

## ARTICLE – The long-term economic effects of the pandemic are uncertain

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The pandemic has caused a deep global downturn. It is very difficult to say how it will affect the global economy in the longer run. This depends partly on how long it takes until the pandemic is under control and partly on the economic policy response, but also on the size and duration of the changes in household and corporate behaviour caused by the pandemic. Consequently, forecasts are presently more uncertain than normal. In the main scenario, the pandemic is assumed, to some extent, to have permanent effects on the economy. To reflect the major uncertainty surrounding the development of the main scenario, a couple of mechanisms that could lead to the effects on the Swedish economy being more permanent are discussed here.

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### Conceivable economic effects of the pandemic in the long term

It is highly uncertain how the pandemic will affect growth potential in the global economy in the longer term. The crisis has triggered many structural changes and, in the wake of attempts to minimise the spread of infection, it is not unlikely that people's consumption patterns will change. These changes in consumption patterns, which could be persistent, affect the economy in many different ways.<sup>47</sup> One direct effect, for example, is that many aeroplanes stay grounded or ships stay in port, meaning that some capital has become unusable and redundant. Other effects include increased online shopping and working from home, which could change demand for shop premises, workplaces and homes, thereby having effects on the property market.

Restrictions and people's changed behaviour to reduce the spread of infection during pandemics and save lives increase unemployment. The pandemic has particularly impacted sectors where many people find their first job and where workers have a weak attachment to the labour market (above all, within the retail trade, hotels and restaurants).<sup>48</sup> Entry into the labour market may be delayed for many people, which risks having persistent negative effects on the labour market. People who have been unemployed for a longer period risk losing competence and skills, increasing the risk that

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<sup>47</sup> See J. M. Barrero, N. Bloom and S. J. Davis, "Covid-19 is also a reallocation shock", NBER working paper no. 27 137, 2020.

<sup>48</sup> See, for example, H. Joo, B. Maskery, A. Berro, L. Rotz, Y. Lee and C. Brown, "Economic impact of the 2015 MERS outbreak on the Republic of Korea's tourism related industries", *Health Security* 17, pp. 100-108, 2019.

they will get caught in long-term unemployment.<sup>49</sup> In addition, distance learning at schools and universities to reduce the spread of infection could entail negative effects for education and people's future prospects.<sup>50</sup>

People's experiences from the pandemic risk having lasting effects on confidence among households and companies by changing our assessment of the risk that serious events of this type can occur. This could lead to households building up their saved capital, just to be on the safe side, and to persistent lower corporate investment.<sup>51</sup>

During the crisis, both governments and companies have experienced shocks to global supply and production chains, which may now lead them to reorganise their value chains and move some production from other countries to Sweden or nearby countries, a process known as re-shoring.<sup>52</sup> This may involve increased production costs and may decrease the degree of specialisation, which could restrain productivity and raise inflation when technological advances no longer spread so easily.

However, the pandemic need not only have negative long-term effects on the economy. For example, investment needs not become lower if productivity growth falls: local production also requires investment, and increased investment is necessary for the actual transition of production. More local production also means more expensive labour, which could promote technical innovation and lead to higher productivity. The digitalisation of services also means that new technology may be spread around the world, even if production takes place more locally. This digitalisation has been accelerated by the pandemic with many efficiency gains as a consequence.<sup>53</sup> The pandemic has also forced the emergence of more efficient solutions for many companies and within medical care, for example with more flexible workplaces and new forums for meetings. The major economic policy stimulation measures are acting as support for economic recovery and, with the right design, may also facilitate structural transformation.

## Great uncertainty over the long-term economic effects of the pandemic

If confidence among households and companies is damaged more permanently, households' propensity to save will become higher and their willingness to invest lower than in the main scenario, with lower consumption and corporate investment

<sup>49</sup> For more information on the long-term effects of the pandemic on employment, see the article "The long-term effects of the pandemic on output and employment", Sveriges Riksbank, Monetary Policy Report, July 2020.

<sup>50</sup> Less teacher-led instruction time and difficulties in getting help with questions weakens learning, particularly for weaker students; see UNESCO, "COVID-19 Educational Disruption and Response", <https://en.unesco.org/covid19/educationresponse>, 2020.

<sup>51</sup> This phenomenon is sometimes called 'belief scarring' in the literature; see J. Kozlowski, L. Veldkamp and V. Venkateswaran, "Scarring Body and Mind: The Long-Term Belief-Scarring Effects of COVID-19", National Bureau of Economic Research (NBER), Working Paper 27439, 2020.

<sup>52</sup> See, for instance, Sveriges Riksbank, Business Survey, May 2020.

<sup>53</sup> Deutsche Telekom AG, "Impact of Covid-19: Corona as a catalyst for digitalization?", 2020.

as a consequence. In the short term, production costs will also increase as an effect of production becoming more local. This means that it will take longer for the level of GDP to return to the same level as before the pandemic.<sup>54</sup> The stronger effects of the deteriorated quality of education during the pandemic and long-term periods of unemployment will cause people's competence and work experience to decrease, employment to fall and unemployment to rise more than in the main scenario.

Even if the real economy develops weakly in such a scenario, it is not clear what the effects will be on inflation. Abroad, inflation will be slightly lower, but, unlike GDP and unemployment, for example, the relationship between inflation in Sweden and inflation abroad is not particularly strong. It is therefore likely that the supply and demand effects of individual countries will affect inflation in various ways. As Sweden's imports and exports form a relatively large share of GDP, we are affected more than other countries by shocks in global supply chains. Such a development will reduce competition among the surviving companies more than in the main scenario, meaning that they will be able to start increasing their margins more. That is, if demand rises faster than supply. In addition, productivity is lower, which means that it costs more for companies to produce a unit. This will contribute to Swedish inflation becoming higher than in the main scenario. Finally, lower growth in the labour force, due to an ageing labour force, will probably lead to poorer public finances and higher inflation, a development hastened by the pandemic.<sup>55</sup> However, a more rapid increase in inflation would not necessarily give reason to make monetary policy less expansionary in various ways.

There is also a possibility that the pandemic will lead to the more positive development of the real economy in the longer run. Crises often hasten structural transformations in the economy. Under the right conditions, this can create higher investment. A combination of expansionary fiscal policy that stimulates investment and structural reforms could lead to higher productivity and higher growth in the longer term. The reforms announced by the EU under the framework of Next Generation EU have the ambition of contributing to such a development.<sup>56</sup>

Thanks to its strong public finances, Sweden has good conditions to implement an expansionary fiscal policy combined with structural reforms. Investments in human capital and infrastructure could contribute to growth at the same time as a broad tax reform, for example, could boost the economy's long-term potential.

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<sup>54</sup> The discussion in this section is based on results from the Riksbank's general equilibrium model, MAJA; see V. Corbo and I. Strid, "MAJA: A two-region DSGE model for Sweden and its main trading partners", Working Paper Series 391, Sveriges Riksbank, 2020.

<sup>55</sup> See the discussion in: C. Goodhart and M. Pradhan, "The great economic reversal: Ageing societies, waning inequality and an inflation revival", Palgrave Macmillan, 2020. This book's main message is that the previously highly favourable demographic conditions, particularly in China, and rising degree of globalisation are in the process of changing. In this case, the labour force's opportunities to negotiate conditions will improve, leading to higher wage growth, higher inflation and greater equality.

<sup>56</sup> See European Council, "Conclusions", EUCO 10/20, 2020.