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Research Nordic

Long winter ahead - what if the Nordic economic recovery is side-tracked by a new global COVID-19 shock?

Spring looks promising but next comes winter

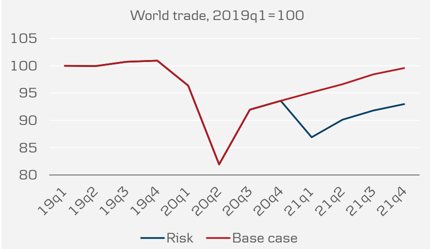
Vaccines are coming and normal life can be spotted on the horizon. In the short term, COVID-19 will, however, be present among us and the threat of a severe second global economic dip in case of new economy-wide lockdowns remains elevated (we put 15% on a downside scenario in our recent *Big Picture - Darkest before dawn*). The repercussions for the following economic rebound could be significant. In this research piece, we will look at what such a scenario could look like and what it would entail for the Nordic economies. Overall, the Nordics look more robust than most, with fewer infections and solid public finances to counter a setback in economic activity via investments and support for companies through another rough patch in the global pandemic. New cases are rising in Sweden and Denmark, though, and the Danish government recently introduced a partial lockdown of about half the country. The Nordics are all small, open economies, highly dependent on global demand and there is only so much public support can do.

The crisis is caused by weak foreign demand and domestic restrictions

COVID-19 is weighing heavily on the global economy, restrictions are weighing on the Danish, Swedish and Norwegian economies and tougher restrictions across Europe are threatening to derail the pickup in demand for Nordic goods and services once again. We know coronavirus survives better in cold temperatures, people are indoors more and see more people in the holidays. The virus is also spreading fast in the US and could trigger quite substantial lockdown measures. We have created a scenario for the Nordics using input from Oxford's global economic model and risk scenarios to derive a consistent view of a potential crisis across the Nordics. We attach a likelihood of 15% to a scenario of this severity.

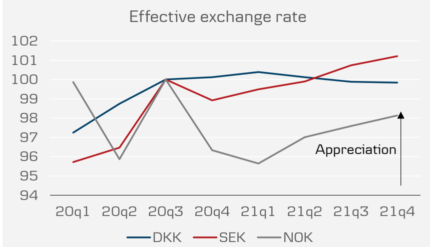
The increase in infections and the restrictions in the Nordics and rest of Europe that we are already seeing now limits the pickup in economic activity in the Nordics in Q4. In our what-if-scenario, we imagine a global second wave of virus infections peaks in Q1. A hard Brexit or US-China tensions may also weigh on sentiment. Global economic activity declines by about 5% (half of the size of the shock in H1 20). Exports decline in the Nordics, reflecting lockdowns in key export markets and a decline in world trade. Danish exports have shown some robustness through the first wave in the spring due particularly to pharmaceutical exports which are not affected much by a global pandemic. On the other hand, a large shipping sector is very sensitive to a crisis like this and the currency peg forces DKK, currently close to a 10-year high, to appreciate even further, worsening competitiveness significantly in a situation where demand is already declining. Swedish exports are notoriously more sensitive to the global business cycle with significant machinery production but on the other hand Swedish exporters can enjoy some relief from a weaker SEK.

World trade declines again



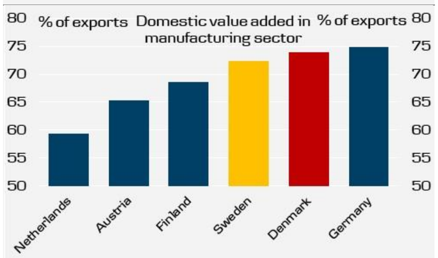
Source: Oxford Economics, Danske Bank

Exchange rate supports Sweden and Norway but becomes headwind for Denmark



Source: Oxford Economics, Danske Bank

Denmark and Sweden less sensitive to supply shortages



Source: OECD TiVA data, Danske Bank

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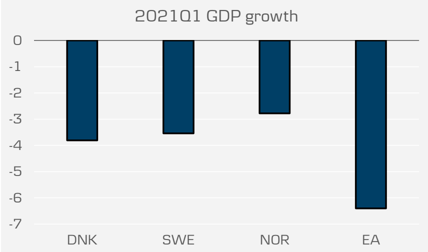
Globalisation has made corporate production processes sensitive to supply problems. However, this is less of a problem in both Denmark and Sweden than in other countries as almost 75% of value creation in manufacturing sector exports is produced by Danish and Swedish companies, respectively - which is more than other comparable countries, see also *Nordic Research: Danish and Swedish exports relatively robust to supply problems*, 31 March. Norway's oil dependency adds sensitivity in a scenario like this where oil prices decline below USD30 per barrel and cause investments to plunge, but like Sweden, exporters can enjoy some relief from a weaker NOK.

Infections and restrictions peak in Q1 and consumption declines markedly. The impact is significantly smaller than in the spring though, primarily because a big part of consumption such as travel and experiences is already at a minimum. Along with the lockdowns, equity markets sour as investors' risk aversion increases significantly, which contributes to a further decline in business investments, exacerbating the economic downturn. In this scenario, GDP declines between 3 and 4% in Q1 in the Nordics, still significantly less than in the euro area, because infections are more widespread there and restrictions are harder.

Nordics hit less severely

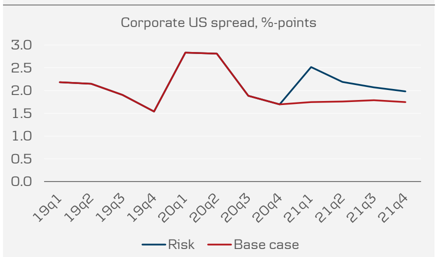


Source: Oxford Economics, Danske Bank

Plunging risk sentiment tightens financial conditions and bankruptcies emerge

This time, the deep recession raises concerns that corporates will default on loans, leading to a rise in corporate spreads and a squeeze on financial conditions more generally particularly in the US but also spreading to Europe. After restrictions are eased in Q2, an initial sharp rebound in economic activity emerges as economies re-open but sluggish growth follows as a broad based decline in consumer sentiment encourage households to build up precautionary savings due to fear of unemployment and declining income in the future. The consolidation in households is amplified by tightening credit conditions. The crisis has now turned into a more classic recession with more permanently weak demand, not only driven temporarily by the restrictions and/or higher infection numbers. Even as the pandemic abates and restrictions are loosened, the economic recovery remains modest because the big decline in economic activity has caused persistent damage to labour markets and economies across the most important Nordic export markets. This means an approximate stand still in GDP in 2021 as a whole in the Nordics and the euro area; a bigger hit to the euro area where the economy is currently operating further below potential.

Corporate spreads widen...



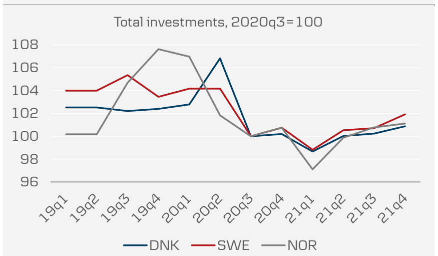
Source: Oxford Economics, Danske Bank

Economic policy will not suffice this time

In contrast to the first wave with unprecedented fiscal stimulus in most major economies, some governments are not capable of embarking on new support measures as public debt levels are already very high. Austerity is greater in the countries with the highest interest rates on their public debt. Even with austerity measures, however, government debt levels remain elevated in some countries – including within the euro area – and risk premia stay persistently high. The Nordics have room to increase public consumption, which will cushion the economic downturn significantly, but the large blow to the global economy and key export markets will weigh heavily.

Central banks will ease monetary policy by stepping up QE. However, they are running low on dry powder after a year with massive intervention. Monetary policy interest rates are already zero or negative, and they fail to fully offset the shock to the economy, thus, prolonging the downturn.

... causing investments to decline



Source: Oxford Economics, Danske Bank

Solid rebound could become standstill

	GDP	
2021, %	Risk	Base
Denmark	-0,1	3,0
Sweden	-0,7	3,8
Norway	0,9	3,9
Euro area	-0,4	4,9

Source: Oxford Economics, Danske Bank

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This research report has been prepared by Danske Bank A/S (‘Danske Bank’). The author of this research report is Bjørn Tangaa Sillemann, Analyst.

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Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

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