6 March 2020

The Coronavirus Crisis

Nordics exposed to economic fallout from coronavirus

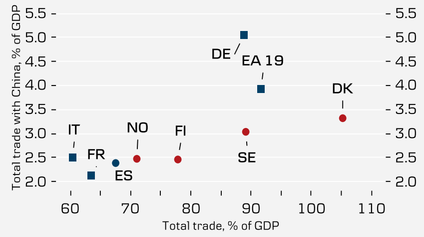
- **The Nordic economies will be affected, but less severely than elsewhere in Europe – in the magnitude of 0.2-0.3 percentage points lower GDP growth in 2020 in the main scenario.**
- **The Danish government is waiting to see what happens, and we do not expect a rate cut – on the contrary, a small hike looks likely.**
- **Riksbank to cut in April, Swedish government looking into short-term measures.**
- **The economic effects of the virus mean a Norwegian rate hike is no longer likely, but the bar is high for a cut.**
- **Finland is preparing but sees limited risk so far.**

We expect the outbreak of the coronavirus, and the countermeasures against it, to have a significant impact on economic growth globally, including Europe, in the first half of 2020 (see *The Coronavirus Crisis: U-shaped rather than L-shaped global recovery*, 4 March 2020). The Nordic countries will also be affected through the same mechanisms: disruption of inputs to production especially from China, possible disruption to domestic production as employees stay away, and disruption to demand as consumers avoid stores, restaurants, travel, etc. However, there is reason to believe that the impact in the Nordics will be smaller than in Europe as a whole. The Nordics have relatively less direct exposure to China, and consumer services such as hotels, restaurants, recreation and culture are relatively smaller parts of the economy, although of course still significant. Among the Nordics, only Denmark has a surplus in tourism spending (foreign residents spend more in Denmark than Danish residents spend abroad), and even for Denmark it is a small surplus. The spread of the virus has so far been modest in the Nordics, although it is now accelerating in Sweden and Norway, where a number of ski tourists were infected in Italy. There is in general a high level of trust in the competence of the authorities. If the economic impact escalates, the Nordics have policy options to counter it, as public finances are healthy and, in the case of Sweden and Norway, there is room to cut interest rates if deemed necessary.

Denmark: wait and see

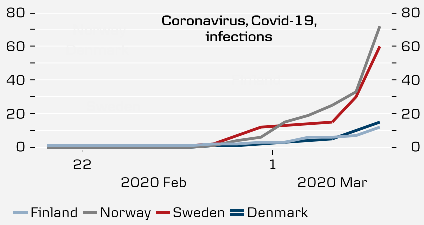
Among the Nordic economies, Denmark has the largest direct exposure to trade in goods with China, and Danish production is quite reliant on imports from other Asian countries. Danish exports of shipping services amounted to 11.2% of GDP in 2019. Transport companies A.P. Møller-Mærsk and DSV Panalpina have warned that the situation has created uncertainty for their earnings this year. However, any decline in shipping exports is likely to be almost completely matched by a similar decline in imports, and hence would have a limited impact on Danish GDP. While Danish production is not especially reliant on inputs from China, OECD data shows significant reliance on inputs from South Korea and Japan, where production could also be disrupted. However, these numbers are very much driven by imports of ships, and delays in ship deliveries are not likely to have a significant impact on Denmark.

Open economies exposed to China



Source: Macrobond Financial

Number of infections rising



Note: Numbers updated 5 March 14:00 CET.
Source: News reports

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In the domestic economy, we are waiting for data to see if there has been any effect. So far, surveys have not showed any decline in confidence or expectations among either businesses or consumers, and the data does not indicate any supply problems. However, the data we have at present does not really cover the period since the middle of February, when the contagion outside of China started to accelerate. Our base case is for GDP growth to be dampened slightly less than in the euro area, taking our forecast from 1.4% to 1.2%. However, there is significant risk that the outcome will be worse, both in Denmark and the rest of Europe. If we are right about the growth outlook, we could see a slight uptick in unemployment, although it is hard to forecast. If large numbers are barred from working due to suspicion of infection, that could reduce unemployment.

Note that PMI data for Denmark is extremely volatile and not a good guide to the state of the economy.

The Danish government has not announced any specific economic countermeasures, but Finance Minister Nicolai Wammen stated in a newspaper interview that the government is ready to “open the toolbox” if necessary. A particular concern is smaller companies that could run into liquidity problems as either supply or demand is temporarily cut off. One possible solution mentioned by the minister could be to postpone VAT and employee tax payments. That was done in 2009, when companies were allowed to delay payments by a month in most cases. If that was done today and all businesses used the option, we estimate that it would add about DKK50bn in liquidity. However, given the negative interest rates on deposits, only those companies that really needed it would be likely to use the option. There is little tradition in Denmark for work-sharing schemes such as in Germany, probably due to the more flexible labour market.

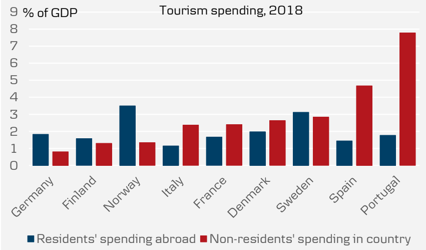
Monetary policy in Denmark is, as always, only targeting the exchange rate peg to the EUR. The drop in equity markets recently has weakened the DKK, which was already to the weak side of the target. The Nationalbank has intervened in FX markets to support the DKK since October. If the ECB cuts rates by 10bp, we expect the Nationalbank to take the opportunity to narrow the interest rate differential by leaving Danish rates unchanged. If there is no ECB cut, we expect a 10bp hike in Denmark before mid-year.

Sweden: Riksbank to cut in April, government preparing

In Sweden, a survey by the major chambers of commerce suggested that a majority of respondents (some 50-75%) have been affected by the coronavirus. About 20% said they had to delay outgoing deliveries and some 35% said they had delayed incoming deliveries. Hence, a significant number of companies are affected, although the economic impact is hard to gauge. The engineering industry has reported that supply disruptions may lead to lay-offs if production comes to a halt. To avoid that, the engineering industry has proposed “short-term work”, government support to partially cover wage costs in the event of a production standstill. The cost would be shared between the employee, the employer and the government. The government said this measure would be introduced shortly. The government also said that it is prepared to use fiscal policy measures if needed (albeit unclear what the trigger would be). It estimates that public investments, public consumption and outright transfers (in declining order) are most efficient in terms of the impact on employment.

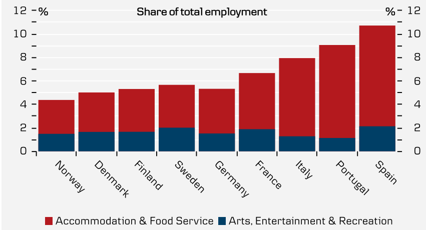
In our view, manufacturing is most likely to be hurt by the coronavirus. However, there is reason to believe that tourism-dependent businesses such as airlines, hotels and restaurants and the event business in general would also be hit.

Less tourism could have a mixed effect



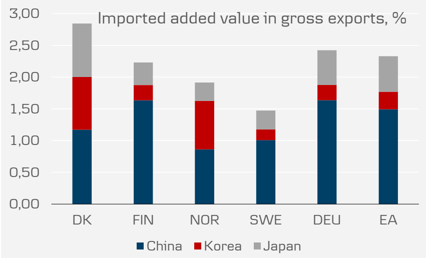
Source: National accounts, OECD

Services a significant part of demand



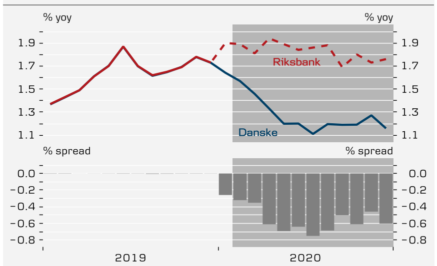
Source: Macrobond Financial

Danish exports rely on Asian imports



Source: OECD Tiva database

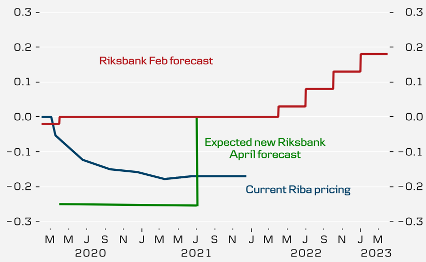
A deteriorating inflation outlook (CPIF excl. Energy) on the back of coronavirus



Source: SCB, Riksbank, Danske Bank

The Swedish government estimates that the coronavirus will lower GDP growth by 0.3 p.p. in 2020, which seems a reasonable estimate to us. China accounts for about 5% of Swedish exports and imports. However, significant uncertainty lies in the possible indirect effects via major economies such as the Eurozone (a prime concern) and the US. This includes the duration of the impact: the longer it lasts, the bigger the impact is likely to be.

Riksbank to cut in April, but to signal that this would be temporary



Source: Macrobond Financial, Riksbank, Danske Bank

The stock market decline, if extended, may reduce consumer spending short term, in particular if this coincides with increased uncertainty about the labour market outlook. There are some signs of abating price expectations in the property market.

The impact on the inflation outlook is, again in the short run, entirely negative: sharply falling energy prices, increasing risk for slowing wage growth (in Sweden, we saw the risk of low central wage agreements already before the coronavirus), downward pressure on airline tickets/charter packages during the upcoming spring/summer tourist season and a gradually strengthening krona. Importantly, the employers' association said it prefers a one-year agreement with very low wage increases due to coronavirus uncertainty. Moreover, the diverging policy paths between the Riksbank and its peers has strengthened the KIX index to its strongest level in a year and further SEK appreciation is set to put marked downward pressure on imported inflation. Our updated inflation forecasts imply that CPIF and CPIF excl. Energy will print at 0.9% y/y and 1.4% y/y, respectively, in March, the last data print before the April monetary policy meeting. This 0.5 p.p. and 0.4 p.p. below the Riksbank's respective forecasts. Needless to say, there is significant risk that inflation expectations will drop to very low levels if our forecasts are correct.

A subdued inflation outlook far below the target is, hence, the justification for our take on the Riksbank.

Accordingly, we change our call on the Riksbank. We now expect the Riksbank to reduce the repo rate by 25bp back to -0.25% at the April meeting, the level prevailing before the dubious December hike. A repo rate cut is most likely the first line of defence for the Riksbank, which has repeatedly emphasised that zero is not a lower bound. However, we expect the Riksbank to be eager to underline that this would be a temporary stimulus, which is why we expect the new repo rate path to include a 25bp hike one year forward as a reminder of that.

Balance sheet expansion is state dependent. Disrupted value chains for a protracted period could cause liquidity problems for corporates – if banks are unable/unwilling to help, then the Riksbank will provide liquidity fast (faster than in 2009, when it was slow). This would probably not be directly but through banks by offering banks cheap funding, where everything could be used as collateral. Why not directly to corporates? Because there is no infrastructure for that and because corporates usually do not possess the kind of collateral the Riksbank requires. In 2009, the Riksbank's lending facility could be used with covered bonds as collateral, which also helped to compress covered bond spreads eventually.

If there is increased QE, we believe it will probably involve both govvies and KI (but not covered bonds for the time being).

Norway: the bar is high for cutting rates

Originally, the basic concerns for the Norwegian economy were related to supply-side distortions for several sectors importing from China, and some demand-side related factors.

With a commodity-based and energy-intensive export industry, Norway is closely tied to the global economy and commodity markets. China is one of Norway's largest trading partners and the total import of goods was around 11.0% at the end of last year. It is mainly finished goods and electronic products that are imported from China. Exports to China were around 2.5% of total exports. Two-thirds of exports were goods, with machinery and equipment, chemical raw materials (fertilisers and silicon) and seafood being the main product groups. For the export of services, sea transport is the largest sector, including Norwegian tourism companies.

In addition, China's growth slowdown has fuelled lower oil demand, which has led to a sharp fall in oil prices. Norwegian companies also play an important role in the metal industry. Given China's industrial heaviness, fears of reduced activity have helped drive down metal prices, including aluminium prices.

However, currently, the number of cases of coronavirus in Norway is 86, which represents an increase of over 50% d/d. All cases can be traced to overseas travel, especially Italy, due to many Norwegians spending their winter holidays in weeks 8 (Oslo area) and 9 (Bergen area) there. The authorities at least claim to know the origins of all cases. No serious illness or deaths so far indicate that perhaps a lot of testing is being done, but the travel pattern implies a risk that Norway will be 'over-represented' compared to peers.

People are increasingly being encouraged to work from home. Some public venues and events have been cancelled.

As a result, the downside risk now mainly stems from demand-side factors related to efforts to contain the coronavirus in Europe including Norway. There seems to have been a major increase in the number of cancellations of air travel and hotel and restaurant bookings by households and corporates, both internationally and domestically.

It is hard to estimate the overall effect of the measures taken by the private sector, but based on the assumption that these risks will persist for a couple of months, we have adjusted our forecast for mainland GDP downwards by 0.2 p.p. in 2020 to 1.8%. This includes the indirect effects from lower global growth in the same period, but also anticipates some fiscal response targeted at those companies/sectors most affected by the change in behaviour.

The Norwegian government has not yet announced any specific economic countermeasures, but Prime Minister Solberg referred to the large room for fiscal expansion if needed in a recent interview on Norwegian State television.

Even if other central banks are likely to cut rates, we do not think Norges Bank will cut rates in March for the following reasons:

1. Norges Bank has no history of cutting rates during periods of market turmoil.
2. Much still suggests the negative impact of COVID-19 will be temporary.
3. High inflation, a positive output gap and rising house price growth make 'insurance cuts' tricky, i.e. unlike the Fed last summer, the cost of cutting rates is much higher.
4. The NOK FX acts as substantial buffer to growth (now 3.5% weaker than projected).
5. Fiscal policy is a more direct way to support the economy via extended unemployment benefits amid temporary lay-offs, for example.
6. Even though the oil price has dropped USD17 per barrel since early January, long-term oil prices have dropped only modestly; for example, around USD2.5 p/b for oil

delivered in three years. The latter would affect investments decisions among oil companies.

We think it is more likely that NB will provide liquidity to the market in order to ensure the negative supply shock does not translate into a negative demand shock. Norges Bank could use its 'judgement' factor to argue for a cut bias in the rate path even if other factors (NOIS, wage growth, inflation and oil-adjusted NOK) are clear arguments for a continued tightening bias. This leaves calling NB very tricky. While domestic data releases are now clearly in the background, we note that 10 March is set to deliver the key Regional Network Survey and the final inflation print ahead of the 19 March NB meeting. However, the collection period for this survey was likely c.25 January-25 February, making the information value lower than usual.

That said, we no longer expect Norges Bank to hike rates in 2020, unless the global shock turns out to be less pronounced and/or more short-lived than we currently expect.

In the case of a more prolonged and/or deeper recession due to the coronavirus, the authorities have a broader toolbox available:

- There are practically no short-term limits to how expansionary fiscal policy can turn; in 2009, the expansionary effect was 1.9% of GDP. This is especially so for cash support or tax relief to corporates exposed to negative demand shocks. Also, there is a possibility of increasing the income support to workers laid off temporarily from the current 62% of the normal wage to 100% compensation.
- A restart of the Government Bond Purchase programme to secure credit to companies suffering liquidity restrictions.
- Finally, Norges Bank has room to cut interest rates by at least 100bp to 0.50% if needed.

Finland: modest exposure

As trade in goods and services has grown, and tourism flows increased, the Finnish economy has become more exposed to the Chinese economy in recent years. In 2019, goods exports to China amounted to 5.5% of Finnish total goods exports, and imports from China comprised 7.5% of total goods imports. This makes China more important than the UK as a trading partner (these numbers are according to Finnish data, which deviates from the IMF data used in the chart on page 1). Forest industry products and machinery are the most important export items.

Travel bans are limiting business negotiations currently, and demand for investment goods could fall. So far, most companies have remained quiet about the potential impact. Finnair, the main Finnish flight carrier with a significant number of flight connections between Asia and Europe, has issued a profit warning. Tourism from China has probably fallen in a usually busy February, which would have had a negative impact on Finnish travel-related business. On the other hand, Finland has a negative travel balance, which provides a buffer against any coronavirus-related travel decline.

Many Finnish companies have sizeable operations in China, and to our knowledge, they have not experienced major disruptions to operations so far. Locally in Finland, some 130 people, including students at a teacher training school, face an immediate two-week quarantine following exposure last week to a pupil diagnosed with coronavirus. All in all, if the coronavirus outbreak is contained soon, the damage to the Finnish economy is likely to be small. A longer-lasting battle against the coronavirus could lead to a more sizeable impact through multiple channels.

The Finnish government has set aside EUR8.9m for additional costs arising from situations such as the coronavirus outbreak and said it is prepared to amend the budget to cover any excess costs. The government said that while there is currently no coronavirus epidemic in Finland, itis fully prepared for an epidemic. The government has not said anything about potential economic countermeasures. The existing public deficit and already weaker economic outlook before the coronavirus limit the size of a possible stimulus package. There is a EUR1bn additional stimulus mechanism that could be used if the economy contracts by at least 1% over two consecutive quarters. Hence, any major reaction is likely to be delayed until there is evidence of a recession.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Frank Jullum, Chief Economist Norway, Lars Olsen, Chief Economist Denmark, Michael Grahn, Chief Economist Sweden, and Pasi Kuoppamäki, Chief Economist Finland.

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