8 per cent.

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