A deceleration, but no sudden stop

The Ukraine war is having a sizeable economic impact. We have lowered our 2022 global GDP growth forecast from 4.1 to 3.2 per cent. Our downward adjustment for the euro area is much larger than for the US and the Nordic countries. Fiscal initiatives – especially in defence and energy – will soften negative effects. The war is speeding up inflation, and labour markets will not weaken enough to persuade central banks to hold off on monetary tightening. We expect more and earlier key rate hikes, which will help to bring about a clear decline in inflation during 2023.

The war in Ukraine has radically changed the conditions for economic forecasting. Aside from the direct consequences of the war there are spill-over effects, for example in the form of sanctions, trade disruptions and refugee flows. Despite monumental uncertainty, just like during the COVID-19 pandemic, forecasts must still be made as a basis for economic policy and financial analyses. During the period just before the outbreak of the war, and during the first days of the war, it was natural to work with different scenarios directly linked to how it would unfold – for example in terms of a full-scale vs a limited invasion or a short-lived vs a protracted war. Right up until the Russian attack on February 24, most observers saw a low probability of a full-scale, protracted war. In such a situation, it was natural to link the very serious military and humanitarian situation that we are now in to a deep global economic crisis, with soaring energy prices as an important driving force.

The war is triggering a variety of economic forces. Now that the war has been under way for just over a month, we see that many different forces are affecting events It is hardly possible to base economic forecasts on single, specified assumptions about the course of the war. This is especially clear from the energy market, where prices have fallen somewhat after an initial upturn. The outlook is also affected by spending pressures related to military build-ups, refugee flows and general fiscal stimulus measures. This will help ease the consequences of high energy prices and other trade disruptions.

Cautious economic forecasts. Partly due to the prevailing great uncertainty, some observers are trying to postpone major adjustments in their forecasts. But central banks have recently been forced to reveal their thinking when making interest rate announcements. In particular, the European Central Bank very cautiously lowered its euro area GDP growth forecast from 4.4 to 3.7 per cent for the full year 2022. Even in its negative alternative scenario, the ECB foresees decent growth of 2.3 per cent. In mid-March, the Organisation for Economic Cooperation and Development published a report entitled *Economic and Social Impacts and Policy Implications of the War in Ukraine*. The OECD's model simulations mainly assume that the war will last a long time. The report is also based on the commodity prices prevailing two weeks after the war broke out, including oil prices that were higher than today's. Despite these unfavourable conditions, the negative impact of the war on GDP growth over the next year was only about one percentage point, both for the world as a whole and for the 38 mainly affluent OECD countries. But the OECD foresees a more significant impact on inflation: about 2½ points.

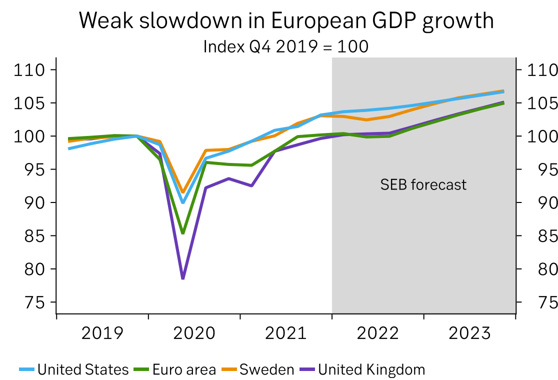
Spotlight on energy prices. The OECD's simulations raise several general questions that forecasters are now grappling with. As for oil prices, various sensitivity analyses indicate that a USD 20/barrel higher oil price would slow GDP growth by 0.6 percentage points in the euro area, while the effect for the United States would be only around 0.3 points due to domestic oil production. For other forms of energy, mainly natural gas, price increases have been more dramatic and historically unique. This makes the consequences harder to assess, even if their effects on household incomes can be more or less pinpointed. Rising prices for agricultural commodities, mainly wheat, will be an important part of the analysis – given Russia's and Ukraine's large share of global production and exports. The

consequences in metal markets are perhaps the hardest to assess. Russia is a key exporter of such strategically important metals as nickel, palladium, platinum and copper. A reduced supply of these could greatly disrupt the global economy in vital areas, for example by slowing the pace of the green transition. Since Russia's metal export revenues are not as large as its energy export revenues, there is a greater risk of export bans being imposed in order to disrupt the international economy.

Russia and Ukraine commodity exports
% share of world exports, 2020

Source: OECD

Prolonged effects of the Ukraine crisis. Our main scenario in this *Forecast Update* is based on the assumption that the Ukraine conflict will affect the world economy for a relatively long time. Although fighting may decrease in intensity, the sanctions against Russia will probably stay largely in place over the next few years. Energy prices will still be high, although we assume they will fall back somewhat, in line with forward market pricing. We are assuming average oil prices of USD 100 per barrel in 2022 and USD 85 in 2023. Keeping prices at such comparatively moderate levels will require that production outside Russia increases somewhat and that Russian oil exports are not completely cut off but will find ways out into the world market. Subdued growth will also mean lower energy demand, which will also help hold down prices. But it is possible that today's forward prices in the oil market are based on expectations of a sharper decline in demand or a shorter war scenario than we have forecast. This implies an upside risk for our oil price assumption and our general inflation forecast.



The euro area will be hardest hit. In various publications, we have recently explained why we are downgrading our growth forecasts for several major economies. We have lowered our overall GDP growth forecast for developed market (OECD) countries by about 1 percentage point for the full year 2022. Greater dependence on energy imports from Russia is the main reason behind a larger downward adjustment for the euro area than for other major economies. This is especially true of Germany's and Italy's large gas imports, whereas domestic energy production is one reason behind our smaller downgrades for the United States and the United Kingdom. Meanwhile households are being squeezed by generally high inflation and will soon be hit by higher interest rates. One key question will be to what extent households use the buffers they built up during the pandemic. In the US, rapid pay increases will also help improve household resilience in the short term but will also increase pressure on the Federal Reserve to take steps aimed at cooling down the economy.

Global GDP growth
Year-on-year percentage change

			Diff NO Jan*	
	2022	**2023**	***2022***	***2023***
United States	2.9	1.7	*-0.6*	*-0.4*
Japan	2.2	1.5	*-1.0*	*0.3*
Germany	2.0	3.5	*-2.0*	*0.1*
China	5,2	5,1	*0.0*	*-0.3*
United Kingdom	3.5	3.2	*-1.0*	*0.3*
Euro area	2.0	3.3	*-2.0*	*0.4*
The OECD countries	2.7	2.4	*-1.0*	*0.0*
Emerging markets	3.6	4.3	*-0.9*	*-0.2*
World, PPP	**3.2**	**3.5**	***-0.9***	***-0.1***

Source: OECD, IMF, SEB. PPP=Purchasing power parities.
*Percentage points.

Fiscal stimulus programmes will ease the slowdown. Meanwhile there are forces that will soften the slowdown. For example, crises and wars in themselves drive economic activity in the form of military build-ups and refugee reception, which require various kinds of resources. They also

strengthen the motivation for investments, both public and private, that will accelerate the energy transition and reduce dependence on Russia. We are now also seeing fiscal stimulus programmes aimed at easing the direct impact of rising energy prices. The OECD's main scenario assumes that new fiscal stimulus due to the Ukraine war will boost GDP growth by about 0.5 points over the next year. Our assessment is similar. We may well see governments signalling even larger spending than this. But it is reasonable to expect fairly long lead times when it comes to capital spending initiatives. Displacement effects will also make themselves felt, since labour markets are already tight in many countries.

Nordic resilience. The Nordic economies are generally more resilient than the European Union average. One reason is that inflation will be somewhat less dramatic, among other things due to the marginal role of natural gas in Nordic energy supplies. There is also greater fiscal policy manoeuvring room. We have revised GDP growth for Sweden, Denmark and Finland about 1 percentage point lower for the full year 2022. We expect growth to reach 2 per cent in all three countries. In Sweden, household consumption accounts for a fairly large share of our downward adjustment, although capital spending and exports will also be weak in the near term. In the case of Finland, it is mainly the manufacturing sector that is being hampered, since more than 5 per cent of exports went to Russia last year. Consumption is less affected than in various other countries, and capital spending is supported by a favourable price trend for Finnish exports. Norway is doing better, and we have marginally lowered our forecast for mainland GDP growth: by 0.2 percentage points to 3.5 per cent in 2022. Rising real wages and high savings make households resilient. The reason for our downgrade is instead that traditional goods exports are being hampered by weaker external demand.

GDP growth, Nordics and Baltics
Year-on-year percentage change

			Diff NO Jan*	
	2022	2023	*2022*	*2023*
Sweden	2.0	3.0	*-1.0*	*0.3*
Norway **	3.5	1.5	*-0.2*	*-0.1*
Denmark	2.0	3.0	*-1.3*	*0.0*
Finland	2.0	1.5	*-1.0*	*-0.1*
Nordic countries	**2.4**	**2.5**	***-0.9***	***0.0***
Lithuania	0.1	1.5	*-3.4*	*-1.8*
Latvia	1.8	2.5	*-2.8*	*-1.3*
Estonia	0.6	2.0	*-2.6*	*-1.0*
Baltic countries	**0.7**	**1.9**	***-3.1***	***-1.5***

Source: OECD, SEB. *Percentage points ** Mainland

Growth slump in the Baltics despite reduced dependence on Russia. Economic ties between the Baltic countries and Russia have decreased over the past decade. Russia's percentage of total Baltic trade also overstates their dependence, since the figure is swelled by transit trade – goods that pass through the Baltic countries but with very limited value added. The Baltic economies will nevertheless be affected to a greater extent than the euro area and Nordic averages. High inflation is the biggest problem, and we expect CPI to end up at around 11 per cent in Estonia and Lithuania for 2022 as a whole, greatly undermining household purchasing power. Ukrainians have contributed greatly to an increased labour supply, especially in construction, which is also hampering growth now that this source of labour is being blocked. However, the EU stimulus programme and domestic fiscal policy initiatives will ease the slowdown. We are revising overall GDP growth in the Baltic economies some 3 percentage points lower for the full year 2022. Although we expect these economies to bounce back by late 2022, we are also substantially lowering our GDP growth forecast for 2023. The biggest downward adjustments are for Lithuania, partly due its somewhat higher level of trade with Russia and Ukraine as a share of the total. In particular, transit trade through Lithuania has held up so far, while declining in Latvia and Estonia, which implies a bigger potential for decline ahead. This year's GDP growth will be highest in Latvia, partly because large-scale pandemic-related lockdowns in late 2021 have created greater potential for recovery.

Deep Russian recession due to the war. We have lowered our full-year 2022 growth forecast for all emerging market (EM) economies from 4.5 per cent to 3.6 per cent, compared to the *Nordic Outlook* we published in late January. This is largely because a sharp decline in the Russian economy is now likely, due to the invasion of Ukraine and the resulting sanctions against Russia. Instead of growth of about 3 per cent, we now expect GDP to shrink by 8 per cent in 2022 and about 4.0 per cent next year. This assumes that fighting will subside before summer, that Russia will not significantly escalate its attacks and that the EU will continue to import Russian gas and oil at current quantities for another year or so. GDP will keep falling in 2023 because the EU plans to reduce its dependence on Russian gas by 80 per cent, but this forecast is highly uncertain. If Russia's energy exports were completely blocked, its economy could shrink by about 20 per cent.

GDP growth, emerging market (EM) sphere
Year-on-year percentage change

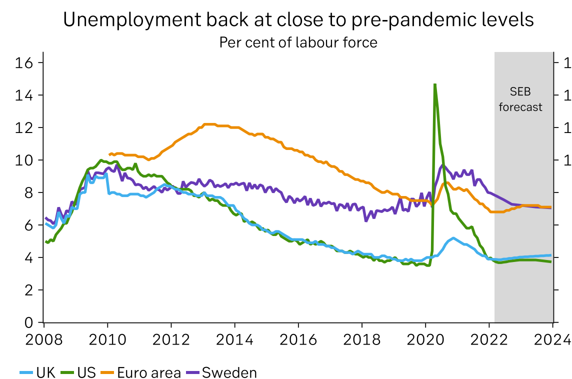
			Diff NO Jan*	
	2022	2023	*2022*	*2023*
China	5.2	5.1	*0.0*	*-0.3*
India	6.0	7.8	*-0.1*	*1.6*
Brazil	0.9	2.2	*0.0*	*0.0*
Russia	-8.0	-4.0	*-10.8*	*-6.0*
Emerging markets	**3.6**	**4.3**	***-0.9***	***-0.2***

Source: OECD, SEB. *Percentage points

China will fall short of its growth target. China has now set a GDP growth target of 5.5 per cent for this year, but we believe that its economy will grow by only 5.2 per cent despite new stimulus measures. The country will soon ease its strict COVID-19 strategy, but lockdowns aimed at stopping the spread of the virus – combined with a slowdown in the important construction and real estate sector – will reduce growth. For EM countries in general, high inflation is the biggest problem. The Ukraine war has amplified earlier inflationary impulses due to bottlenecks in global production and value chains, as well as rising energy prices. The fact that Russia, Ukraine and Belarus are major exporters of grains, cooking oil and fertilisers will drive up food prices in many countries. This will undermine purchasing power – especially in EM economies, where consumers spend a larger share of their income on food and energy. There is an imminent risk of food shortages in the Middle East and parts of Africa.

Modest spill-over effects in labour markets. Labour market developments will determine the extent to which a downgraded growth outlook will affect monetary policy. Because the war will cause a surge in inflation, a significant weakening in labour markets is required before central banks hold off on monetary tightening. Downward revisions in GDP growth forecasts of the magnitude we are now making are hardly enough to make this happen. In most countries, adjustments to unemployment forecasts are in the 0.2-0.3 percentage point range.

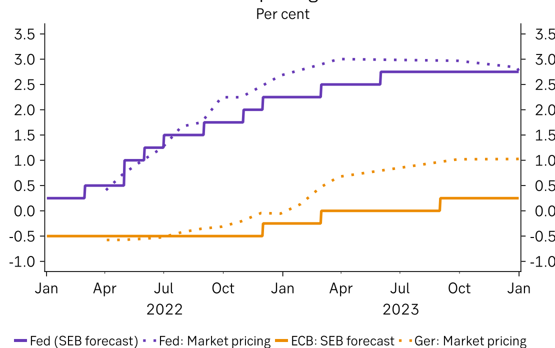
Unemployment back at close to pre-pandemic levels
Per cent of labour force



Source: Statistics Sweden, Eurostat, BLS, ONS, Macrobond, SEB

Resource utilisation will determine long-term room for recovery. Downward adjustments in 2022 GDP growth forecasts will increase the potential for slightly faster growth in 2023, but in the US we have lowered our growth forecast for next year as well. Rapid pay increases and large labour shortages indicate a clearly overheated labour market. There is still potential for the labour force participation rate to normalise in the long run, following its decline during the pandemic, but at present we see reasons to make cautious assumptions in this area. In Western Europe, lower resource utilisation provides better potential for recovering lost ground. By late 2023 we expect above-trend GDP growth, although our upward adjustment for the full-year average is marginal. The labour supply is affected by the recent activation of the EU's Temporary Protection Directive, which enables those who are now arriving as refugees from Ukraine to quickly land jobs. The opportunity to work may improve the lives of many of them during their stay in the EU, but since the refugee flow largely consists of women arriving alone with children, it is unreasonable to expect any major impact on overall EU labour supply.

Fed & ECB: Market pricing and SEB forecast
Per cent



Source: Macrobond, SEB

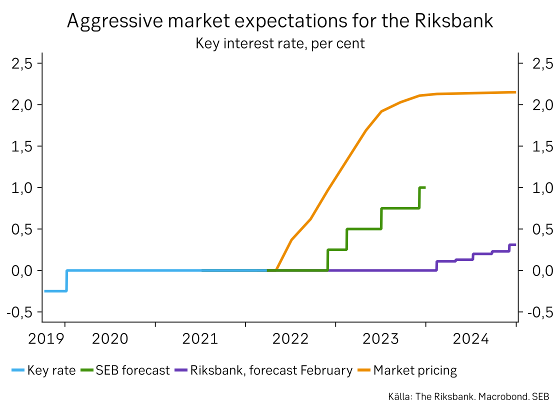
Central banks will prioritise inflation-fighting. Because the inflation-driving effects of the latest dramatic developments appear likely to be greater than their growth-hampering effects, the market has redoubled its expectations of interest rate hikes. This has also been consistent with central bank signals that action is needed to prevent chronic inflation. Our downgrades in GDP growth are also not big enough to justify forecasts of a clear shift in central bank strategies. Since *Nordic Outlook* appeared in late January, we have gradually adjusted our key interest rate forecasts upward. We have raised our forecasts for the Fed, the Riksbank and Norges Bank at the end of 2023 by 50 basis points. Our forecast for the Fed's key rate is now largely in line with market pricing, while our ECB forecast remains below consensus.

Central bank key interest rates
Per cent

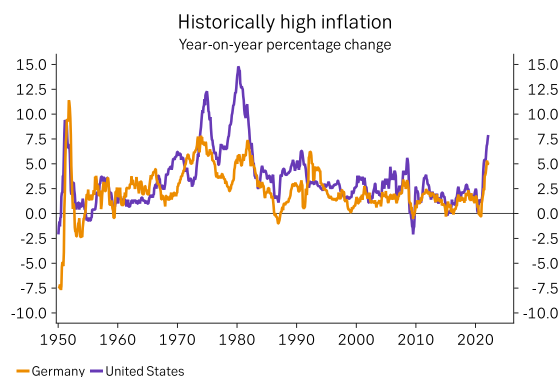
	Mar 28, 2022	Jun 2022	Dec 2022	Dec 2023
Federal Reserve (US)	0.50	1.25	2.00	2.50
ECB, deposit rate (euro area)	-0.50	-0.50	-0.25	0.25
Bank of England (UK)	0.75	1.00	1.00	1.50
Riksbank (Sweden)	0.00	0.00	0.25	1.00
Norges Bank (Norway)	0.75	1.00	1.75	2.25

Source: Central banks, SEB.

A painful re-assessment by the Riksbank soon. As for the Riksbank, uncertainty is now especially great. After its February interest rate decision, in which the Executive Board decided to continue declaring that Swedish rate hikes will not happen before 2024, market expectations have become increasingly aggressive. The market is now pricing in about four hikes during 2022 and one or more next year to a key rate level above 2 per cent. The question is how the Riksbank will now handle this dramatic shift in expectations. In response to unexpectedly high February inflation, Governor Stefan Ingves and Deputy Governor Anna Breman have signalled a policy change. The Executive Board is likely to use every conceivable opportunity to make this clear before its next policy announcement in late April. We also see clear upside risks to our forecast and a rather high probability of an increase as early as the policy meeting in late June. The Riksbank has made very sharp reversals on various occasions in recent decades, and there are many indications that another such occasion is on the way. But at the same time, market pricing seems a bit too aggressive. We find it hard to believe that the Riksbank would deliver increases at the priced-in pace now that Sweden's next national wage round is about to begin. Although employer organisations and labour unions now seem to be calling for some kind of signal from the Riksbank that it is taking the inflation threat seriously, aggressive rate hikes would probably be viewed as indicating distrust of their ability to conclude responsible collective agreements.



Comparisons with 2008 are starting to become irrelevant. Central banks are now planning continuous key interest rate hikes, even though economic growth is being squeezed from various directions. This is risky, of course. The rather flat US yield curve has also fuelled discussion about recession risks, since a negative-sloping yield curve has been a reliable recession indicator. In spite of this, central banks no longer wish to remain passive, for several reasons. Well into the pandemic, it was possible to describe the inflation surge as "transitory" and largely supply side-driven. For a long time, the experiences of 2007-08 served as a warning. At that time, European central banks in particular helped deepen the recession that had been triggered by the global financial crisis, by raising their key rates – due to worries that energy-driven inflation would spread. But comparisons with 2008 are now largely irrelevant, since inflation has reached significantly higher levels. In addition, we have seen greater general acceptance of price increases, resulting in a broader wave of inflation. In the US and the UK, pay hikes have also taken off much faster than in 2008. It is now up to central banks to ensure that we do not enter an environment where annual price increases become the new normal.

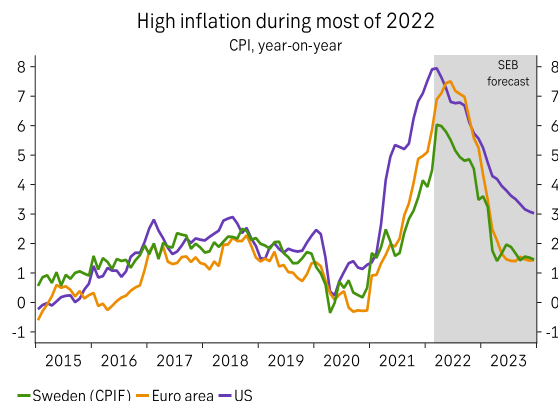


Korean War or oil crisis inflation? Instead, two other inflation shocks after the Second World War are comparable with that of today. The Korean War (1950-53) led to a sharply increasing need for transport and materials, which triggered rapidly rising inflation. "Korean War inflation" became the first major test for the Bretton Woods system, with its fixed exchange rates and US dollar gold peg that had been launched in 1945. Inflation fell relatively fast, which probably helped to strengthen confidence in the system. This laid the foundation for the stable inflation environment that predominated in the 1950s and 60s. However, when the OPEC oil cartel implemented major production cuts in 1973, oil prices soared. The Bretton Woods system had recently collapsed, making the global economy especially vulnerable. There was no clear strategy for how to respond to the upturn in oil prices, but

individual countries tried to sustain economic activity by enacting various fiscal policy measures. Monetary policymakers in most countries mainly accommodated a general acceleration in price and wage increases. As a result, economies – especially the US, the UK and the Nordic countries – were plagued by years of volatile, high inflation that hampered capital spending and growth.

New challenges to fiscal-monetary policy coordination. Early in the COVID-19 pandemic, it was fairly uncontroversial to say that fiscal policy would play a major role as the impact of monetary policy began to fade. Fiscal policymakers also had a more suitable toolbox. As central banks have begun to signal a shift back towards monetary tightening, attitudes to fiscal policy have become more ambivalent. In the US, the Fed has welcomed a more cautious fiscal policy, which can also help to cool the economy, whereas the Riksbank, for example, has continued to welcome fiscal stimulus. Downward adjustments in the growth outlook are now strengthening arguments for more expansionary fiscal policies. In many countries, there is also broad political support for the need to invest in the green transition and boost defence budgets. The argument that this should justify exemptions from fiscal policy frameworks also seems to be gaining support.

Excessive fiscal activism? A word of warning is appropriate, however. We have now experienced a rather long period of increased economic policy activism. At first it mainly involved monetary stimulus, but it gradually expanded to fiscal stimulus. The pandemic has reinforced this trend – not only the idea that fiscal stimulus has a larger general role in stabilisation policy, but also an increased tendency to micro-manage, with compensation for rising energy prices as one recent example. If this is pushed too far, there is a risk that we will repeat the mistakes of the 1970s. Fiscal activism may drive up inflation expectations, especially if the market begins to suspect that governments do not mind that inflation pushes down the real value of government debt. This would further increase pressure for central bank rate hikes.



Stabilisation policy likely to withstand pressures. Although the current stabilisation policy regime is facing its greatest-ever challenge, it will probably withstand the pressures. After all, we are unlikely to head into an environment of major price and wage increases year after year. In countries where centralised pay agreements are important, this would also require employer and employee organisations to lose confidence in the long-term ability of central banks to keep inflation in check. Nor is it likely that the bargaining power of US employees will permanently increase in a way that generates recurring high pay increases. And while fiscal constraints will probably be eased to some extent, it is unlikely that the political system in advanced economies will really want to challenge the system of independent central banks, whose main task is to ensure price stability. Longer-term inflation expectations also support our main forecast that inflation will fall more clearly in late 2023.

Downside risks dominate. The war and the aftermath of the pandemic will create various types of downside risks. The conflict in Ukraine may escalate in a way that has more far-reaching economic consequences. It is also conceivable, for example, that we are underestimating the impact of current sanctions and trade tensions. A stronger inflation surge would erode household purchasing power and greatly weaken the profitability of many businesses. Downside risks dominate, but we cannot rule out a more positive trend either. Aside from a faster resolution of the Ukraine conflict, it is conceivable that we are underestimating the positive forces of post-pandemic normalisation. This may apply to the demand side, in the form of pent-up consumption and capital spending needs, and to the supply side, where the flow of people back into the labour market may be stronger than expected.