Research Reports

Second COVID-19 wave will delay recovery while awaiting a vaccine

New stimulus packages on the way but central banks will not cut rates

Nordic Outlook

November 2020

Contents

The world in an iron grip
A hard-to-manage virus

The clock is ticking steadily towards the day the whole world is waiting for: when a vaccine against COVID-19 is available. At least ten vaccine candidates have now reached Phase 3 clinical trials, and experts believe that production and distribution can begin around year-end. This would be a major step in efforts to defeat the virus, yet there are lingering uncertainties, for example about the effectiveness and public acceptance of vaccines.

The global economic recovery in Q3 2020 was an upside surprise, even though 95 per cent of the world's labour force had been affected in varying degrees by restrictions. Today the trend is unfortunately in the wrong direction; the expected second COVID-19 wave is disturbingly strong, leading to new restrictions that will slow recovery for the next six months.

New relief packages are thus being enacted, while earlier crisis responses can be utilised to a greater extent. In 2020 fiscal stimulus is already five times larger than during the Great Recession of a decade ago and is more effective, since more money goes straight into the economy. This provides hope for a recovery.

Once the economic recovery is on firmer ground, we need to lift our gaze. The crisis has undoubtedly speeded up the integration of digital technology into how (and what) we produce and consume in terms of goods and services. Some of these changes are temporary, others permanent. This "new world" is challenged by the need for processes that reallocate production resources in economies. Companies that are viable in the long term and expanding sectors need support – even shrinking and eventually phased-out sectors need help – posing challenges to the financial sector and the labour market. Yet this Fourth Industrial Revolution offers huge opportunities for businesses, households and societies to generate stronger, greener growth that provides new jobs and higher productivity.

This November 2020 issue of *Nordic Outlook* analyses the continued global consequences of the COVID-19 crisis. We also include five in-depth theme articles on:

- A new world
- Working from home
- Future of the USD
- The EM economies
- 2020 wage round

We hope *Nordic Outlook* gives you new insights about today's challenging global prospects. Stay safe, and let us all help each other get the world back on its feet!

Robert Bergqvist
Chief Economist

Håkan Frisén
Head of Economic Forecasting

The global economy

Second COVID-19 wave will delay recovery while awaiting a vaccine

The United States

The decline in 2020 GDP looks set to be less than expected. New fiscal stimulus is on the way, although tensions between the White House and the Senate may limit its scope. The Fed is prepared to increase its bond purchases to fend off any upturn in yields.

Page 28

The euro area

Due to increasing COVID-19 cases and new restrictions, GDP will fall again in Q4 and 2021 will start anaemically. Then recovery will gain momentum, aided by fiscal stimulus and exports. The ECB will focus on QE policy, but a key rate cut cannot be ruled out.

Page 31

Emerging markets

The EM countries – led by China – have recovered, but their 2020 GDP growth has been adjusted lower. The situation is mixed, however: a country's export structure and fiscal manoeuvring room play a major role in how severely it is impacted by the crisis.

Page 25

The United Kingdom

A one-two punch from the pandemic and Brexit is pressuring the British government and central bank to prop up the economy. We expect some form of trade agreement with the European Union, but growth will be slower than in other large economies.

Page 33

A strong recovery in Q3 2020 is being followed by lockdowns as a new COVID-19 wave arrives. GDP will fall in the OECD countries; the euro area and the UK will again be hardest hit. Thanks to new stimulus and good prospects that vaccinations can soon begin, GDP will rebound next spring, but low resource utilisation will contribute to a need for continued extreme monetary policy – also highlighting its drawbacks, including wider economic gaps.

The coronavirus pandemic and the US presidential election have recently dominated economic and financial market developments. The recovery in North America and Western Europe continued in September, and incoming statistics for October have also mainly provided upside surprises. Viewed only on the basis of final statistics, we thus have reasons to paint a brighter picture now. But as the second wave of COVID-19 cases turns increasingly serious, our future perspective shifts dramatically. Restrictions and lockdowns have gradually become more extensive, especially in Western Europe. The spread of the virus has also increased in the United States, but new restrictions have mainly been regional. Analysing the consequences of this second wave for growth and policy making is one important element of *Nordic Outlook*, November 2020.

Global GDP growth
Year-on-year percentage change

	2019	2020	2021	2022
United States	2.2	-4.0	3.6	3.8
Japan	0.7	-5.8	2.4	0.7
Germany	0.6	-6.2	3.2	4.2
China	6.1	2.0	8.0	5.6
United Kingdom	1.3	-11.5	4.7	6.6
Euro area	1.3	-7.6	4.0	4.3
Nordic countries	1.6	-3.1	3.7	3.1
Baltic countries	3.7	-2.9	3.4	3.4
OECD	1.6	-5.7	3.8	3.4
Emerging markets	3.8	-3.3	6.2	4.3
World, PPP*	2.8	-4.4	5.1	3.9

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

We expect GDP to fall in the OECD countries during the fourth quarter of 2020. The first months of 2021 will also be very weak. During the second quarter a clearer recovery will begin, among other things because risk groups and health care employees may have started to be vaccinated against COVID-19, judging from the actions of the public authorities in charge. Measured as annual averages, these new events will mean that we are adjusting our GDP growth forecast for 2020 upward and our forecast for 2021 downward by about the same numbers. A steeper upturn in 2021 will also help lift our 2022 full-year forecast. Our global GDP forecast is largely unchanged. This is because changes in emerging market (EM) economies are showing the opposite pattern: the impact of the pandemic in 2020 now looks larger than expected, opening the way for a more powerful recovery in 2021. However, this assumes that there will not be any clear second COVID-19 wave in Asia.

Potentially major long-term consequences? Our overall main conclusion is thus that the second wave will not have any crucial negative impact on GDP growth over the next few years. But it will probably lead to further crisis responses. This may worsen the long-term disadvantages of such measures as ultra-loose monetary policies – in the form of growing economic gaps, weak pressure for change and non-optimal allocation of capital. As for fiscal stimulus, we cannot rule out that higher public debt will become a long-term problem. In the near term, extending certain crisis systems may lead to distortions in the competitive situation and perhaps a greater level of abuse of these systems. Other long-term consequences are discussed in two theme articles, “A new world” (p 13) and “Working from home” (p 16). The latter examines conceivable major changes in the labour market.

Will the post-election calm in the US last? The close outcome can be expected to result in recounts and legal actions, but these are unlikely to change the outcome and financial markets have initially reacted with a sense of relief. Although the election result is not yet officially certified, it is clear that Joe Biden will be the new US president. The Senate outcome will not be decided until early January, but the Republicans will probably retain their majority. Now that the election is over, the parties can probably overcome earlier deadlocks and reach agreement on short-term crisis responses. Further ahead, we are also likely to see new stimulus packages, though the likely Republican majority will stop portions of Biden’s election programme. In Western Europe as well, weaker economic conditions will probably lead to large new fiscal stimulus. Government debt will climb sharply to historically high levels this year in the 37 mainly affluent countries of the OECD, but in most countries it will level off in 2021 measured as a percentage of GDP.

Active fiscal policies will ease the burden on central banks. But the increasing spread of the virus will still push down resource utilisation and inflation in a way that will also trigger further monetary policy expansion. We believe central banks will choose to expand quantitative easing (QE) programmes in various ways but will want to avoid additional key interest rate cuts for as long as possible. In Western Europe, the pressure is heaviest on the Bank of England, which needs to help sustain an economy that has been hit extra hard by the pandemic and Brexit (British withdrawal from the European Union). In Sweden, too, pressure is increasing on the Riksbank as a stronger krona and modest long-term pay hikes in long-term labour agreements will push down inflation and inflation expectations.

The low interest rate and bond yield environment will persist. European government bond yields have recently fallen to their lowest since March, due to an acceleration in the spread of COVID-19 and clear indications of new stimulus from the European Central Bank (ECB) and others. In the US, a divided Congress has reduced the likelihood of massive fiscal stimulus, easing upward pressure on yields. We thus expect nominal yields to climb only gradually next year as the economic outlook improves. But we expect the Federal Reserve (Fed) to slow any upturns in real yields. At the end of 2021 we believe 10-year Treasury yields of 1.20: 40 basis points higher than today. We expect equivalent German bonds to yield -0.40 per cent.

Deficits and interest rate convergence will push down the US dollar. Since the COVID-19 crisis broke out, key interest rate convergence has put downward pressure on the dollar. Interest rate policies remain an important driver, but without large interest rate movements, other forces become more important. We believe that such fundamentals as budget deficits and current account balances may end up playing a larger role as central banks continue to buy government securities in order to keep interest rates and bond yields down. This implies that the dollar will continue to weaken and that the EUR/USD exchange rate will reach 1.30 towards the end of our forecast period; this represents our new estimate of the long-term equilibrium rate. The Swedish krona is gaining strength against many other currencies during the crisis, a sign of larger defensive qualities than before. This is connected to such factors as strong government finances. The Fed's "money printing" and weak euro area economies – with a risk of an ECB interest rate cut – will continue to put appreciation pressure on the SEK. We see good potential for a stronger krona, with the EUR/SEK rate reaching 9.70 by the end of 2022.

Cost control has kept corporate earnings up. Stock markets have recently been under pressure because of pandemic-related growth worries and uncertainty connected to the US presidential election. But in light of the strong recovery since last spring's crash, stock markets have shown great resilience. Predominantly favourable Q3 reports have provided support for stocks. Companies continue to show impressive cost control and flexibility. This is one reason why this year's decline in earnings has been less than feared. Expanded restrictions and lockdowns will remain a threat, but with access to COVID-19 vaccines approaching, the risk that longer-term earnings forecasts need to be downgraded will diminish. Given the prospect of very low rates and yields, we do not see today's valuations as worrisome, especially if we calculate price-earnings ratios on the basis of earnings levels that appear reasonable once the situation has normalised to a greater extent towards the end of our forecast period.

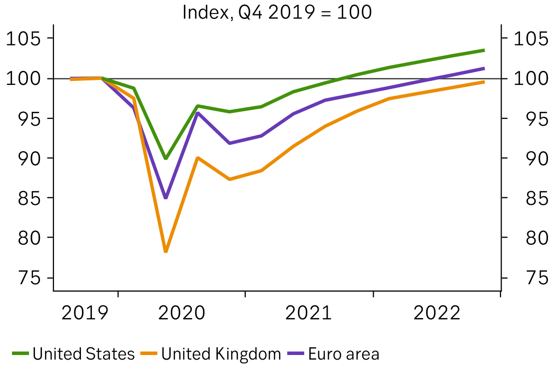
Given the prospect of very low rates and yields, we do not see today's valuations as worrisome

Second COVID-19 wave is hitting Europe hardest

The spread of the virus has increased sharply in recent weeks, greatly changing the short-term economic outlook. This applies especially to Western Europe, where the situation has deteriorated dramatically in large economies such as the United Kingdom, France, Italy and Spain, but also in several smaller countries. We have probably not yet seen the peak of the resulting lockdowns, and our forecast for the fourth quarter of 2020 assumes that they will be further expanded in November, yet at present they still appear likely to be much milder than last spring. The authorities seem to be attaching greater importance to maintaining industrial production and otherwise trying to limit damage to the supply side of the economy; the UK is a partial exception in this respect. But restrictions on travel, leisure activities and social life in general look set to be just as tough as last spring. The number of new infections reported in the US has also increased alarmingly in many states, but restrictions are being expanded to a much smaller extent than in Europe.

New GDP declines in the second virus wave

Index, Q4 2019 = 100



Source: Macrobond, SEB

Winter closures before a vaccine changes the playing field. Looking ahead, it is reasonable to assume that some restrictions will remain for the rest of 2020. For example, restrictions in Germany and France will initially apply for about one month (November) and can hopefully be eased at least partly over Christmas and New Year. Yet this will be conditional on ending the spread of COVID-19. If the infection curve more or less follows last spring's pattern, the peak should occur before year-end and the number of new cases will thus decrease in Q1, suggesting some economic recovery.

The 2021 growth curve will depend on COVID-19 vaccine availability. The main scenario among European authorities now seems to be that risk groups and health care employees can begin to be vaccinated in Q2, while broader population categories may be vaccinated during the summer. The imminent arrival of large-scale vaccinations should have a clear stabilising effect on financial markets. Disappointments will not be so important as long as companies can maintain corporate earnings expectations. But the results of official strategies for reopening economies will be more double-edged. The authorities may conceivably be especially reluctant to take chances by easing restrictions when a vaccine seems only months away.

GDP, seasonally adjusted quarter-on-quarter changes
Per cent

	Q1 2020	Q2	Q3	Q4
United States	-1.3	-9.0	7.4	-0.9
Euro area	-3.7	-11.8	12.7	-4.0
Germany	-1.9	-9.8	8.2	-3.5
Spain	-5.2	-17.8	16.7	-5.0
United Kingdom	-2.5	-19.8	15.2	-3.0
Sweden	0.2	-7.8	4.3	0.1
Norway	-2.2	-6.3	5.2	0.6
Denmark	-1.6	-6.8	4.2	-2.0
Finland	-1.4	-4.4	3.0	-2.4
Lithuania	0.0	-5.9	3.6	-0.9
Latvia	-2.3	-7.3	7.3	-2.9
Estonia	-2.2	-5.6	4.6	-1.8

Source:Eurostat,OECD, SEB

Downward adjustments in 2021 GDP growth. In economic forecasts, quarterly curves are normally "smoother" than historical outcomes. This should certainly not be interpreted as meaning that forecasters believe the future will be calmer than the past. Instead it reflects a humble realisation of how uncertain forecasts are. Today's situation is special because sharp fluctuations during Q2 and Q3 2020 showed what dramatic consequences the lockdowns had, but also how quickly activity could resume once restrictions were eased. Based on this experience, there are reasons to be more flexible than usual and allow various assumptions about restrictions and vaccine availability to clearly determine the quarterly trajectory in the coming year. The Q4 2020 decline in GDP will be far milder than in Q2, partly due to gentler lockdowns but also because third quarter GDP was still well below pre-pandemic levels. Looking at full-year 2021 forecasts, the consequences of the second wave will lead to clear downward revisions. In the euro area, we are lowering our GDP growth forecast by 2.6 points. On the other hand, the positive surprises seen in Q3 will mean higher growth for the full year 2020. We are also revising our forecast for 2022 upward for the euro area and the UK as a result of the new recovery curve.

Gentle US downturn and divided EM situation. Last spring's pattern, with major Western European economies suffering some of the most widespread lockdowns, seems to be repeating itself. But in the US, too, faster coronavirus spread will temporarily derail the recovery, leading to a small GDP decline in Q4. Among emerging market (EM) economies, the situation is divided (see theme article, p 25). China appears to be managing without serious reversals and can thus maintain positive growth this year. Yet Beijing has been cautious about stimulus measures in order to avoid increasing debt. This is one reason why we will not see the same commodities boom as during the Chinese investment projects after the global financial crisis. In many other EM countries, however, the pandemic situation has worsened, with major economic consequences. This is especially true of India, where GDP is now expected to shrink by 9 per cent this year. Argentina, Mexico and South Africa are other sizeable EM economies that are showing large GDP declines.

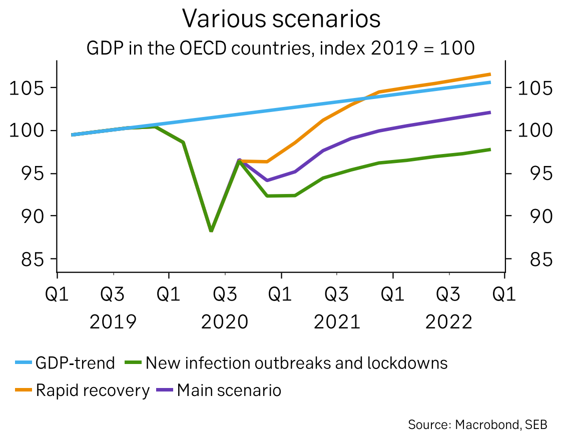
Beijing has been cautious about stimulus measures in order to avoid building up too much debt

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

	2019	2020	2021	2022
China	6.1	2.0	8.0	5.6
India	4.9	-9.0	8.6	4.0
Brazil	1.1	-6.0	3.0	2.5
Russia	1.3	-4.5	3.7	2.5
Emerging markets, total	3.8	-3.3	6.2	4.3

Source: IMF, SEB

New challenges in the Nordic and Baltic countries. So far, all of the Nordics and Baltics have weathered the pandemic unexpectedly well, with GDP declines milder than the EU average in 2020. Widespread lockdowns were relatively brief in several countries, for example helped by the sectoral structure of the Danish and Finnish economies. There are many indications that this time around, these countries will again be less hard-hit than Europe in general. With a certain lag, the spread of the virus has nevertheless accelerated sharply in recent weeks, although the number of deaths and severe illnesses has so far remained well below last spring's levels. Some types of restrictions, such as social distancing, may even be tougher than last spring.



A second wave changes the risk situation

A more serious second wave of COVID-19 changes the point of departure for our risk analysis. In some respects, it can be argued that the trend of the pandemic is actually in line with our earlier negative scenario (see *Nordic Outlook*, September 2020). However, compared to this scenario the recovery during the third quarter was stronger. So far, we have avoided many of the negative secondary effects of the actual pandemic that drive this scenario. There is still great uncertainty, and our "new" negative scenario assumes that the spread of COVID-19 will be even more dramatic and that a vaccine will take longer to develop and will also be less than fully effective. If the economy is hit by broader, more long-lasting lockdowns and restrictions, it will be difficult to avoid a significant wave of bankruptcies that will be accompanied by severe financial market instability. In such a situation, it will be difficult to repeat the strong rebound that we saw when economies reopened this past summer. Looking at annual averages, the difference between our negative and main forecasts is largest for 2021, when GDP OECD countries will fall by 0.3 per cent, compared with 4.0 per cent growth in the main scenario.

Various scenarios
GDP growth in the OECD countries, per cent

	2020	2021	2022
Main scenario	-5.6	3.8	3.4
Negative scenario	-6.1	0.8	2.7
Positive scenario	-5.1	7.3	3.9

Source: Organisation for Economic Development and Cooperation (OECD), SEB

Ketchup effect may lead to strong consumption. Even in our positive scenario, the recovery will now inevitably lose momentum. But some months into 2021, there is greater potential for better economic performance than in our main scenario. The arguments are largely the opposite of those in our negative scenario. The spread of the virus may be slower and the vaccination process may get started somewhat faster and also be more effective. It is also possible that we are underestimating the power of the economic policy stimulus dose when it has better conditions to have an impact, among other things because households will open their wallets and use their savings from 2020 once consumption opportunities broaden. In this scenario, GDP growth in the OECD countries during 2021 would end up at 7.7 per cent. We foresee a somewhat larger probability for the negative scenario than the positive one.

Will Suganomics help Japan to rebound?

On September 16 Yoshihide Suga, Japan's former chief cabinet secretary, became prime minister after Shinzo Abe was forced to resign for health reasons. Abe's economic policy, known as Abenomics, has dominated Japanese economic policy making since 2012. In short, it consists of three main elements ("arrows"):

1 Ultra-loose monetary policy
2 Expansionary fiscal policy
3 Structural reforms

Abenomics has not been so successful. Despite a robust monetary policy, the Bank of Japan has not achieved its 2 per cent inflation target. Public sector debt is expected to reach 266 per cent of GDP by the end of 2020, while major structural reforms have been conspicuously absent. Potential GDP growth is around 0 per cent, due to an ageing population. Suga has thus taken over an economy with structural weaknesses and policies that are now also challenged by COVID-19.

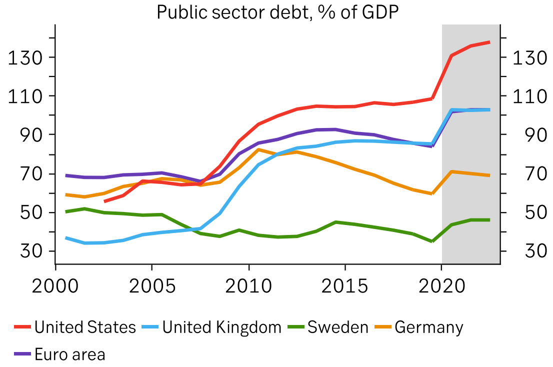
Japan's recovery will be slow. Suga has stressed the importance of continuity. We thus do not believe that Suganomics will diverge greatly from Abenomics. But digitisation and climate change are two areas where Suga appears to have more ambitious goals than his predecessor. New reforms in the digital field will create more light at the end of the tunnel, but downside risks predominate. We estimate that Japanese GDP will fall by 5.8 per cent in 2020. During 2021 the economy will grow by 2.4 per cent and in 2022 by 0.7 per cent. The inflation target will not be achieved.

New COVID-19 wave – new stimulus

Crisis responses during 2020 have been uniquely powerful (see *Nordic Outlook*, September 2020). These programmes have totalled more than 25 per cent of global GDP, with fiscal stimulus accounting for two thirds of this. Now that the second wave of the pandemic is hitting the world economy, we also expect a wave of stimulus measures. For example, when Germany and France unveiled new lockdowns in late October, they indicated immediately that new relief is on its way to protect businesses and households that are affected. Sweden's finance minister has made a similar commitment. We believe that the government will add new fiscal stimulus worth SEK billion 50-70 in the next 6 months. In the US, a heightened level of political conflict ahead of the November 3 election created political blockages. Given the currently most likely election outcome, with Joe Biden becoming president and a continued Republican majority in the Senate, any fiscal stimulus package will probably be more cautious than Biden's election platform indicated.

Debt upturn will level off

Public sector debt, % of GDP

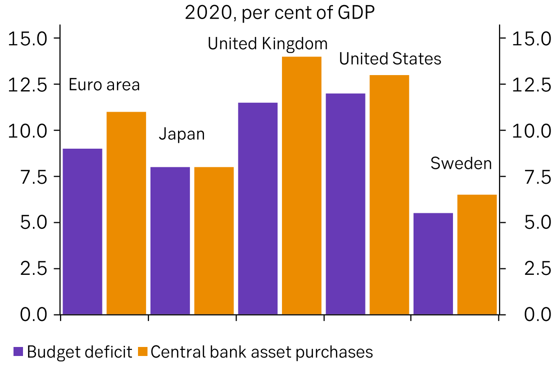


Source: IMF, SEB

Rising debts, but central banks are providing support. Despite large-scale fiscal stimulus, the public sector debt burden does not seem too frightening. This is partly because budget deficits and debt build-up in 2020 does not look as dramatic as they might have seemed when the stimulus measures were launched. This is due to a milder economic downturn for the full year 2020 than expected, which has also slowed the upturn in unemployment. In addition, the scale of various relief and lending programmes was very large, partly to create confidence among various actors. Central bank purchases of government securities are also holding down the level of bond yields. Viewing 2020 as a whole, their net purchases have been somewhat larger than the public sector deficits of major OECD countries. In the prevailing situation, with very low inflation pressure, there are no obstacles to this kind of coordination between monetary and fiscal policies. In the US, the Fed's large-scale QE programme provides great manoeuvring room. Markets are also relying on the ECB to remain active, which is clear from the record-narrow bond yield spreads between euro area countries. In Europe, differences in fiscal strength may eventually play a larger role. This may cause the countries in southern Europe that have been worst affected by the pandemic to lose further ground.

Central bank purchases exceed public deficits

2020, per cent of GDP



Source: Bloomberg, SEB

Formal tightening in the next couple of years. When we measure the growth impulse in a given year, the change in stimulus dose is crucial. At the macro level, this can be defined as the change in the budget balance, corrected for cyclical effects (structural balance). Even if the second wave of the virus leads to new fiscal spending, it is difficult to match the enormous stimulus programmes of 2020. The task of policy makers will be to maintain a certain injection into the economy and then gradually withdraw stimulus programmes when the recovery is on firmer ground some time during 2021. In most countries, we will technically see a fiscal tightening in both 2021 and 2022. But compared to earlier economic crises, we believe that tightening will be milder and that mistakes like the one during the euro crisis a decade ago – when austerity measures were forced on the worst-hit countries – will be avoided. We should also bear in mind the special conditions that applied during the pandemic. Because the opportunity for consumption in many areas has been blocked, household savings have increased significantly. This creates extra potential for increases in consumption once economies reopen. In this way, the effects of this year's large stimulus measures will also spill over into 2021 and 2022.

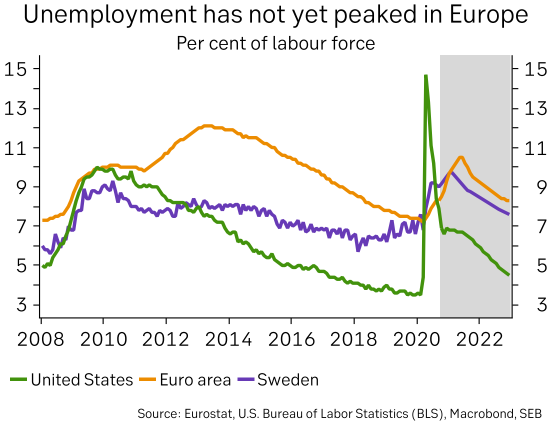
In this way, the effects of this year's large stimulus measures will also spill over into 2021 and 2022

Different patterns of unemployment

So far, registered unemployment in Europe has increased less than feared. This is both due to the economic recovery and the fact that furloughs (or "short-term lay-offs") partly obscure underlying developments. We believe that in Europe, unemployment will climb in the near future. In Sweden the upturn will be relatively mild, peaking next March. In the euro area, we expect the jobless rate to culminate in May or June at 10.5 per cent: more than 2 points higher than the latest figure. The upturn will be partly because of lockdowns, due to the second wave of the virus. Businesses are also eventually likely to terminate some of their furloughed employees once they have seen that production could be maintained and even increased with a smaller headcount.

Gradual decline in US unemployment. In the US as well, we are seeing some cooling in the labour market as companies in hard-hit sectors, such as civil aviation and recreation, adjust their costs to a downturn in demand that looks set to last a long time. But we do not believe that unemployment will climb, assuming that no widespread restrictions are imposed. The absence of the type of imbalances that normally cause economic fluctuations, along with continued fiscal and monetary policy support, still mean that the labour market recovery will be less prolonged than after the 2008-

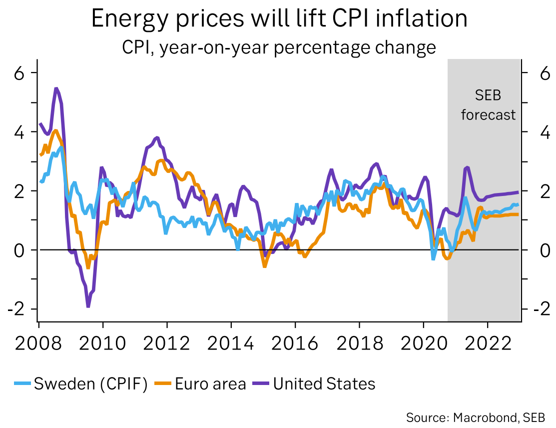
2009 crisis. We expect unemployment to fall to 4.5 per cent by the end of our forecast period: one percentage point above the record-low figures before the pandemic and somewhat above the Fed's estimate of equilibrium unemployment of around 4 per cent.



Stable inflation is resilient to challenges

The risk that exceptional monetary stimulus combined with disruptions in global supply chains will result in rising inflation has been a theme of recent public discourse. The summer recovery was sectorally imbalanced, with very strong demand in specific areas, which also posed an inflation risk. Although we may note price increases in specific areas, they have been far from enough to offset general downward pressure on wages and prices due to low resource utilisation.

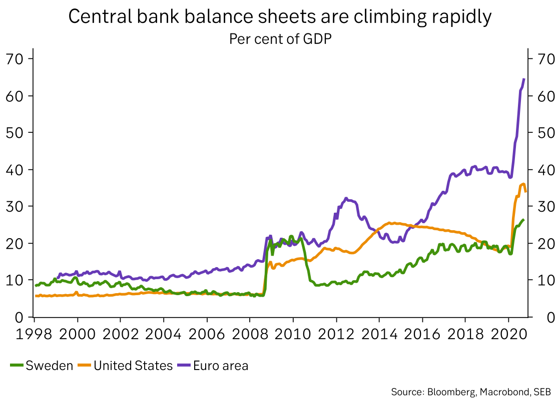
Low risk of supply side-driven inflation shock. CPI inflation has climbed due to the oil price recovery, and base effects will intensify this effect, especially in early 2021. Core inflation (CPI excluding energy and food prices) fell significantly last spring, but in recent months this movement has partly reversed. Both downward and upward movements have probably been amplified by the methods used to deal with the problem that some prices in the CPI basket could not be measured when economic activities were almost entirely shut down. Looking ahead, it is unlikely that the second wave of restrictions, which look set to be milder than the first, will lead to supply side-driven inflation impulses. Pay increases have generally slowed, and assuming prolonged high unemployment in Europe over the next couple of years, the rate of increase will probably remain at levels that will make it difficult for central banks to achieve their inflation targets. In Sweden, for example, newly signed national pay agreements will provide yearly increases of around 2.2 per cent. If US unemployment at the end of 2022 is as low as 4 per cent, it means that a renewed discussion about the shape of the "Phillips curve" is not too distant. However, we believe that no wage- and salary-driven upturn in inflation is likely during our forecast period.



Increased pressure on central banks

Given their already extremely expansionary monetary policies, central banks have limited room to deal with the second wave of COVID-19. We believe that to the greatest possible extent, central banks want to avoid negative key interest rates – considering the adverse side effects and weak effectiveness of such key rates in the prevailing situation. Their message is thus that fiscal policy makers must continue to bear the main responsibility but that central banks are prepared to ensure that the yields on public sector debts remain low. This can be ensured by promising record-low key rates even if there are some inflationary impulses, and by also expanding their bond purchases in order to counter any rising long-term yields.

The Fed's increased opportunities to let inflation overshoot its target after periods when it has mostly been below-target imply that a hike in the key interest rate is not expected until after 2023. The Fed has signalled that it is prepared to buy an unlimited quantity of bonds, but since May it has slowed the pace of such purchases. In order to support the recovery, however, we believe the Fed is prepared to counter any rising real yields resulting from new fiscal stimulus measures by expanding or reallocating its bond purchases.



The ECB's large-scale purchases have helped push down bond yields in the euro area on a broad front. As a consequence of record-low core inflation and a weaker growth outlook, the ECB has also clearly signalled that new actions will be unveiled in December. Although the ECB has signalled that it sees room for further key interest rate cuts without excessively negative side effects, our main scenario is that it will abstain from such cuts. This implies that more cheap loans (TLTRO) and bond purchases top the ECB's agenda. We expect the ECB to expand its Pandemic Emergency Purchase Programme (PEPP) by another EUR 500 billion, which would enable bond purchases at the current pace until the end of 2021. The ECB will then have room to help sustain weaker countries by purchasing proportionately more from countries with the biggest government debts.

Since September, the Bank of England has studied the possibility of introducing negative key rates, but our forecast is that the BoE will leave its key rate at 0.10 per cent and instead expand its QE purchases. As long as the British economy is being squeezed by COVID-related restrictions and the consequences of Brexit, the door to rate cuts will be kept open.

Sweden's Riksbank is also keeping the door open to key interest rate cuts, but signals during recent months do not suggest that such action has moved any closer. Due to a weaker economic growth outlook, we instead believe that the QE programme will be expanded by another SEK 100 billion and extended until the end of 2021 at the Riksbank's policy meeting in late November. But a cut by the ECB would, increase the pressure on the Riksbank to follow suit, and we believe that the probability of a rate cut is somewhat higher than the market is now pricing in. Unless the krona appreciates sharply, however, our main scenario is that the repo rate will remain unchanged at zero per cent throughout our forecast period.

Norges Bank has maintained a zero key interest rate since May. Even though the Norwegian central bank has not entirely ruled out negative interest rates, it would require serious economic setbacks and renewed market turbulence for this to materialise. A rate hike is also distant, but we are still expecting an initial hike in mid-2022, which would imply a key rate of 0.25 per cent at the end of 2022. Norges Bank thus stands out as the only central bank we expect to hike its key interest rate during our forecast period.

Trade pact will give temporary relief

More than four years after the Brexit referendum, the moment of truth is approaching. After 47 years of membership, the United Kingdom withdrew from the European Union early in 2020. At the end of the year, its temporary transition period will end. Our main scenario is still that the UK and the EU will soon conclude a trade agreement that will reduce uncertainty and thus lead to various positive near-term effects. Yet this does not change our perception that the UK economy will be harmed by the divorce.

Paradoxically, geographic proximity and decades of integration with the EU have made the negotiations harder. The discussions seem to have boiled down to a few symbolic issues on which both sides have had difficulty compromising. From the EU's perspective a new agreement will have to be less advantageous than the European Economic Area pact, under which countries like Norway and Iceland pay substantial contributions to the EU budget. Because of physical proximity (the Eurotunnel, the electricity market etc.) and large flows of goods, a future agreement must be more detailed than the EU's trade agreement with Canada, for example. Such issues as state aid, conflict resolution mechanisms in case of trade disputes and access to British fishing waters have been the biggest stumbling blocks. From a British perspective, the desire for self-determination was a driving force behind EU withdrawal, and control of fishing quotas was a strong symbolic issue even during the Brexit referendum of 2016. Loud rhetoric on these issues is partly a negotiating ploy, and since mid-October a willingness to compromise has become clear as negotiations have intensified. The EU seems able to meet the British part-way on fishing and state aid. The EU also seems to have shifted its tactics by outwardly letting the UK look like the winner in the talks.

Negative effects regardless of final wording. A comprehensive trade agreement will have positive effects due to reduced uncertainty, but trade will unavoidably be adversely affected. The agreement can lower tariffs, but without the freedom of movement provided by the EU single market, the UK faces major challenges in both the short and long term. In addition, trade in services is not included in the current talks. Calculations presented by the OECD and others after the Brexit referendum indicated a significant slowdown in British GDP growth after the UK leaves the single market, with or without a UK-EU agreement. The OECD also recently showed that trade barriers in the form of border controls, goods declarations etc. make up a large proportion of the deterioration in trading conditions. In our forecasts, we have assumed a negative impact of 0.3 per cent annually.

Theme:

A new world

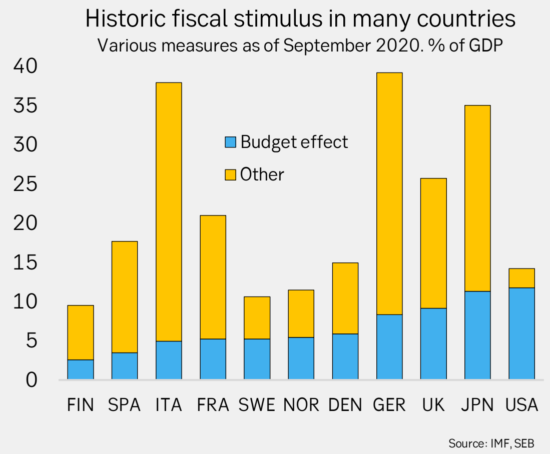
Temporary or permanent sectoral changes?

The COVID-19 crisis – recently reinforced by a second wave – is expected to enter another challenging phase in 2021, with a focus on higher solvency risks for businesses and on the impact of the processes that will shift production resources from shrinking to growing sectors. Digital technology will offer good potential for creating equitable and green economic growth, while providing new jobs and higher productivity. Once the post-COVID recovery is on firmer ground, the world will need long-term economic policies and industrial strategies that ease this transformation. Not doing this properly might threaten financial stability and lead to persistent high-level unemployment.

Temporary or permanent sectoral changes?
Developments in many economies confirm a sizeable reallocation of both consumption and investments in time and between sectors in 2020. Restrictions created pent-up consumption needs for certain goods, which then normalised as governments eased lockdowns. There has also been substitution between goods and sectors, for example more retail sales and food purchases but less travel and restaurant visits. Our ways of producing goods and services have also changed. Statistics from the Bank of England and others confirm remarkably high substitution levels during 2020 (i.e. large changes in GDP weights and activities), which increased by ten times compared to generally sluggish substitution effects in the past 30 years.

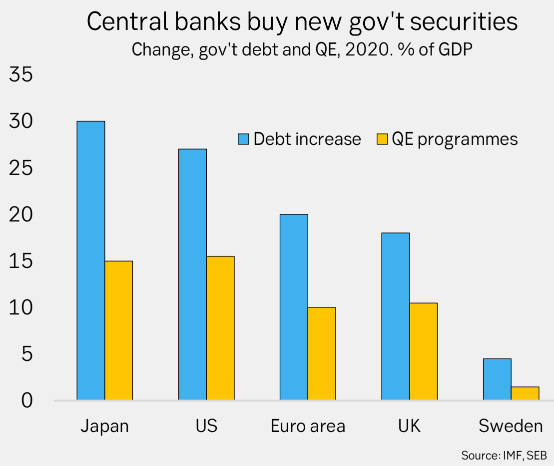
If these substitutions are permanent, which they probably are for some goods, services and sectors, labour and capital will need to be reallocated from shrinking and perhaps vanishing sectors to sectors that are expected to survive or emerge in a "new world". These transformations will increase the risk of capital and job losses, which might challenge financial stability due to an increasing number of bankruptcies. This would also delay global economic recovery. Economic policy makers must find a balanced way forward that can speed up the transformation in order to achieve faster, more sustainable recovery while decreasing the risk of growth reversals, greater economic inequality, mounting social and political instability and delays in climate-related investments.

Quick, solid, forceful policy responses in the spring of 2020 helped prevent an acute liquidity crisis in many countries. We estimate global fiscal stimulus at about USD 13.5 trillion or 15 per cent of global GDP: five times more than in the 2008-2009 crisis (see chart below). In addition, central banks have provided relief both in the form of low key interest rates and "money printing" (see chart below). Their balance sheets have expanded by at least USD 6 trillion during 2020. Given today's money multiplier (for Europe) this is equivalent to about USD 24 trillion in added money supply. Without any responses, the spring 2020 liquidity crisis would quickly have been transformed into an insolvency crisis, with dramatic consequences for both financial stability and GDP growth.



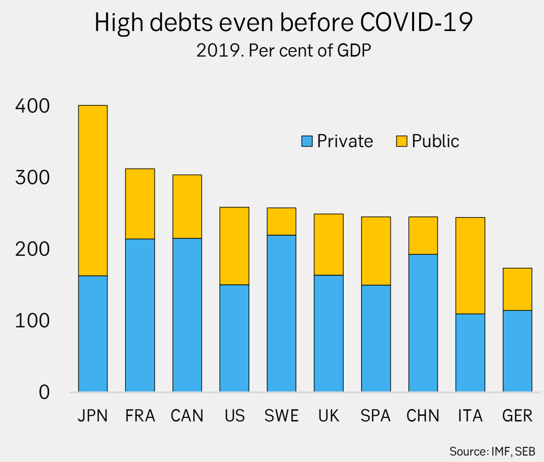
Challenges to the financial system

The stability of the global financial system will be challenged in 2021 by two potential risks that will be amplified if economic recovery is delayed: first, a price correction due to stretched asset valuations, and second, companies that have survived with the help of relief measures but are not considered viable in the long term after a permanent structural transformation.



Today's well-functioning global financial system is part of the solution to the COVID-19 crisis, not part of the problem, but things can quickly change. An increase in corporate bankruptcies normally also leads to rising unemployment. According to new research by the Bank for International Settlements (BIS), unemployment increases three times more – given the same GDP decline – if an economy is hit by "unbalanced recession" (i.e. with bankruptcies concentrated in certain sectors). These recessions tend to be deeper and longer, leaving a clearly negative impact on the labour market because skills gaps must first be filled to enable labour to move into new expanding sectors and companies. COVID-19 must be described as an unbalanced recession.

The corporate sector has received various types of relief. For example, governments have provided extensive loan guarantees and offered cash and liquidity support. Companies have also received indirect relief by means of wage subsidies for shorter working hours and cash payments to households. In addition, central banks have offered large loans on favourable terms and have bought corporate and government bonds. Fiscal and monetary policies have thus enabled companies to cope with liquidity shortages by increasing their debt, delaying tax payments and other means. This implies that company solvency risk has been postponed. New liquidity problems may thus quickly lead to credit problems, even for fundamentally healthy businesses – if the recovery is delayed.



Surprisingly low bankruptcy levels

According to BIS data, globally the number of corporate bankruptcies is at a five-year low even though many economies experienced a free fall in 2020. This is also reflected in credit market pricing, where spreads remain narrow – though wider than before the COVID-19 outbreak. About 75 per cent of last spring's widening of credit spreads has now been reversed. The credit market seems to assume that bankruptcies and insolvencies should not be a major problem ahead, although history shows that bankruptcies normally reach their highest level about one year after GDP has decelerated, which means in the spring of 2021.

The bankruptcy situation reflects this year's crisis policies and regulatory changes. Governments and central banks have adopted a "whatever it takes" approach to helping companies weather the crisis. In March, for example, Germany gave companies stricken by financial problems the option of not having to declare bankruptcy. BIS and the International Monetary Fund (IMF) are warning that without new stimulus, the COVID-19 crisis may generate about a 20 per cent increase in the number of bankruptcies next spring.

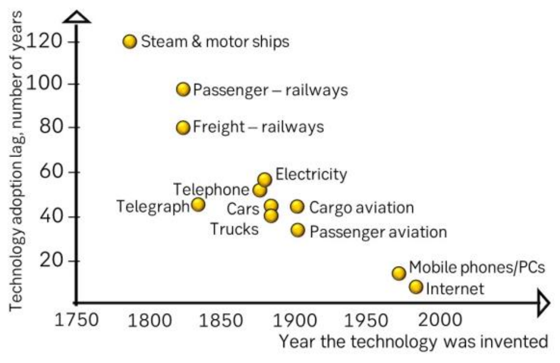
Short and long-term choices

The COVID-19 crisis has not only boosted public sector debt, but also corporate debt. Governments and central banks face difficult trade-offs and need to decide whether to extend or to phase out liquidity and credit support. An excessively early phase-out is destabilising and may lead to tighter credit and problems for banks. Extending crisis responses, on the other hand, might increase risk-taking and reduce the pressure for change in the economy – in a situation where reallocation of resources is necessary. Failure to acknowledge problems risks aggravating them, due to potentially negative effects on productivity and capital allocation.

Facing a digital transformation

The era of digital production, sometimes called the Fourth Industrial Revolution, began even before the outbreak of the COVID-19 crisis. Today it is obvious that digital technology has made rapid advances and that acceptance of the new technology in society has increased at record speed. The Riksbank's latest *Business Survey* was only one of many publications to confirm this, noting that "the pandemic has accelerated developments that were already happening."

Industrial revolutions generate curiosity and concerns. New opportunities arise, but there are fears that jobs may disappear before new ones have time to emerge. So far, the world has seen three industrial revolutions: in the late 18th century (mechanical production), late 19th century (mass production) and late 1960s (automated production). There is little evidence that these revolutions created structural unemployment; new jobs emerged in new sectors. It is also worth noting how adoption of new technologies has speeded up: 120 years for the first technology shift, 50 years for the second and 15 for the third.



The Fourth Industrial Revolution includes a mix of physical, digital and biological systems, accentuated by exponential growth in our capacity to store and process knowledge and learning. The adoption of these new technologies is likely to occur faster than during the third revolution and is being speeded up by the pandemic (see above). There are many indications that the world is quickly embracing new digital technologies. Countries that have an already existing and well-tested digital infrastructure and populations with a positive attitude towards new technology are also regarded as having coped somewhat better with the COVID-19 crisis. This applies to the Nordic and Baltic countries, for example (see *Nordic Outlook,* September 2020).

Once the recovery is on firmer ground, policy makers are expected to focus on easing the transformation towards more digital, green economic growth. The speed of the transition will increase pressure on governments and central banks to manoeuvre both the survival and the expansion of new companies that can take advantage of digital technologies and other advances. Meanwhile they will need to make it easier to phase out companies that are not viable in the long term. Reallocation of both capital and labour will pose challenges to policy makers.

Covid-19 is generating heightened uncertainty. Corporate and political decision makers have been hampered by worries about possible permanent changes and long-lasting damage to the economy. This implies increased caution among both employees and businesses about shifting to new sectors and investments. Because employees in shrinking sectors probably do not meet the demands of expanding sectors in terms of skills and training, there is an increased risk of structural unemployment and greater economic inequality. The resulting uncertain will mean that adjustment to new developments will be slower.

Economic policy makers are expected to become more selective and to gradually focus more and more on structural policies and strategies for the medium- and long-term development of industry and the economy. Investments in health, digital and green infrastructure and education can generate productive, inclusive and sustainable growth. This will require cooperation at both the national and global level. The divided political landscape may unfortunately lead to deadlock and delays in decision making.

To facilitate reallocation of resources, for example in labour markets, economic policy makers need to:

- lower barriers that keep individuals and businesses from embracing new technologies and changing their behaviour
- identify and address knowledge and skills gaps within companies and sectors
- develop effective training and educational programmes at the company and national level
- strike a balance between job mobility and job security.

Difficult balancing act in 2021

The growing strength of the pandemic will mean continued downside risks to economic recovery. It is thus reasonable to extend crisis responses for another six months; government budget costs need not increase dramatically, since many existing crisis measures have not been fully utilised. This also implies increased challenges, for example misallocation of capital and delays in shifting capital and labour. But sooner or later, adjustment to the new situation needs to take place. Both political responses and cooperation will be needed in order to facilitate the transformation, while not jeopardising financial stability and job growth.

Theme:

Working from home

Remote work may lead to a global labour market and QE4-ever

The growing trend towards remote work has the potential to create a global labour market. In rich countries, it will intensify existing downward pressure on wages. Central banks will find it ever harder to generate enough inflation, so QE policies may become permanent. Investors can benefit from both ultra-loose monetary policies and a continued rise in their share of corporate earnings. Political leaders will try to offset widening gaps with more redistributive fiscal policies, but this is no easy task in an increasingly global world.

When the global COVID-19 pandemic broke out, many people feared it would lead to major reversals for globalisation. It might well reinforce the trend towards shrinking world trade as a percentage of global GDP that we have seen since the 2008-2009 financial crisis. This article instead highlights the potential for a revitalisation of the global labour market that might be driven by increasing the chances for remote work. The trend that it portrays embodies both threats and opportunities. On the one hand, equilibrium unemployment may plunge while educated individuals in less-developed countries get an increased chance of landing well-paid jobs. But this might also worsen today's wide economic gaps, leading to social and political tensions.

One big change resulting from the pandemic is a huge expansion in the trend towards working from home. The longer the pandemic lasts, the higher is the probability that the sharp increase in remote work will remain as a lasting effect, long after COVID-19 has ceased to be a problem. Such a revolutionary change in the daily routines of hundreds of millions of employees worldwide has the potential to create major consequences in many different areas, both in the labour market and in the economy as a whole.

For example, an increase in remote work will reduce the need for passenger transport, which in turn will adversely affect everything from auto sales to the taxi business and civil aviation – which has already become apparent. Meanwhile reduced travel is positive from a climate standpoint. Perhaps the most obvious effect of letting people work from home is that the need for office space will shrink, and this space can instead be used for more housing in major cities. While the disappearance of offices will lead to an increased supply of city centre flats, remote work will also result in less demand for such flats as the advantages of living close to the office diminish. This may eventually help narrow the price differences between housing in city centres and suburban or rural areas.

Remote work can open up completely new opportunities for people to choose freely where they want to live. According to a recent Kantar Sifo opinion survey, three out of four respondents in Sweden hope the pandemic will lead to changes in their work situation. Topping their wish list is greater opportunities to work from home.[i] Another Kantar Sifo study shows that nearly four out of ten office workers would consider moving if the trend towards better remote work opportunities continues, and 5 per cent are even thinking about performing their job from abroad.[ii] In the traditional employment model, an employee is usually required to physically report to a workplace five days a week. If this requirement should disappear in the future, it may not be entirely beneficial to employees. If the office becomes less important, one of the most important competitive advantages enjoyed by employees in the Western world will also disappear. When a company's employees gather at an office each day, the office becomes a natural barrier against the company employing people who work remotely.

New opportunities for remote recruitment. But if the office becomes less important, this also reduces the obstacles to hiring remote employees. Employers can begin searching for employees – and employees can begin searching for jobs – regardless of geographic location. The result will be a major step towards a more globalised labour market. Obviously there are also other obstacles such as language, cultural differences and time zones, but in many cases the office is actually the main reason why companies search for labour locally and why employees look for jobs close to where they live.

A better-functioning labour market means lower NAIRU. In a global labour market where employees can work remotely, competition to recruit the best workers will increase. The most attractive, well-educated people will be able to pick and choose among different job offers. Labour market mobility will also improve as obstacles to accepting a job in another location or another country diminish. For example, a person can accept a job in another city without affecting the rest of the family. That person's significant other will not need to find a new job, and their children will not need to start at a new school. Many people are reluctant to move to where there are jobs, a factor that has always caused the labour market to function less efficiently and has created marching problems and big gaps in unemployment levels between regions. Increased opportunities for remote work can lead to improved matching in the labour market and a lower level of natural unemployment (non-accelerating inflation rate of employment, or NAIRU) in the economy.

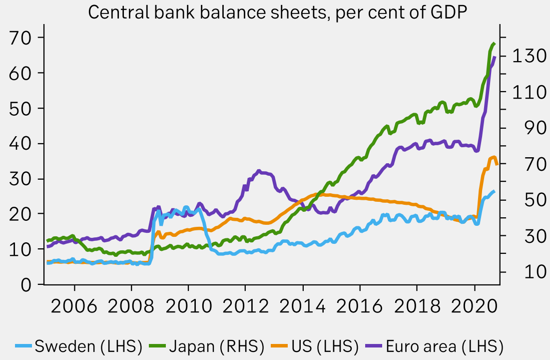
Companies will be net winners. Although employees will enjoy greater flexibility and other benefits, such as lower expenses for commuting to and from their jobs, the biggest winners in a more global labour market will be companies. Many employees in richer countries who are not among the most attractive in the labour market may have a tougher time, since to a greater extent than before they will have to compete with cheaper labour. This may include competing both with workers from their own country – but from regions with a lower pay situation – and with workers from other countries with lower income levels. A corresponding change due to globalisation has been under way in manufacturing for decades, causing many industrial jobs to move to low-cost countries. In the service sector, too, many simple office jobs have already moved abroad or have been automated, while more qualified or hard-to-automate jobs have been protected so far. But as offices gradually disappear and remote work becomes a normal element of many business operations, there is every reason to believe that both domestic and foreign competition for many office-based service jobs will increase.

Wages and salaries may be squeezed in the Western world. In the future, just like today, developments will be driven by cost-cutting efforts on the part of employers. The principle will be the same as it always has been: jobs tend to move to where they can be done the most cheaply. For emerging market countries this change is a major opportunity, while for many employees in richer countries like Sweden and the United States it may lead to major challenges. The more jobs can be performed remotely, the greater will be the downward pressure on wages and salaries in the richest countries. One bottleneck, of course, is that there is a shortage of educated labour in many less-developed countries, but with the aid of new technology it will be increasingly possible to undergo education and training remotely. This will open the way for training a lot more people, completely without regard to where they are located in the world. Remote training will be a major opportunity for people in poorer countries.

QE 4-ever may be needed to generate inflation. A world with an ever-increasing element of remote work will also create major challenges for the world's central banks. Higher wages and salaries are traditionally the most important source of stable inflation pressure over time. Pay increases boost a company's production costs, which they offset by raising their prices, thereby generating inflation. Unlike many other inflation drivers, such as a weaker currency or higher commodity prices, the pay hiking process repeats itself year after year, creating stable inflation pressure. Combined with a structural squeeze on wages and salaries as a consequence of greater competition for jobs and a better-functioning labour market with lower NAIRU, it will become even harder to bring about pay-driven inflation. The bigger the structural squeeze on wages and salaries, the more expansionary monetary policy will have to be to enable inflation targets to be achieved. This suggests that interest rates will remain around – or even below – zero, while quantitative easing (QE) by means of asset purchases must continue long after the COVID-19 pandemic has relaxed its grip on the economy. In many countries, developments will resemble what we have already seen in Japan, though not driven by the same causes.

Central banks let their balance sheet grow

Central bank balance sheets, per cent of GDP



Source: Macrobond, SEB

Rising asset prices will create wider gaps. Companies will benefit because an increasingly global labour market will ensure that production costs can be kept low. The long-prevalent trend towards shareholders taking a larger percentage of profits at the expense of employees will thus gain more fuel. Meanwhile low interest rates and permanent central bank asset purchases will boost the value of equities and other assets. The result will be a continued widening of gaps in society, which will subject political leaders to growing demands to offset these widening gaps by adopting active fiscal policies, which means higher taxes on investors and high income earners. Meanwhile this is no easy task in a world that is moving towards an increasingly globalised economy and labour market.

Major changes take time, but some of them have already happened. As always when facing paradigm shifts, one important question is how long all this will take. No one seriously believes that everyone working from home today as a consequence of the pandemic will continue doing so to the same extent once the virus has faded away. But the ball has started rolling, and the coronavirus has undoubtedly speeded up the process. Although most employees will return to their customary workplaces, many will probably also continue to work much more from home than they did before the pandemic. If the new normal will be that people work at home two or three days a week, companies may need only half as much office space as today.

The need for investments in order to embrace the new opportunities. Many companies have doubtless already come to the conclusion that they can begin to reduce their office space. Because a growing percentage of employees will be working from home regularly, companies are likely to invest a lot of resources to make sure that things function as smoothly for remote workers as for those who are sitting at the office. The business sector will probably make large investments in new technology over the next few years in order to make these developments possible. Technological innovation will also be an important factor in ensuring that remote work functions better and better and that the productivity of remote workers will not suffer. New methods will probably need to be developed to evaluate, manage and enable employees to interact with each other in an environment where the office is no longer their natural gathering point. It is impossible to say how long all of this will take, but the important thing is that the process is already under way. The longer the pandemic continues, the more established and widespread remote work will be and the faster the transition will occur.

[i] *Kollega* (Swedish trade union magazine), September 29, 2020: "Fortsatt distansjobb kan öka flyttviljan" (Continued remote work may increase the desire to move).

[ii] *Örebronyheter* (local newspaper), September 27, 2020: "Fyra av tio kontorsarbetare beredda flytta vid fortsatt distansarbete" (Four out of ten office workers prepared to move if remote work continues).

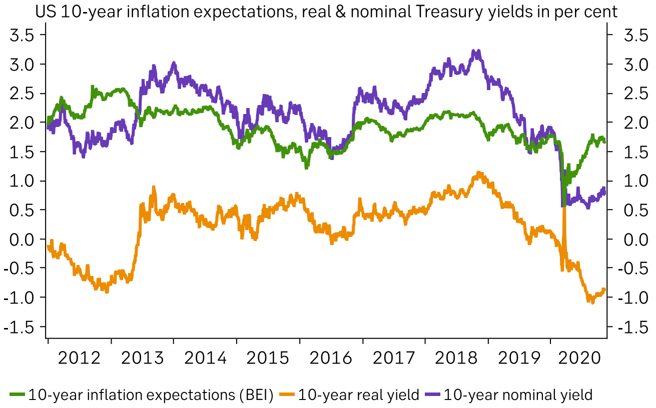
Fixed income

Low yields will persist

European government bond yields have recently fallen to their lowest since March, following an acceleration in the spread of COVID-19 and clear indications of new stimulus from the ECB and others. In the US, a likely divided Congress reduces the likelihood of massive fiscal stimulus, easing upward pressure on yields. We expect low short-term rates for some time. Nominal long-term yields will rise only gradually as the outlook improves, but the Fed will slow any upturns in real yields.

Fed to prevent eventually rising real yields with more QE

US 10-year inflation expectations, real & nominal Treasury yields in per cent



Source: Bloomberg, Macrobond, SEB

10-year government bond yields
Per cent

	Nov 5	Dec 2020	Dec 2021	Dec 2022
United States	0.79	0.80	1.10	1.20
Germany	-0.66	-0.60	-0.50	-0.40
Sweden	-0.10	-0.10	-0.05	0.05
Norway	0.70	0.70	0.75	0.85

Source: National central banks, SEB

After record-low US Treasury yield volatility in September, the market has recently shown somewhat larger movements. New pandemic-related restrictions, signs of slowing economic activity and record-low core inflation have pushed down European long-term yields; German 10-year government yields are at their lowest since March. Uncertainty has also dominated US yields. After climbing first on expectations of a clear Biden victory, long-term US yields fell after the election. US 10-year Treasuries are yielding just below 0.80 per cent, in the middle of the 40 basis point range prevailing since March. Their German equivalent has fallen to -0.66 per cent. This means that the US-German yield spread has widened to 145 basis points, up 45 points since the low in April.

In the US, a likely divided Congress after the election will mean that the Democrats' chances of pushing through a massive stimulus package have diminished, easing upward pressure on yields. Given the need for new crisis responses, however, Congress will probably agree on new stimulus in the next few months. This means the federal deficit will continue climbing in 2021. After initially issuing mainly Treasury bills, the Treasury Department has boosted its bond issues in recent months. But due to large Fed purchases, mainly last spring, the supply of bonds outside the Fed has shrunk by around USD 400 billion in 2020. There is great uncertainty about 2021, but the Treasury forecast suggests a net bond supply of around USD 2 trillion. At its current pace, with the Fed buying USD 80 billion in Treasury bonds per month, the bond supply will thus increase relatively sharply in 2021. However, the Fed has emphasised that fiscal and monetary policy makers should work together to support economic recovery. This indicates that the Fed is willing to counter yield increases by expanding or re-allocating bond purchases.

How much the Fed will allow long-term nominal yields to climb depends on what happens with the market's inflation expectations. A combination of fiscal and monetary policy where central banks buy most of government borrowing is, in practice, "monetary financing" of public sector debt (see *Nordic Outlook*, May 2020). The absence of structural fiscal stimulus measures will mean that the Fed will have continued difficulty pushing inflation expectations higher. We thus expect nominal yields to rise only gradually next year (see forecast table) as the economic outlook improves.

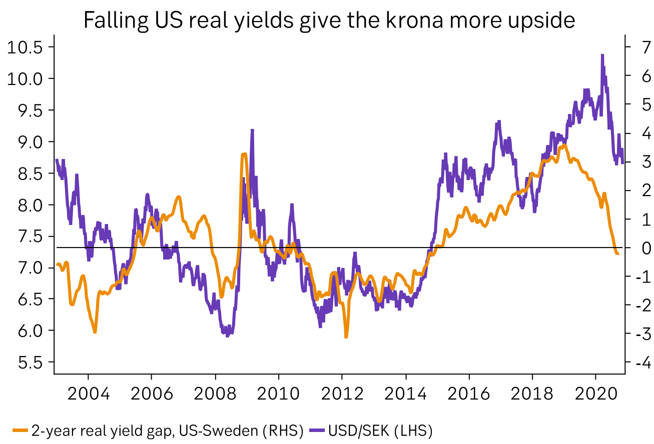
Clear signals that the European Central Bank (ECB) will enact new monetary stimulus in December is helping to squeeze German yields and euro area yield spreads. Despite large-scale fiscal stimulus in Europe as well, the ECB's bond purchases – which are expected to be extended until at least the end of 2021 – imply that the ECB will buy virtually all bonds being issued next year by euro area governments. Combined with record-low core inflation, a German 10-year yield is expected to remain close to current levels, rising to only -0.50 per cent at the end of 2021.

Despite unexpectedly strong government finances, Swedish 10-year yields have not kept pace with the downturn in German yields; the yield spread has thus widened by some 10 basis points since October. We believe this spread will shrink in the next few months, supported by expanded Riksbank bond purchases and continued relatively strong government finances. We thus expect the spread to remain in a relatively narrow 40-50 bps range in 2021. The spread between Norwegian and German 10-year bonds has also widened. Yields in Norway remain well above those in many other countries. We believe demand will rise next year, related to greater demand for the currency. Since fiscal stimulus measures are being financed from the Government Pension Fund Global (GPFG), the Norwegian government bond supply is expected to be largely unchanged in 2021. We are forecasting a spread of 125 bps against German 10-year bonds at year-end 2021.

The FX market

Deficits will help push the US dollar lower

As always, the dollar is the anchor of the global FX market. During much of 2020, converging key rates helped weaken the USD. Relative monetary policies remain a driver, but we believe government finances will be increasingly important. Assuming the new president adds more large fiscal stimulus programmes, the USD should continue to weaken. The focus on government finances will also benefit the krona; given its attractive valuation, we expect the USD/SEK exchange rate to drop below 8.00 in 2021.



Source: Bloomberg, SEB

Exchange rates

	Nov 5	Dec 2020	Dec 2021	Dec 2022
EUR/USD	1.18	1.20	1.25	1.28
USD/JPY	104	104	100	98
EUR/GBP	0.90	0.90	0.87	0.85
EUR/SEK	10.28	10.20	9.85	9.70
EUR/NOK	10.83	10.80	10.25	9.95

Source: Bloomberg. SEB

2020 has been a turbulent year in the foreign exchange market. The COVID-19 crisis initially strengthened large. liquid currencies, which often happens when the global economy encounters a crisis. As usual, the US dollar became a safe haven when worries about financial market stress climbed rapidly in February and March. But rather soon, it became apparent that other drivers were taking over as central banks added liquidity and restarted quantitative easing. During 2020 the clearest exchange rate trend has been a weaker dollar, and this is not so surprising since the Federal Reserve was the only major central bank that had a key interest rate it could cut.

Monetary policy is likely to remain a key market driver in 2021. The sustainability of public finances is also likely to drive the FX market. Our USD theme article (p 21) explains how the dollar will face further challenges as the economy begins to normalise again after COVID-19. The US has added more stimulus than other advanced economies, with budget deficits totalling nearly 20 per cent of GDP. A massive supply of Treasury securities will generate upward pressure on long-term yields. The Fed will not accept this, but instead will buy such securities to hold down yields. which in turn will help push the dollar lower.

A weak USD also creates a dilemma for other central banks. The European Central Bank (ECB) has signalled that it must cut its key rate if the euro keeps rising. The Bank of England (BoE), the Reserve Bank of Australia and others have also "threatened" negative rates. But according to our valuation model, the USD is still overvalued, following the collapse of US real yields. The long-term EUR/USD equilibrium rate, which has been around 1.15-1.20 for some time, has soared to nearly 1.30. We believe the FX market rate will move up towards this level during our forecast period. The United Kingdom has now announced a second big lockdown that will put further pressure on the weak British economy. The risk of a rate cut early in 2021 has increased and the BoE is more likely to deliver it if UK trade talks with the EU do not turn out as planned. Yet the pound is so undervalued that we expect a slight appreciation against the euro, with the EUR/GBP rate reaching 0.87 by the end of 2021.

During 2020 the krona has been the G10 currency that has appreciated the most against the USD. This has been possible despite a deep economic slump, because Sweden's large savings surplus has contributed to a strong net position that has reinforced the krona's defensive qualities. Also contributing to this appreciation is that the Riksbank exhausted most of its toolkit even before the crisis struck and that the krona was deeply undervalued at the start of 2020. A weaker USD and the threat of a new ECB rate cut will create the potential for rapid SEK appreciation: many Swedish institutions are still exposed to a stronger dollar, and companies have built up large FX reserves since Sweden introduced negative key rates. At present, the Riksbank is not expressing any concern about the krona and is playing down the risk of a repo rate cut. We thus see potential for a continued SEK appreciation and expect the EUR/SEK rate to reach 9.85 by the end of 2021. Rate cuts may become a possibility if EUR/SEK surpasses 9.65.

The Norwegian krone has lost ground after having benefited from general positive risk sentiment in markets this summer. As a small and less liquid currency, the NOK is pro-cyclical and largely driven by oil price trends. Deteriorating global growth prospects, which also weigh on oil prices. again pushed the EUR/NOK rate temporarily above 11.00. Positive market reactions to the US presidential election have supported the krone and EUR/is NOK expected to reach 10.80 at the end of 2020. The NOK remains undervalued, and prospects of recovery and a vaccine in 2021 should support renewed appreciation. We forecast EUR/NOK rates of 10.25 and 9.95 at the end of 2021 and 2022 respectively.

Theme:

Future of the USD

American stimulus policy is lowering the outlook for the world's reserve currency

When the global economy is hit by recessions, the United States is usually the country that responds the fastest in order to support domestic demand. The COVID-19 crisis is no exception. US fiscal stimulus packages implemented to date are far more extensive than those enacted in Europe. The Federal Reserve, too, has taken major steps to help sustain economic growth, but its monetary easing has meanwhile weakened the US dollar – a trend that we believe will persist for the next two years.

Just over three years ago (*Nordic Outlook*, September 2017) we wrote a theme article entitled "The world will benefit from a weaker dollar". Our thesis was that especially emerging market (EM) economies and world trade would benefit from a slightly weaker dollar. At the same time, we did not believe that USD dominance as a global reserve currency would be challenged in the near term. We are sticking to these views. Although China and Europe together account for about 35 per cent of global GDP, neither the yuan nor the euro is attractive enough to challenge the dollar any time soon. China hopes to let its yuan float more freely, but it is not close to having the flexibility and convertibility required of a reserve currency. While the euro is liquid enough to serve as an alternative, euro area internal imbalances, lack of a common fiscal policy and constant crises disqualify it from replacing the dollar. This leaves the dollar, our reserve currency for almost 50 years.

Since 2015, despite various challenges the dollar has been strong – partly due to President Donald Trump's tax cuts and a strong US stock market performance compared to other countries. The Fed's 2015-2018 key rate hikes also contributed by making it costly to currency hedge the dollar. The COVID-19 has changed the situation, however, making the USD something of a punching bag. We believe there is room for further weakening. If we are right, central banks like the European Central Bank (ECB) and the Riksbank will have a tough time with their inflation targets, assuming both the euro and the Swedish krona keep appreciating.

The USD is the base for global FX trading

As a reserve currency, the dollar is by far the most frequently used currency in global trade. About 90 countries have their currency tied to the dollar. When the Bank of International Settlements (BIS) ranks the volume of foreign exchange (FX) trading, the dollar comes out far ahead of other liquid alternatives (see the table below). Since the dollar is part of nearly 9 out of 10 FX transactions, understanding the general trend in this market is usually a matter of correctly foreseeing the direction that the USD is moving.

Global FX market turnover (BIS)

Percentage shares of average daily turnover

Currency	2001	2004	2007	2010	2013	2016	2019
USD	89.9	88.0	85.6	84.9	87.0	87.6	88.3
Euro	37.9	37.4	37.0	39.1	33.4	31.3	32.3
JPY	23.5	20.8	17.2	19.0	23.0	21.6	16.8
GBP	13.0	16.5	14.9	12.9	11.8	12.8	12.8
AUD	4.3	6.0	6.6	7.6	8.6	6.9	6.8
CAD	4.5	4.2	4.3	5.3	4.6	5.1	5.0
CHF	6.0	6.0	6.8	6.4	5.2	4.8	5.0
CNY[3]	0.0	0.1	0.5	0.9	2.2	4.0	4.3
HKD[3]	2.2	1.8	2.7	2.4	1.4	1.7	3.5
NZD[3]	0.6	1.1	1.9	1.6	2.0	2.1	2.1
SEK	**2.5**	**2.2**	**2.7**	**2.2**	**1.7**	**2.2**	**2.0**

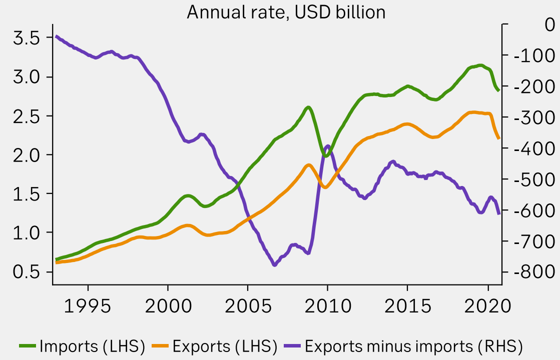
US government finances show deep deficits. The global COVID-19 pandemic has created large holes in public sector finances. The US has demonstrated relatively high economic growth in recent years compared to Europe and will continue to do so in the next couple of years. One reason is that the US has used fiscal policy much more aggressively to stimulate the economy and avoid deep, far-reaching negative growth effects from the pandemic. US government finances are likely to show record-sized deficits for years to come. Since the Fed is currently financing most of the budget deficit, the US has no problems finding buyers for all the Treasury securities it issues. With the national debt expected to reach over 130 per cent of GDP in the next few years, however, the country's credit-worthiness may start to be questioned. This would probably put further pressure on the dollar if the country's AAA credit ratings were lowered.

The large supply of Treasury securities is increasing upward pressure on long-term US bond yields. The question is whether the Fed will accept this. The Senate does not seem to end up with the Democratic majority that was expected before the November 3 election, so future stimulus packages will probably not be as large as in President-elect Joe Biden's election platform. It is nevertheless reasonable that the large deficits the US appears likely to generate will put upward pressure on yields. The Fed will limit this upturn by purchasing Treasuries and has also said it will take responsibility for supporting the economy if political leaders do not act. Since yields will not be allowed to rise much, the dollar should instead fall as a consequence of this policy. The Fed recently adopted a more flexible average inflation target, which will allow inflation to overshoot its 2 per cent target for some time, since the consumer price index (CPI) has remained predominantly below 2 per cent for a lengthy period. This, in turn, means that the dollar will not initially enjoy support as the economy rebounds, when the Fed normally tightens policy again.

The US trade balance is also expected to deteriorate. The global imbalances that culminated in the 2008-2009 financial crisis have decreased. From a foreign exchange perspective, they are more sustainable today since the deficits are small as a percentage of GDP. But large-scale fiscal stimulus measures and rising domestic demand will add to US deficits again, and the trade deficit will probably end up around the levels we saw just before the global financial crisis. This increase adversely affects the dollar in several ways. Rising trade deficits are always a negative signal for the FX market. US exporters as well as importers also have stronger incentives to currency hedge their trade flows, now that the cost has fallen. If exporters and importers change their currency hedging by 5 per cent, this gives rise to outflows of several hundred billion dollars.

United States trade balance

Annual rate, USD billion



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

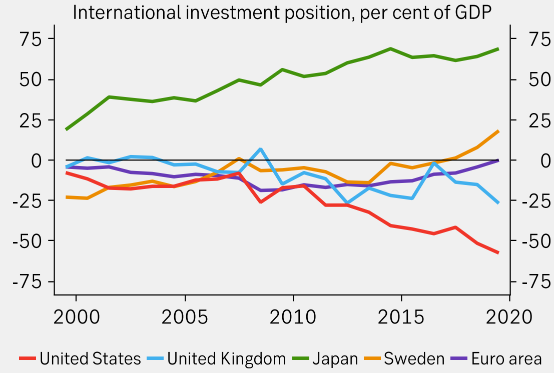
The US balance sheet is raising a red flag

At a meeting with European finance ministers in 1971, newly appointed US Treasury Secretary John Connolly said, "The dollar is our currency, but your problem." What he meant was that the US could no longer maintain the value of the dollar in terms of gold. The old Bretton Woods system collapsed, and with it the dollar..

The US is still living in a Bretton Woods world. Despite the transition to floating exchange rates, the US has continued to act in the spirit of Connolly, as if its currency were mainly a problem for other countries. Because of the dollar's reserve currency status, other countries have continued to finance relatively large US current account deficits. Over the past decade, the country's net international investment position (the difference between what the US owns abroad and what other countries own in the US e.g. "NIIP") has climbed rather dramatically (see chart on next page) from –10 to –62 per cent of GDP. The International Monetary Fund (IMF) usually raises a red flag when a country's NIIP drops below –35 per cent of GDP, but the US can probably handle a larger debt position thanks to the status of the dollar. Over the years, other countries have financed US trade deficits mainly by purchasing US Treasury securities. As the table below indicates, 75 per cent of the US NIIP consists of debt securities. The attraction of buying these securities lies in the return that an investor can expect to receive. As we have shown in earlier reports, US long-term Treasury yields have looked sufficiently attractive to foreign investors, even taking into account the cost of currency hedging such holdings. But after the Fed lowered its key interest rate this year and re-introduced quantitative easing (QE), the outlook is not as promising. Since the US will not offer yields as high as before, the USD should weaken further to make US Treasury securities attractive to foreign buyers.

US external debt is growing

International investment position, per cent of GDP



Source: Macrobond, SEB

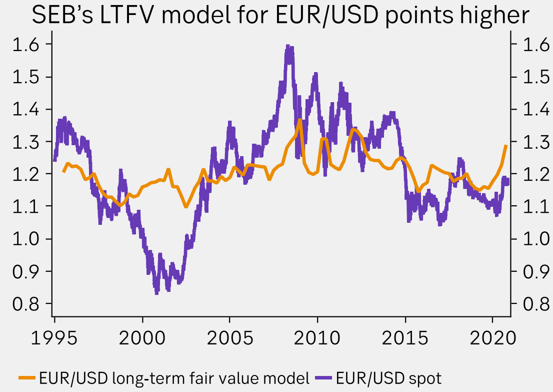
US: Net international investment position, Q2 2020
USD billion

	Assets	Liabilities
Direct investments	7,943	10,097
Equities	8,546	9,203
Fixed income securities	3,847	12,831
Derivatives	2,751	2,729
Miscellaneous	5,202	7,060
Reserves	585	
Total	**28,873**	**41,919**
Net		-13,046
Per cent of GDP		**-62**

Rising incentives to currency hedge pose a clear disadvantage for the dollar. Other countries have shown a preference for American assets in recent years. US stock exchanges performed better than European ones, and the Fed hiked its key interest rate compared to other countries, making dollar hedging expensive. The situation is different today. A reasonable assumption when we look at the US balance sheet is that a large proportion of foreign-owned assets in the US have dollar exposure that has not been currency hedged. If our assumption is correct, there are very large potential flows to identify here. Fixed income investments are normally fully currency hedged, even though a majority of global reserves are in USD (which are not currency hedged). Other countries own more than USD 9 trillion worth of US equities. Every percentage point that the dollar hedging level increases gives rise to a dollar-negative flow of around USD 90 billion. Given the size of foreign investors' holdings, these hedging flows thus have the potential to become much larger than the portfolio investments that flow between countries each year. US investors can also reduce their degree of currency hedging (i.e. sell dollars and buy other currencies) on their investments abroad. As the table shows, the US owns USD 8.5 trillion worth of equities abroad and also has USD 8 trillion in direct investments (which are normally not currency hedged). Since the Fed already cut its key rate in March 2020, the USD should already have been hedged to some degree, but these decisions take time to make and then implement. We believe there is still potential for large USD-negative flows.

USD fair value has fallen by 10 per cent this year. Falling real yields are the main reason why our equilibrium model is setting the benchmark EUR /USD exchange rate nearly 10 per cent higher today than in 2019. For the USD/SEK pair, the long-term equilibrium exchange rate has fallen even more: from 8.50 to below 7.50. This means that even though the krona has appreciated by 15 per cent against the USD this year, it is as undervalued now as it was at the start of 2020.

SEB's LTFV model for EUR/USD points higher

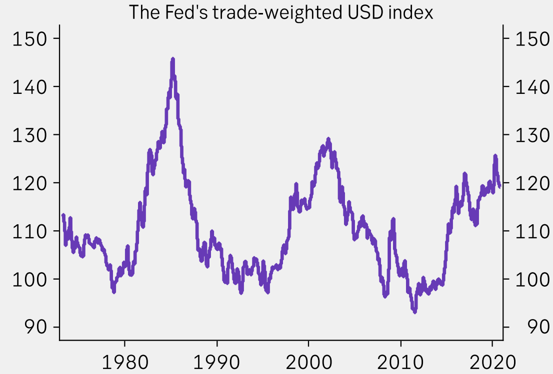


Source: Bloomberg, SEB

The dollar will lose another 10 per cent in the next couple of years. Overall, we expect the dollar to keep falling and believe this may happen rather quickly once the US election results have sunk in. The dollar is overvalued and the US also has large government budget deficits and foreign trade deficits that will push down the currency. The Fed has cut its key interest rate to near-zero, the USD is no longer expensive to currency hedge and there are very large foreign holdings of US assets that should see an increasing USD hedge. The dollar usually moves in 8-10 year cycles. Our forecast is that the USD/SEK exchange rate will drop below 8.00 next year and then continue towards our estimated equilibrium rate of 7.44 during 2022.

Historically large USD fluctuations

The Fed's trade-weighted USD index



Source: Federal Reserve, Macrobond, SEB

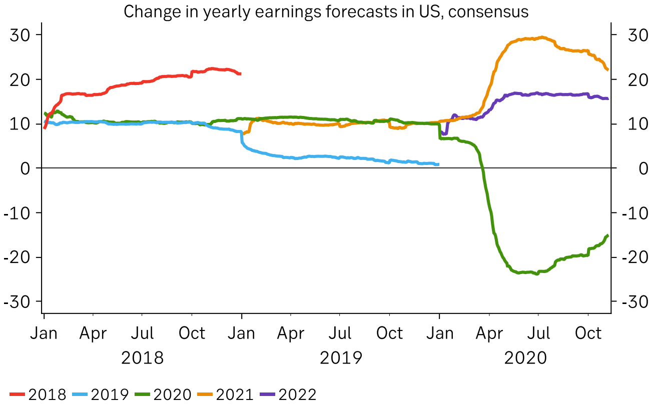
The stock market

Good potential, but short-term risks

A reasonable share price correction has intensified as COVID-19 worries challenge growth forecasts. Quarterly reports show surprisingly strong profits, thanks to good cost control. Political uncertainty and the pandemic are causing disruptions, albeit of a transitory nature. Ultra-loose interest rates and bond yields, plus a recovery supported by stimulus programmes, make today's equity valuations reasonable. Continued digitisation and a focus on sustainability will fuel new stock market upturns.

Positive earnings trend

Change in yearly earnings forecasts in US, consensus



Source: Bloomberg, SEB

Valuations seem reasonable if today's earnings forecasts hold up and bond yields stay low

Strong upturn, followed by new challenges. It is not surprising that this past summer's strong stock market upturn has been followed by a correction. Uncertainty about future US policies, including a near-term delay in fiscal stimulus, has now been joined by worries about growth due to new COVID-19 outbreaks and lockdowns. With interest rates and yields apparently stuck at permanently ultra-low levels – but unlikely to fall further – and equities that seem fully valued in a historical perspective, future growth and earnings will be crucial to stock market performance.

Milder earnings downturn this year but renewed uncertainty. The summer recovery is clearly reflected in Q3 corporate reports. The surprises are bigger for profits than for sales. As during Q2, companies were successful in cost-cutting. Although full-year 2020 earnings will fall, the slump looks shallower than forecasters had feared last spring. At global level, earnings are now expected to fall by 21 per cent this year, compared to forecasts of 25 in the spring. Corresponding US figures are -16 and -23 per cent. Because of the upward revision for 2020, earnings forecasts for 2021 have been revised downward accordingly. In absolute terms, projected 2021 earnings forecasts are unchanged, which means that analysts expect the same earnings level next year as in 2019, but somewhat higher in the US. Today's more uncertain growth outlook may push down earnings forecasts in the immediate future, however.

Economic policies will continue to support growth. As often during crises, economic policies have an especially large impact on growth. It appears that we can rely on monetary policy to remain stimulative, with positive effects on financial markets since increased liquidity dampens volatility and low interest rates support valuations via lower discount rates. If forecasts of growth and earnings are to prove correct, further fiscal stimulus will be needed, especially if there are new pandemic-related lockdowns. If Biden faces a Republican-controlled Senate, it will probably give him a smaller stimulus package than he has proposed but also limit or block his proposed tax hikes. This combination may very well be perceived as the best outcome from a stock market perspective.

High but reasonable valuations. Stock market valuations have been generally questioned by many observers, as share prices have hit new all-time highs despite squeezed earnings. Shares are undoubtedly trading at high price-to-earnings (PE) ratios in historical terms. In the US, the S&P 500 index averages a PE ratio of 22 based on projected 12-month earnings. But we are (probably) in the midst of a period of sharp earnings recovery. Using consensus forecasts for full-year 2021 earnings, PE ratios are below 20, and estimates for 2022 push them down to 17. This is higher than the historical average of around 15 but hardly daunting, given low interest rates and yields. And if we exclude the digital giants that account for 20 per cent of the S&P 500, we can adjust PE ratios lower by about 3. Today's digitisation winners have a big impact on stock indices. Their high PE ratios can be defended on the basis of dazzling earnings growth, powerful structural trends and dominant market positions. Our conclusion is that valuations are not a major problem, provided that earnings forecasts are more or less correct.

Potential in Asia and for sustainability. Outside the US, Asia (ex Japan) is the region with the largest element of IT and digitisation firms, most notably China's Alibaba and Tencent. A better growth outlook and more stable COVID-19 situation also provide support there, along with Biden's less unfavourable trade policy – factors that make these stock markets attractive, along with reasonable valuations. Another trend gaining more and more ground in markets is sustainability. We see major potential for companies that will help bring about a transition to a more sustainable world, especially with the support of political initiatives on both sides of the Atlantic.

Theme:

The EM economies

Waiting desperately for a vaccine

The emerging market (EM) economies – led by China – have begun to recover, but the impact of restrictions to slow the spread of COVID-19 will keep activity low at least until a vaccine is generally available in the second half of 2021. EM growth will be helped by China and eventually the US, but since China has chosen to limit its stimulus measures, support from rising commodity prices is likely to be smaller than after the global financial crisis. The global economy is experiencing a second wave of restrictions, but next year will likely be dominated by a recovery and 2022 by stabilisation. Possible exceptions include Turkey, South Africa and the poorest countries in Africa, where debt burdens will increase during the pandemic.

Like richer countries, the EM economies have begun to recover after sharp GDP declines, especially during the second quarter of 2020. There are nevertheless major differences between countries. Among the worst affected are Peru and India, where GDP fell by 30.2 and 23.9 per cent year-on-year respectively, but Argentina, Mexico, South Africa, Malaysia and the Philippines also reported declines of 15-20 per cent. At the other end of the scale is China, which is in a class by itself with a year-on-year growth rate of 3.2 per cent in the second quarter and 4.9 per cent in Q3. Aside from China, South Korea (-1.3 per cent in Q3) and Indonesia (-5.3 per cent in Q2) are showing signs of strength, but Russia, Poland and Turkey have also managed relatively well, with declines of less than 10 per cent.

A combination of three factors explains most of the differences: 1) the extent of the spread of the virus, 2) the degree of dependence on exports and foreign tourism, as well as the composition of a country's exports and 3) the scale of fiscal stimulus measures. In general, economies like China, South Korea and Taiwan that quickly imposed tough restrictions have recovered more quickly. Also relatively closed EM economies that have been able to replace imports with domestic production and countries that launched major fiscal stimulus programmes have managed better. There are also signs that economies with significant exports of computer and other IT equipment – for example South Korea and Taiwan – have experienced smaller downturns.

Now that we have final figures for Q2 and indications of a strong recovery in Q3 followed by a slowdown in Q4, we have lowered our forecast of the 2020 GDP downturn in the EM sphere to 3.3 per cent, from 2.5 per cent in the September issue of *Nordic Outlook*. The biggest reason for this revision is that we lowered our growth forecast for India to -9.0 per cent, from -5.6 per cent in our last issue. Also contributing to the revision are lower forecasts for the Philippines and Malaysia.

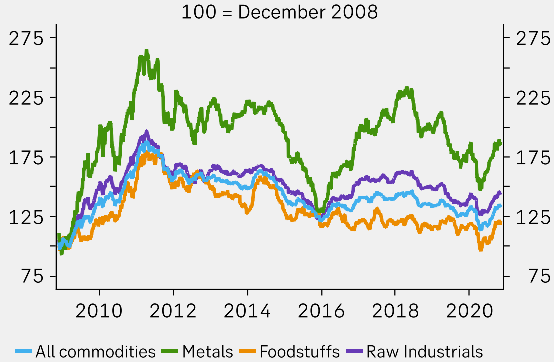
GDP growth, BRIC countries and EM sphere
Year-on-year percentage change

	2019	2020	2021	2022
China	6.1	2.0	8.0	5.6
India	4.9	-9.0	8.6	4.0
Brazil	1.1	-6.0	3.0	2.5
Russia	1.3	-4.5	3.7	2.5
Emerging markets, total	3.8	-3.3	6.2	4.3

Source: IMF, SEB

Cautious stimulus in China. One crucial difference between the 2008 financial crisis and the current COVID-19 crisis is China's caution. Beijing launched a programme totalling about 13 per cent of GDP in late 2008, mainly focusing on infrastructure investments. It led to rapidly rising commodity prices. In early 2011, these prices were more than 20 per cent higher than at their peak before the financial crisis, which benefited commodity-producing EM economies. Combined with a large influx of capital to the EM sphere due to the Fed's introduction of quantitative easing (QE), China's stimulus policy had a strong impact on growth via international trade. This time around, China has abstained from similar measures out of concern about increased debt and in order to avoid driving speculative price bubbles in the real estate and stock markets.

Commodity prices expected to rise moderately
100 = December 2008

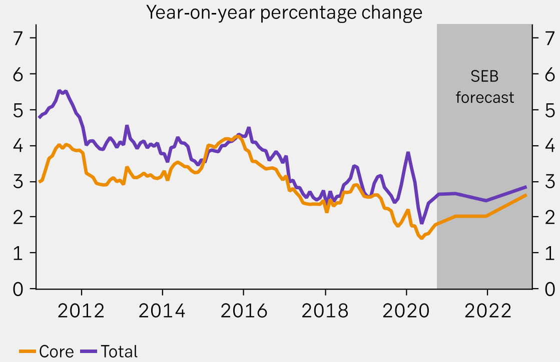


Source: Commodities Research Bureau (CRB), BLS, Bloomberg, Macrobond, SEB

Commodity prices have recovered their entire spring decline, according to America's Commodity Research Bureau (CRB) index, but they remain almost 30 per cent below their 2011 peak. We expect commodity prices to continue rising gradually, but with certain differences between product categories. Oil and other energy prices have not rebounded to the levels prevailing at the end of 2019. We expect oil prices to remain relatively stable in the near future, since the current agreement between OPEC and Russia will create a balance between limited production and weak demand growth. Due to gradually rising demand as the global economy recovers, oil prices will climb to an average of USD 55/barrel in 2021 and USD 65 in 2022.

Base metal prices fell sharply starting in mid-January, when it became clear that the Chinese economy, which accounts for about half of global demand, would decelerate. Since then a recovery has begun, led by iron ore prices but also copper and nickel. Higher metal prices will benefit economies like India, South Korea, Russia, Brazil, Ukraine, Vietnam and South Africa. Agricultural and food prices have been less affected by the pandemic but should see a rising trend this coming year due to COVID-related disruptions and less favourable weather this year, especially in the US. Overall, the recovery in commodity prices will have a positive effect on investment plans and economic activity in the EM sphere, but in the absence of major stimulus measures in China such effects will be comparatively small compared to the recovery after the financial crisis and China's 2015 slowdown.

EM consumer price inflation
Year-on-year percentage change



Source: National statistical offices, Macrobond, SEB

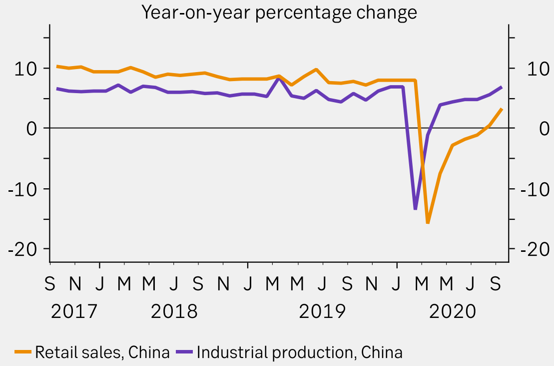
Inflation in EM countries is showing a mixed picture. In Asia it is generally below official inflation targets, except for India – where the September rate of 7.3 per cent is above the 6.0 per cent maximum in the central bank's target range. In Central and Eastern Europe, inflation has climbed in recent months and is at or just above-target, except in Turkey where inflation of 11.9 per cent is far above target. In Latin America, too, inflation has climbed after an initial decline when the pandemic broke out, but it remains near target except in Brazil, where it remains well below target. Weaker EM currencies have generally been a major driver of higher inflation. Low capacity utilisation will help keep EM inflation stable at a historically low level in 2021, after which it will climb a bit in 2022.

Central banks under political pressure. Most EM economies have eased monetary policy. We believe there is now very little room for further easing. A few central banks, including those in Russia and India, will probably cut their key rates before year-end, but otherwise key rates are likely to remain unchanged during 2021 and then be hiked gradually in 2022 as the recovery gains momentum and inflation rises. One risk is that EM central banks will wait too long to tighten monetary policy in order to help sustain the recovery. In part, this may be a consequence of pressure to enable governments to more easily boost their debt burden, due to stimulus measures during the pandemic. Further ahead, this may lead some central banks to lose control of price increases. Central banks in countries with high or sharply rising government debts – such as Brazil, South Africa, Mexico and India – run an especially great risk of losing credibility in their fight against inflation.

Large capital outflows. The EM economies noted record-sized capital outflows in the form of portfolio investments in bond and stock markets when the pandemic broke out. The situation has stabilised in recent months, but compared to earlier crises, capital flows have been slow to reverse. Despite relatively wide interest rate and yield spreads between richer countries and the EM sphere, as well as quantitative easing that has boosted money supply in developed markets, investors have been hesitant. The risks of rising national debts and continued weak growth among EM economies have led many investors to wait. Because of monetary policy easing, yields are too low to offset higher risks. We will probably have to wait until a COVID-19 vaccine is widely available in the EM countries later in 2021 before we see a clear increase in capital flows and investments in the EM countries.

Retail sales lagging industrial production

Year-on-year percentage change



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

China's recovery continues at a healthy pace. The authorities have successfully limited the spread of COVID-19 by using drastic measures, thereby creating the conditions for a gradual recovery. Some monetary and fiscal stimulus has also helped, but the economy has not yet recovered its entire decline. GDP grew by 4.9 per cent year-on-year in Q3. The manufacturing and construction sectors grew by 6.0 per cent in Q3, and strong order bookings suggest continued expansion, but the service sector has not recovered as quickly. New stimulus measures will be needed in order to restore confidence among consumers. Domestic tourism has begun to grow again, but travel during Golden Week in 2020 was still 28 per cent below 2019. This year the economy is expected to grow by 2 per cent, followed by a sharp recovery of 9.0 per cent in 2021. We generally expect Beijing to be cautious about stimulus measures in order to avoid higher debt. Perhaps the authorities also want to reduce expectations that China will generate growth of around 6 per cent every year.

India is one of the countries hardest hit by the pandemic. This is partly self-inflicted, since a hasty and poorly executed economic lockdown combined with little fiscal manoeuvring room led to a record-sized GDP decline of 24 per cent in Q2. Indian authorities have begun to ease the restrictions, but millions of migrant labourers were forced to return to rural areas in search of food and work during the lockdown. It will take time before they are again available to work in manufacturing and construction. The Reserve Bank of India (RBI) eased its monetary policy when the pandemic struck, but due to inflation above 7 per cent in September, the RBI has paused further key interest rate cuts. Even if the current key rate of 4.00 per cent is lowered a bit, the economy will still shrink by about 9 per cent for the full year 2020. In 2021 we expect an 8½ per cent rebound, followed by a moderate 4.0 per cent in 2022.

The Russian economy has performed relatively well so far. The GDP decline was only 8.0 per cent in Q2, despite a country-wide quarantine, lower oil production and limited fiscal stimulus. Replacement of imports with domestic production and unexpectedly strong exports contributed to Russia's resilience. Capital spending also proved robust, while consumption fell by 22 per cent. Pent-up demand drove a recovery in Q3, but a second COVID-19 wave has slowed economic activity again, especially in the service sector. The Kremlin is very unwilling to borrow money for fiscal stimulus measures, especially abroad, but there will be some infrastructure spending. Russia's central bank has kept its key rate unchanged at 4.25 per cent since July due to a sharp depreciation in the rouble and rising inflation, but rate cuts are likely in late 2020 and during 2021 if oil prices begin to climb and Moscow manages to thaw its frosty relations with Washington. Overall we expect GDP to fall by 4.5 per cent in 2020 and then recover slowly to 3.7 per cent growth in 2021, followed by 2.5 per cent in 2022.

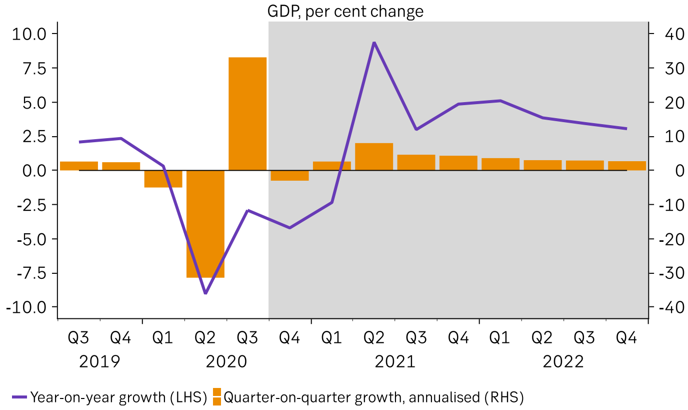
Brazil's GDP fell by 11.4 per cent in Q2. This posed a severe challenge to the government, since only 3 years had passed since one of the country's worst economic crises in modern times. But compared to Mexico, with its GDP decline of 18.7 per cent, the downturn was moderate. Government strategies to reduce the spread of COVID-19 have been poorly coordinated between regional and federal levels, but a fiscal relief programme targeting the poorest Brazilians has prevented a deeper economic decline. Worries about weakening federal finances and interruptions in the reform process have nevertheless weighed down the Brazilian real. Low inflation created room for the central bank to cut its key rate (Selic) to a record-low 2.00 per cent, where it is likely to remain until Q3 2021. A combination of rising inflation and a national debt approaching 100 per cent of GDP is likely to force Selic upward to 5.00 per cent by the end of 2022. There have been plenty of controversies surrounding President Jair Bolsonaro, but a strong desire among voters for change is allowing a reform process to continue, despite turbulence in the National Congress. We expect GDP to fall by 6.0 per cent in 2020 and then grow by 3.0 per cent in 2021 and 2.5 per cent in 2022.

The United States

Stimulus and COVID-19 keys to growth

Limited restrictions and a new stimulus package will provide support for US economic growth after another temporary slump late this year. Fiscal policy parameters will be determined by which party controls the Senate. If Congress remains divided, this will limit the room for some of the spending planned by the next president, Joe Biden. The Fed will keep its key rate at close to zero and keep expanding its balance sheet rapidly.

Sharp initial upswing followed by more gradual recovery



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.2	-4.0	3.6	3.8
Unemployment*	3.7	8.1	6.5	5.2
Wages and salaries	3.3	4.6	2.0	1.8
CPI	1.8	1.3	1.9	1.9
Core PCE (the Fed's target variable)	1.7	1.5	1.8	1.6
Public sector balance**	-6.3	-19.0	-10.0	-7.0
Public sector debt**	109	131	136	138
Fed funds rate, %***	1.75	0.25	0.25	0.25

* % of labour force ** % of GDP *** At year-end. Source: Macrobond, SEB

Smaller GDP decline than previously feared

After falling by 9 per cent in Q2 2020, GDP rose more than 7 per cent in Q3. Even assuming a temporary slump in Q4, we are revising our full-year forecast upward to -4.0 per cent, from -5.5 per cent in September. Fiscal policy will remain expansionary in 2021. We expect negotiations on further stimulus to resume once the dust has settled after the election. We believe that a new package totalling at least USD 1 trillion (5 per cent of GDP) will be enacted by the new Congress. After a lengthy vote-counting process, Joe Biden has won election as the 46th president of the United States, according to leading US and international media networks. Control of the Senate will be determined by two run-off elections in January; our main scenario is that the Republicans will retain control, but this is not certain. A divided Congress would limit Biden's room to implement his policies but will not stop the possibility of another stimulus package. We expect fiscal policy to remain expansionary even with a recalcitrant Senate, leading to big budget deficits and rapidly rising national debt. Together with the Federal Reserve's ultra-loose monetary policy, this will help GDP grow by 3.6 per cent in 2021 and 3.8 per cent in 2022. We expect the economy to be back at its pre-pandemic level in about a year, but by the end of 2022 it will still not have closed the gap compared to earlier growth trends. We expect a 4.5 per cent jobless rate at the end of our forecast period.

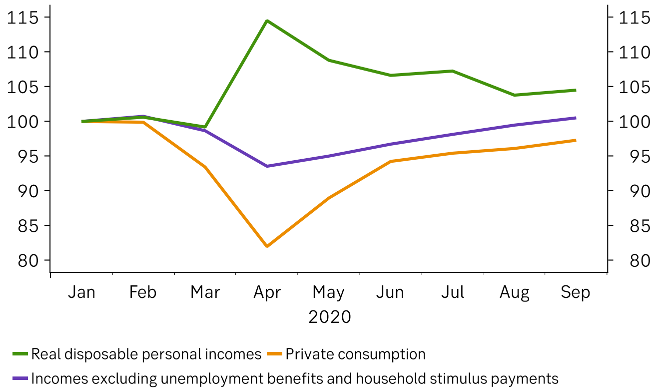
A historically powerful economic policy response is the main reason for the initially rapid pace of recovery. Stimulus measures have totalled about USD 3 trillion (14 per cent of GDP) so far this year, greatly easing the consequences of the pandemic for households and businesses. For example, one-time payments and temporary unemployment benefit supplements boosted household disposable incomes by 15 per cent in April, despite a surge in unemployment from just above 4 per cent to nearly 15 per cent. In the spring and summer, businesses received grants if they retained employees. Borrowing costs for large firms and local authorities are being kept down by Fed lending programmes, while historically low home mortgage rates due to the Fed's near-zero key rate and bond purchases have helped sustain the housing market. Housing starts are back at 2019 numbers and September sales of existing homes were the highest since May 2006. The crisis is uneven, with low-paid and young people in service occupations especially hard hit while older middle- and high-income earners hold on to their jobs to a greater extent. This has contributed to a resilient housing market.

Households and businesses have remained optimistic. Restrictions – not worries about the future – have held back consumption and production during the pandemic. Although the mood among consumers and small businesses fell steeply when the crisis broke out, it still did not reach the same low levels as during the 2008-2009 financial crisis. Indicators are now above historical averages; the NFIB small business optimism index is not far from pre-pandemic levels. Indicators for larger manufacturing and service companies, such as purchasing managers' indices (PMIs) and the Institute for Supply Management (ISM) indices, are back at levels pointing to expansion. It is not so strange that businesses are signalling production increases from the current low levels.

The COVID-19 crisis has had an uneven geographic and sectoral impact. Hardest hit have been trend-setting western and north-eastern states, where the virus spread first and lockdowns were more far-reaching, as well as tourist states like Nevada and Hawaii. The South has coped better in economic terms. At the sectoral level, the crisis has heavily impacted recreational and tourist services, but also the transport, education and health sectors. In manufacturing, auto production saw the biggest declines but also the fastest recovery. Production of investment goods such as mining, energy and especially the steel and aviation industries have remained weak, while the tech sector has been largely unaffected. Affluent households have led a rapid turnaround for consumer capital goods. Because demand fell less in the US than in many other countries, the trade deficit rose after a rapid recovery for imports. Business investments again climbed in Q3 2020. In a historical comparison, the slump thus seems to have been deep but relatively short-lived.

Fiscal policy has supported incomes and consumption

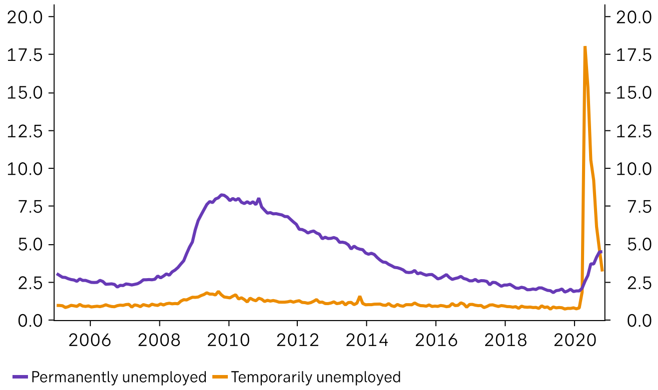
Index Jan 2020=100



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

Temporary unemployed return to work, permanent losses up

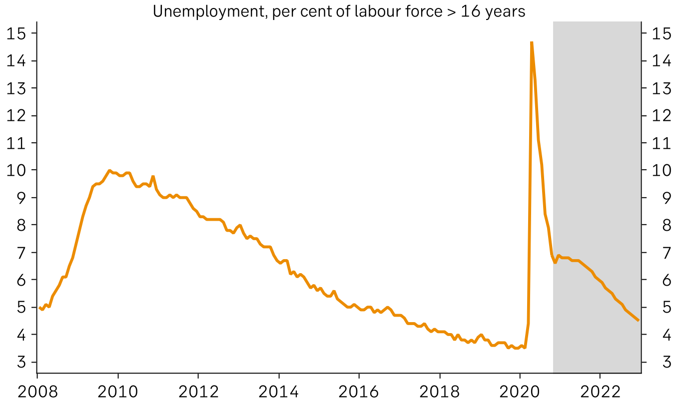
Millions of individuals



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

Unemployment has fallen rapidly compared to earlier crises

Unemployment, per cent of labour force > 16 years



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

COVID-19 may lead to new reversals this winter. The virus spread this past summer slowed the pace of reopening and the upturn in private consumption, but relatively mild restrictions enabled the economy to avoid new downturns. In October and November, infection rates surged again and the number of new cases exceeded the July peak. A spread to new Midwestern states and more testing are two reasons, but earlier-affected areas are also showing signs of increased infections. It can no longer be ruled out that the US, like Europe, will be forced into new lockdowns this winter, but our main scenario is that extensive disruptions in production and the transport sector can be avoided and that restrictions will be less widespread than in Europe. Household consumption will benefit from a high savings ratio after last spring's relief programmes. Disposable incomes fell after a large proportion of unemployment benefits expired in July, but in September incomes were still 4.5 per cent above their February level. Worries about COVID-19 are nevertheless expected to once again lower the demand for entertainment and restaurant services, while the potential for replacing such consumption with increased goods purchases should be more limited after an earlier strong upturn in retail sales.

The labour market recovery is starting to lose momentum as benefit levels have fallen. This is another reason for greater caution. Temporarily unemployed individuals continued to return to their jobs in November, but meanwhile there has been a definite upturn in the number of permanent dismissals as businesses began adjusting their fixed costs to changes in demand after the pandemic. For example, large employers in the civil aviation and recreation sectors have announced cutbacks this autumn. The phase-out of grants to companies that retain employees is decreasing their staying power. This is especially true if new restrictions may need to be imposed before a vaccine becomes generally available next year. The absence of imbalances of the types that have normally triggered cyclical fluctuations, as well as continued fiscal and monetary stimulus, still mean that the labour market recovery will be less sluggish than after the 2008-2009 crisis. We expect unemployment to fall to 4.5 per cent by the end of our forecast period: one percentage point above the record-low figures before the COVID-19 crisis and somewhat above the Fed's estimate that equilibrium unemployment is around 4 per cent.

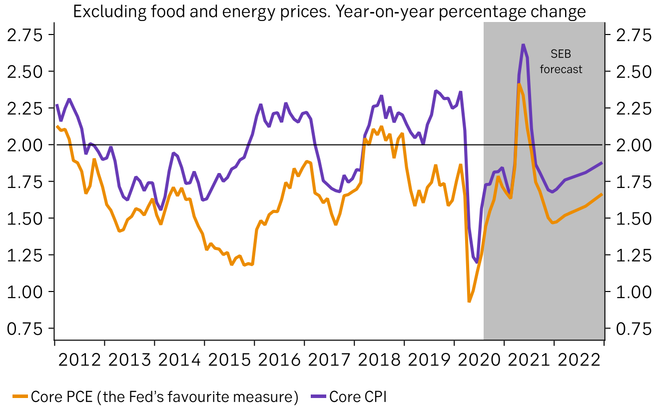
Fragile recovery will create the need for further stimulus. This applies especially to the risk that a more widespread wave of bankruptcies will trigger a new downturn. The outlook for US manufacturers and exporters is also worsening due to a second wave of COVID-19 in Europe and economic weakness elsewhere. Because of low capacity utilisation in manufacturing and uncertainty related to the pandemic and to post-election federal policies, the recovery in business investments will slow. But our main scenario – a Democratic president and a Republican-run Senate – may generate a relatively harmonious business climate. The prospects of a corporate tax hike seem to be more limited, while the risk of new trade conflicts will diminish.

More ambitious Fed job and inflation targets

The Fed recently adopted new policy guidelines, which imply that it will not intervene to slow a downturn in unemployment as long as inflation is low. The central bank will also have greater flexibility in allowing inflation to overshoot its 2 per cent target after periods when it has mostly been below-target. At its September meeting, the Fed also adapted its forward guidance by promising to keep the key interest rate unchanged until the economy is back at full employment and inflation has reached 2 per cent, as well as overshooting this target for a period. Fed forecasts indicate that this point will not be reached until after 2023. Even if another stimulus package helps speed up recovery, we believe the Fed will be patient about both the labour market and inflation outlook. We expect the near-zero key rate to remain in place well beyond our forecast horizon. The Fed has meanwhile signalled that it will not act any more aggressively to speed up fulfilment of its target.

Large but temporary virus-related inflation movements

Excluding food and energy prices. Year-on-year percentage change

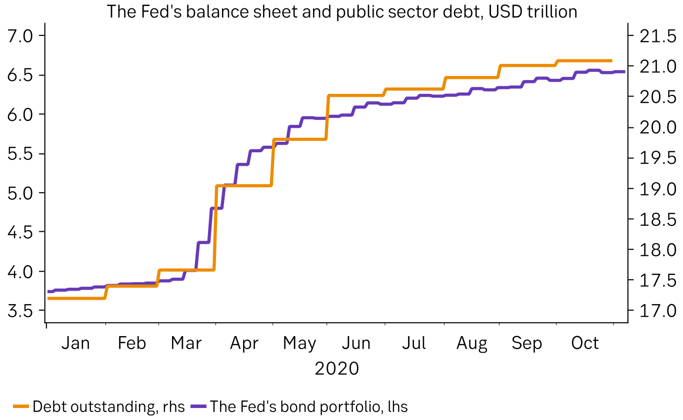


Source: Macrobond, SEB

The risk of new tariff wars will diminish as China trade policy is coordinated with US allies

The Fed has kept up with the increase in public sector debt

The Fed's balance sheet and public sector debt, USD trillion



Source: Federal Reserve, U.S. Department of Treasury, Macrobond, SEB

Low underlying inflation. Since last spring, the coronavirus crisis has generated historically unparalleled price movements. As a result, uncertainty about US inflation is higher than usual. The Fed almost always focuses on core inflation, which excludes energy and food and better reflects the underlying trend, but even this has been volatile. Due to base effects, inflation is expected to exceed the Fed's target next spring, but still-high unemployment and weaker-than-normal demand suggest that underlying price pressure is low. We expect inflation to fall back below the Fed's target by mid-2021. The fact that the COVID-19 crisis does not seem to have created any major production problems, for example due to the destruction of international value chains, supports this conclusion.

The Fed is ready to respond to upside pressure on long-term yields. Bond purchases will continue at a pace of at least USD 120 billion per month (USD 80 billion in Treasury bonds and USD 40 billion in mortgage-backed bonds). The Fed's message is that it is best for the economy if fiscal and monetary policy makers work together. We believe the Fed is prepared to accelerate its asset purchases to counter upward pressure on long-term yields from higher issuance requirements in case of another stimulus package. If the Fed must act before such a package can be approved, it can focus its purchases on longer maturities instead of buying along the entire yield curve like today. We also consider it likely that the Fed will increase the proportion of T- bond purchases. So far this year, the Fed has bought about ¾ of increased debt (Treasury bonds and bills). We expect it to keep up with the pace of federal borrowing. We believe the Fed will speed up its purchases a bit next year and that they will continue well into 2022. This will push its balance sheet above USD 9 trillion, or to more than 40 per cent of GDP, by the end of next year. Letting its balance sheet grow will decrease the risk that continued large budget deficits (10.5 per cent of GDP in 2021 and 8 per cent in 2022) will have a crowding-out effect.

New president but probably a still-divided Congress

The US presidential election resulted in a victory for Democratic candidate Joe Biden. The Democrats will keep control of the House of Representatives, while the Senate majority will be determined by two run-off elections in Georgia in early January. A divided Congress will make it hard for Biden to push through many of his economic policies, including about USD 4 trillion in tax hikes over 10 years, USD 2 trillion in green infrastructure investments over four years and large-scale social spending. Yet there is consensus in Congress about the need for further stimulus to help households and businesses during the pandemic, although there are different opinions on the size and focus of such a package. Once the election is past, we believe the deadlock will ease and Congress will agree on a package of at least USD 1 trillion (5 per cent of GDP) including extended jobless benefits, new small business grants and larger grants to state and local governments. If the Democrats also win control of the Senate, we see an upside risk for our growth forecast.

In foreign policy, the president has freer hands. Tensions with China will persist, but the risk of new tariff wars will diminish as China trade policy is coordinated with US allies in Europe and Asia and via the World Trade Organisation (WTO), whose dispute settlement function can resume once the US allows the appointment of new judges. The US can also re-join the Paris climate agreement. Since Biden's fiscal policy powers will be curtailed by the Senate, monetary policy makers will have to shoulder a larger share of the burden in promoting recovery. This strengthens our belief that the Fed's near-zero key interest rate will last a long time but also increases the risk of fiscal excesses further ahead.

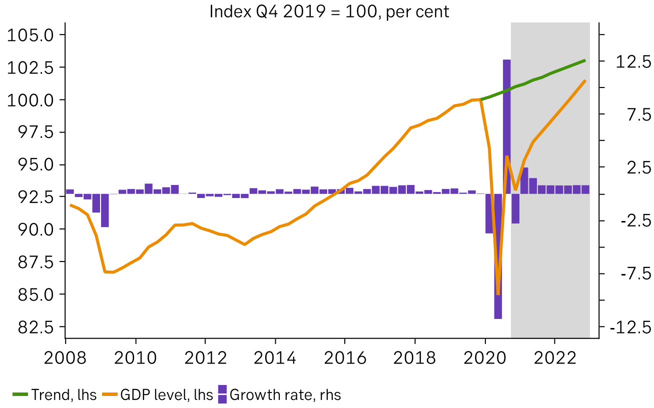
The euro area

New COVID-19 wave is weakening recovery

The recovery in Q3 was surprisingly strong but with COVID-19 infections rising again, leading to new restrictions, GDP will again decline in Q4 and 2021 will start on a weak note, before the recovery again gathers pace. Fiscal stimulus will provide continued relief but for various reasons, its impact will shrink in many countries next year. The ECB will focus on QE policy, but key rate cuts cannot be ruled out. GDP will fall by 8.8 per cent in 2020, then rebound by 5.8 per cent in 2021 and 4.3 per cent in 2022.

Increased COVID-19 spread will contribute to weaker growth

Index Q4 2019 = 100, per cent



Source: Eurostat, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.3	-7.6	4.0	4.3
Unemployment*	7.6	8.0	9.9	8.8
Wages and salaries	1.9	1.5	1.5	2.0
CPI	1.2	0.3	0.8	1.2
Public sector fiscal balance	-0.6	-8.9	-6.5	-4.7
Public sector debt**	84.0	102.4	103.3	103.3
Deposit rate, %***	-0.50	-0.50	-0.50	-0.50
EUR/USD***	1.12	1.20	1.25	1.28

*% of labour force **% of GDP ***At year-end. Source: Eurostat, SEB

Multi-dimensional economic tug-of-war

After a surprisingly strong surge in economic activity in the third quarter, when GDP rose by 12.7 per cent, we are now facing reversals due to a second wave of COVID-19, which looks set to be more severe than expected. Since the consequences of last spring's lockdowns were so dramatic, political leaders probably wish to avoid repeating the same strategies for as long as possible. Yet downward adjustments in GDP forecasts for the next few quarters are unavoidable and significant, especially for the fourth quarter this year when GDP is expected to fall by 4 per cent. In late 2021, we expect growth to recover as vaccines become available to broader population segments. Partly due to the rapid and unfavourable COVID-19 trend, risks will be on the downside. Growth gaps between euro area countries will probably be wider than expected in 2020 with German GDP falling by 6.2 per cent compared to almost or more than 10 per cent in the other three major economies. But further ahead, the worst-hit countries are likely to regain lost ground, so GDP growth rates in different economies will converge. Difficulties in reaching a constructive trade deal on British withdrawal from the EU (Brexit) will generate further near-term uncertainty. Although the United Kingdom will be the worst affected, the euro area will also suffer major consequences; some 6 per cent of the region's exports go to the UK.

Will manufacturing stay resilient? Now that new lockdowns are on their way, it will again be important to analyse how various sectors will be impacted. Sentiment indicators have become increasingly divergent over the past two months. So far, manufacturing sector confidence remains intact, especially in Germany. Optimism among manufacturers has continued to climb, while purchasing managers' indices (PMIs) in service sectors have again fallen below the neutral 50 mark. This pattern is likely to persist as long as restrictions keep tightening. Social distancing and fewer options for leisure activities mainly affect services, while public officials now seem eager to keep other production going. As a result, economies with large manufacturing sectors are coping better. If we compare the largest euro area countries, manufacturing accounts for 22 per cent of the German economy, followed by 18 per cent in Italy, 16 per cent in Spain and only 12 per cent of the French economy. Industrial order bookings have improved in most countries but are still far below normal. This also applies to export volume. Although manufacturing will not be directly affected by the lockdowns, the question is how resilient the sector is when other parts of the economy are showing weaknesses. Indirect effects in the form of lower demand for certain consumer and investment goods will soon emerge. On the other hand, European exports and industrial production are benefiting from stronger global demand, especially from China.

Stimulus measures will continue but show wider differences. As the economic recovery loses strength, we are likely to see new fiscal stimulus packages in the euro area. For example, both Germany and France presented additional measures to alleviate the pressure on companies and households at the same time as new COVID-19 related restrictions were introduced a couple of weeks ago. Meanwhile it will be hard to make these programmes even more expansionary than the big ones implemented in 2020. Instead of stepping up these measures further, public authorities will have to strike a balance between relief policies and a phase-out of programmes at a pace that the economy can handle. Signals from international organisations clearly indicate that stimulus programmes should be phased out gradually. The manoeuvring room will also obviously vary between countries, even though central bank asset purchases are pushing interest rates and bond yields to record-low levels. It may create some political tensions that a country like Germany, going into the crises with a fiscal surplus, has more economic muscle than France, Spain and Italy, all with a government debt level above 100 per cent of GDP. But last summer's approval of the new EU recovery fund indicates stronger cohesion and solidarity among member countries, although there are different opinions about implementing the package, for example between the German EU presidency and the European Parliament. For the euro area countries as a whole, we expect fiscal policies to be neutral or slightly contractionary in 2021.

GDP growth forecasts

Quarter-on-quarter, Q2 and Q3 2020 and year-on-year, per cent

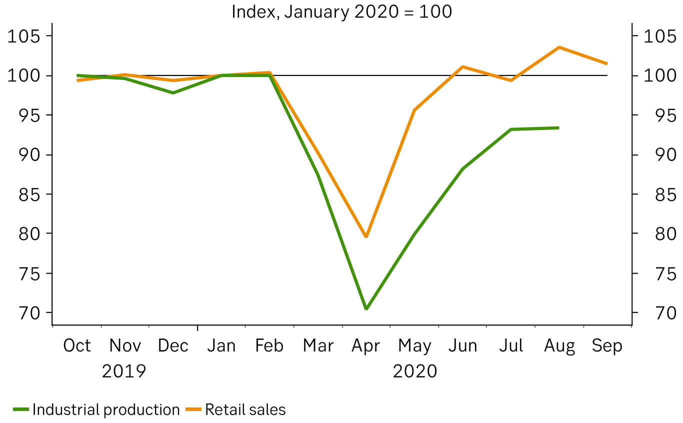
	Q 1	Q 2	Q 3	Q 4	2021	2022
Germany	-1.9	-9.8	8.2	-3.0	3.2	4.2
France	-5.9	-13.7	18.2	-5.0	5.6	4.4
Italy	-5.5	-13.0	16.1	-4.0	5.1	4.0
Spain	-5.2	-17.8	16.7	-5.0	4.4	6.5
Euro area	-3.7	-11.8	12.7	-4.0	4.0	4.3

Source: Eurostat, SEB

More focus on ECB bond purchases and cheap liquidity, but a key rate cut cannot be ruled out

Slower improvement in manufacturing than retail

Index, January 2020 = 100



Source: National statistical offices, Macrobond, SEB

Stimulus is sustaining household purchasing power

Because of relief measures and "short-time work" programmes, unemployment has climbed surprisingly little considering the dramatic decline in GDP. One result is that consumer optimism has not fallen to the record lows measured during the global financial crisis or the subsequent euro crisis a decade ago. This is also reflected in home prices, which have remained relatively stable. Income improvements via stimulus programmes, combined with limited consumption opportunities in some areas, have pushed the household savings ratio up to record-high levels. This will provide potential for higher consumption in 2021. But the new wave of lockdowns will contribute to continued unemployment increases in the near term. The latest figures from September show euro area unemployment of 8.3 per cent. We expect the jobless rate to climb to about 10 per cent by mid-2021, before again beginning to fall.

Consumption is still hampered by lockdowns. Consumption and retail sales are slowing, after a clear recovery in the summer. Countries that were hit less hard by COVID-19 and that have greater resources to support domestic demand – such as Germany – are performing more strongly, with retail sales now back at pre-pandemic levels. In tourist- and service-dependent Spain, retail sales are still 10 per cent lower than before the crisis. Although we are seeing some substitution from services to goods and increased e-commerce, it is reasonable to believe that consumption will generally be hurt by new lockdowns and lingering restrictions, for example in the cultural, restaurant and other service sectors, until well into 2021. We have thus lowered our consumption growth forecast for the full year 2021 from 8 to 5 per cent.

The ECB is focusing on its balance sheet

Underlying inflation pressure in the euro area eased substantially during the summer, and CPI inflation in October was 0.3 per cent. Some prices are still rising due to coronavirus-related effects, but this does not change the overall picture of a general squeeze on inflation. Low resource utilisation will hold back wages and prices throughout our forecast period, and a relatively strong euro will also dampen imported inflation. Like the European Central Bank (ECB), we expect inflation to climb slowly, but by end-2022 it will stand at 1.2 per cent – well below the ECB's target of nearly 2 per cent.

More QE above all, but a key rate cut cannot be ruled out. Like other central banks, the ECB has substantially boosted its bond purchases this year. The Pandemic Emergency Purchase Programme (PEPP), its biggest and most important instrument, has helped push down a wide variety of bond yields. PEPP has also helped narrow the spreads in government bond yields between countries. For example, Italian 10-year bonds reached their lowest-ever yields in mid-October, and the yield spread to Germany stands at 130 basis points. Given already extremely expansionary policies and growth challenges that are difficult for the ECB to influence directly, the focus will remain on promoting efficient markets by means of liquidity injections that will keep yields and spreads low. The ECB has room to help sustain weaker economies by purchasing proportionately more bonds from countries with the largest government debt. Although the ECB has signalled that it sees room for further key interest rate cuts without excessive negative side effects, our main scenario is that it will abstain from such cuts. This means that additional cheap TLTRO loans and bond purchases top the agenda of the ECB, which already delivered further TLTRO loans at its October policy meeting. We expect the ECB to expand PEPP by another EUR 500 billion this autumn, enabling it to continue bond purchases at its current pace until the end of 2021.

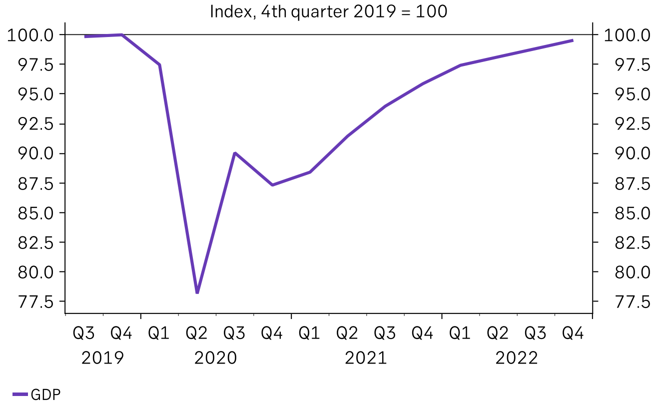
The United Kingdom

A one-two punch due to Brexit and Corona

The UK is responding to the strongly growing COVID-19 cases with new restrictions, which will hamper the recovery that began in Q3. The EU and UK will probably end up with a trade agreement, but EU withdrawal will still harm the British economy. This one-two punch calls for central bank and especially government measures to prop up the economy. Negative supply-side effects from Brexit will contribute to somewhat higher price and wage pressures than elsewhere in Western Europe.

Long way back after one-two punch

Index, 4th quarter 2019 = 100



Source: Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.5	-11,5	4.7	6.6
Unemployment*	3.8	4.5	6.1	5.4
Wages and salaries	3.5	-0.2	0.2	1.2
CPI	1.8	0.8	1.8	1.6
Public sector balance**	-2.1	-16.5	-9.0	-7.0
Public sector debt**	85.4	108	110	115
Key interest rate, %***	0.75	0.10	0.10	0.10
EUR/GBP***	0.85	0.90	0.87	0.85

* % of labour force ** % of GDP *** At year-end. Source: Macrobond, SEB

Worst performance among major economies. GDP fell more than 20 per cent in the first half of 2020. Even with the expected 15 per cent third quarter rebound, the full-year decline in GDP will be 11 per cent. Last spring's lockdowns and restrictions were very far-reaching, and now that the number of COVID-19 cases and hospital stays is again rising sharply, extensive new extensive restrictions are being imposed and the recovery will lose momentum, in particular during the coming six months. Despite our expectations of GDP to rise by 4.7 and 6.6 per cent in 2021 and 2022, GDP will not reach its pre-crisis level. While we have seen a sharp decline in GDP so far, unemployment has only climbed by 0.5 points to 4.5 per cent. This is mainly due to the large-scale Coronavirus Job Retention Scheme (CJRS) and because lockdowns have prevented people from undertaking job searches at all or registering as jobseeker.

An uphill battle, regardless of any trade deal. Also hampering the economy is that the UK will finally leave the EU single market, which accounts for about half of British exports and imports. Negotiations on a UK-EU trade agreement have been anything but smooth since the Brexit referendum in June 2016 (see box, p 12). Although our main scenario is a last-minute trade deal, most international organisations agree that the impact of Brexit on British GDP will be strongly negative, compared to continued EU membership (we are assuming 0.3 percentage points yearly).

Highest public sector debt since early post-war period. Like other countries, the UK has launched major fiscal stimulus initiatives, including the CJRS, grants to businesses and households as well as various loan programmes. The government's 2020 fiscal deficit is expected to reach 16 per cent of GDP. Looking ahead, coronavirus-related needs and the consequences of EU withdrawal will require continued fiscal support. We thus expect public sector debt to climb above 115 per cent of GDP: a level reached earlier only during or after war time.

Some inflation pressure despite hampered growth. Brexit-related uncertainty has pushed down the pound for a rather long time, contributing to inflation. Weak economic growth will continue to weigh down the currency, but a trade agreement with the EU would decrease uncertainty and probably help the pound to regain some lost ground against the euro. This would ease inflation pressure, but on the other hand British wages and salaries are likely to increase a bit faster than in other countries. At present, unemployment is relatively low. Looking ahead, Brexit will hamper the labour supply due to tighter migration rules. The UK will probably also become generally less attractive as a destination for skilled labour from other countries. A tighter labour market may eventually create challenges for the Bank of England (BoE), and it will become more and more important for the UK to instead break out of its weak productivity growth trend. But during our forecast period, inflation will stay below 2 per cent, reaching 1.6 per cent at year-end 2022.

Will the BoE resort to a negative key interest rate? British monetary policy has become increasingly expansionary, with an emphasis on BoE bond purchases and supplying liquidity to businesses and banks. The BoE has also cut its key interest rate to 0.10 per cent and has implemented preparations for negative interest rates, in part to ensure that banks are actually ready if it takes this step. We believe that the UK-EU trade negotiations will be crucial and that a deal will be reached, persuading the BoE to abstain from negative key rates, but in case of failed talks and/or more extensive lockdowns we expect the BoE to make the move to negative key rates. If the outlook in the real economy weakens, we thus do not believe that the inflationary tendencies that Brexit may generate will prevent the BoE from taking further action.

The Nordics

Sweden

The recovery will lose momentum when new restrictions are imposed, but a renewed GDP decline can probably be avoided. A stronger krona and low pay hikes will push down inflation, yet the Riksbank will keep its key rate at zero and instead expand its QE.

Page 38

Norway

Fiscal stimulus measures will continue to provide support when the recovery slows. Households will manage relatively well, but low capital spending will cool GDP growth ahead. In 2022, Norges Bank will be among the few central banks to hike its key rate.

Page 41

Denmark

Because of an unexpectedly fast recovery in Q3, our GDP forecast for 2020 will not need to be lowered despite new lockdowns. Upward pressure on the Danish krone may trigger key interest rate cuts, even if the ECB leaves its key rate unchanged.

Page 43

Finland

The economy has held up relatively well during the pandemic, but now its resilience appears to be fading. Structural challenges such as weak productivity growth and an ageing population will hamper future growth.

Page 44

Theme:

2020 wage round

Falling inflation expectations challenge the Riksbank

Sweden's industrial sector quickly completed collective bargaining after the national wage round resumed in October. Despite a weak labour market due to the pandemic, unions achieved a marginal speed-up in pay hikes compared to the 2017 agreement. To some extent, the two sides thus followed a tradition of not letting the current situation completely colour their negotiations. But if we count the 7 months since the previous contract expired on March 31, the deal implies a slowdown in pay hikes. With agreements running until March 31, 2023, pay increases are likely to end up well below what is compatible with the Riksbank's 2 per cent inflation target. Employer and union inflation expectations have also fallen. If this trend continues, it will put the Riksbank under pressure. Will we end up in the same situation as in 2012-2014, when the two sides accused the Riksbank of not taking its own target seriously?

Industrial employers and unions have reached agreement on new pay increases after a month of negotiations. The wage round resumed on October 1 after being interrupted by the COVID-19 outbreak. A few weeks later the union side rejected the first proposal by a group of "impartial negotiation leaders" (OPO), but the two sides struck a deal on November 1 which provides a 5.4 per cent pay hike during the period until the end of March 2023. The proposed pact thus runs for 29 months, but since it includes no retroactive pay hikes for the 7 months since the previous industrial sector contract expired on March 31, 2020, it can also be interpreted as a 3-year agreement. If we allocate its pay hikes over the entire 3-year period, we get a slowdown to 1.8 per cent yearly, but looking only at the next 29 months the hike is 2.23 per cent. The union side in particular chose to highlight the latter figure, enabling it to argue that the increase was (marginally) higher than the previous 3-year pact, worth 2.17 per cent annually. Negotiations will now begin in other private sectors, but no major divergences from the "industrial sector norm" are expected, since most unions supported the demands of the industrial unions in last autumn's union coordination discussions. But the largest union – the Municipal Workers – chose to follow its own path and has already won slightly higher pay hikes than industrial unions, since certain public sector labour shortages have been further accentuated during the pandemic.

Moderate impact from the pandemic. Regardless of how we calculate annual pay hikes, the pandemic contributed to lower figures. But it is also clear that the two sides have followed their tradition of not letting the current national mood entirely colour the outcome of their negotiations. Employers also seem to have been prepared to pay a bit extra to ensure a longer-running agreement. Today, actual hourly pay increases depend on how we define working hours, as long as the "short-time lay-off" system lasts. The National Accounts (Nationalräkenskaper, NR) wage concept is based on actual hours worked, while the statistics series known as Konjunkturlönestatistiken (KL) is based on planned or contractual hours. As the table shows, differences between these definitions are sizeable. We believe the KL metric is more relevant for assessing underlying trends. Well into the future, pay hikes will be lower than what is compatible with the Riksbank's 2 per cent target. Over time, 3.5 per cent yearly hikes are viewed as consistent with the target, but given recent weaker productivity growth, the level may now be lower.

Forecasts of wage and salary increases
Year-on-year percentage change

	2019	2020	2021	2022
Riksbank, KL, Sep	2.6	1.7	2.3	2.7
NIER, KL, Sep	2.6	1.9	2.2	2.5
SEB KL	2.6	1.7	2.4	2.5
Riksbank, NR, Sep	3.9	4.3	0.4	2.5
NIER, NR, Sep	3.9	5.2	-0.8	2.4

Source: Statistics Sweden, Riksbank, National Institute of Economic Research (NIER), SEB

In its latest Monetary Policy Report, the Riksbank said it is not considering key interest cuts in the near term, but added that "the repo rate can also be cut if this is assessed to be an effective measure, particularly if confidence in the inflation target were to be threatened." Since effectiveness and confidence in the inflation target can both be linked in various ways to wage formation, there is reason to look more closely at the relationship between monetary policy and wage formation. Stylising a bit, we can distinguish a few periods ("regimes") that have dominated relations between the Riksbank and the two labour market sides in recent decades.

Regime 1: Riksbank admonitions on "responsibly" low pay hikes. For years, the Riksbank maintained a high profile in trying to influence wage formation. When the macroeconomic framework featuring floating exchange rates and inflation targets was introduced in the 1990s, it was vital to establish the credibility of the inflation target so the rate of pay increases could slow after decades of high levels. Despite a weak labour market, the first wage round under the new framework resulted in pay increases in the range of 5-6 per cent. This experience soon led to a reform, the 1997 "Industry Agreement", which has subsequently had a major influence on wage formation. Yet up until 2010-2011, the Riksbank – albeit with varying intensity – actively tried to admonish the employer organisations and unions not to agree on excessively high pay hikes.

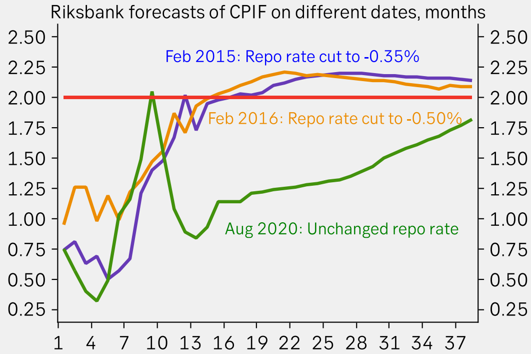
Regime 2: Employers and unions criticise the Riksbank for neglecting its inflation target. During 2012-2014 the relationship between the Riksbank and these organisations changed significantly. After the key rate hikes of 2010-2011, the krona appreciated sharply, which contributed to falling inflation. During 2012-2014 CPIF inflation (CPI excluding interest rate changes) averaged around 1 per cent. The Riksbank justified its half-hearted efforts to push up inflation by saying, for example, that it wanted to slow the upturn in home prices and household debts. Aside from low actual inflation, this "lean against the wind" policy also contributed to falling inflation expectations. In this situation, employers and unions concurred in their sharp criticism that the Riksbank's lack of interest in meeting its inflation target made it impossible to use the target as an "anchor" for wage formation.

Regime 3: Criticism of the Riksbank for exaggerated eagerness to reach the inflation target. Criticism by employers and unions around 2014 coincides with the government's decision to give the Financial Supervisory Authority (FSA) the main responsibility for macroprudential oversight, which decreased the legitimacy of the Riksbank's "leaning against the wind". This also contributed to the Riksbank's shift towards a full commitment to pushing up inflation, which began with a 50 basis point repo rate cut in July 2014. After this, the inflation expectations of the two sides moved higher, but they needed a long time to become convinced. Ahead of the current wage round, the union side was prepared to again embrace the inflation target as an anchor, but the employers stated with increasing clarity that they fundamentally viewed inflation targeting policy as inappropriate. In 2018 and 2019, business sector representatives often criticised the Riksbank for trying too dogmatically to achieve the inflation target. This included criticism about ignoring such negative side effects as exchange rate volatility and the bargain prices of Swedish assets.

New problems with low inflation expectations. It is not so strange that the Riksbank has now published a price and wage forecast in which it confesses that achieving its inflation target within 2-3 years (see chart below) will be difficult. If the central bank had acted differently, it would have exposed itself to criticism for making unrealistic forecasts and perhaps also for indirectly trying to influence the wage round. Now the risk is instead that inflation expectations will sink further below from the 2 per cent target, again putting us in a "regime 2" situation with employer organisations and unions blaming the Riksbank for not taking its own target seriously. Leading economists on the employer side have already opined that not even the Riksbank itself seems to believe that its inflation target can be fulfilled.

Greater tolerance for divergence from target?

Riksbank forecasts of CPIF on different dates, months



Source: Riksbank, Macrobond, SEB

Honesty seems to have its price. Understanding that the Riksbank's more realistic price and wage forecasts can have such consequences is likely to influence its Executive Board's future guidance. The reason the Riksbank now wants to avoid cutting the repo rate to below zero seems to be that it is taking negative side effects more seriously, including the consequences of a weak krona. It also sees further rate cuts as especially ineffective in a situation where pandemic-related restrictions are hampering economic activity. But if inflation expectations fall, the Riksbank will face pressure from different sources. For example, one can argue that real interest rates will be pushed up from two directions when the Riksbank keeps interest rates higher than necessary at the same time as inflation expectations are drifting downward. Once pandemic-related restrictions are relaxed, one can argue even more forcefully that an unnecessarily high real interest rate will hamper growth – something mainstream academics are likely to emphasise.

What can the Riksbank do to maintain inflation expectations? The Riksbank has a lot to gain by not closing the door to negative interest rates. Instead, there are reasons for signalling a slightly "exaggerated" probability of negative rates, even the central bank would actually rather not deliver them. Increased asset purchases (QE) are one way to keep up monetary stimulus, although this also has negative side effects, and bond shortages will soon emerge. Expanded QE may be a signal to political leaders that they can count on low interest rates provided that fiscal policy makers assume the main responsibility for stimulus in the recovery phase.

Inspiration from the US. The Federal Reserve has been given greater flexibility to allow inflation to exceed its target for a period, as compensation for earlier shortfalls. This has contributed to rising inflation expectations. In slightly looser terms, the Riksbank has also signalled acceptance of a period of above-target inflation for the same reason. Yet it is still doubtful whether this type of not-so-binding commitment is really enough to keep inflation expectations up. Looking ahead, it is conceivable that the Riksbank can design formal principles for symmetrical target fulfilment over time. But it should be recalled that not long ago, a parliamentary commission of inquiry on the Riksbank proposed restricting the central bank's freedom of action.

A strong krona may be a problem in the long run. The employer and employee sides have generally agreed not to let short-term currency fluctuations affect the room for pay increases. During 2012-2014 ("regime 2"), however, it was clear that they perceived EUR/SEK exchange rates of well below 9 as a problematic side effect of the Riksbank's "lean against the wind" strategy. Since 2014, the EUR/SEK equilibrium exchange rate has moved upward somewhat, so the pain threshold is probably higher than before. But from today's levels of around 10.25, we probably still have a long way to go before the strength of the krona is perceived as problematic. In our latest "SEK Views" in October, we presented a scenario in which the EUR/SEK rate drops to 9.65. In this situation, CPIF would end up well below the Riksbank's forecast, mainly staying under 1 per cent until the end of 2022. In such a scenario, the Riksbank would probably lower the repo rate to negative levels.

Is more at stake in Sweden than elsewhere? To summarise, the COVID-19 crisis combined with long-term collective bargaining contracts including relatively low pay hikes have caused the Riksbank to change its strategy. The bank now admits that it will take a long time to reach the inflation target and seems ready to show greater tolerance for low inflation in the prevailing environment. The behaviour of the employers and unions will determine the Riksbank's manoeuvring room. If their long-term inflation expectations are allowed to shift further from the 2 per cent target, this will strengthen the employers' view that the target has become irrelevant in principle. But as long as Swedish public opinion strongly rejects joining the euro area, it is hard to see a reasonable alternative. This implies that there is perhaps more at stake in Sweden than elsewhere, although the Riksbank is far from alone in fighting troublingly low inflation.

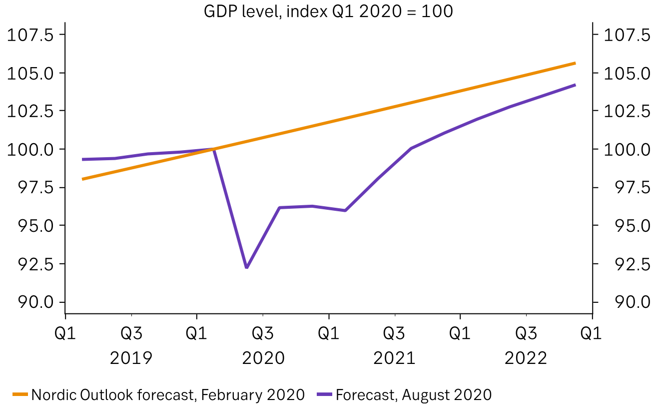
Sweden

Strong recovery faces new obstacles

After a strong third quarter of 2020, the recovery will lose momentum for the next six months as restrictions are re-imposed. This will mainly affect next year's GDP growth, which we are revising down to 2.7 per cent. Further fiscal stimulus and the removal of restrictions will speed up growth again by mid-2021, but GDP will remain below trend at year-end 2022. Low pay hikes will contribute to below-target inflation. The Riksbank will expand its QE programmes but keep the repo rate at zero.

GDP still below trend at year-end 2022

GDP level, index Q1 2020 = 100



Source: Statistics Sweden, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.3	-3.1	2.7	4.4
Unemployment*	6.8	8.5	9.1	8.0
Wages and salaries	2.5	1.7	2.4	2.5
CPIF (CPI excl. Interest rate change)	1.7	0.4	1.1	1.4
Net lending**	0.5	-3.5	-3.3	-2.0
General government debt**	35.1	39.5	41.0	40.0
Repo rate, %***	0.00	0.00	0.00	0.00
EUR/SEK***	10.51	10.20	9.85	9.70

*% of labour force **% of GDP ***At year-end. Source: Statistics Sweden, SEB

A record-sized GDP decline during Q2 2020 was followed by an unexpectedly large recovery during the summer. We believe the full-year 2020 GDP decline will be limited to 3.1 per cent: a significant downturn but still only half what we forecast in May, when the situation seemed at its darkest. In recent weeks, we have seen signs that the recovery has lost momentum. Increased COVID-19 spread both in Sweden and elsewhere will contribute to a GDP decline in Q4 2020 and sharply curtail growth early in 2021. This is one reason why we have adjusted our full-year 2021 forecast from 4.2 per cent to 2.7 per cent. However, we have raised our growth projection for 2022 by 1.3 points to 4.4 per cent. Unemployment stabilised this summer, but will climb again in the coming six months and is expected to peak at 9.7in February. This upturn is less than in our earlier forecasts, but at year-end 2022 the jobless rate will be 7.6 per cent: roughly 0.5 points higher than before the outbreak.

Rapid rebound for manufacturing

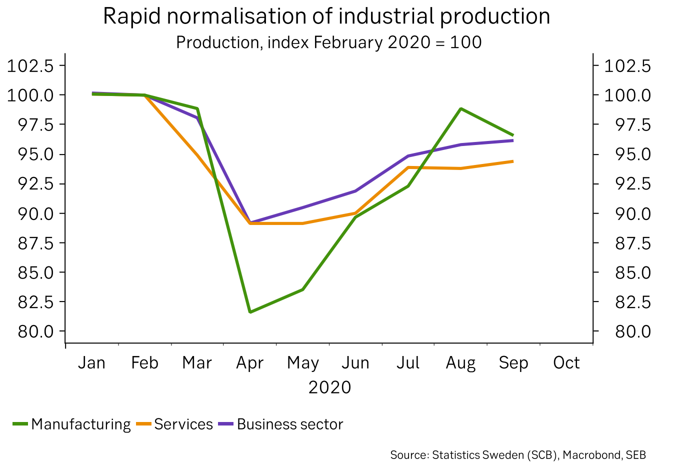
Sweden's recovery in Q3 was broad-based, but manufacturing provided the biggest surprise. Both exports and industrial production regained nearly their entire spring decline, and short-term indicators have so far held firm against service sector weakness. Ongoing economic deceleration in other countries will contribute to a slight decline in industrial production, but the tendency of pandemic-related restrictions to affect services more severely than manufacturing will persist. Households and businesses are being prevented from consuming many services, thus contributing to higher goods consumption. This is reflected in rapid recovery for retail sales and car registrations in many countries, diverging completely from normal cyclical patterns in which households mainly decrease purchases of cars and other durable goods as unemployment rises. There are many indications that manufacturing will remain relatively strong as the recovery broadens during the second half of 2021, but in the near term there are risks that manufacturing will be indirectly hurt by weaknesses in other sectors, for example via lower capital spending needs. German manufacturing recovery has been weak, raising another question mark. Total merchandise exports will fall by only 3.0 per cent in 2020, then climb by 3.0 per cent in 2021 and 5.7 per cent in 2022. Due to a large service export decline, overall exports will fall by 4.5 per cent this year. In 2021 and 2022, overall exports will grow faster than merchandise exports as service exports recover.

Residential construction will prop up investments. Capital spending fell by nearly five per cent in Q2, mainly driven by a sharp drop in machinery investments. Rapid recovery in manufacturing suggests that much of this downturn is temporary, and we expect a relatively fast recovery over the next few quarters. Residential investments stabilised late in 2019 after a decline that began early in 2018. Strong demand for housing has contributed to resilience in construction during the COVID-19 crisis, and a turnaround in the number of housing starts suggests that residential investments will now gradually accelerate. Public sector investments are also showing signs of speeding up again after decelerating in 2019. Yet total construction investments will stay relatively weak throughout our forecast period, since construction of commercial properties is decreasing due to demand problems in the service sector. Overall, capital spending will shrink by 3.0 per cent this year but will rebound by 4.0 per cent in 2021 and by 5.0 per cent in 2022.

Mixed outlook for household consumption

Household consumption fell by about 10 per cent during the first half of 2020, including a sharp 8 per cent decline in Q2. This downturn has no historical parallels in modern times; the largest previous decline in a single quarter was just over 2 per cent in early

1983. Year-on-year, the 5 per cent drop during the 1992-1993 krona crisis was the previous record. A number of factors will determine how quickly consumption recovers. The current second wave of COVID-19 infections will derail the recovery for restaurants, hotels and travel services due to new recommendations from the Public Health Agency of Sweden and generally more cautious households. The outlook for other kinds of consumption is relatively good, but retailers are also likely to be hit by certain restrictions. Household purchasing power will fall this year by nearly 1 per cent, but mainly due to lower stock market dividends. Low inflation, tax cuts and higher subsidies including more generous unemployment benefits will help prop up incomes.

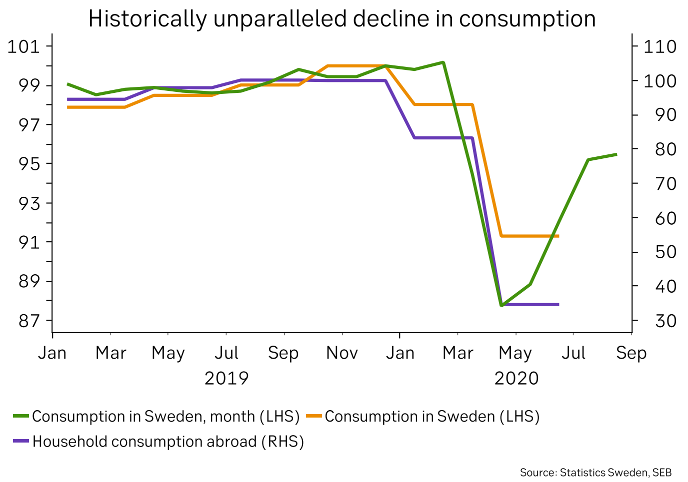


Household incomes and savings ratio

Year-on-year percentage change

	2019	2020	2021	2022
Real disposable income	3.4	-0.8	3.8	2.6
Private consumption	1.2	-3.5	2.5	3.6
Savings ratio, per cent of income	16.4	16.4	17.6	17.3

Source: Statistics Sweden, SEB



A surge in purchasing power during 2021 and 2022. It is reasonable to assume that the decline in stock dividends will be reversed in 2021 and 2022, contributing about 3 per cent yearly to the increase in purchasing power. One important factor for consumption will be to what extent households offset lower spending for restriction-affected services with increased spending for goods and services that are still available. For example, this applies to international travel, which accounted for nearly 7 per cent of total consumption in 2019 and fell by 65 per cent in the first half of 2020. Fully booked Swedish ski resorts this coming winter suggest that households have a strong desire to change their consumption habits, but generous trip cancellation rules make it especially uncertain to what extent these plans will materialise. Strong retail sales and a relatively healthy recovery for new car registrations also suggest a strong desire to replace some types of consumption with other types. Further ahead, once the pandemic has come under control there are many indications that household consumption patterns will normalise and that Swedish tourism abroad and foreign tourist visits to Sweden will revert to pre-crisis levels. It is more doubtful whether business travel will return to previous routines, now that businesses have created new channels for communicating with their customers and suppliers. Corporate services account for one third of sales in the hotel and restaurant business and half of all air travel. There is thus a major risk that part of the large downturn in these sectors will be permanent.

Home prices will continue to climb. Home prices have been more resilient than expected. In 2020 the price increase will be nearly 10 per cent: the strongest upturn since 2016. This trend is being driven primarily by surging prices for single-family houses. Rising unemployment will probably help cool the upturn this autumn and some months into 2021, but we do not believe this effect will be enough to push down home prices. We thus expect price increases in the 0-5 per cent range both in 2021 and 2022, which will also help sustain an upturn in residential construction, with recent weaknesses mainly being driven by fewer tenant-owned units.

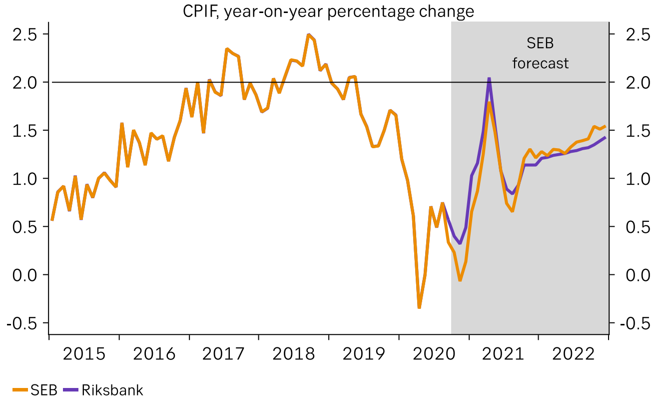
Higher unemployment this winter

Like growth, the labour market has shown less weakness than expected. After a rapid upturn last spring, unemployment has stabilised during the past 3-4 months. In September, employment was 2.5 per cent lower than at the beginning of the year. Short-term indicators have greatly improved but still suggest that employment will stabilise this autumn. New restrictions suggest new weakness, however, and we expect a downturn of more than another one per cent in the next 3-6 months. The wage subsidy scheme introduced last spring has been utilised less than expected, but in September it still covered more than 100,000 people (equivalent to 2-2.5 per cent of total employment). The scheme will probably be extended until mid-2021, but businesses affected by permanently weaker demand are still likely to increase their lay-offs of employees now receiving such subsidies. We expect unemployment to climb more than 0.5 points this winter before gradually falling again as the recovery gains renewed strength in the second half of 2021.

Lasting low inflation. The recently signed collective agreement between industrial employers and unions suggests that the rate of pay increases will decelerate, contributing to continued troublingly low inflation in the opinion of the Riksbank (see theme article, page 35). Inflation has nevertheless bounced back somewhat, after having been negative during the spring. The upturn is mainly due to rising energy prices, while CPIF excluding energy has shown great volatility. The September figure of 0.9 per cent, for example, was the lowest since 2014. Large price declines for travel and hotel services, for instance – many of which are likely to be temporary – have contributed to the downturn, but underlying inflation pressure is also low. Aside from a deceleration in pay increases, stronger krona exchange rates and lower food prices have helped hold down inflation. During spring 2021, we expect CPIF inflation to climb significantly due to base effects, temporarily reaching 2.0 per cent. But after that, it will fall sharply and bottom out at 0.8 per cent next September. CPIF will then remain well below the Riksbank's two per cent inflation target and reach 1.5 per cent at the end of 2022.

Below-target inflation

CPIF, year-on-year percentage change

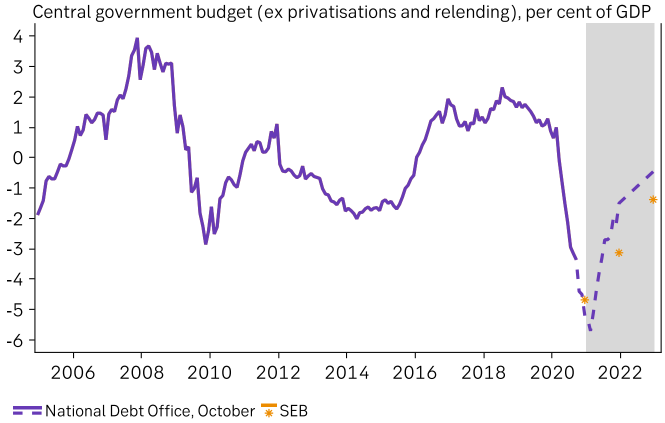


Source: Riksbank, Macrobond, SEB

The Riksbank will avoid cutting its repo rate as long as possible, but there are no limits to QE

Better than feared but still large deficits

Central government budget (ex privatisations and relending), per cent of GDP



Source: National Debt Office, SEB

Great pressure for new Riksbank actions

At its July policy meeting, the Riksbank decided to extend its quantitative easing (QE) asset purchases until the end of June 2021 and increase their volume to SEK 500 billion. At the September meeting, the central bank announced no new actions but its Executive Board emphasised that it is prepared to do more if the situation deteriorates and that the door to key interest rate cuts is open. The reasons why the Riksbank is not lowering its repo rate below zero, despite low inflation and depressed resource utilisation, are not entirely transparent and seem to vary between Board members. One reason appears to be that the Riksbank has re-assessed the advantages and disadvantages of a weak krona. In addition, because of the Riksbank's swelling balance sheet, the banking sector would be harder pressed than previously by negative interest rates, making it more difficult to avoid negative interest rates on household bank accounts this time around. The minutes of the September meeting and recent speeches do not indicate that the Riksbank is moving closer to a repo rate cut, and we still believe that an expanded balance sheet via QE is the most likely action in order to achieve a more expansionary policy. We expect the QE programme to be expanded by another SEK 100 billion and to be extended until the end of 2021 at the Riksbank's meeting in late November. In addition, the Riksbank will continue to reinvest all maturing bonds. In our assessment, the likelihood of a rate cut is somewhat higher than the market is now pricing in, but unless the krona strengthens sharply our main scenario is that the repo rate will remain at zero throughout our forecast period. The probability of a rate hike in the foreseeable future is very low. The Board has made it clear that the Riksbank is prepared to let inflation exceed its target during a period without needing to hike the repo rate. Looking further ahead, the Riksbank may possibly follow the example of the US Federal Reserve and more clearly formulate how it can compensate for an earlier bias towards below-target inflation.

Lower deficit than expected, but more stimulus is likely. Despite large stimulus programmes, public finances have surprised on the upside. This is partly because GDP has fallen less than anticipated, which has kept tax revenues up. In addition, relief measures like wage subsidies and "reorientation support" to offset company revenue losses have been utilised less than budgeted. In its October forecast, the National Debt Office lowered its projection of the government's borrowing requirement to SEK 256 billion, compared to over SEK 400 billion in its May forecast. Even with stimulus measures totalling more than SEK 100 billion in the 2021 budget, public sector debt looks set to remain low, both historically and in an international perspective. This allows room for further programmes, and we believe the government will add SEK 50-70 billion worth of stimulus during the next six months. The budget for the election year 2022 is also likely to include lots of new programmes, though not as generous as those for 2021. Since the stimulus impulse is defined as a change in structural saving from one year to another, ever stronger doses are constantly needed for measures to be recorded as expansionary, which is difficult to deliver in light of everything that was done in 2020. Fiscal policy will thus formally look rather neutral in 2021 and a bit contractive in 2022. Meanwhile we believe that households have built up buffers by saving more this year. Once the economy reverts to greater normality, they will have room to release some of these reserves, which may be interpreted as a delayed fiscal stimulus. Despite stimulus, deficits will fall to 3.3 per cent of GDP in 2021 and 2.0 per cent in 2022. Public sector debt will climb this year and next, but fall to 40 per cent of GDP in 2022.

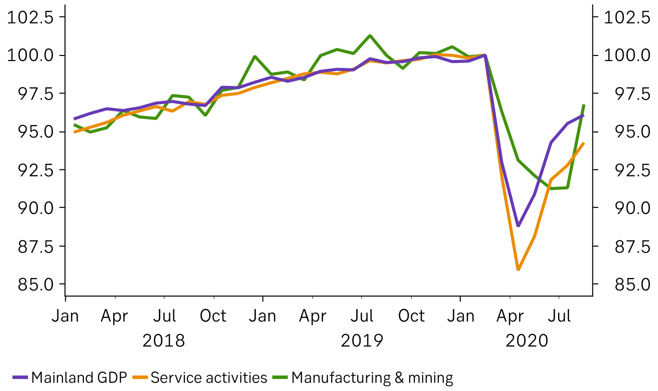
Norway

Recovery led by household demand

The economic recovery has unfolded largely as expected, led by strong household demand. Downside risks have nonetheless increased due to a resurgence in COVID-19 infections, resulting in new restrictions in Norway and globally. This will slow the recovery in the service sector and labour market. Fiscal policy will remain expansionary to support the economic recovery. Despite rising home prices and high inflation, Norges Bank is expected to stay put at 0 per cent until mid-2022.

The mainland economy has not yet fully recovered

Index 100 = Feb 2020



Source: Statistics Norway, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.2	-1.9	3.0	3.5
Mainland GDP	2.3	-3.4	3.3	3.2
LFS unemployment*	3.7	4.7	4.4	4.1
Annual wage and salary increases	3.5	1.9	2.5	2.7
CPI-ATE inflation	2.2	3.0	2.1	1.8
Key interest rate, %	1.50	0.00	0.00	0.25
EUR/NOK**	9.84	10.80	10.25	9.95

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

Recovery on track, but downside risks linger

Following a 11.2 per cent cumulative decline in February to April, mainland GDP growth has subsequently recovered to 3.9 per cent below its pre-pandemic level. The economic recovery started earlier and has been stronger than initially assumed, driven by a revival in domestic demand – especially private consumption. This is reflected in strong contributions to mainland GDP growth from the service sector following the relaxation of supply-side restrictions. This development was behind the relatively large upward revision to our growth projections in September's *Nordic Outlook*. National accounts data since then have been broadly as expected, with sequential growth in mainland GDP falling 6.3 per cent in Q2. The third quarter data will be published on November 12, but monthly data indicate a solid quarterly rebound of nearly 5 per cent.

Growth momentum will slow towards the end of the year and into 2021. In late October and early November, the government implemented new national containment measures aimed at restricting social contacts in private and public areas. Even stricter measures and partial closures have been imposed in major cities with high infection rates. The trend in infections has become alarming, but the government wants to try and avoid a total lockdown similar to that experienced in March. So far the restrictions are not extensive enough to trigger a halt in economic activity, though it will prolong the recovery in the private service sector, which accounts for almost 40 per cent of overall GDP and employment. Combined with new lockdowns elsewhere in Europe, downside risks to growth have increased. We have nudged our forecast marginally lower. We expect mainland GDP to fall by 3.4 per cent in 2020, followed by a 3.3 per cent increase in 2021. Although growth will have recovered from its fall since February by the end of 2021, mainland GDP will remain below its pre-pandemic trend throughout our forecast period. Total GDP will fall by 1.9 and rebound by 3.0 per cent in 2020 and 2021, respectively.

Fiscal policy will remain expansionary next year. The government has shown a strong willingness to support the economy during the COVID-19 crisis. Its budget proposal for 2021 indicates that the government aims to actively use fiscal policy to stimulate demand during the recovery. Following a 4.5 percentage point contribution to mainland GDP in 2020, the government estimates a coronavirus-adjusted fiscal impulse of 1.0 point in 2021. Due to lower-than-expected costs of various relief schemes, spending of petroleum revenues in relation to the Government Pension Fund Global has been revised downward to 3.9 per cent in 2020 and is expected to be in line with the 3.0 per cent fiscal policy rule in 2021.

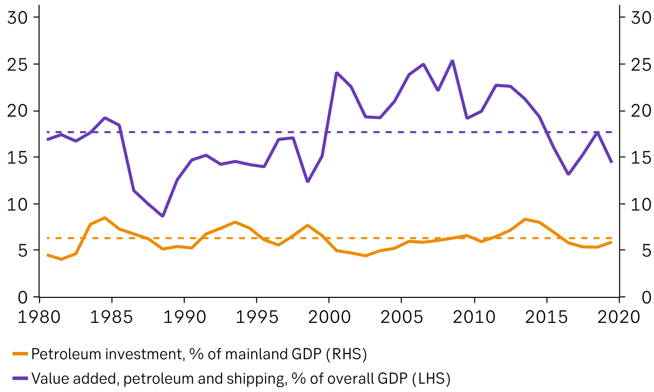
New lockdowns and oil weigh on manufacturing

While the service sector recovery appears to be taking its time, momentum in the manufacturing sector has picked up. The recovery has been driven by consumer and intermediate goods. The latter segment has benefited from the recovery among Norway's trading partners, but lockdowns in the euro area will add downside risk to foreign demand ahead. This should contribute to a somewhat slower rebound in shipments of traditional goods of near 2.0 per cent in 2021 and 4.0 per cent in 2022. We expect the contribution to mainland GDP from net trade to turn negative from next year.

There is still a large split in manufacturing where producers of capital and petroleum-related goods are struggling. Sentiment remains depressed and companies are reporting a decline in new orders in both domestic and export markets. This is related to the bleak outlook for petroleum investment, since the completion of several major projects and a thin backlog are limiting activity. Lower oil prices will weigh further on capital spending, but the fiscal support package implemented in May will encourage operators to implement some capacity expansions and new development projects. The capital spending outlook is thus better than initially feared, and the downturn is expected to be less severe than in the 2014-2015 oil shock. We forecast a cumulative decline of 11.5 per cent during 2020-2022, which is both shorter and smaller than the 32 per cent fall during 2014-2017. Moreover, both value added and employment in the sector are lower today, suggesting less severe negative secondary effects to the mainland economy. Mainland business investment is, however, expected to fall both this year and next. Capacity utilisation is well below normal, and large uncertainty surrounding the economic recovery is weighing on companies' investment intentions. Our forecast implies a cumulative negative contribution from gross fixed capital spending to GDP of 1.7 percentage points in 2020-2021.

A less oil-dependent economy

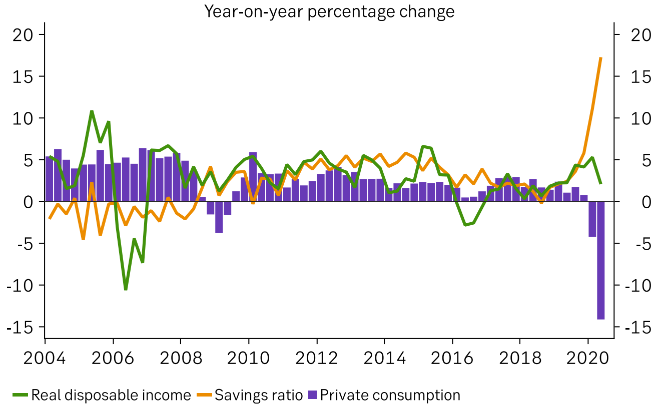
Per cent of mainland GDP and overall GDP



Source: Statistics Norway, Macrobond, SEB

Household savings and consumption

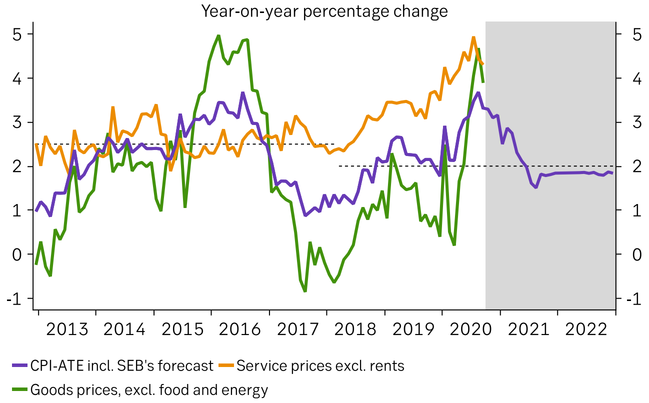
Year-on-year percentage change



Source: Statistics Norway, Macrobond, SEB

CPI-ATE inflation below target in 2021

Year-on-year percentage change



Source: Statistics Norway, Macrobond, SEB

Strong household demand

Record-low mortgage rates and increased jobless benefits, combined with travel restrictions, have powered household consumption of goods. Such spending has increased by 5.2 per cent since February, but overall private consumption has been dragged lower by a 12.7 per cent decline in spending on services. The latter has been recovering since May, but new supply-side restrictions are likely to slow the recovery ahead. The downtrend in registered unemployment is so far intact, driven by a decline in furloughs, while the regular jobless rate has been steady at 4.7 per cent over the past six months. New restrictions and considerable economic uncertainty will halt the downturn ahead, and unemployment is projected to remain above its pre-pandemic level in the next couple of years. Record-high household savings, reaching 17.3 per cent of disposable income excluding dividends in Q2, should limit the risk to consumption. We forecast that private consumption will fall by 7.9 in 2020 and rebound by 7.3 per cent in 2021. Strong household demand is also visible in record-high existing home sales. A favourable supply-demand balance has supported home prices, which are up 3.9 per cent so far this year compared to the same period of 2019. We forecast an annual increase in existing home prices of 4.4 per cent in 2020 and 6.2 per cent in 2021, which should stimulate a rebound in residential investment from next year.

Puzzlingly high inflation in services

After rising to 3.7 per cent in August, the highest level since CPI-ATE (CPI excluding taxes and energy) was introduced in 2003, the inflation rate fell to 3.2 per cent in September. High inflation on imported goods is the most important driver behind the upturn, but the exchange rate will contribute to goods prices falling sharply in 2021. Inflation in services has also risen significantly over the past two years in a way that deviates from historical patterns. Unusually large price increases for administrative services such as health care are a partial explanation, but the acceleration is relative broad-based. Moreover, service prices as measured in CPI-ATE were given an extra boost by a VAT reduction on certain services last spring which was not fully passed on to actual prices. Some temporary driving forces in combination with moderate wage pressure suggest a broader decline in service inflation, but uncertainty about what has been driving the upturn lends unusually high uncertainty to the inflation forecast for the next few years. We continue to expect CPI-ATE inflation to fall below target in the second half of 2021. Our forecast is roughly in line with Norge Bank's latest assessment. The sharp fall in electricity prices has resulted in CPI rising at a much slower pace this year than underlying inflation, but futures prices indicate that this should turn around in 2021-2022.

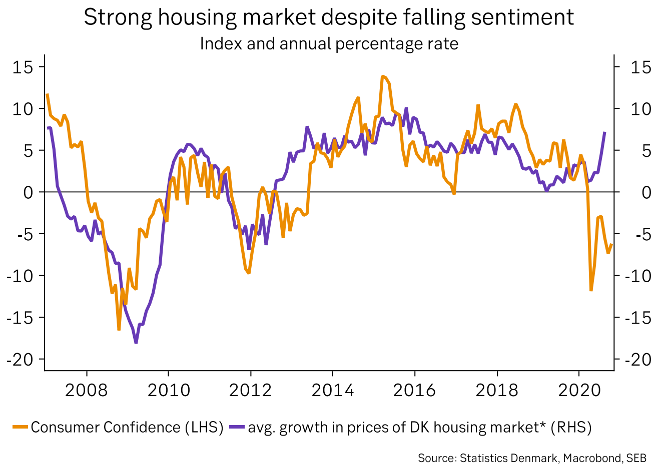
High economic uncertainty puts Norges Bank on hold

Norges Bank has kept its key interest rate steady at zero per cent since May. Though the central bank has not fully ruled out negative rates, a severe economic setback and renewed financial market turmoil would be needed for it to consider such action. A rate hike also appears distant. Norges Bank has stated that "The sharp economic downturn and considerable uncertainty surrounding the outlook suggest that the policy rate should be kept on hold until there are clear signs that economic conditions are normalizing". This also implies that uncertainty must recede before Norges Bank assigns greater weight to financial imbalances in its rate-setting equation. Increased downside risks stemming from rising infections and new restrictions in Norway and among trading partners also call for a cautious approach. We forecast a first rate hike in autumn 2022, implying a key rate of 0.25 per cent by year-end 2022.

Denmark

Constrained growth

Weighing the impact from the latest virus restrictions against the faster-than-expected rebound of the Danish economy, we are raising our year-on-year GDP forecast for 2020 to -4.2 per cent, while downgrading our 2021 estimate to 4.3 per cent. In the current situation, we expect Danmarks Nationalbank to follow suit if the ECB cuts its key interest rate.



Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.8	-4.2	4.3	3.5
CPI	0.8	0,4	0,9	1,3
Wages and salaries	2.0	1.7	2.0	2.8
Public sector fiscal balance*	3.7	-1.0	0.0	1.0
Public sector debt*	33.0	40.0	38.0	35.0
Current account	8.9	8.0	7.5	7.0
Key interest rate (CD rate), %	-0.75	-0.6	-0.6	-0.6
EUR/DKK**	7.47	7.45	7.45	7.45

* % of GDP ** End of year. Source: Statistics Denmark, DØRS, SEB

A faster-than-expected rebound, but the near-term outlook is challenging. Since the latest release, there have been upward revisions to annual GDP as well as the current account and public sector balances. GDP growth for 2019 now stands at 2.8 percent, up from 2.3 per cent. The Danish economy continued to rebound faster than expected during the third quarter, which in isolation would have justified a significant upward revision in our Danish GDP growth forecast. However, the second wave of virus outbreaks in Europe and the latest series of lockdowns have created strong headwinds for Q4 growth, also in Denmark. Most recently, a close to full lockdown has been announced in parts of Northern Jutland due to a new virus strain found on mink farms. This is complicated from an economic perspective, concerning only a small part of the country, contributing under 10 per cent to GDP. We expect Q4 GDP growth to be reduced by 0.5-1.0 per cent. Thus, our GDP forecast for 2020 has only been raised modestly to a decline of 4.2 per cent, followed by a 4.3 per cent increase in 2021.

Strong consumption has driven the rebound. Since the last *Nordic Outlook* in September, macroeconomic indicators have generally been favourable – suggesting that reopening was proceeding faster than we had expected. Home prices have rebounded, and unemployment declined marginally during Q3, while retail sales soared, perhaps in anticipation of the planned disbursement of frozen vacation funds in October. Consumer confidence remains subdued, with expectations about the national economy depressed, while households still seem to view their own financial situation as positive. Unemployment now appears likely to peak well below the highest level during the global financial crisis, at somewhere around 7.0 per cent. This will provide a platform for private consumption to lead the recovery in 2021. Wage inflation is nonetheless slowing and is likely to remain below 2.0 per cent next year.

Tightening restrictions at least until year-end. The main downside risk to the forecast remains the virus outbreak, with over 1,000 new COVID-19 cases per day, the highest ever. But in a European context, the magnitude of the outbreak in Denmark remains relatively limited. Our take is that like last spring, the Danish government has been quick to react to the pandemic and therefore ultimately may end up imposing fewer intrusive measures. So far, the government has lowered the maximum number of people at social gatherings from 50 to 10 and tightened rules regarding PPE. However, restaurants, shops, cinemas and theatres are still allowed to remain open. Compared with the lockdowns in continental Europe, this should have a significantly smaller GDP impact.

Overfunding of needed financing continues. The budget deficit is likely to be substantially smaller than the government had anticipated. Actual deficits in the past 6 months have consistently been running below budget, and the government appears to have overfunded its financing requirement. This could change with the onset of the second virus wave, which would force the government to provide more relief measures. However, generally speaking, Denmark's public sector finances remain strong in an international comparison. Even with additional support for the economy in 2021, we expect gross debt to peak around 40 per cent of GDP.

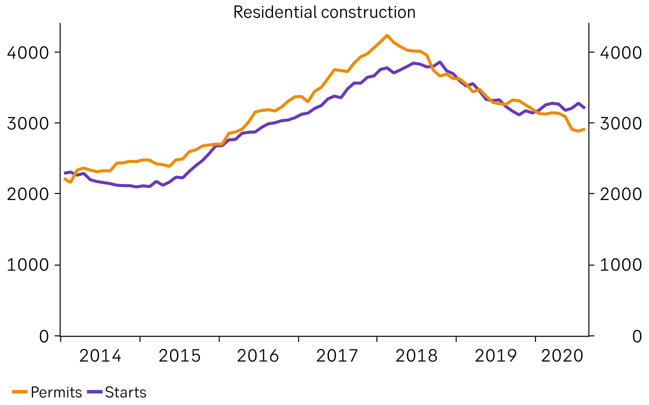
Upward pressure on the krone in 2021. The Danish krone has strengthened versus the euro, following the same pattern as in 2008, when a global sell-off initially forced Danmarks Nationalbank (DNB) to hike interest rates, but the krone subsequently became a safe haven. We do not expect a unilateral Danish rate cut, but the current situation suggests that the DNB will follow the example of the European Central Bank (ECB) if it cuts the key rate in December. Looking ahead to 2021, upward pressure on the krone could open for a unilateral rate cut by the DNB.

Finland

Running out of steam?

So far the Finnish economy has been able to withstand the curse of the coronavirus, but forward-looking indicators hint that these days may be over. Thanks to earlier resilience, this year's GDP decline will be limited to 4.0 per cent. However, the subsequent recovery will be hampered by structural weaknesses. In 2021 we expect the Finnish economy to grow by a modest 2.8 per cent, followed by 2.5 per cent in 2022.

Real estate sector has been slowing already for a while



Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.1	-4.0	2.8	2.5
Private consumption	0.8	-4.6	3.5	2.3
Exports	7.7	-11.0	5.5	4.0
Unemployment*	6.7	8.4	8.8	8.0
Wages and salaries	2.2	1.7	1.8	1.8
HICP inflation	1.1	0.4	1.2	1.5
Public sector fiscal balance**	-1.1	-7.5	-4.5	-3.0
Public sector debt**	59.4	70.2	72.0	73.0

* % of labour force ** % of GDP. Source: Eurostat, SEB

Is resilience about to end? With one of the smallest GDP declines in Q2, Finland showed surprising resilience to the COVID-19 crisis. Now the economy seems to be showing the same resilience against recovery. After an initial rebound, sentiment indicators have taken a turn downward. This will soon be reflected in real economic data. Furthermore, the outlook is dampened by long-term issues: in 2019, productivity was still at the 2007 level and the working-age population is shrinking. The only EU country to have a higher old age dependency ratio in 2019 was Italy. Addressing such problems is complex and time-consuming, putting a cap on potential growth. For the time being the crucial question is of course if new restrictions can be avoided. While new infections have been kept under control so far, in the past the Finnish government has shown little hesitation in taking the necessary steps to prevent avoidable deaths.

The economic impact of the COVID-19 crisis is barely noticeable in Finnish industrial output data. While during Q2 industrial production dropped by 20 per cent in the euro area, in Finland the decline was limited to just 5 per cent. The manufacturing sector has continued to operate at around 95 per cent of 2019 volume. But while manufacturing sector sentiment and new orders have quickly improved in other countries, in Finland these leading indicators remain deeply pessimistic. Such growing difficulties are also expressed in prices. The decline in the export price index has intensified, showing a 7 per cent year-on-year drop in September. The trade downturn will be further amplified by the importance of services in Finnish exports. A recovery in 2021 looks more and more unlikely. We expect exports to fall by 11 per cent in 2020, then rebound by 5.5 per cent in 2021 and 4 per cent in 2022.

Broad-based deflationary pressure. Deflationary pressure has not been limited to export and producer prices. After gaining some speed in July, inflation has once again decelerated and in August and September it reached only 0.2 per cent. Even the rise in fuel taxes has been unable to offset the impact of low energy prices. Prices have also been adjusted downward in many sectors hit by pandemic-related restrictions, making entertainment, eating out and clothing cheaper. These trends will persist and inflation will remain far below 2 per cent in 2021 and 2022 as well.

Shopping spree for goods. Lower prices and reduced consumption of services has triggered quite a shopping spree. Retail sales rose by more than 5 per cent during the summer. The loss of foreign tourism is not a major concern for the economy, since the share of tourism in GDP has been estimated at only around 2-3 per cent. The problems are more pronounced in the transport sector, and many carriers have lost most of their revenue. Private consumption will rebound by 3.5 per cent in 2021 and 2.3 per cent in 2022.

The investment downturn will be further intensified by COVID-19. The downturn already started in 2019. The construction market has been in a declining trend since 2018 and falling home prices will give developers a further reason to postpone construction plans. On the positive side, there still seems to be demand for credit in the business sector, raising hopes of a continuation in investment plans.

The labour market situation is fragile. Unemployment has remained at 8.4 per cent since May, but the autumn has revealed a number of planned lay-offs and furloughs. A disquieting fact is that in addition to obvious problem areas such as aviation, cuts will hit large exporting sectors such as paper manufacturing and the machine industry. We expect average unemployment to peak in 2021 at 8.8 per cent and decline to 8 per cent in 2022.

The 2021 budget will be expansionary but more moderate than in many countries. This will help to limit the growth of public sector debt, which is expected to reach 73 per cent of GDP by 2022.

The Baltics

Lithuania

Lithuania's GDP downturn will be milder than in the other Baltic countries, although new restrictions will now have an impact. High consumer confidence and an unexpected rebound in wage and salary growth ensure that consumption will lead the recovery.

Page 46

Latvia

Despite somewhat lighter restrictions, the 2020 GDP decline will be larger in Latvia than in neighbouring countries. Stimulus programmes were modest but still managed to slow the upturn in unemployment. We expect an export-led recovery.

Page 47

Estonia

Due to low infection levels, 2020 GDP will fall less than the EU average. Consumption will be a key driving force ahead, benefiting from a controversial pension reform and fiscal stimulus, but public sector debt will still remain at a low 25 per cent of GDP.

Page 48

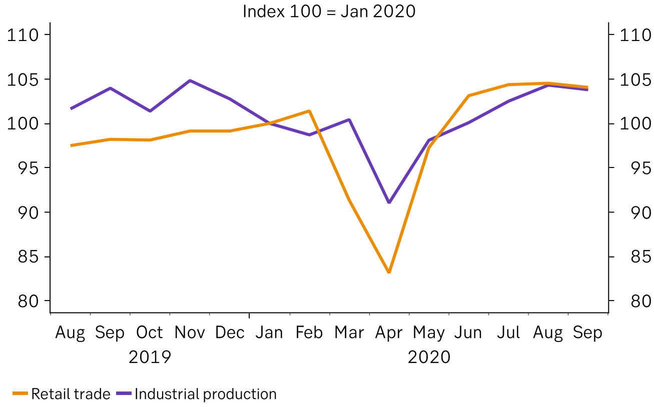
Lithuania

Positive surprises are starting to fade

The economic rebound was strong in the third quarter. However, the resurgence of COVID-19 cases and reintroduction of restrictions started hurting the recovery in early November. The labour market weathered the first wave better than expected, but unemployment will rise in the next few months. Private consumption is also expected to be weaker in Q4 2020. Renewed fiscal relief measures are expected to be more selective.

Back to pre-pandemic levels in Q3 2020

Index 100 = Jan 2020



Source: Statistics Lithuania, Eurostat, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	4.3	-1.5	3.0	3.3
Private consumption	3.3	-2.0	4.0	3.1
Exports	9.5	-2.6	4.6	2.9
Unemployment*	6.3	8.7	8.3	7.5
Wages and salaries	8.8	7.0	4.5	6.0
HICP inflation	2.2	1.1	2.0	2.4
Public sector fiscal balance**	0.3	-7.9	-4.5	-2.2
Public sector debt**	35.9	47.4	49.9	48.7

* % of labour force ** % of GDP. Source: Eurostat, SEB

Lithuania's GDP was down only by 0.8 per cent in the first nine months. Not only did the economy enter the third quarter with a smaller loss in activity than in other EU countries, but it also rebounded strongly. The epidemiological situation eased, and most restrictions were lifted early in the summer. Together with significant fiscal stimulus measures, this contributed positively to the solid recovery in private consumption. Manufacturing also returned rapidly to its pre-pandemic level.

New restrictions, new setbacks. We doubt that the economy will escape a setback late in 2020, since new COVID-19 cases have forced restrictions to be re-introduced. We only marginally downgrade GDP growth forecast for this year from -1.3 to -1.5 per cent. We see an increasing risk that Q1 2021 might be weak, too, but since we were conservative with our earlier 2021 GDP forecast, we are making only minor changes in our projections – we expect GDP growth of 3.0 and 3.3 per cent in 2021 and 2022, respectively. Those forecasts are based on the assumption that Belarus will not stop its cargo flow through Lithuania and there will not be restrictions on trade between countries.

The labour market has sent ambiguous signals in recent months. Registered unemployment jumped from 9.4 per cent in February to 14.6 per cent at the end of October. However, the number of employed individuals has been rebounding and is back at close to the pre-pandemic level. The number of short-hour employees remained insignificant in October. Such changes largely confirm our assumption that the main reason behind the increase in registered unemployment is the newly introduced monthly job-seeker allowance, which caused people to register as unemployed even though they do not plan to look for a job. Registered unemployment will peak in Q1 2021, and we are still forecasting 8.3 and 7.5 per cent average unemployment in 2021 and 2022, respectively.

Average wages and salaries recovered surprisingly fast in Q3 2020, forcing us to revise our growth forecast upward to 7 per cent in 2020. Pay in the public sectors increased twice as fast as in the private sector, but in 2021 we expect pay hikes to decelerate to 4.5 per cent, since minimum monthly wage and salaries in the public sector are planned to rise at a much slower pace than in 2020.

The residential real estate market was back at pre-pandemic levels by early autumn. A recovery in consumer confidence and a stabilisation in household incomes provided support to the real estate market. Meanwhile companies remained cautious about restoring their pace of investments. The government stepped in by launching its Plan for the DNA of the Future Economy, which will increase public investments in both infrastructure and human capital during 2021. Overall, we forecast that capital spending will rise by 5.5 per cent next year, after a 7.3 per cent decline in 2020.

Inflation is in line with expectations. Both headline and core inflation ticked up slightly in the third quarter on higher prices of services. HICP inflation is likely to average around 2 per cent in 2021 and accelerate to 2.4 per cent in 2022.

The government's fiscal policy response was supportive, but the costs were high – the budget deficit will reach about 7.9 per cent of GDP in 2020. Not all stimulus measures were effective, and some of them were more closely related to the two-round October elections than to the need to compensate losses from COVID-19. The Homeland Union, a traditional centre-right party, won the parliamentary elections and is forming a government in coalition with two liberal parties. We believe that the new government will not hurry to reduce the budget deficit, which will be about 4.5 per cent of GDP next year. Public sector debt will unavoidably go up next year, approaching 50 per cent of GDP.

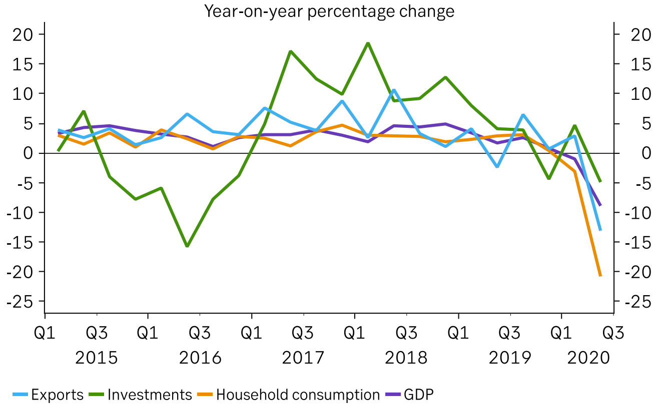
Latvia

Recovery will stall

Latvia's economy had a solid rebound in the third quarter. As the number of new COVID-19 cases increases, the recovery is likely to stall over the next six months. Continued fiscal and monetary relief measures, as well as selective use of restrictions, will prop up the economy. That said, we expect GDP to shrink by 4.6 per cent this year and resume growth by 4.3 per cent in 2021. Despite a resilient labour market, unemployment will peak at 9.5 per cent before turning lower.

GDP by expenditure approach

Year-on-year percentage change



Source: Statistics Latvia, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.2	-4.6	4.3	3.5
Private consumption	3.0	-10.1	5.7	3.5
Exports	1.9	-5.2	3.5	4.0
Unemployment*	6.3	8.8	8.9	7.5
Wages and salaries	7.2	4.3	4.7	4.7
HICP inflation	2.8	0.3	1.9	2.3
Public sector fiscal balance**	-0.6	-8.8	-5.0	-3.7
Public sector debt**	36.9	48.8	51.5	52.5

* % of labour force ** % of GDP. Source: Statistics Latvia, SEB

Less restrictive, but larger drop. Even though COVID-related restrictions in Latvia were somewhat looser than elsewhere in the Baltic region, the country's GDP decline turned out the deepest. In the second quarter, Latvian GDP fell by 8.9 per cent with hospitality and food service (-63.4 per cent) and arts and entertainment (-46.3 per cent) being hit the hardest. This was followed by transport and storage (-26.6 per cent). In other sectors, the decline was below 10 per cent and there were no major surprises, except for the weak performance of the information and communications technology or ICT sector (-6.4 per cent). Economic sentiment recovered from 77.7 to 94.3 between April and September but fell again by 2 points in October. Confidence dropped slightly in industry, construction and services, but in retail remained unchanged. The resurgence in COVID-19 cases suggests that sentiment will weaken further. We expect GDP to fall by 4.6 per cent this year before recovering by 4.3 per cent in 2021. More sustained growth will resume in the second quarter of next year. The main risk to our forecasts is a possible uncontrolled virus outbreak and an ineffective fiscal response. Government should pre-emptively launch a new set of relief measures, making them more selective and targeted.

Consumption will remain weak. The 20.9 per cent drop in household consumption was mainly due to declining consumption opportunities and less generous state aid, as well as household prudence and a very modest downtime support. While the September retail sales were up 5.9 per cent year-on-year, overall consumer spending will only recover gradually and may not reach the levels seen at the end of last year until 2022.

Stimulus for capital spending will be crucial. Capital spending fell by 6.1 per cent in Q2. Our SME survey shows no critical trend towards withdrawal of business investments, but we see uncertainty will weigh on capital spending. In the next couple of years, investments and construction will be propped up by the EU Recovery Fund and the Rail Baltica project, but in the short term the release of EU funds may lag, and the government should increase its capital spending.

The recovery in manufacturing and exports will slow. In September, the manufacturing sector was down 0.6 per cent year-on-year. As more countries begin to tighten their COVID-related restrictions, manufacturing is likely to face new headwinds. Since such measures mainly affect the service sector, their impact on manufacturing should be limited. Strong retail growth and stimulus programmes will create the conditions for a slow recovery in manufacturing. In August, merchandise exports fell by only 3.7 per cent, dashing hopes for a fast recovery. We expect further growth in exports of electrical appliances and equipment, machinery, mechanical appliances and furniture. We expect a gradual recovery in wood product exports to boost export volume, since the sector provides a fifth of all exports.

Low inflation this year. In September, HICP inflation fell by 0.4 per cent year-on-year, significantly dampened by lower energy prices, but this effect will gradually wane. Inflationary pressure primarily stems from services, as the recent downturn has merely slowed wage and salary growth. Inflation will reach 0.3 per cent this year before picking up to around 2 per cent next year.

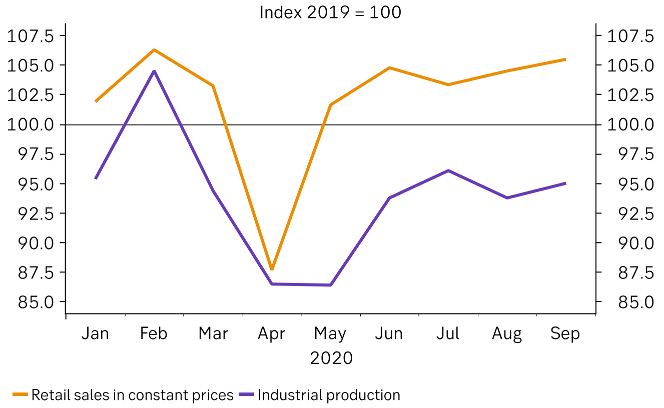
Frugal but effective support to the labour market. Although the government's fiscal stimulus package was quite frugal, it was relatively effective in dampening rising unemployment. From early March to late July, registered unemployment rose from 6.3 per cent to 8.6 per cent. It fell to 7.5 per cent by end of October, but we still expect it to reach about 9.5 per cent before turning lower next year.

Estonia

An invisible recession

Due to lower incidence of COVID-19, so far Estonia has fared better than most other EU countries. In 2020 the decline in GDP will be limited to 3.8 per cent. This of course means that a rebound in 2021 and 2022 will be less impressive than in countries more severely hit by the crisis. We now expect the economy to expand by 3.3 per cent in 2021 and 3.5 per cent in 2022. The key driver of growth will be private consumption, boosted by fiscal stimulus and a controversial pension reform.

Strong retail sales, but industry is still lagging



Source: Statistics Estonia, Eurostat, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	5.0	-3.8	3.3	3.5
Private consumption	3.3	-3.4	3.9	3.2
Exports	6.2	-9.2	4.0	5.0
Unemployment*	4.7	7.2	8.5	6.8
Wages and salaries	7.4	1.7	2.1	4.5
HICP inflation	2.4	-0.6	1.8	2.3
Public sector fiscal balance**	-0.3	-6.5	-4.0	-2.5
Public sector debt**	8.4	21.6	23.2	25.0

*% of labour force **% of GDP. Source: Eurostat, SEB

A relatively mild GDP decline. Although GDP will fall by 3.8 per cent this year, the COVID-19 crisis has in many ways been an invisible recession. During the global financial crisis GDP fell by 19 per cent, home prices plunged by 45 per cent and unemployment peaked at 20 per cent. This time the labour market situation has remained under control, and in many parts of the economy it is hard to detect any signs of a downturn. A relatively low incidence of COVID-19 has helped, but a lot of economic pain has been avoided due to euro area membership, enabling Estonia to benefit from monetary policy intended for economies in much worse shape. The end of the year could bring new restrictions, but they are highly unlikely to be as severe as in densely populated Western Europe.

The retail trade weathered the crises best of major sectors. A large decline in sales was recorded only in April, after which a steady growth has continued. Data on consumption of services is scarcer, but the low spread of the virus and relaxed restrictions have left the part of the service sector catering to domestic clients relatively unharmed. In the tourism sector the situation is worse, but outside Tallinn increased internal tourism has helped to offset much of the losses. In 2021 household consumption will get a boost from a real-life behavioural economics experiment: in September 2021 a controversial pension reform takes effect, enabling people to withdraw money from the 2nd pension pillar. Even if the actual share of people doing so will be small, the total assets in 2nd pillar funds already exceed EUR 5 billion, almost a fifth of GDP. Thus we expect private consumption to be the main driver of growth in 2021 and 2022, increasing 3.9 per cent and 3.2 per cent respectively.

Manufacturing is one of the biggest concerns. The economy relies heavily on exports, which were not doing so great even before the pandemic. Yet in September, the industrial output was just 2 per cent lower than a year ago, while sector's economic sentiment returned to its pre-crisis level. Some caution is still needed, since the recovery of Estonia's largest trading partner Finland has stalled. This could hurt further growth. After a 9 per cent drop in 2020, exports should rise by 4 and 5 per cent in 2021 and 2022.

Low capital spending will be the most serious issue for the economy in the next couple of years. Corporate borrowing remains depressed and despite initial hopes, public construction investments will decrease in 2021 and 2022 compared to 2020. While in Q3 a record number of new construction permits for residential buildings were issued, it remains unclear how much of these will actually be commenced. Sentiment in the construction sector remains depressed, at least for now. We forecast that capital spending will drop by 10 per cent this year, followed by only a moderate recovery of 3 per cent in 2021.

The labour market has stabilised after reaching peak unemployment in May. A worse trend was avoided due to initial government wage subsidies, but after the programme ended in June the labour market has seemed able to cope on its own. Further redundancies remain likely, especially in the tourism sector, but they will mainly affect the capital Tallinn, which still has a number of service sector jobs on offer. Of course the situation remains fragile, as the low coronavirus incidence will probably not last. Average unemployment will rise from this year's 7.2 per cent to 8.5 per cent in 2021, before dropping below 7 per cent in 2022.

The highest budget deficit among the Baltics. According to the 2021 budget, Estonia's deficit will be the highest among the Baltic countries, reaching 6.5 per cent of GDP. New debt will mostly be used to finance ongoing costs such as pension increases rather than capital spending. Deficits will persist during our forecast horizon, increasing public sector debt to 25 per cent of GDP in 2022.

Global key indicators

Yearly change in per cent

	2019	2020	2021	2022
GDP OECD	1.6	-5.7	3.9	3.4
GDP world (PPP)	2.8	-4.4	5.1	3.9
CPI OECD	2.1	1.2	1.6	1.9
Oil price, Brent (USD/barrel)	64	41.5	55	65

US

Yearly change in per cent

	2019 level, USD bn	2019	2020	2021	2022
Gross domestic product	21,433	2.2	-4.0	3.6	3.8
Private consumption	14,545	2.4	-4.3	4.3	3.9
Public consumption	2,995	1.8	0.4	0.3	2.0
Gross fixed investment	4,455	2.4	-2.2	2.6	3.2
Stock building (change as % of GDP)	49	0.0	-0.7	0.5	0.0
Exports	2,515	-0.1	-12.2	9.2	5.3
Imports	3,125	1.1	-9.6	9.7	3.2
Unemployment (%)		3.7	8.3	6.7	5.2
Consumer prices		1.8	1.3	1.9	1.9
Core CPI		2.2	1.8	2.0	1.8
Household savings ratio (%)		7.9	15.5	10.5	8.0
Public sector financial balance, % of GDP		-6.3	-19	-10	-7
Public sector debt, % of GDP		108.7	131.0	136.0	138.0

Euro area

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	11,935	1.3	-7.6	4.0	4.3
Private consumption	6,223	1.3	-9.0	4.5	4.0
Public consumption	2,369	1.9	0.5	2.0	1.0
Gross fixed investment	2,431	5.8	-12.0	5.5	5.5
Stock building (change as % of GDP)	0	-0.5	0.0	0.1	0.1
Exports	5,576	2.5	-9.6	9.2	6.0
Imports	5,108	3.9	-9.8	10.0	5.0
Unemployment (%)		7.6	8.0	9.9	8.8
Consumer prices		1.2	0.3	0.8	1.2
Core CPI		1.0	0.7	0.8	1.0
Household savings ratio (%)		13.2	20.1	17.0	15.0
Public sector financial balance, % of GDP		-0.6	-8.9	-6.5	-4.7
Public sector debt, % of GDP		84.0	102.4	103.3	103.3

Other large countries

Yearly change in per cent

	2019	2020	2021	2022
GDP				
United Kingdom	1.5	-11.5	4.7	6.6
Japan	0.7	-5.8	2.4	0.7
Germany	0.6	-6.2	3.2	4.2
France	1.5	-9.5	5.6	4.4
Italy	0.3	-9.1	5.1	4.0
China	6.1	2.0	8.0	5.6
India	4.9	-9.0	8.6	4.0
Brazil	1.1	-6.0	3.0	2.5
Russia	1.3	-4.5	3.7	2.5
Poland	4.1	-4.0	4.5	3.0
Inflation				
United Kingdom	1.8	0.8	1.8	1.6
Japan	0.5	0.2	0.1	0.5
Germany	1.5	0.5	1.4	1.3
France	1.3	0.5	1	1.5
Italy	1.1	0.0	0.7	0.8
China	2.9	2.5	1.6	2.0
India	3.7	5.8	4.9	4.5
Brazil	3.7	2.4	3.0	3.5
Russia	4.5	3.2	4.1	3.5
Poland	2.3	3.3	2.4	2.5
Unemployment (%)				
United Kingdom	3.8	4.5	6.1	5.4
Japan	2.4	3.4	2.9	2.7
Germany	3.2	4.2	4.3	4.1
France	8.3	9.8	10.2	9.0
Italy	9.9	10.0	11.5	11.0

Financial forecasts

Official interest rates		05-Nov	Dec-20	Jun-21	Dec-21	Jun-22	Dec-22
US	Fed funds	0.25	0.25	0.25	0.25	0.25	0.25
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Euro area	Refi rate	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.10	0.10	0.10	0.10	0.10	0.10
Bond yields							
US	10 years	0.79	0.80	0.90	1.10	1.15	1.20
Japan	10 years	0.02	0.05	0.05	0.05	0.10	0.10
Germany	10 years	-0.66	-0.60	-0.60	-0.50	-0.45	-0.40
United Kingdom	10 years	0.23	0.25	0.20	0.30	0.35	0.40
Exchange rate							
USD/JPY		104	104	102	100	99	98
EUR/USD		1.18	1.20	1.23	1.25	1.27	1.28
EUR/JPY		123	125	125	125	126	125
EUR/GBP		0.90	0.90	0.88	0.87	0.86	0.85
GBP/USD		1.31	1.33	1.40	1.44	1.48	1.51

Sweden

Yearly change in per cent

	2019 level, SEK bn	2019	2020	2021	2022
Gross domestic product	5,026	1.3	-3.1	2.7	4.4
Gross domestic product, working day adjustment		1.3	-3.4	2.6	4.4
Private consumption	2,227	1.3	-3.5	2.5	3.6
Public consumption	1,307	0.1	0.1	1.2	0.8
Gross fixed investment	1,263	-1.0	-3.0	4.0	5.0
Stock building (change as % of GDP)	36	-0.1	-0.8	0.5	0.3
Exports	2,385	3.3	-4.5	4.0	6.1
Imports	2,192	1.1	-5.0	5.0	4.3

Unemployment, (%)	6.8	8.5	9.1	8.0
Employment	0.6	-1.7	-0.6	1.7
Industrial production	1.0	-5.6	6.0	4.5
CPI	1.8	0.5	1.1	1.4
CPIF	1.7	0.4	1.1	1.4
Hourly wage increases	2.5	1.7	2.4	2.5
Household savings ratio (%)	16.1	16.4	17.6	17.3
Real disposable income	3.4	-0.8	3.8	2.6
Current account, % of GDP	4.2	6.0	5.0	4.5
Central government borrowing, SEK bn	-112	230	160	75
Public sector financial balance, % of GDP	0..4	-3.5	-3.3	-2.0
Public sector debt, % of GDP	35.2	39.5	41.0	40.0

Financial forecasts	05-Nov	Dec-20	Jun-21	Dec-21	Jun-22	Dec-22
Repo rate	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate, STIBOR	-0.08	-0.10	0.00	-0.10	0.00	-0.10
10-year bond yield	-0.10	-0.10	-0.15	-0.05	0.00	0.05
10-year spread to Germany, bps	56	50	45	45	45	45
USD/SEK	8.69	8.50	8.09	7.88	7.68	7.58
EUR/SEK	10.28	10.20	9.95	9.85	9.75	9.70
KIX	115.0	113.9	111.2	110.2	109.0	108.6

Finland

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	241	1.1	-4.0	2.8	2.5
Private consumption	126	0.8	-4.6	3.5	2.3
Public consumption	55	1.1	1.4	1.5	1.0
Gross fixed investment	57	-1.0	-3.7	3.0	4.0
Stock building (change as % of GDP)	1	0.3	0.3	0.1	0.0
Exports	97	7.7	-11.0	5.5	4.0
Imports	96	3.3	-8.3	5.0	3.5

Unemployment, OECD harmonised (%)	6.7	8.4	8.8	8.0
CPI, harmonised	1.1	0.4	1.2	1.5
Hourly wage increases	2.2	1.7	1.8	1.8
Current account, % of GDP	-0.5	-1.4	-1.2	-1.2
Public sector financial balance, % of GDP	-1.1	-7.5	-4.5	-3.0
Public sector debt, % of GDP	59.4	70.2	72.0	73.0

Norway

Yearly change in per cent

	2019 level, NOK bn	2019	2020	2021	2022
Gross domestic product	3,376	1.2	-1.9	3.0	3.5
Gross domestic product (Mainland)	2,920	2.3	-3.4	3.3	3.2
Private consumption	1,522	1.5	-7.9	7.3	4.2
Public consumption	816	1.7	2.0	1.5	1.5
Gross fixed investment	883	6.1	-5.5	-1.5	2.2
Stock building (change as % of GDP)		-0.3	0.0	0.0	0.0
Exports	1,212	1.5	-2.3	4.6	3.3
Imports	1,160	5.2	-9.9	5.7	1.4
Unemployment (%)		3.7	4.7	4.4	4.1
CPI		2.2	1.4	2.7	2.2
CPI-ATE		2.2	3.0	2.1	1.8
Annual wage increases		3.5	1.9	2.5	2.7

Financial forecasts	05-Nov	Dec-20	Jun-21	Dec-21	Jun-22	Dec-22
Deposit rate	0.00	0.00	0.00	0.00	0.00	0.25
10-year bond yield	0.70	0.70	0.70	0.75	0.80	0.85
10-year spread to Germany, bps	136	130	130	125	125	125
USD/NOK	9.16	9.00	8.50	8.20	7.99	7.77
EUR/NOK	10.83	10.80	10.45	10.25	10.15	9.95

Denmark

Yearly change in per cent

	2019 level, DKK bn	2019	2020	2021	2022
Gross domestic product	2,335	2.8	-4.2	4.3	3.5
Private consumption	1,061	1.4	-4.4	4.5	3.7
Public consumption	557	1.2	0.4	2.4	0.8
Gross fixed investment	513	3.1	-3.5	5.0	5.9
Stock building (change as % of GDP)		-0.3	0.0	0.0	0.0
Exports	1,362	5.1	-10.1	9.7	4.8
Imports	1,190	2.5	-7.3	9.0	4.8
Unemployment, OECD harmonised (%)		5.2	7.0	6.5	5.5
CPI, harmonised		0.8	0.4	0.9	1.3
Hourly wage increases		2.0	1.7	2.0	2.8
Current account, % of GDP		8.9	8.0	7.5	7.0
Public sector financial balance, % of GDP		3.7	-1.0	0.0	1.0
Public sector debt, % of GDP		33.0	40.0	38.0	35.0

Financial forecasts	05-Nov	Dec-20	Jun-21	Dec-21	Jun-22	Dec-22
Deposit rate	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60
10-year bond yield	-0.52	-0.49	-0.50	-0.40	-0.35	-0.30
10-year spread to Germany, bps	14	11	10	10	10	10
USD/DKK	6.30	6.21	6.06	5.96	5.87	5.82
EUR/DKK	7.45	7.45	7.45	7.45	7.45	7.45

Lithuania

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	49	4.3	-1.5	3.0	3.3
Private consumption	29	3.3	-2.0	4.0	3.1
Public consumption	8	0.1	0.4	0.3	0.5
Gross fixed investment	10	7.4	-7.3	5.5	6.0
Exports	38	9.5	-2.6	4.6	2.9
Imports	35	6.3	-4.4	5.8	3.2
Unemployment (%)		6.3	8.7	8.3	7.5
Consumer prices		2.2	1.1	2.0	2.4
Public sector financial balance, % of GDP		0.3	-7.9	-4.5	-2.2
Public sector debt, % of GDP		35.9	47.4	49.9	48.7

Latvia

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	30	2.2	-4.6	4.3	3.5
Private consumption	18	3.0	-10.1	5.7	3.5
Public consumption	6	2.6	2.4	3.5	2.9
Gross fixed investment	7	3.1	-3.2	4.5	4.0
Exports	18	1.9	-5.2	3.5	4.0
Imports	18	2.3	-6.0	2.3	4.5
Unemployment (%)		6.3	8.8	8.9	7.5
Consumer prices		2.8	0.3	1.9	2.3
Public sector financial balance, % of GDP		-0.6	-8.8	-5.0	-3.7
Public sector debt, % of GDP		36.9	48.8	51.5	52.5

Estonia

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	28	5.0	-3.8	3.3	3.5
Private consumption	14	3.3	-3.4	3.9	3.2
Public consumption	6	3.0	2.6	2.2	2.0
Gross fixed investment	7	11.0	-10.2	3.0	5.0
Exports	20	6.2	-9.2	4.0	5.0
Imports	19	3.7	-12.1	4.5	5.0
Unemployment (%)		4.7	7.2	8.5	6.8
Consumer prices		2.4	-0.6	1.8	2.3
Public sector financial balance, % of GDP		-0.3	-6.5	-4.0	-2.5
Public sector debt, % of GDP		8.4	21.6	23.2	25.0

Research contacts

Robert Bergqvist
Chief Economist
+ 46 8 506 230 16

Håkan Frisén
Head of Economic Forecasting
+ 46 8 763 80 67

Daniel Bergvall
The euro area
+46 8 506 231 18

Erica Dalstø
SEB Oslo
Norway
+47 2282 7277

Ann Enshagen Lavebrink
+ 46 8 763 80 77

Lina Fransson
Government bond markets
+46 8 506 232 02

Dainis Gaspuitis
SEB Riga
Latvia
+371 67779994

Johan Hagbarth
The stock market
+46 8 763 69 58

Per Hammarlund
Theme: The EM economies
+46 8 506 231 77

Carl Hammer
The FX market
Theme: Future of the USD
+46 8 506 231 28

Olle Holmgren
Sweden
+46 8 763 80 79

Johan Javeus
Theme: Working from home
+46 8 506 230 19

Elisabet Kopelman
The United States
+ 46 8 506 230 91

Elizabeth Mathiesen
SEB Copenhagen
Denmark
+ 45 285 517 47

Mihkel Nestor
SEB Tallinn
Estonia, Finland
+372 6655172

Tadas Povilauskas
SEB Vilnius
Lithuania
+370 68646476

Thomas Thygesen
SEB Copenhagen
Denmark
+45 33 28 10 08

Marcus Widén
Euro area,
Sweden,
United Kingdom
+46 8 506 380 06

This report was published on November 10, 2020
Cut-off date for calculations and forecasts was November 05, 2020

SEB is a leading Nordic financial services group with a strong belief that entrepreneurial minds and innovative companies are key in creating a better world. SEB takes a long-term perspective and supports its customers in good times and bad. In Sweden and the Baltic countries, SEB offers financial advice and a wide range of financial services. In Denmark, Finland, Norway, Germany and the United Kingdom, the bank's operations have a strong focus on corporate and investment banking based on a full-service offering to corporate and institutional clients. The international nature of SEB's business is reflected in its presence in some 20 countries worldwide. At 30 September 2020, the Group's total assets amounted to SEK 3,201bn while its assets under management totalled SEK 2,054bn. The Group has around 15,000 employees.

Macroeconomic assessments are provided by our SEB Macro & FICC Research unit. Based on current conditions, official policies and the long-term performance of the financial market, the Bank presents its views on the economic situation – locally, regionally and globally.

One of the key publications from the SEB Macro & FICC Research unit is the quarterly Nordic Outlook, which presents analyses covering the economic situation in the world as well as Europe and Sweden.

Read more about SEB at sebgroup.com.