Economic Preview: Week of 13 July 2020

Publication date: 10 July 2020

Week Ahead Economic Preview

Global overview

- **Industrial production numbers for the US, China, Eurozone, UK and Japan**
- **US and China retail sales**
- **China, UK and Singapore GDP**
- **Bank of Japan and ECB policy meetings**

The coming week sees policy meetings at the Bank of Japan and the European Central Bank accompanied by industrial output numbers for the world's largest economies, as well as retail sales data for the US and China. The latter also releases its second quarter GDP. Inflation data for the US, Eurozone and UK will also be eyed as markets try to assess whether inflation or deflation looks set to dominate the post-COVID world.

The earnings season also starts in earnest with some key tech and financial names including Microsoft, Netflix, IBM, Johnson & Johnson, Pepsi, Honeywell, Bank of America, Morgan Stanley, Goldman Sachs, JPMorgan, Citi, Wells Fargo and Blackrock.

In the US, June updates to industrial production and retail sales will give clues as to the durability of the upturn after rebounds seen in the May data. While surveys have signalled further vigour in terms of economic growth momentum in June, concerns have been fuelled that the upturn could already be losing steam amid renewed COVID-19 lockdowns (page 3).

UK monthly GDP for May, including a split of manufacturing, services and construction data, will be accompanied by inflation numbers and a detailed labour market report. In the Eurozone, industrial production, inflation and trade numbers take the limelight ahead of Thursday's ECB Governing Council meeting. The eurozone's central bankers extended their asset purchase scheme to June 2021 at the last meeting, but the majority of economists believe further policy announcements will be needed in coming months as the economy struggles to find strong growth momentum after the COVID-19 shock (page 4).

In Asia, China's second quarter GDP is the pick of the data releases, though the higher-frequency industrial production and retail sales data for June will provide important detail on whether the rebound since February's lockdown has legs. The Bank of Japan's latest monetary policy meeting meanwhile comes on the heels of signs that Japan's economic recovery is lagging behind the global average. Industrial production data will add insight in this regard (page 5).

Special reports

Asia Pacific: An analysis of how the AsiaPac region is leading the recovery from the COVID-19 pandemic, and a look at what to expect for the second half of the year (**page 6**).

Europe: A look at the lessons from the COVID-19 pandemic from Sweden, which was unique in Western Europe by not implementing a national lockdown (**page 11**).

Upcoming PMI releases

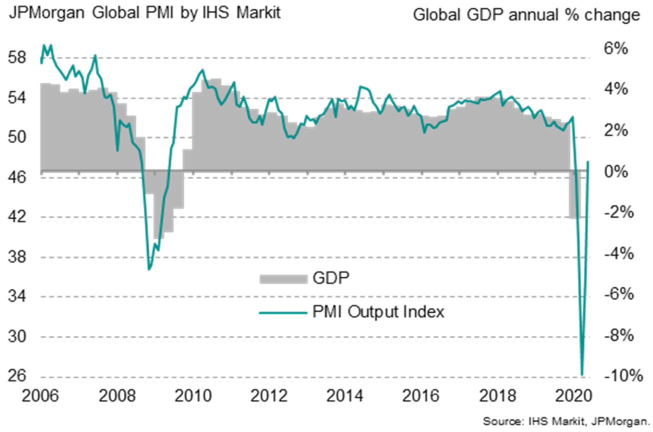
12th July: Worldwide Business outlook surveys

24th July: Flash July PMIs incl. US, Eurozone, Japan, UK and Australia

3rd August: Worldwide manufacturing PMIs

5th August: Worldwide services PMIs

Markets will be looking for confirmation that economies are rebounding after PMI surveys hinted at recovery



China's retail sales and industrial production data are updated alongside second quarter GDP numbers

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Key diary events (UTC)

Monday 13 July

IHS Markit Business Outlook (12 July 23:01 UTC)

US monthly budget statement (Jun)

China new yuan loans, total social financing, M2, FDI, vehicle sales (Jun)

Malaysia starts parliamentary session

Tuesday 14 July

Singapore GDP (Adv, Q2)

Australia business confidence (Jun)

China trade (Jun)

Malaysia jobless rate (May)

Japan industrial production (Final, May)

Germany and Spain inflation (Final, Jun)

UK trade balance, industrial output, GDP (May)

India WPI (Jun)

Euro area industrial output (May)

Euro area and Germany ZEW sentiment (Jul)

US inflation and NFIB business optimism index (Jun)

South Korea jobless rate (Jun) 23:00 UTC)

Wednesday 15 July

UK Visa consumer spending index (Jun)

Australia new home sales (Jun), consumer confidence (Jul)

BoJ monetary policy meeting, quarterly outlook report

Indonesia trade (Jun), business confidence (Q1)

UK inflation (Jun)

Italy inflation (Final, Jun)

US industrial output (Jun), NY Empire State manufacturing index (Jul)

US Fed beige book

India trade balance (Jun)

Thursday 16 July

South Korea and Indonesia interest rate decision

Australia jobless rate, employment change (Jun)

China GDP (Q2), industrial output, retail sales, fixed asset investment, house price index (Jun)

UK employment change (Apr), jobless rate, average earnings (May), claimant count change (Jun)

France inflation (Final, Jun)

Euro area and Italy trade balance (May)

ECB monetary policy meeting

US jobless claims (11-Jul), retail sales (Jun), business inventories (May)

US Philadelphia Fed manufacturing index, housing market index (Jul)

UK consumer confidence (Flash, Jul)

Friday 17 July

Singapore NODX (Jun)

Hong Kong SAR business confidence (Q3)

Euro area inflation (Final, Jun), construction output (May)

US building permits, housing starts (Jun), Michigan surveys (Jul)

Saturday-Sunday 18-19 July

19/7: Japan trade (Jun), BoJ meeting minutes (15-16 Jun) 23:50 UTC

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United States Week Ahead

Retail Sales, industrial production and inflation

By Siân Jones
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Key upcoming US economic data releases include retail sales, industrial production and inflation for June. Although there were signs of an economy beginning to recover at the end of June, the start of July has painted a different picture, with unemployment claims rising as states face a renewed spike in COVID-19 cases, with many firms that reopened having to shut once again to prevent the spread of the virus. Meanwhile, the IHS Markit US Business Outlook report will provide key insight into company's expectations towards employment, investment and business activity over the coming year.

Retail Sales

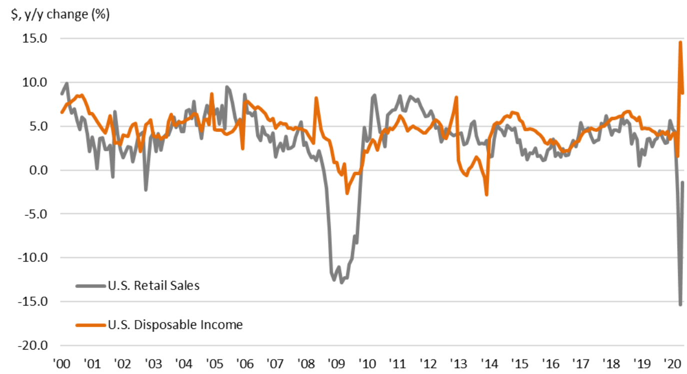
Following an historic decline in retail sales during April, May data signalled a pick-up in consumer spending across the US. The reopening of businesses and relaxation of some COVID-19 restrictions aided sales. The coming months may prove to be trickier for retailers and shop owners as incomes are squeezed and spikes in new virus cases become apparent. July signals the end of additional unemployment support payments, with those made permanently unemployed and those facing job losses set to see their incomes come under pressure. At the same time, the forced closure of businesses again amid a surge in cases will dampen any pent-up demand further.

Industrial production

Moves towards a recovery in the manufacturing sector were highlighted by a markedly slower rate of decline in production in June, according to the latest IHS Markit PMI data. Although still signalling a slight contraction in overall industrial output on a quarterly basis, the latest data indicated a turnaround from the severe decreases seen in April and May.

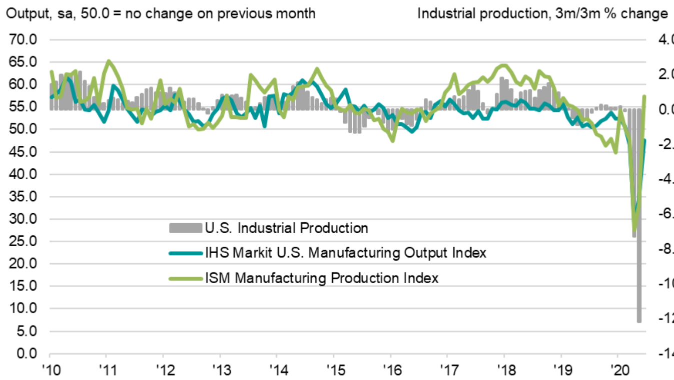
Meanwhile, the latest update to inflation is expected to show price pressures becoming more apparent as spending increased during June. That said, core inflation is set to remain subdued as demand for goods and services stays historically weak.

Moves towards a recovery in retail sales has been seen as businesses begin to reopen



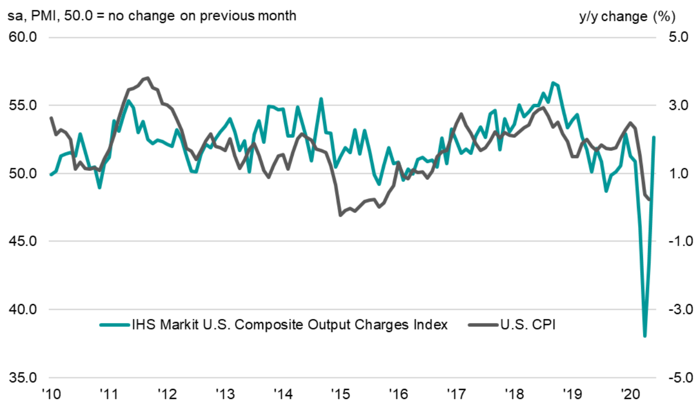
Source: U.S. Census Bureau, BEA, U.S. Department of Commerce

A slower rate of decline in industrial production expected in June



Sources: IHS Markit, ISM, Federal Reserve

Inflationary pressures are set to pick up at the end of the second quarter



Sources: IHS Markit, Bureau of Labour Statistics, U.S. Department of Labour

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Europe Week Ahead

UK GDP, employment and inflation, ECB rate decision

By Paul Smith

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A variety of official data releases across Europe next week will give important guidance on initial recovery trajectories from the COVID-19 downturns, with Thursday's ECB rate decision adding additional interest for monetary policy watchers.

UK GDP, employment data

It's an especially busy week in the UK, with the country's national statistics office set to release a smorgasbord of figures relating to GDP, the labour market and prices. The monthly GDP numbers are expected to show a strong uplift in economic output in May following April's unprecedented -20.4% collapse. However, despite an easing of lockdown restrictions, social distancing measures are likely to have continued to depress the economy, especially in sectors offering consumer services, meaning GDP will remain well down on pre-COVID levels.

Meanwhile, with data from recruitment consultants pointing to sharp contractions in hiring activity and vacancies, UK unemployment will have likely continued to step higher in the three months to May.

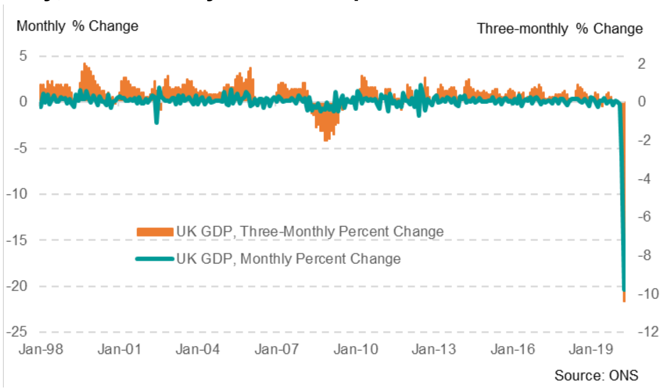
With depressed economic conditions dampening demand, and evidence of company price discounting, UK consumer price inflation for June should meanwhile remain well below the Bank of England's target.

ECB rate decision

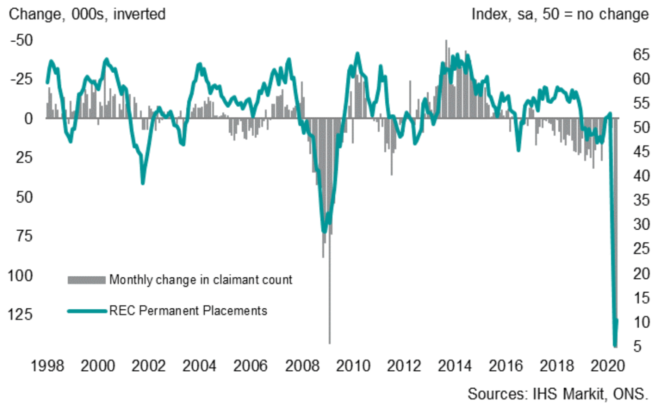
We expect to see strong monthly May industrial production and construction growth figures for the eurozone, but the data will inevitably highlight a long way to go to fully recover the deep production loss seen so far this year. Whilst PMIs and official data on German industry – the region's key manufacturing growth engine – suggest the recovery is now underway, the upswing has been underwhelming so far given the sheer size of the fall in activity related to COVID-19.

With many more months of strong gains therefore required to make up the output gap, policymakers at the ECB – who are also facing weak core inflationary pressures – will be keeping this firmly in mind when meeting in Frankfurt to set euro area monetary policy for the final time before the summer break.

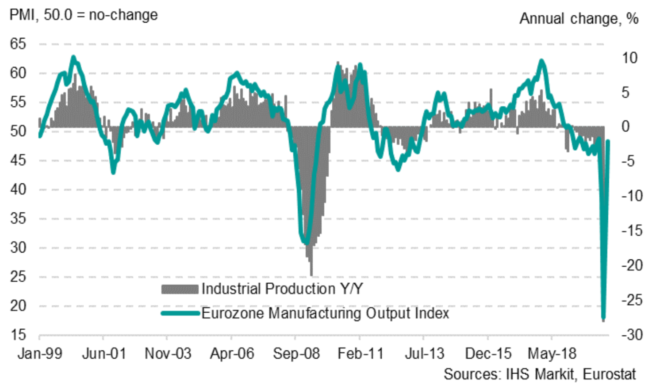
UK economic output set for strong monthly growth in May, but economy remains depressed



Official data to show further sharp increases in UK jobless claims and unemployment



Eurozone manufacturing output is recovering, but has some way to go to address the COVID-19 related downfall



Asia Pacific Week Ahead

China's second quarter GDP, Bank of Japan policy meeting

By Bernard Aw
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Next week sees a busy data calendar. With China being early to lockdown and first to reopen its economy, its second quarter GDP update will be keenly watched, providing clues as to the trajectory of recovery for other countries. Other higher frequency Chinese economic data such as industrial production and retail sales will also gather interest.

Other key Asian highlights include trade updates from a number of regional economies plus employment data in Australia, South Korea and Malaysia. Malaysia will resume its parliamentary sitting next week, with eyes on potential leadership challenge. The release of IHS Markit Business Outlook surveys at the start of next week will also provide insight of business expectations about the year ahead.

Central bank policy action will come from Japan, South Korea and Indonesia.

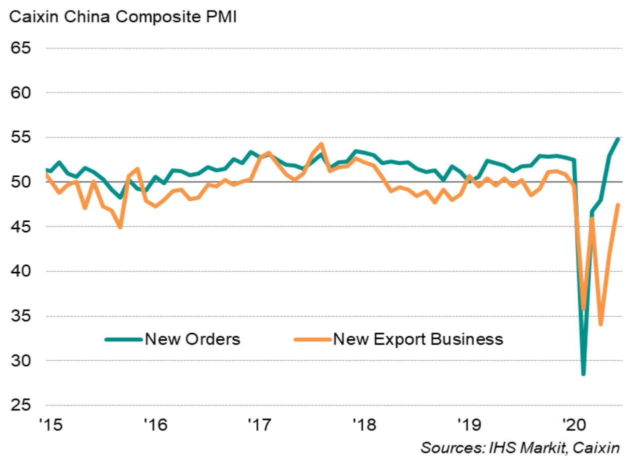
China recovery

An earlier lockdown in China saw the rate of economic contraction peak in February, helping the country to take an earlier lead in the recovery so far. As such, analysts will parse the second quarter GDP data for clues on the possible recovery path of other economies. The Chinese economy is projected to have expanded at an annual rate of 0.6% during the second quarter, rebounding from the -6.8% slump in the opening quarter. June updates to trade, industrial production and retail sales will also be eagerly monitored for guidance on further recovery. Caixin PMI data showed how the recovery has been fuelled mainly by domestic demand, hinting that further recovery may be limited, especially if external demand remains subdued.

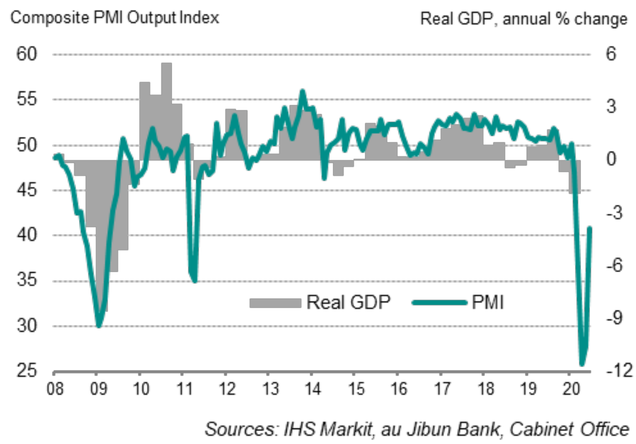
Monetary policy

The Bank of Japan meets next week to decide on monetary policy. The meeting is framed by the bank's updated quarterly report, providing the latest assessment of growth risks and projections. The au Jibun Bank Japan PMI indicated that the Japanese economy continued to struggle amid the collapse of global demand for trade and tourism, plus a headwind from last year's sales tax hike, adding to fears that the slump may extend into the third quarter.

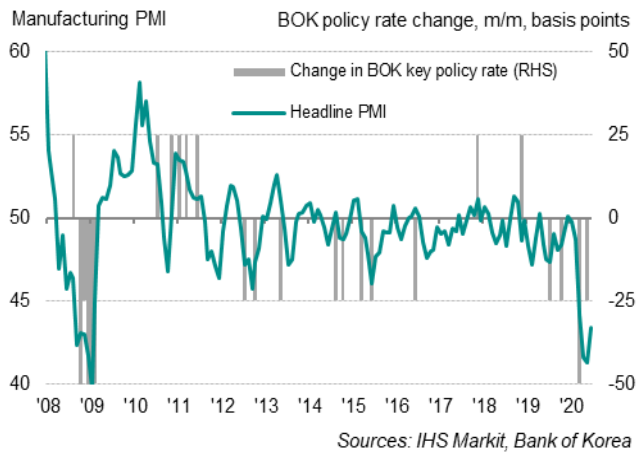
Domestic demand drives China's recent recovery amid a weaker global trade environment



Japan PMI and economic growth



South Korea PMI and monetary policy



APAC Special Focus

Covid-19: Asia-Pacific leads Global Recovery from Pandemic

By Rajiv Biswas
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The Asia-Pacific (APAC) region has been badly hit by the impact of the COVID-19 pandemic during the first half of 2020, with lockdown measures and travel bans in many Asian economies having triggered sharp contractions in GDP. The pandemic and associated lockdowns have disrupted industrial production and consumer spending in many Asian economies, with the tourism industry having collapsed since March 2020.

However, with the number of new COVID-19 cases slowing to very low levels in many APAC economies during May and June, domestic lockdown measures have been eased significantly in a growing number of nations. The latest PMI surveys indicated a rise in the headline PMI in many APAC economies, therefore suggesting that most of the region saw the rate of contraction peak in April, with marked improvements recorded in May and June as lockdowns were relaxed. The exception is mainland China, where an earlier lockdown meant the rate of decline peaked back in February, hence explaining China's lead in the global recovery so far.

Improving APAC economic growth momentum is expected in the second half of 2020, as domestic demand gradually recovers from lockdowns while export orders from key markets in Europe and North America also improve. By 2021, with the pandemic expected to be contained, a stronger economic rebound is expected in the APAC region, led by buoyant growth in China.

China leads APAC economic recovery

As the COVID-19 pandemic escalated in China during the first quarter of 2020, it created severe disruptions to industrial production due to the strict lockdowns imposed on industries and households. However, after these lockdown measures were eased during February and March, Chinese factories ramped up output during the second quarter of 2020. Industrial production recovered rapidly. By May, production was up 4.4 % year-on-year, while production of high technology goods rose by 8.9% year-on-year. However new export orders contracted sharply during the second quarter due to the impact of lockdowns imposed in key foreign markets, notably the US and EU. With lockdowns in the US and EU being lifted during May and June, new export orders are expected to gradually improve during in the second half of 2020.

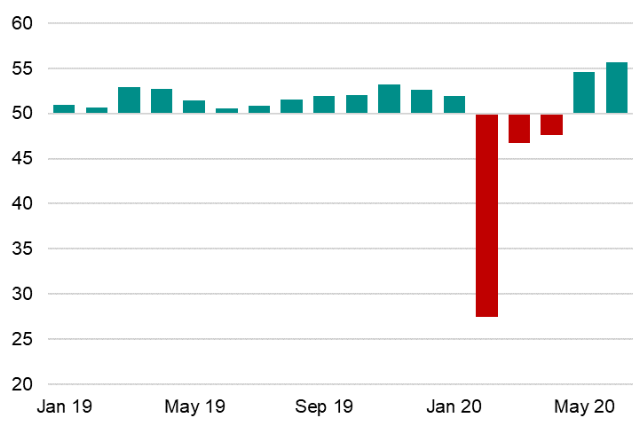
While the recovery in China's domestic consumer demand has been relatively gradual, with retail sales in March down 15.8% year-on-year, this had improved significantly by May, with the annual rate of decline in retail sales narrowing to just 2.8%.

China's vehicle sales rebounded during May, helped by a strong surge in sales of commercial vehicles, which rose by 48% y/y, while passenger vehicle sales rose by 7% y/y. This compared with a 42% y/y decline in vehicle sales during the first quarter of 2020.

Caixin PMI data, compiled by IHS Markit, showed that Chinese economic growth gained momentum in June, adding to further signs that the economy is recovering from the impact of the coronavirus pandemic. Business sentiment and order book growth also improved solidly.

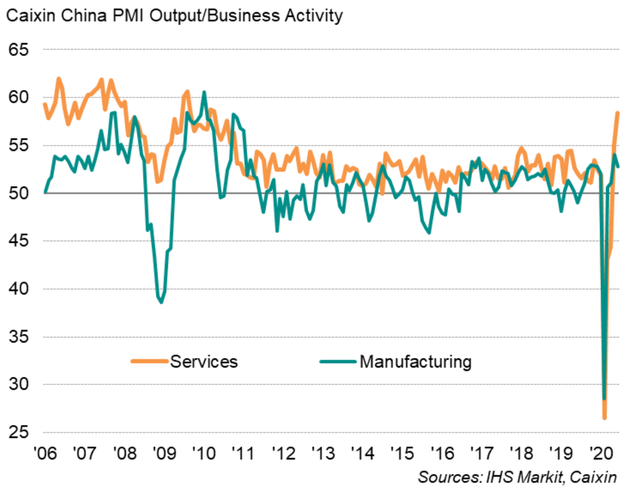
The survey data also indicate that China's recovery has been fuelled mainly by domestic demand amid a weakened global trade environment. However, with employment continuing to fall in June, which could dampen local consumption, any further recovery may be limited, especially if external demand remains subdued.

Caixin PMI shows stronger growth in Chinese business activity during June, but still does not commensurate with the scale of the fall in February



Sources: IHS Markit, Caixin

China's services business activity growth accelerated in June while manufacturing output rose at slower rate



Japan's recovery lags behind

Due to Japan's success in containing new cases during May, the State of Emergency ended on 25th May. Due to the protracted period of weak consumer spending during the duration of the State of Emergency, both domestic manufacturing new orders and services sector activity were badly impacted.

The lifting of the State of Emergency in late May was a key positive factor for domestic consumption expenditure, boosting services activity levels. PMI data showed the downturn in services activity eased considerably during June.

Meanwhile, the global slump in economic activity during the second quarter of 2020 has also hit Japanese new export orders. Provisional export data from the Japanese Ministry of Finance show that exports in May contracted by 28% y/y. This followed a 22% y/y contraction in exports for the month of April.

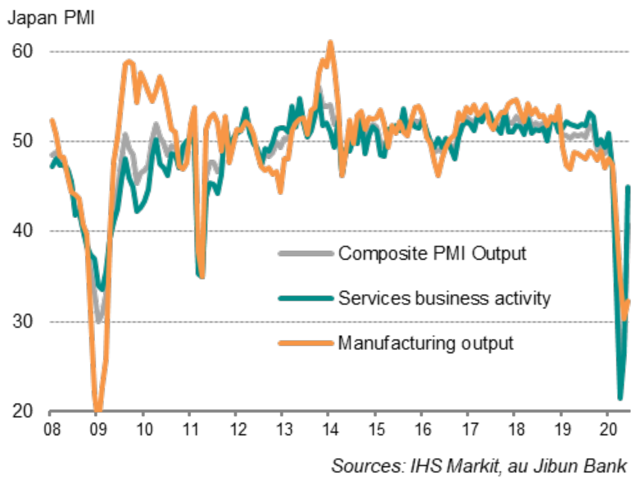
PMI and manufacturing output

Reflecting slumping exports, the Japanese manufacturing sector has remained weak. Japan's industrial production fell by 25.9% y/y in May and was down 8.4% month-on-month. Japanese government survey data from companies points to a significant rebound of 5.7% m/m in June and 9.2% m/m in July.

Japan's GDP contracted by an annualized 2.2 percent in the first three months of the year, the second consecutive quarter of GDP decline, pushing the Japanese economy back into another recession. Due to the State of Emergency conditions, Japanese GDP is expected to contract again in the second quarter, before gradually recovering in the second half of 2020.

The latest au Jibun Bank PMI data, also compiled by IHS Markit, showed business activity in Japan's private sector contracted sharply again in June despite an easing of emergency measures taken to limit the COVID-19 pandemic. While the downturn moderated further from April's record decline, the Japanese economy continued to struggle amid the collapse of global demand for trade and tourism, adding to fears that the slump may extend into the third quarter. Deflationary pressures meanwhile persisted as a result of further deterioration of demand in the economy. Signs of a recovery were elusive as business sentiment about the year-ahead outlook remained pessimistic on balance.

Easing of Japan's lockdown measures benefit services as trade weakness continued to weigh on factory output

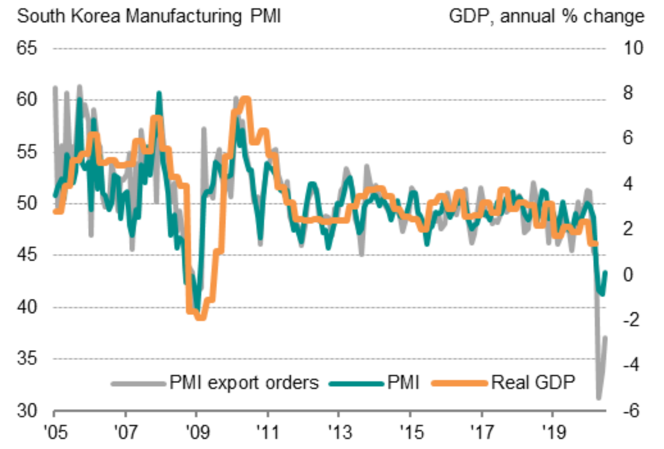


South Korean domestic demand improves but exports slump

South Korea's success in containing the escalation in new Covid-19 cases during March has allowed South Korean domestic demand to improve during April and May, with the number of new cases still remaining low during June. According to data from the Ministry of Trade, Industry and Energy based on surveys of major retailers, South Korea's retail sales in May rose 2.0% compared to the same period last year, with online retail sales having jumped 13.5% y/y.

However, the manufacturing sector, which is heavily reliant on external demand, remained under pressure. June PMI data indicated a further deterioration of operating conditions, with production volumes and new order inflows continuing to contract at marked rates. In particular, the PMI's gauge for new export orders continued to signal a rate of decline stronger than any seen prior to the pandemic.

South Korea PMI and economic growth



Sources: IHS Markit, Bank of Korea

Official data likewise showed that South Korea's export sector has been hit hard by the impact of lockdowns in key markets such as the US and EU. Ministry of Trade, Industry and Energy data show that South Korea's exports in May saw a year-on-year decrease of 23.7% to USD 34.9 billion. Auto exports dropped 54% to USD 1.8 billion, due to the falling global demand in major markets, notably the United States and Europe. In May, South Korean merchandise exports to the US fell by 29%, while exports to the EU were down 25% and shipments to ASEAN fell 30%, impacted heavily by lockdown measures in these markets.

Australian economy rebounds in June as lockdown eased

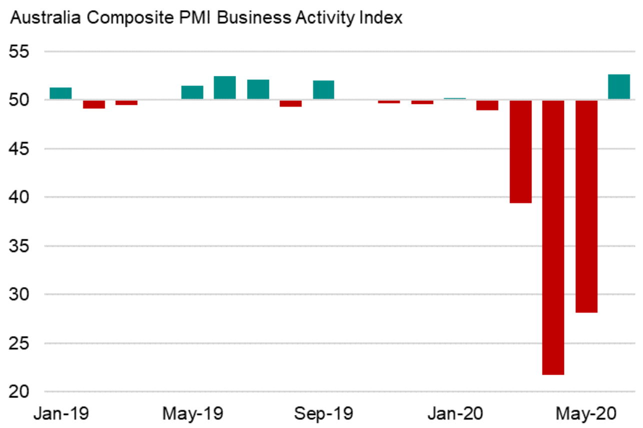
Although Australia managed to rapidly contain its COVID-19 epidemic, the impact of lockdown measures and travel bans is expected to push the economy into its first recession in 29 years.

GDP growth in the first quarter of 2020 already recorded a contraction of 0.3% quarter-on-quarter, with lockdown measures only having impacted on the economy in late March. However, with severe lockdown measures and travel bans in place during much of the second quarter, the economic contraction in the three months to June will be much more severe. Nevertheless, with COVID-19 restrictions starting to be gradually eased in May and June, a gradual improvement in economic growth momentum is expected in the second half of the year. The latest PMI surveys showed business activity in the Australian economy returned to growth during June amid an easing of COVID-19 restrictions, adding to recovery signs after four months of contraction resulting from the pandemic.

While the data will fuel hopes that the Australian economy could return to growth in the third quarter, the latest data represent only a relatively mild upturn compared to the unprecedented declines recorded in recent months. Looking ahead, further recovery could be constrained if a paucity of demand persists in the coming months or if rising COVID-19 new cases result in prolonged lockdown measures in some states.

Firms expect output to rise over the next 12 months as they continue to emerge from lockdown. Despite this improved sentiment, Australian companies generally remained reluctant to invest in new capacity, as sales remained subdued. Employment fell further as operating capacity remained in surplus compared to the pre-pandemic period.

Australia PMI shows only a mild growth in business activity during June as lockdown restrictions ease



Sources: IHS Markit, CBA

A recent spike in new cases in the state of Victoria in early July has also increased concerns about a new wave of the epidemic, with some renewed lockdown measures having been put in place. If the spread of new COVID-19 cases were to escalate significantly, this could have a renewed negative impact on economic growth.

Southeast Asian economies rebound as lockdowns eased

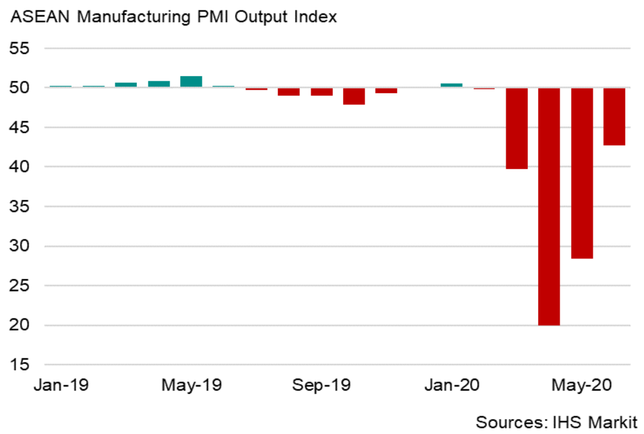
The economic impact of the COVID-19 pandemic across the ASEAN region has been mixed, with some nations such as Vietnam having largely avoided any significant domestic epidemic, while other nations such as Indonesia, Philippines and Singapore have suffered more severe economic shocks.

Indonesia, which is the largest economy in ASEAN, is still facing a high level of daily new COVID-19 cases, increasing the uncertainty about how long and protracted the impact of the domestic epidemic will be on the national economy. In Singapore, the protracted lockdown is expected to result in a severe contraction in second quarter GDP, plunging the economy into a severe recession for 2020.

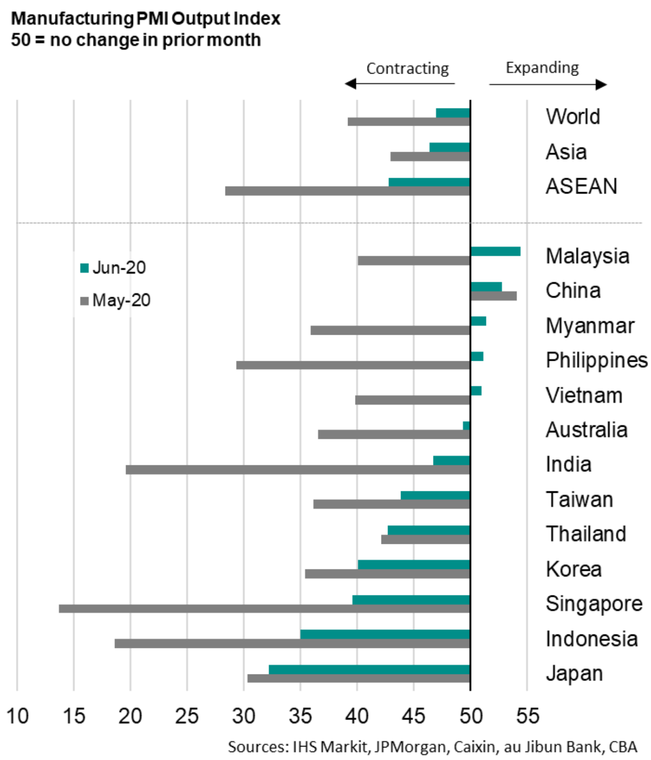
Vietnam has been very resilient to the economic shocks of the pandemic, with the total number of domestic COVID-19 cases very low so far, at just 355 persons, with zero deaths. Consequently, domestic demand has been quite stable, with retail sales down just 0.8% y/y in the first half of the year so far. Industrial production has also been robust, with manufacturing output up 4.6% y/y so far this year, helped by a 9.8% y/y increase in output of computer, electronic and optical products.

Malaysia and Thailand experienced a rising number of new COVID-19 cases during March and early April, but were able to control the number of new cases significantly during May, allowing the easing of lockdown measures. Despite the easing of lockdown measures, both nations are expected to experience recessions in 2020, reflecting the slump in consumption spending in recent months as well as the decline in exports to key global markets. The collapse in international tourism is also a significant negative factor for both economies.

ASEAN PMI indicated a further, but much slower, rate of deterioration of factory conditions in June



The ASEAN Manufacturing PMI, an aggregate index calculated from national PMI data compiled by IHS Markit for seven Southeast Asian countries, rose to a four-month high in June. However, by remaining below 50, the latest figure continued to signal a deterioration in ASEAN manufacturing conditions. Performance was also varied across the monitored economies, with Vietnam and Malaysia recording an improvement in factory conditions, while the rest reported a deteriorating, with Singapore and Thailand seeing the sharpest decline.



India faces recession due to protracted lockdown

In India, a national lockdown began on 25th March and has continued in various phases during June, albeit with significant easing of restrictions since early May. This protracted lockdown has resulted in the severe disruption of industrial production and consumer spending, with GDP growth forecast to contract sharply during the second quarter 2020, pushing Indian GDP growth for the 2020-21 financial year into a deep recession. However, unlike many other countries which have eased lockdown measures, India has faced continued escalation in the number of daily new COVID-19 cases during June. Consequently, the future path of lockdown measures remains highly uncertain, particularly if new daily cases continue to escalate.

As a result of the lockdown measures, Indian industrial production was heavily disrupted during late March and during April, although a limited restart of certain industries has gradually occurred since 22nd April. Indian industrial production fell by 55.5% y/y in April. Manufacturing output, which accounts for 77.6% of the total industrial production index, declined by 64.2% y/y.

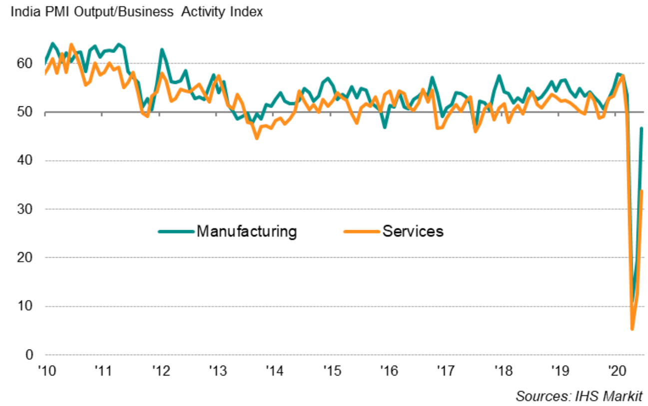
The services sector has also been badly hit by the impact of lockdown measures on retail trade and the collapse of domestic travel and tourism.

More encouragingly, PMI data for India showed that the downturn lost momentum in June, coinciding with the relaxation of COVID-19 related restrictions. The Composite PMI Output Index, covering both the manufacturing and services sectors, rose from 14.8 in May to 37.8 in June. While the latest figure remained well below 50, thereby signalling a substantial decline in output, it was comparatively higher than the extreme readings recorded in April and May. Nevertheless, overall demand conditions remained subdued in June, accompanied by a broad-based decline in employment.

By sector, PMI data showed a marked easing in the decline in manufacturing output, suggesting the sector is near stabilisation. In contrast, services activity contracted at a substantial pace, though not as severe as in April and May.

The severe recessionary conditions in 2020 are also expected to further drive up non-performing loans in the Indian banking sector, adding further downside risks to the path of economic recovery in 2021.

India PMI (manufacturing and services output)



Outlook

Due to the impact of the pandemic-related lockdown measures and international travel bans, the Asia-Pacific region is expected to be in recession in 2020. However, the significant moderation in the number of new COVID-19 cases in many major economies in the APAC region in recent months has created the platform for a gradual recovery of domestic demand during the second half of 2020. A gradual recovery in other major economies in coming months, notably the US and EU, will also help to drive a rebound in new export orders for the Asia-Pacific export sector.

China, the world's second largest economy, is leading the world recovery, with economic activity rapidly returning to more normal levels for both manufacturing and services. A key strength supporting China's rapid economic rebound is the large size of the domestic consumer market, which has helped to support improving new orders in both the manufacturing and services sectors. Strong growth in China in 2021 is expected to boost the export sectors of many other Asian economies, given the importance of China as a key market.

Overall, GDP growth momentum is expected to gradually improve in the APAC region during the final half of 2020, helped by improving domestic demand and an upturn in new export orders from key global markets, notably the US and EU. In 2021, renewed positive growth is forecast for the APAC region as the pandemic fades, with regional growth momentum buoyed by a strong economic rebound in China.

Europe
Special Focus

COVID-19: Lessons from the Swedish approach

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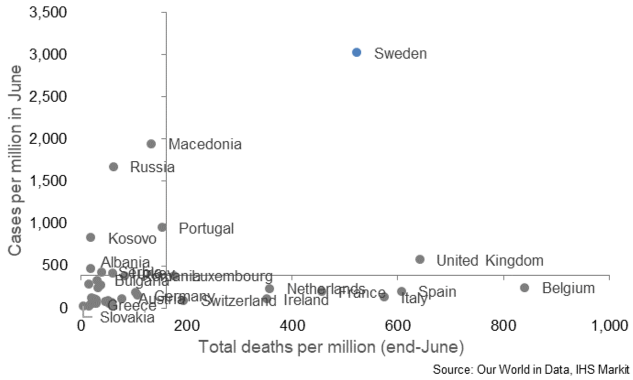
Uniquely in Western Europe, the Swedish government did not implement a national lockdown to contain the spread of the COVID-19 virus. Instead, it sought to generate voluntary behavioural changes based on guidance from the country's chief epidemiologist. Shops, restaurants, bars and all non-essential services were allowed to operate under new rules ensuring social distancing. Primary schools remained open, meaning essential workers did not need to stay at home, while high schools and universities largely switched to online teaching. Workers were advised to work from home and limit non-essential travel, while external borders remained open for arrivals from Europe without the need to self-isolate or be tested. Gatherings of up to 50 people were allowed, whereas most European countries banned gatherings of more than five people. The strategy was designed to allow the virus to spread through the population in a controlled manner, building a degree of herd immunity without overwhelming the health system, while insuring against potential future waves of the virus.

This came at the cost of a much higher death toll than in neighbouring countries, although Belgium, Italy, Spain, and the United Kingdom, which imposed strict lockdowns, fared even worse. Moreover, the transmission of the virus in Sweden remains extremely high in international terms, with over 3,000 new cases per million people recorded in June, almost ten times the European average (Chart 1). One of the main arguments in favour of the Swedish approach was that it would safeguard the economy and limit the adverse effects that accompany economic recessions, such as a loss of employment leading to suicides or mental health problems. This has proven partially correct.

Chart 1: COVID-19 total deaths and cases per million in June (Europe)



Impact on the economy

The Swedish economy was the only one in Western Europe that did not contract in the first quarter (Chart 2), apart from Ireland where GDP was distorted by tax-related transactions of multinational companies. However, Sweden's underlying growth drivers do not necessarily vindicate the government's strategy. Although the country's private consumption fell by less than the Western European average, the decline was larger than in Finland, which imposed a strict lockdown. Somewhat counter-intuitively, despite the strict lockdowns across Europe denting foreign demand, net exports were the only positive contribution to Swedish growth (Chart 3), driven by the largest quarterly surge in goods exports in a decade. Without the contribution of net exports, the Swedish economy would have contracted by 1.6% in the first quarter, which would have been in line with other small West European economies.

Chart 2: Q1 2020 GDP and private consumption

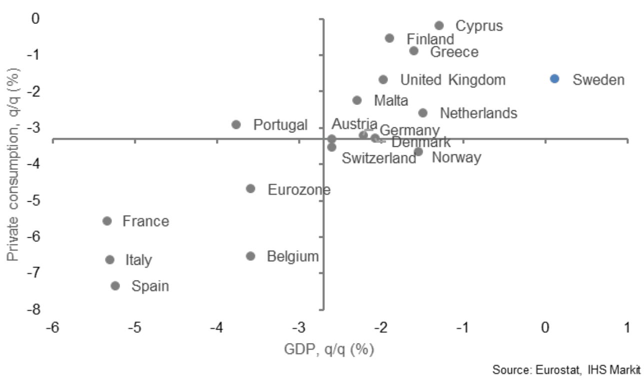
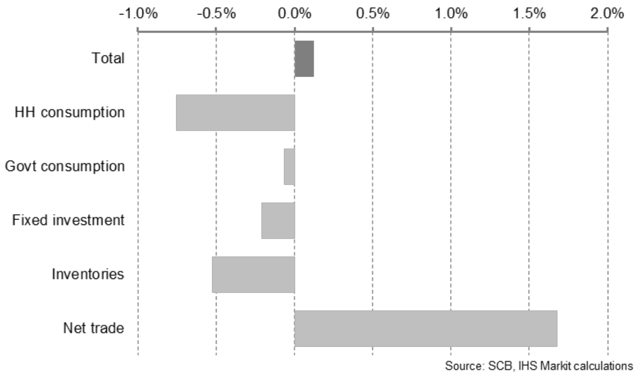
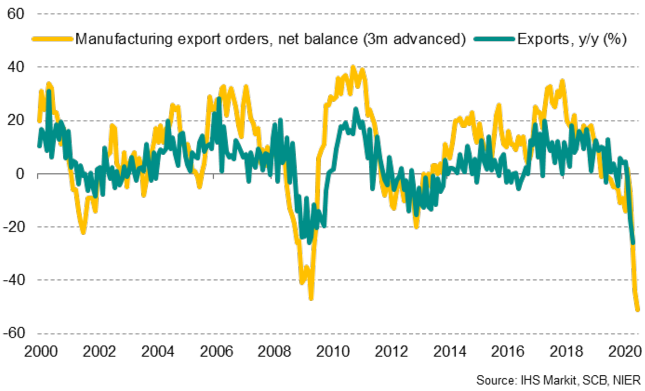


Chart 3: Sweden's contributions to quarterly growth, Q1 2020



However, there are some key downside risks to the country's near-term outlook. According to leading indicators, goods exports, the key growth driver in the first quarter, are heading for a major contraction. They were down by 26% year on year (y/y) in May, equivalent to the nadir reached during the financial crisis, while manufacturing export orders sank in June to a lower level than in 2008–09 (Chart 4).

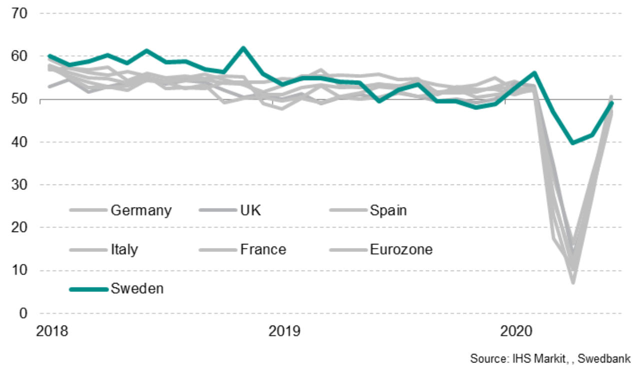
Chart 4: Goods exports and export orders



Private consumption is likely to hold up better than elsewhere in Europe in the second quarter, but this will hurt net exports. Sweden's service-sector purchasing managers' index (PMI) never sank to the low teens, unlike elsewhere in Europe (Chart 5). This is likely to have a mixed impact on second-quarter growth as stronger private consumption is likely to have pushed up imports, removing the key support provided by net exports.

Chart 5: Service sector PMIs

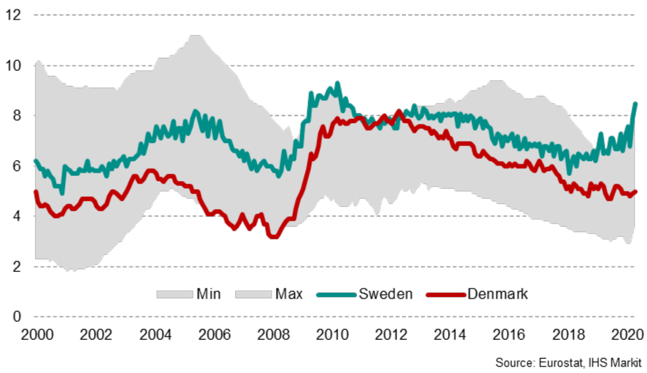
Index, >50 indicates expansion



Despite the lack of a strict lockdown and large fiscal and monetary policy stimulus, Sweden's unemployment rate shot up the most among its peers (Chart 6) and is likely to peak in double digits by early 2021. This is a key tail risk for the banking sector and the wider economy, given that Swedish households are among the most indebted in Europe, with a debt-to-disposable-income ratio of above 180% at the end of 2019.

Chart 6: Unemployment rate in Scandinavia, Benelux, Germany, Austria

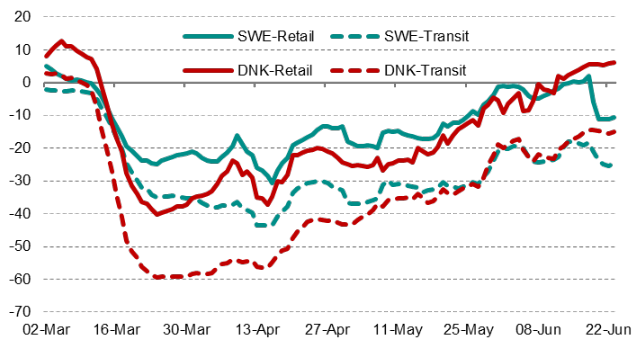
%



According to real-time activity trackers, Sweden is losing its advantage over economies that imposed a strict lockdown and successfully contained the virus (Chart 7). While the latter are likely to experience a strong rebound in consumer spending owing to pent-up demand, near-term activity in Sweden may remain relatively subdued as a result of consumers' concerns about the still-wide circulation of the virus.

Chart 7: Activity tracker

% deviation from baseline, (7-day moving average)



Source: Google Mobility Report, IHS Markit

The Swedish economy outperformed all of its peers in the first quarter, although the success was unrelated to its COVID-19 virus strategy but rather driven by strong foreign demand for its goods exports. According to leading indicators, this key support will diminish in the second quarter, while consumption-related imports are likely to make net trade a drag. The technical rebound from the third quarter of 2020 also risks being subdued, owing to the persistence of restrictions, a rise in the unemployment rate, and fears about the high prevalence of the virus. Although the government and central bank have already deployed large policy stimulus, more may be needed.

Policy response and available ammunition

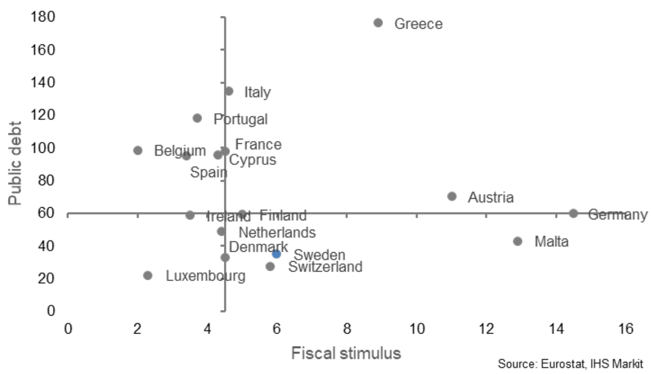
Sweden's policy response was large and swift, with the bulk announced in the second half of March. Its fiscal stimulus package is similar to those adopted across Western Europe, with the central and costliest element being the government assuming a large part of the payroll for affected companies to maintain employment. However, unlike in other countries, the affected companies are required to contribute towards the furlough scheme, which probably explains the steeper rise in the unemployment rate in Sweden. Other fiscal measures focus on supporting companies' cash position by delaying tax payments for up to a year, reducing social contributions, and the government assuming the cost of sick leave for up to two months. In total, the announced fiscal stimulus amounts to over 6% of GDP, comparable with peer countries, with a further 4.5% of GDP in loans and loan guarantees for small and medium-sized enterprises.

The Riksbank announced a new lending facility with zero interest, although banks will be penalized if they don't lend to the real economy. The lending rate, the Riksbank's facility for unlimited lending against collateral, was cut twice, from 0.75% to 0.1%. Asset purchases of SEK 300 billion (6% of GDP) were later expanded (to SEK 500 billion or 10% of GDP) and extended to June 2021. The policy rate (repo rate) has remained unchanged at zero, although at least two executive board members prefer to bring it down to negative during recovery, to stimulate domestic demand.

The Swedish government is in a good financial position to provide more support as its public debt is among the lowest in Europe (Chart 8). New measures could focus on the most affected sectors, such as retail and hospitality, which were the hardest hit in terms of job losses through to May. For the time being, the Riksbank is likely to prefer expanded asset purchases and loan facilities over repo rate cuts in the near term. In its early July monetary policy report, the Riksbank expects the repo rate to remain unchanged at zero in the forecast horizon, until the third quarter of 2023.

Chart 8: Fiscal stimulus and public debt

% of 2019 GDP



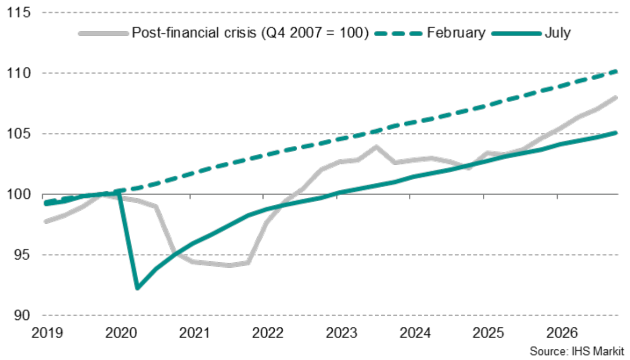
Source: Eurostat, IHS Markit

Outlook

For the full year 2020, we expect the economy to contract by just under 5%, which is significantly less than for the eurozone. Sweden is likely to return to the end-2019 GDP level at the end of 2022, more than a year earlier than the eurozone, but similar to Denmark. The crisis is likely to leave permanent output losses, with the Swedish economy expected to be permanently lower by around 5% compared with our February baseline (Chart 9). The rebound in the third quarter is likely to be more subdued in Sweden than elsewhere in Europe, as in the latter it will be related to the unwinding of lockdown measures and extremely high growth rates in some sectors that have seen a near-total collapse in activity. This will not be the case in Sweden, where levels of domestic activity never collapsed to the same extent and where a relatively high infection rate in the summer months may weigh down on consumer spending.

Chart 9: Sweden's GDP forecast

Q4 2019 = 100



The bottom line is that Sweden's strong performance in the first quarter, which has the biggest impact on full year growth, had little to do with its COVID-19 virus strategy, while the economy faces significant downside risks in the near term. The economy is unlikely to outperform its closest neighbours in the medium term.

The Swedish strategy has come at a cost of a much higher death toll and an unclear exit strategy from the current level of restrictions. However, Sweden is unlikely to change course.