Research Reports

A world marked by both
setbacks and advances

Nordic Outlook

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SEB

Contents

Setbacks and advances
Still on the right path…

Enormous efforts were made in 2020 both to save lives and to limit negative GDP effects and job losses. Governments and central banks launched relief packages worth nearly USD 21 trillion – equivalent to 24 per cent of global GDP in 2019. Our forecasts are now strongly coloured by the aftermath of the pandemic and crisis responses and their lasting impact on health, economic growth and the political landscape.

Unfortunately 2020 ended on a negative note, with a renewed COVID-19 surge and a wave of lockdowns. The global economy thus faces an uphill struggle in early 2021. The storming of the US Congress on January 6 is also casting long political shadows and uncertainty during our 2021-2022 forecast period.

But there are also quite many bright spots. Global cooperation has made it possible to begin vaccinations. The world has thus taken much-anticipated steps towards sustainably overcoming COVID-19. Meanwhile businesses and households have shown a strong desire to normalise production and consumption patterns. This underlying potential dynamism combined with a reopening of the struggling, labour-intensive service sector – plus continued stimulus measures by the US, the EU and others – will lay the groundwork for a healthy recovery, mainly in 2021 but also in 2022.

The relative strength of the global manufacturing sector, compared to the hard-pressed service sector, reflects the unusual nature of the COVID-19 crisis. It has shifted consumption towards goods and away from services that require face-to-face interaction. The trade recovery has also been helped by the preservation of global value chains. More predictable US trade policies and a Brexit agreement will further reduce uncertainty, enabling trade to contribute to global recovery.

This February 2021 issue of *Nordic Outlook* analyses the continued global consequences of the COVID-19 crisis. Our path forward will include both setbacks and advances, but these will not change its direction. We illustrate this path with four in-depth theme articles:

- Inflation
- Foreign exchange market
- Trade and politics
- The Riksbank

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!

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The global economy

The recovery will take off in the second half of 2021

The United States

A weak start to 2021 will be followed by a roaring new take-off as President Biden's stimulus packages are rolled out. The Fed will keep its key rate at close to zero and continue bond purchases at an unchanged pace this year, while the dollar loses ground.

Page 23

The euro area

The latest COVID-19 wave will lead to a new recession this winter but due to the strength of manufacturing, the downturn will be far milder than last spring. Crisis relief measures and a new EU recovery package will provide support and limit damage to the economy.

Page 30

China

First in and first out of the COVID-19 crisis, China will lead the global recovery. The service sector recovery has caught up with manufacturing, and Chinese exports will benefit as vaccination drives help revive international demand. Despite various challenges, yuan appreciation will continue.

Page 34

The United Kingdom

Widespread COVID-19 infections and the negative effects of the country's divorce from the European Union will lead to sharper GDP declines than elsewhere. The Brexit process will also create increased political polarisation, with different parts of the UK pulling in opposite directions.

Page 33

Global recovery is being delayed by lockdowns due to this winter's COVID-19 surge, but the GDP decline early in 2021 will be milder than last spring. By mid-year, growth will take off as more people are vaccinated. Exceptional stimulus is creating questions about inflation, public sector debt and widening social gaps, but our main scenario is that it will support a balanced upturn amid continued low interest rates and yields and a normalisation of corporate earnings.

The various phases of the COVID-19 pandemic continue to dominate economic and financial developments. Incoming data from late 2020 have mainly surprised on the upside, even though the second wave of lockdowns started as early as the beginning of November. Since then, the spread of the virus has escalated further and led to expanded restrictions. But vaccination roll-outs have now begun in many countries, helping sustain optimism both in sentiment surveys and in financial markets. Although vaccines enable us to see the light at the end of the tunnel, the economic response to the lockdowns in the next few months will be important. Many sectors are hard-pressed. Further official stimulus measures will be needed to limit the number of bankruptcies and redundancies in struggling sectors.

Exceptional stimulus measures obscure our view. One important task of *Nordic Outlook*, February 2021, is to analyse what shape economies will be in once restrictions can be phased out more permanently. Official crisis responses have been so far-reaching that it is rather difficult to distinguish the underlying situation on various issues. What is the actual condition of labour markets in various countries, and how large a debt burden have we imposed on the future once the crisis has faded? Perhaps the most important question is to what extent stimulus measures, especially exceptional monetary expansion, will change the solid low inflation environment of recent decades. Long-term behavioural changes due to the crisis are also of interest. It has been popular to draw far-reaching conclusions that the "post-coronavirus world" will look different. Some sectors will probably suffer prolonged downturns, but we will probably also see big rebounds in many areas due to a strong urge to get back to normal life.

Good potential for a lasting recovery. Our main scenario is that a sustained and balanced recovery will begin late this spring when vaccinations reach wider population groups, while the spread of infections will also be slowed by warmer weather in the northern hemisphere and a higher degree of immunity. The recovery will make its strongest advances during the second half of 2021 but in Europe, GDP growth measured as an annual average will nevertheless be higher in 2022. Most indications are that over the next few years, expansion can occur without general bottleneck problems on the supply side of the economy. Although there are already signs that companies are finding it hard to find the right employees in some sectors, for example in the United States, this is a rather narrow phenomenon and is probably largely driven by the fact that the restrictions themselves hamper labour mobility. Public sector debt is rising sharply in many countries, especially the US. Yet as long as the central banks are prepared to help, we see no risks that major austerity measures will be needed in the next few years. Now that Joe Biden has finally moved into the White House, the political risk level is also lower, despite deep polarisation in American society.

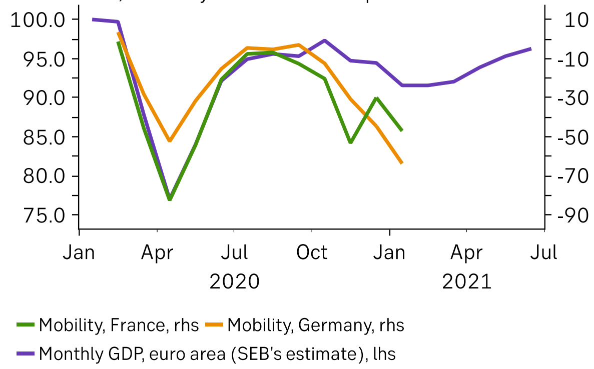
A main scenario in the spirit of Goldilocks. Room for economic expansion, as well as persistently low interest rates and bond yields, will creates favourable conditions for financial markets in the medium term. In this environment, we do not consider today's historically high share price valuations particularly worrying. Our forecast of a continued moderate stock market upturn is based on expectations that a rebound in earnings will occur. Cyclical "value companies" should then also benefit, especially in the Nordic countries. Predominantly positive news about the US economy – combined with an even more expansionary fiscal policy now that the Democrats have also won a majority in the Senate – have recently helped to push up bond yields. We believe 10-year US Treasury yields will keep rising rise gradually, despite the Fed's dovish signals, reaching 1.70 percent by the end of 2022, or 50 basis points higher than in our November forecast. Given larger "reflationary elements" in the US, while German long-term yields are below zero, we see prospects for the dollar to recover during 2022. But in 2021, we believe that the dollar's role as a defensive currency will be undermined by higher risk appetite. Our forecast is that the EUR/USD rate will peak at 1.28 by the end of this year. The upward trend of the Swedish krona is expected to continue in this environment, despite the Riksbank's decision to build up its foreign exchange reserve, and also supported by the fact that it is expected to refrain from interest rate cuts.

Resilient despite broad lockdowns

Recent widespread COVID-19 infections have led to expanded and prolonged restrictions and lockdowns. According to some kinds of indicators, lockdowns in Europe are as extensive as last spring. This applies, for example, to the University of Oxford's Government Stringency Index. Meanwhile other metrics – such as mobility indices – are showing that everyday life is not as paralysed as last spring. Businesses and households are apparently more prepared to manage the situation, and there is also a greater political ambition to design the restrictions in ways that still allow workplaces to remain open. Since government statistics are published after a time lag, it is still unclear how extensive the economic damage will be. But statistical offices in many countries now publish monthly figures that are fairly close to the GDP concept, which will make it easier to monitor future developments.

Growth and mobility: A clear association

Index, February 2020 =100 and per cent of normal

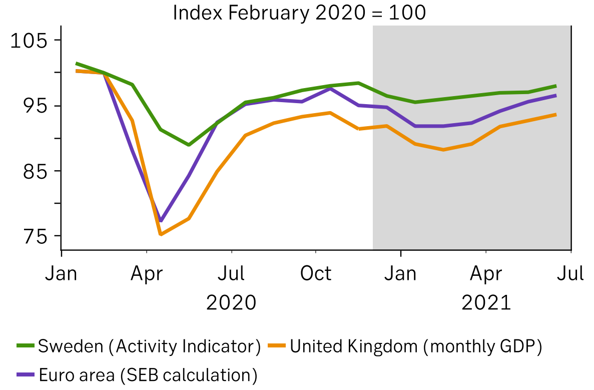


Source: Google, Macrobond, SEB

Manufacturers are far more resilient than last spring. Restrictions in the Nordic and Baltic countries appear likely to be milder than in most of Western Europe. Large Western European countries have again imposed tougher restrictions, and the United Kingdom is also affected by uncertainty about the repercussions of Brexit and future trade relations with the European Union. When we divide our GDP growth forecast into individual months, British GDP ends up about 12 per cent below its pre-crisis level in February, the lowest month. Last April and May, British GDP was down a full 25 per cent. As for the euro area, we predict a low in February of about 8 per cent less than the pre-crisis level. This, too, is clearly milder than the low last April. The Nordic countries have implemented new lockdowns a bit later than the major economies. However, our monthly forecast records a low in January that is 5 per cent below the pre-crisis level, compared to an 11 per cent decline in May. The main reason why activity levels are not falling as deeply as last spring is that the manufacturing sector is performing far better.

GDP trends on monthly basis

Index February 2020 = 100

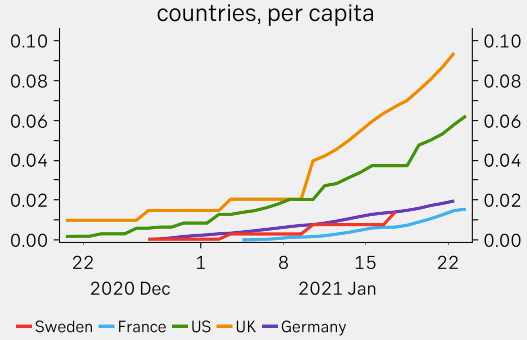


Source: U.K. Office for National Statistics (ONS), Macrobond, SEB

Different speeds in vaccination campaigns

So far, vaccination campaigns have only just begun. The data are still uncertain, but among larger countries the UK and US have progressed furthest. Denmark is also doing well, but Israel is the pacesetter, having vaccinated more than 35 per cent of its population. To what extent the pace of vaccination will determine when economies can begin to reopen is too early to tell. So far, no country has reached a level of vaccination that is sufficient to give the population decisive protection.

Number of people vaccinated in selected countries, per capita



Source: Our World in Data, Macrobond, SEB

Considering the political tensions now surrounding the vaccination issue, the authorities in charge are likely to come under pressure. This should lead to increased convergence between countries in their pace of vaccination. Our interpretation is that because of the EU's coordinated vaccine purchases, supplies will be evenly distributed among different countries. There should thus also be potential for a uniformly rapid vaccination process, at least from an accessibility perspective. At present, only two vaccines have been approved for use in the EU (BioNTech/Pfizer and Moderna). This is limiting supply, and in order for the EU not to lose further ground, additional vaccines such as the one from AstraZeneca must soon be approved. Those countries that have progressed faster, such as Israel and the UK, have secured larger deliveries through early vaccine agreements or emergency approvals of some variants. Now that vaccination campaigns have gained momentum in advanced economies, the issue of fair distribution at the global level is becoming increasingly heated. At least in the initial phase, poorer countries seem to be lagging behind and not receive the same allocation.

No clear normalisation until summer. The spread of the virus has worsened recently, making the vaccine issue even more crucial. The main message conveyed by the authorities in charge is that it should be possible to vaccinate broad categories of people before this summer. Our basic assumption is that governments will be cautious about reopening economies before vaccinations have reached sufficiently broad segments of the population. Yet it is reasonable to assume that warmer weather in the northern hemisphere and a higher degree of immunity will also help to slow the spread of infection this spring.

Assuming that vulnerable groups have also been vaccinated by then, there will be room for some easing of restrictions by the end of Q1 or by Easter. This will contribute to a slight recovery during Q2, but no definitive normalisation is expected to occur until later in the summer. Our forecast thus assumes a significant upturn in summer tourism compared to 2020, which is especially important for the countries of southern Europe.

Increasing gaps between US and Europe

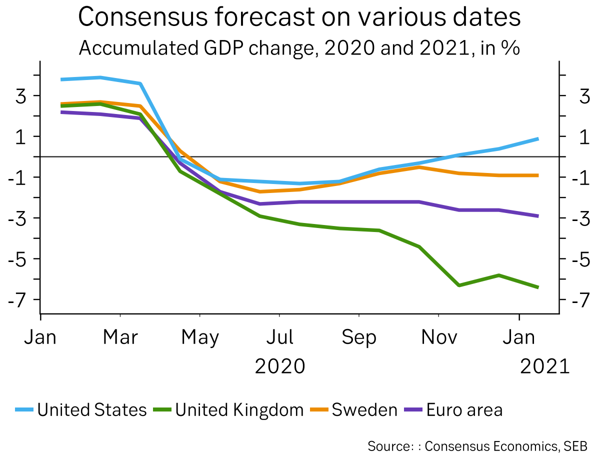
The changes in our *Nordic Outlook* forecast since November 2020 have been driven by several factors. Despite expanded pandemic-related restrictions, late 2020 turned out stronger than expected and the GDP decline in 2020 now looks set to reach only 3.7 per cent, compared to our previous forecast of 4.4 per cent. The picture in 2021 is more divergent. Despite extensive virus spread, US restrictions are much milder than in Western Europe. We have also factored in even larger fiscal stimulus measures, now that it is clear that Democrats have majorities in both houses of Congress. We have thus upgraded our GDP forecast for 2021 by nearly a full percentage point. In Western Europe, lockdowns early in 2021 will inevitably lead to significant downward adjustments for the full year.

Global GDP growth

Year-on-year percentage change

	2019	2020	2021	2022
United States	2.2	-3.5	4.5	3.6
Japan	1.0	-5.2	2.1	0.7
Germany	0.6	-5.2	2.0	4.0
China	6.1	2.3	8.0	5.6
United Kingdom	1.3	-10.3	3.5	8.2
Euro area	1.3	-6.6	3.1	4.9
Nordic countries	1.5	-2.7	3.0	3.8
Baltic countries	3.7	-2.7	2.7	4.2
OECD	1.6	-4.9	3.7	3.7
Emerging markets	3.8	-2.6	6.2	4.8
World, PPP*	2.8	-3.7	5.0	4.3

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



Increasing divergence between economies. Recent developments are reinforcing a trend that began last summer. The above chart shows how the consensus forecast for total GDP growth in 2020 and 2021 (i.e. the level in 2021) has changed over time. At first, most forecasters thought that the pandemic crisis would have quite similar effects on different economies, but since then forecasts for the US have been adjusted in line with trends, while downward revisions have continued in the euro area and especially the UK. Our own new forecast in this *Nordic Outlook* also indicates that the consensus forecast for Western Europe is still too optimistic. Forecasts for Sweden have long followed the American pattern, but recently we have seen a divergence here as well. Although the reasons differ, there are similarities with developments during the global financial crisis. At first, there were hopes that Western Europe would do better because the underlying imbalances were not as serious, but in the end it turned out that the US bounced back faster and more easily, due in part to a more resolute policy response.

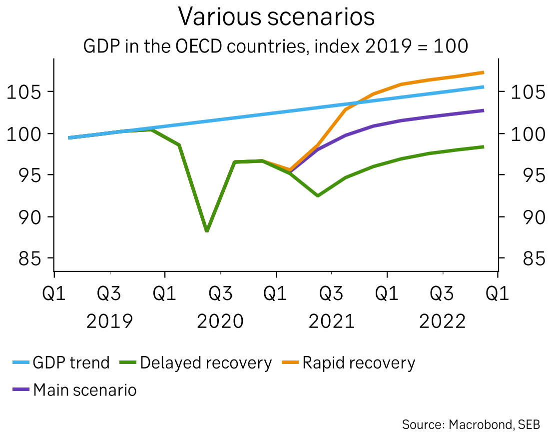
A last-minute free trade agreement

British and EU delegations finally succeeded in reaching a post-Brexit trade agreement after a long autumn of repeatedly missed deadlines. Under the circumstances, the agreement must be regarded as the most advantageous that was possible, and in the end it contained few surprises. A number of temporary transitional rules and gradual implementation of rules on the transport and fishing sectors, for example, will mitigate short-term economic effects. But the new reality of restrictions on merchandise trade will still mean higher costs and a risk of disruptions in supply chains. Companies on both the British and EU sides will need to become accustomed to new administrative routines, something that initially became most apparent in the case of foods with a short shelf life. But the Christmas Eve agreement does not represent the end of a long Brexit process. Changing the tight UK-EU relationship will require recurrent negotiations and collaborative arrangements. For example, large-scale trade in services between the UK and the EU is not regulated in the agreement. Electricity markets in northern Europe are closely linked and must now be adapted. We are sticking to our forecast that over time, GDP growth in the UK will be 0.3 percentage points lower per year under the new agreement than if the country had remained an EU member. For the EU as a whole, the effect will be smaller, but individual economies such as Ireland and Malta will be affected to at least as great an extent as the UK.

Rapid growth in Europe next year. The widening gap between the US and Western Europe will have consequences for both financial markets and future forecasts. The difference between the most recent figures and expectations in early 2020, before the pandemic struck, can be seen as a rough measure of the GDP gap for the full year 2021. For the US, the level is 3 percentage points lower than in early 2020, while the corresponding decline for the UK is almost 10 points. Although the UK's withdrawal from the European Union is expected to have permanent detrimental effects, there is still major recovery potential throughout Western Europe, as reflected in the adjustments to our full-year forecasts for 2022. The increase will also occur later in the Nordic countries. This is especially clear in Sweden, where we expect GDP to climb by 4.8 per cent in 2022 after a rise of 2.8 per cent in 2021.

The second wave is changing the risk picture

The increasing spread of COVID-19, combined with the imminent vaccination of broad population groups, is changing the risk picture in various ways. In the short term, we see greater downside risks, because we may be underestimating the negative effects of the current large-scale restrictions and potential virus mutations. It is also possible that hopes for normalisation of daily life as a result of vaccinations are exaggerated. If we have a prolonged period of lockdowns, its spill-over effects in the form of bankruptcies and financial stress may be larger than last spring, since many businesses were then under severe pressure for a considerable period. In such a situation, it will be difficult to repeat the strong rebound we saw when economies reopened last summer.



"Ketchup effect" may lead to strong consumption. In the near term, we foresee only a limited upside compared to our main forecast, since a speedy removal of pandemic-related restrictions seems highly unlikely. But a bit later in 2021, there is greater potential for a more favourable trend than in our main forecast. We may have underestimated the power of stimulus measures once they have better conditions to work in, for example due to households and businesses opening their wallets and using their savings from 2020. Unlike the 2008-2009 crisis, there is no great need for households in general to repair their balance sheets, which historically suggests a rapid recovery. Our positive scenario implies that some months into 2022, the GDP level will not only be higher than before the COVID-19 crisis but is also above the underlying trend. We believe that the probability of our positive and negative scenarios is approximately equal – around 20 per cent.

Rapid recovery not problem-free. From a broad societal perspective, it would of course be good to have a powerful recovery in which the labour force that has suffered during the pandemic can quickly be mobilised. This would also ease the burden on public finances and thus diminish future vulnerability. But at the same time, such a scenario would also raise questions about how stable our current low-inflation environment actually is, and whether central banks need to decide sooner on appropriate exit strategies. It is not unreasonable to imagine that even a rapid recovery might be marginally negative for stock market performance, at least if we assume that there is a clearly inflationary reaction. This may serve as a reminder that the balanced recovery in our main scenario will be challenged from different directions in the future.

Various scenarios for the OECD countries
GDP growth, per cent

	2020	2021	2022
Main scenario	-4.9	3.9	3.5
Negative scenario	-4.9	-0.4	4.7
Positive scenario	-4.9	5.7	6.1

Source: OECD, SEB

Crisis responses difficult to measure

In many countries, the official response to last year's huge GDP declines was to enact highly expansionary economic policies. When central bank toolkits proved insufficient, fiscal policy makers responded and took over the main responsibility. Compensating for the economic deceleration by means of "short-time work" subsidies (wage subsidies) and direct aid to businesses – at the same time as the costs of medical care and vaccinations has skyrocketed – puts heavy pressure on public sector finances. For a long time, 2020 budget deficits seemed destined set to reach record-high levels, given all the programmes that were being unveiled. But now that hard data are available, the burden does not seem so dramatic. This is especially apparent in Sweden, where the 2020 deficit is likely to reach only 3.5 per cent of GDP. This can be compared to double-digit deficits in 1992 at the culmination of a financial crisis. We may well also see the same pattern in other countries, once we have a more complete picture of the situation.

Different metrics for fiscal stimulus. Fiscal stimulus programmes can be measured in a variety of ways. During 2020 it was important to quickly get some idea of how large the commitments of different countries actually were. The amounts were historically very large, but comparisons can be tricky. The International Monetary Fund has used the concepts of direct and indirect effects, with the former (direct) influencing the budget balance. Indirect stimulus consisted of such programmes as loans and guarantees. Some of these programmes affect neither the budget balance nor government debt (a possible future loss affects the budget balance when it occurs). Others such as deferred taxes that the recipient will eventually pay, affect government debt but not financial savings. Many programmes have attracted a rather low degree of utilisation, which may be interpreted either positively or negatively. Some programmes may have been too complex or poorly designed to fulfil any purpose. But their broad framework probably also created a confidence-building effect that softened the economic downturn, thereby indirectly reducing the need to use them.

Cyclically adjusted saving as an official impulse metric
International organisations such as the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) measure fiscal stimulus effects as the change in cyclically adjusted financial saving in a given year. The idea is that a budget change that is not due to economic activity should be defined as politically determined. In this way, it is possible

to make assessments of policy direction without being dependent on detailed and impenetrable lists of programmes from different countries. This approach also has its weaknesses, since the metric depends on estimates of potential GDP growth as well as knowledge of how sensitive public finances in various countries actually are to changes in underlying economic activity. As a result, these calculations should be interpreted with caution and be regarded as rough estimates. The above table is based on the OECD's December calculations. We have made some assumptions of our own, for example about future fiscal stimulus programmes. One difficulty with the calculation is that today's crisis responses include important elements that ease the burden on existing systems. In Sweden, one typical example is that the current wage subsidy scheme reduces pressure on the unemployment insurance system. Because newly introduced programmes of this kind replace traditional "automatic stabilisers", the OECD's method may underestimate the stimulus impulse, but we have tried to adjust the metrics to take this into account.

Stimulus impulse
Change in structural budget deficit, per cent of GDP.
Plus signs mean a stimulus effect, negative the opposite

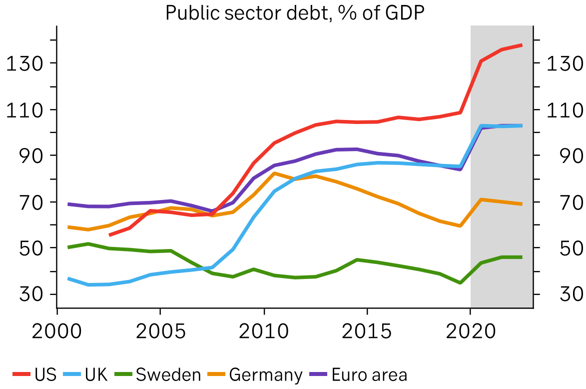
	2020	2021	2022	2020-22
OECD	5.0	-0.5	-2.0	2.5
United States	6.0	0.0	-2.5	3.5
Japan	5.5	-3.0	-1.5	1.0
Euro area	3.0	0.5	-1.5	2.0
Germany	4.5	-1.0	-1.0	2.5
United Kingdom	7.0	-2.0	-2.0	3.0
Sweden	2.0	0.5	-1.0	1.5

Source: OECD, SEB

Minor fiscal tightening in 2021 and 2022. The dose of stimulus in 2020, measured as the change in structural saving, looks set to total around 5 per cent of GDP for the 37 mainly affluent OECD countries as a whole. Sweden stands out as having a relatively small expansion effect. This is because the weakening of the budget appears likely to end up at only half as much as in the US, the euro area and the UK. Due to the prolonged COVID-19 crisis and this winter's lockdowns, new programmes will be launched in the near future in most countries. It is also likely that most countries will support the recovery with various forms of restart programmes once their economies are ready to reopen more permanently. But it will not be easy to match the large stimulus packages from 2020. At present, fiscal policy in the OECD countries as a whole looks set to have a minor tightening effect (half a per cent of GDP in 2021 and 2 per cent in 2022). But we should recall that household saving increased significantly during 2020, when portions of consumption were blocked. This means that the stimulus measures from 2020, aimed at maintaining household incomes, may have a delayed growth impact in the future.

Biden's new stimulus will increase US national debt
There are relatively wide differences in manoeuvring room between countries. In Germany and the Nordic countries, relatively low government debt levels will permit a lot of flexibility ahead. The strong position of the dollar as a global reserve currency also allows room for continued stimulus in the US. With the Biden administration benefiting from Democratic majorities in both the Senate and the House of Representatives, we can expect further stimulus packages this year, totalling about the same size as those that were implemented in 2020. The stimulus impulse will thus be neutral. In the euro area and Sweden, which did not enact equally large packages in 2020, this year's stimulus will be slightly expansionary, although during 2021 and 2022 their programmes will be smaller than those in the US. Because of larger deficits in the US than in Europe, the increase in public sector will be more pronounced.

Upturn in debt will level off
Public sector debt, % of GDP

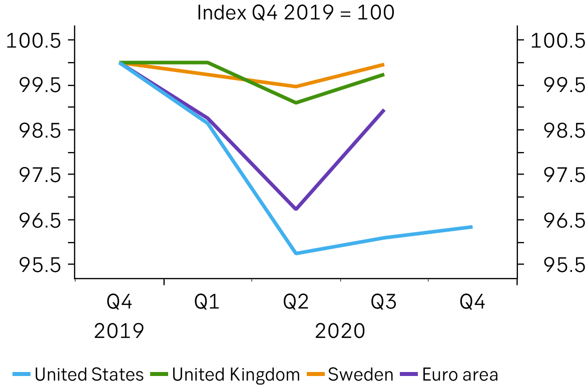


Source: IMF, SEB

Resilient labour markets

Labour markets are continuing to show resilience, at least according to the traditional unemployment metrics used in Labour Force Surveys (LFSs). In countries with very large GDP declines – such as the UK – we have hardly seen any upturn in unemployment at all. However, because of all the stimulus measures and relief programmes that have been enacted, it is difficult to interpret traditional metrics. Throughout the COVID-19 crisis, the gap between the US and Europe has been amazingly wide. This is partly due to different social safety net systems, but the contrast has been reinforced by the purely technical design of relief programmes. The US crisis response has aimed at replacing incomes, rather than making it easier for businesses to retain their workforce and thus maintain high employment. In the US, employment fell 13 per cent by mid-2020, but those who remained on the job worked about as much as before. Unemployment rose very rapidly in the spring of 2020 and has fallen relatively sharply since then.

Different response on labour force
Index Q4 2019 = 100

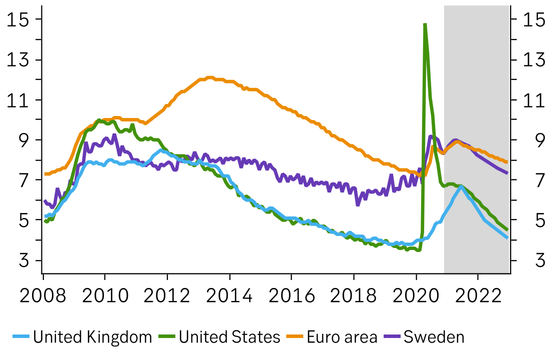


Source: Macrobond, SEB

Mysterious trend in the UK. In Europe, however, crisis responses have aimed at enabling businesses to retain their employees through various types of wage subsidy systems. As in the US, the number of hours worked has largely followed the decline in GDP, but the number of employees has fallen to a much smaller extent, reflecting a decrease in average working hours. During the third quarter of 2020, for example, employment in the euro area was only 2 per cent below pre-crisis level, while the number of hours worked fell by 5 per cent. The UK showed a very large decline in GDP without unemployment having risen much. A decrease in average working hours has helped to maintain employment in an environment with a sharp decline in the number of hours worked. The UK Office for National Statistics (ONS) has announced that LFS data-gathering problems during the pandemic may have led to overestimation of employment, but this is probably not the whole answer to the mystery.

Unemployment close to its peak in Europe

Per cent of labour force



Source: Macrobond, SEB

School shutdowns are affecting the labour supply. Labour supply trends have differed greatly between countries. In the US, the number of people available to the labour market fell by a total of 4 per cent during the first half of 2020 and has since recovered only marginally. Although we believe that US unemployment may fall to 4 per cent by the end of 2022, the potential for boosting the labour supply means that overheating risks are remote. In Europe, we are seeing a divergent trend that seems to be partly due to school shutdowns. Parents of school children may have lost their jobs, but since they are not available to the labour market, they are not counted as unemployed. The fact that the labour force in the euro area fell sharply during the second quarter, then recovered in the third quarter, may have been largely due to this. Large fluctuations in the labour supply thus contribute to changes in unemployment. In Sweden, where schools have been open, we see almost no decline in the labour force. This is one reason why unemployment has risen more than in the euro area, despite a smaller decline in GDP.

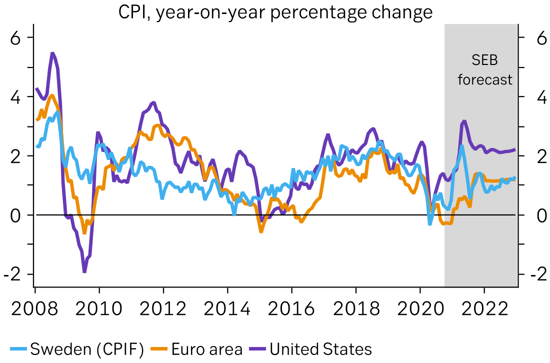
A balancing act when phasing out relief programmes. Looking ahead, we have a slightly more optimistic picture of labour market trends than before. We are likely to see some increase in unemployment in Europe as wage subsidy programmes are phased out, but it will probably not exceed one percentage point. In Sweden, for example, the number of people in such programmes has already shrunk by 80 per cent without any major effect on unemployment attributable to the phase-out. Because of this relatively rapid recovery, the degree of permanent exclusion from the labour market will be quite small. The wage subsidy system thus appears to have been successful in providing relief to businesses and employees. However, there is always a risk that measures aimed at bridging over a temporary downturn in demand will lock employees into old economic sectors. To the extent that the pandemic leads to lasting changes in demand patterns, these programmes may slow down the structural transformation process. It is thus an important balancing act to withdraw relief measures at a reasonable pace.

Stable inflation will be resilient to challenges

How inflation reacts to the current experimental environment – with large official stimulus measures – will be crucial to the entire forecast situation. Our "Theme: Inflation" article (page xx) discusses various aspects of this in a broad perspective. We can see both upside and downside risks, but our conclusion is that the low-inflation environment of recent decades is likely to persist. Concerns that disruptions in global supply chains or sharply increased demand in specific areas would result in rising inflation have not become a reality. Although we have noted price increases in specific areas, they have been far from sufficient to offset the general downward pressure on both wages and prices due to low resource utilisation.

Energy prices will lift CPI inflation

CPI, year-on-year percentage change



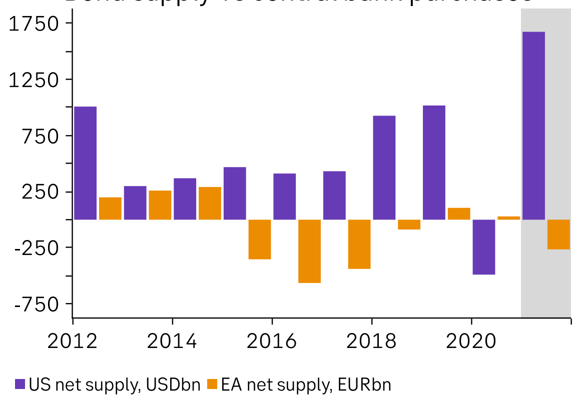
Source: Macrobond, SEB

No monetary shortcuts to inflation. Although CPI inflation is now rising, driven by the recovery in oil prices, this spring that upward impulse will be amplified by base effects. Differences between the US and the euro area related to inflation are now also intensifying, especially in terms of expectations. In the US, core inflation (CPI excluding energy and food prices) is also rising significantly following an earlier slump; after peaking this spring, it will stabilise slightly above 2 per cent starting in the autumn. However, the Fed's favourite inflation metric – core PCE – is expected to remain somewhat below 2 percent. We are sticking to our view that in situations of continued credibility for inflation targets, there are no shortcuts to inflation. It will thus be necessary for monetary expansion to cause genuinely higher demand and tighter labour markets – ultimately also leading to faster wage and salary growth – before inflation can rise more enduringly. In Europe, such a trend seems distant. Due to generally slowing pay increases and persistently high unemployment, the rate of price increases will remain at levels that will make it difficult for central banks to achieve their inflation targets. In Sweden, for example, newly concluded collective agreements will provide yearly pay increases of around 2.2 per cent. US unemployment will fall as low as 4 per cent by the end of 2022, which means that a renewed discussion about the shape of the "Phillips curve" is not too far away, especially since wage and salary metrics are currently hard to interpret. However, we believe that no wage-driven upturn in inflation is likely during our forecast period.

Central banks will face various challenges

Because of the moderate inflation outlook, central banks will also be in a position to help sustain economies during the second COVID-19 wave, but there is limited room for manoeuvre and continuing hesitation among many central banks to cut their key interest rates to below zero. Fiscal policy makers must therefore continue to bear the main responsibility, but the central banks are ready to ensure that yields on government debt remain low. They can do this by promising low key rates even if some inflationary impulses should materialise, and by increasing their bond purchases to counteract rising long-term yields.

Bond supply vs central bank purchases



Source: Macrobond, SEB

Because of growing cyclical differences, central banks will face various challenges in the future. Yet we do not believe that any major changes in monetary policy will take place early in our forecast period. The Fed has announced that "tapering" of its stimulative asset purchases will follow the same principles as in 2014, when it reduced purchases for 10 months from an initial SEK 85 billion per month. It then carried out its first key rate hike just over a year later. This indicates that tapering is not an issue for 2021, as long as rate hikes are a couple of years away. From a fixed income market perspective, it is interesting to compare the size of asset purchases with new issuances linked to borrowing requirements. The above chart shows net supply in the US and euro area. New fiscal stimulus will contribute to a sharp increase in US government bond supply in 2021. This is expected to create upward pressure on US long-term yields and support our forecast of a steeper yield curve. However, we are maintaining our forecast that the Fed is prepared to expand or re-allocate the maturities of its bond purchases if real yields begin rising too much. In the euro area, ECB asset purchases are expected to continue exceeding the bond supply, thus limiting the rise in yields.

Norges Bank out of step again. Sweden's Riksbank is under pressure because persistently low inflation is threatening to push inflation expectations further and further below its 2 per cent target, but our main scenario is that we will avoid repo rate cuts to back below zero per cent. If the EUR/SEK exchange rate falls to 9.50, such cuts are likely. In line with some previous historical episodes, Norges Bank is expected to follow its own path. Given the risks of excessively low key rates over a long period, we expect gradual rate hikes in Norway back to pre-crisis levels. A rate hike as early as 2021 cannot be ruled out, but our main scenario is two hikes during 2022.

Gradual recovery in the EM economies

The emerging market (EM) economies have begun to recover after sharp GDP downturns during 2020, but there are big differences between countries. Among the hardest-hit economies are India, Mexico, Argentina, the Philippines, South Africa and Peru, where GDP appears to have shrunk by 8 to 14 per cent in 2020. China stands out in contrast, with positive growth of 2.3 per cent. Turkey also seems to have avoided a GDP decline, thanks to an explosive increase in lending by banks – but at the price of a significant currency depreciation and double-digit inflation, which forced the central bank to tighten monetary policy. Taiwan and individual countries in Africa, such as Kenya, also appear to have avoided a decline in GDP last year. South Korea, Indonesia, Poland and Russia managed relatively well, with declines of less than 4.0 per cent. Three factors explain most of the differences: 1) the extent of COVID-19 spread, 2) the composition of exports and degree of dependence on exports and foreign tourism and 3) the scale of fiscal stimulus measures.

A complicated vaccination process has begun. Compared to the November issue of *Nordic Outlook*, we have raised our GDP growth forecast for the EM sphere to -2.8 per cent from -3.3 per cent, due in part to upward adjustments for countries such as India, Russia and Brazil. However, we can see that the recovery lost ground in late 2020 and early 2021 due to increased coronavirus spread and the re-imposition of restrictions in EM economies as well. Looking ahead, we expect vaccination programmes to start taking off in some EM economies. Yet despite international cooperative efforts such as COVAX, hoarding by richer countries is likely to delay vaccinations in the EM sphere. Several EM countries such as China, India and Brazil have developed their own vaccines, but not all clinical testing is complete. Some show signs of relatively low effectiveness.

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

	2019	2020	2021	2022
China	6.1	2.3	8.0	5.6
India	4.9	-7.5	9.1	7.2
Brazil	1.1	-5.0	3.0	2.5
Russia	1.3	-5.0	3.7	2.5
Emerging markets, total	3.8	-2.6	6.2	4.8

Source: IMF, SEB

Major potential for India. Overall, we expect GDP growth in the EM economies to accelerate during the second half of 2021 and approach trend level late in 2022. Our 2021 forecast is unchanged, but we have revised our 2022 forecast upward by almost 0.5 percentage points. This is mainly due to a significant upward adjustment for India. While China's overall growth in 2020-2021 has not lost much ground compared to the underlying trend, the situation is completely different in India. The GDP level there in 2021 will be only marginally higher than in 2019. Assuming an underlying growth trend of around 8 per cent, India has large recovery potential. Our forecast of some 7 per cent growth in 2022 is thus still relatively cautious.

Commodity prices keep rising. Metal prices fell early in 2020 when it became clear that the Chinese economy, which accounts for about half of global metals demand, would be affected by the pandemic. But because of China's rapid recovery, prices also recovered relatively early. The price of iron ore has led the upturn, but there have also been significant increases for copper and nickel. Base metal prices are expected to climb by 5 per cent in 2021 when the global recovery spreads geographically. However, it will mainly be the service sector that regains lost ground, limiting the impact of demand for commodities. In addition, China's stimulus measures are not on the same scale as after the global financial crisis of 2008-2009 or after the 2015 slowdown. Agricultural and food prices are also expected to climb moderately during 2021.

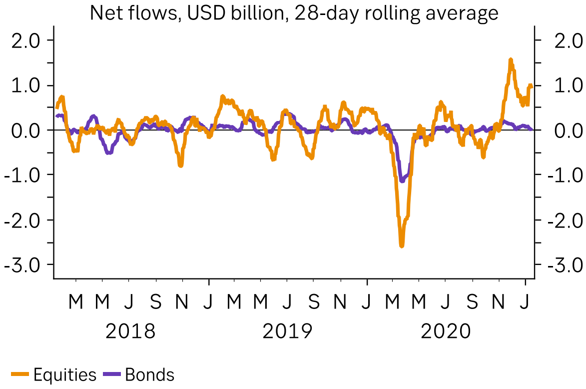
Oil prices will stabilise at higher levels. Recent upturns in oil prices are one reason why we have adjusted our forecast of the 2021 average Brent crude price from USD 55 to 59 per barrel: a sizeable increase compared to the 2020 average of USD 43. Both demand and production are expected to grow during our forecast period, but Saudi Arabia's appetite for higher prices may lead to output restrictions that cause temporary price peaks during 2021. Gradually increased supply from Libya, Iran and elsewhere will nevertheless push down prices. With Joe Biden as the new president, the United States will re-join the JCPOA nuclear energy agreement, which will enable Iran to boost its oil exports during 2022. In addition, we expect US oil production to increase gradually in an environment where a higher price level is established. Taken together, this means we believe prices will stabilise around USD 60 per barrel in 2022, representing a downward adjustment from our earlier forecast of an annual average of USD 65 per barrel.

Mixed inflation picture. Generally speaking, inflation in the EM economies has now fallen to a historically low level. In Asia, it is mainly below or within official inflation targets. This now also applies to India, where inflation during most of 2020 was well above 6.0 per cent – the top of the Reserve Bank of India's tolerance band. In Central and Eastern Europe, inflation gradually fell during 2020 and is now close to or just below targets, except in Russia where it is temporarily somewhat above target. In Turkey, however, inflation is nearly 15 per cent. In Latin America the picture is mixed, but in Brazil inflation has climbed. Weaker EM currencies have generally been an important driver of higher inflation. Low capacity utilisation and negative output gaps will keep EM inflation relatively stable at historically low levels in 2021, after which it will climb somewhat in 2022.

Central banks under political pressure. Most EM economies loosened their monetary policies after the pandemic broke out, but we are now seeing very limited room for additional easing. Some central banks – for example in Russia, India and Mexico – will probably lower their key interest rates during 2021, however. Otherwise we expect key rates to be unchanged during 2021 and then gradually be raised in 2022 as the recovery gains momentum. Notable exceptions are Turkey, which will probably need to tighten its monetary policy further, and Brazil, which has seen a clear upturn in inflation. One risk is that some countries will wait too long with tightening. This may partly be a consequence of political pressures to enable governments to lend more and continue to support the recovery. Further ahead, this may cause some central banks to lose control of price increases. In particular, countries with high or rapidly rising government debt – such as Brazil, South Africa, Mexico and India – may lose credibility in their fight against inflation.

Flows of foreign investments into EM economies

Net flows, USD billion, 28-day rolling average



Source: Macrobond, SEB

High liquidity in rich economies searching for returns. EM economies recorded record-sized capital outflows in March 2020 when it became clear that the pandemic would be global. The situation reversed in November after the American presidential election and news that effective vaccines were close to being produced and distributed. After a slight cooling at the end of 2020, inflows have resumed. Very low interest rates and yields in the OECD countries are expected to contribute to continued net inflows of investments to EM countries, especially when the spread of COVID-19 decreases. One risk we are keeping an eye on is rising EM debts, mainly government debts. Historically, investments in EM equities have been larger and have shown higher volatility than flows into bonds, but the difference has recently widened as flows into equities have exploded. This is probably because the expected returns on EM bonds are historically low, while problems with debt payments have made investors more aware of potential contagion risks in large EM countries like Turkey, South Africa, Brazil and India, where government finances have weakened significantly.

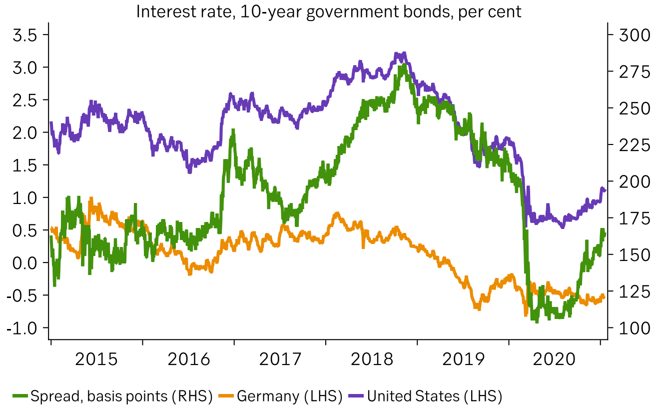
Fixed income

Upward pressure from low levels

COVID-19 vaccine optimism, fiscal stimulus, growing government bond supply and rising inflation expectations will push up long-term US yields in 2021. Their impact on European yields will be more limited. We expect short-term yields to move sideways while the trend of long-term yields will depend on the Fed's success in nudging market expectations towards gradually smaller bond-buying. Negative vaccine news and rising real yields are risks to our scenario.

Rate spreads between the USA and Europe are rising

Interest rate, 10-year government bonds, per cent



Source: Macrobond, SEB

10-year government bond yields

Per cent

	21 Jan	Jun 2021	Dec 2021	Dec 2022
United States	1.08	1.30	1.40	1.70
Germany	-0.53	-0.55	-0.40	-0.20
Sweden	0.08	0.00	0.05	0.25
Norway	1.00	1.00	0.85	1.05

Source: National central banks, SEB

Ten-year US Treasury yields have doubled since their August low of 0.50 per cent, as the "reflation scenario" has won market support. The latest upturn mainly reflects rising inflation expectations. Since real yields have fallen – combined with new stimulus packages and positive vaccine news – the stock market has benefited while the US dollar has lost value. In the euro area, inflation expectations have turned higher, but nominal yield upturns seems to have been halted by lower real yields. We expect both the Fed and ECB to keep key rates unchanged in 2021-2022.

The fixed income market outlook will be determined by a few key factors. New fiscal stimulus packages, such as Joe Biden's recently announced USD 1.9 trillion "American Rescue Plan", will boost the supply of long-term government bonds. We also expect the US and others to launch "recovery" plans with a focus on green, sustainable growth. They will fund these packages with higher taxes to only a limited extent. Given a more positive growth environment, this spring's expected temporary upturn in US inflation, to about 3 per cent, is likely to stress the fixed income market by pushing inflation expectations upward. The Fed has a high threshold for expanding its monthly USD 120 billion asset purchases. If long-term yields climb for the right reasons – a better outlook and normalisation of inflation expectations – this will be accepted by central banks, as long as it does not risk creating an unwelcome re-pricing of stock markets and other assets, for example via rising real yields. During the second half, the Fed will face the major challenge of communicating a gradual reduction in its securities purchases. Ten-year US Treasury yields will stand at 1.40 at the end of 2021 and 1.70 per cent at the end of 2022.

Euro area yields have largely not climbed at all despite higher US yields. The German 10-year yield bottomed at -0.90 per cent last spring, and expanded asset purchases have kept the yield relatively stable at around –0.50 per cent recently. Spreads between German and other euro area yields have narrowed gradually after widening last spring; in most cases they are about the same as at the end of 2019. Large ECB asset purchases (currently about EUR 90 billion per month), low inflation and shaky economic data suggest that yields will remain near current levels for the next six months. When the recovery takes off in the second half, we expect 10-year German yields to begin climbing, but due to continued bond purchases and low inflation expectations, the upturn will be moderate. Ten-year German yields will be -0.40 and -0.20 per cent at the end of 2021 and 2022, respectively.

The long-term yield spread between Sweden and Germany has gradually widened since mid-2018, mainly due to Riksbank key interest rate hikes in late 2018 and in 2019. The spread continued to widen last year and remained close to the highest levels recorded since the global financial crisis, apparently driven by slightly lower general interest rates in the euro area and expectations that in principle, the ECB will never hike its key rate again. In Sweden, the market has begun to price in a possible key rate hike in 2023, while expectations of a rate cut have been reduced to 3-4 basis points. Once inflation has slowed ahead of this summer, expectations of a rate cut will probably increase again and speculation about a hike will be postponed. Combined with slightly higher euro area yields, this suggests that the yield spread against Germany will narrow somewhat during the second half of 2021.

The Norwegian-German long-term yield spread is wide, partly reflecting Norges Bank's rate hike signals plus a liquidity premium. A relatively limited bond supply and an undervalued krone are expected to limit the upturn in 10-year yields. The spread will be 125 basis points at the end of both 2021 and 2022.

Theme:

Inflation

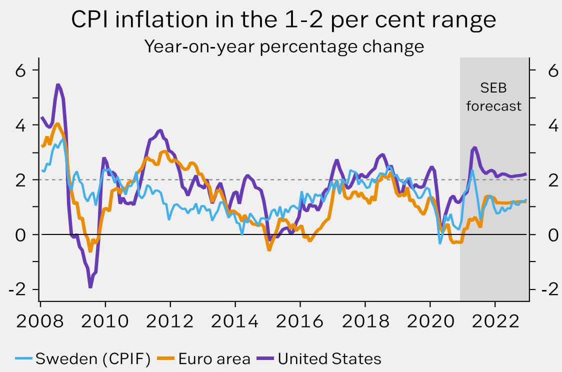
Are the rumours of its death greatly exaggerated?

The fixed income market and forecasters regard a reawakening of inflation as a logical consequence of both the economic recovery – once restrictions are lifted – and of monetary expansion. Our forecast shows a fairly undramatic inflation trend in 2021-22, with certain upside risks. Making our forecast more uncertain are questions about the strength of structural disinflationary forces and the impact of new post-pandemic consumption and production behaviours. This theme article illustrates ten dimensions of inflation.

The fixed income market expects just over 2 per cent inflation in the United States, for example, over the next 5-10 years. In the euro area, corresponding expectations are just over one per cent. These are still low levels, yet the highest for the US since late 2018. Rising inflation expectations would also trigger upward pressure on long-term bond yields. For the real economy and thus the financial system, this may lead to painful reassessments of what can be regarded as sustainable debt levels and reasonable valuations of various assets, such as share prices and housing prices.

But the driving forces behind inflation are far from self-evident due to the structural changes of the past few decades and most recently also the COVID-19 crisis. The disinflationary forces of globalisation and digital technology have been significant. Low core inflation over the past 20 years hardly reflects weak demand; before the pandemic, some countries were showing their lowest unemployment in half a century.

Changes in consumption and production patterns in the aftermath of COVID-19 may push inflationary pressures both upward and downward in the short and medium term. At present, it is difficult to determine whether the sectoral changes noted during 2020 are temporary or permanent (see “Theme: A new world” in *Nordic Outlook*, November 2020). The following theme article illustrates ten dimensions of inflation that affect our thinking and our inflation forecasts.

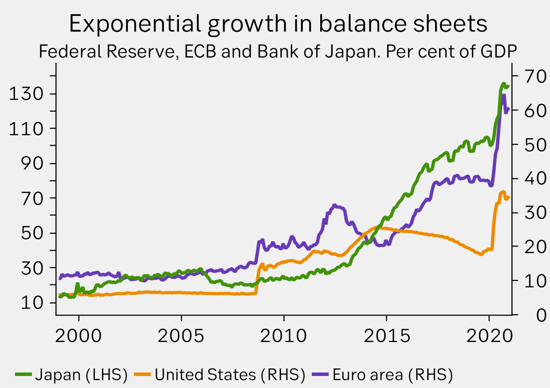


A multi-dimensional perspective

When we peer into the future and discuss various dimensions of inflation, it is appropriate to start with a simple frame of reference. Such a framework usually cites four main drivers behind inflation, that is, long-term price increases for a large number of products:

- Central banks printing too much money.
- Heavy demand for goods and services.
- Rising production costs for goods and services..
- Higher inflation expectations.

These drivers vary in strength over time and may also overlap. The ten dimensions of inflation we identify based on the above framework lead to our conclusion. The first chart indicates how we have compiled and estimated inflationary forces during 2021-2022.



1. Massive monetary expansion

Global central banks have created about USD 18 trillion in new money since the 2008 financial crisis. This is an increase of at least 450 per cent; our calculation assumes that the "money multiplier" is 1, although 4 is closer to reality.[1] At the same time, the global economy has grown by about 45 per cent. This, together with falling neutral interest rates, has contributed to very strong asset price inflation, but the link between asset price increases and higher demand/consumption has been weak, probably due to economic inequality and ageing populations. It is difficult to generate goods and services inflation with the help of central bank money-printing unless demand increases and/or inflation expectations rise (see below). **Conclusion:** The wealth effect seems to have a limited impact on demand. Thus CPI inflation does not increase either. However, inflation expectations may rise. See point 8 below.

2. The resource situation and imbalances

The COVID-19 crisis has created an obvious imbalance between supply and demand, primarily in the service sector, which normally pushes down wages and prices and thus inflationary pressures. The International Monetary Fund (IMF) estimates that in 2021 the output gap – a metric showing the under-utilisation of an economy's production resources – is more than 2 per cent of GDP in large advanced economies and will remain negative for the next five years. However, two factors make this metric especially tricky to interpret: a) due to the crisis, GDP data are subject to great uncertainty; b) digitisation and increased remote work are raising questions about both the supply and demand side of the economy. **Conclusion:** The ability of the resource situation to provide guidance on inflationary pressures in 2021-22 is unclear. An estimate can be questioned by both those who expect and those do not expect higher inflation.

3. A resilient manufacturing sector

Globally, the manufacturing sector and its value chains have demonstrated surprising resilience during the COVID-19 crisis, while the labour-intensive service sector has been hit very hard. One common feature of earlier crises is that they have been accompanied by a painful balance sheet recession: a protracted recovery process that has shrunk production capacity and has reduced growth. As a result, prices for labour and products have been squeezed. The portion of the service-producing sector that manages to weather the crisis with the help of stimulus programmes will rebound much faster and can cope with increased service consumption, thus lowering the risk of price increases. In addition, higher consumption of services – once pandemic-related restrictions are lifted – may reduce the demand for goods. **Conclusion:** Businesses will probably have stronger pricing power than during previous recovery processes. At the same time, it is reasonable to try to compensate for last year's lower earnings with higher prices, but we do not regard this as a particularly strong inflationary force.

4. Powerful, effective fiscal stimulus

Our calculations show that the volume of global fiscal stimulus measures (approximately USD 12.5 trillion) is about five times larger than during the 2008-09 global financial crisis. It is probably also more powerful, since the money went directly to households and businesses, not to financial institutions as during the financial crisis. However, some of these stimulus measures – such as loan guarantees and deferred tax payments – are likely to have less impact on growth than measures that have an immediate budgetary effect. During 2021, the effects on demand are expected to become visible as COVID-19 restrictions are eased and new steps are

[1] The monetary multiplier indicates how many new monetary units result from the first unit created by a central bank. For example, the present monetary multiplier for the euro area is around 4.

taken towards normalisation. The European Union's seven-year budget and recovery fund, totalling EUR 1.824 trillion, will start rolling out in 2021. The new US president is also expected to propose further stimulus packages. **Conclusion:** The possibility that the impact of stimulus packages on global demand is being underestimated constitutes an upside risk.

5. The Phillips curve – alive or dead?

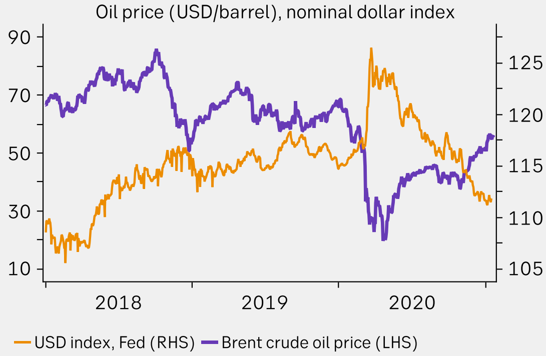
Wage and salary growth has been relatively insensitive to the labour market situation for a long time, reflecting such factors as globalisation over the past 15-20 years, the entry of the Asian workforce into the production resource market and well-established inflation expectations. During the COVID-19 crisis, the impact of digital technology and automation on what we buy and produce and how we work is also expected to bring lasting changes in the labour market; reallocation processes will lead to shrinking and expanding sectors, with surpluses in some job categories and shortages in others. **Conclusion:** Wider divergence in pay and greater uncertainty due to structural changes are expected to dampen pay increases and thus inflationary pressures – at least in the short term.

6. Globalisation or regionalisation?

COVID-19 has raised the issue of the need for greater regionalisation as a way of ensuring global value chains against new disruptions, such as new pandemics or increased protectionism and trade barriers (see point 3 above). The re-emergence of national borders and protectionism has further boosted worries about higher global inflationary pressure. **Conclusion:** Well-functioning value chains and new trade agreements do not suggest the death of globalisation (see "Theme: Trade and politics", p 26). This reduces the risk of higher production costs and thus of inflation.

Towards higher oil prices and a weaker USD

Oil price (USD/barrel), nominal dollar index



Source: Intercontinental Exchange (ICE), Federal Reserve, Macrobond, SEB

7. Commodity prices up, US dollar down

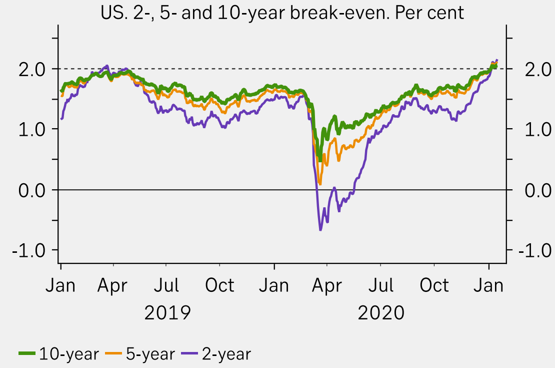
The consensus view that the USD will weaken in 2021 implies (modestly) higher imported inflation in the US and lower inflationary pressure in countries that will see their own currencies appreciating (such as Sweden). This past autumn's oil price upturn of USD 10 dollars per barrel to USD 50 will have an impact on inflation during the first half of 2021 and will be further intensified by an expected oil price hike of another USD 5 per barrel in 2021. The oil price upturn will be modified by a higher probability of increased oil production, especially in the US. **Conclusion:** These price impulses from currencies/commodities often have only a temporary effect on inflation, unless inflation expectations increase at the same time.

8. More normal inflation expectations

When the COVID-19 crisis broke out early last year – leading to sharp GDP declines – inflation expectations fell significantly, though they managed to stay above zero. After the launch of stimulus packages in the spring and the stock market rebound since March 23, expectations have risen and normalised. **Conclusion:** Inflation expectations of up to about 2.5 per cent should be the focus of central bank targeting, but levels above this risk fuelling upward spirals and may thus raise questions about the design and credibility of economic policies.

Inflation expectations are approaching 2%

US. 2-, 5- and 10-year break-even. Per cent



Source: Federal Reserve, Macrobond, SEB

9. Daring to defy a 700-year-old trend...?

Core inflation in the OECD countries has shown a surprising stability of about 1.5 per cent over the past 20 years – despite a number of severe crises. Viewed in an even longer perspective, historical data from the Bank of England show that global inflation over the past 700 years has averaged 1.6 per cent. **Conclusion:** It is hard to defy these long-term inflation patterns, although 700 years of inflation data of course include major variations and uncertainties. So the trend in the OECD is more interesting, as well as reassuring.

10. Better with inflation than deflation

It is easy to get the impression that the world has no inflation. Adjusted for temporary effects, inflation is obviously far from being a dormant phenomenon. On the other hand, inflation has fallen below central bank targets (in most cases around 2 per cent). Also noteworthy is that the risk of deflation has been small despite the serious situation in many economies during 2020, for example; Deflation expectations à la Japan have not been noted either. **Conclusion:** The picture is not entirely clear, but the risk of deflation is limited. This is pushing real interest rates and yields down to historically low levels, which is good for economic recovery, green investments and asset prices.

Theme:

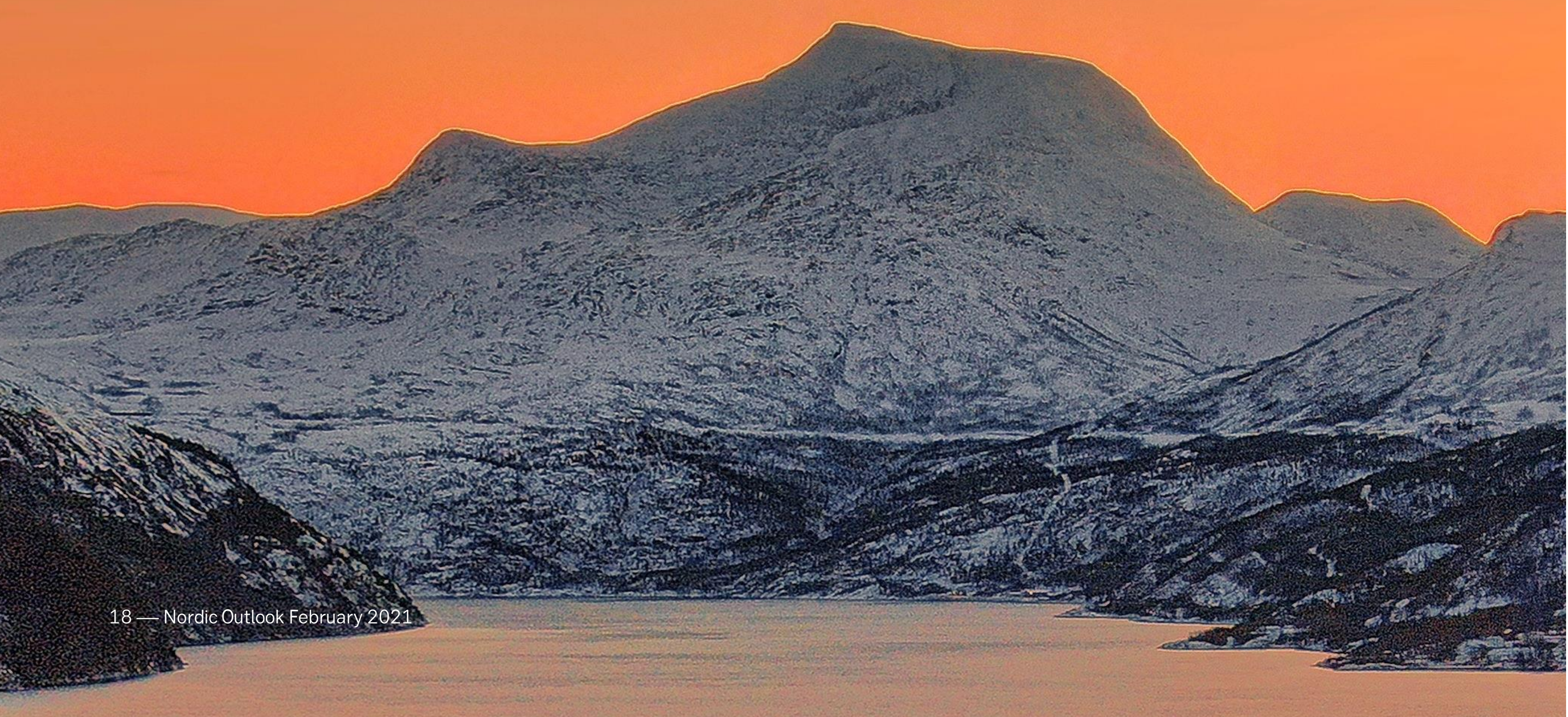
The FX market

Where are we headed when key rates are in the cellar?

The impact of the crisis year 2020 on the foreign exchange market was not hard to predict. The Fed cut its key interest rate to the level where many other central banks had ended up. The US dollar fell as the world's reserve currency lost its interest rate advantage. We still expect a weaker dollar in 2021, but we now believe it may regain lost ground in 2022. The Riksbank has recently shown its discomfort with a steadily appreciating currency. The krona is thus squeezed between strong fundamentals and the risk that negative rates will return.

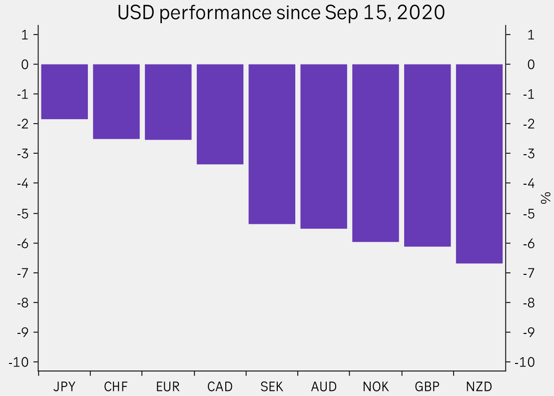
Several factors contributed to US dollar appreciation in the second half of the 2010s. The United States got its economy back on track faster than Europe after the global financial crisis, enabling the Federal Reserve to begin normalising monetary policy. With Donald Trump in the White House, the country implemented large tax cuts, which benefited growth. The US stock market also kept rising as tech companies triumphed around the world. The COVID-19 crisis eventually put an end to this, and the Fed joined other central banks with key interest rates at zero or thereabouts. In trade-weighted terms, the dollar lost about 10 per cent in 2020. In *Nordic Outlook*, November 2020 we discussed the reasoning behind our forecast that the dollar would continue to weaken in the near future.

The general key to success in FX forecasting is to get the direction of the dollar right. For example, in trade-weighted terms, the Swedish krona tends to move in the opposite direction from the dollar. So when the dollar is strong, the krona is usually weak and vice versa. This mechanism applies to many currencies. There have also been relatively stable 7-8 year cycles where the dollar alternates between strength and weakness. But is this true anymore? Powerful central bank interventions may have eliminated normal phenomena. In the following, we describe how we view exchange rate trends over the next few years, with a focus on the dollar, euro and krona.



Cyclically oriented currencies will keep climbing
Stock markets began 2021 on a positive note, setting new records. Despite the serious pandemic situation, we are raising our global GDP forecasts a bit. In the US, Democrats have gained control of both the Senate and House of Representatives, boosting hopes of a more stable recovery including major fiscal stimulus. The global vaccine roll-out supports this positive outlook. Early in last year's market recovery, cyclical currencies started to climb. We believe this trend will continue. Small export-dependent countries, as well as commodity-exporting currencies, have benefited most from better recovery prospects and rising commodity prices. Global stimulus efforts suggest a continued bright stock market outlook, also benefiting cyclical currencies in the future. Yet the biggest gains have probably already occurred. We expect generally smaller exchange rate movements in 2021 than 2020.

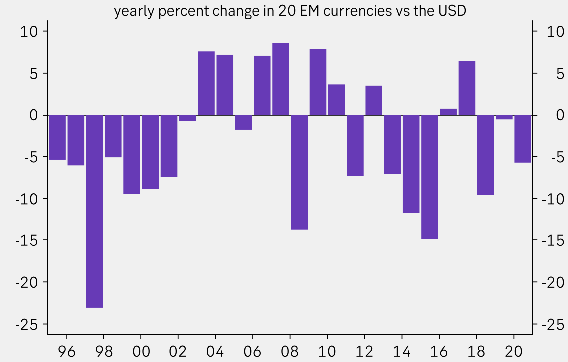
USD performance since Sep 15, 2020



USD will regain lost ground in 2022. The US Dollar Index (DXY) has trended lower since 2020, though we have seen a slight recovery so far this year – probably because US real interest rates have climbed earlier than expected. But we believe the dollar will soon fall again. The Biden administration's big new fiscal spending plans will eventually strengthen the dollar in at least two ways: by improving the growth outlook and by pushing up real interest rates. Given increasing current account deficits, the need for foreign funding may help lift both yields and the dollar. How much of the large new Treasury bond supply the Fed can absorb will thus play an important role in the short-term dollar outlook. One key issue related to this is how big an upturn in yields the Fed can accept (see *Currency Strategy*, January 2021). In the last *Nordic Outlook*, we discussed various factors weighing down the dollar, for example rising foreign debt. These problems will persist, but we now believe the dollar may bottom out by the end of 2021, when we expect the EUR/USD exchange rate to reach 1.27. After that a stronger US economy is likely to push the rate down to 1.23 by late 2022. An initially stronger euro will also help delay the European Central Bank's phase-out of the expansionary programmes it has launched, which illustrates that there are various forces that limit upward movement in the EUR/USD rate.

Some turnaround for EM currencies. In a recovering global economy, many Asian currencies are in a good position. Emerging market currencies have long faced a very difficult environment. Most have continuously lost ground over the past 10 years. During 2021 there will be a respite, and we expect EM currencies to recover slightly. Asia is in the forefront, with China again acting as the economic growth engine. We believe the Chinese will let the yuan appreciate, with the USD/CNY exchange rate falling from today's 6.45 towards 6.20.

Long-term trends in EM currencies
yearly percent change in 20 EM currencies vs the USD

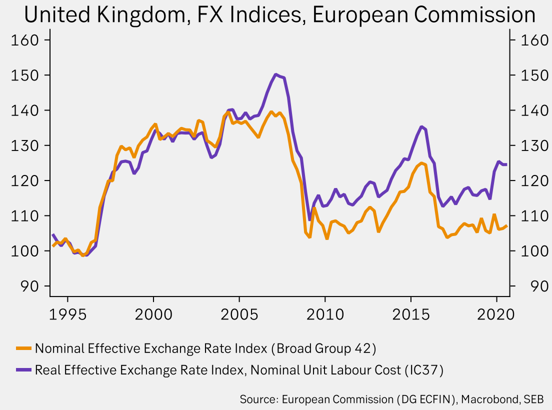


Source: Bloomberg, Macrobond, SEB

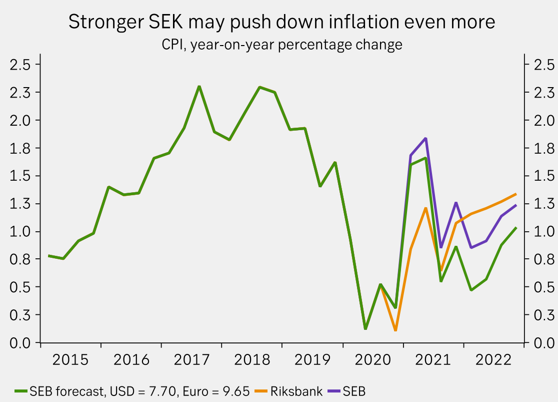
What drives currencies, besides cyclical exposure?
Low interest rates and central bank promises of low key rates for the next several years have made interest rate differentials less important as a currency driver. Today there is no clear relationship between such differentials (carry) and currency performance. But changes in differentials are still a key explanatory factor for movements of various currencies against the USD. This past autumn, other factors clearly played a major role as well. Our short-term fair value models employ a multi-factor model to determine the drivers of various currencies. The most important factor (for daily exchange rates) has been risk appetite, followed by commodity prices. As the recovery becomes more solid, these short-term factors should diminish in importance. Instead, fundamentals will take over, especially debt and room for fiscal stimulus.

Slight post-Brexit appreciation for the British pound
Perhaps the trendiest currency on this year's FX market is the pound. After more than 50 months of talks, , the two sides agreed on how the United Kingdom will leave the European Union single market. It remains to be seen how the Christmas Eve trade agreement will impact economic growth. In any event, the market has now already lowered its risk premium for the pound, which has risen cautiously. During the first half of 2021 we see potential for slight additional appreciation, with positioning and a cheap stock market as the main drivers. We also believe that the Bank of England will refrain from cutting its key interest rate below zero, which the market is discounting right now. We believe the EUR/GBP rate may move down to 0.85, but there are major uncertainties and the long-term outlook appears problematic. The UK has large budget deficit, government debt is soaring, and the current account balance will worsen further as a result of Brexit. Nor do we believe that UK competitiveness is as flattering as the fair value models for the pound would claim. Its real effective exchange rate has moved sideways even though the nominal exchange rate has fallen (see chart below). In a 3-5 year perspective (beyond our forecast horizon), the pound will probably weaken again. A

depreciating currency has often been a way to maintain competitiveness and to ease current account deficits.



Much-anticipated comeback for the Swedish krona. At the beginning of 2020 the EUR/SEK rate was above 11 and the USD/SEK above 10. The Riksbank did not seem entirely happy with this, and its key interest rate hike to 0 per cent in December 2019 was probably partly related to this. When the Fed eased its monetary policy and Swedish institutions increased their currency hedges in dollars, the USD/SEK rate fell from 10.50 to a low of 8.15. Because this movement was so strong, the Riksbank is now once again keeping an eye on the FX market. A stronger krona lowers the price of imported goods, and it is obvious (see chart) that the Riksbank will have a very hard time reaching its 2 per cent inflation target anytime soon.



Ingves is increasing the foreign exchange reserve. The krona is still undervalued, albeit only marginally. We can speculate as to what this meant when the Riksbank announced early in 2021 that it will pay off the foreign currency loans raised by the National Debt Office for the Riksbank's FX reserve. This step is logical, considering that for a long time Riksbank Governor Stefan Ingves has wanted to increase the size of this reserve. This means that the Riksbank will sell the equivalent of SEK 180 billion during the next three years and buy foreign currencies (to pay off the NDO's FX loans). This is a gigantic amount, corresponding to about 30 per cent of the current account deficit. These purchases will help slow the krona's upward trend.

Did monetary policy aspects determine the timing? Although monetary policy aspects were not decisive, it is reasonable to assume they were among factors that determined the timing of this move. Foreign hedge fund managers, at least, probably interpret it as a signal that the Riksbank is now keeping an eye on the krona and that the EUR/SEK exchange rate has a floor. Some Riksbank Executive Board members have also warned the market that negative key rates may be re-introduced. The bank's FX transactions, along with its ongoing quantitative easing (QE) programme, will greatly increase excess liquidity in the Swedish banking system. According to current plans, the Riksbank will buy another SEK 360 billion worth of bonds this year. It will also buy another SEK 180 billion worth of foreign currencies over the next three years. This will increase excess liquidity by about SEK 420 billion in 2021 (interest rate -0.10 per cent). The Riksbank can, of course, reduce costs to the banking system by issuing more Riksbank certificates (0.00 per cent). If it lowers the repo rate, all liquidity (today SEK 875 billion) will be invested at a negative interest rate. At the end of 2021 it will be nearly SEK 1,300 billion. The amount has doubled since the repo rate was raised to zero, so this time a negative repo rate would have a more SEK-negative effect, holding down the value of the krona.

SEB exchange rate forecasts

	Jan 21	Jun 2021	Dec 2021	Dec 2022
EUR/USD	1.21	1.25	1.27	1.23
USD/JPY	104	101	99	102
EUR/GBP	0.89	0.86	0.85	0.85
EUR/SEK	10.11	10.10	9.80	9.70
EUR/NOK	10.29	10.10	10.00	9.90

Source: Bloomberg, SEB

Moderate potential for further SEK appreciation. All in all, this means that we now foresee limited potential for SEK appreciation. During the first half of 2021, we believe the EUR/SEK exchange rate will remain in the 10.00-10.25 range, partly because the spring dividend season is SEK-negative. During the second half, we believe that the krona may appreciate somewhat, with the EUR/SEK rate at 9.80 late in 2021. The USD/SEK rate will continue falling to a bit below 8.00 in 2021.

The Norwegian krone will recover slowly. No country has the potential to stimulate its economy like Norway, but the Government Pension Fund Global (Oil Fund) has also helped inflate wage and salary costs. Despite relatively tight monetary policy, the krone has continuously lost ground against the SEK. As the economy recovers and oil prices settle at higher levels, we expect the NOK to keep climbing a bit against the euro. We have also raised our forecast. To cover budget deficits, the government is taking large amounts out of the Oil Fund, contributing to a positive flow situation for the NOK. The recovery will also probably make Norges Bank the first in the region to hike its key rate, early in 2022. We thus predict that the EUR/NOK rate will be 10.00 at the end of 2021. The NOK will remain somewhat weaker than the SEK, but we mainly expect NOK/SEK to be near parity during our forecast period.

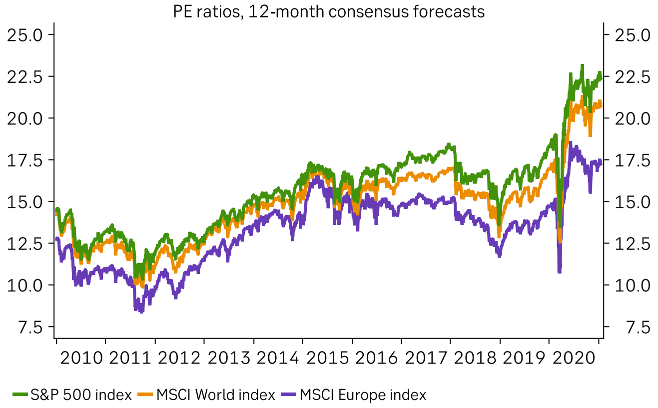
The stock market

Recovery may push share prices higher

The huge stock market recovery of 2020 is reason for caution. But if growth forecasts prove correct – while interest rates, bond yields and inflation stay under control – there is potential for share prices to keep rising. In a recovery, cyclical value companies should be able to regain lost ground, but the long-term digitisation trend will continue to benefit growth companies. Given today's powerful worldwide sustainability efforts, last year's strong performance by growth companies may persist.

High valuations not unreasonable

PE ratios, 12-month consensus forecasts



Source: Bloomberg, SEB

We now foresee better conditions for cyclical companies

Powerful earnings rebound in 2021. Not surprisingly, last year saw a dramatic plunge in the earnings of listed companies. Many fourth quarter reports remain to be published, but the consensus forecast points to a global earnings decline of around 18 per cent for the full year 2020. To forward-looking investors, though, future figures are more interesting. With an economic recovery expected, and with low comparative figures from 2020, the analyst community foresees earnings increases of around 25 per cent this year and more than 15 per cent in 2022. These forecasts seem reasonable, assuming that our economic growth expectations turn out to be correct and the spread of COVID-19 is curtailed as planned. Continued powerful central bank support and new fiscal stimulus measures are also expected. The forecasts imply that listed company earnings may hit new high before global GDP reaches its pre-crisis level. This is because so far, companies have been successful in adjusting their costs and thereby generating a larger profit margin per unit sold. There is admittedly also a potential negative side: continued aggressive cost savings probably mean staff reductions, which would push down economic growth.

Large discrepancy between share prices and the real economy. Expected earnings surges are naturally one of the main explanations for the share prices rallies we have seen since last spring. But with global share prices rising by 10-15 per cent during a year when growth and earnings showed extremely large declines, there is cause for reflection. Consider the market's discounting mechanism. As we know, equities are valued on the basis of future earnings forecasts. The most common approach is to study earnings multiples – price-to-earnings (PE) ratios – based on projected 12-month earnings. But in an extreme situation like what we witnessed last year, investors saw reasons to lift their gaze beyond both last year's earnings crash and this year's recovery phase.

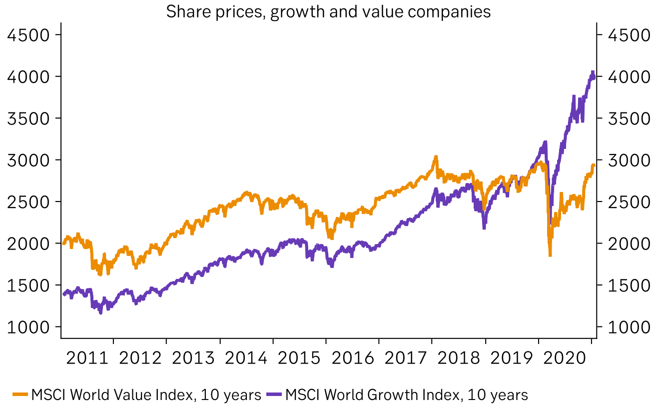
High but reasonable valuations. Today's share valuations are undoubtedly high in a historical perspective. Based on projected 12-month earnings, world stock markets are showing PE ratios around 21, driven upward by US shares at around 23. The expected sharp earnings increases in 2021 appear well discounted. But if we look ahead at 2022 earnings forecasts, PE ratios are 2-3 units lower. Excluding the digital giants (the FAAMG companies) and assuming their high valuations can be defended given rapidly rising profits, PE ratios fall by another couple of units. We still end up on the high side of historical average valuations, but this can be justified due to lower interest rates and yields. We can thus accept inflated valuations even though they are unlikely to survive significant earnings disappointments. But so far, the recovery has been accompanied by the opposite: upside earnings surprises.

Growth companies were last year's winners. The above observation about the FAAMG companies shows that a global index includes many differences in both performance and valuations, both in geographic and sectoral terms. In a globalised world, the performance and potential of various sectors has greater explanatory value than a company's geographic domicile. Last year's stock market performance included very large differences between sectors. The general trend was that more cyclical sectors were at a disadvantage, while companies driven by structural growth trends were rewarded. Among global sectors, we saw upturns of around 50 per cent for technology companies, followed by consumer discretionary goods, a category that now includes large digitisation winners like Amazon. At the bottom, with sharply negative figures, were energy companies and banks, but traditional industrial companies also performed more weakly than indices.

Successful COVID-19 responses benefited Asia. Large sectoral differences largely explain geographic variations. US indices have fewer cyclical components and a higher proportion of growth companies than European indices. Broad US indices have thus served as engines for the world equity indices, with the S&P 500 gaining 16 per cent last year while the growth-oriented NASDAQ stands out with an upturn of around 45 per cent. In local currency terms, broad European indices showed downturns of more than 5 per cent (a bit less if the UK is excluded). In USD terms, due to the decline of the dollar the figures for Europe are positive but still below global averages. Among other regions, Asia stands out on the plus side thanks to favourable sectoral composition but also greater success in limiting the spread of COVID-19. Commodity-heavy emerging markets have struggled despite rising commodity prices..

Long period of focus on value companies

Share prices, growth and value companies



Source: Bloomberg, SEB

Value companies may regain ground

Share prices, growth and value companies

Source: Bloomberg, SEB

If growth, interest rate and yield forecasts prove correct, there is continued stock market potential

Moderately rising yields indicate normalisation. The relative strength of growth companies vs more cyclical value companies faded a bit in Q4 2020. The prospect of economic recovery this year, supported by vaccine roll-outs and fiscal stimulus, is creating better conditions for cyclical companies. Meanwhile we are seeing signs that the interest rate/yield component in our calculations may shift direction. After many years of downward-trending yields, US long-term Treasury yields have climbed somewhat – driven both by higher inflation expectations and the risk of a somewhat earlier retreat from the current extremely expansionary monetary policy. We regard modest movements in that direction as welcome from a stock market perspective, since they signal a normalisation of the economic situation. But larger, faster upturns would create growth risks – given high global debt – putting pressure on already elevated share valuations. This is especially true of growth companies, with rising yields hurting the present value of future profits.

Nordic candidates for revised valuations. The global recovery will create attractive conditions for many companies in the Nordic countries. Nordic stock markets have a larger proportion of cyclical companies, and because of the big valuation gaps between growth and value companies, there are numerous candidates for upwardly revised valuations in the region. Although the recent appreciation of the Swedish krona has had a negative effect on the Stockholm stock exchange, the strength of the SEK coincides with a brighter growth outlook – which is a stronger force in the opposite direction. We expect Nordic industrials, with Sweden as the largest component, to deliver a pre-tax earnings increase of 25 per cent this year, despite the currency headwind.

Continued upside for sustainability following Biden's election victory. Surveys show that many investors have already begun to rotate their portfolios and reduce their overweight in growth shares, but from a tactical perspective we still see potential for value companies. Looking further ahead, many indications still favour strong digital companies. Experience from the pandemic can be expected to speed up the pace of an already powerful digitisation trend. High valuations will limit the potential, however. Another sector that will continue to benefit from structural trends is products and services that contribute to a more sustainable world. More and more investors are focusing on such companies, and sustainable funds are rapidly increasing their market share, while the flow of capital to this type of products is accelerating. Also supporting this trend is that Democratic election victories in the US promise solid investments in this field. China's new five-year plan and powerful political initiatives in the European Union also aim at steering capital towards more sustainable investments, with a focus on the carbon dioxide emission target in the 2015 Paris Agreement.

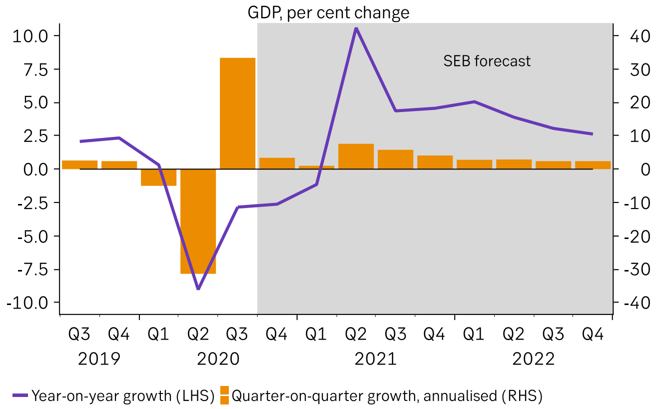
Long-term potential even though many positive trends are priced in. Investor surveys also show that fund managers have relatively high risk-taking in their portfolios, with a larger proportion of equities than historical averages. Together with valuations that already discount an optimistic scenario, this limits the potential for major upturns. But stock markets seldom perform badly during periods of good economic growth. Ultra-low interest rates and bond yields will also keep the TINA (There Is No Alternative) effect in place. Meanwhile central banks and governments are creating a floor by promising continued stimulus. This suggests that the growth picture must become clearly worse and/or valuations must climb really high before major share price downturns materialise. Profit-taking – leading to downturns of 10 or perhaps 15 per cent – will nevertheless remain a natural part of the picture. Over the next 12 months, we foresee high single-digit upside potential.

The United States

A weak start, followed by a roaring take-off

The US economy has been resilient during the pandemic. Growth will slow in early 2021, but further stimulus measures under a Democratic-controlled Congress are likely to fuel a new economic take-off later in the year. We expect GDP to increase by 4.5 per cent in 2021: an upward adjustment by nearly one point. The Fed will keep its key rate at close to zero and continue expanding its balance sheet at an unchanged pace this year.

A recovery on hold, followed by a roaring take-off



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

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.2	-3.5	4.5	3.6
Unemployment*	3.7	8.1	6.1	4.6
Wages and salaries	3.3	4.7	2.7	1.8
CPI	1.8	1.3	2.3	2.2
Core PCE (Fed target variable)	1.7	1.4	1.8	1.9
Public sector balance **	-6.7	-15.5	-13.0	-8.0
Public sector debt **	108	126	133	135
Fed funds rate, %***	1.75	0.25	0.25	0.25

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

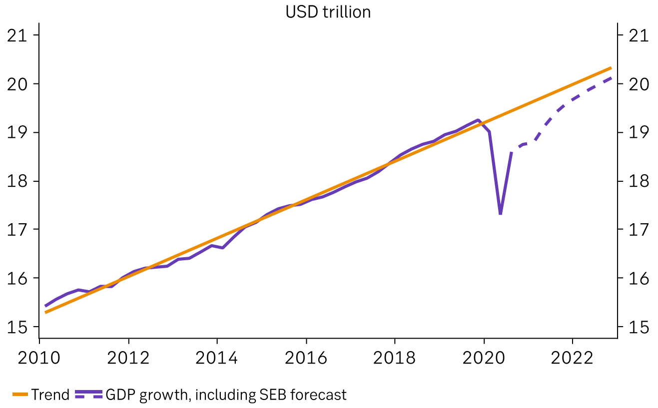
Vaccines provide hope beyond this winter's slump

The recovery from last spring's historically large GDP slide has gone faster than expected, supported by record-low interest rates and by stimulus measures. GDP looks set to fall by only 3.5 per cent in 2020: the biggest downturn in modern times, including the global financial crisis (2.5 per cent in 2009), but still far better than the roughly 7-8 per cent predicted by the OECD and IMF last June. COVID-19 vaccinations have begun, instilling new courage in the economy. Households and companies can now plan for a return to a more normal situation by the second half of 2021: a major difference compared to the deep uncertainty prevailing at the start of the pandemic. Prospects of new fiscal stimulus rounds during the Biden administration are setting the stage for a powerful growth surge when virus-related restrictions ease. We have revised our GDP forecast for 2021 to 4.5 per cent, from 3.6 per cent in November. We expect GDP to climb by 3.6 per cent in 2022 as growth gradually slows towards trend. This forecast implies that GDP will be back at pre-crisis levels by the second half of this year, 1½ years after the pandemic broke out – about half as long as it took for the economy to recover from the 2008/2009 crisis. But it will not fully close the gap compared to the previous growth trend.

Zero growth in early 2021. The recent COVID-19 resurgence will lead to a slowdown in Q4 2020, and we forecast growth of close to zero in Q1 2021. These effects are mild compared to developments in Europe, and especially compared to last spring's slide. We expect a temporary dip in consumer services and retail. Manufacturing and business services, on the other hand, have shown resilience despite signs of increased virus-related disruptions in deliveries and labour supply. The ISM manufacturing index rose in December to its highest since August 2018 and the start of the US trade war with China. Longer delivery times, normally a positive economic signal but now a consequence of the pandemic, help "artificially" lift the index. But components that reflect underlying demand, such as production and orders, have also risen to clearly expansionary levels. This confirms the impression that businesses are now looking beyond the short-term challenges caused by the virus. According to the ISM non-manufacturing index, service sector sentiment has remained at levels that indicate growth. Exceptions are sectors that depend on social interaction, such as entertainment and hospitality.

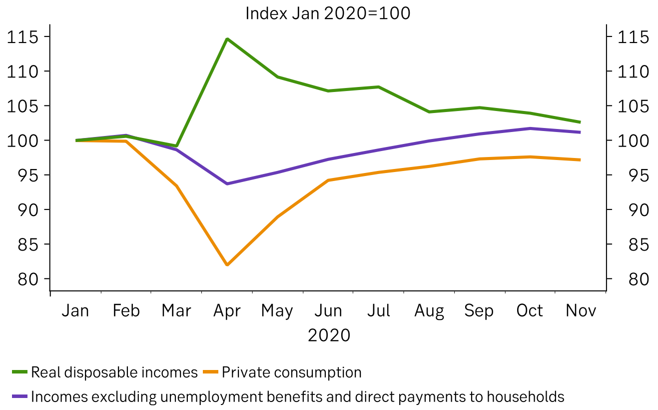
Brief slump in capital spending, but lagging exports. The manufacturing recovery was initially driven by durable consumer goods, especially cars, and by strong demand for IT and telecom equipment, but it is now showing signs of broadening towards investment and input goods excluding energy. In November, manufacturers' order bookings for capital goods, excluding volatile defence and aircraft orders, were 7 per cent above February levels – indicating a shorter slump in manufacturing sector investments than in previous downturns. In construction, the situation is divided. Low interest rates and low housing supply have greatly accelerated residential construction, offsetting a decline in other construction, especially in the private sector. Residential construction continues to contribute positively to GDP, but the pace of growth is expected to slow after last year's rapid expansion. US stimulus measures have been more powerful than in other countries, contributing to growing foreign trade deficits. We expect net exports to contribute negatively to GDP. Optimistic export order estimates in the ISM manufacturing index signal a continued future upswing, but exports have a long way to go before reaching pre-crisis levels. Exports to China have kept rising rapidly, but not enough to fulfil the terms of the "Phase One" trade pact signed early in 2020. By December, according to the Peterson Institute, China had imported US goods corresponding to less than 60 percent of the full-year 2020 target. We believe President Biden will adhere to the pact for the time being, to maintain pressure on China, but the risk of new punitive tariffs has diminished. US trade policy after Trump is discussed in a theme article on page 26.

US real GDP will return to pre-crisis levels by this autumn



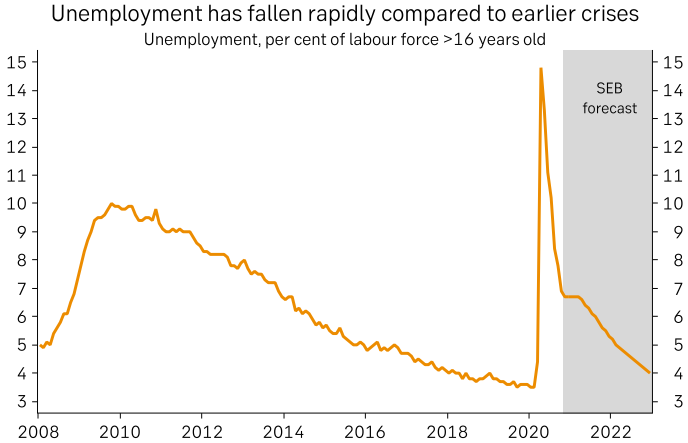
Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

Fiscal stimulus has propped up incomes and consumption



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

Unemployment has fallen rapidly compared to earlier crises



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

Strong household finances support spending

A worsening COVID-19 situation, new signs of labour market weakness and a phase-out of stimulus measures dampened consumer confidence late in 2020. After a strong recovery, especially for retail, private consumption fell in November for the first time since its collapse in April. This was due to new restrictions, not a lack of purchasing power. In November, real disposable income was still 2.5 per cent above the levels at the beginning of 2020. Meanwhile savings have remained high and rising share and home prices boosted household wealth. The savings ratio has fallen from over 30 per cent in April, but the current level of 13 per cent is still higher than the 7.5 per cent reported at the beginning of 2020. However, parts of the household sector are in a vulnerable situation because previously generous unemployment benefits have expired.

"Ketchup effect" for private consumption. In December, Congress finally agreed on a new stimulus package, including relief for small businesses and extended unemployment benefits – though at lower levels than in last spring's package – plus new direct payments of USD 600 per eligible adult. The Democrats, like President Trump, demanded USD 2,000 per person. Biden has promised to deliver this. It could provide another powerful boost to consumption this spring and eventually revitalise private services. Last spring's direct payments (USD 1,200 per person) contributed to a one-time surge in disposable incomes of about 15 per cent in April, the same month that unemployment rose to its highest since the 1930s. According to one survey (NBER Working Paper), households expected to spend an average of 40 per cent of the first payment. If the next round has similar effects, this may boost consumption by almost 1 per cent of GDP. Our forecast is that private consumption will rise nearly 5 per cent this year after falling by nearly 4 per cent in 2020.

A normal labour market is still a long way off. Unemployment has fallen sharply since its peak last spring. This is a clear difference compared to previous crises, reflecting the fact that many temporarily unemployed people were able to return to work when the economy reopened. More than half of the lost jobs have been recovered, but close to 10 million Americans are still jobless. Unemployment was 6.7 per cent in December. This figure exaggerates the recovery, partly due to technical problems with statistical classifications (contributing up to half a percentage point) but above all because labour force participation has fallen by about 2 points since the pandemic began. In December, the jobless rate fell for the first time since last spring. A decline of 140,000 jobs was driven by cuts in entertainment, hotels and restaurants, while manufacturing, business services, retail and construction added jobs. Those who lost their jobs are mainly classified as temporarily unemployed, and many should be able to regain their jobs when COVID-19 restrictions ease, but the number of permanent and long-term unemployed has gradually risen. In April, nearly 90 per cent of jobless individuals were classified as temporarily unemployed; today, the figure is just over 40 per cent, suggesting that the decline will slow in the future. In the coming months we expect a flattening or even a slight increase. We forecast average unemployment of 6.1 per cent this year and 4.6 per cent in 2022. At the end of our forecast period, unemployment will be 4 per cent, not far above the 50-year lows that prevailed before the COVID-19 crisis. We are thus optimistic about the long-term damage caused by the pandemic, compared to the period after the global financial crisis.

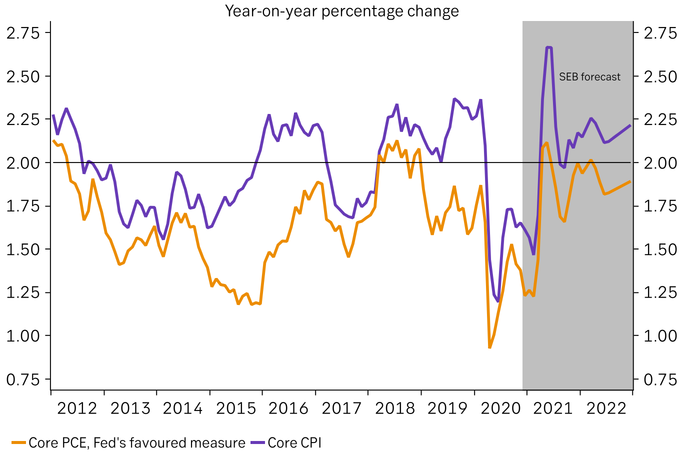
Biden is preparing massive stimulus packages

New fiscal stimulus measures would pave the way for a rapid return to more normal economic conditions. After two Senate run-off elections in Georgia, Democrats have a narrow majority in the

Senate (including Vice President Kamala Harris' tie-breaking vote) and in the House of Representatives. While legislation generally requires a qualified majority in the Senate (60 out of 100 votes), proposals that affect spending, revenue and debt ceilings can be approved by a simple majority under certain conditions. Democratic senators from conservative states will enjoy a swing vote, which still limits the scope for a leftward shift in policies compared to the party's election platform. The immediate focus will be on ensuring a continued recovery; this is vital for the 2022 mid-term elections. Biden has announced a new deficit-financed stimulus package of USD 1.9 trillion. Aside from larger direct payments it is expected to expand and extend unemployment benefits until the mid-2021 and give more money to small business, state and local authorities, as well as for vaccinations and the safe opening of schools.

Basis effects will cause a temporary inflation spike

Year-on-year percentage change

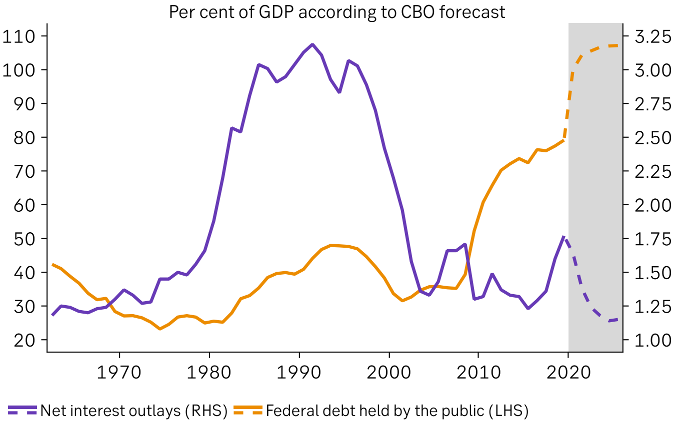


Source: <Property Source not found.>, Macrobond, SEB

Public debt will reach 135 per cent of GDP. Low interest rates will enable the US to bear a higher debt burden

Low interest expenses despite exploding public debt

Per cent of GDP according to CBO forecast



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

Later in spring, we also expect Biden to unveil parts of his green infrastructure investment plans, as well as expanded health insurance, partly financed by some of his previously announced tax hikes on high-income earners and companies. Including the December 2020 package (USD 900 billion) we expect unfunded spending to total USD 2.8 trillion in 2021. This represents a stimulus dose of 13 per cent of GDP. Public debt will keep climbing rapidly, reaching 135 per cent of GDP by the end of our forecast period. But low interest rates will enable the US to bear a higher debt burden. According to the Congressional Budget Office (CBO), 2020 Federal interest outlays as a share of GDP were about half a percentage point lower than in 2000, while debt rose from about 30 to over 100 per cent of GDP.

Reduced underlying inflationary pressures. Disruptions from the pandemic have led to volatile prices for many goods and services. Due to base effects, core inflation excluding food and energy will temporarily exceed 2 per cent in the first half of 2021. Changes in composition – since employment has fallen mainly in low-wage jobs – have helped to keep up average pay hikes, which are now around 5 per cent. But low resource utilisation suggests that underlying inflation pressures will remain subdued. Not even 3.5 per cent unemployment before the crisis triggered any clear acceleration. Remarkably, about one third of small businesses report a labour shortage according to an NFIB survey despite prevailing high unemployment, but this probably at least partially reflects the impact of the pandemic. The Fed's favourite inflation metric, core PCE, is expected to remain just below its 2 per cent target at the end of 2022 (read more about inflation on page 15)

The Fed will keep its key interest rate close to zero

Fed policy makers adjusted their economic forecasts higher in December, with a majority continuing to indicate an unchanged key interest rate of 0.00-0.25 per cent until the end of 2023. We are not ruling out the possibility that a rate hike might be brought forward a bit if the recovery speeds up but are sticking to our forecast of an unchanged near-zero key rate until the end of 2022. According to new guidance, Fed bond purchases will continue at their current pace of USD 120 billion per month at least until "substantial further progress" is made towards the Fed's employment and inflation targets. The latest Fed minutes did not show any plans by policy makers to adjust either the size or composition of these purchases, even though the central bank foresees short-term risks to the economy from the pandemic.

Focus on when the Fed will start tapering its bond purchases. The Fed has announced that tapering will follow the same principles as in 2014. At that time, purchases were reduced over a ten-month period from a starting point of USD 85 billion per month, followed by an initial interest rate hike just over a year later. This indicates that tapering will not be an issue in 2021, provided that Fed interest rate hikes lie a few years ahead. The Fed's total purchases last year corresponded to almost the entire budget deficit; this year we think the Fed will buy around half or a third if only looking at Treasury bonds. The Fed's adoption of average inflation targeting and its intention to let inflation temporarily overshoot 2 per cent seems to have gained a foothold in market-based inflation expectations. As a result, real 10-year Treasury yields remain close to -1 per cent, despite rising nominal yields after Biden's victory in the Senate run-offs. We believe the Fed can accept higher yields as long as they are driven by increased optimism about the economy and/or rising inflation expectations. But if higher borrowing requirements put pressure on long-term yields in a way that significantly tightens financial conditions, the Fed can be expected to act – for example by boosting the share of longer maturities among its purchases.

Theme:

Trade and politics

The return of multilateralism – or new setbacks?

Despite the pandemic and historic GDP declines, the world's governments refrained from protectionism in 2020. This will help economic recovery in 2021 and 2022. With Joe Biden as the new US president and an expected rebirth of the World Trade Organisation (WTO), there will be small but important steps back to multilateralism, increased trade policy predictability and lower risk premiums. We expect global trade volume to grow by 8 per cent this year and a further 5 per cent in 2022, bringing us back to pre-crisis levels by the end of next year.

World trade volume is expected to have fallen by 10 per cent in 2020. Commodities, vehicles/vehicle parts and tech products are among the biggest global trade items – which are greatly affected by economic cycles, industrial innovations and security policy decisions. A resurgence of COVID-19 in late 2020 and early 2021 has led to new restrictions that are expected to hurt trade in the short term, but not in the long term.

The pandemic is the first full-scale global crisis since the Second World War, yet governments have successfully maintained the global trading system. In crisis situations, there is a greater temptation to de-prioritise global cooperation and act in ways that pass on necessary and often difficult adaptation processes to others. Overall, this has not happened in 2020.

Trade policy is not just about tariffs and quotas. Complex bureaucratic decision-making processes, currency policy and state aid are hidden trade barriers that lurk in the background. Impediments to trade make recovery more difficult, for example by hampering exports, capital spending and technology transfers.

A new direction for trade policy is now possible. With Joe Biden in the White House, the US is expected to once again take steps towards greater multilateralism, which can also revitalise the WTO and encourage new free trade agreements. But crisis policies in individual countries and their impact on the competitive situation may lead to conflicts in the aftermath of COVID-19.

Not a restoration of pre-Trump policies

Biden will bring a change of tone and more predictability to global trade. The weak US industrial investment trend since 2018 supports the view that the trade war has not benefited the economy. Biden has promised to review Section 232 steel and aluminium tariffs and Section 301 tariffs on China. New steel tariffs were imposed for "national security" reasons – a source of irritation to US allies. The Biden administration will not regard EU countries as enemies but as potential partners. The risk of further trade war escalation through new tariffs on European cars can probably be forgotten. US criticism of the WTO and its conflict resolution system pre-dated Trump, but we believe Biden can open the way to the appointment of a new WTO director general and a functioning appellate body (below). Still, a restoration of pre-Trump trade policies is unlikely.

Protectionism is firmly established within both the Democratic and Republican parties. Biden secured his victory with support from some of the same Rust Belt votes that handed Trump the presidency in 2016. Biden's need for steelworkers' union support is an obstacle to a unilateral roll-back of steel tariffs. Biden has pledged to work with US allies towards fairer trade conditions. The new investment agreement with China, signed by the EU despite the incoming Biden administration's direct appeal for a delay, represents a setback in plans to form a united front against China.

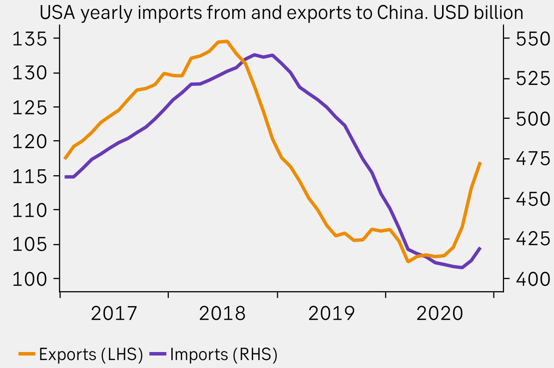
Trade policy is subordinate to Biden's domestic agenda. It will no longer focus only on ensuring cheap imported consumer goods. The Trump administration turned foreign trade into a scapegoat for US de-industrialisation, a view partly shared by Democrats. But tariffs will be replaced by an active industrial policy aimed at improving the competitiveness of US manufacturers and workers, including more domestic procurement, support for the transition from fossil fuel energy and investments in infrastructure, education and training. After the pandemic, Biden – like Trump – also wants to reduce US dependence on global supply chains for medical equipment and other key products.

Reaching broad new trade agreements is a lower priority. We do not expect the US to resume negotiations soon on the TTIP trade pact with the EU or on joining the Trans-Pacific Partnership. But China has boosted its influence through the new RCEP regional trade pact, underscoring the cost of US isolationism under Trump. Democrats view the new US-Mexico-Canada Agreement (USMCA) as a model in terms of ensuring good working conditions and environmental practices. This will complicate negotiations on new pacts with low-wage countries, but climate is a new area of global collaboration that may also enable Biden to bypass Congress and impose carbon border taxes.

Trump's legacy mainly consists of the Phase 1 pact with China. Regulated import volumes from the US have not solved the underlying problems between the two countries, but the agreement still represents progress in such fields as forced technology transfers and intellectual property rights. We believe that Biden will stick to the agreement even though China has not met its import targets. Tariffs will remain in place to exert pressure ahead of the next step, concerning Chinese government interference in the economy. Biden must also deal with unfinished trade talks with the UK and the ongoing conflict with the EU about digital taxation.

US trade with China is down since 2018

USA yearly imports from and exports to China. USD billion



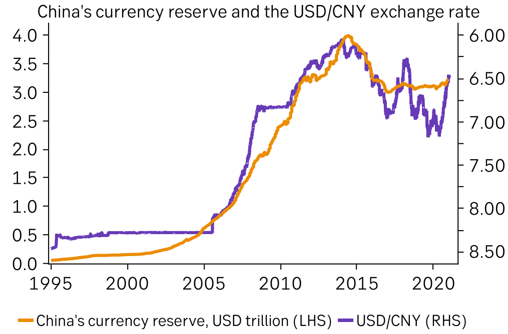
Source: U.S. Census Bureau, Macrobond, SEB

Stronger yuan will ease trade conflicts

China let the yuan rise by 7 per cent against the dollar – about 4 per cent in effective terms (BIS) – during 2020. Our conclusion is that a USD/CNY rate of about 6.50 is close to equilibrium. This will decrease the risk of trade policy conflicts.

The yuan keeps climbing, despite COVID-19

China's currency reserve and the USD/CNY exchange rate



Source: Macrobond, SEB

The strength of the yuan also reflects a dollar that has lost US Federal Reserve short-term rate support, but China probably wants to show a stronger currency for three reasons:

Symbolic value: The yuan signals that China's economy has COVID-19 under control and is stronger than many advanced economies, including the US. China wants to present itself as one of the main friends of globalisation and free trade and as fulfilling the G20 agreement not to gain competitive advantages via currency policy.

Stabilising: Chinese firms, especially state-owned ones, have about USD 3 trillion in dollar-denominated assets. China's debt problems are easing as the yuan strengthens against the dollar.

Attractiveness: A stronger yuan increases the world's appetite for Chinese financial assets and makes it less appealing for foreign companies to currency-hedge direct investments in China.

"More – not less – free trade"

Trade disputes not only mean that major economic interests in the US, China, the EU and the rest of the world are at stake. They are also a matter of tactics. The US, China and the EU are locked in a strategic competition for economic, technological, political and ideological leadership, with US and EU market-driven capitalism facing off against Chinese state-led capitalism. But the pandemic and the climate crisis are two obvious examples of situations that require alliances between numerous countries that have common goals (multilateralism). The world's governments are facing global challenges that require global solutions. This will also provide platforms for expanded trade cooperation.

Several important symbolic and practical steps were taken in the trade policy field during 2020, despite the ongoing COVID-19 crisis. For example, 15 Asian countries including China signed a Regional Comprehensive Economic Partnership (RCEP) in November. These countries account for around 30 per cent of the world economy. A post-Brexit UK-EU trade pact also fell into place at the last minute. But given the US-Chinese trade war and the paralysis of the WTO in recent years, a global multilateral trading system cannot be taken for granted.

WTO – rising from the ashes in 2021?

The WTO's 164 member countries account for 98 per cent of global trade. They have agreed on trade rules and how to comply with them. At the 2019 G20 summit in Osaka, leaders underscored the importance of rapidly reforming the WTO with a view to achieving results at its June 2020 summit in Kazakhstan. The pandemic has delayed this summit until June 2021.

Criticism of the WTO, which is widely viewed as an independent institution designed to resolve international trade disputes, concerns regulations that have not kept pace with changes in global trade and the emergence of large new economies such as China. The WTO is also regarded as treating fields like goods, services and data in separate silos. Digital technology is transforming trade at a rapid pace, in terms of how we trade and what is traded. But there are no regulations on how to monitor e-commerce.

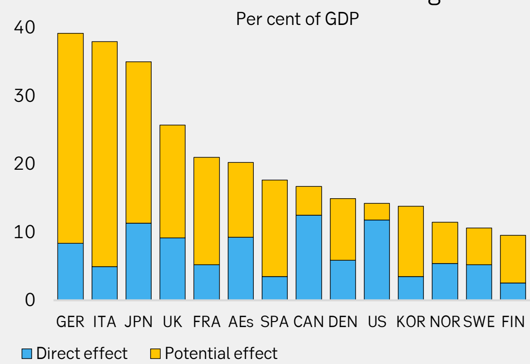
The WTO Appellate Body ceased to function in December 2019 when the US blocked the appointment of new judges. The short-term impact of this has been manageable, but there is a growing risk of new disputes when countries' rights cannot be examined and defended.

The WTO is in a crisis and has obviously lost legitimacy among its member countries; in some governments, confidence in the WTO is more eroded than in others. This has meant that the "law of the jungle" has assumed a more prominent role in the trade policy field in recent years, while the WTO's Appellate Body has been put out of action (see above). But it is noteworthy that no country has chosen to end its WTO membership. Instead, 23 countries are applying to join the WTO, which is an important signal. At the June 2021 summit, we expect the WTO to spell out steps towards reform.

COVID-19 policies – a source of conflicts?

During the COVID-19 crisis, countries have launched stimulus measures which total an estimated USD 20 trillion (23 per cent of yearly global GDP) so far. Fiscal stimulus accounts for two thirds of this amount. The programmes have had a **direct** impact on government budgets, for example via large public investments and corporate tax relief. Businesses have also received **indirect** government relief, for example through capital grants (including civil aviation) and sizeable loans and loan guarantees. Crisis relief policies are defensible, but they also affect the global competitive landscape.

Fiscal stimulus measures during 2020



Source: IMF, October 2020

In the EU, state aid is regulated by treaties and must be approved by the European Commission. Such EU countries as Germany, Italy, France and Spain have provided aid to businesses totalling 20-30 per cent of GDP. US aid to businesses via fiscal stimulus packages is less than in the EU and Japan, but aid via the central bank is correspondingly larger. The degree of utilisation and how quickly economies recover will determine the risk of trade disputes over the next couple of years.

Moving back towards normality

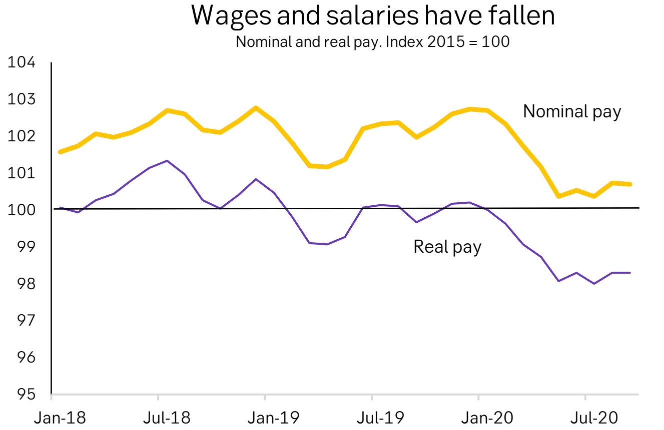
Domestic political shifts in the US make a return to the pre-Trump, pro-free trade climate unlikely. Domestic interests now enjoy priority over new trade agreements. The focus of the Biden administration will be on ensuring domestic economic recovery as well as good middle class jobs and incomes. But there is less risk that new tariffs will disrupt international trade, and the tone of conversation between the US and its allies is moving towards re-engagement.

The economic recovery will be driven by the service sector as various restrictions are lifted. The pandemic has led to temporary changes in consumption and other behaviour, with more goods consumption at the expense of the service sector. Normalisation will mean that global trade may grow more slowly during 2022, but without any interruption in the upward trend.

Japan

Small steps towards a brighter future

Tough COVID-19 restrictions continue to hurt recovery, but vaccinations and manufacturing resilience have led to hopes of a 2.1 per cent GDP rebound this year. Investments and private consumption will contribute to growth in 2021-22. Inflation will not reach the Bank of Japan's 2 per cent target during our forecast period. The BoJ will thus maintain its expansionary monetary policy in 2022, too. There is an urgent need for reforms to keep Japan from repeating previous GDP setbacks.



Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.0	-5.2	2.1	1.0
Unemployment*	2.4	2.8	2.7	2.6
CPI excluding food prices	0.5	0.1	0.1	0.5
Public sector fiscal balance**	-3.3	-14.2	-6.4	-3.2
Public sector debt**	238	266	264	263
Repo rate***, %	-0.10	-0.10	-0.10	-0.10
USD/JPY***	109	104	99	102

*Per cent of labour force **Per cent of GDP ***At year-end. Source: IMF, SEB.

COVID-19 is expected to have contributed to a 5.2 per cent decline in Japanese GDP during 2020. Recurring restrictions aimed at combating the spread of the virus are holding back domestic demand. As restrictions are lifted in Japan and other countries this spring, combined with monetary and fiscal stimulus, we expect cautious steps towards a brighter future. We foresee GDP growth of 2.1 per cent this year and 1.0 percent in 2022. This is above potential growth, which the Bank of Japan (BoJ) estimates at ± 0 per cent. Downside risks predominate, and the economy is vulnerable to stalled globalisation, increased competition in the global tech sector and protectionism. Our forecast assumes that the 2020 Tokyo Olympics will be held one year late, starting in late July. This will help fuel the economic recovery during 2021.

Japan must avoid repeating mistakes from previous crises. After the "bubble economy" crisis of the early 1990s, the "Asian" financial crisis of the late 1990s and the 2008-09 global financial crisis following the collapse of Lehman Brothers, Japan showed significantly weaker growth trends. Structural reforms are needed to boost production capacity by means of increased labour supply, more business investments and/or higher productivity. For obvious reasons, so far Prime Minister Yoshihide Suga has mainly focused on various measures to stem the spread of the coronavirus and help companies and households weather the current crisis. Suga will presumably continue to follow the main features of "Abenomics" (ultra-loose monetary policy, expansionary fiscal policy and structural reforms), but digitisation and climate change are two areas where Suga seems to have more ambitious goals than his predecessor Shinzo Abe. This may help to ease some of Japan's structural problems, such as the labour shortage.

The large cash reserves that companies built up over many years have shrunk, but they are still big enough to give Japanese manufacturers a global advantage and to fund increased investments, provided that the recovery begins this spring. Meanwhile the BoJ intends to contribute strongly to corporate credit resources. In December it extended its business lending programme for six months until September 2021. The BoJ is thus hoping to encourage investments in capital, labour and research.

Japan's unemployment is believed to have peaked at 3.1 per cent. We expect it to fall slowly during our forecast period to 2.5 per cent. Wage and salary growth slowed sharply as unemployment rose. We expect it to rise at a sluggish pace over the next two years. The government and the BoJ are trying to reduce the risk that companies and households will permanently lower their growth and inflation expectations. COVID-19 has pushed Japan back into deflation; in the fourth quarter of 2020, core inflation dropped almost to -1 per cent. Inflation is expected to be in the range of 0.0-0.5 per cent during our forecast period. Downside risks persist.

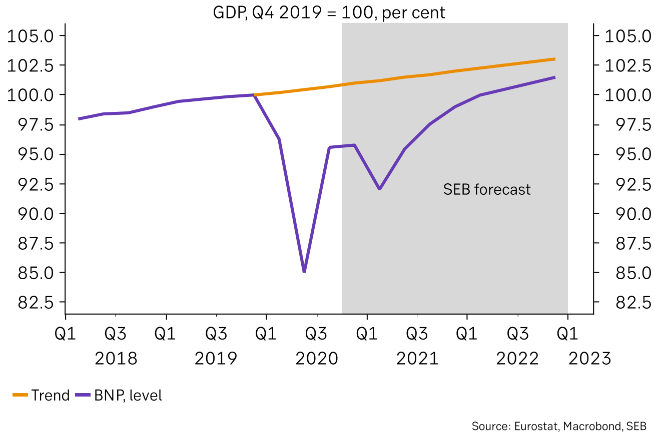
The BoJ will thus not achieve its 2 per cent inflation target. Long-term inflation expectations among households and businesses have trended downward for several years and are currently around 1 per cent (looking ahead 5-10 years). In the short term, stimulus policies have helped to improve the financial situation of businesses, but it is doubtful whether this can help lift pay levels and thus inflationary pressure. An expected decline in the US dollar also poses a downward risk to inflation. We expect the USD/JPY exchange rate to be 99 at the end of 2021 and 102 at the end of 2022.

The euro area

Recovery in pause mode

Due to the increased spread of COVID-19 and expanded restrictions, euro area economies will shrink again this winter. Manufacturing is more resilient than last spring, so GDP levels will not fall as far as then, but we are lowering our full-year 2021 growth forecast significantly. Crisis relief measures will nevertheless help mitigate structural damage. Once vaccines are in place, there is thus good potential for a relatively strong recovery during the second half of 2021 and in 2022.

Increased virus spread will contribute to weaknesses ahead



Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.3	-6.6	3.1	4.9
Unemployment*	7.6	8.0	8.7	8.2
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	-8.5	-7.0	-4.8
Public sector debt**	84.0	103.3	106.3	106.6
Deposit rate. %***	-0.50	-0.50	-0.50	-0.50
EUR/USD***	1.12	1.20	1.27	1.23

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

COVID-19 and vaccines will control near-term events

The past year was a real roller coaster, with uniquely large fluctuations in economic activity. The mid-2020 recovery was impressive, but only portions of the spring decline had been recouped by the time the second pandemic wave arrived. The serious spread of the virus has now led to new restrictions and lockdowns that will greatly hamper economic activity in the near future. Q4 was apparently not as bad as expected, with GDP moving sideways mainly due to sustained industrial production and construction. But the weak period will be more prolonged. We expect GDP to fall by almost 4 per cent during Q1 2021. In some respects, the restrictions are more extensive than last spring, especially in Germany, but overall we still believe that the economic trend will be far from the deep slump in Q2 2020. There is also greater preparedness among businesses and households to deal with the situation and an ambition to tailor the restrictions to ensure that in spite of everything, workplaces can remain open to a greater extent. Last summer's events also show that economies can rebound fairly quickly once restrictions are lifted. In Q2 2021, the vaccination process will probably have come far enough to make this possible, although it looks as if the euro area will lag somewhat behind countries like the US and the UK. Although we have revised our near-term forecast downward, we have thus not lowered the projected GDP level towards the end of our forecast horizon. The decline in GDP during 2020 now looks set to reach 6.6 per cent, and because of the more prolonged slump we expect a full-year 2021 rebound of only 3.1 per cent; a downward revision by 0.9 percentage points. We foresee GDP growth of 4.9 percent in 2022; higher than in our previous forecast.

Manufacturing looks surprisingly strong. It continues to perform more robustly than the service sector, and after last autumn's recovery, manufacturing indicators have kept climbing. The ambition to keep workplaces open as far as possible is benefiting manufacturing more than services. Germany stands out on the plus side, with a manufacturing PMI of over 58 in December. France, Italy and Spain are also above the 50 threshold denoting expected growth, although not equally strong. Forward-looking production components are strongest, but other components are also at decent levels. However, the employment indicator remains below 50, which is not surprising given the general economic situation and uncertainty. The manufacturing order situation is described as good, especially in domestic markets. By October, industrial production had recouped almost its entire pandemic-related decline, with year-on-year growth of -4 percent. We believe industrial production will continue to show resilience, although some contagion effects from weaknesses elsewhere in the economy are probably unavoidable.

Exports have fallen somewhat more than industrial production and were 3 per cent lower in November than a year earlier. It is clear that demand is determined by what pandemic phase a country is in. Exports to China are largely unchanged year-on-year, while exports to other regions have fallen by 10-15 per cent in current prices. We are also seeing such a decline in the UK, where Brexit-related trade problems have created barriers. In line with the overall economic trend, we expect exports to rebound when growth outside the euro area picks up during the second half of 2021. As expected, capacity utilisation is low, although it has improved since last spring and summer. Given the uncertain situation, businesses are predictably hesitant about investments, which we expect to lag when the recovery regains momentum this autumn and only begin to show more dynamism in 2022. Stable – and in most countries climbing – home prices will help keep up residential investments.

The need for further stimulus measures

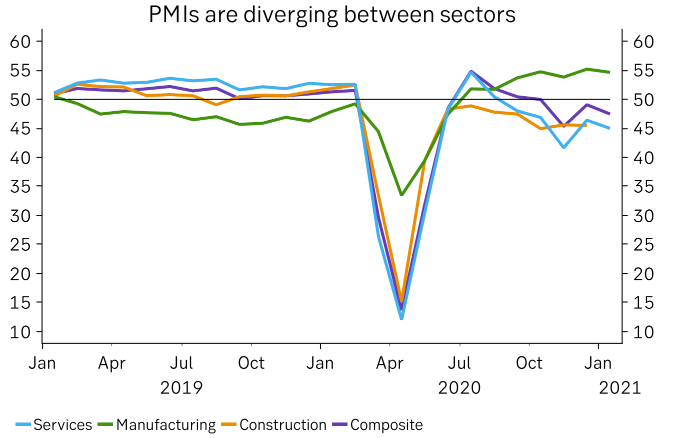
After negotiating a post-Brexit trade pact with the UK and a seven-year budget late in 2020, the EU will shift its political focus to such concerns as its new recovery fund, Germany's federal election and EU-US relations. Following approval of the recovery fund, important steps have already been taken at the national level – even in countries where there has been resistance that might disrupt implementation. Germany's decision to support intergovernmental transfers and EU borrowing was a major step, both in the short and long term. But this will not keep the election in Germany from being important, since Chancellor Angela Merkel is stepping down after helping ensure stability in EU cooperation efforts for many years.

GDP growth forecasts

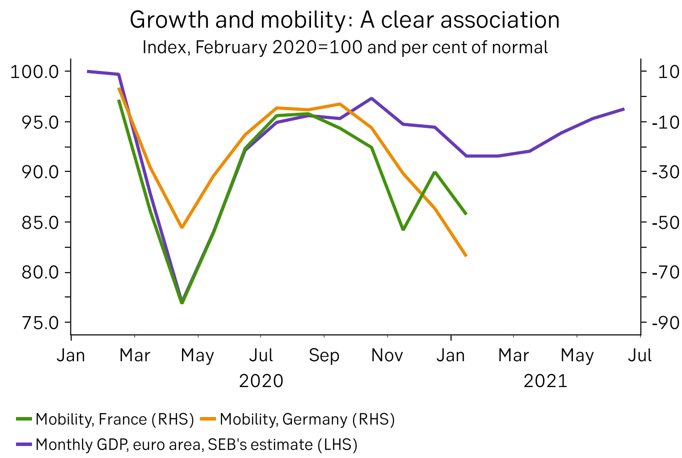
Quarter-on-quarter and year-on-year, per cent

	Kv 4	Kv 1	Kv 2-	2020	2021	2022
Germany	0.5	-2.5	2.0	-5.2	2.0	4.0
France	-0.5	-3.5	4.0	-8.2	5.0	4.9
Italy	0.0	-4.0	3.0	-8.3	3.4	6.5
Spain	0.0	-4.0	3.5	-11.1	2.7	6.1
Euro area	0.2	-3.9	3.7	-6.6	3.1	4.9

Source: Eurostat, SEB



Source: IHS Markit, Macrobond, SEB



Source: Google, Macrobond, SEB

Although the Brexit trade agreement reached in December meant that a total EU-UK divorce was avoided, many questions remain about its consequences. Negotiations will continue on issues that have not been resolved or have been postponed. With Joe Biden taking over as US president, we will see an attempt at a fresh start to improve EU-US cooperation. But the relationship has always been complex, with consensus on issues such as defence, trade and democracy, while differences on global issues have often emerged between the US and Western Europe, especially France. Looking ahead, we are likely to see tensions on matters like policies towards Russia and Iran. The management of the COVID-19 crisis may also lead to internal tensions. In more and more countries, we are seeing national policies being scrutinised and governments being criticised. This is also occurring in an environment where such issues as the environment and migration already have great explosive power.

National stimulus measures will finally get help from the EU. Given the prolonged duration of the pandemic, crisis measures will remain important. In 2021 member countries will benefit from EU relief packages. In addition to the usual long-term budget funds, they include the Next Generation programme totalling EUR 750 billion. To be rolled out over a 3-year period, it will provide EUR 390 billion in grants and the rest in loans: equivalent to 6 per cent of GDP or 2 per cent annually. This will be an important supplement to national budgets, which are hard pressed by emergency relief and already high debt. The aim is to give the programme's investments and reforms a green touch, with at least 30 per cent of funds earmarked for environmental projects. Much of this will be tied to national plans that must be developed and funded, which means they may take some time to have an impact. As a result, it may be hard to fulfil the EU's ambition of making the package front-loaded.

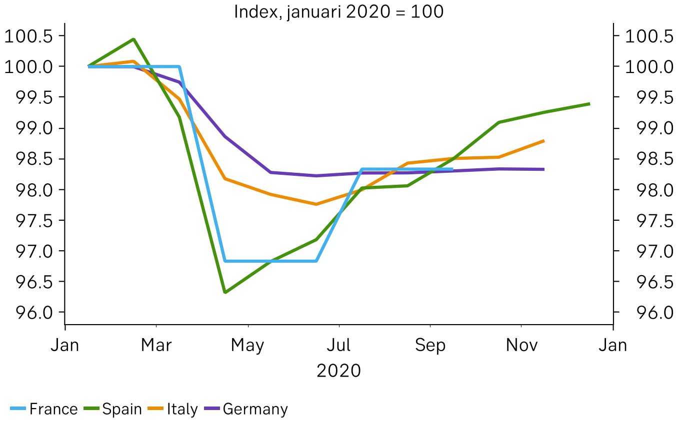
Extra support to weaker countries. The Next Generation programme is designed to give a larger share to countries with weaker economies that are more severely affected by the COVID-19 crisis, thereby narrowing the differences in fiscal manoeuvring room among EU members. So far Germany has clearly contributed more. This is likely to remain true as the recovery package is rolled out in the next few years. We believe the severe pandemic situation and delayed recovery will lead to new relief programmes being unveiled in the near future across the region. Overall fiscal policy, including EU-level programmes, will be expansionary also 2021. Support will be lower though as the acute need to mitigate the effects of lost production and demand diminishes. Now it is a matter of striking a balance and ensuring that efforts to stimulate demand are not removed too early. Fiscal policy will have an expansionary effect totalling 0,5 per cent of GDP in 2021, followed by a contraction of 2 per cent of GDP in 2022. Euro area budget deficits in 2020 are expected to have totalled 8.5 per cent of GDP. They will gradually shrink to just under 5 per cent in 2022. Public sector debt surpassed 100 per cent of GDP in 2020 and will remain essentially the same throughout our forecast period.

Households are saving and biding their time

Household consumption recovered significantly when euro area economies reopened during the summer. Of 12.5 per cent total growth in Q3 2020, consumption contributed a full 7.5 points. The remaining restrictions on the service sector stimulated consumption of goods, thereby strengthening the upturn in retail. But now we are seeing lockdowns squeeze the economy and create volatility. Retail sales fell surprisingly fast, 6 per cent, as early as November. In France the decline was a full 18 per cent compared to October as a result of early lockdowns, where the only exceptions were made for essential businesses but retail sales rose in December by a full 40 per cent. This means that we will see a weak trend around the turn of the year with a more pronounced weakness in the first quarter. Meanwhile there is reason to believe that the downturn will again be temporary and that consumption will recover markedly later this year. Vaccines are now being rolled out across the region, although later than in the US and elsewhere. Positive effects will increase once the vaccine has reached a large percentage of the population, which is expected to occur by the end of Q2. In addition, underlying positive factors such as rising home prices and high savings will ease the impact of tighter fiscal policies.

Employment is climbing slowly after last spring's lows

Index, januari 2020 = 100

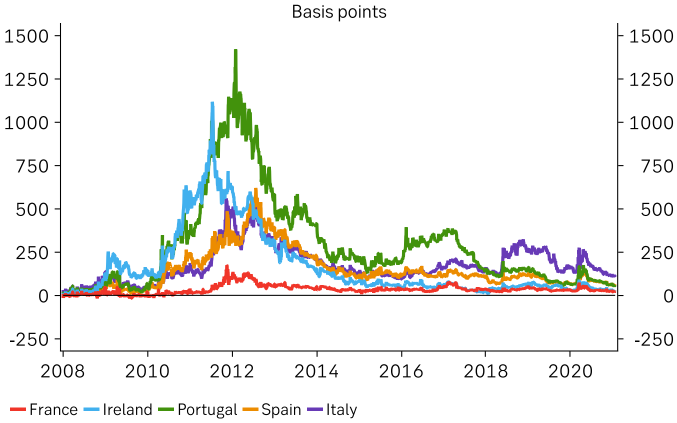


Source: National statistical offices, Macrobond, SEB

As long as the pandemic situation remains severe, we foresee a bias towards further expansion of stimulus programmes.

ECB squeezes government bond yield spreads

Basis points



Source: Macrobond Financial AB, Macrobond, SEB

Resilient labour markets. Euro area labour markets have been surprisingly buoyant, but various relief measures – especially "short-time work" schemes – and falling labour force participation are hiding part of their deterioration. Last autumn's recovery helped many people return to their normal jobs and unemployment fell from 8.7 per cent in August to 8.4 per cent in October. But now that restrictions have expanded again, the jobless rate is likely to begin climbing this winter and spring. We expect it to peak at almost 9 per cent around mid-2021. Once vaccines are in place, a relatively strong recovery will lead to clear labour market improvements in the autumn, but experience from earlier recessions indicates that it takes a long time to repair the damage. We believe unemployment will be higher at the end of 2022 than when the COVID-19 crisis began early in 2020. Measured as annual averages, unemployment will be 8.7 per cent in 2021 and 8.2 per cent in 2022.

ECB: Unchanged expansionary policy

In December, inflation remained at -0.3 per cent – the fifth straight month below zero. Core inflation is a bit above zero. It is hard to identify anything that might change this picture in the near term, since demand is low, wages and salaries are climbing slowly and a strong euro is helping to stem inflation. Some effects are temporary, and base effects will contribute to higher inflation ahead. Overall, our view is fairly similar to that of the European Central Bank. Both the Harmonised Index of Consumer Prices (HICP) and core inflation will climb to around 1 per cent and will thus remain well below the ECB's target of nearly 2 per cent throughout our forecast period.

The same tools will remain in use. At the December and January meetings, the ECB clearly signalled that it is ready to do anything to help sustain the economy. But the ECB meanwhile seems satisfied with its current policy direction, after the changes it made in November. ECB President Christine Lagarde emphasised that the bank will continue its balance sheet expansion at the same pace before. In November the ECB laid the groundwork for maintaining its current stimulus dose as long as required. The most important change was to expand the Pandemic Emergency Purchase Programme (PEPP) by EUR 500 billion to EUR 1,850 billion and extend it by nine months until March 2022. This total amount will allow continued monthly bond purchases of EUR 80-100 billion during the first half of 2021, followed by a phase-down. Lagarde kept the door wide open, noting that the full amount may not need to be used but that it can be increased if required. The ECB meanwhile extended its lending programmes (including TLTRO), which will supply the financial sector with cheap liquidity throughout 2021.

Balance sheet the most important tool. ECB regards its balance sheet as the most important tool at a time when key interest rates are already below zero. In light of differences in economic strength and fiscal room for manoeuvre, it is important that the ECB now allows deviations from its "capital key", enabling it to buy additional bonds from the more indebted economies. We believe that the benefits of further enlargements in bond purchases are marginal and that the important thing in the near future will be to maintain the current rate of expansion. If the ECB's bond purchases continue at their current pace, their volume in 2021 will be largely equivalent to the region's national budget deficits. Financial conditions improved significantly during the second half of 2020 and the ECB aims at keeping the present level of expansion intact, but not increasing bond purchases. Instead, ECB focus on printing money for the private sector via long-term, cheap loans, to banks (TLTRO) to boost credit expansion. No major changes in policy are likely, but as long as the pandemic remains severe, we foresee a bias towards further expansion of stimulus programmes.

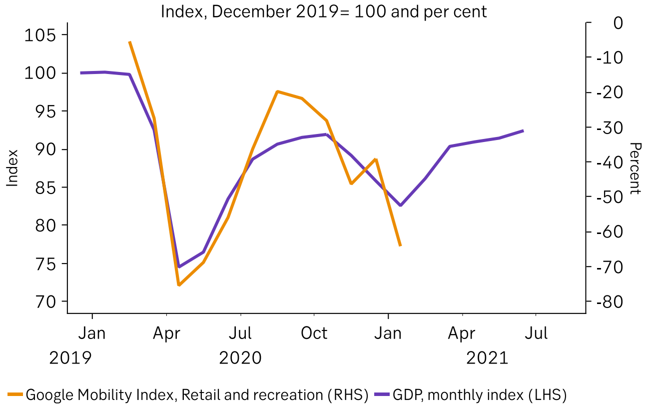
The United Kingdom

Third COVID-19 wave overshadows Brexit

After four and a half years, December 31, 2020 marked the end of the initial Brexit process, with the UK finally breaking off formal ties with the EU. The Christmas Eve trade agreement should be considered the best possible outcome under the prevailing conditions. The new COVID-19 variant and a third lockdown phase will overshadow the trade-related impact of Brexit in the short term. Major challenges lie ahead during 2021, when a politically divided union will also be put to the test.

UK double dip

Index, December 2019= 100 and per cent



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

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.4	-10.3	3.5	8.2
Unemployment*	3.8	4.5	6.1	5.4
Wages and salaries	3.5	-0.2	0.2	1.2
CPI	1.8	0.9	1.7	2.0
Public sector balance**	-2.2	-16.5	-9.0	-7.0
Public sector debt**	85.4	108.0	110.0	115.0
Key interest rate, %***	0.75	0.10	0.10	0.10
EUR/GBP***	0.85	0.89	0.87	0.85

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

Most vulnerable in Europe. The UK economy is not only affected by risks connected to future trade relations with the European Union. The COVID-19 pandemic is also hitting the UK harder than the rest of Europe. The government has generally imposed more far-reaching lockdowns than in other countries. A new, more contagious virus variant, first discovered in the UK, has contributed to a third wave of lockdowns in most parts of the country. These will severely curtail economic growth in many sectors until at least the end of February. Q3 2020 growth figures show that the UK economy was 8.6 per cent below its pre-crisis level, compared to 4.4 per cent in the euro area. Now most indications are that it is losing further ground. For the full year 2020, too, the UK is expected to be at the bottom of the charts, with a GDP decline of more than 10 per cent.

Recovery will be delayed. Indices that track people's movements around the country are beginning to approach the same low levels as in spring 2020, but we believe that due to previous experience the economic consequences will be less far-reaching. The UK has also been early in the vaccination process, potentially enabling it to ease restrictions earlier than Continental countries. The strength of the recovery during Q3 2020 is another source of confidence, but the longer major lockdowns continue, the more service businesses will shutter permanently, with lasting consequences for the labour market. Because of the weak start to the year, we have lowered our GDP growth forecast for 2021 by almost one and a half percentage point to 3.1 per cent. In terms of annual averages, 2022 will instead be the big recovery year; we expect GDP growth of 8.2 per cent.

Rising unemployment, but reasons to expect a tight labour market. Despite the large GDP decline, the rise in unemployment has been very moderate. The October jobless rate was 4.9 per cent; only 0.9 points higher than at the outbreak of the COVID-19 crisis. The design of the UK's job retention scheme has instead led to a sharp decline in average working hours and productivity, which will probably be reversed when the economy can reopen. We still believe that unemployment will rise – peaking at just above 6.5 per cent in mid-2021. In the slightly longer term, declining mobility in the European labour market may lead to a tighter UK labour market, creating a risk of bottleneck problems in many sectors.

Rising inflation pressure despite weak economic activity. The Christmas Eve trade agreement has decreased the risk of a sharp depreciation in the pound, but rising costs for cross-border trade will lead to higher inflationary pressures – which may be reinforced by labour market bottlenecks. Our forecast is that inflation will rise to 2.0 per cent in 2022. During the foreseeable future, however, the Bank of England (BoE) will focus more on monitoring developments in the real economy than on any inflationary trends. At present, the BoE's November increase in asset purchases is sufficient. Because of the UK's relatively orderly exit from the EU, we believe that the central bank will refrain from negative key interest rates. Instead, fiscal policy will continue to bear the heaviest stabilisation policy burden. Planned tax increases have been postponed.

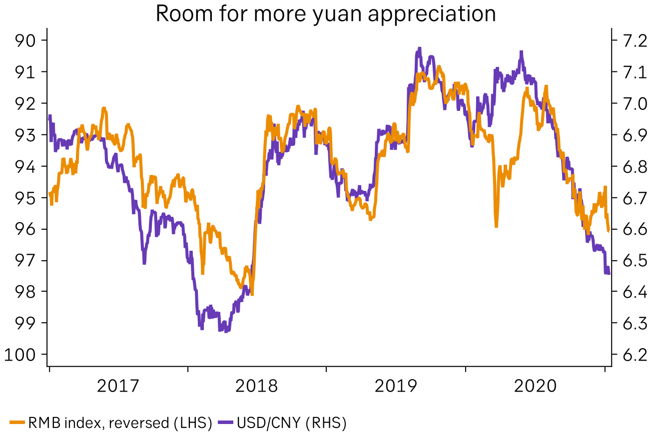
Political polarisation will continue. The issue of leaving the EU has divided the British people for almost five years and pitted different parts of the UK against each other. The newly negotiated trade rules will be most noticeable in Northern Ireland and at the south-eastern tip of England, the main hub of cross-border goods trade. The Scottish parliamentary elections in early May will once again focus on the issue of independence for Scotland, where opposition to Brexit has also been greatest. Criticism of the government's handling of the pandemic also boosts the likelihood that the ruling Scottish National Party may finally play a decisive role in the balance of power in the Westminster Parliament. Political risks will thus hang over the British economy for a long time to come.

China

Still leading the global recovery

China's growth outlook implies that it will continue to lead the global recovery after COVID-19. GDP will grow by 8.0 per cent this year. We expect base effects and high activity to result in double-digit GDP growth in the first quarter of 2021. Meanwhile global vaccinations will help increase external demand. Yet we are aware of China-specific challenges that risk slowing the country's recovery. Even so, we expect yuan appreciation to continue.

Room for more yuan appreciation



Source: Bloomberg, SEB

Key data
Year-on-year percentage change

	2019	2020	2021	2022
GDP	6.1	2.3	8.0	5.6
CPI	3.1	2.5	1.6	2.0
Public sector fiscal balance*	-2.8	-3.6	-3.0	-3.0
Bank reserve requirement, %**	13.0	12.5	12.5	12.0
1-year loan prime rate**	4.15	3.85	3.85	3.85
Deposit rate, %**	1.50	1.50	1.50	1.50
7-day reverse repo rate, %**	2.50	2.20	2.20	2.20
USD/CNY**	6.96	6.50	6.20	6.00

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

China's GDP will grow by 8 per cent this year after having shown a sustained recovery through most of 2020. During Q4 the economy accelerated to a growth rate of 6.5 per cent year-on-year, which has been confirmed by various high frequency data indicators. The service sector is slowly catching up with the earlier recovery in manufacturing. The new orders component of the purchasing managers' index is still trending higher, indicating further near-term gains. Industrial production is benefiting from strong exports and rising domestic demand, offsetting a minor slowdown in infrastructure and property investments. The underlying momentum, along with significant base effects due to the GDP decline in Q1 2020, suggests that China will show double-digit growth in Q1 2021.

Hopes for an end to the global pandemic have risen in recent months. Yet logistic challenges remain in many parts of the world as well as some scepticism among the general public about taking a COVID-19 vaccine. We have assumed large-scale vaccine roll-outs during Q2. Significant delays in vaccinations could worsen global risk sentiment and slow international demand for Chinese goods, thereby impeding the recovery.

Several China-specific challenges may jeopardise the recovery. First, credit growth will slow in 2021. Although we expect the People's Bank of China (PBoC) to keep its key interest rates unchanged during our forecast period, the effects of earlier rate cuts will fade with a 6-9 month transmission delay. Moreover, upcoming regulatory tightening in the property sector's capital requirements will also slow lending growth.

Second, we expect some of the fiscal stimulus to be unwound, even though domestic demand has apparently not yet achieved a solid foundation. We expect the central government to lower the cap on its fiscal deficit towards 3.0 per cent of GDP, from 3.6 per cent in 2020. We also do not expect the government to issue another round of "special pandemic" treasury bonds this year.

Third, we believe that Beijing's recent resolve to re-impose market discipline will lead to more corporate bond defaults. Although the PBoC is supplying needed liquidity, there is a risk that credit to fundamentally solid companies may be pulled down by bad credit.

Finally, household consumption remains sensitive to new COVID-19 outbreaks. The strategy of imposing localised lockdowns and rolling out mass testing seems to have been successful, but continued uncertainty will delay a full-bodied recovery in private spending.

Yuan appreciation has more room to run than we initially expected. Meanwhile the consolidation of the USD/CNY exchange rate in December meant that the yuan lost ground against the currencies of its most important trading partners, as reflected by the pullback in the RMB Index. We expect the PBoC to be tolerant of a stronger yuan. Allowing the RMB Index to trade higher towards 98 would aid the recovery in domestic consumption. Although the PBoC is in no rush to aggressively tighten monetary policy, it is relatively hawkish compared to other major central banks. Overall, we expect financial conditions to continue tightening. Combined with our expectations of further decline in the USD, we expect the USD/CNY rate to reach 6.20 by end-2021 and 6.00 by December 2022.

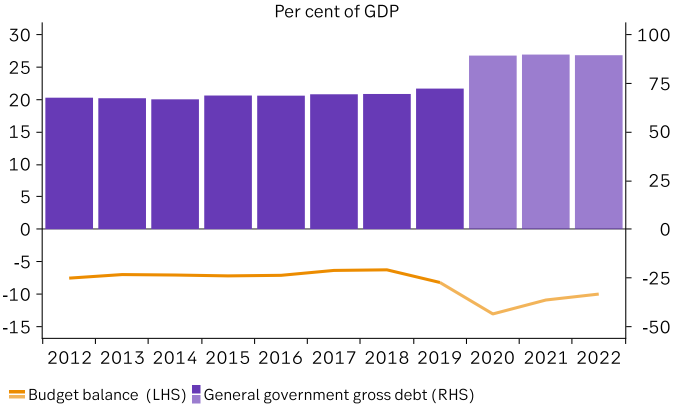
India

Sluggish and uneven recovery

Light is beginning to appear at the end of India's economic tunnel – but many challenges remain, which will hold back the recovery. It will take time for all migrant workers who moved back to the countryside to return. The banking system is likely to need support. Monetary policy will have to do the heavy lifting, as weak government finances put restrictions on fiscal stimulus. Growth of roughly 9 per cent this year is not enough to bring India's GDP back to its pre-pandemic trend.

India's worsening government finances pose a challenge

Per cent of GDP



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

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	4.2	-7.5	9.1	7.2
CPI	3.7	6.6	4.6	4.0
Public sector fiscal balance*	-7.4	-11.0	-8.0	-6.0
Current account balance*	-1.0	1.7	-1.0	-1.6
Key interest rate, %**	5.15	4.00	3.50	3.50
USD/INR**	71.4	73.1	69.0	69.5

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

GDP rebound in 2021. With more than 10 million COVID-19 cases and over 150,000 deaths, India has the highest infection figures in the world after the United States. However, India's pandemic is clearly in retreat. This is reflected in rising consumer confidence, employment, vehicle traffic and air travel. The economic recovery appears likely to be gradual and unevenly distributed. GDP fell by an estimated 7.5 per cent last year and is expected to increase by 9.1 per cent this year from a low starting point before stabilising in 2022 when GDP growth falls back to 7.2 per cent. The recovery in 2021 will be driven by a gradual normalisation of consumption and net exports.

The mass movement to rural areas will hamper manufacturing. The service sector – which accounted for nearly 54 per cent of GDP before the pandemic broke out – is growing again, though at a slow pace. Meanwhile the manufacturing sector is still struggling with the consequences of the mass movement of migrant workers back to rural areas during last spring's lockdowns, but the situation appears likely to improve. The authorities began COVID-19 vaccination programmes in mid-January. Although delays may occur, we expect that confidence in the economy will gradually gain strength in 2021 and 2022. Exports and industrial production are also likely to increase as more and more people are vaccinated worldwide. Demand for labour will thus increase gradually. One potential drag on the economic recovery is the quality of lending by banks, which was very poor even before the pandemic. The Reserve Bank of India (RBI) expects the ratio of non-performing loans to nearly double by September 2021, reaching 13.5 per cent of total lending.

Monetary policy will bear the heaviest burden. So far the central government has been cautious about fiscal stimulus measures in order to avoid weakening its finances too much. Monetary policy has thus borne the heaviest burden. The RBI lowered its key interest rate by a total of 115 basis points to 4.00 per cent on two unscheduled occasions in March and May. Since then the central bank has paused its rate-cutting due to stubbornly high inflation despite weak demand. But room for further cuts seems to have opened up, because inflation fell sharply from 6.9 per cent year-on-year in November 2020 to 4.7 per cent in December and is now thus within the RBI's 2-6 per cent tolerance band. We expect a rate cut of 50 bps to 3.50 per cent during the first half of 2021, followed by an unchanged key rate until the end of 2022.

The government will be forced to make concessions. Despite a tight fiscal policy, the government budget deficit looks set to reach about 11 per cent of GDP during the financial year ending March 31, 2021 (the IMF forecast is 13 per cent). An expansionary fiscal policy looks inevitable during the next financial year. Protests against reforms in the agricultural sector have been under way since last August, and even if Prime Minister Narendra Modi does not roll back the reforms, his administration is likely to make concessions that will cost money. Incentives to boost investments in the manufacturing sector, especially by foreign companies that are concerned about India's erratic tax laws, will lead to decreasing revenue. The government will probably also make infrastructure investments as the pandemic loosens its grip, in order to kick-start economic activity. We expect the overall budget deficit to shrink to about 8 per cent of GDP in 2021 and 6 per cent in 2022. General government debt will stabilise at just below 90 per cent of GDP.

Stronger currency. We expect the economic recovery to drive a gradual appreciation of the Indian rupee from its current 73.3 per US dollar to 69.0 this year. A stabilisation of the exchange rate looks most likely in 2022, but worsening government finances pose a risk to the rupee.

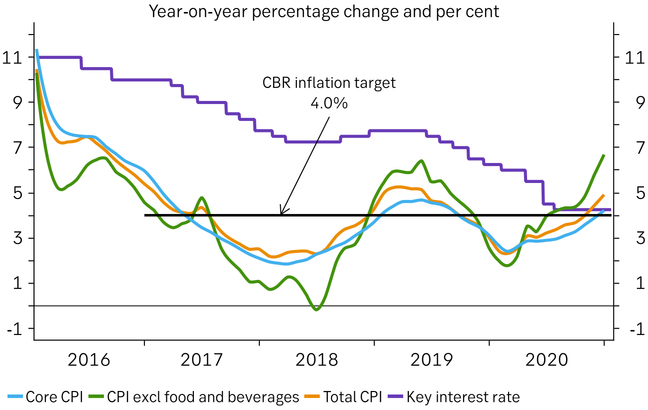
Russia

Sedate recovery, due to tight fiscal policy

The Russian economy has weathered the pandemic relatively well. GDP fell by only 4 per cent in 2020. Gradually rising oil prices and production will help drive economic growth over the next two years, but because the authorities have been cautious about fiscal stimulus measures the recovery will be fairly slow. Government finances remain strong, which should provide some support to Russian financial markets during late 2021 and 2022.

Rising inflation is forcing the CBR to pause its key rate cuts

Year-on-year percentage change and per cent



Source: Central Bank of the Russian Federation (CBRF), Russian Federal State Statistics Service (Rosstat), Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.1	-4.0	3.5	2.5
CPI	4.5	3.4	3.9	4.0
Government debt*	13.9	18.9	19.0	18.5
Current account surplus*	5.8	3.0	3.0	3.5
Wages and salaries (nominal)	7.3	5.2	6.0	7.5
Key interest rate, %**	6.25	4.25	4.00	6.00
USD/RUB**	61.9	74.1	69.5	75.0

*Per cent of GDP **At year-end.
Source: IMF, Rosstat, Central Bank of the Russian Federation, SEB

Russia experienced a rapid increase in the spread of COVID-19 last autumn, leading to an economic slowdown, but infections appear to have diminished in recent months. The statistics are difficult to interpret due to holidays and reduced testing. The Kremlin has avoided a national lockdown in order to minimise the economic impact. Instead, local restrictions have been imposed, especially in major urban areas. One uncertainty factor in our forecasts is that Russia has not yet been hit hard by the new coronavirus variant, which has contributed to increased infections in parts of Europe.

GDP seems to have shrunk by about 4.0 per cent in 2020. Some of the weakness late in 2020 will probably affect the first quarter of 2021, but we expect the cautious recovery that is now discernible to gain a firmer footing during Q2. Russia was one of the first countries to announce that it was close to developing and testing a vaccine, Sputnik V. Although production has been relatively slow, a vaccination programme has now begun. So far the population has been sceptical about Sputnik V, but test data indicate high effectiveness. If no severe side effects emerge, vaccinations should steadily increase. The official goal is to vaccinate 70 per cent of the population by November 2021, which is perhaps a little optimistic.

Monthly statistics on economy activity are divergent. Industrial production and natural resource extraction continue to grow, although their level remains lower than in 2019. The service sector is struggling. Overall, we estimate that GDP will grow by 3.5 per cent in 2021 and 2.5 per cent in 2022, since structural weaknesses such as high corruption, an unfavourable investment climate and inefficient state-owned companies will remain.

The finance ministry is cautious about stimulus measures. Large-scale fiscal stimulus programmes to support the economy are unlikely, since the Kremlin wants to minimise any increase in central government debt. President Vladimir Putin would like to retain as much political flexibility as possible. Rising government debt might expose Russian financial markets to greater volatility and increase vulnerability to potential sanctions by the US or the EU.

Monetary policy will ease in 2021 and tighten in 2022. Inflation averaged 3.4 per cent in 2020, the second lowest annual figure since the collapse of the Soviet Union. This is a result of orthodox monetary policy, which the CBR embraced whole-heartedly after the 2014 crisis, but the figure conceals a big difference between the beginning of 2020 when inflation was 2.3 per cent and the end of the year when it was 4.9 per cent. A weakening of the rouble, caused by plunging oil prices in March and the economic slowdown, was the main driver. Other contributing factors behind the inflation upturn were hoarding and bottlenecks in goods distribution. As oil prices rise and the economy recovers, we believe that the rouble will gradually appreciate and inflation will fall to the CBR target of 4 per cent. This will enable the central bank to cut its key interest rate from the current 4.25 per cent to 4.00 per cent during 2021. Overall, we expect inflation to stabilise around 4.0 per cent at the end of 2021 and 2022. Monetary policy will probably be tightened in 2022 as the economy recovers more clearly. We believe the key rate will be 6.0 per cent by year-end.

Geopolitics a constant risk factor. Russian authorities have gradually adopted a tougher stance towards opposition voices, which has led to criticism especially from the US and the EU. US-Russian disputes also risk receiving more attention from the Biden administration. Additional large-scale sanctions against the Russian government and central bank are not part of our main scenario. We instead expect tit-for-tat retaliation in response to suspected Russian actions, such as cyber intrusions.

Theme:

The Riksbank

Challenges for the monetary policy framework

Debate on monetary policy frameworks and their applications has gained new momentum, due to the changes that the US Federal Reserve implemented during 2020. The Fed's expanded ability to test how hot the labour market can become before harmful overheating symptoms emerge will change the playing field substantially. Evaluations of such frameworks are now also taking place in Europe. The overriding role of the inflation target is enshrined in the Treaty on European Union, which entails some restrictions. But the European Central Bank (ECB) is likely to make its inflation target symmetrical. Sweden's recent report of the Commission of Inquiry on the Riksbank did not propose much in these areas that was new. Instead the Riksbank seems intent on broadening responsibility for managing the challenges faced by stabilisation policy.

The Fed is also taking steps towards price level targeting, in the sense that its previous bias towards undershooting the inflation target will now be offset by increased tolerance for overshooting it. There is an asymmetry in this arrangement. The Fed wants to avoid committing itself to forcing inflation below 2 per cent if it faces the opposite of today's challenge after a period of above-target inflation. This attitude reflects which way the winds are now generally blowing; by various means, the Fed wants to avoid being caught in the trap that arises when a low neutral real interest rate eats up the manoeuvring room of interest rate policy on the downside. In practice, this shift represents a kind of forward guidance in a dovish direction. It has already had some effect in the form of rising inflation expectations, though announcements in the US and elsewhere on fiscal stimulus have also played a part.

Bad timing for the Riksbank Commission of Inquiry. The economic crisis caused by the pandemic, combined with the Fed's changes, seem to have created some confusion in the Swedish monetary policy debate. The report of the parliamentary Commission of Inquiry on the Riksbank, published early in 2020, will now start to be processed in the political system. But this will take a long time, and some of its proposals even require amending the constitution. There were probably expectations of more concrete proposals on how monetary policy could meet new challenges. But this is largely already in the hands of the Riksbank. The EU Treaty's restrictions also apply to Sweden, even though we are outside of the euro area. This includes the possibility of formally elevating employment to a target of equal importance alongside inflation. The report instead focuses on more clearly delimitating areas of responsibility between the Riksbank – on the one hand – and Parliament, the government and other public agencies such as the Swedish Financial Supervisory Authority (FSA) and the National Debt Office (NDO) on the other. This may concern frameworks for the management of foreign exchange reserves, the Riksbank's balance sheet, equity capital, asset purchases and so on. As the Riksbank gains access to more and more tools that have a profound impact on the entire market economy, this becomes increasingly important. It may sometimes seem that the Riksbank "takes on" a bit too much, perhaps because it has a strong organisation with great authority and confidence in its capabilities.

Riksbank out of step with other countries. Looking at Swedish public debate, we can certain say that criticism of the Riksbank in recent years has aimed at bringing about changes that would go in the opposite direction from what the Fed is now doing. Critics have argued in various ways that the Riksbank should not devote all of its ammunition to pushing up inflation:

"Leaning against the wind". An even more expansionary monetary policy has the disadvantage of driving up asset prices and household debt. By "leaning against the wind" and taking this into account, the Riksbank can mitigate future problems.

"Mission impossible". The Riksbank should realise that it is waging a hopeless battle against international disinflationary forces and should therefore increasingly accept deviations from its 2 per cent inflation target. A lowering of the inflation target is sometimes regarded as one way of adapting to these new conditions.

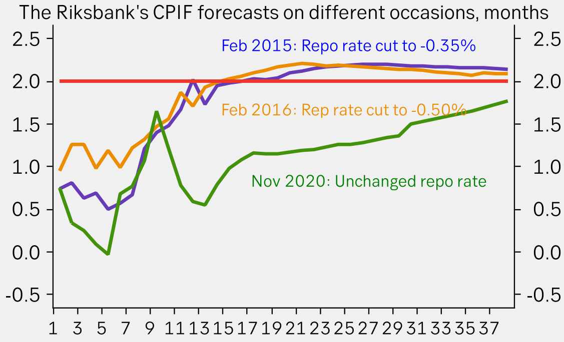
"That maddening CPI metric". The CPI has various shortcomings. Some people argue that it is too narrow and should also take asset prices into account. A more common argument is that Swedish CPI is measured in an overly sophisticated way. For example, Statistics Sweden makes more quality adjustments for price increases than its peers in other countries. Increases in official CPI thus tend to be lower than price increases for a more "down to earth" consumption basket.

Harder to use the Fed as a model. The above factors have been put forward as reasons why the Riksbank's struggle to bring inflation up to target has actually been unnecessarily aggressive and sometimes harmful. Our own assessment is that problems with measurement methods are often exaggerated, and we see clear disadvantages in lowering the target as an adjustment to a recalcitrant world. But we have some sympathy for the idea that in certain situations it is reasonable to "lean against the wind" and take into account such risks as runaway household debt and asset prices. We have also identified other factors that make the application of monetary policy more difficult, for example time lags in the inflation process, with inflationary impulses often arriving late in the economic cycle. The Riksbank's focus on actual inflation in such an environment has led to a clear pro-cyclical pattern, with its key rate increases in 2001 and especially 2008 as clear examples. It has also made key rate cuts amid heated economic conditions. We thus view the Fed's pragmatism in also taking into account the general economic situation – especially in the labour market – as a way to make monetary policy work, even in an environment where an inarticulate Phillips curve provides ambiguous associations between economic conditions and price and wage formation.

Special disadvantages of negative key interest rates. There has been an especially great need for increased flexibility when negative interest rates and a highly volatile krona have created uncertainty for economic actors. We believe the Riksbank has now also begun to view this situation as a problem. Over the past six months, it has published inflation forecasts that "admit" the difficulties of reaching the inflation target within its forecast horizon. In spite of this, the bank has settled for expanded asset purchases but has refrained from rate cuts. Of course, there is a risk that this will lead inflation expectations to fall uncomfortably low.

Increased tolerance for deviations from the inflation target

The Riksbank's CPIF forecasts on different occasions, months



Source: The Riksbank, Macrobond, SEB

No plans to lower the inflation target. Deputy Governor Per Jansson is perhaps the Riksbank Executive Board member who has discussed these issues most concretely, for example in a recent speech entitled "Some thoughts on the need for changes to inflation targeting" (December 16, 2020). The Board includes differing points of view, but it is interesting to examine Jansson's ideas about how the current situation – where inflation looks set to remain low for the foreseeable future – can be managed given the conditions prevailing in Sweden. He firmly rejects the idea of lowering the inflation target and adopting a relaxed attitude to inflation that remains persistently below target, saying that this would only aggravate the situation by leading to unnecessarily high real interest rates and further declines in inflation expectations. In the long run, such action would further reduce monetary policy manoeuvring room in an environment of depressed neutral real interest rates. His thoughts are probably close to the international mainstream, both among academics and policy makers, and it seems unlikely that Sweden would move in that direction.

Is it possible to raise the inflation target? Jansson goes further and is rather sceptical of the Fed's attempt to raise inflation expectations with its long-term guidance. He concludes that at least it is not suitable to Swedish conditions. Instead, he raises the bigger question of the potential for raising the inflation target to 3 per cent in the long run, to increase room for manoeuvre and create more distance from the zero interest rate bound. Although this feels remote at present, conditions may change once the economic situation normalises. He also believes that global disinflationary forces may weaken in the long term. Making an early announcement of plans for a higher inflation target when the opportunity presents itself might raise inflation expectations in the near future.

Help from fiscal policy and wage formation. Yet the big picture today is attempts to broaden responsibility for dilemmas we face in fiscal policy, macroprudential supervision and wage formation. During the COVID-19 crisis, fiscal policy makers have shouldered greater responsibility, cheered on by international organisations and central banks. Jansson raises the question of whether it is possible to formalise fiscal relief measures so they arrive faster and are not delayed by political battles. He discusses the interaction between the Riksbank and wage formation. "Maintaining confidence in the inflation target, so that it can continue to function as a benchmark for price-setting and wage formation…is the whole point of inflation targeting," Jansson writes. He addresses the debate on the role of the "industrial sector's benchmark" in Swedish wage formation, noting that this system worked smoothly for a long time but may now create socio-economic imbalances. This is mainly due to the tendency to reach pay agreements that are a bit too low to be compatible with the inflation target. In addition, the current system makes it hard to change relative wages in ways that might make the labour market work better, which is also a problem.

A focus on both inflation targets and other countries. The leading role of the industrial sector in Swedish wage formation has recently been questioned with varying intensity. The main criticism is that the system is actually rigged for fixed exchange rates. In such a system, industrial firms exposed to foreign competition are the first to suffer if high pay increases undermine their competitiveness. In a world of floating exchange rates and inflation targets, domestically oriented sectors are affected at least as severely if the Riksbank is forced to hike key interest rate in response to collective pay agreements that threaten to drive up inflation. This is nothing new, of course. Ever since today's wage formation framework took shape in the mid-1990s, employer and employee organisations have tried to balance both perspectives and take into account restrictions imposed both by the inflation target and pay increases in other countries. There is a consensus between the two sides that they cannot rely on exchange rate movements to offset large deviations from pay increases in other countries – especially Germany – within a reasonable time. This is one good reason for preserving the system of letting the industrial sector go first and establish a "benchmark" for the rest of the Swedish labour market.

Stronger reasons to enter a minefield. As long as pay increases tended to be slightly higher than consistent with the inflation target, the Riksbank often took the initiative to offer advice. But after the opposite problem emerged around 2012, it has probably been considered more sensitive to complain about excessively low pay agreements in a world of generally low wage hikes. The reason why a Riksbank Executive Board member now chooses to get involved in this very sensitive topic is probably that the balance has been disrupted a bit. This past decade, both the Riksbank and the ECB have found it hard to reach their inflation targets, due to strong disinflationary forces. These forces have been even stronger in the euro area, which has also suffered an existential crisis. An underlying decline in the nominal exchange rate of the krona is a natural consequence, both theoretically and anecdotally. This is also reflected in SEB's estimates of the krona's equilibrium exchange rate, which has moved upward and is now believed to be about SEK 9.70 per EUR.

Reversing the target for pay hikes? Such estimates are, of course, uncertain and must be handled with care. Employer and employee organisations are probably wise to remain cautious about relying on exchange rate movements to offset large divergences from other countries. Yet there are signs that the pendulum is swinging in the other direction. Sometimes it is considered a problem that Sweden has succeeded a little better than the euro area in meeting its inflation target; it would thus be desirable for Sweden to have a lower rate of price and pay increases in the future than the euro area. In principle, this means accepting a reverse version of the historical "sin" than the Fed now wants to atone for. Instead of compensating for earlier undershooting of the target by allowing higher inflation, Sweden would try to push down the rate of pay and price increases to compensate for the previous trend. Such an approach represents a major deviation from floating exchange rate principles and would introduce strong deflationary forces into the economy. It is therefore reasonable for the Riksbank to object to this.

Three-year pay agreements were recently put in place. Given the prevailing labour market situation, the Riksbank can hardly complain about their levels. In any case, the two sides have no reason now to begin discussing systemic changes It is also difficult to foresee that an increase in the inflation target, for example to 3 per cent, will seriously be under international debate anytime soon. Sweden can hardly pursue this path alone. There will be calls for the Riksbank to display its own creativity to find solutions that will allow it manoeuvring room and prevent inflation expectations from moving in a direction that indicates serious credibility problems. Unfortunately, on various occasions in recent decades the Riksbank has been unclear about its intentions, and its lack of flexibility has led to sudden policy shifts and sometimes harsh applications of the existing framework. At present, the Riksbank wants to avoid lowering its key interest rate to negative levels. But since its motives are quite unclear, there is a risk that it will deliver cuts at a time when actual inflation is again falling – at a stage when the economy has reached firmer ground – giving monetary policy a pro-cyclical direction again, as we have seen several times in the past.

The Nordics

Sweden

Due to mild restrictions, the economic cycle will be smoother than elsewhere, taking off this autumn. GDP will surge by nearly 5 per cent in 2022. Low inflation will pressure the Riksbank, but its key rate will stay at zero as fiscal stimulus eases monetary burdens.

Page 41

Norway

The mainland economy is showing resilience despite last autumn's re-imposition of restrictions. After a mild downturn, the stage is set for a solid rebound. Given an improved growth outlook and rising home prices, Norges Bank will hike its key rate in 2022.

Page 45

Denmark

The recovery has been put on hold, since restrictions have been extended. Led by consumers, growth will take off later this year due to a fast vaccine roll-out and easy credit conditions. A strong DKK will increase the risk of a key rate cut in 2021.

Page 47

Finland

Relatively low COVID-19 rates have helped Finland avoid full-scale lockdowns. The recession has been fairly mild, and the economy will recover in 2021. But growth will be hurt by "old" problems like stagnant productivity and a shrinking workforce.

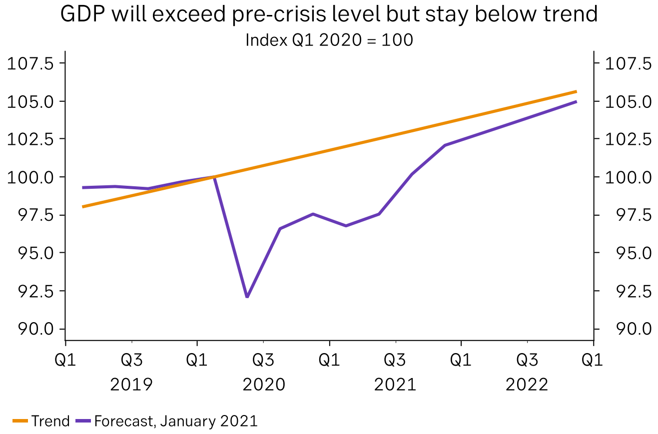
Page 48

Sweden

Smoother cycle, due to fewer restrictions

Due to milder restrictions, the economic cycle will be smoother in Sweden than elsewhere. The GDP decline early in 2021 will be gentler, while this spring's recovery will be a little weaker. But in the second half of the year, the recovery will pick up speed, helping push GDP growth to nearly 5 per cent in 2022. Low inflation will still put pressure on the Riksbank, but we believe its key interest rate will remain at 0 per cent, partly because new fiscal stimulus will ease the burden on monetary policy.

GDP will exceed pre-crisis level but stay below trend



Source: Statistics Sweden, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.3	-2.6	2.8	4.8
Unemployment*	6.8	8.3	8.7	7.7
Wages and salaries	2.5	1.7	2.4	2.5
CPIF (CPI excl. Interest rate change)	1.7	0.5	1.4	1.0
Net lending**	0.6	-3.3	-3.2	-1.9
General government debt**	35.0	38.7	38.5	36.5
Repo rate, %***	0.00	0.00	0.00	0.00
EUR/SEK***	10.51	10.20	9.80	9.70

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

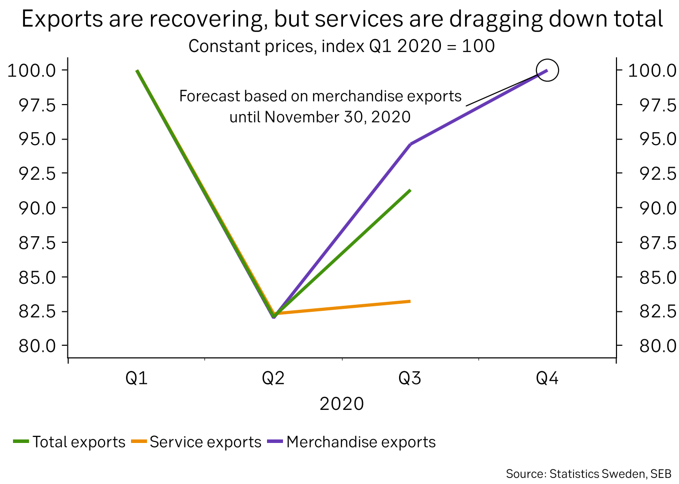
Fourth quarter 2020 GDP appears to have been stronger than earlier feared, with an expected quarter-on-quarter increase of 1 per cent. Although purchasing managers' indices (PMIs) remain close to cyclical peaks, we expect GDP to fall by 0.8 per cent in Q1 2021. Restrictions and lockdowns have broadened both in Sweden and elsewhere. Most indications are that this will hamper the economy for another few months and exert heavy pressure on certain sectors. Sweden's vaccination roll-out has lagged behind expectations, and there are risks of further delays. The outlook for a recovery during the second half of 2021 is good, but full-year GDP growth will reach only 2.8 per cent due to the weak start. Although we foresee some levelling off in the course of 2022, average GDP for the year will be a full 4.8 per cent. We have adjusted our annual forecasts for 2020-2022 upward compared to earlier projections and are sticking to our main forecast of an unchanged zero key interest rate, although an increasingly strong krona has made a rate cut more likely. The Riksbank will continue its quantitative easing (QE) this year according to the plans it presented in November, and next year's asset purchases will offset maturing bonds. Partly due to foreign currency purchases, the Riksbank will continue to expand its balance sheet gradually during our forecast period. We believe the government will unveil new stimulus measures this spring on a scale that will make fiscal policy largely neutral in 2021.

Goods exports up, service exports sluggish

In December, Sweden's manufacturing PMI rose to about the same level as its highest figures in recent decades, but the overall index was elevated because unusually many companies are reporting long delivery times, which is probably due in part to disruptions in production. But rising order bookings, higher production and even increased employment are the most important drivers. Both merchandise exports and industrial production were higher in November than at the start of 2020, confirming the impressive recovery. Elsewhere in the world, too, the manufacturing sector is far more resilient than last spring, but retail lockdowns in many European countries will nevertheless have some contagion effects. We thus expect industrial production to fall by 1-2 per cent in Q1 2021 – a modest downturn compared to about 15 per cent in Q2 2020. Looking ahead, manufacturers will be well equipped to benefit from the global recovery that will begin later in 2021. We expect merchandise exports to grow by 4.0 per cent in 2021 and 5.0 per cent in 2022, after a modest 2.0 per cent decline in 2020.

Structural problems for service exports. Despite rebounding merchandise exports, total exports are about 9 per cent lower than at the beginning of 2020, since service exports have fallen significantly. This is mainly because of large downturns for transport and travel services, but also exports of many types of business services. We will probably see renewed declines after the very moderate upturn discernible during Q3 2020. Service exports are likely to remain at low levels until summer, but then contribute positively to GDP growth. Yet part of the downturn, especially related to business travel services, appears to be structural. We expect service exports at the end of 2022 to remain lower than before the COVID-19 crisis. But because of strong merchandise exports, total exports will be substantially higher than in early 2020, though a bit below the previous growth trend.

Residential construction will boost investments. Capital spending fell by nearly five per cent in Q2 2020. Machinery investments plummeted nearly 20 per cent but recovered three fourths of their decline in Q3 and will probably continue their upturn in the near term. The number of housing starts fell in Q3, but we still believe that residential construction is on its way up after having gradually declined since 2017. Commercial property investments are showing signs of falling, however, and the weaknesses that were already apparent in late 2019 are intensifying because the COVID-19 crisis is hampering demand for both office and retail space. We may conceivably see a lasting trend of relocation away from major cities and towards more remote work, leading to long-term pressure on the commercial property market. But a continued increase in public sector investments will help to increase total investments at a healthy pace. Having fallen by 1.5 per cent during 2020, capital spending will grow by 4.0 per cent in 2021 and 6.0 per cent in 2022.

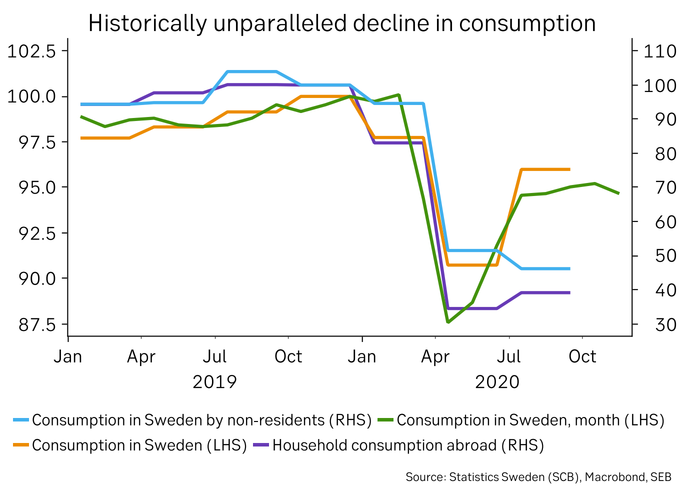


Household incomes and savings ratio

Year-on-year percentage change

	2019	2020	2021	2022
Real disposable income	3.1	-1.2	4.7	2.8
Private consumption	1.3	-4.5	2.5	4.0
Savings ratio, per cent of income	15.9	17.5	18.9	18.0

Source: Statistics Sweden, SEB



Delayed recovery in consumption

Household consumption fell by 10 per cent during the first half of 2020. This is by far the sharpest drop ever; the 5 per cent year-on-year decline during the 1992-93 krona crisis was the previous record. Despite a strong recovery in Q3, consumption was five per cent lower than at the end of 2019, and monthly data show that the upturn stalled as early as August. Consumption of services plunged, while goods consumption – aside from a brief downturn during the spring – was almost completely unaffected. The most dramatic trend was in tourist services, with Swedes consuming 60 per cent less tourism abroad while tourism in Sweden by non-residents fell by 50 per cent. New restrictions point to low or even falling tourism abroad in the first half of 2021, contributing to continued weak consumption. Lower Christmas shopping indicates that the negative trend on a monthly basis began in December. Assuming that the spread of COVID-19 gradually falls due to vaccines and warmer weather, there is good potential for a strong recovery by summer.

Record-high savings. Although household incomes fell by 7.5 per cent in Q2 2020, this was almost entirely because of lower share dividends. As early as Q3, incomes were higher than in the same quarter of 2019. Expansionary fiscal policy, rising employment and normalisation of share dividends suggest a strong increase in income this year. Household savings have risen, especially because of a record-sized increase in bank balances. This also points to a strong upturn in consumption once restrictions are eased.

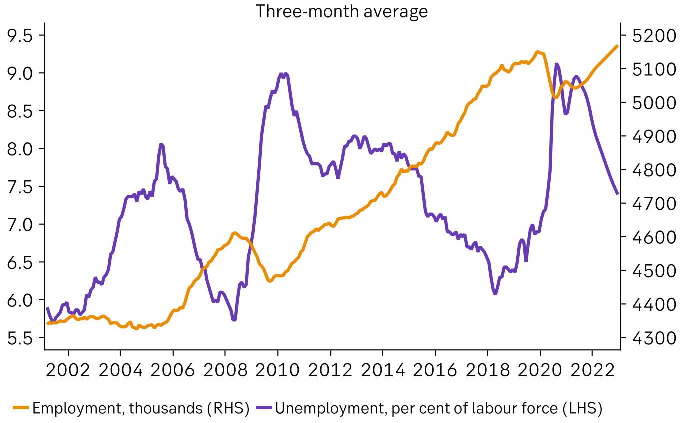
Home prices will continue to climb. Home price increases slowed down a little towards the end of 2020, partly due to seasonal factors. The SEB Housing Price Indicator has fallen slightly, but its level suggests a yearly price increase of more than five per cent. This trend will be driven mainly by large price upturns for single-family houses, but prices of tenant-owner units are now also exceeding their earlier peaks from 2017. We have again adjusted our home price forecast upward, and we expect yearly increases in the range of 3 to 5 per cent in both 2021 and 2022 after an upturn of more than 10 per cent during 2020.

Higher unemployment this winter

After an upturn of about two percentage points last spring, unemployment stabilised in the summer and fell during the autumn. Meanwhile employment has recovered some of its steep spring decline. A large number of employees received wage subsidies, which helped to limit the upturn in unemployment. According to the Labour Force Survey (LFS), at the peak in May 2020, 270,000 people – equivalent to nearly 5 per cent of the labour force – received subsidies. The risk that some of those receiving subsidies would be terminated has been one important reason for our forecast that unemployment will continue to rise, but this argument has weakened because the number of subsidy recipients fell to about 50,000 in November without pushing unemployment higher. For example, according to the Economic Tendency Survey of the National Institute of Economic Research (NIER), hiring plans in the business sector have risen to levels that suggest a slight increase in employment. Assuming that GDP falls during Q1 2021, a slight upturn in unemployment is still the most probable scenario, but we now believe that the jobless rate will not exceed nine per cent this spring, which is somewhat lower than the peak summer 2020 levels. When growth takes off during the second half of 2021, unemployment will initially fall rapidly, and by the end of 2022 it will only be a bit higher than in early 2020. But we should remember that unemployment had begun to rise even before the pandemic struck. Its level at the end of 2022 – 7.3 per cent – is still nearly one point higher than in 2018, when joblessness reached its lowest level since the global financial crisis. Statistics Sweden (SCB) has announced that starting in January 2021 it will implement adjustments to the LFS in compliance with directives from Eurostat. These adjustments will reduce the number of people defined as employed, but since fewer people will belong to the labour force the impact on relative unemployment is unclear. During 2021 SCB will also present figures using current definitions in order to continue its historical time series, but there is a risk that labour market statistics will be hard to interpret for a long time to come.

A temporary unemployment surge this winter

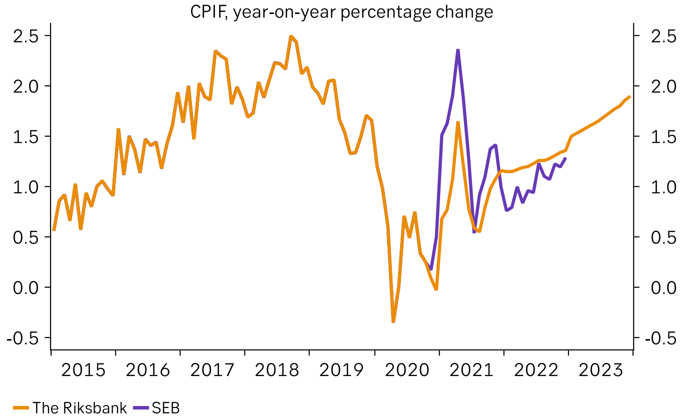
Three-month average



Source: Statistics Sweden, SEB

Large fluctuations in the inflation rate during 2021

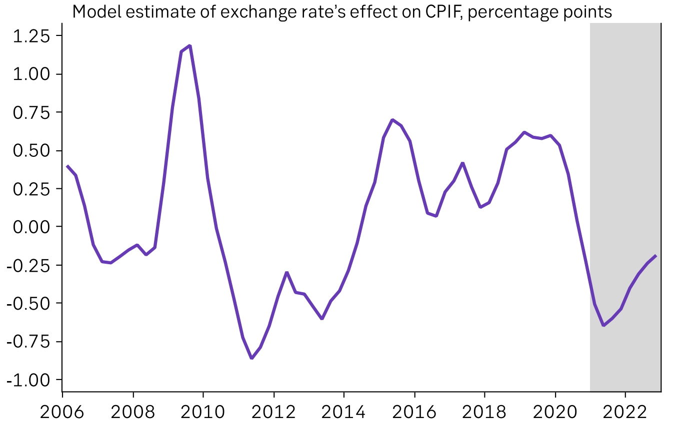
CPIF, year-on-year percentage change



Source: The Riksbank, SEB

Stronger exchange rate will push down inflation

Model estimate of exchange rate's effect on CPIF, percentage points



Source: SEB

Strong krona will push down inflation

After industrial employers and unions signed their collective agreement in early November, other economic sectors followed this benchmark. However, the Municipal Workers managed to negotiate somewhat higher pay hikes and also win retroactive increases for 2020. The industrial agreement included pay hikes of 2.2 per cent yearly during 29 months. This was slightly higher than the outcome of the 2017 wage round, but taking into account the lack of retroactive increases for 2020, these pay increases were lower.

Volatile inflation in 2020. Inflation generally underwent unusually large fluctuations during 2020. Many prices showed large movements, as well as unusual seasonal variations due to lockdowns and restrictions. Because of a slightly colder winter, electricity prices appear likely to climb rather dramatically in early 2021. Since energy prices were record-low during the same period of 2020, the inflation rate will surge from 0.4 per cent in December 2020 to 2.4 per cent in April 2021. Forward contracts indicate that energy prices will then fall again during the summer, contributing to lower inflation. For CPIF excluding energy, we expect a temporary upturn to 1.6 per cent this spring due to weak comparative months in 2020. However, an increasingly strong krona suggests that the underlying inflation trend in 2021 will be weak, and when all temporary price movements have faded away, inflation will end up at less than one per cent by the end of this year. Inflation will climb somewhat as the economic recovery picks up, but it will not exceed 1.3 per cent by the end of 2022.

Continued pressure for new Riksbank actions

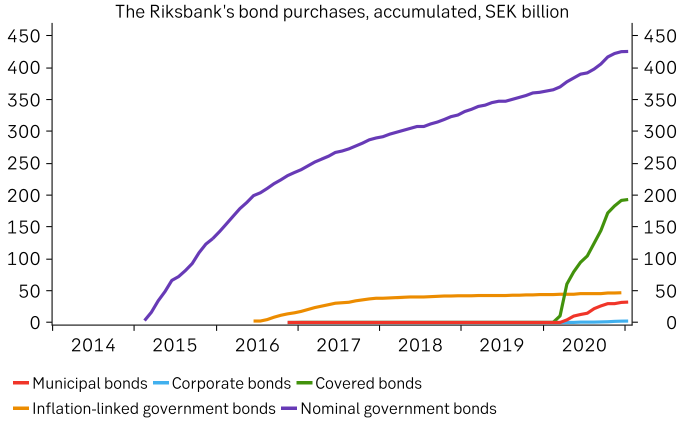
Rising inflation this winter and spring will give the Riksbank a little breathing room. Although the central bank will view the upturn as temporary, inflation expectations will probably gain a little support. At its November policy meeting the Riksbank decided to extend its quantitative easing (QE) purchases until the end of December 2021 and increase their volume to SEK 700 billion. There are many indications that the upcoming February meeting will leave current policy unchanged, but after that various forces will pull in different directions. Despite good prospects for economic recovery in the coming months, there will be increased pressure for further Riksbank actions if inflation falls again in line with our forecast. At present it is unclear what strategy the Executive Board will choose. The Riksbank has continued to repeat the message that at present, a key interest rate cut would not be an effective step, but this may change in the future. The minutes of the Board's November meeting gave the impression that various members were considering a rate cut if further stimulus should be needed. However, no member dissented from a rate path that signalled an unchanged repo rate during the next couple of years. One way of interpreting this is that the probability of a rate cut is as large as the probability of a rate hike during our forecast period.

Expansionary bias, both for the repo rate and QE. Our main forecast is that the repo rate will remain at zero throughout our forecast period. But if the krona appreciates more and faster than expected, inflation and inflation expectations will probably fall further. This would undoubtedly increase the likelihood of rate cuts. The Riksbank has announced bond purchases that will keep its balance sheet growing this year. We believe that during 2022, purchases will continue at a relatively rapid pace to offset maturing bonds. The Riksbank's decision to increase its currency reserve by about SEK 180 billion will contribute to continued balance sheet expansion until the end of 2023. There is also a substantially higher probability that the Board will expand Riksbank purchases if yields and risk aversion rise, rather than making smaller purchases than planned.

Expanded purchases. When bond purchases were expanded in November, housing bond and municipal bond volumes rose, while government bonds purchases decreased. So far, the Riksbank has only reported purchases for the first quarter, but assuming that its allocation will be the same for the rest of this year, the volume of government bonds not held by the Riksbank will increase for the first time since its purchases began in 2015. Almost 60 percent of purchases are now mortgage bonds, and towards the end of 2021 Riksbank holdings of these will be almost as large as in government bonds. The stock of covered bonds is gradually rising but the volume not held by the Riksbank will fall. This is expected to cause already low interest margins for these bonds to tighten further.

Large purchases of covered bonds

The Riksbank's bond purchases, accumulated, SEK billion

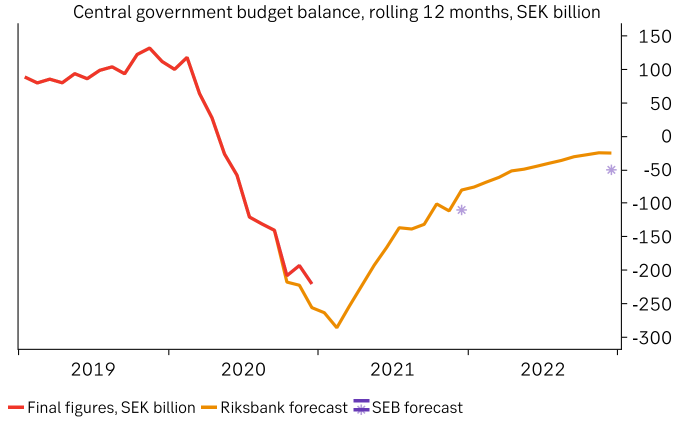


Source: The Riskbank, SEB

Rate cuts are likely if the krona climbs more and faster than expected and inflation ends up surprising on the downside

The 2020 budget deficit was less than previously feared

Central government budget balance, rolling 12 months, SEK billion



Source: Swedish National Debt Office (Riksgälden), Macrobond, SEB

Fiscal policy will have a neutral impact in 2021

In terms of fiscal policy 2020 was a year of many supplementary budgets, as developments in the COVID-19 crisis forced the government to propose sizeable stimulus measures in many areas. Because the downturn was not triggered by underlying economic imbalances, but instead by pandemic-related lockdowns, policy makers had to apply fresh thinking in choosing their responses. To a great extent, these measures have eased the burden on Sweden's classic automatic stabilisers. In the labour market, for example, government "short-time work" subsidies kept people in their jobs, instead of collecting traditional unemployment benefits. The economic downturn and related stimulus measures have had a significant impact on public finances, but the outcome has nevertheless been better than previously feared. This is partly because the economy shrank less than expected, so that relief programmes did not have to be fully utilised. So far there are no full-year 2020 figures for the overall public sector, but the central government will be hardest hit. Its budget deficit ended up at SEK 221 billion, compared to the National Debt Office (NDO) forecast of SEK 402 billion last May when the situation looked gloomiest.

Large stimulus this year, too. Because public finances are in somewhat better shape than expected, there will be room for further stimulus. Last autumn the government unveiled stimulus programmes totalling more than SEK 100 billion for 2021. Since then the government has extended various crisis packages, which it estimates at a total of SEK 30 billion. We will probably see further stimulus measures – some of them in the form of recurrent supplementary budgets during the year – totalling an additional SEK 40 billion. Overall, we expect such measures to be of about the same magnitude as during 2020, which means that fiscal policy will have a somewhat expansionary impact on growth in 2021. Given the government's massive response during the acute crisis, this is undoubtedly impressive. International estimates indicate that only a few countries will have the resources to avoid tighter fiscal policies this year. Years of budget surpluses and debt reduction are now clearly providing Sweden with welcome manoeuvring room.

New stimulus measures in 2022, but some fiscal tightening. Looking ahead to 2022 the budget will inevitably be tighter, since fiscal impact is measured as the change in the cyclically adjusted budget balance from one year to the next. We will probably see new stimulus packages in 2022, and the official fiscal framework will continue to be disregarded. It is unreasonable to believe that these packages will be on the same scale as the crisis responses that are now gradually being phased out. The fiscal tightening process will, however, occur in a situation where household purchasing power will be rapidly increasing. Overall, we expect the public sector deficit to shrink marginally this year to 3.2 per cent from 3.3 per cent of GDP in 2020. In 2022 we expect it to continue downward to 2 per cent of GDP. The central government's borrowing requirement will fall from about SEK 220 billion in 2020 to SEK 110 billion this year and SEK 50 billion in 2022. General government debt will climb moderately to just short of 39 per cent of GDP in 2020, up from 35.0 per cent of GDP before the COVID-19 crisis. The National Debt Office's gradual reduction of lending for the Riksbank's currency reserve is one important reason for the decline.

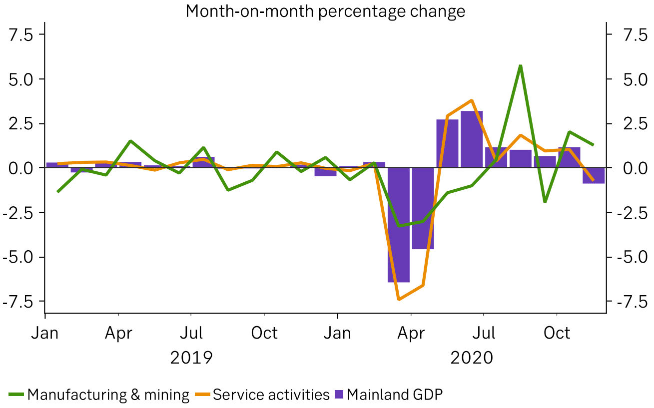
Norway

Norges Bank eyeing policy normalisation

Despite a second COVID-19 infection wave and new restrictions this past autumn, the mainland economy has shown resilience. The slowdown in growth near-term will be mild, while prospects for a solid recovery in 2021 have strengthened. Household demand will lead the upturn, supported by fiscal policy and lower-trending unemployment. The improved growth outlook, combined with rising home prices, will persuade Norges Bank to start hiking its key interest rate in early 2022.

A relatively mild downturn in late 2020

Month-on-month percentage change



Source: Statistics Norway, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	0.9	-1.3	3.4	2.8
Mainland GDP	2.3	-3.0	3.8	3.1
LFS unemployment*	3.7	4.7	4.1	3.9
Annual wage and salary increases	3.5	2.2	2.5	2.7
CPI-ATE inflation	2.2	3.0	2.0	1.8
Key interest rate, %	1.50	0.00	0.00	0.50
EUR/NOK**	9.84	10.48	10.00	9.90

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

Year-end coronavirus wave milder than feared

The mainland economy has been recovering since May, led by expansionary policies and an easing of containment measures, which have supported a revival in domestic demand and service sector activity. Sequential growth in mainland GDP rebounded a hefty 5.2 per cent in Q3, following a 6.1 per cent plunge in Q2. Growth will slow again in Q4 after reinstatement of containment measures in late 2020 due to a second COVID-19 wave. Measures are focusing on social distancing and reducing imported infections. Mainland GDP fell 0.9 per cent in November, which was significantly less than the 10.7 per cent cumulative decline in March-April. Less extensive lockdowns, combined with increases in retail trade and manufacturing, limited the decline. Data indicate a mild slowdown in sequential mainland GDP growth to 1.2 per cent in Q4, with official figures to be published on February 12.

Mainland GDP should post a strong recovery this year as broad-based vaccination roll-outs in Norway and abroad will allow for widespread relaxation of containment measures. Strong household demand should lead the recovery and fiscal policy will remain supportive. Adjusted for temporary crisis measures, fiscal support will lift mainland GDP growth by 1.0 percentage points in 2021 and a new relief package will be announced shortly. Mainland GDP growth is expected to reach pre-pandemic level by summer 2021. This is based on a 3.8 per cent increase in 2021 following an expected 3.0 per cent decline in 2020. Growth should remain above trend at 3.1 per cent in 2022. Total GDP will fall by 1.3 and rebound by 3.4 per cent in 2020 and 2021, respectively.

A divided recovery in manufacturing

The manufacturing sector has weathered the second wave of infections and restrictions fairly well, as reflected by sentiment indicators. There is still a clear split in manufacturing as output of traditional goods has fully recovered while petroleum-related production is 7.4 per cent below pre-pandemic level, but oil investment is likely to be less of a drag on manufacturing than initially feared. Statistics Norway's Oil Investment Survey for Q4 showed that operators had noticeably lifted their investment estimates for 2021. The fiscal support package encourages operators to implement capacity expansions and new development projects before temporary tax changes expire at the end of 2022. We forecast that petroleum capital spending will fall 7.0 per cent in 2021 and rebound by 0.5 per cent in 2022, boosting activity in the oil service industry during the period 2022-2024. Traditional manufacturing will be supported by a pick-up in foreign demand. We expect traditional goods shipments to rebound 2.9 and 5.4 per cent in 2021 and 2022, respectively.

Capacity utilisation in manufacturing remains below normal, but investment plans according to both the regional network and the Business Tendency Survey point to a smaller decline than initially assumed. Moreover, a rebound in residential investment suggests that private mainland capital spending should have a rather neutral effect on growth in 2021 while contribute positively in 2022.

Recovery led by household demand

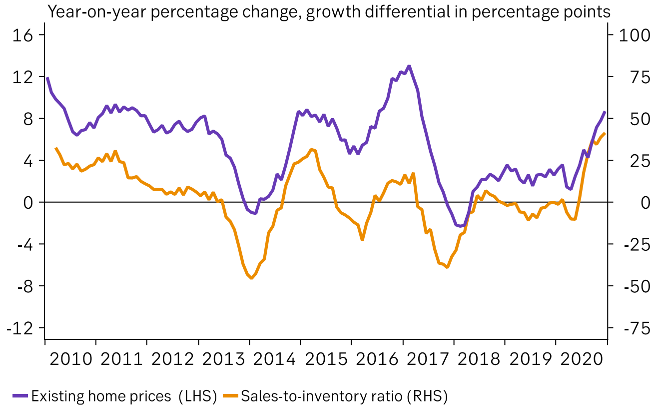
Household consumption of goods has been supported by a changed shopping pattern since the pandemic outbreak and has increased by 11.9 per cent since February. Meanwhile, spending on services (roughly half of private consumption) has been dampened by containment measures and is down 13.9 per cent from its pre-pandemic level. Such consumption should rebound strongly once supply restrictions are eased. Historically high savings and pent-up demand should further underpin consumption, despite moderate income growth. Moreover, the upturn in registered unemployment in late 2020 due to re-imposed restrictions proved small and short-lived. Unemployment is likely to trend lower as the economic recovery strengthens. We forecast unemployment, as measured by the Labour Force Survey, averaging 4.1 per cent in 2021 and 3.9 per cent in 2022, which is above the 3.7 per cent average in 2019.

Low interest rates boost home prices

Existing home prices have been trending steadily upward since a temporary fall in March-April, with the year-on-year rate reaching 8.7 per cent in December. Prices rose 4.5 per cent in 2020, and though this is weaker than the vigorous growth seen in 2016-2017, it still implies a pick-up from the 2.6 per cent rise in 2019. The housing market has been supported by a favourable combination of low supply and record-strong sales, and historically low mortgage rates are also likely to support prices this year. The mortgage lending regulation was tightened somewhat in Q4 2020, as the level of the flexibility quota was reinstated. The regulation has been extended to 2024 but no further tightening is expected before autumn 2022 at the earliest. We forecast an annual increase in existing home prices of 7.2 per cent in 2021.

Home prices supported by fundamentals

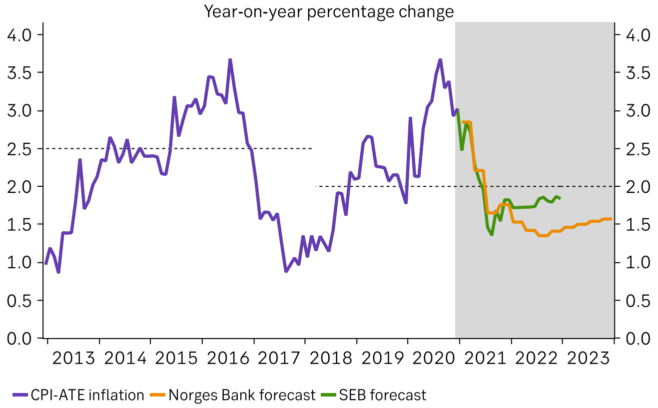
Year-on-year percentage change, growth differential in percentage points



Source: Real Estate Norway (Eiendom Norge), Macrobond, SEB

CPI-ATE inflation below target in coming years

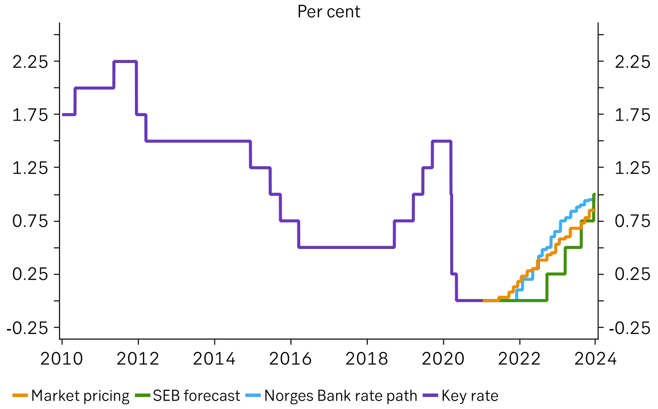
Year-on-year percentage change



Source: Bank of Norway (Norges Bank), Statistics Norway, Macrobond, SEB

Expectations for Norges Bank

Per cent



Source: Bank of Norway (Norges Bank), Macrobond, SEB

Inflation to fall rapidly below target

As in many other countries, inflation fluctuated greatly during 2020 due to unusual price movements caused by lockdowns, but CPI-ATE inflation (excluding taxes and energy) accelerated and was on a par with historical peak levels. High goods inflation was the most important driver, but service prices also rose at a historically high rate. Price declines for hotels and travel services, which in some countries have been 15-20 per cent, have been far smaller in Norway. Excluding the temporary VAT reduction in May 2020 (as is done in the CPI-ATE), many of these prices have even accelerated. Towards the end of 2020, the inflation rate began to fall. Several factors point towards a further decline this year. Upward pressure on goods inflation due to the previous weak exchange rate has been partially reversed, suggesting a fairly rapid downturn in inflation. Service inflation is also expected to correct partly due to a return to normal VAT levels in July. An incomplete impact on actual prices is highly likely, resulting in a slowdown in CPI-ATE inflation. We expect CPI-ATE inflation to fall from nearly 3 per cent in December to 1.5 per cent by mid-2021 and remain at this level in 2022. Due to sharply rising electricity prices, CPI will rise rapidly this winter and inflation will periodically exceed 3 per cent.

Vaccinations suggest faster policy normalisation

While keeping its key rate at 0 per cent, Norges Bank has signalled that it is ready to start normalising monetary policy a year from now. The flexible inflation target allows the bank to adopt a growth-oriented policy focus. Below-target inflation is thus no hindrance as long as capacity utilisation is rising. Due to expectations of broad-based vaccinations in 2021, the bank sees prospects for a strong recovery and expects capacity utilisation to pick up markedly starting this summer, approaching normal level by mid-2022. Once the recovery gains a foothold and uncertainty about the outlook fades, financial stability risks are likely to gain importance. The risk of keeping key rates too low for too long will justify gradual hikes to pre-crisis levels. A lift-off as early as 2021 cannot be ruled out though it is not our main scenario. We forecast two rate hikes per year starting in March 2022 to 1.00 per cent by end-2023.

Norges Bank's hawkish policy stance supports NOK

Oil prices increased notably early this year, making the NOK one of the best performing G10 currency so far in 2021. Positive risk appetite and a relatively hawkish Norges Bank have further supported the krone. Expansionary fiscal policy will prompt Norges Bank to continue purchasing large amounts of NOK on a daily basis in 2021. We expect the krone to rebound further against the euro and forecast that the EUR/NOK exchange rate will fall to 10.00 and 9.90 by the end of 2021 and 2022, respectively.

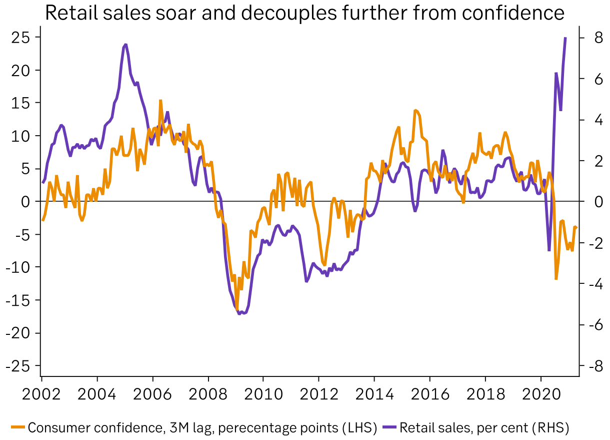
Norwegian government bonds (NGBs) are trading with a large yield spread against their German peers, reflecting Norges Bank's relatively hawkish policy stance as well as a liquidity premium. The 10-year spread against Germany is likely to remain wide due to the introduction of a new 10-year bond in February and Norges Bank's upcoming rate hikes, but a relatively favourable supply outlook combined with a promising NOK outlook is likely to limit the upturn in the 10-year yield. We forecast a 10-year yield spread of 150 basis points by the end of 2021 and 2022.

Denmark

Recovery delayed

As restrictions continue into 2021, we have adjusted our forecast for Denmark, marginally increasing 2020 GDP growth to -4.0 percent and reducing 2021 GDP to 3.0 percent, as large portions of the economy remain in lockdown. We expect consumer demand to undergo a powerful rebound due to a fast roll-out of vaccines and easy credit conditions. A continued strong DKK increases the probability of a unilateral rate cut in 2021.

Retail sales soar and decouples further from confidence



Source: Statistics Denmark, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.9	-4.0	3.0	4.5
CPI	0.8	0.4	1.1	1.3
Wages and salaries	2.0	1.9	1.8	2.9
Public sector fiscal balance*	3.8	-3.0	-2.0	0.0
Public sector debt*	33.3	44.0	41.0	38.0
Current account*	8.8	7.5	7.5	8.0
Key interest rate (CD rate),%	-0.75	-0.60	-0.60	-0.70
EUR/DKK**	7.45	7.45	7.43	7.46

*% of GDP **At year-end. Source: Statistics Denmark, DØRS, SEB

Recovery delayed. Since the last *Nordic Outlook* in November, Q3 GDP numbers have been released, showing Danish GDP growth of 5.2 per cent quarter-on-quarter, which was largely in line with our forecast. Macro data generally suggested this strong growth would carry into Q4. However, due to changes in coronavirus restrictions, we now expect this to be followed by two quarters of negative growth before a genuine recovery unfolds once vaccines have reached a sufficient scale. We have thus marginally increased our 2020 forecast to -4.0 per cent, reduced the 2021 forecast to 3.0 per cent and upgraded 2022 growth to 4.5 per cent.

Pandemic continues into 2021. When the last *Nordic Outlook* was published, we had just received news of tighter local restrictions in Northern Jutland related to a virus mutation from mink farms. Our assumption was that the restrictions would be removed before Christmas. Regional restrictions were indeed eased after the culling of all minks. However, a new surge in virus cases emerged as we approached Christmas. Rather than easing restrictions, the whole country was put into a hard lockdown similar to the regional restrictions. This meant closure of all non-essential shops and services as well as schools and universities. Due to fears of a new and more contagious virus strain from the UK, the lockdown has been extended at least until February 7. However, a fast roll-out of vaccines has kindled hopes of a gradual reopening this spring.

Suppressed consumer demand. Consumption showed extremely strong growth prior to the Q4 lockdown. Fuelled by a big one-off payment of frozen holiday pay, retail sales rose more than 10 per cent annually at the start of the quarter. Consumers have large savings and banks are easing lending conditions, according to the loan officer survey from Danmarks Nationalbank. Easy credit conditions both support consumer demand and create wealth effects by driving home prices higher. This is unlikely to be reflected in strong demand growth over the winter, as consumers are prevented from accessing many spending opportunities. However, once vaccines allow for a more permanent reopening, we expect consumer demand to undergo a powerful rebound, with growth of 3.5-4.0 per cent in 2021 and 2022.

Smaller job losses than last spring. Unlike the lockdowns last spring, the Q4 iteration does not appear to have led to significant job losses. Weekly data suggest a path very similar to the normal seasonal pattern, although this may reflect furlough schemes and other measures designed to make companies hold on to labour during the temporary disruption. As a result, it will not take many quarters of rebounding employment to restore upward pressure on wage and salary inflation. In 2020 and 2021 we expect wage pressures to remain subdued at just under 2 per cent, but the following years are expected to show an acceleration, reaching 3 per cent by the end of 2022. From a competitiveness perspective, this is not a major concern as Denmark still runs a huge current account surplus.

Unilateral rate cut possible

As we have pointed out earlier, the Danish krone has reacted in 2020 a lot like it did in 2008, by initially selling off on dollar liquidity concerns but then recovering due to strong fundamentals. The DKK is now at the very strong end of its range versus the EUR. While there are still no signs of intervention, there is a rising probability of a unilateral rate cut at some point this year.

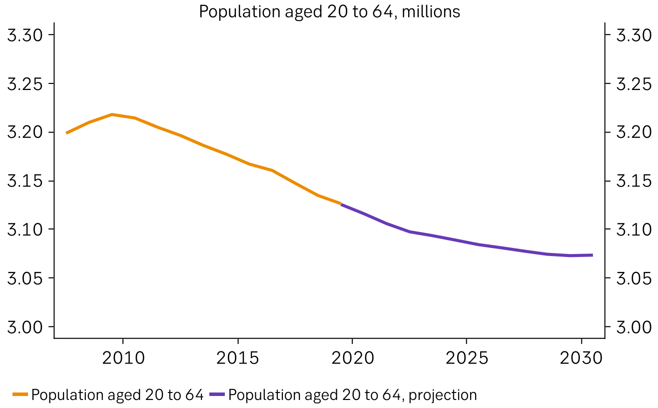
Finland

Recession kept at bay

Sound health policy has also been a cure for the economy, as Finland has managed to hold down its coronavirus infection rate while at the same time keeping recession at bay. However, little has changed regarding the long-term productive capacity of the economy. Slow productivity growth and a shrinking workforce will remain an impediment. GDP is expected to grow by 2.8 per cent in 2021 and 2.5 per cent in 2022, after declining by 3.3 per cent in 2020.

Shrinking labour force is a drag on growth

Population aged 20 to 64, millions



Source: Statistics Finland, Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	1.1	-3.3	2.8	2.5
Private consumption	0.8	-4.5	3.6	3.0
Exports	8.0	-9.8	6.0	4.0
Unemployment*	6.7	7.8	8.0	7.5
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	-7.0	-4.5	-3.0
Public sector debt**	59.4	68.5	71.0	72.0

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

A job well done. Finland has done an excellent job in keeping down the spread of the coronavirus. Both last spring and autumn, Finland had one of the lowest infection rates in Europe, enabling the country to avoid full-scale lockdowns and limiting damage to the economy. According to our forecast, GDP fell by 3.3 per cent in 2020, which is less than half the euro area average. The Finnish economy will recover in 2021, growing by 2.8 per cent, but old problems such as a dwindling labour supply and weak productivity growth will limit further gains. In 2022 GDP will increase by only 2.5 per cent.

Households will spend more if they are allowed to. As holidays abroad and bar nights were cancelled, Finns used their money to go shopping for goods. The last time retail sales experienced such a spike in demand was almost a decade ago. Tightening of restrictions late last year gave the retail sector a further boost, with sales soaring 7 per cent higher than a year earlier. The government will be careful not to lift restrictions before the main groups at risk have been vaccinated. This means that the same trends will continue throughout the first quarter of this year. But once restrictions are lifted, households that have been well protected from the crisis will undoubtedly return to their previous consumption habits. Service sector recovery will boost private consumption by 3.6 pe cent in 2021, followed by still strong 3 per cent growth in 2022.

Mixed results in manufacturing. Industrial production declined by just 3 per cent in 2020. However, among sub-sectors the figures were mixed. While the biggest industry – machinery manufacturing – remained at its 2019 level, there was a significant loss of output in the second-ranking forest product industry and results even worsened late in the year. Compared to our last *Nordic Outlook*, the manufacturing outlook has nevertheless improved. The previous free fall in new orders slowed significantly in Q4. In late November, it was up by 9 per cent. Manufacturing sector sentiment improved in December but remains far below its historic average. While the upturn in goods trade may not be too significant in 2021, the recovery in services will boost exports by 6 per cent in 2021.

The labour market has been a positive surprise. Instead of the expected increase, unemployment fell slightly last autumn. The labour market is quite rigid and tends to react to changes in demand with a significant lag. Due to ongoing restrictions, unemployment will increase marginally in the first half of 2021, but on average it will be limited to 8 per cent. In the second half of this year the jobless rate will start to fall. It will average 7.5 per cent in 2022. The COVID-19 crisis has had little impact on wage and salary growth, which will be close to 2 per cent in both 2021 and 2022.

Capital spending has fallen less than expected, but in 2021 the investment appetite of the private sector will be very limited. Gross fixed capital spending will grow just by 1.8 per cent in 2021, increasing to 2.5 per cent in 2022 when the private sector becomes more active. A positive sign is the uptick in residential construction, which had been spiralling downward for a couple of years. The current temporary increase in household savings will hopefully help to sustain that momentum.

Public debt soaring again. While in previous years Finland has made serious attempts to get its public finances under control, the pandemic has brought its debt-to-GDP ratio to new highs. However, since the crisis has had a less severe impact than feared, it remains likely that the budget deficit can be brought under the 3 per cent threshold in 2022. Key objectives for the government will include resolving “old” issues such as stagnant productivity and a shrinking workforce, for which finding a cure will be no easy task.

The Baltics

Lithuania

The economy looks set to shrink much less than in other parts of Europe. A stable export sector and powerful, successful stimulus measures have softened the downturn. Pay increases have also been strong, promising a speedier recovery.

Page 50

Latvia

Recovery is on hold as pandemic-related restraints choke consumption, but stimulus programmes will help ensure a rapid economic rebound once restrictions are lifted. A newly established agency will focus on ensuring a smooth vaccination roll-out.

Page 51

Estonia

Good incomes and a pension reform, along with the important export sector, will help prevent as deep an economic downturn as elsewhere in the euro area – a big difference compared to the 2008-2009 crisis. A new government may change current policies.

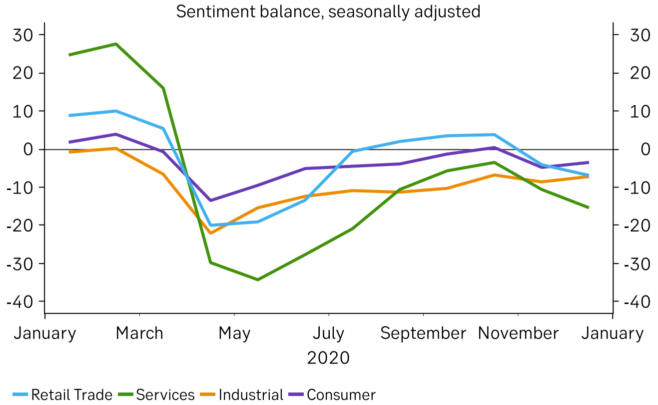
Page 52

Lithuania

Frozen start to 2021

Lithuania failed to avoid a second lockdown late last year and is thus starting 2021 on a weak note. We believe the economy can still recover swiftly once restrictions are lifted, but that might not happen until the second quarter. COVID-19 vaccinations started with an adequate momentum, but their future pace depends on available supplies. Unemployment will stabilise in mid-2021. Fiscal stimulus will be significant this year too, keeping the budget deficit above 7 per cent of GDP.

Sentiment figures remain stronger during the second lockdown



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

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	4.3	-1.5	1.8	4.2
Private consumption	3.3	-2.7	2.6	3.5
Exports	9.5	-2.4	4.0	5.4
Unemployment*	6.3	8.7	9.1	7.7
Wages and salaries	8.8	9.3	4.5	6.0
HICP inflation	2.2	1.1	2.0	2.4
Public sector fiscal balance**	0.3	-7.6	-7.2	-3.7
Public sector debt**	35.9	47.5	52.2	50.1

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

Tougher end of 2020. Due to a sharp resurgence in new COVID-19 cases, the government was forced to impose tough restrictions late last year. However, as in other countries during the second lockdown, consumer and business sentiment declined by much less than last spring. Manufacturing activity remained particularly resilient. We believe the overall decline in GDP during 2020 was close to our previous forecast of 1.5 per cent. We cut our GDP growth forecast for 2021 from 3.0 to 1.8 per cent, since we are including the negative effects of current restrictions, which will be lifted only gradually in the coming months. This also means that stronger recovery will not occur until the second half. We are thus raising our 2022 growth forecast from 3.3 to 4.2 per cent.

Manufacturers benefited from stronger export demand in Q4 2020. However, companies had problems dealing with increasing COVID-19 cases among employees. Short-term export orders indicate that early 2021 will be comfortable enough, but prolonged lockdowns among main trading partners might reduce demand temporarily again. We forecast that manufacturing sector investments will recover in 2021 after last year's slump.

Private consumption is expected to recover swiftly after restrictions are lifted. Last year's experience demonstrated that both retail sales and consumption of services can be restored rapidly. A similar recovery led by pent-up demand might occur again in Q2 2021. Generous government stimulus measures and the relatively small economic decline last year helped to maintain a rather stable financial situation for households. In 2021 private consumption will benefit from a 9.6 per cent increase in average old age pensions and higher universal child benefits.

Unemployment will peak in the second quarter of 2021. Unemployment jumped last year, but much less than we feared initially, since the government invested a lot in job retention schemes. In 2021 various government subsidies for employees have also expanded, easing the burden for employers. As in other countries, youth employment has been harder hit during the pandemic. Surprisingly, the labour force participation rate did not drop last year. This is a positive sign that the labour market might recover fairly rapidly once the pandemic is over.

Wage and salary growth will decelerate in 2021. Average pay increased by more than 9 per cent last year, or even more than in 2019. Strong pay increases were among the main factors that supported private consumption in 2020. However, the average growth figure was boosted by a sharp increase for public sector employees. In 2021 the average gross pay increase will decelerate towards 4.5 per cent, since public sector pay and minimum wages will increase less than last year.

The residential real estate market swiftly recovered from last spring's slump. Strong growth in average wages and salaries, a rebound in home price expectations and positive net migration helped the market to get through 2020 relatively smoothly. Home prices increased by around 6 per cent last year, and we expect the same growth rate in 2021. The commercial property market was hit harder, but even here investment activity was solid.

Surprisingly, the fiscal response to the pandemic crisis was one of the largest in EU and helped to cushion the economic slump. We forecast that the budget deficit will be only marginally smaller in 2021. The government has allocated EUR 1.1 billion or 2.2 per cent of GDP in its 2021 budget for expenditures related to COVID-19. The newly formed centre-right coalition government has promised to review the tax system and reduce various exemptions, but we believe it will not initiate major reforms until 2022.

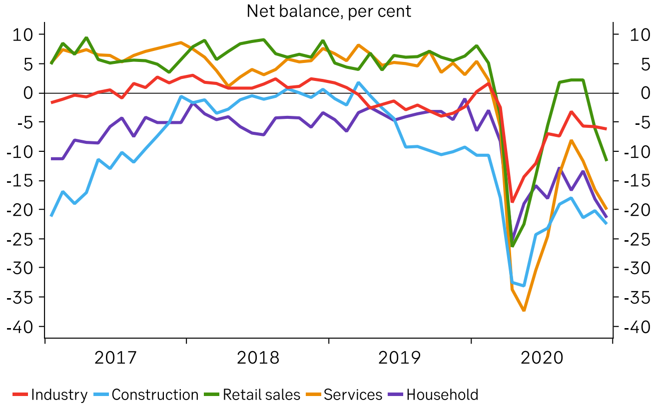
Latvia

Waiting for a rebound

Surging COVID-19 infection rates and the resulting lockdown late in 2020 will interrupt the recovery. But this time around, the downturn will be more limited. Lower consumption will be offset by strong growth in manufacturing and merchandise exports. We expect a sizeable economic rebound in Q2 2021. Improved fiscal stimulus should prop up the labour market. We expect the economy to grow by 3.9 per cent this year and 4.6 per cent in 2022 as consumption and investment strengthen.

Confidence indicators

Net balance, per cent



Source: Macrobond, SEB

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	2.2	-4.7	3.9	4.6
Private consumption	3.0	-10.1	4.3	5.7
Exports	1.9	-4.2	3.5	4.0
Unemployment*	6.3	8.4	8.7	7.5
Wages and salaries	7.2	5.4	6.0	6.7
HICP inflation	2.8	0.2	1.2	2.2
Public sector fiscal balance**	-0.6	-8.8	-6.0	-3.7
Public sector debt**	36.9	48.8	52.5	54.5

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

Back in a zone of high uncertainty. Amid a rapid surge in COVID-19 cases, Latvia declared a state of emergency on November 9 and introduced new restrictions. Not surprisingly, December economic sentiment fell to 88.1. Confidence declined slightly in industry and construction but fell more sharply in retail trade and services. Sentiment will stabilise as restrictions start to ease, but not earlier than in March.

Restrictions are choking consumption again, and it will be hard to bring infections under control during Q1. November retail growth fell to 1.4 per cent. Payment card data indicate a continued negative trend in December, but broader stimulus measures will help preserve household income better than during the first wave. There is still scope for improving access to benefits, however. Helped by vaccinations and control measures, public spending will again push the economy towards recovery in Q2 and Q3. There is a risk that the virus may return by year-end, but a recurrence of the current situation will be avoided. The economic rebound will most likely be broad-based. The entertainment, catering and recreation sectors will grow, but continued restrictions may limit momentum. The same goes for tourism and transport, which will not reach pre-crisis levels before 2022. We expect the negative effects from the transit and financial sectors seen in 2020 to significantly abate this year. Due to the unexpectedly large impact of the second wave, we have lowered our 2021 growth forecast to 3.9 per cent. A full recovery in 2022 will push growth to 4.6 per cent.

Merchandise exports and manufacturing will maintain a good momentum. Driven by grain, wood production, electrical equipment and mechanical goods, Latvia's exports grew by 9.1 per cent in November. Export growth will help to enable manufacturing expansion. In November, manufacturing increased by 4.3 per cent year-on-year. Nearshoring opportunities and exports will allow manufacturing to expand by 3-4 per cent this year.

Inflation will revive. Falling energy prices were still behind annual deflation of 0.5 per cent in December. Prices of goods fell by 1.4 per cent, but service prices rose by 1.6 per cent. As restrictions start easing, the desire to spend will likely put additional pressure on prices, especially services. Inflation will reach 1.2 per cent in 2021 and rise further to 2.2 per cent in 2022.

The ongoing downturn will push unemployment to 9-9.5 per cent in Q1 before it starts to fall. Improved relief measures, such as wage subsidies for the partially employed and working capital subsidies, will slow the rise in unemployment. In the first half of 2021, hiring will remain cautious, though demand for employees will stay strong in ICT, construction and manufacturing. By the end of the year, unemployment will shrink to 8 per cent.

Wage and salary growth slowed only partially as the belief that current problems are temporary predominated and as demand for skilled labour remained strong. In 2021, pay increases will speed up. It is very likely that some decreases in wages will occur in the accommodation and catering industry amid uneven recovery. This year, wage and salary growth will accelerate to 6-6.5 per cent.

The race to beat the virus is on. Reacting to ineffective attempts to contain the pandemic and a poor vaccination roll-out, Prime Minister Arturs Krišjānis Kariņš replaced his health minister in January. A special agency will be established to ensure smooth mass vaccinations. This will be crucial in ensuring Latvia's path towards recovery.

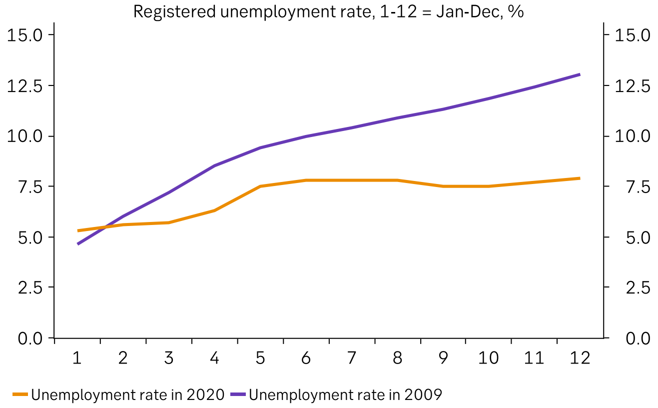
Estonia

Limited damage bodes well for 2021

The 2020 recession ended up being much more benign than feared. This gives the economy a good starting position for a swift recovery. A strong labour market, high savings and general optimism about the prospects for the economy will boost household demand and help GDP growth to recover to 3.3 per cent in 2021 and 3.8 per cent in 2022.

A very different crisis

Registered unemployment rate, 1-12 = Jan-Dec, %



Source: Estonian Labour Market Board (TTA)

Key data

Year-on-year percentage change

	2019	2020	2021	2022
GDP	5.0	-2.8	3.3	3.8
Private consumption	3.3	-2.2	4.5	4.0
Exports	6.2	-8.0	5.0	5.0
Unemployment*	4.7	7.0	8.5	6.8
Wages and salaries	7.4	3.0	3.0	4.5
HICP inflation	2.4	-0.6	1.4	2.3
Public sector fiscal balance**	-0.3	-5.2	-5.0	-3.5
Public sector debt**	8.4	18.5	23.2	25.0

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

Milder impact than in the global financial crisis. Compared to initial forecasts made last spring, the downturn has been much milder than expected. We estimate that GDP fell only 2.8 per cent in 2020, probably one of the least bad outcomes in the euro area. This is very different compared to the 2008/2009 financial crisis, when the country lost a fifth of its output. Limited damage means that the economy will quickly rebound in 2021.

Manufacturing outperforms expectations. During the COVID-19 crisis, one looming question was the health of Estonia's important manufacturing sector, which faced problems long before the virus outbreak. Despite the initial shock, output soon improved and in Q4 2020, merchandise exports were already growing at a double-digit rate year-on-year. Strong sentiment and a low comparison base suggest that exports will also thrive in the first half of 2021. Yet COVID-19 could have also more long-term effects. As supply chain risks have moved up on the agenda, few manufacturers will be happy to move their production any time soon. This will delay long-expected structural changes.

Private consumption will be the main driver of growth in 2021. It is not easy to find signs of the COVID-19 crisis in retail sales data. In 2020, volume increased by a solid 3 per cent. As elsewhere, retail sales were supported by limited options to consume services and a resilient labour market. Strong demand from confident households will drive growth in 2021 as well. In addition to the gradual easing of restrictions and general optimism, a high savings ratio, an improving labour market and continuing pay increases will boost sales. In Q4 2021 a further jump in demand is expected as a controversial pension reform will enable people to withdraw and spend their 2nd pillar pension savings. The reform will also influence 2022, when private consumption will swell by 4.0 per cent.

Mixed signals regarding capital spending. A set of divergent trends will affect the investment climate in 2021. On one hand, the recession has had a severe impact on corporate balance sheets and public investments will remain at previous year's level. Yet lending and business confidence are surprisingly high. The number of new residential construction permits has also skyrocketed, although it is hard to tell how much of these will turn into housing starts in 2021. Making any forecasts under such conditions is tough, to say the least. But according to our main scenario, capital spending will increase only by 3 per cent in 2021, followed by a stronger 7 per cent upturn in 2022.

The labour market will get worse before it gets better. After a long standstill, unemployment once again started to rise in late autumn last year, driven by the second wave of COVID-19 and the resulting restrictions. In Q1 2021 the unemployment rate will increase further, but the upturn will still be limited. In many sectors the crisis has not managed to put an end to chronic labour shortages, and salaries have continued to increase. Previous help from migration has become more problematic because of restricted travel as well as political pressure to curb immigration. This will be especially challenging for the IT and construction sectors. These trends will be amplified by an expected swift recovery in the second half of 2021. The average unemployment rate in 2021 will be limited to 8.5 per cent, while pay levels will increase by 3 per cent.

New government. A corruption scandal, related among other things to the use of COVID-19 economic aid, has unexpectedly given Estonia a new liberal government. This could bring some changes to the budget as well as new ideas on how much support the economy needs to recover from the crisis. The Ministry of Finance currently estimates the budget deficit at more than 6 per cent of GDP, but the actual shortfall will probably be smaller.

Global key indicators

Yearly change in per cent

	2019	2020	2021	2022
GDP OECD	1.6	-4.9	3.7	3.7
GDP world (PPP)	2.8	-3.7	5.0	4.3
CPI OECD	2.1	1.4	2.0	2.0
Oil price, Brent (USD/barrel)	64	43	59	60

US

Yearly change in per cent

	2019 level, USD bn	2019	2020	2021	2022
Gross domestic product	21,433	2.2	-3.5	4.5	3.6
Private consumption	14,545	2.4	-3.9	4.8	4.3
Public consumption	2,995	1.8	0.3	-0.1	1.8
Gross fixed investment	4,455	2.4	-1.3	5.0	3.0
Stock building (change as % of GDP)	49	0.0	-0.7	0.5	0.0
Exports	2,515	-0.1	-11.9	11.6	3.3
Imports	3,125	1.1	-9.2	11.0	3.7
Unemployment (%)		3.7	8.1	6.1	4.6
Consumer prices		1.8	1.3	2.3	2.2
Core CPI		2.2	1.7	2.1	2.2
Household savings ratio (%)		7.5	16.0	19.3	17.8
Public sector financial balance, % of GDP		-6.7	-15.5	-13	-8
Public sector debt, % of GDP		108.4	126.4	132.7	135.1

Euro area

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	11,936	1.3	-6.6	3.1	4.9
Private consumption	6,223	1.3	-8.0	4.5	5.5
Public consumption	2,369	1.9	0.3	0.5	1.0
Gross fixed investment	2,431	5.8	-8.4	3.0	5.0
Stock building (change as % of GDP)	0	-0.5	-0.3	0.0	0.0
Exports	5,576	2.5	-9.6	9.2	6.0
Imports	5,108	3.9	-9.7	10.0	5.0
Unemployment (%)		7.6	8.0	8.7	8.2
Consumer prices		1.2	0.3	0.8	1.2
Core CPI		1.0	0.7	0.9	1.0
Household savings ratio (%)		13.2	20.1	17.0	15.0
Public sector financial balance, % of GDP		-0.6	-8.5	-7.0	-4.8
Public sector debt, % of GDP		84.0	103.3	106.3	106.6

Other large countries

Yearly change in per cent

	2019	2020	2021	2022
GDP				
United Kingdom	1.4	-10.3	3.5	8.2
Japan	0.7	-5.2	2.1	1.0
Germany	0.6	-5.2	2.0	4.0
France	1.5	-8.2	5.0	4.9
Italy	0.3	-8.3	3.4	6.5
China	6.1	2.3	8.0	5.6
India	4.9	-7.5	9.1	7.2
Brazil	1.4	-5.0	3.0	2.5
Russia	2.0	-4.0	3.5	2.5
Poland	4.5	-3.3	3.0	5.0
Inflation				
United Kingdom	1.8	0.9	1.7	2.0
Japan	0.5	0.1	0.1	0.5
Germany	1.5	0.5	1.4	1.3
France	1.3	0.5	1,0	1.5
Italy	1.1	0.0	0.7	0.8
China	2.9	2.5	1.6	2.0
India	3.7	6.6	4.6	4.0
Brazil	3.7	3.2	3.0	3.5
Russia	4.5	3.4	3.9	4.0
Poland	2.3	3.4	2.5	2.5
Unemployment (%)				
United Kingdom	3.8	4.5	6.1	5.4
Japan	2.4	2.8	2.7	2.6
Germany	3.2	4.2	4.3	4.1
France	8.3	8.2	8.8	8.6
Italy	9.9	9.3	10.0	9.8

Financial forecasts

Official interest rates		21-Jan	Jun-21	Dec-21	Jun-22	Dec-22
US	Fed funds	0.25	0.25	0.25	0.25	0.25
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10
Euro area	Refi rate	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.10	0.10	0.10	0.10	0.10
Bond yields						
US	10 years	1.10	1.30	1.40	1.60	1.70
Japan	10 years	0.02	0.05	0.05	0.10	0.10
Germany	10 years	-0.53	-0.55	-0.40	-0.30	-0.20
United Kingdom	10 years	0.30	0.25	0.40	0.50	0.60
Exchange rate						
USD/JPY		104	101	99	101	102
EUR/USD		1.21	1.25	1.27	1.24	1.23
EUR/JPY		125	126	126	125	125
EUR/GBP		0.89	0.86	0.85	0.86	0.85
GBP/USD		1.36	1.45	1.49	1.44	1.45

Sweden

Yearly change in per cent

	2019 level, SEK bn	2019	2020	2021	2022
Gross domestic product	5,026	1.3	-2.6	2.8	4.8
Gross domestic product, working day adjustment		1.3	-2.9	2.7	4.8
Private consumption	2,227	1.3	-4.5	2.5	4.0
Public consumption	1,307	0.1	-0.9	1.2	0.8
Gross fixed investment	1,263	-1.0	-1.5	4.0	6.0
Stock building (change as % of GDP)	36	-0.1	-0.6	0.4	0.4
Exports	2,385	3.3	-5.0	4.7	5.6
Imports	2,192	1.1	-6.9	5.3	4.0
Unemployment, (%)		6.8	8.3	8.7	7.7
Employment		0.6	-1.3	0.0	1.6
Industrial production		1.4	-4.1	6.0	4.5
CPI		1.8	0.5	1.3	1.0
CPIF		1.7	0.5	1.4	1.0
Hourly wage increases		2.5	1.7	2.4	2.5
Household savings ratio (%)		15.9	17.5	18.9	18.0
Real disposable income		3.1	-1.2	4.7	2.8
Current account, % of GDP		4.6	5.2	4.7	4.5
Central government borrowing, SEK bn		-112	221	110	50
Public sector financial balance, % of GDP		0.6	-3.3	-3.2	-1.9
Public sector debt, % of GDP		35.0	38.7	38.5	36.5

Financial forecasts	**21-Jan**	**Jun-21**	**Dec-21**	**Jun-22**	**Dec-22**
Repo rate	0.00	0.00	0.00	0.00	0.00
3-month interest rate, STIBOR	-0.04	0.00	-0.10	0.00	-0.10
10-year bond yield	0.03	0.00	0.05	0.15	0.25
10-year spread to Germany, bps	56	55	45	45	45
USD/SEK	8.35	8.08	7.72	7.86	7.89
EUR/SEK	10.11	10.10	9.80	9.75	9.70
KIX	113.5	113.5	110.2	109.9	109.6

Finland

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	241	1.1	-3.3	2.8	2.5
Private consumption	126	0.8	-4.5	3.6	3.0
Public consumption	56	1.4	0.8	1.5	1.0
Gross fixed investment	57	-1.1	-2.3	1.8	2.5
Stock building (change as % of GDP)	1	0.3	0.3	0.1	0.0
Exports	97	8.0	-9.8	6.0	4.0
Imports	96	3.0	-7.5	5.0	3.5
Unemployment, OECD harmonised (%)		6.7	7.8	8.0	7.5
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	-0.5	-0.3	-0.3
Public sector financial balance, % of GDP		-1.1	-7.0	-4.5	-3.0
Public sector debt, % of GDP		59.4	68.5	71.0	72.0

Norway

Yearly change in per cent

	2019 level, NOK bn	2019	2020	2021	2022
Gross domestic product	3,584	0.9	-1.3	3.4	2.8
Gross domestic product (Mainland)	3,003	2.3	-3.0	3.8	3.1
Private consumption	1,548	1.4	-7.6	6.6	4.5
Public consumption	842	1.9	1.8	1.6	1.5
Gross fixed investment	891	4.8	-4.2	-1.2	1.9
Stock building (change as % of GDP)		0.0	-0.3	0.1	0.0
Exports	1,357	0.5	0.0	4.3	3.7
Imports	1,200	4.7	-8.6	3.6	4.2
Unemployment (%)		3.7	4.7	4.1	3.9
CPI		2.2	1.3	2.7	2.0
CPI-ATE		2.2	3.0	2.0	1.8
Annual wage increases		3.5	2.2	2.5	2.7

Financial forecasts	**21-Jan**	**Jun-21**	**Dec-21**	**Jun-22**	**Dec-22**
Deposit rate	0.00	0.00	0.00	0.25	0.50
10-year bond yield	1.00	1.00	1.10	1.20	1.30
10-year spread to Germany, bps	153	155	150	150	150
USD/NOK	8.50	8.08	7.87	8.02	8.05
EUR/NOK	10.29	10.10	10.00	9.95	9.90

Denmark

Yearly change in per cent

	2019 level, DKK bn	2019	2020	2021	2022
Gross domestic product	2,335	2.9	-4.0	3.0	4.5
Private consumption	1,061	1.4	-3.5	3.6	5.0
Public consumption	557	1.2	-1.5	0.4	0.8
Gross fixed investment	513	3.1	0.3	5.1	6.1
Stock building (change as % of GDP)		-0.3	0.0	0.0	0.0
Exports	1,362	5.1	-8.7	3.8	5.3
Imports	1,190	2.5	-6.5	4.8	4.8
Unemployment, OECD harmonised (%)		5.1	5.9	6.1	5.5
CPI, harmonised		0.8	0.4	1.1	1.3
Hourly wage increases		2.0	1.9	1.8	2.9
Current account, % of GDP		8.8	7.5	7.5	8.0
Public sector financial balance, % of GDP		3.8	-3.0	-2.0	0.0
Public sector debt, % of GDP		33.3	44.0	41.0	38.0

Financial forecasts	**21-Jan**	**Jun-21**	**Dec-21**	**Jun-22**	**Dec-22**
Deposit rate	-0.60	-0.60	-0.60	-0.70	-0.70
10-year bond yield	-0.39	-0.41	-0.26	-0.20	-0.10
10-year spread to Germany, bps	14	14	14	10	10
USD/DKK	6.14	5.94	5.85	6.02	6.07
EUR/DKK	7.44	7.43	7.43	7.46	7.46

Lithuania

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	49	4.3	-1.5	1.8	4.2
Private consumption	29	3.3	-2.7	2.6	3.5
Public consumption	8	0.1	0.3	0.2	0.2
Gross fixed investment	10	7.4	-4.0	3.5	6.0
Exports	38	9.5	-2.4	4.0	5.4
Imports	35	6.3	-3.8	5.1	4.9
Unemployment (%)		6.3	8.7	9.1	7.7
Consumer prices		2.2	1.1	2.0	2.4
Public sector financial balance, % of GDP		0.3	-7.6	-7.2	-3.5
Public sector debt, % of GDP		35.9	47.5	52.2	50.1

Latvia

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	30	2.2	-4.7	3.9	4.6
Private consumption	18	3.0	-10.1	4.3	5.7
Public consumption	6	2.6	2.6	3.2	2.9
Gross fixed investment	7	3.1	-1.2	3.5	4.5
Exports	18	1.9	-4.2	3.5	4.0
Imports	18	2.3	-4.5	2.4	4.5
Unemployment (%)		6.3	8.4	8.7	7.5
Consumer prices		2.8	0.2	1.2	2.2
Public sector financial balance, % of GDP		-0.6	-8.8	-6.0	-3.7
Public sector debt, % of GDP		36.9	48.8	52.5	54.5

Estonia

Yearly change in per cent

	2019 level, EUR bn	2019	2020	2021	2022
Gross domestic product	28	5.0	-2.8	3.3	3.8
Private consumption	14	3.3	-2.2	4.5	4.0
Public consumption	6	3.0	3.5	1.8	1.5
Gross fixed investment	7	11.0	-3.9	3.0	7.0
Exports	20	6.2	-8.0	5.0	5.0
Imports	19	3.7	-7.8	5.5	6.0
Unemployment (%)		4.7	7.0	8.5	6.8
Consumer prices		2.4	-0.6	1.4	2.3
Public sector financial balance, % of GDP		-0.3	-5.2	-5.0	-3.5
Public sector debt, % of GDP		8.4	18.5	23.2	25.0

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