Corona hits the Nordics and Baltics

- Limited effects on growth and labour markets so far but with a continued and broadened spread of the virus the economic consequences will be large.
- GDP growth expected to be 0.4-1.0 percentage points lower in the Nordics and Baltics in 2020

The uncertainty regarding the economic development ahead is exceptionally high. Just up until recently, the consensus view among economist on corona’s economic consequences was that of a V-scenario, i.e. a marked but temporary downturn. This now appears increasingly as a pious hope. More likely now is a U-scenario, which would mean that the decline phase will be more extended but temporary. However, it cannot be ruled out that the virus could have lasting negative effects, for example by leading to permanently reduced international trade.

Below we estimate the effects of the covid-19 (corona) virus on the Nordic and Baltic economies. These are based on the OECD’s global scenarios that were published on March 2, 2020. The OECD’s main scenario means that global GDP will be 0.5 percent lower this year as a result of corona. This scenario is based on relatively optimistic assumptions, including that further spread of infection will be limited. The scenario can thus almost be seen as a description of what has already happened.

In an alternative scenario, more severe but also more likely, the spread of infection is assumed to include Europe and the United States to a greater extent, which means that the economic consequences are greater. In this scenario, they estimate that global GDP growth in 2020 will be halved, from about 3.0 percent to 1.5 percent.

**Effect of corona on GDP growth 2020**

GDP-growth (%) from Swedbank’s January forecast and corona effects to Nordics & Baltics by OECD global scenarios

<table>
<thead>
<tr>
<th>Country</th>
<th>Swedbank, January 2020</th>
<th>Optimistic scenario</th>
<th>More likely scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>1.2</td>
<td>-0.2 p.p.</td>
<td>-0.8 p.p.</td>
</tr>
<tr>
<td>Norway</td>
<td>1.7</td>
<td>-0.2 p.p.</td>
<td>-0.7 p.p.</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.4</td>
<td>-0.2 p.p.</td>
<td>-0.4 p.p.</td>
</tr>
<tr>
<td>Finland</td>
<td>1.1</td>
<td>-0.2 p.p.</td>
<td>-0.5 p.p.</td>
</tr>
<tr>
<td>Estonia</td>
<td>2.4</td>
<td>-0.3 p.p.</td>
<td>-1.0 p.p.</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.2</td>
<td>-0.3 p.p.</td>
<td>-1.0 p.p.</td>
</tr>
<tr>
<td>Lithuania</td>
<td>2.6</td>
<td>-0.3 p.p.</td>
<td>-1.0 p.p.</td>
</tr>
</tbody>
</table>

Note: The scenarios are done using Moody’s Analytics global macroeconomic model. As a starting point Swedbank Economic Outlook (SEO) January 2020 and OECD scenarios for global growth from March 2020 are used. See [http://www.oecd.org/economic-outlook/](http://www.oecd.org/economic-outlook/). A complete set of forecasts will be presented in the next SEO 21st of April 2020.

Sources: OECD, Moody’s Analytics and Swedbank.

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Assumptions about the ECB and the Fed
In the optimistic scenario, the European Central Bank (ECB) is neither expected to lower the already low key interest rate nor to increase ongoing bond purchases. However, more targeted measures cannot be ruled out, for example, companies that end up in liquidity difficulties are supported by preferential loans (TLTRO) through the banks. However, the US Fed is expected to continue to lower interest rates in the near future. In addition to the recent rate cut of 50 basis points, two further reductions of 25 basis points are expected in March and April respectively to 0.50-0.75 percent.

In the severe scenario, the Fed is expected to lower its key rate two more times, combined with 100 basis points down to 0.00-0.25 percent. The ECB implements targeted measures to support companies that end up in liquidity difficulties through conditional and favourable loans to the banks (TLTRO). However, the ECB in this scenario also avoids wider stimulus in the form of reductions in key rates or increased bond purchases.

Limited effects on the Nordic and Baltic countries in the optimistic scenario
In the optimistic scenario, the effects on the Nordic and Baltic countries will be small. GDP growth is projected to decline by 0.2–0.3 percentage points in 2020 compared with the January forecast, and then to recover already the following year. Since the decline is so small, it does not have any significant effects on employment and unemployment. However, some individual industries and companies may suffer worse than others.

In this scenario, the economic-political response from the countries is lacking, that is, both monetary- and fiscal policy are left largely unchanged in the Nordic and Baltic countries.

Noticeable effects if global economy is more significantly affected
In the severe scenario, which means that global GDP growth will be halved by 2020, the effects on the Nordic and Baltic economies, on the other hand, will be noticeable. In this scenario, GDP growth will be between 0.4-0.8 percentage points lower. The somewhat greater effect in Sweden and Norway, than in Denmark and Finland, is explained by a stronger slowdown in exports in these countries.

As the effect on growth is relatively large, the labour markets will also be affected to a greater extent with some delay.

Sweden is the worst affected country. The trend of rising unemployment is expected to be accentuated and the level will reach 7.7 percent next year. This corresponds to 15,000–20,000 more unemployed than projected in our January forecast. The weaker economic trend also temporarily dampens inflationary pressure. In the severe scenario, Swedish inflation drops by 0.3 percentage points, which means that CPIF inflation would fall to about 0.6 percent as the annual average for 2020. This could be a concern for the Riksbank, but our assessment is that the central bank will not make policy changes even in this scenario. After all, the fall in inflation is temporary and the threshold for lowering interest rates or commencing bond purchases is deemed to be high.

Fiscal policy is expected to be somewhat more expansionary. This includes targeted support for vulnerable sectors and increased investment in education and labour market policies to slow the rise in unemployment. We also expect slightly higher government subsidies. However, the challenging parliamentary situation makes it difficult to implement more comprehensive measures.

According to the calculations, the effects on Finland will be somewhat smaller than on Sweden, but in the case of Finland, it should also be noted that there have been very large statistical revisions that have already pushed growth very low. A corona effect of about -0.5 percent would push Finland's economy into a recession. At the same time, the positive employment growth would stop and unemployment turn up

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even more clearly than what has now happened. In the severe scenario, our assessment is that fiscal policy would become somewhat more expansionary.

**Norway** would also be hit hard in this scenario. Lower growth is expected to lead to a marked rise in unemployment. Norges Bank is expected to ease monetary policy with a total of two interest rate cuts during the course of 2020. However, interest rate cuts are expected to come gradually and reactively only when there are clear signs that the economy is slowing down. However, it cannot be ruled out that the response from Norges Bank will be faster and more proactive, like the reductions implemented during the 2011/2012-euro crisis.

**Baltic** countries are likely to be negatively affected by the ongoing spread of the coronavirus through three major channels. First and probably the most important – foreign trade flow disruptions. The effects of this is likely to be biggest on Estonia and Lithuania, as their share of total exports in GDP is larger. Furthermore, Estonia seems to be more vulnerable through the import channel, as 7.3 percent of imported goods are originating in China and two thirds of them are intermediate goods used as manufacturing inputs. Exports to China from Baltic countries make up only around 1 percent of total exports, but the negative effect on exports is likely be indirect, due to weaker demand in the Nordics and other important markets across the EU. Second – tourism, entertainment, accommodation and catering sectors are likely to be negatively affected due to fewer incoming and domestic tourists. Although the number of tourists coming from China was relatively small, only around 1 percent of all incoming tourists, the flows from other countries are also likely to ebb, as people will prefer to (or are told to) stay at home. Here Estonia looks more vulnerable, as it is much more dependent on incoming tourists than the other two Baltic countries. Finally, domestic demand across Baltic countries is likely to be weakened if negative effects from foreign trade and tourism start denting employment and wage growth. Households, fearing the worst, are likely to increase their savings rates and postpone consumption of non-necessities.

Admittedly, some positive side effects are possible in both short and medium term – manufacturers across the EU may be trying to substitute lagging goods from China with locally produced substitutes, creating opportunities for Baltic and Nordic countries.

**Mechanisms that cannot be captured in the model**

The above model estimates are associated with great uncertainty and probably not all factors that can hold back economic development are taken into account. In particular, it is difficult to estimate the effects of the measures now being taken by the authorities, the business community and households to avoid further spread of infection. What are the consequences of cancelled trips and that people become more restrained with socializing?

The scope and time aspect are crucial here. To illustrate this, let's look at Sweden's total annual production value (GDP), which amounts to about SEK 5,000 billion. With around 250 working days, this means that during an average day goods and services are produced to a value of about SEK 20 billion. Thus, if the country stops for 2-4 weeks, this means a temporary reduction in production of about SEK 200-400 billion. This is not today's situation as most things are still rolling as usual. A more reasonable assumption is that production is only 95 per cent in 2-4 weeks. This would mean production reductions of SEK 10-20 billion, which corresponds to 0.2-0.4 percentage points lower growth for the full year 2020.

It is unlikely that such a unique shock to the economy as the corona is completely captured by macro models. The overall effects on the economy are likely to be greater than the direct effects on industry and exports as a result of broken production chains and lower global growth. The model estimates also take into account the indirect effect of generally increased uncertainty, which dampens domestic demand, for example through lower consumption by households and investment from companies, but the extent is difficult to estimate.
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