Scenarios: How could rates, the pandemic and climate interplay?

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- **The unusual uncertainties surrounding both the pandemic with Omicron, and financial conditions surrounding inflation, make it useful to think through some scenarios**
- **These do not represent our base case, but rather extreme situations that help us grasp how factors could interplay**

Scenario I: Pandemic ends, financial conditions stay loose	**Scenario II: Pandemic ends, but financial conditions tighten severely**
If the pandemic starts to fade in 2022 in a manner that prevents further economic restrictions, 2022 could see even stronger above trend growth than in our base case, which slowly normalizes as the reopening phase passes. Consumers shift their purchases back from goods to services which eases pressure on supply chains and cools inflation. Monetary policy will stay accommodative as long as global GDP is below its potential. This means that with discretionary fiscal spending on covid support no longer required, there is more leeway for public investments in decarbonisation. Also, households can spend their excess savings (in the Eurozone around 750 billion euro) on investments in energy efficiency of their homes.	A very different world emerges if we assume that the pandemic ends in 2022, but economies overheat. Consumers may switch their attention to services, but shortages of staff (caused by a large scale and permanent retreat of the labour force) force employers to raise wages dramatically. As services comprises large parts of today's economies, these wage increases can set in motion wage-price spirals – a dynamic not seen for decades. Global supply chain disruptions might also take longer to ease. For example, the zero- tolerance strategy of the Chinese government could lead to continued local lockdowns, despite few people being infected. In addition, freight capacity increases may cause new frictions in road transportation in destination economies that face labour shortages. Price pressures would then endure in both services and industry. Central banks slam on the brakes by raising rates, with a disorderly response by financial markets. Central banks have limited room to retreat from their tightening strategy until prices cool. Via currency exchanges and external financing, global financial tightening comes at a time when emerging economies have only started to recover. This triggers a global recession. Public debt issuance for climate spending becomes expensive, and carbon pricing politically unfeasible.
Scenario III: Pandemic endures, financial conditions stay loose	**Scenario IV: Pandemic endures and financial conditions tighten severely**
With the enduring pandemic, economically harmful restrictions remain. Governments switch to a more adaptive support scheme. Instead of balance sheet support (EU) or direct income support (US), workers are incentivised to move towards economic activities that continue during restrictions (health care, transport logistics, renewable energy). The adjustments cause large scale bankruptcies and unemployment which in turn lowers demand and cools inflation. Monetary policy stays ultra-loose, and fiscal spending on retraining further raises public debt. With the focus on worker mobility, a major hurdle for pro-active climate policy (labour shortages) eases. As a result, climate policy – although not the priority – gets a major boost.	Probably the most unlikely scenario, but worth considering. In this world, the pandemic drives continued lockdowns, with governments supporting the economy as until now. This means balance sheet support for European firms and large-scale stimulus checks for American consumers. Bankruptcies and unemployment stay low, but labour shortages in sectors that grow during lockdowns continue to increase. Consumers, particularly those in receipt of direct income support, raise their goods consumption driving supply shortages and higher inflation. Aggravating this situation is lengthy hard lockdowns in China, causing manufacturing output to drop significantly. All of this adds fuel to already high inflation, with central banks finding rate rises unavoidable. Financial markets panic, as not only rates rise steeply but also the pandemic endures. The combination of historic high public debt levels and severe financial tightening could trigger a debt crisis.