

ARTICLE – Alternative scenarios for the economic recovery

In the Riksbank's forecast, GDP will grow at a good pace this year and next year, both in Sweden and among our most important trading partners, and resource utilisation will rise quickly towards a normal level. But the forecast is uncertain. This article illustrates the uncertainty with the aid of two alternative scenarios. Household consumption has been held back during the pandemic, and it is not impossible that consumption expenditure could increase at a faster pace than is assumed in the forecast. In such a scenario, resource utilisation in the Swedish economy can become much higher than normal towards the end of the forecast period. If the spread of infection were instead to begin to increase again, before we have built up an adequate resistance to the disease, the recovery will probably be much slower. There would then also be a risk that countries with high indebtedness and weak banking systems would be hit particularly hard. In this worse scenario, both domestic demand and demand for exports would be lower than in the main scenario, and unemployment would become entrenched at a high level. To support the recovery, there may be motivation for further measures from both monetary policy and fiscal policy.

Several sources of uncertainty in the forecast

Spread of infection, vaccinations and restrictions

The economic prospects for the coming quarters are still affected to a large degree by how the spread of infection develops, by the measures taken to limit the spread of infection, and by the authorities' economic support measures. The successes in developing effective vaccines probably mean that many households can gradually return to their earlier living and consumption patterns during 2021. In the Riksbank's forecast, it is assumed that mass vaccination will be carried out during the first half of 2021 and that the spread of infection will therefore be slowed down in the United States, Europe and Sweden. As immunity increases, and the spread of infection slows down, the authorities are also expected to gradually ease the restrictions that have been introduced.

But there are still risks of a setback when it comes to the spread of infection and immunity. New mutations of the virus causing COVID-19 are being spread and several companies in the pharmaceuticals industry are now preparing to deal with future mutations. Many governments are aiming to vaccinate most of their citizens during the

first half of 2021, but the logistical challenges are substantial and it is still unclear what percentage of the population in various countries is willing to be vaccinated. It is also clear that access to vaccines will vary substantially between countries and regions, which will affect economic prospects on a global level.

Uncertainty over strength of recovery

Even if the assumptions in the main scenario regarding the spread of infection, immunity and restrictions are realised, the continued economic recovery is still fraught with uncertainty. One question is how quickly and to what extent households and companies will return to earlier consumption patterns and ways of working, when this is possible. Will some households invest more money than normal on travel, restaurant visits and other forms of entertainment? The first scenario describes how GDP growth, unemployment and inflation may develop once the spread of infection has been slowed down, if households in Sweden and abroad increase their consumption at a faster pace that was assumed in the main scenario.

Another question concerns the size of the economic damage caused by the crisis. Last year, unemployment rose rapidly around the world and many companies were forced to take out large loans to save their businesses. Moreover, public indebtedness has increased substantially in many countries as a result of extensive economic support measures. When the support is phased out and the loans are to be repaid, many companies may experience difficulty in meeting their payment obligations. In some areas, unemployment may rise again, banks may suffer rising credit losses and some countries may then have difficulty implementing new support measures as their public finances are already weak. In the second scenario, it takes longer than expected to reduce the spread of infection and private consumption therefore increases at a slower pace than in the main scenario. At the same time, the problems with indebtedness and corporate bankruptcies are larger than expected, particularly in some European countries. Altogether, this means the recovery is much slower than in the main scenario, both in Sweden and abroad.

Alternative scenario - faster recovery in Sweden and abroad

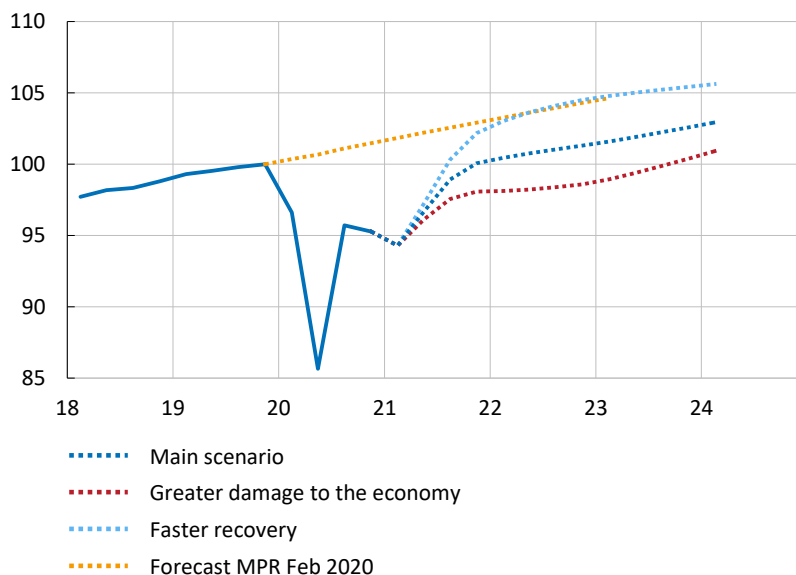
In the scenario “Faster recovery”, it is assumed that the spread of infection and restrictions develop roughly as described in the main scenario, but that consumption and GDP increase at a faster pace, both in Sweden and abroad. Despite some initial problems with deliveries, vaccination gets under way on a large scale in the spring. It then becomes clear that many households want to return to their earlier consumption patterns very quickly, and demand therefore rises substantially. Some households with relatively high incomes, who as a result of the pandemic have had an involuntarily high level of saving over the past year, decide to indulge themselves with more expensive restaurant visits, travel and other forms of entertainment.²⁶ In this scenario,

²⁶ Analyses of high-frequency data regarding consumption, business income and employment in the United States show that last year’s deep and sudden fall in GDP can largely be explained by relatively well-off

it is assumed that companies in service sectors succeed well on the whole in rapidly expanding their operations again, following the cutbacks, even if bottlenecks arise in some areas.

Figure 55. GDP abroad (KIX-2)

Index, 2019 Q4 = 100, seasonally adjusted data



Note. KIX-2 is an aggregate of GDP in the United States and the euro area. Unbroken line refers to outcomes, broken lines to the Riksbank's forecast.

Sources: Bureau of Economic Analysis, Eurostat and the Riksbank.

Figure 55 shows a KIX-weighted measure of GDP in the euro area and the United States, called KIX-2. The figure shows the dramatic GDP development in 2020 and the Riksbank's growth forecast for this year and the coming years. As a comparison, the corresponding forecast published one year ago in the February 2020 Monetary Policy Report is also shown. In the scenario "Faster recovery", the strong increase in private consumption leads to GDP abroad (KIX-2) growing by almost 6 per cent, both this year and next year. This can be compared with the growth in the main scenario of just over 4.5 per cent this year and 4 per cent next year. In Sweden, too, GDP grows much faster than in the main scenario (see Figure 56 and Table 2).

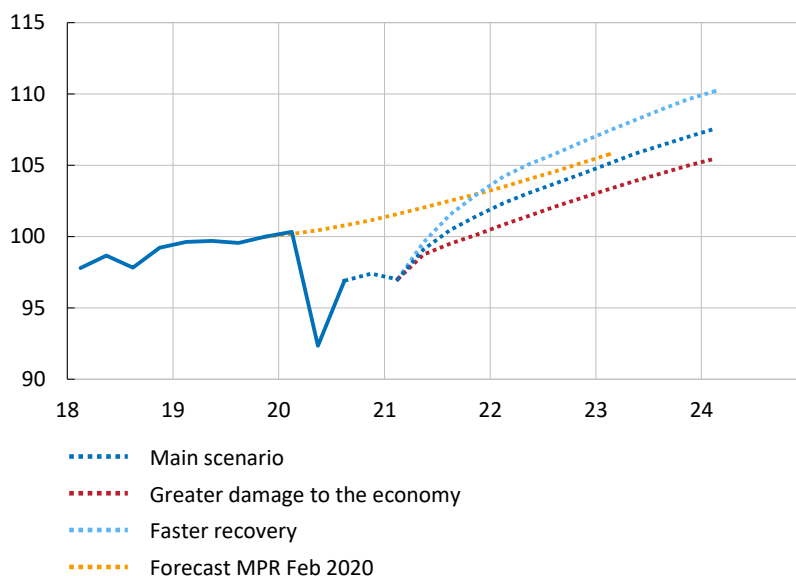
The higher growth means that the problems in the labour market become less serious. Many of those who lost their jobs last year worked in industries that require relatively low qualifications and in Sweden a disproportionate amount of young people

households quickly cutting back on certain types of luxury consumption of services, such as visits to restaurants and beauty parlours and travel. Expenditure on other types of consumption, which require less physical contact with other people, was much smaller and recovered relatively quickly; in the middle of July, consumption in goods was higher than prior to the pandemic. The results indicate that the high savings ratios measured last year were largely due to households involuntarily cutting back on their consumption to avoid the spread of infection. See Chetty et al. (2020), "How did Covid-19 and stabilization policies affect spending and employment? A new real-time economic tracker based on private sector data.", NBER working paper no. 27431, published in June 2020 and most recently revised in November.

were affected by unemployment.²⁷ This means that in many cases it is a question of workers who are flexible and jobs that can relatively easily be recreated when demand rises again. In this scenario, employment rises faster than in the main scenario and in Sweden unemployment falls to below 7 per cent towards the end of the forecast period (see Figure 57). The lower unemployment also means that wages rise at a faster pace and that inflation is pushed up. It is assumed in this scenario that Swedish monetary and fiscal policy remain as expansionary as in the main scenario, and this contributes to resource utilisation and CPI inflation rising faster than in the main scenario (see Figure 58). An inflation rate that overshoots the target could help to anchor inflation expectations more firmly around 2 per cent, which would be good for price setting and wage formation. A scenario where inflation rises more quickly during the forecast period need not be a reason to make monetary policy less expansionary in different ways.

Figure 56. GDP in Sweden

Index, 2019 Q4 = 100, seasonally adjusted data



Note. Unbroken line refers to outcomes, broken line to the Riksbank's forecast.

Sources: Statistics Sweden and the Riksbank.

Alternative scenario - greater damage to economy

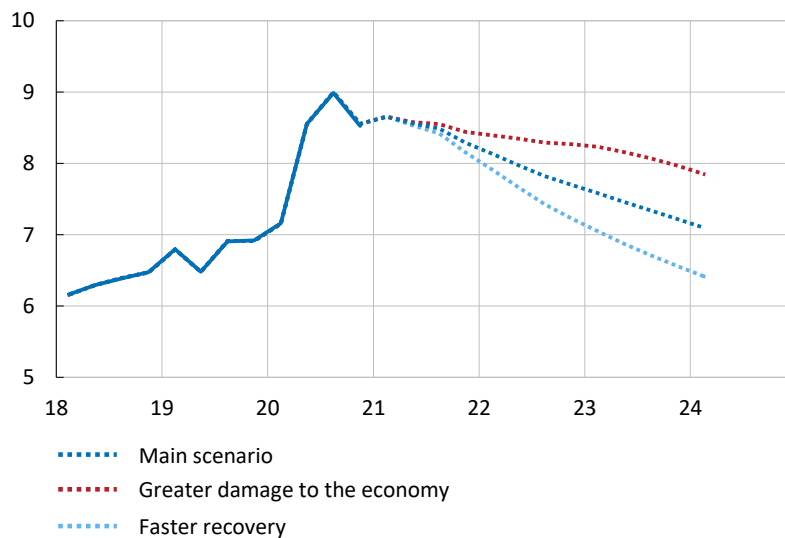
In the scenario "Greater damage to the economy" it takes longer than expected to manage the spread of infection and build up immunity to the disease. Private consumption therefore grows more slowly than in the main scenario, both in Sweden and abroad. At the same time, it becomes clear that an unexpectedly large number of companies have experienced difficulties during the crisis, not least in some euro area countries, which have suffered particularly large falls in GDP. When the authorities

²⁷ Unemployment also rose relatively quickly in the group of those born abroad. See I. Häkkinen Skans "The coronavirus crisis and the labour market - effects in the short and long term", Economic Commentary no. 1 2021.

begin to phase out the extensive support measures implemented in 2020, and when companies are to begin paying back the loans they took during the crisis, many businesses find it difficult to manage their payments.²⁸ Bankruptcies increase and the situation is further aggravated when the problems in some countries spread to the banking system.

Figure 57. Unemployment in Sweden

Percentage of labour force, 15–74 years, seasonally-adjusted data



Note. Unbroken line refers to outcomes, broken line to the Riksbank's forecast.

Sources: Statistics Sweden and the Riksbank.

Slower growth in consumption, more bankruptcies and tighter credit terms mean that GDP abroad grows much slower than in the main scenario (Figure 55 and Table 2). When the economic outlook for the euro area is adjusted downwards, Swedish households also become more cautious with their expenditure and consumption growth is slowed down further. However, demand for Swedish exports also slows down, and altogether this means that GDP growth this year is no higher than 2 per cent. Next year, growth rises to just over 3 per cent, but this is nevertheless much lower than the almost 4 per cent growth in the main scenario (see Figure 56 and Table 2). Lower GDP growth also means that the demand for labour is lower and that unemployment only falls below 8 per cent towards the end of the forecast period (see Figure 57). The lower resource utilisation on the labour market in turn slows down wage growth.

In this scenario, it is assumed that the ECB will take action to make monetary policy in the euro area more expansionary. Economic prospects are weakened in particular in

²⁸ Last year, many national parliaments in the euro area decided on extensive, temporary emergency measures. According to the European Commission's calculations, these emergency measures corresponded on average to almost 3.5 per cent of the euro area's GDP, but the size of the measures varied significantly between the different countries in the monetary union. A large share of the money was used for direct support payments to households and companies to cover loss of income. This year, many countries are planning to substantially reduce the size of their support and at the same time, to increase expenditure on more traditional fiscal policy measures aimed at stimulating demand in general. See "Communication from the Commission to the European parliament, the Council, and the European Central Bank on the 2021 Draft Budgetary Plans" issued in Brussels on 18 November 2020.

the euro area, and moreover fiscal policy in several countries in the monetary union is limited by high public sector debt. The calculations reported here are based on the same assumptions regarding Swedish monetary and fiscal policy as in the main scenario. In this scenario, resource utilisation in the Swedish economy is much lower, compared with the main scenario, and this also has repercussions on the rate of price increase. It takes longer time for CPIF inflation to reach the target of 2 per cent. Such a development could very well motivate making economic policy more expansionary in Sweden, too. If the need for monetary policy stimulation increases, asset purchases and measures to promote the supply of credit in the economy will continue to be important tools. It is also entirely possible that the repo rate may be cut, particularly if confidence in the inflation target were under threat. In a scenario with new downturns in the economy, fiscal policy at the same time has an important role to play. This applies in particular if economic problems affect one particular sector of society harder than others.

Table 2. GDP growth in Sweden and abroad

Annual percentage change

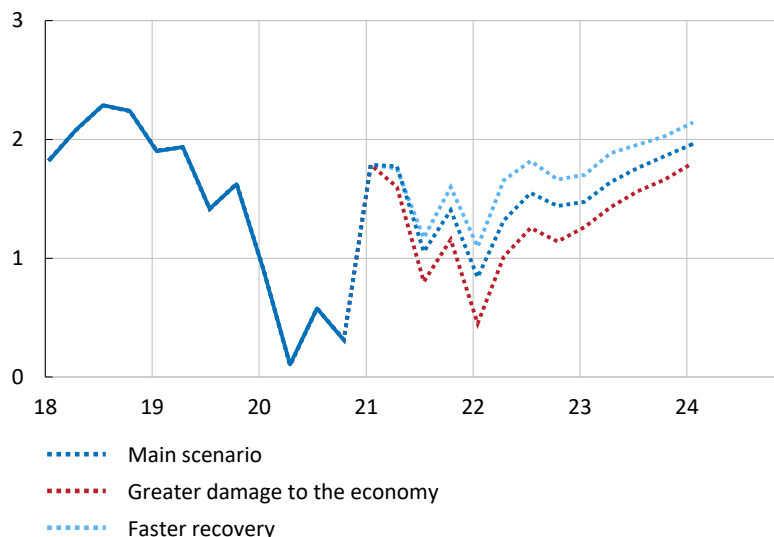
	2021	2022	2023
KIX-2, main scenario	4.7	4.0	1.2
Faster recovery	5.8	5.9	1.3
Greater damage to the economy	3.7	2.3	1.4
Sweden, main scenario	2.9	3.9	2.6
Faster recovery	3.5	5.3	2.8
Greater damage to the economy	2.0	3.1	2.2

Note. GDP KIX-2 is an aggregate of GDP in the United States and the euro area. Unbroken line refers to outcomes, broken lines to the Riksbank's forecast.

Source: The Riksbank.

Figure 58. CPIF

Annual percentage change, quarterly data



Note. Unbroken line refers to outcomes, broken line to the Riksbank's forecast.

Sources: Statistics Sweden and the Riksbank.