Nordic Outlook
January 2023

The final act in a four-year economic drama

Research reports

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January 2023

The West is headed towards a mild recession

The year 2022 was unusual in many ways. The war in Ukraine cast long shadows over the world and dashed hopes that the recovery of 2021 would continue. Instead, the inflation and energy shortage problems that emerged during the COVID-19 pandemic were amplified and the year was dominated by crisis management on several fronts: Central banks had to engage in interest rate hikes to try to curb inflation. European governments negotiated no fewer than nine sanctions packages against Russia while addressing the threat of an acute energy shortage. And households had to gracefully accept both declining real wages and falling asset values.

But while a lot of things went wrong, there was no lack of bright spots. At an early stage, soft indicators from both businesses and households began pointing towards recession, yet hard data showed impressive resilience. Economic growth and labour markets surprised on the upside, and when the year was over the expected deceleration had not arrived.

This creates a very interesting situation as we now head into 2023 and as the economic drama of the past years is approaching an end. We still expect the global economy to slow down, but how bad will it get? Forecasters around the world have alternated between optimistic hopes of a benign soft landing and dystopian predictions of a deep recession. Our view is that most evidence suggests a recession after all and that many Western countries will have to settle for growth around zero or even below.

At the same time, we are pleased that solid improvements in the energy field will allow the worst-case scenarios for Europe to be more or less written off. Inflation has now probably passed its peak in Europe and has already fallen significantly in the United States – contributing positively to the overall situation, since central banks will thus soon be finished with their key interest rate hikes. This will create opportunities for recovery in both the economy and financial markets during the second half of 2023. One important piece of the puzzle is how China will perform – now that the country has rapidly dismantled its strict COVID strategy. There are many indications that things will go well, but there are risks. As for financial market performance, there are many intriguing questions: Will last year's US dollar dominance be seriously challenged? And will the world's stock markets get their revenge, or do we have another gloomy year ahead of us? Looking further ahead, it will soon also be time to start asking what lessons we can learn from this crisis, and especially the sharp reversals in economic policy.

There are many exciting questions, and we look forward to following them together with you during the year.

This January 2023 issue of *Nordic Outlook* includes four theme articles that discuss the following issues:

- China's reopening
- US climate policy
- A burden on households
- Fading energy crisis

We wish you pleasant reading!

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The global economy

The United States | page 17

The economy is decelerating but the Federal Reserve is holding off on declaring victory over inflation, since the labour market remains strong and there is a lingering risk of wage-driven inflation. We expect GDP growth of 0.5 per cent in 2023.

China | page 31

China's political leaders are now focusing on economic recovery. GDP will increase by 5.5 per cent this year. Strict COVID-19 controls have been dismantled faster than anticipated. We are revising our 2023 CPI inflation forecast upward to 3.0 per cent.

The euro area | page 24

Inflation is past its peak but will remain relatively high. Combined with higher interest rates, this will lead to a mild recession in 2023. The European Central Bank will soon hike its deposit rate to 3.25 per cent, before cuts begin in early 2024.

United Kingdom | page 30

The outlook is gloomy. We expect negative GDP growth this year. Household real incomes will be squeezed by high inflation and rising interest rates, while continued goods and labour shortages will create challenges, both short- and long-term.

International overview
Mild recession, despite aggressive central banks

High inflation and rising interest rates will finally take their toll, and a recession will arrive during 2023. Inflation has now fallen and Europe's energy supply situation has improved markedly, which will help make the recession milder than feared. China's earlier-than-expected reopening is also positive, and its economy will accelerate in 2023. Global downside risks are mainly linked to underestimation of interest rate sensitivity. Looking ahead, a clearer decline in inflation may create room for positive growth surprises.

The global economy showed continued resilience well into 2022. Although households have been squeezed by rising interest rates and high inflation, consumption has held up relatively well. Partly due to the desire to return to a more normal life when COVID-19 restrictions are gone, a significant share of the savings buffers built up during the pandemic has been spent. Businesses have benefited from an easing of global supply disruptions as well as continued relatively healthy demand in many areas. A recent decline in energy prices has also reduced cost pressures. GDP growth in 2022 thus looks set to turn out stronger than we had expected in most countries.

Global GDP growth
Year-on-year percentage change

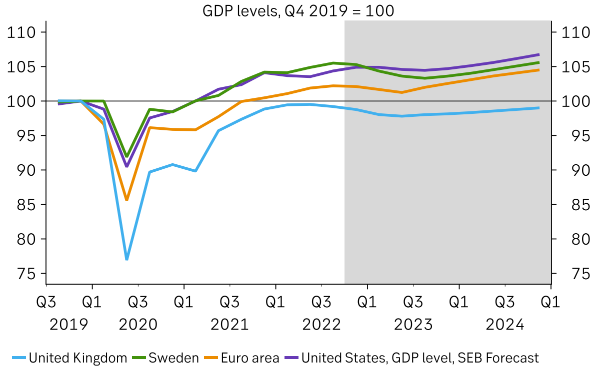
	2021	2022	2023	2024
United States	5.9	2.0	0.5	1.2
Japan	2.1	1.9	1.8	1.3
Germany	2.6	1.8	-0.3	2.4
China	8.1	3.0	5.5	4.9
United Kingdom	7.6	4.0	-1.2	0.7
Euro area	5.3	3.4	0.0	1.9
Nordic countries	4.4	2.6	-0.3	1.7
Sweden	5.1	2.9	-1.2	1.1
Baltic countries	5.9	1.4	0.2	3.3
OECD	5.7	2.9	0.7	1.7
Emerging markets	6.7	3.7	3.9	4.5
World, PPP*	**6.0**	**3.3**	**2.5**	**3.3**

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

Mild recession during 2023. In recent weeks, leading indicators have weakened in such a way that a mild recession in early 2023 is still likely. Household buffer savings are starting to dry up, and confidence indicators in the business sector have fallen to levels suggesting some decline in output. But the delay in the downturn has contributed to some upward adjustments in our full-year 2023 GDP growth forecasts for both the United States and Western Europe. Despite short-term problems in China with widespread virus transmission, the lifting of COVID-19 restrictions has also made it possible to revise Chinese GDP growth upward. A general increase in central bank hawkishness is delaying a rebound – one reason why we have instead revised our 2024 GDP forecasts downward.

The respite has reduced the likelihood of a deep crisis. Behind the relatively small revisions in our forecast figures are big changes in the risk picture and in the interactions between the performance of the real economy, economic policies and financial markets. Resilience in 2022 helped us to avoid a situation where the economy entered a recession while inflation was on the rise. Such a "perfect storm" would have been even harder for central banks to deal with. This would have triggered a scenario of severe stress symptoms in the financial system, with credit tightening further reinforcing the downturn in the real economy. The time we have now gained has consequently reduced the risks of a deep recession. This is reflected, for example, in the rising share prices of recent months.

Mild recession ahead
GDP levels, Q4 2019 = 100

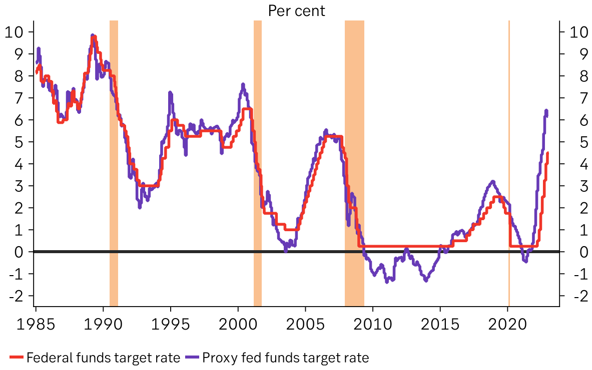


Source: Macrobond, SEB

Central banks have become more hawkish. Meanwhile, economic resilience has been one reason why central banks have signalled that they need to do more to bring inflation under control. Raising the stakes in this way makes the timing of the growth slowdown and of the decline in inflation especially important. We see various reasons why the inflation outlook has improved in the slightly longer term, and why the risks of a wage-price spiral like that of the 1970s have thus faded. The energy market outlook for the next couple of years now seems better (see theme article, page 27), while freight prices have tumbled and agricultural commodity prices have fallen. In Europe, especially the Nordics, wage responses to inflation also suggest that a destructive wage-price spiral is unlikely. But the decline in core inflation will probably be so sluggish that central banks will feel justified in carrying out their plans for aggressive tightening in the near term.

Monetary policy is being tightened from different directions

Per cent



Source: Federal Reserve Bank of San Francisco, Federal Reserve, Macrobond, SEB

Has interest rate sensitivity been underestimated? The shift to aggressive monetary policy increasingly seems to be the main downside risk in our forecast, especially considering the lengthy time lag before rate hikes have an impact on the economy. Before the global financial crisis, for example, the US Federal Reserve raised its key interest rate by 4.25 percentage points over a period of just over two years. Now the Fed is hiking its key rate more than that in less than one year, and its speed is now more in line with its austerity measures of the 1970s. In addition, the Fed has shifted from being a net buyer of securities to slimming down its balance sheet (moving from quantitative easing, QE, to quantitative tightening, QT). According to calculations by the San Francisco Fed, the actual tightening effect has been around 2 percentage points above that of the key rate. In Europe there are also similar risks, although key rates are not expected to reach such high levels as in the US. Weak economies with high public debt in southern Europe and highly leveraged households with a large share of variable-rate borrowing in Sweden and Norway are especially vulnerable. Yet today's inflation environment is holding down real interest rates, suggesting that the tightening may not be so severe. This might help explain the resilience shown by both businesses and households.

Faster inflation slowdown conceivable. The potential for more favourable economic performance lies mainly in inflation falling faster than according to the current consensus and our main forecast. The rapid dynamic of the upturn phase may be replaced by its mirror image, as the large price gains of spring 2022 begin to vanish from the 12-month figures. Meanwhile actual declines are conceivable in areas where price levels have been the most extreme, mainly in the energy field. Very recently, there has been anecdotal information about a sharp decline in input costs for many companies. We are still choosing to interpret this cautiously, while awaiting more reliable signals from business surveys. A faster decline in inflation would directly ease pressure on households as well as open the way for looser monetary policies, which in turn would provide support for a solid stock market upturn. We believe that the risk picture concerning the growth outlook is now symmetrical after a rather long period dominated by downside risks.

Various scenarios for the OECD countries

GDP growth, per cent

	2022	2023	2024
Main scenario	2.9	0.7	1.7
Negative scenario		-1.5	0.0
Positive scenario		2.0	3.2

Source: SEB

Bond yields have peaked. Our financial market conclusions (see pages 14-16) are based largely on the above risk analysis and timing issues regarding central bank hiking cycles as well as GDP and inflation developments. Because of more favourable inflation signals, bond yields have come down from the peaks recorded last autumn. In the short term, the tough attitude of central banks means that we foresee the potential for a slight rebound. After that, long-term yields will fall again as the inflation downturn becomes more pronounced and the market focus shifts from key rate hikes to future rate cuts. We expect the yield on 10-year US Treasury securities to fall gradually to 2.80 per cent by the end of 2024. We believe the Riksbank is likely to start actively selling government bonds this autumn, which will put upward pressure on yields.

Krona weakness despite more favourable conditions. The euro has recovered unexpectedly fast due to lower US inflation figures and improving European energy supply. A downward correction in the EUR/USD exchange rate is likely during the rather turbulent period we foresee in the near term. After that, the EUR/USD rate will continue to move towards levels that are more justified by fundamentals, reaching 1.12 by the end of 2024. Despite various favourable factors, including improved risk appetite, the Swedish krona has remained weak. The European Central Bank's tough signals and market worries about the Swedish housing market are probably among reasons why the EUR/SEK rate remains high. Over time, economic recovery and low valuations will help the krona appreciate a bit. We believe that EUR/SEK will be slightly above 10 by the end of 2024. A rebound in oil prices will help the Norwegian krone appreciate a little earlier. We expect the EUR/NOK rate to reach 10 by this summer.

The stock market has reacted positively to the brighter inflation outlook after a dismal 2022. Given the expected slowdown in economic growth, we see a major risk of downward revisions to 2023 earnings forecasts, which implies risks of a stock market correction in the near term. But investors have probably priced in lower corporate earnings already, at least in part, and are now starting to look further ahead towards the next phase. Assuming that our main scenario proves correct, we expect global stock indices to deliver a reasonably good return – above the historical average of 5-7 per cent.

Multi-faceted challenges

In addition to traditional macroeconomic trends, several other major issues affect the economic outlook. This *Nordic Outlook* therefore includes theme articles that analyse the consequences of 1) the lifting of COVID-19 restrictions in China, 2) the rapid transition in energy markets due to the Ukraine war, as well as potential trade disruptions and 3) the risk that the competitiveness of European industry will be eroded, in light of structurally vulnerable energy supplies and the launch of America's *Inflation Reduction Act*. A fourth theme article analyses the situation of households from different standpoints.

Protectionist threats in new climate policies

After more than a year of negotiations, US congressional Democrats managed to agree in August on a slimmed-down version of Joe Biden's election promises on climate, energy, health care and taxes. The name of the *Inflation Reduction Act (IRA)* is actually misleading, since the package is not expected to have any major impact on inflation (see theme article on US climate policy, page 20). Yet the new law has triggered strong reactions. The US is thereby assuming greater climate responsibility, which is positive. But meanwhile the law includes clear steps towards a more protectionist US industrial and trade policy, by reducing costs of domestic production and development of green energy technology. The IRA will thus exacerbate the risks of fragmentation in the global economy following the COVID-19 pandemic and amid an increasingly tense security policy situation.

European countermeasures on the way. European Union business representatives have warned that the IRA could lead to European de-industrialisation due to the current energy crisis. After extensive criticism from the EU the Biden administration has made some minor concessions, but they hardly change the main thrust of the new law. As a result, the EU will face difficult challenges in developing its own industrial and climate policy. It is important to strike the right balance between ensuring the competitiveness of EU industry while maintaining good transatlantic cooperation to avoid an escalating trade war that would worsen geopolitical tensions.

China's reopening will fuel higher growth

Protests against COVID-19 restrictions and an economic slow down during 2022 finally persuaded Chinese authorities to reverse their COVID policy. The reopening of society occurred faster than expected. We forecast that GDP growth will reach 5.5 per cent in 2023 and 4.9 per cent in 2024. This is a strong recovery compared to 2022. There are also upside risks to our forecast. Expansionary fiscal and monetary policies, support for the crisis-hit real estate sector, large accumulated household savings and pent-up consumption needs after large-scale lockdowns suggest a solid economic take-off in 2023. But the reopening is not without its complications. Virus transmission rapidly accelerated when restrictions were lifted during Q4 2022. Among other things, this has put pressure on the health care system, which is struggling to cope with the surge in demand. While it may be a little too early to declare victory, the worst fears of massive absenteeism from workplaces and new problems for global value chains appear not to have materialised.

GDP growth, emerging markets
Year-on-year percentage change

	2021	2022	2023	2024
China	8.1	3.0	5.5	4.9
India	8.7	6.8	6.0	6.2
Brazil	4.6	3.0	0.8	2.0
Russia	4.7	-4.0	-3.0	1.5
EM economies, total	6.7	3.7	3.9	4.5

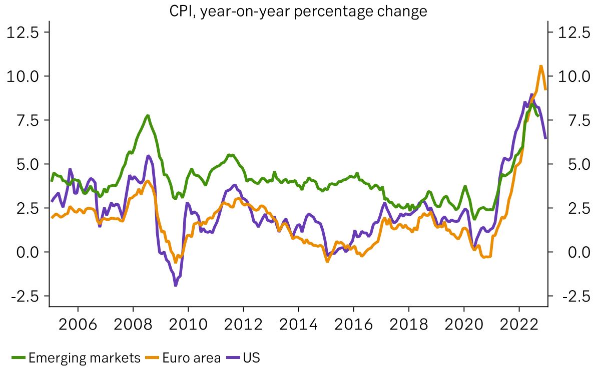
Source: IMF, SEB

A moderate rise in inflation. China's reopening has led to greater inflationary pressures as demand in some areas has outstripped supply. With an eye to earlier Chinese inflation patterns, hoarding during the pandemic and the ability of authorities to regulate price increases, we have revised our 2023 inflation forecast upward to a rather moderate 3.0 per cent from the previous 2.1 per cent. A larger increase in inflation, which would trigger more restrictive economic policies, nevertheless poses a certain downside risk to our GDP growth forecast.

Slowdown in other EM economies. Other major emerging market economies will instead decelerate in 2023 because of weaker global economic conditions. Growth will also be hampered by tighter financial conditions due to rising interest rates and a strong US dollar, as well as a general lack of room for stimulus measures. Energy and other commodity prices have fallen from earlier peaks. This levels the playing field a bit between commodity exporters and other EM countries. Sanctions due to the Ukraine war will continue to weigh on the Russian economy, but the decline in GDP will still be modest. Since the economies of China and other EM countries are moving in different directions, GDP growth in our EM sphere will end up about the same in 2022 and 2023, followed by an acceleration in 2024.

Modest inflation upturn in EM sphere

CPI, year-on-year percentage change



Source: U.S. Bureau of Labor Statistics (BLS), Eurostat, Macrobond, SEB

Inflation on its way down. The inflation upturn in EM economies has been milder than previously feared, given the greater relative weight of food and energy as well as the higher underlying trend compared to more developed countries. Just as in the US, inflation in the EM sphere has peaked and is on its way down. There are various reasons why inflation has not soared even higher. EM economies were relatively quick to tighten their monetary policies, both for inflation reasons and to prevent their currencies from weakening. In addition, EM countries are less dependent on natural gas than Europe in particular. Many of them have continued to import cheap Russian oil.

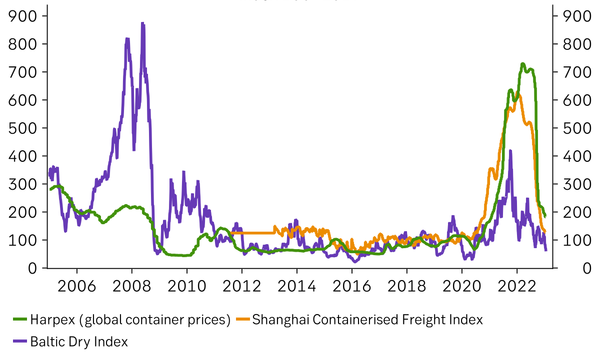
A fading energy crisis, but rising prices

The cooling of the global economy caused the prices of oil, coal and natural gas to fall sharply late in 2022. The EU also managed to cope with the impact of exceptional natural gas and electricity prices unexpectedly well. Increased imports of liquefied natural gas (LNG), mild weather conditions and impressive adaptability on the part of manufacturing companies and households enabled the EU to build up its gas inventories to a level around 15 per cent above normal. The crisis has largely faded, and the risk of gas rationing this winter and next is very small. Nevertheless, the global market for fossil fuels is expected to remain tight. The price of natural gas (using the TTF price in Amsterdam) is still three times normal – but well below 15 times normal, which was the level in late August 2022. We expect natural gas prices in Europe to rise somewhat from today's levels, but the annual average for 2023 will still be lower than in 2022.

OPEC has had a challenging period these past eight years, because output growth outside of the oil cartel was very strong. This has now changed. We believe market power will be predominantly in OPEC's hands over the next five years. In light of this, and since sanctions against Russia will cause a significant decline in the supply of oil and gas, we expect the price of Brent crude to rise to an average of USD 110/barrel this year and USD 100/b in 2024.

Freight prices have fallen

Index 100=2019



Source: Baltic Exchange, Shanghai Shipping Exchange, Harper Petersen & Co., Macrobond, SEB

Tough balancing act for fiscal policymakers

Fiscal policymakers face a difficult balancing act. They must deal with an economic slowdown, but stimulus measures risk making it harder for central banks to fight inflation. International organisations that used to advocate aggressive fiscal policies are now warning that unfunded stimulus measures will create problems. Last autumn's turbulence in the United Kingdom, where an expansionary mini-budget led to rising bond yields and a government crisis, was a cautionary tale.

The energy crisis is dominating European fiscal policy. The crisis packages launched in the US and the EU during the pandemic – including a focus on green investments, energy, digitisation and infrastructure –

are now providing an investment boost after a certain time lag. There has also been extra defence and security-related spending due to the Ukraine war. The energy crisis is affecting Europe more than other parts of the world economy. It is driving an increase in investments aimed at a long-term transition in the energy landscape but is also creating a need for large-scale subsidies to ease the short-term impact of high energy prices on households and businesses. Germany is now taking advantage of its strong public finances to provide larger subsidies than other countries. This has created tensions, since some countries in southern Europe cannot afford such generosity. Because of political gridlock in the US Congress, major political reforms are unlikely during the rest of Joe Biden's first term as president.

Public sector fiscal balance
Per cent of GDP

	2021	2022	2023	2024
United States	-10.9	-4.0	-5.5	-6.5
Euro area	-5.1	-3.9	-3.0	-2.5
United Kingdom	-8.0	-4.3	-2.3	-1.5
Sweden	-0.1	1.2	0.4	-0.7
OECD	-8.2	-4.4	-4.2	-4.3

Source: Statistics Sweden, SEB

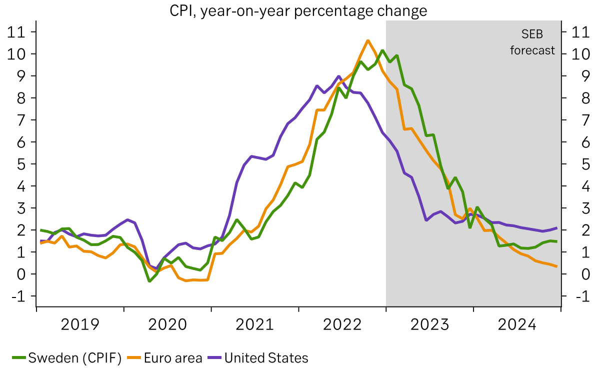
Large differences in electricity price subsidies. The electricity price subsidies that European households are now receiving are softening the downturn. *Bruegel*, a think tank based in Brussels, has tried to compare the scale of the various national subsidies. The differences between countries are very large. Germany is at the top, with subsidies totalling more than 7 per cent of GDP over a period of 15 months. Also notable is that households in the euro area – as in the case of interest expenses – have energy contracts that significantly delay the impact of price changes in electricity markets. Sweden is at the bottom in terms of the scale of its subsidies, reflecting the long delay in payments. But even under the proposals have now been presented, Swedish energy price subsidies will be relatively low in international terms. The government's generally cautious fiscal stimulus measures are especially remarkable considering Sweden's fundamentally strong public finances and the fact that this year's GDP downturn looks set to be larger than elsewhere in Europe.

Some easing on the inflation front

Although inflation trends in the US and Western Europe have been a mixed bag, favourable signals have recently predominated. Freight prices are now largely back at pre-pandemic 2019 levels. Overall prices of input goods have also declined, although their levels are still higher than normal, while agricultural commodity prices have stabilised. In the US, inflation has surprised on the downside for three months in a row. Previously large price increases for used cars are being reversed, helping to bring monthly core inflation figures (excluding food and energy) back down to pre-pandemic levels. Headline CPI inflation peaked at 9.1 per cent in June 2022 and was 6.4 per cent in December. We are forecasting that it will fall to 2.5 per cent by June and then stabilise at that level.

In Europe, inflation has reached higher levels than in the US. There is also a significant time lag compared to US trends. Our forecast indicates that the harmonised index of consumer price (HICP) in the euro area peaked at 10.6 per cent inflation in October. The decline in HICP inflation will be relatively sharp in 2023, but the annual average will still end up at a bit above 5 per cent. Falling energy prices will make a large contribution, but there is great uncertainty – partly because different ways of designing electricity price subsidies have different effects on inflation metrics. On page 25, we present an alternative scenario for energy and food price pass-throughs, with HICP inflation falling below zero in early 2024. This indicates downside risks to our forecast in the short term. In Sweden, inflation has kept climbing. CPIF (CPI excluding interest rate changes) reached a year-on-year high of 10.2 per cent in December, partly driven by a weak krona. This is probably the peak, although CPIF will probably be close to 10 per cent in January and February too. After that, a clear decline will begin, mainly driven by base effects as large price increases that occurred in the spring of 2022 begin to disappear from the 12-month figures. By the end of 2023, we expect CPIF inflation close to 2 per cent.

Inflation will fall
CPI, year-on-year percentage change



Source: Macrobond, SEB

More sluggish decline in core inflation. Looking ahead, central banks are likely to focus increasingly on core inflation. Euro area core inflation accelerated in

December. Its decline is expected to be rather sedate over the next six months. Producer prices for consumer goods are still rising relatively fast, and retailers continue to report plans for sizeable price hikes. This suggests that there is still some inflationary pressure. Rising rents and hikes in various public fees are other contributing factors.

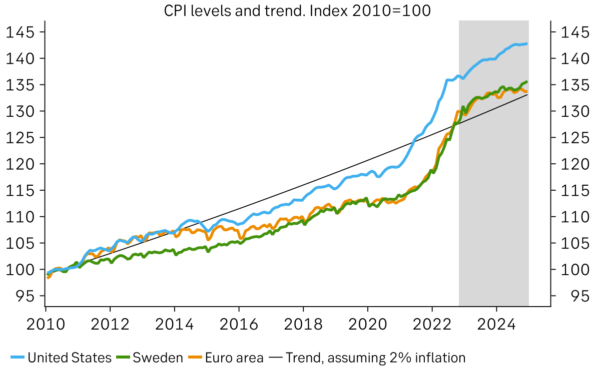
Some moderation in US pay increases. Wage formation is crucial to both actual medium-term inflation and the risks of a long-term shift in the inflation environment. US pay increases in the private sector slowed to a bit above 5 per cent year-on-year. The latest monthly figures reinforce the view that growth has peaked. The tight labour market, with 3.5 per cent unemployment, suggests continued upward pressure on wages and salaries. But we believe that short-term wage growth of 5 per cent will be enough to enable increases to fall to levels that will open the way for key interest rate cuts. Job vacancies have already started to fall, indicating that concerns about a sharp rise in equilibrium unemployment may be exaggerated.

Depressed real wages in Sweden. In the euro area, pay hikes have also accelerated somewhat, although the rate of increases is slower than in the US. Businesses have generally been able to maintain their profitability relatively well, allowing them room to offer some inflation compensation to their employees. Our forecast is that overall annual pay hikes in the euro area will end up at around 4.5 per cent in 2023 and 2024, which is in line with the outcome of German pay negotiations. Sweden's national wage round is now entering a crucial stage. The negotiating bids that have now been presented suggest that collective agreements will result in slightly lower increases than in the euro area in both 2023 and 2024. We are sticking to our forecast that pay hikes will total 4.5 per cent in 2023, but we have lowered our 2024 forecast slightly to 3.2 per cent. All in all, our price and wage forecasts indicate that real wage growth in Sweden will be somewhat slower than in other countries.

Diminishing risk of lingering 1970s-style inflation. As inflation began to soar in 2022, for a while it became increasingly popular to draw parallels to the stagflation era of the 1970s. But such a development is starting to look increasingly unlikely. Long-term inflation expectations have remained rather close to inflation targets. Pay hikes are accelerating a bit, but a harmful wage-price spiral seems distant. Fiscal policymakers look set to adopt a fairly neutral stance in 2023 and 2024, which also suggests that the mistakes of excessive fine-tuning ambitions during the 1970s will not be repeated. Once contagion effects have worked their way through the system, base effects combined with some normalisation of bloated price levels will push down inflation. This means that actual risks will be more on the downside by the end of 2024 and that inflation may indeed fall well below target for a while. There are still upside risks in our inflation forecast, but they are instead linked to short-term inertia or traditional overheating risks, mainly in the US and UK labour markets.

Above-trend price levels after the inflation shock

CPI levels and trend. Index 2010=100



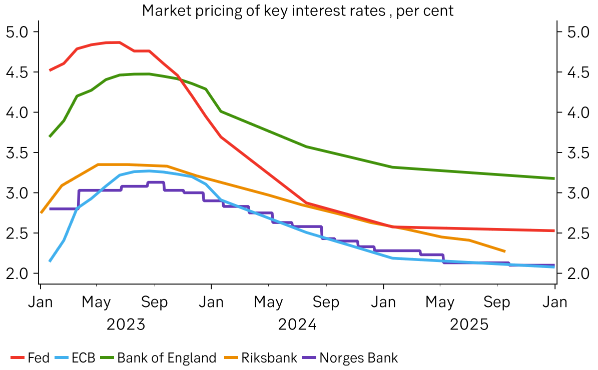
Source: Macrobond, SEB

The precautionary principle reigns

Most central banks are now nearing the end of their rate hiking cycle in an environment where actual inflation appears to have passed its peak, but where demand and the labour market are showing resilience. But uncertainty about the supply side of the economy, especially concerning the workforce, is among the reasons why central banks are currently being cautious about signalling an end to their hiking cycle. The markets are already pricing in future interest rate cuts, which also creates a need to hold back so that the impact of earlier tightening is not offset by too rapid a decline in long-term yields.

The market is shifting its focus to future rate cuts

Market pricing of key interest rates , per cent



Source: Macrobond, SEB

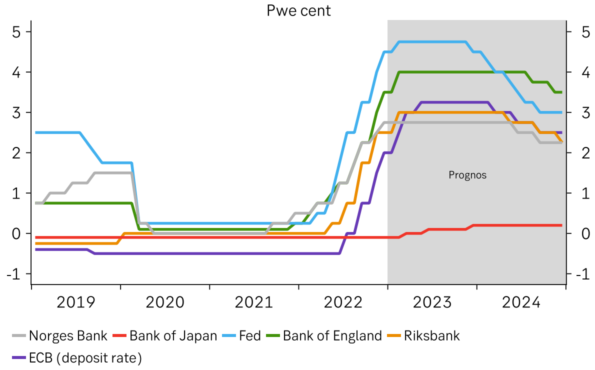
The Fed is almost there. We are sticking to our forecast that the Federal Reserve will deliver a final rate hike – bringing the federal funds range to 4.50-4.75 per cent –

at its meeting in early February. After that, it will leave its key rate unchanged until the end of 2023, when it will gradually begin cutting it to 3.00 per cent by end-2024. This is still slightly above the level that the Fed regards today as neutral. In the short term, there is an upside risk to our forecast, connected to the Fed's rhetoric and its own forecasts of a peak above 5 per cent. We expect the Fed to continue slimming down its balance sheet this year, but at a slow pace whose effect will be quite small compared to changes in the key rate. In line with the previous reduction in the Fed's balance sheet in 2018-19, we believe that it will pause this process prematurely once there have been significant rate cuts, i.e., during 2024.

The ECB has become more hawkish in response to high inflation, concerns about rising wages and new fiscal stimulus measures in the euro area. We now expect the ECB to raise its deposit rate by 50 more basis points each at the next two meetings in February and March. After a final 25 bp hike in May, the deposit rate will peak at 3.25 per cent. The ECB will start cutting rates again in mid-2024, with the deposit rate reaching 2.50 per cent at the end of our forecast period. The ECB has now also started downsizing its balance sheet, and we expect this process to accelerate during 2023. The Bank of England, like the Fed, will end its interest rate hikes in the first quarter of this year. Even the laggard Bank of Japan has now begun to take small steps towards a less expansionary monetary policy. We expect the BoJ to abandon the negative key rate at its April meeting and gradually raise it to 0.30 per cent by the end of the year. The BoJ is phasing out its bond purchases at a very cautious pace, and its balance sheet will continue to grow throughout our forecast period.

Differences in interest rate sensitivity have an impact on the pace of interest rate hikes. Norway and Sweden stand out with their high proportion of variable-rate loans and a large decline in home prices, which means that their interest rate hikes are not expected to keep pace with the ECB. Norges Bank is signalling a final key rate hike in March, depending on data. We believe that due to clearer signs of a slowdown in Norway's mainland economy and an upcoming peak in core inflation, the key rate will stay at today's level of 2.75 per cent. Falling resource utilisation and high interest rate sensitivity among households will then pave the way for rate cuts in 2024.

SEB forecast: We are approaching peak key rates



Source: Macrobond, SEB

A gloomy growth outlook, a weak exchange rate and high inflation are creating a dilemma for Sweden's Riksbank. We believe the bank will deliver a final 50 bp point rate hike to 3.00 per cent in February; slightly above its latest rate path and 25 bps above our November forecast. Once inflation has fallen more clearly during 2024, we expect the Riksbank to cut its key rate by a total of 75 bps to 2.25 per cent by the end of our forecast period. The Riksbank has completely stopped reinvesting maturing bonds, which means that its balance sheet is now shrinking rapidly. We believe the Riksbank will follow the Bank of England's example and start actively selling government bonds during the second half of 2023, without significantly impacting household mortgage costs, given the short fixed interest periods of these loans.

Evaluating policy frameworks after a crisis

Various crises have often led to a rethinking of economic policy frameworks or their applications. For example, the stagflation era of the 1970s led policymakers to give up their ambitions to fine-tune resource utilisation in the economy. As a result of the crisis that began around 1990, currency pegs and other soft forms of exchange rate collaboration were largely abandoned. This simplified a country's choices: either full-scale currency unions or floating exchange rate regimes – a dilemma that still divides public opinion in Sweden. The global financial crisis that began around 2008 was followed by a massive expansion of regulatory systems aimed at making the financial system more robust.

Lasting changes in the security policy situation. It is interesting to start thinking about what lessons can be learned from the crisis we are currently in. As for the security policy situation, all indications are that we are entering a new era, although there are still different scenarios for how the Ukraine war will evolve. The belief that mutual trade dependence would bring Russia closer to the EU has been shattered. Among other things, this is likely to change Europe's energy supply situation for the foreseeable future. Hopes that increased exchange would promote a rapprochement between China's political system and the West were abandoned by the US during Donald Trump's presidency. As discussed in the theme article on page 20, there are also various general challenges to global free trade, potentially escalating tensions even between allies such as the US and the EU.

Nevertheless, policy frameworks have been useful. As for our conclusions about stabilisation policy frameworks, a lot will depend on how 2023 unfolds. Over the past year, there has naturally been strong criticism of central banks for their exceptional policy reversal: from years of playing down inflation risks and fuelling higher asset prices to implementing historically very aggressive key interest rate hikes. If our main scenario – a mild recession and a return of inflation close to central bank targets during our forecast period – proves correct, it can still be argued that the existing policy framework has weathered a tough challenge relatively well. It is hard to deny that the established inflation targets have, in fact, helped to prevent long-term inflation expectations from soaring – an important difference compared to the 1970s.

Questionable strategy shift at the wrong time. This does not detract from the great need to carefully evaluate different aspects of how policy frameworks have been applied. The period before the recent inflation surge was marked by an overreliance on strong disinflationary forces. In retrospect, the Fed's change of strategy in 2020 – when it shifted from a more pragmatic view of the relationship between resource utilisation and inflation (the Phillips curve) to an experiment in which it tested the limits of how far it could actually push down unemployment – was badly timed. Partly because of central bank signals to governments that they could expect low interest rates for a long time, fiscal policy in many countries became overly expansionary in 2021. Such bodies as the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) acted in the same spirit. It should be a lesson for the future that recommendations should not based on the assumption that existing exceptional circumstances will be permanent.

Weak forecasting skills lead to pro-cyclical policies. The difficulty of forecasting actual inflation trends has also been revealed in a rather brutal way over the past year. One consequence of this lack of forecasting skills is that monetary policy tends to be pro-cyclical, i.e., it reinforces cyclical fluctuations. When inflation was low, it was expected to remain so forever. Now that it has climbed, central banks have gradually shifted to the more pessimistic camp regarding inflation. One conclusion we can probably draw from this is that central banks should be pragmatic and always keep an eye on resource utilisation in the economy. Even central banks that have a narrowly defined inflation target – and that lack any formal mandate to ensure high and stable resource utilisation – have the potential to do so in practice. Quite naturally, the potential benefits of stimulus measures in a situation of high resource utilisation are quite small, compared to the risks that things will go wrong.

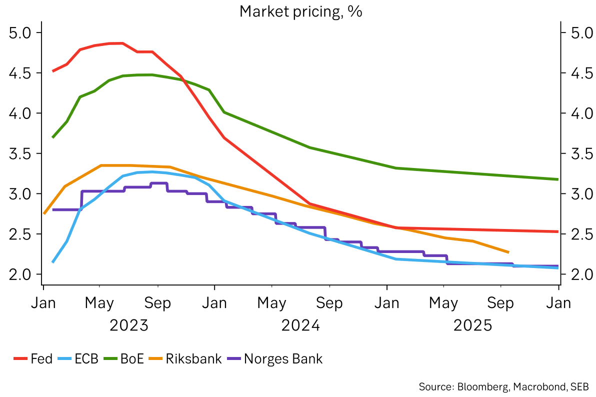
Room to ease negative side effects. The general question of how much volatility in different variables is acceptable in order to fine-tune inflation to targets also needs to be raised. During the pandemic, for example, home prices were driven up sharply. In small countries with floating exchange rates, large currency movements create various kinds of problems. There should be room to take greater account of such downsides even in the current system, and to avoid rigid adherence to the ends and means of inflation targeting. During earlier periods, for example, central banks have experimented with tolerance or target ranges for inflation and relied more on "leaning against the wind" by keeping an eye on the risks of borrowing and home price bubbles. Although there were sensible reasons for moving away from such a policy, recent experience suggests that it may again be worth weighing its advantages and disadvantages.

Not only the fault of central banks. However, it is not only the fault of central banks that they have gradually drifted towards a more literal application of inflation targeting. EU and national regulations have tended to move in the same direction. A reasonable basic concept here is that the more limited their area of responsibility, the easier it is for central banks to maintain their independence. At one time, Swedish labour unions and employer organisations were also strongly critical of the Riksbank's failure to bring inflation up to its target. Fairly moderate deviations were viewed as a threat to the role of the inflation target as an anchor in wage formation.

Fixed income
Timing of rate cuts and balance sheets in focus

With inflation turning or about to turn lower and the US Federal Reserve and European Central Bank rate hiking cycles in their final stages, markets are focusing more on balance sheet reduction and prospects for future rate cuts. In the US, long rates have peaked but some upside risks remain in the euro area. Swedish long yields are expected to rise above Germany in 2023, while the Norwegian equivalent will narrow next year.

Soon the hiking period will be over. Global bond yields rose sharply until October 2022, but the upturn has come to an end. This is not surprising given that central banks are expected to end their hiking cycles this winter or spring. Long-term yields tend to peak before policy rates, then decline during the rate cutting cycle. However, temporary increases by 50-70 basis points in long rates have historically been quite common during a US rate cutting cycle.



Volatile downward trend for US long rates. We expect fed funds to peak at 4.50-4.75 per cent in Q1 and rate cuts to begin in December. Market pricing of the fed funds peak has been relatively stable at 5.0 per cent since October. Expectations on future rate cuts have meanwhile increased by more than 100 basis points, a move that has pushed the 10y yield around 90 basis points lower from the October peak. We expect the US 10y yield to trade in a 3.25-3.75 per cent range for most of this year and fall to 3.0 per cent by end-2023. In 2024, a further decline in yields will depend on the outlook for fed funds. Current market pricing for fed funds in late 2024 is around 2.75 per cent, which is in line with our forecast.

Euro area: Time for balance sheet reduction. The ECB is concerned about medium-term inflation risks and indicates further rate hikes. We expect a deposit rate peak at 3.25 per cent in May, with the ECB then waiting until mid-2024 before cutting rates. Repayments of targeted longer-term refinancing operation (TLTRO) loans and a reduction in the ECB's securities holdings will likely shrink the Eurosystem balance sheet by EUR 1.2-1.5 trillion in 2023. Together with a substantial increase in government bond supply, it will contribute to slightly higher core euro area yields in the coming months, with potentially larger effects in the periphery. Market expectations of future ECB rate cuts are modest but likely to increase, which should limit the upside in longer-dated yields even before actual key rate cuts.

10-year government bond yields
Per cent

	Jan 19	Jun 2023	Dec 2023	Dec 2024
United States	3.37	3.40	3.00	2.80
Germany	1.96	2.30	2.00	1.90
Sweden	1.78	2.30	2.20	2.10
Norway	2.77	2.95	2.60	2.45

Source: National central banks, SEB

Swedish-German yield spread from negative to positive. The Swedish-German 10-year spread has turned more negative in the beginning of the year, driven by expectations of more ECB rate hikes and earlier Riksbank cuts. Swedish bonds also remain under pressure from low supply, and the 10-year government yield is currently around 20 basis points below Germany. We expect the Riksbank to start selling bonds outright in the second half of this year. Consequently, Swedish bond yields are likely to rise above German ones later this year. At the end of 2023, we expect Swedish 10-year yields to be 2.20 per cent, or 20 basis points higher than in Germany.

Norwegian yield spreads vs Germany have tightened substantially since last summer, with the 10-year narrowing by over 100 basis points. A diverging monetary policy outlook and large European funding needs suggest further Norwegian outperformance in 2023. Moreover, a strong household rate sensitivity will push Norges Bank to start cutting rates ahead of the ECB. We expect Norwegian 10-year yields of 2.45 per cent by the end of 2024, 55 basis points higher than Germany.

The FX market
The krona is weak despite favourable conditions

In 2022 the FX market saw two different phases: first the US dollar surged after Russia's invasion of Ukraine, but then in the autumn and winter the euro regained a surprisingly large share of its decline. The Swedish krona continues to be weighed down by the war and energy crisis. The rally in the world's stock markets last autumn did not lift the krona. Valuations clearly favour the krona. But given the geopolitical risk picture and the focus on falling Swedish home prices, its recovery will take time.

An impressive come-back for the euro. Last year's gloomy environment subjected the euro to powerful headwinds. The economic and political consequences of the Ukraine war were far more severe for Europe than for the US. Dependence on Russian gas and oil made the euro vulnerable as Western European manufacturers were threatened with energy rationing. Meanwhile, trade surpluses were squeezed as import prices rose faster than export prices (weaker terms of trade), which put immediate pressure on the euro. But late in 2022, economic drivers became more euro friendly. The dollar lost ground when risk appetite bounced back in response to favourable American CPI figures. This also helped shift the focus of attention from US to European key interest rate hikes. For various reasons, Europe also managed to weather the energy crisis unexpectedly well, and full natural gas inventories have enabled markets to declare an end to worries about this winter's energy supply.

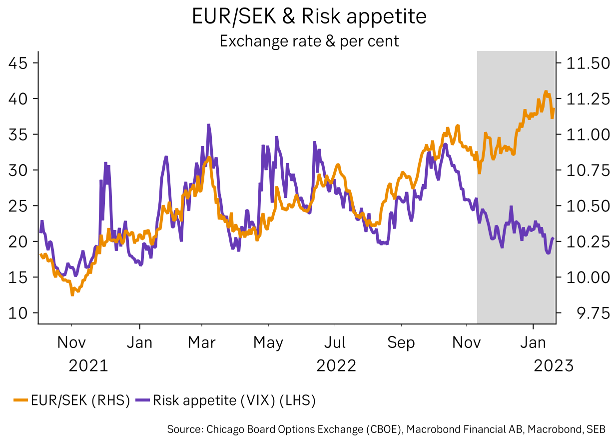
Dollar depreciation in 2023 after initial correction. We now believe that a downward correction for the EUR/USD rate is likely in early 2023. Market positioning for a stronger euro has probably gone too far, and support from falling energy prices is expected to fade as we approach normal levels. The Fed is close to its peak interest rate, but since cuts will be delayed until end 2023 this is unlikely to push down the USD so much in the short term. We also believe that the Q4-22 report season will trigger disappointments that will curb risk appetite and pull down the euro. We thus predict that EUR/USD will fall to 1.05 in Q1 2023, then rebound and reach 1.12 by end-2024. Various forces will help the euro approach levels more justified by fundamentals, including a re-allocation from high-valued US assets to lower-valued European ones, an energy transition requiring large investments and Asian reserve managers that boost their relative exposure to European bonds when yields are again positive in Europe.

Exchange rates

	Jan 20	Jun '23	Dec '23	Dec '24
EUR/USD	1.08	1.06	1.08	1.12
USD/JPY	130	128	125	120
EUR/GBP	0.88	0.89	0.91	0.93
EUR/SEK	11.20	10.65	10.25	10.05
EUR/NOK	10.67	10.00	9.75	9.65

Source: Bloomberg, SEB

Krona weakening is hard to explain and problematic. In Sweden, this winter's favourable trend – including hopes of slowing inflation, rising share prices, falling long-term bond yields and fixed income securities with clear AAA ratings – has not been enough to strengthen the krona. Instead, EUR/SEK has kept rising in an environment that is otherwise usually krona-positive. Three possible contributing factors: 1) geopolitical risks and delays in the NATO membership process; 2) ECB hawkishness that has pushed short-term euro rates higher than Swedish ones; and 3) international concern about Sweden's housing market, expressed by the unwinding of krona positions. The weak krona is one reason why Swedish inflation is now higher than in comparable countries. Valuations and recovery will probably enable the SEK to eventually begin rising. We believe EUR/SEK will again fall below 11.00 this spring, continuing down to 10.25 late in 2023.



Unexpectedly weak start to 2023 for the Norwegian krone. The NOK has had an even shakier start than the SEK and is now the weakest-performing G10 currency. But we believe it will benefit from a rebound for oil and gas prices in 2023. Like the SEK, the NOK will also be supported by a general economic recovery, which will help the EUR/NOK rate to reach 9.75 by year-end.

The stock market
When headwinds turn into tailwinds

After a tough 2022, many investors are looking forward to a brighter future. Headwinds are fading as inflation and interest rates peak, and as China reopens. But first we must get through a recession that will squeeze today's rather optimistic earnings forecasts. There is a risk of disappointments here, especially after the latest stock market upturns. With one eye on short-term growth risks and the other on next year's likely recovery, we are sticking to our neutral stock market view for the time being.

The old saying "Don't fight the Fed" proved correct again last year, although plenty of other factors weighed on the stock market, such as China's COVID-19 lockdowns and the tragic Ukraine war that drove Europe's energy crisis. But the final quarter of 2022 saw a marked recovery, reversing almost half of the year's downturn. Major stock markets are now around 10-15 per cent below their peaks of about one year ago.

Opinions differ on whether this upturn marks the resumption of a more favourable trend or whether it is a "bear market rally". We are leaning towards a kind of middle ground. In our view, stock markets bottomed out globally last autumn. But we foresee a lot of headwinds in the near future. Several bright spots have appeared in recent months, especially when it comes to inflation – reinforcing our view that equities have passed their low point. This is fuelling hopes of an early end to central bank rate hikes, which has probably caused long-term yields to fall. China's reopening has also awakened hopes of higher growth, although it may pose upside risks to inflation as global demand increases.

Offsetting this is "the world's most predicted recession". We see major risks that today's corporate earnings forecasts – analysts expect a 5 per cent global upturn – will be pushed lower as US and European economic growth ends up around zero. But we are in good company. Surveys show that portfolio managers expect slightly negative earnings growth this year. The market is thus likely to tolerate some downward adjustments. However, if growth proves weaker than expected, there are downside risks both for earnings and share prices.

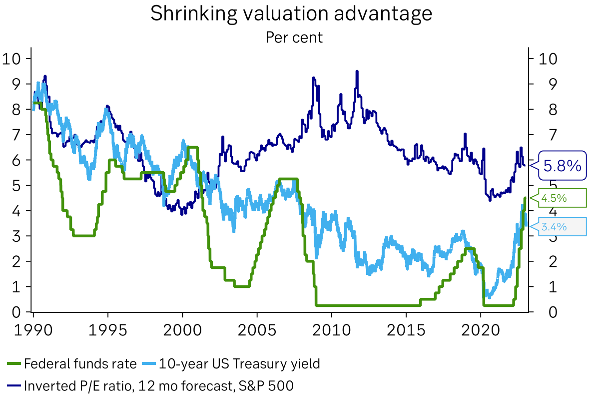
The question of the discount horizon will remain crucial to stock market performance, as concerns about growth and earnings coincide with an improving inflation and interest rate situation. The longer-term stock market outlook appears more hopeful now than last year.

Investors are still cautious about risk-taking. This provides some support, but after the latest stock market upturn, it is difficult to argue that share valuations are especially attractive. The global price-earnings (P/E) ratio is over 15, with the growth stock-oriented US pulling the ratio higher. This is well below the highs during the pandemic recovery, but also somewhat above the lows of previous recessions. Another factor is that – putting it a bit cavalierly – yields are again part of the system. We expect long-term bond yields to spend this year at levels around 3.5 per cent in the US and 2.5 per cent in the euro area and Sweden. Add one or more percentage points in credit spreads, depending on risk level, and obviously the fixed income market now offers viable alternatives to equities.

More reasonable valuations of risk assets

Higher bond yields are generally good news for managers of diversified portfolios, adding more strings to their bow. But as the chart below indicates, this also means that the wide valuation gap between stocks and bonds – expressed here as an inverted P/E ratio, or "earnings yield" – has shrunk. This comparison (famous in the 1990s as the "Fed model") still shows a slight advantage for stocks, but is based on today's probably overstated earnings forecasts and leaves out the higher returns on corporate bonds.

In the near term, downward adjustments in earnings forecasts will justify a continued cautious attitude towards stock markets. If our main growth scenario proves correct, however, we are close to the point where it will be time to look ahead to the next phase. For the full year, we expect global equity indices to deliver reasonably good returns, above historical averages of 5-7 per cent.



Source: S&P Global, U.S. Department of Treasury, Federal Reserve, Macrobond, SEB

The United States
Mild but sluggish recession as tight Fed policy bites

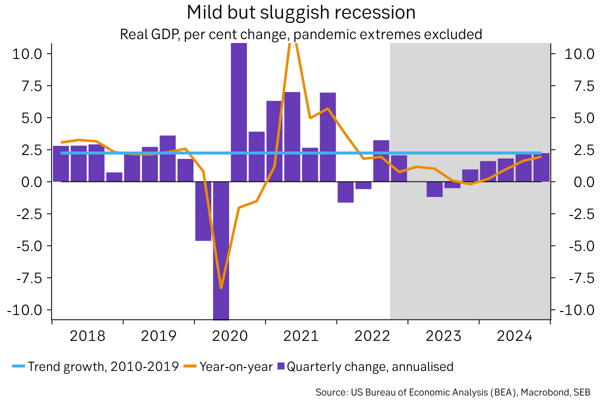
The US economy is decelerating under the weight of rapid rate hikes. Inflation will fall back to the Federal Reserve target by the end of our forecast period. But the mild recession we expect will not be enough to persuade the Fed to declare victory, as long as the labour market remains strong, and consumption resilient. It will raise its key rate in one more step early this year. Cuts will not begin until late 2023 and the key rate will stay above the Fed's estimated neutral rate for the rest of the period.

Increased hopes of a soft landing. Stronger growth in the second half of 2022 and moderate year-end inflation data have reinforced hopes of a soft landing. We expect GDP growth of 2 per cent last year (Q4 results will be published on January 26): a bit above our November forecast. The easing of inflation will support private consumption as real incomes again rise. Meanwhile aggressive Fed hikes will continue to impact interest rate-sensitive parts of the economy. Household resilience will weaken as previous savings buffers are depleted. We still foresee a dip in GDP this year, but we expect this to occur later and be a little milder than previously projected. We have raised our 2023 forecast to 0.5 per cent (0.1 per cent in November's *Nordic Outlook Update*) but lowered our 2024 forecast to 1.2 per cent (November: 1.5 per cent). One reason is that we expect the Fed to proceed cautiously with rate cuts.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	5.9	2.0	0.5	1.2
Unemployment*	5.4	3.6	4.0	4.9
Wages and salaries	4.2	5.2	4.2	3,2
Core PCE (Fed target metric)	3.5	5.0	3.4	2.0
Public sector balance**	-10.9	-4.0	-5.5	-6.5
Public sector debt**	128	122	124	127
Fed funds rate, %***	0.25	4.50	4.50	3.00

*% of labour force **% of GDP ***Upper end of the Fed's range.
Source: Macrobond, SEB



Greater pessimism in the business sector

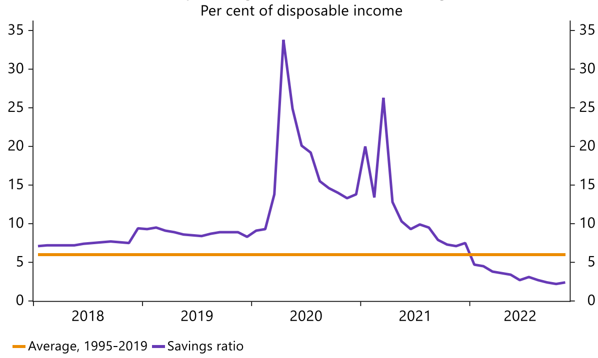
Late in 2022, manufacturing sentiment fell to levels that signal a marked slowdown in industrial production. Weak international conditions and a strong US dollar are reflected in falling order estimates. Previous support from large order backlogs has faded, and actual production fell in November. Meanwhile improved supply chains and falling input prices have reduced cost pressures, supporting expectations of a continued decline in goods inflation. Last year the service sector regained ground it had lost during the pandemic, but service sector sentiment fell steeply late in 2022 to slightly contractive levels. Small businesses remain pessimistic and have begun to scale back hiring plans, while earlier labour shortages have eased somewhat.

Reforms will soften the downturn in capital spending. Business investments, excluding construction, have been uneven this past year. Order bookings for capital goods, excluding defence and aircrafts, are pointing towards a slowdown ahead. This will be partly offset by the Biden administration's push for investments in infrastructure, domestic semiconductor production and climate, although phased in over a lengthy period (see theme article, page 20). Total capital spending is expected to fall by about 2.0 per cent in 2023, mainly due to the construction sector, but rebound in 2024.

Reduction in savings rescued consumption

During 2022, households maintained their consumption despite falling real incomes by tapping into the large financial buffers built up during the pandemic. According to the Fed, these buffers peaked at around 10 per cent of GDP (USD 2.3 trillion) during the third quarter of 2021 and then fell by about one fourth by mid-2022. This suggests that households still have significant reserves. But according to the Fed, most of these savings were held by households in the upper half of the income distribution, which suggests that the remaining buffers are unlikely to be fully spent. The savings ratio, as a share of disposable monthly income, levelled off late last year at its lowest levels since before the global financial crisis, at just over 2 per cent. Meanwhile falling asset prices have eroded total household financial assets, which are back at pre-pandemic levels as a percentage of GDP.

Sharp swings in household savings
Per cent of disposable income



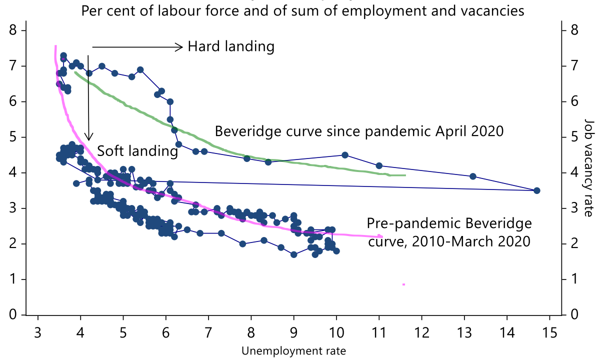
Uncertain outlook as consumption forces shift. This year, households will benefit from rebounding real incomes as inflation slows, but they will probably be more cautious about drawing down savings as the labour market starts to weaken. Auto purchases seem to have been especially hard hit by supply-side problems but are also more sensitive to interest rates. In 2022 fiscal policy tightened sharply as large pandemic stimulus programmes ended but will be more neutral this year. Upcoming negotiations over the debt ceiling, where Republicans are expected to demand sharp spending cuts, are a downside risk for the next couple of years, however. We expect private consumption to grow at a moderate pace of around 1 per cent in both years, down from nearly 3 per cent last year.

Rate-sensitive housing market. Thirty-year mortgage rates appear to have peaked. Sales of existing homes may thus bottom out soon, having fallen nearly to the lowest levels that were recorded during the pandemic, and before that in 2010. We expect residential construction to keep falling during the first half of 2023, along with home prices. Spill-over effects to the rest of the economy will still be limited, compared to the 2007-2008 housing crash. This is mainly because variable rate loans account for a very low share of household debt, which is also moderate as a share of incomes. Housing-related spending for electronics and appliances has fallen steadily since last spring, though not dramatically. Yet the number of employees in the construction sector has unexpectedly kept growing.

Hot labour market, especially for low-paid

Last year the labour market was characterised by shortages, rapid job growth and historically low unemployment. Labour force participation has stagnated since early 2022, amplifying these imbalances. In this setting, the employment cost index (ECI) has risen at its fastest pace since the early 1980s. Newly acquired bargaining power, especially among low-paid workers, has led to narrowing pay inequities. Some groups have seen their real wages rise since the start of the pandemic.

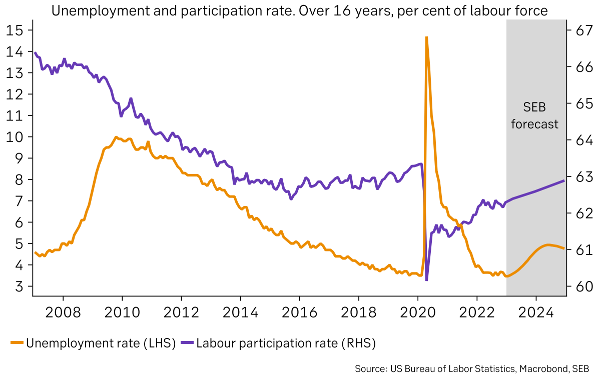
New vacancy/unemployment ratio?
Per cent of labour force and of sum of employment and vacancies



Equilibrium unemployment in focus for the Fed. The number of job vacancies still indicates a historically tight labour market. The ratio between vacancies and unemployment (the Beveridge curve) suggests worse matching after the pandemic. If this persists, the jobless rate may need to be pushed up well above the 4 per cent that the Fed today regards as an equilibrium level. But a better balance can also be achieved without increased layoffs. The fact that the vacancy rate has begun to fall in an otherwise strong labour market indicates an opportunity to follow the steepest part of the old Beveridge curve (the stylised pink curve in the above chart), rather than the post-pandemic curve (the green curve). Such a development would open the way for the soft landing that the market is hoping for, but which the Fed does not yet dare to confirm.

Moderate rise in unemployment. Unemployment fell in December to 3.5 per cent – matching the pre-pandemic 50-year low. Job growth has started to decelerate, but in December it was still higher than its pre-pandemic average (180,000) and well above the 100,000 that the Fed views as consistent with a stable labour market. Rising layoffs in recent months and a growing number of initial jobless claims, though from low levels, may indicate that the labour market is approaching a turning point. But in the leisure and hospitality sector, the number of jobs is still 900,000 lower than before the pandemic, indicating a potential for continued gains as other sectors shrink. In addition, the labour shortage is apparently making employers hesitant about laying off employees. Our forecast assumes that unemployment will rise during the spring and peak at just below 5 per cent in early 2024. The historical pattern is that an increase in unemployment of more than half a percentage point triggers a vicious circle – forcing many people to curtail their consumption before compensation levels have time to rise. The remaining savings reserves may help to avoid such a situation this time around, but this assessment is uncertain.

Modest rise in unemployment, sluggish participation
Unemployment and participation rate. Over 16 years, per cent of labour force

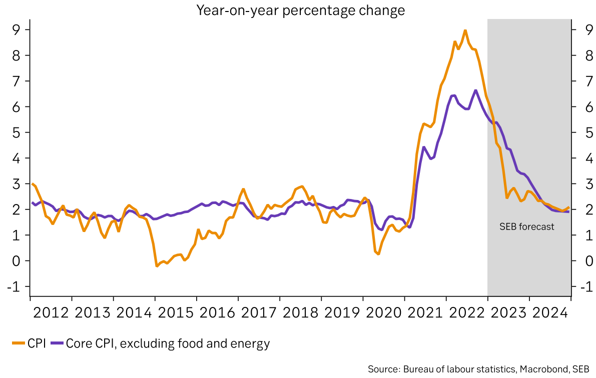


Structural challenges to the labour supply. So far, hopes of boosting supply to improve labour market balance have been dashed. At the end of 2022, labour force participation was still 1 percentage point below its pre-pandemic level. This gap is explained primarily by a decrease in participation by people over age 55. Worries about illness and strong personal finances were probably among the reasons why many people speeded up their withdrawal from the labour market during the pandemic. This should be a temporary problem. Once the individuals who left during the pandemic reach the age when they might have been expected to retire anyway, labour force participation should rebound. However, an ageing population and a more negative US view of labour immigration still suggest that it will be hard to return to a pre-pandemic participation rate. In the absence of a clear uptick in productivity, this means that the Fed is likely to be cautious in its assessment of how fast the US economy can grow over time.

High but decelerating pay increases. Private sector wage and salary growth slowed a bit during Q3 to just over 5 per cent year-on-year, from nearly 6 per cent in mid-2022. Recent monthly figures also show a slowdown, reinforcing the perception that pay hikes have peaked. But monthly statistics are not fully reliable since they are not adjusted for changes in workforce composition and are often revised. The still tight labour market is an upside risk to our wage and salary forecast.

Inflation seems to have peaked, both overall and excluding food and energy (core inflation). Reduced bottlenecks in the form of shorter delivery times and falling freight and input prices suggest that goods prices will continue to fall this spring, as increased competition forces companies to lower still-high margins. Service inflation is more uncertain. Rents, the single largest component of core inflation (40 per cent), are expected to rise at a rapid pace during the spring. However, since rent increases in new leases appear to have stalled, it will only be a matter of time before rents as measured by the CPI also begin to level off. The Fed is now expressing less concern about rents. The central bank's focus is on services excluding energy and rents, which, over time, follow changes in labour costs. Such prices were also subdued late last year. But we see a risk of renewed acceleration in early 2023, before the labour market weakens more clearly. Overall, we expect an initially sluggish decline in core inflation. However, both metrics are expected to be back at target by the end of our forecast period. This means that the Fed's favourite metric, core PCE, may be slightly below target again.

Inflation back at target by end of forecasting period
Year-on-year percentage change



The Fed will keep its foot on the brake

Given the mild recession we foresee, the Fed will hold off on declaring victory over inflation. The inflation rate has peaked, reducing the risk that inflation expectations will get stuck at too high a level and helping to prevent a wage-price spiral. But as long as the labour market does not normalise, there will be lingering concerns about wage-driven inflation – especially if rising real incomes drive new consumption. Meanwhile the Fed is aware of the risk of tightening its monetary policy in a slowing economy. Last year the federal funds rate was raised at the fastest pace since the early 1980s. Lower long-term bond yields have provided some relief in financial conditions, partially offsetting the effect of Fed hikes. But banks have continued to tighten lending conditions, which is also reflected in surveys of small businesses. The Fed's gradual balance sheet reduction is also having an impact. We believe the Fed will hike its key rate one last time during Q1 2023 to a peak of 4.75 per cent. It will begin rate cuts in late 2023, and the federal funds rate will be 3.0 per cent at the end of 2024. It will thus remain above the Fed's estimated neutral level – around 2.5 per cent – until the end of our forecast period.

Theme:

US climate policy

Finding balance between competition and EU-US cooperation

The world is divided over the IRA – which includes a historic, far-reaching USD 369 billion climate package. The US is now showing welcome, concrete leadership on the climate issue. But the IRA is also part of an industrial and trade policy that gives domestic manufacturers competitive advantages in ways that violate World Trade Organisation (WTO) rules. After extensive criticism from the European Union, the Biden administration has made minor concessions, but the package remains in force. Our conclusion is that the EU must build on its own industrial and climate policy, while striking the right balance between competition and the necessary transatlantic cooperation to avoid trade wars in a new geopolitical situation.

Since its enactment in August 2022, the US **Inflation Reduction Act (IRA)** has generated strong reactions in the EU. The package has rightly been viewed by Brussels as a set of clear, vigorous steps towards a more protectionist American industrial and trade policy, by cutting costs for US producers and developers of green energy technology. European business representatives warn of a de-industrialisation of the EU due to the current energy crisis, saying the EU may be forced into deeper cooperation and greater dependence on Eastern countries including China.

The apparent goals of the IRA and its subsidy policy are to make American green energy and technology an important future export product, reduce US dependence on other countries (increase strategic autonomy) and generate more (green) jobs at home. The EU has launched its own green policy, but it is not enough. A global race to develop green technology is welcome in the ongoing climate crisis. But if the world is now moving towards greater geoeconomic fragmentation, this decreases the chances that green technology can help solve the climate crisis.

What is the Inflation Reduction Act (IRA)?

After more than a year of internal negotiations, last August the Democrats in Congress agreed on a slimmed-down version of President Joe Biden's 2020 election promises on climate, energy, health care and taxes. A strong focus on inflation risks and public finances gave rise to its name – the Inflation Reduction Act (IRA) – which is grossly misleading. The law's overall impact on inflation is likely to be small. The reform is overfunded and will help reduce budget deficits by an estimated USD 238 billion. This is a respectable sum, but still no more than about 1 per cent of GDP, spread over a ten-year period. But because its expenditures are front-loaded and future tax revenues are uncertain, the reform may still have some positive impact on GDP in the next few years, including stimulating larger private climate investments.

The IRA represents a historic breakthrough for US climate policy. By 2030, the new law will help reduce US greenhouse gases emissions by an estimated 40 per cent – a long way towards meeting US pledges of over 50 per cent under the Paris Agreement. The comparison is based on 2005 levels, however.

The carrot, not the stick, is decisive. The law is based on the political realities of the US Congress. Lacking a qualified majority, Democrats had to take advantage of "reconciliation" rules linked to the budget process, including tax credits and direct subsidies, rather than regulations and fees. Parts of the Democratic Party are also highly dependent on protecting the oil and gas sector, and the package includes new oil and gas extraction licenses.

Green industrial policy. The IRA includes historic investments in, among other things, renewable/fossil-free energy production within mature technologies such as solar, wind and nuclear power, newer ones such as "green" hydrogen, carbon dioxide capture/storage, as well as electric vehicles, where the US has fallen behind. Last year, for example, US electric car sales accounted for about 5 per cent of the total, compared to about 10 and 20 per cent in Europe and China, respectively. The IRA reflects promises in Biden's election platform to strengthen America's industrial base, increase the number of green industrial jobs and strengthen labour. The transition will take place in a way that benefits the entire supply chain within the affected sectors.

The tax credit for the purchase of electric vehicles – USD 7,500 per light vehicle – is linked to a requirement that they must be assembled in North America and that batteries must contain a gradually rising share of components from the US or its trading partners under the US-Mexico-Canada Agreement (USMCA) and, as regards critical minerals, from countries with which the US has trade agreements. These requirements are largely aimed at reducing dependence on China in supply chains. The law establishes a cap on new electric vehicle prices (USD 55,000 for smaller and USD 80,000 for larger vehicles) and an income ceiling (USD 300,000 per household). The previous 200,000 vehicle limit per manufacturer is being scrapped, so domestic automakers such as General Motors and Tesla can again participate. The requirement for collective labour agreements is also gone. A new tax credit for used electric vehicles has been introduced. The price cap excludes many models, but Tesla recently announced price cuts on several models to qualify.

The Inflation Reduction Act (IRA). USD billion

Increased revenue and savings		**738**
Reform of drug prices, etc.		281
15 per cent minimum corporate tax		222
Strengthening tax collection		101
Tax on share buy-backs		74
Miscellaneous		60
Increased investments*		**499**
Energy security and climate policy		369
Clean energy tax credit	161	
Lowering emissions	40	
Clean fuel and vehicle tax credit	36	
Component, battery etc. tax credit	37	
Energy efficient housing etc. tax credit	37	
Conservation, research, etc.	49	
Health care subsidies		108
Government deficit reduction		**238**

Source: Committee for a Responsible Federal Budget (CRFB) and Congressional Budget Office (CBO).
* Including loan guarantees

The EU's late awakening and frustration

Europe's reaction to the IRA appears to have been delayed, even though Biden signed the bill in August. This was probably because of two other acute crises: the Ukraine war and the energy crisis. But in recent months, the EU has become more vocal, persuading Washington to re-adjust some details of the IRA package. But our conclusion is that positive effects of these changes on EU industry are barely measurable.

Brussels' main criticism of the IRA is that it links extensive climate subsidies with, among other things, demands for domestic production. This criticism refers both to US government tax credits and to the package's direct financial subsidies to manufacturers. Trade experts agree with the EU that the IRA in its current form, including large subsidies, obviously violates WTO national equal treatment rule. The subsidies are clearly targeted to the vehicle industry, which is crucial to the EU economy, making these subsidies especially troubling. The tax credits offered to buyers of vehicles assembled in the US, Canada and Mexico are equivalent to an indirect 15 per cent import duty on vehicles from the EU. This has prompted several EU companies to consider moving production to North America to benefit from the IRA.

The IRA has some similarities with the EU's European Green Deal and the green investments made possible through Next Generation EU. The combined efforts of the EU and the US mean that two of the world's major economic players are investing heavily to slow down the climate crisis. However, there is a risk that this race will occur at the cost of increased protectionism and a risk of poorer resource allocation and less innovative power.

Late in 2022, **the European Commission announced two proposals** that represent a counteroffensive to US industrial policy: 1) a new EU government fund to subsidise companies' transition to climate-neutral operations; 2) a review of the EU framework for state aid to industry. The Commission intends to unveil a proposal for the new fund by this summer. The money in this fund will go to industries and green projects of common interest to the EU. As the proposal looks today, the money will come from a re-allocation of funds within existing budgets. In the short term, the Commission wants to increase the funds that are already available – and can be expanded – within the framework of -RepowerEU, the EU's plan for saving energy, producing cleaner energy and diversifying EU energy supplies. RepowerEU now has funds totalling about EUR 245 billion. Additional funds may be obtained from such sources as the European Investment Bank (EIB) and various private initiatives.

A review of the regulations regarding state aid is also among the Commission's priorities. The goal is to have a state aid policy that is "bigger, faster and simpler" than today's regulations. The Commission is expected to submit proposals in January, leading to a discussion of these issues at the EU summit on February 9-10. Among the ideas being considered is that state aid in a given country should also be allowed to take global conditions into account, not just developments among the EU's 27 member states. However, new crisis funds and more flexible state aid rules are controversial issues not only for EU countries, but also for the rest of the world.

Europe's energy insecurity a major problem

The EU energy crisis is another risk factor that may persuade manufacturers to relocate to countries like the US. Predictable energy supplies and prices are critical factors for industrial operations in Europe, which must meanwhile undergo a clean energy transition. The unpredictability of the Ukraine war and Moscow, a vulnerable energy infrastructure and increased political intervention are contributing to greater energy insecurity – in a situation where new green technologies must be developed and electrification must be implemented. If the EU cannot offer such predictability, there are reasons for companies to consider moving to the US or Asia.

The EU and the US established a joint working group last autumn (the EU-US Inflation Reduction Act Task Force) to devise solutions. Just before the end of 2022, the US announced that it had changed its tax deduction guidelines so that privately leased cars would meet the same conditions as commercial vehicles, which need not be assembled in North America. However, the European Commission would like to see more easing for electric vehicles owned by private individuals. The EU also wants the US to review the requirements that battery components must originate from the US or its trading partners (a field in which the US and EU currently has no trade agreement).

Balancing collaboration and competition

Because of the new domestic political situation in the US after last autumn's mid-term elections – with a Republican majority in the House of Representatives – the potential for major amendments to the IRA must be regarded as very limited. The most likely scenario is that the IRA package will not change, and the law will thus act as a magnet to attract companies from other countries.

The need for continued good transatlantic relations in an increasingly strained geopolitical situation means that it is now up to the EU to increase its competitiveness and attractiveness. But achieving maximum global exchanges of green technology and transition strategies will require coordination of climate, industrial and trade policies to ensure that industrial subsidies and domestic production rules lead to the right balance between competition and collaboration, without strengthening protectionism.

Japan
Monetary policy shift, as planned – still expansionary

Inflation has risen, but it is still well below that of many other countries. The Bank of Japan (BoJ) will continue small steps towards less expansionary policy. This spring's wage agreements are critical to the shape of monetary policy, which we expect to diverge clearly from those of other G7 countries. Pent-up post-pandemic demand will boost near-term GDP growth, but weaker international conditions and structural forces will dampen the GDP outlook. Japan will still grow faster than both the US and the euro area.

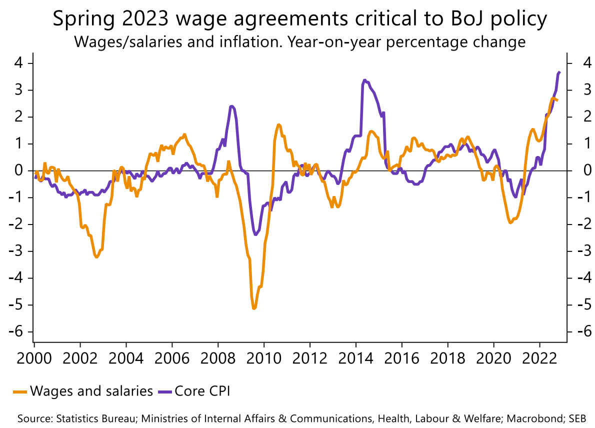
World economic conditions have a continued adverse effect on Japan's growth outlook, despite positive forces in the domestic economy. The recovery in the service sector is evident as COVID restrictions are eased. Meanwhile both monetary and fiscal policies will help to support economic growth. This autumn's supplementary budget totalling 5.5 per cent of GDP – extending over several years – will improve growth without being inflationary. We expect Japan to show relatively stable performance this year and next, but downside risks predominate. GDP growth will reach 1.8 per cent this year after a 1.9 per cent upturn in 2022. In 2024, we expect GDP to increase by 1.3 per cent.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	2.1	1.9	1.8	1.3
Unemployment*	2.8	2.6	2.5	2.4
CPI	-0.2	2.5	4.3	2.3
Public sector fiscal balance**	-6.7	-7.9	-3.6	-2.4
Public sector debt**	262	264	261	260
Key interest rate, %***	-0.10	-0.10	0.30	0.30

*% of labour force **% of GDP ***At year-end. Source: IMF, SEB

Private consumption is being hampered by clear downward pressure on real wages due to high inflation, yet we expect demand to rise during our forecast period as COVID-related household savings fall. Government grants to offset high energy bills will continue through September 2023, and the household savings ratio will fall from 8.7 per cent at end 2021 to pre-pandemic levels of around 2 per cent by the end of our forecast period. Businesses have maintained their earnings level despite headwinds due to high commodity prices. Sharp yen depreciation in 2022 – nearly 15 per cent against a currency basket – has generally benefited the export sector and contributed to moderate investment growth. The BoJ's latest Tankan survey indicates a positive investment outlook, despite mounting international economic and geopolitical risks.



The labour market is expected to become tighter, partly due to greater demand in the service sector. Meanwhile labour supply is shrinking due to an ageing population and less influx of older people and women into the labour market – boosting the potential for faster wage growth. This spring's pay negotiations take place amid labour shortages and lower employee purchasing power. The initial proposal from RENGO – Japan's trade union confederation – appears to be 3 per cent. Employers acknowledge the need to increase pay when purchasing power is squeezed by high inflation. This suggests more sustained wage growth acceleration, which will enable the BoJ – under Governor Haruhiko Kuroda's successor – to move away from Abenomics and its extremely loose monetary policy.

The BoJ's decision late in 2022 to widen its yield curve control (YCC) tolerance range for 10-year government bonds from ±25 to ±50 bp is widely regarded as a first small step towards more normal monetary policy, but bond purchases under its quantitative easing (QE) policy have remained sizeable. The BoJ will leave behind its negative key rate (-0.10) per cent at the April meeting once higher wage agreements can be confirmed. It will then hike in 10 bp increments in June, September and December to 0.30 per cent (end 2023) and keep key rate at this level during 2024. QE will be phased out very cautiously due to continued downside inflation risks. In December 2023, the USD/JPY exchange rate will be 125; in December 2024, USD/JPY will trade at 120.

Euro area
Despite economic resilience, a downturn is imminent

The euro area remained surprisingly resilient in the third quarter, but indicators suggest that GDP began to fall in late 2022. We are thus sticking to the view that high inflation and rising interest rates will finally lead to a mild recession – with GDP being unchanged in 2023. Inflation has passed its peak but will remain relatively high in 2023. The European Central Bank has adopted a more hawkish stance, which means that we now expect the ECB deposit rate to reach 3.25 per cent some months into 2023 – before rate cuts begin.

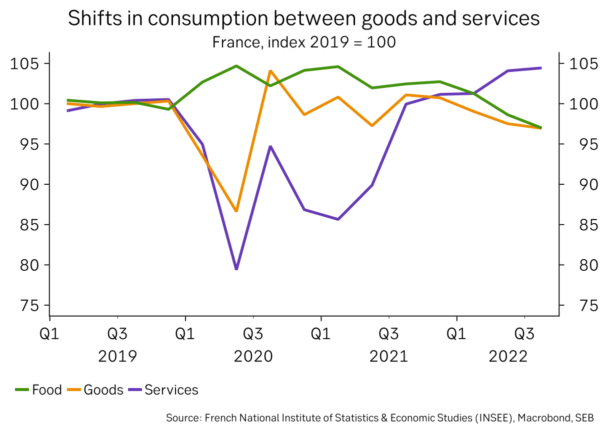
For many months, euro area economies have withstood increasingly fierce headwinds. Household spending has been resilient, with pent-up post-pandemic consumption demand weighing more heavily than pressure from rising prices and interest rates. Another upside surprise has been capital spending. But a lengthy period of higher prices should eventually result in falling consumption as savings buffers begin to shrink (see theme article, page 39). By all accounts, economic growth turned negative in the final months of 2022. We expect falling GDP during the first half of 2023 before a recovery begins. After an increase of 3.4 per cent in 2022, we expect zero growth in GDP in 2023. During the second half of 2023 a recovery will kick in, with GDP growth accelerating to 1.9 per cent in 2024.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	5.3	3.4	0.0	1.9
Unemployment*	7.7	6.7	6.9	7.9
Wages and salaries	4.1	4.5	5.0	4.2
CPI	2.6	8.4	5.3	1.2
Public sector balance**	-5.1	-3.9	-3.0	-2.5
Public sector debt**	95.4	94.5	93.0	92.0
Deposit rate, %***	-0.50	2.00	3.25	2.50

*% of labour force **% of GDP, ***At year-end. Source: Eurostat, SEB

Delayed impact on households
Some cost increases are having an impact on household finances only after a significant time lag – which has helped to sustain consumption. While higher food prices, for example, have had an immediate effect, delays in the impact of rising energy and interest expenses have varied greatly between individuals and countries. Some households have energy contracts that are directly affected by higher market prices, but many European households have fixed contracts – leading to significant delays in price increases. In countries with a high proportion of rented accommodations, such as Germany, the delay will also be longer. It often takes a relatively long time before energy and interest expenses trigger rent hikes. There are also signs that consumer price index statistics in some places have exaggerated the increase in energy costs, suggesting a more gradual decline in consumption (see more below). About 70 per cent of euro area household loans carry fixed rates, which will also delay the impact of interest rate increases.



Service consumption has softened the downturn.
When pandemic-related restrictions were lifted in the spring of 2022, service consumption rose significantly as expected, while goods consumption fell from bloated levels in some areas. More surprising, however, is that service consumption was still strong in late 2022. Both economic theory and historical experience suggest that households prioritise the consumption of more necessary goods in times of crisis when they are being pressured from different directions. Our interpretation is that households have had such a strong preference for returning to normal habits that they have been prepared to greatly reduce the large savings buffers that they had built up during the pandemic. Because of continued price hikes going forward, we expect households to finally be forced to tighten their belts. In some euro area countries, preliminary statistics show that households have already started to behave according to

accepted economic theory, cutting back on their entertainment spending and slowing capital goods purchases. We expect overall household consumption to decline by 0.5 per cent in 2023.

Large underlying investment needs. Capital spending activity has also held up relatively well, partly because public and private investments are being stimulated by previous crisis measures. The need to address both the short-term energy crisis and the longer-term green transition is also driving energy investments. Overall, we expect capital spending to fall only marginally in 2023, which is unusual during a recession.

Exports have recovered from the pandemic, but China's lockdowns have continued to have an adverse effect. This is especially apparent from weak export figures for Germany and France. Another contributing factor is that the level of vehicle production in Europe has been weak for a long time. Thanks to China's reopening, falling transport costs and generally decreasing disruptions in global value chains, exports will eventually gain more momentum, posing some upside risk to our GDP forecast.

GDP forecasts

Year-on-year percentage change

	2021	2022	2023	2024
Germany	2.6	1.8	-0.3	2.4
France	6.8	2.5	0.5	2.5
Italy	6.6	3.8	0.3	1.8
Spain	5.1	5.1	0.7	3.1
Euro area	5.3	3.3	0.0	1.9

Source: Eurostat, SEB

Continued high demand for labour

The resilience of euro area economies is also reflected in continued strong labour markets. Unemployment fell to pre-pandemic levels during the summer of 2022, and business hiring plans suggest continued rising employment in the near term. But further ahead, weaker economic activity – especially in the service sector – will push up unemployment. Due to the time lag between GDP changes and the labour market, unemployment will not rise until the second half of 2023. Measured as an annual average, it is expected to climb to 6.9 per cent in 2023 and 7.9 per cent in 2024.

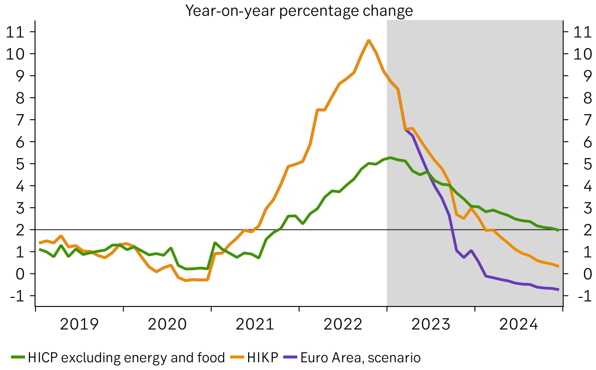
Compensatory wage hikes a key issue for inflation. High inflation is creating strong pressure for compensatory wage and salary increases. The risk of a wage-price spiral has been widely debated as central banks around the world have hiked their key interest rates at a rapid pace. Because wage formation in the euro area is more likely than in the US and UK to take place by means of centralised negotiations, the wage response will be more delayed, which has helped to create increased uncertainty for the ECB. Businesses have generally been able to maintain their profitability relatively well, which increases the likelihood of an acceleration in the rate of wage growth. Our forecast is that pay increases in the euro area as a whole will end up at around 4.5 per cent annually during 2022-2024, which is in line with the outcome of German pay negotiations. Pay increases at this level should be manageable from an inflation targeting standpoint, but some indicators suggest an upside risk to our forecast – with wage and salary growth reaching well above 5 per cent.

Plummeting inflation during 2023

We believe that inflation peaked in October when the EU's harmonised index of consumer prices (HICP) rose 10.6 per cent year-on-year. We expect a relatively clear downturn during 2023, but inflation will still be above the ECB target all year, with a December figure of 3.0 per cent. The average will be a bit above 6 per cent. This means that prices will still climb substantially. The fact that the energy situation in Europe now looks significantly better than assessments in early autumn 2022 means that the risk picture can quickly be changed in the other direction. The energy issue has also affected food prices. If a larger rebound and energy prices also affect food prices, a downward trend could be reinforced. The chart below shows a mechanical scenario where 2/3 of the energy and food component increase in the HICP since mid-2021 gradually reverses over the next two years.

HICP has peaked, but inflation will remain high in 2023

Year-on-year percentage change



Source: Eurostat, Macrobond, SEB

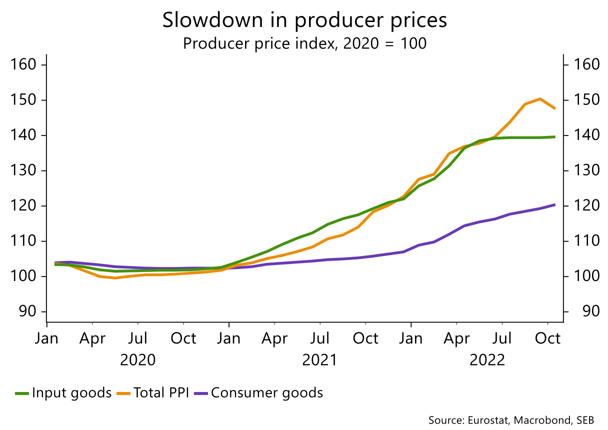
Greater focus on core inflation. Sharp increases in food and energy prices have accounted for about half the rise in headline HICP. Core inflation, which excludes these items, was around 5 per cent at year-end 2022. One important question in 2023, aside from wage formation, is how much price increases that are in the system have not yet worked their way through to consumer prices. Energy and food prices, as well as other cost increases, have obviously had a broad impact on downstream prices. The existence of price indexation clauses in contracts (such as rental agreements) will also contribute to a slower downturn in core inflation than in headline inflation.

Signs of moderating inflationary pressures. There are now various signs that the rate of monthly price increases is about to decelerate. According to surveys, corporate price expectations have come down markedly, although they still indicate rising prices. Producer price indices (PPIs) also suggest that prices early in the production chain have levelled off. After a natural lag between input goods and consumer goods, the slowdown has now also reached consumer goods. This will mean less uncertainty about how much price - pressure is left in the system. But service price increases are affected by goods price increases only after a certain time lag. Combined with indexation clauses and accelerating pay increases, rising service prices are thus likely to be a driving force that will keep core inflation up throughout 2023.

Overestimated inflation surge?
Late in 2022, Eurostat issued a clarification highlighting information-gathering problems related to household energy prices – one example of large current statistical uncertainties. In the Netherlands, for example, all electricity contracts are approximated by new contracts and are thus linked to the prevailing (high) market prices. But many households are on fixed contracts. This is one reason why the upturn in energy prices has been exaggerated in inflation statistics. The Netherlands Bureau for Economic Policy Analysis (CPB) estimates that the inflation rate may have been overstated by as much as over 2 percentage points in late 2022. Data availability and differences in calculation methods thus seem to have been an important reason why the contribution of energy prices to inflation metrics in various countries differed so greatly in 2022. It is one example of how methods that work in "normal situations" can go awry in extreme conditions. This overestimation of inflation may also explain the resilience of consumption, when we economists are fooled by "excessively high" inflation statistics (and thus an excessive decline in real household incomes).

Controversial fiscal policies

Fiscal policy continues to play a central role in the euro area. Large pandemic-related stimulus programmes have now been replaced by policies that are primarily aimed at covering part of household and business energy costs. But there are major differences among EU members. Since the autumn of 2021, Germany has offered subsidies equivalent to 7 per cent of GDP, while most other member countries are offering 3 to 5 per cent. The design of these programmes has also varied, contributing to major differences in inflation rates. Fiscal policymakers are facing a balancing act, in which they must avoid making it too difficult for central banks to bring down inflation. One large stimulus programme that is now being rolled out is Next Generation EU (NGEU), which provides a boost to investments in such fields as digitisation, the green transition and energy. This multi-year programme is mainly focused on structural change, but due to the EU energy crisis it has also been used for more short-term purposes.



A hawkish ECB believes it will not achieve its inflation target for a long time. Early in the rate hiking cycle, the ECB lagged other central banks. Recently it has adopted a more hawkish tone, causing long-term bond yields to rise, and not only in Europe. The nuances of ECB communication shifted during the autumn, implying that its tone may conceivably change again. The ECB is also being more vague than other central banks, so the scope for interpretation is quite large. Its recent harsher tone is partly because the ECB now regards the path back to its inflation target as a more protracted process. However, we believe that subdued economic activity will help to dampen wage and price pressures during the latter part of our forecast horizon. In the short term, we predict that the ECB will raise its deposit rate in 50 basis point steps at the next two meetings followed by a final 25 basis point increase from today's 2 per cent to 3.25 per cent. In response to developments in the real economy, and with inflation falling towards target, the ECB – like other central banks – will ease its monetary policy in 2024. We believe that the deposit rate will be back at 2.50 per cent by the end of 2024.

Theme:

Fading energy crisis

Smaller risks, but still a tight market

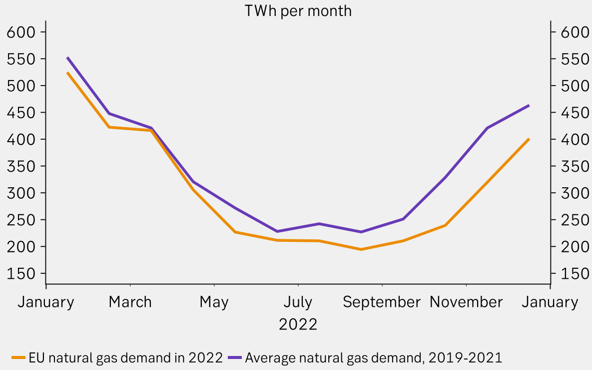
Prices for oil, coal and especially natural gas in the EU fell sharply during the second half of 2022. The risk that natural gas will be rationed in the European Union this winter and next is now close to zero. But the global fossil fuel market will still be tight. We expect EU natural gas prices to be lower than in 2022 but higher than they are now, since elevated prices are needed to keep demand subdued. Meanwhile we expect oil prices to be higher in 2023 than in 2022 as China reconnects to the world while oil supply from Russia is curbed.

A cooling global economy – with lower demand and COVID-19 lockdowns in China – helped to drive oil, coal, and natural gas prices sharply lower late in 2022. The EU also managed to adapt to its energy crisis surprisingly well. Ultra-high natural gas prices in the EU led to a boom in liquefied natural gas (LNG) imports, while demand fell 26 per cent below the 2019-2021 average in October and November due to warm weather for that time of year, high prices, energy curbs and various types of energy saving and efficiency measures (Germany managed to install a new LNG import terminal at record speed during Q4 2022). EU natural gas inventories are now 16 per cent above normal. There is consequently close to zero risk of natural gas shortages and rationing during the rest of this winter, as well as next winter. Market forces now have nine months to ensure that EU natural gas inventories are at satisfactory levels in October 2023. But the question is whether current natural gas prices are too low. We are already seeing stronger natural gas demand and softer LNG imports because of much lower prices.

Major worries after loss of Russian natural gas supply. Fears ran deep that the EU economy would collapse as Russian natural gas exports to the EU dropped to only 10-20 per cent of normal in mid-2022 and then stayed at that low level. As a result, natural gas prices spiked to 1,500 per cent of normal in late August. But high prices are meanwhile the cure for high prices. Demand fell by around 26 per cent in October and November compared to the average for 2019-2021. LNG imports, while already high in the first half of 2022, rose even higher in the second half since European natural gas prices were much higher than in the rest of the world and thus attracted huge LNG cargo inflows to Europe. Natural gas production and exports from Norway to the rest if Europe also got a boost, since gas prices were much higher than oil prices.

Noticeably lower gas consumption than usual

TWh per month



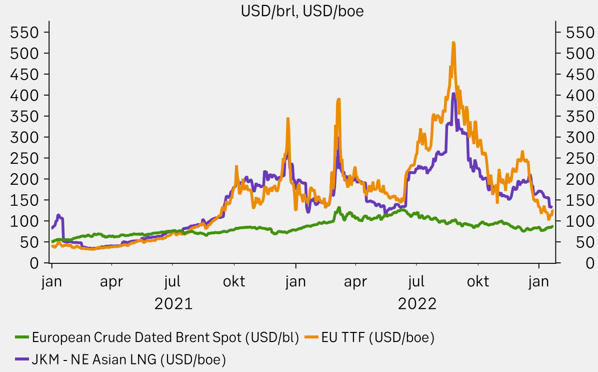
Source: Macrobond, SEB

The EU adapted quickly and broadly in response to high natural gas prices. Demand for alternative energy sources increased, and parts of the EU's energy-intensive industry closed. Industrial companies instead bought semi-finished products from other parts of the world where the energy crunch was less severe. Households did their part, both by directly reducing consumption but also by undertaking energy efficiency measures. German industrial output fell only 1 per cent during 2022. At the end of the year, one third of German companies still saw potential to reduce natural gas consumption even further. So far, the winter has also been unusually warm in Europe, which has helped to lower the demand for natural gas. Because of its COVID-19 lockdowns, China needed less oil and gas. This also eased the energy crisis in the EU.

Lower natural gas prices and fading market forces. Although weather conditions and market forces did much of the job, the EU should be praised for how it has handled the energy crisis. With natural gas inventories about 16 per cent above normal, the crisis is nearly over and the risk of natural gas rationing in the winter of 2023/24 is practically non-existent. EU natural gas prices (using the TTF gas price in Amsterdam) are still three times higher than normal, but that is far below the 15 times normal that prevailed in late August 2022. The front-month (February) TTF natural gas price is currently EUR 63 per megawatt hour (MWh) or USD 107 per barrel of oil equivalent (boe). The TTF front-month price averaged EUR 132/MWh in 2022, and during the second half of the year it had a premium of EUR 30/MWh over Japanese LNG prices. The high prices caused a drop in demand both in Europe and in Asia, and the premium allowed more natural gas to flow to Europe instead of Asia. The TTF price is now almost half of what it was in 2022 and is now trading at a discount to the Japanese LNG price.

Energy prices have fallen

USD/brl, USD/boe



Source: Macrobond, SEB

China has removed its official COVID restrictions and is gradually reconnecting with the rest of the world, with increased demand for oil and gas as a result (a strong rise in Chinese oil purchases is already taking place). Diesel prices in the EU are now at USD 126/b which is more expensive than TTF natural gas at USD 107/boe. We do not know how much substitution from natural gas to diesel there was in 2022. But we can at least say that there will not be any substitution at current prices. Strong market forces helped to solve Europe's energy crisis in 2022. But these market forces are now significantly reduced. Total EU natural gas demand was only down 16 per cent in December versus the 2019-21 average, 10 percentage points less than in October-November. LNG imports to the EU also looks like they are softening. So far this year they are averaging 3.7 TWh/day versus 5.1 TWh/day in December 2022. We expect a rebound in natural gas prices from current levels, since higher prices are probably needed to sort out EU energy challenges.

We still have a tight fossil energy market where we have lost some 2.5 m boe per day of Russian natural gas which no longer goes to the EU. Western sanctions and curbs to Russian crude oil exports have had less of an effect since it is possible to reroute Russian oil to other places. Russian crude oil production is today estimated at 9.8 million b/d, which is 0.7 m b/d below Russian's production cap. Its oil production is projected to fall further by up to 1.6 m b/d in Q2 2023, according to the US Energy Information Administration (US EIA), due to a lack of sophisticated Western oil services. Total losses of Russian fossil fuel production could thus amount to some 3-5 boe/d. We thus expect a tight global fossil energy market and continued elevated prices in 2023.

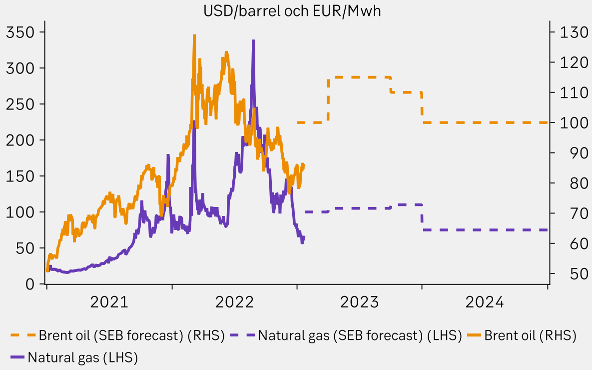
In 2022 the world was plagued by a diesel crisis we had not seen since 2008. Global refining capacity contracted in 2021 for the first time in 30 years. Non-China diesel demand rebounded in 2022 as the world reopened after COVID lockdowns. But then came the invasion of Ukraine, which made the situation much worse. Russia normally exports 3 million b/d of oil products, with a large proportion going to Europe, where it is an integral part of the refined oil product market – not least through important feedstock products like vacuum gas oil (VGO), which Europe uses in upgrading units to make diesel. This year, sanctions and the reopening of China may again make the situation worse.

Starting on February 5, the EU and the UK will no longer import seaborne oil products from Russia as new sanctions kick in. The Group of 7 (G7) countries have also said they will implement a price cap on Russian oil products, just like they did with Russian crude oil on December 5 last year. So far, the latter policy has depressed the price of Russian crude in the global market, since Asian buyers have gained more leverage to negotiate prices when the EU and G7 countries are not buying. Market players are not yet worried about the new sanctions, but maybe they should be, since the rerouting of these Russian products to Asia could prove more difficult than rerouting Russian crude. Diesel margins versus Brent crude have been strengthening since early December, and diesel is today trading at a USD 40/b premium to Brent crude versus a more normal premium of USD 15/b. Having reopened, China will soon be moving back to large-scale international aviation. The new sanctions have the potential to drive diesel premiums back up to peaks of more than USD 60/b, as in 2022.

Higher real and nominal oil prices ahead. Brent crude oil spiked to USD 138.3/b in March 2022 right after Russia's invasion of Ukraine. Brent crude averaged USD 99.9/b in 2022, some 70 per cent above the 2015-2019 average of USD 58/b. But adjusted for inflation, the average during this period was USD 70/b, which means that the average Brent crude price in 2022 was instead 45 per cent higher than the 2015-2019 average. If we stretch out the comparative period and look at the average price during 2008-2021, the nominal price was USD 77/b, while the inflation-adjusted price was USD 98/b. This implies that the 2022 price of USD 99.9/b was only 4 per cent above the inflation-adjusted 2008-2021 average of USD 98/b. It is important to note that the period from 2015 to 2019 was a special low-price period. US shale oil production expanded uncontrollably while non-OPEC, non-US production also expanded solidly as elevated capital spending over the years to 2014 began to pay off. During the coming five years, we expect muted US shale oil production growth due to recent consolidation of the sector. There are also signs that the lion's share of the richest US shale resources has now been extracted, which could also create some headwinds to further expansion.

Brent oil and natural gas prices

USD/barrel och EUR/Mwh



Source: Intercontinental Exchange (ICE), Macrobond, SEB

OPEC has had a challenging period since 2014, due to very strong growth in non-OPEC production. We now believe that market power has shifted back and will predominantly be in the hands of OPEC over the coming five years, which means significantly higher oil prices than USD 70/b. Because of this – as well as extensive sanctions towards Russia, which have led to significant losses in oil and gas supply – we expect Brent crude to average USD 110/b in 2023 and USD 100/b in 2024.

The United Kingdom
A protracted recession

The outlook is gloomy. GDP growth is expected to be negative this year. The cost crisis and rising interest rates will be an expensive story for both households and businesses. A continued stretched labour market will reduce the scope for stimulus. Fiscal policy will be tight in the near term. Headline inflation will remain around 7 per cent in 2023 and fall to the Bank of England's 2 per cent target by mid-2024. The BoE interest rate hiking cycle will end in the first quarter of this year, and in 2024 the door to rate cuts will open.

The rising cost of living is weighing on growth. Household real incomes will be squeezed by high inflation and rising interest rates, while continued shortages of goods and labour will create challenges in both the short and long term. GDP growth has slowed, and short-term indicators point to a clear deceleration in the coming year. During 2023, GDP is expected to fall by 1.2 per cent due to sharply rising household and business costs combined with tighter monetary and fiscal policies. A stabilisation is expected in 2024, when inflation falls towards 2 per cent, while the Bank of England (BoE) cuts interest rates slightly – lifting GDP by 0.7 per cent.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	7.4	4.0	-1.2	0.7
Unemployment*	4.5	4.1	4.8	5.3
Wages and salaries	5.9	5.0	4.2	2.1
CPI	2.6	9.1	7.6	2.6
Public sector balance**	-8.0	-4.3	-2.3	-1.5
Public sector debt**	95.3	90.0	88.0	86.0
Key interest rate, %***	0.25	3.50	4.00	3.50

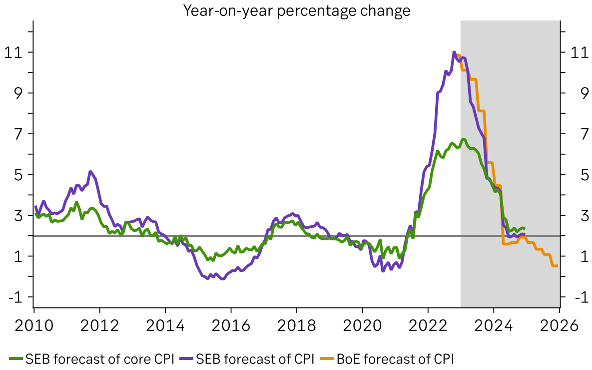
*% of labour force **% of GDP ***At year-end. Source: ONS, SEB

Continued major challenges in the labour market. The UK labour market remains stretched. A shrinking labour supply is expected to drive up wages and salaries. In addition, ongoing strikes demanding higher compensation for inflation look set to continue. Labour shortages and a rapidly ageing population are dampening potential growth to 1.5 per cent, adding to inflationary pressures.

Households will take the biggest hit. Due to a combination of falling real wages, tight fiscal and monetary policies and a slowdown in the housing market, household purchasing power will decline sharply. Our forecast is that consumption will decrease by 3 per cent for the full year 2023.

Inflation will remain high. Headline inflation peaked at nearly 11 per cent in October, and our forecast is that it will remain high in the near term. Inflation is being sustained by elevated energy prices, a tight labour market, sustained pay increases and the weakness of the British pound. Annual average inflation for 2023 is expected to reach 7.6 percent. As the economy falters and pressure on global value chains continues to ease, global goods inflation will decline. The fact that energy prices have fallen slightly will also diminish inflationary pressures. During 2024, headline inflation will fall sharply but will still be at 2.6 per cent by the end of 2024.

CPI has peaked; core CPI will peak in early 2023
Year-on-year percentage change



Source: Bank of England, Macrobond, SEB

Tough headwinds for Rishi Sunak. Since Mr Sunak took over as prime minister in October, his task has been to restore stability to financial markets and regain the confidence of the British people. His success in doing so will be crucial for his own and the Tories' chances of winning the next parliamentary election, which must be held by January 2025.

BoE is approaching its peak key interest rate. Our forecast is that the BoE will raise its key rate one last time in February to 4.00 per cent. We then expect the key rate to stay at this level during the rest of 2023. The BoE was also the first major central bank to actively sell fixed income securities to reduce its balance sheet. As inflation falls towards the BoE's target during the first half of 2024, the possibility of interest rate cuts totalling 50 basis points will open up.

Theme:

China

Policy pendulum swings towards growth

China's policymakers are now committed to delivering a growth rebound in 2023. After a dismal 2022, GDP is expected to rise 5.5 per cent during 2023 before easing to 4.9 per cent in 2024. Strict COVID-19 controls have been dismantled faster than anticipated. Official economic targets will be released in March, and policies are geared towards engineering a domestic recovery. We are thus choosing to revise our 2023 CPI inflation forecast upward to 3.0 per cent. Combined with Fed hawkishness, the USD/CNH exchange rate will weaken to 6.60 by the end of 2023 and to 6.45 at end-2024.

After China's yearly Central Economic Work Conference (CEWC), the country signalled a renewed focus on growth. During 2023 the emphasis will be on annual growth targets. With renewed policy support, a growth target of above 5 per cent is quite likely. Our forecast is GDP growth of 5.5 per cent during 2023, but there are clear upside risks. Policymakers are intent on a recovery in growth, which is expected to come from higher domestic consumption. Major R&D investments in high tech sectors will also be accelerated, specifically in various parts of the energy sector and in artificial intelligence (AI).

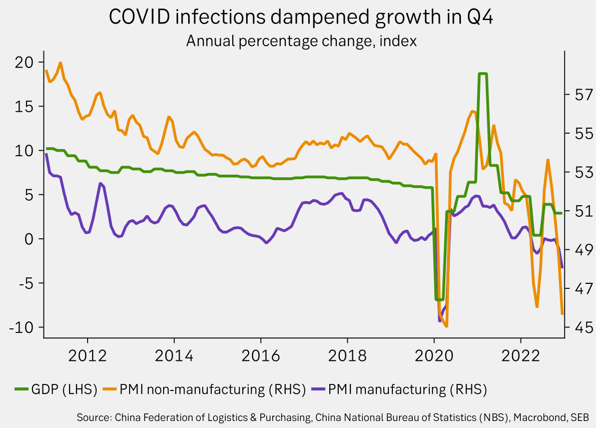
A clear focus on growth. Economic targets for 2023 will be released in March, but policymakers have already set in motion an economic plan for a rebound in the coming months, including increased fiscal spending. But they will need to think about cost sharing between the central and local governments. Unnamed sources suggest that Beijing is also considering raising the 2023 special purpose bond quota to RMB 3.8 trillion from RMB 3.65 trillion in 2022. The cap on the general budget deficit will likely be increased to 3.0 per cent of GDP from the 2022 target of 2.8 per cent.

Key data
Year-on-year percentage change

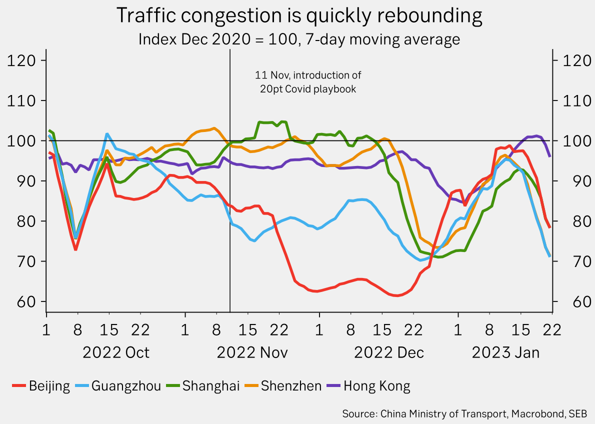
	2021	2022	2023	2024
GDP	8.1	3.0	5.5	4.9
CPI	0.9	2.0	3.0	2.4
Fiscal balance	-3.8	-4.9	-4.5	-4.0
Bank reserve req,%**	11.5	11.00	10.50	10.50
1-year loan prime rate, %**	3.80	3.60	3.60	3.60
7d reverse repo rate, %**	2.20	2.00	2.00	2.00
USD/CNY**	6.36	6.90	6.60	6.30

*% of GDP **At year-end. Source: IMF, SEB

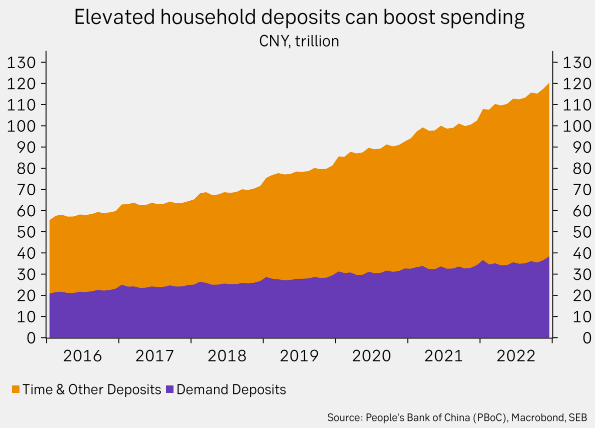
The spread of COVID-19 had a deep impact on domestic activity. The rapid dismantling of COVID controls contributed to a rapid spread of the virus and a deep decline in domestic activity during November and December, dampening GDP growth. China has also decided to do away with mass testing, which makes official figures of daily infections and mortality unreliable.



Higher COVID transmission in the near term, but an economic recovery further ahead. The sharp decline in traffic in China suggests widespread COVID transmission. Since the turn of the year, however, mobility indicators are fast rebounding in cities where infection waves seem to have peaked. But the situation is not stable, and the extended Lunar New Year holidays will likely spread the virus further, resulting in volatility in domestic activity. But once the wave of infections has peaked, a full-bodied recovery may emerge.



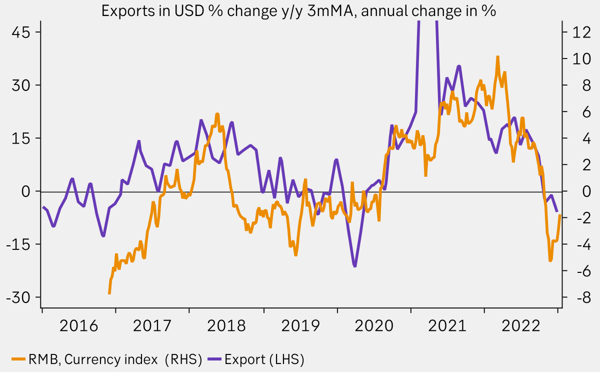
High savings will provide another tailwind to consumption. During the pandemic, consumer confidence fell sharply. This prompted households to save much more. Their financial position is thus very strong, and there is plenty of room for higher consumption once the economy recovers.



Policy support for the embattled property sector is intensifying. Aside from pledges of direct financing lines to selected developers, China is looking to relax restrictions on borrowing. This may be the biggest adjustment that Beijing can make to ease refinancing conditions. The previous rounds of support have already allowed some of the developers to issue equity, reducing the risk of defaults by the end of Q4 2022. Even so, household confidence in the sector may take time to recover. Moreover, land sales of local governments have yet to pick up, which is still capping the ability of developers to raise pre-selling revenues.

Increased inflationary pressures after China's reopening. Global commodity prices have already found support and climbed despite concerns about an imminent worldwide recession. Meanwhile, the recovery of household spending will not be limited to goods purchases – in stark contrast to the spending pattern that emerged in developed economies. Along with the rebound in consumer sentiment and spending, demand for international travel by Chinese households will pick up. Thus, the rise in private spending will be more balanced. Overall, we are upwardly revising our 2023 CPI inflation forecast to 3.0 per cent from our previous forecast of 2.1 per cent. The lag in inflation will allow the People's Bank of China (PBoC) to maintain a supportive policy and lower the reserve requirement ratio in Q1.

Falling exports may limit appreciation of trade-weighted RMB



Source: China Customs Statistics (CCS), China Foreign Exchange Trade System, Macrobond, SEB

Positive drivers will allow the USD/CNH exchange rate to approach 6.60 by end-2023. The sharp appreciation of the yuan against the US dollar since December can be explained by China's policy shift towards prioritising growth and by the decline of the dollar. Beyond expectations of a Chinese growth rebound and a better-functioning property sector, the market will likely want to see rising activity indicators in the coming months. Meanwhile, external demand for exports is already waning, while the improvement in domestic demand should prop up imports. A deepening contraction in exports may prompt policymakers to limit the appreciation of the trade-weighted Chinese currency in H2. Moreover, pent-up demand for international travel by Chinese tourists will inevitably lead to a deterioration in the service trade account. Overall, we expect the current account surplus to narrow in 2023. Yet foreign capital inflows will likely pick up, providing an offset to the tighter current account surplus.

The Nordics

Sweden | page 35

After impressive economic resilience, we expect a 1.2 per cent GDP decline this year. Downside risks are mainly connected to a potential collapse in housing construction, while more vigorous fiscal stimulus measures represent upside opportunities.

Norway | page 42

A slowdown in mainland GDP growth, combined with a peak in core inflation in early 2023, means that Norges Bank is probably done hiking its key rate. We expect rate cuts starting in Q1 2024.

Denmark | page 44

Falling real wages, lower home prices and tighter credit conditions have squeezed households and businesses, but a milder energy crisis than feared will help sustain the economy. We expect unchanged GDP this year, then 2.5 per cent growth in 2024.

Finland | page 46

We are forecasting a mild recession, with a GDP decline of 0.3 per cent this year, as household pessimism grows and export orders dwindle. The economy will recover next year, but GDP growth will only reach an anaemic 1.4 per cent.

Sweden
Recession is finally arriving

After impressive economic resilience, we expect this year to begin with falling GDP. We have revised our 2023 forecast higher, but the year's 1.2 per cent decline will be clearly larger than the EU average. Important drivers are falling real incomes and a large downturn in housing construction. Looser fiscal policy may soften the downturn, but high inflation will lead to a difficult balancing act. We now expect the Riksbank to hike its key interest rate by 50 basis points to 3.00 per cent in February, before cuts begin in 2024.

Although Swedish households have faced strong headwinds, the resilience of the economy has been a continued surprise. GDP growth in the third quarter of 2022 was above trend, and Q4 also seemed to start off strong. Meanwhile, most sentiment indicators have fallen to levels normally consistent with falling GDP, and we now expect growth to turn negative. Because inventory build-up accounted for large positive contributions to growth over the past two quarters, the downturn will be abrupt. We now expect GDP to decline by only 1.2 per cent this year (1.5 per cent in our November forecast). Because the recovery has also been postponed, we have lowered our 2024 growth forecast from 1.3 per cent to 1.1 per cent. Downside - risks are mainly connected to a potential collapse in residential construction. On the upside, there is a chance that the government will finally launch more vigorous fiscal stimulus measures than the relatively cautious ones our forecast assumes.

Key data
Year-on-year percentage change

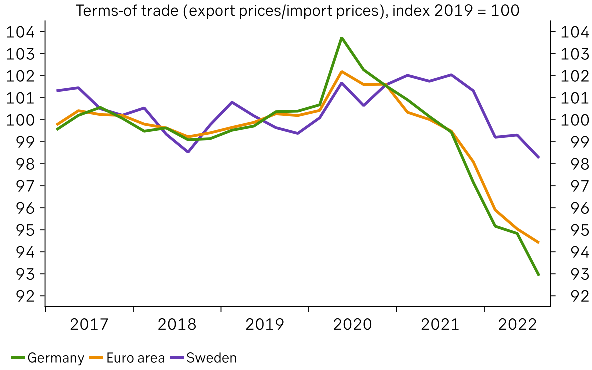
	2021	2022	2023	2024
GDP	5.1	2.8	-1.2	1.1
Unemployment*	8.8	7.5	8.1	8.5
Wages and salaries	2,6	2,7	4.5	3.2
CPI	2.2	8.4	9.1	2.5
Net lending**	-0.1	1.2	0.4	-0.7
General government debt**	36.3	31.5	29.8	30.8
Policy rate, %***	0.00	2.50	3.00	2.25

*% of labour force **% of GDP ***At year-end. Source: Eurostat, SEB

Moderate decline in manufacturing

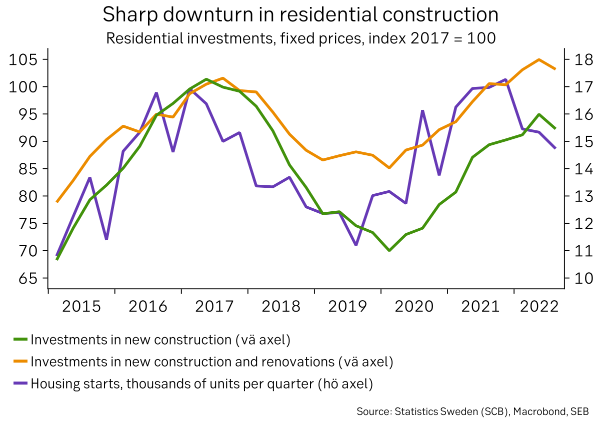
Industrial production and merchandise exports had already reverted to their pre-pandemic trend in early 2022. Since then, the upturn has gradually lost momentum. For example, the purchasing managers' index (PMI) and the National Institute of Economic Research's Economic Tendency Survey suggest that manufacturers started losing ground late last year. International demand and energy price developments will determine the depth of their downturn. High energy prices have weakened the competitiveness of the euro area, especially German manufacturers. Sweden is a net electricity exporter and uses very little natural gas, which is a potential competitive advantage (see chart below). But so far, its electricity price subsidies have been significantly smaller. If disbursements of these subsidies continue to be delayed, Swedish businesses risk being as severely affected as their counterparts elsewhere in Europe. Partly due to increased defence spending and investments in new energy production, the downturn in exports and industrial investments will be moderate compared to other recessions. We believe exports will fall by 2.0 per cent during 2023 and then grow by 4.0 per cent in 2024.

Rising energy prices are affecting competitiveness
Terms-of trade (export prices/import prices), index 2019 = 100



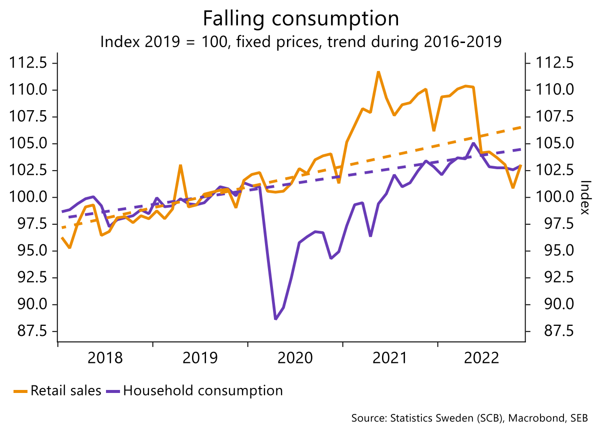
Source: Statistics Sweden (SCB), Eurostat, German Federal Statistical Office (Statistisches Bundesamt), Macrobond, SEB

Sharply falling residential investments. Falling home prices and soaring construction costs are now putting heavy pressure on housing construction. We expect housing starts to halve from 67,000 units in 2021 to 30-35,000 this year. Residential investments will fall by a total of 30 per cent in 2023 and 2024, reducing GDP growth by about 0.7 percentage points per year. There is widespread uncertainty, and anecdotal information indicates downside risks and dramatic freezes of new projects, but some form of stimulus measures for housing construction will probably be launched if this downturn threatens to be larger than we have forecast. Lower demand for commercial premises will also contribute to falling construction investments. We expect overall capital spending in Sweden to fall by 3.1 per cent this year and by another 0.3 per cent in 2024.



Squeezed households will cut consumption

Along with residential investments, household consumption will be the main driver of this year's GDP decline. Real wages are projected to fall by a total of 11 per cent in 2022 and 2023. This is larger than the downturn in the early 1980s, when they fell by about 10 per cent over a four-year period. But the decline in real disposable incomes will be only about 4 per cent, due to tax cuts and increased subsidies. The fall in disposable incomes will be on a par with developments in the early 1980s but far milder than during the crisis of the early 1990s, when disposable incomes dropped by 10 per cent. At that time, a collapse in employment was an important driver, while the labour market looks significantly more resilient this time around.



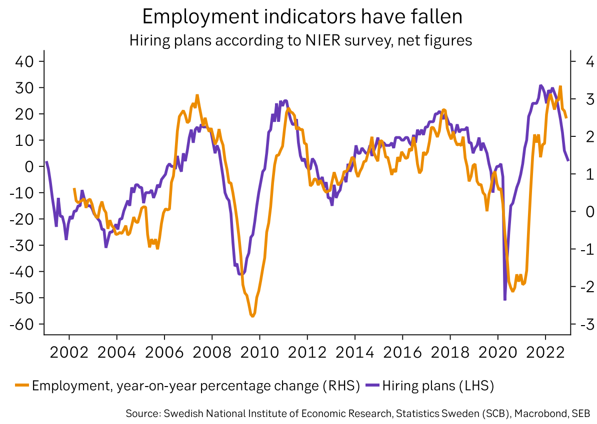
Reduced savings are a downside risk to consumption. During the past six months, retail sales have fallen by nearly 10 per cent, while the downturn in total household consumption has been only around 3 per cent. This trend is expected to continue during the first half of 2023. Annual average consumption will fall by 1.7 per cent. So far, households have reduced their savings to maintain consumption. As savings buffers shrink, there is an increased risk of an even larger consumption downturn.

Household incomes and savings ratio
Year-on-year percentage change

	2021	2022	2023	2024
Real disposable income	3.1	-0.3	-2.5	1.8
Private consumption	6.0	2.7	-1.7	1.2
Savings ratio, % of income	15.5	11.9	12.3	11.9

Source: Statistics Sweden, SEB

Home prices will continue to fall. Home prices had fallen by a total of 15 per cent by November (12.5 per cent seasonally adjusted), compared to their peak in February 2022. The downturn slowed late in 2022, and SEB's Housing Price Indicator recovered somewhat in January. We expect home prices to continue falling during the first half of 2023, and we are sticking to our forecast that the overall home price downturn will reach 20 per cent. The average interest rate on a home mortgage loan with a three-month fixed interest period had risen from 1.4 per cent in late 2021 to 3.2 per cent in November 2022. Our forecast is that this interest rate will reach 4.2 per cent during the spring, which means that the average cost of a mortgage will have more than tripled. Interest expenses will increase from 2.5 per cent to an estimated 5.5 per cent of household incomes.



Rising unemployment during 2023

The Swedish labour market was unexpectedly strong during most of 2022, but late in the year indicators such as business hiring plans and new job vacancies turned downward. So far, this decline is moderate and there are many indications of continued job growth in early 2023. Because GDP is starting to fall, employment will probably also shrink this year, but after a certain time lag. During the financial crisis of 2009 and the pandemic of 2020, employment fell by more than 3 per cent. Since the next GDP downturn is now expected to be much milder, we believe that employment will fall by only a moderate 1.5 per cent. But the decline in output is now affecting labour-intensive service sectors and construction, posing a downside risk to our forecast.

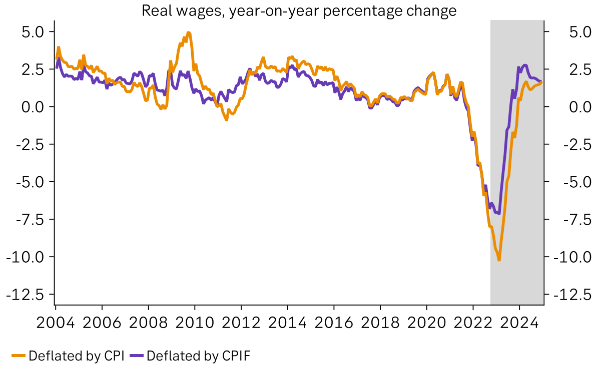
Resource utilisation below normal by the end of 2023. Unemployment will climb from today's 7.5 per cent to 8.5 per cent by end-2023 and remain at that level in 2024. Partly due to a strong upturn in labour force participation in the past few years, unemployment will be stuck at relatively high levels compared to pre-pandemic figures. Initial resource utilisation is high, but shortages according to the NIER's Economic Tendency Survey fell from a record level in Q4 and will probably continue to below their historical averages late in 2023.

Moderate pay hikes, despite high inflation

The national wage round is now entering a crucial stage. After the labour unions launched demands for one-year pay hikes of 4.4 per cent, industrial employers responded with a proposed increase of 2 per cent, plus a one-time payment equivalent to 1 per cent in 2023. The employers' proposal might be part of a slightly longer-term agreement. Further negotiations lie ahead, but the two sides do not seem far apart. Including a one-time pay-out of 1 per cent, pay hikes in 2023 could end up quite close to union demands, which might lead to lower pay hikes in 2024. But there is great uncertainty. We are sticking to our forecast that pay hikes will be 4.5 per cent in 2023 but have slightly lowered our forecast for 2024 to 3.2 per cent. This would mean somewhat lower pay increases than in the euro area and Germany.

Record-sized real wage declines

Real wages, year-on-year percentage change

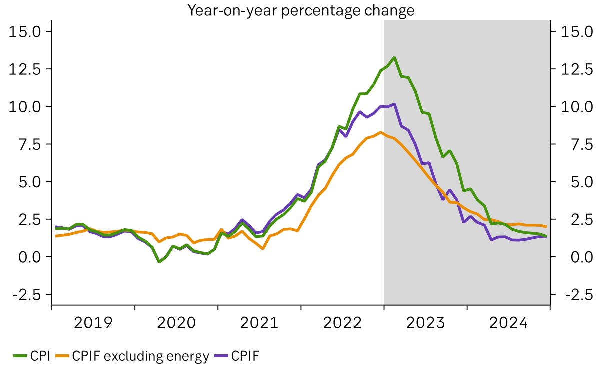


Source: National Mediation Office, Statistics Sweden, SEB

Inflation will fall, but at an uncertain pace. Inflation rose to new highs in December, with CPIF (the consumer price index excluding interest rate changes) at 10.2 per cent and CPIF excluding energy at 8.4 per cent. Due to large base effects as rapid price increases in early 2022 vanish from the 12-month figures – combined with sharp electricity price declines – both metrics will probably fall in early 2023. But over the next six months, various factors will keep core inflation up. A large majority of companies in the retail sector are planning new price hikes, while producer prices for consumer goods continue to climb rapidly, partly due to a weak Swedish krona. Due to cost increases in 2022, many administratively set prices will continue to rise early in 2023: for example, fees for refuse collection and water, plus cooperative housing dues and rents.

Inflation will fall in 2023

Year-on-year percentage change

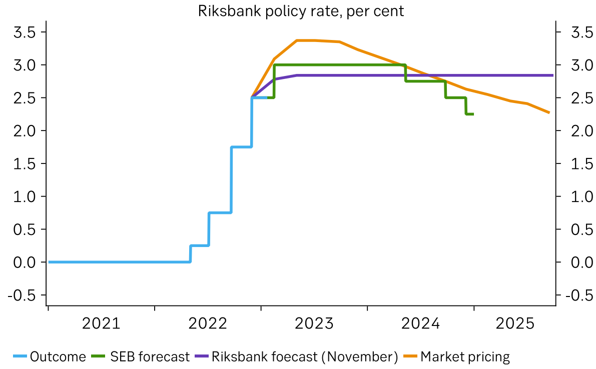


Source: Statistics Sweden, SEB

A more favourable inflationary environment ahead. The potential for lower inflation further ahead has nevertheless improved. For example, prices of goods that are early in the production chain have begun to fall. US inflation indicators and actual inflation have both fallen sharply, which also increases the likelihood of a similar trend in Europe. Pay hikes will accelerate a bit, but this will not jeopardise the inflation target. Swedish core inflation will gradually fall to 2 per cent, and a slight decline in electricity prices suggests that CPIF inflation will end up below target in 2024. Due to rising mortgage rates, we expect total CPI to increase by an average of 3 percentage points more than CPIF in 2023.

Final rate hike in February

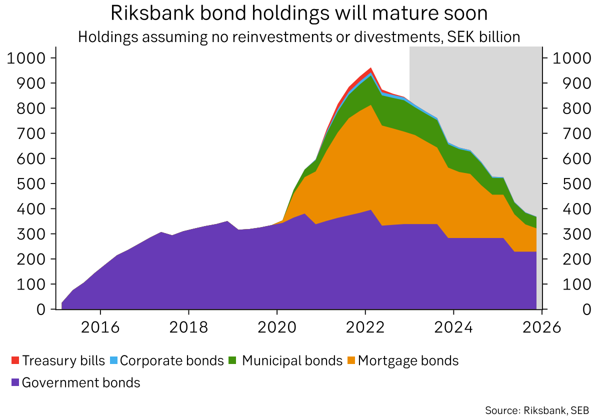
Riksbank policy rate, per cent



Source: Riksbank, SEB

A 50 basis point rate hike in February

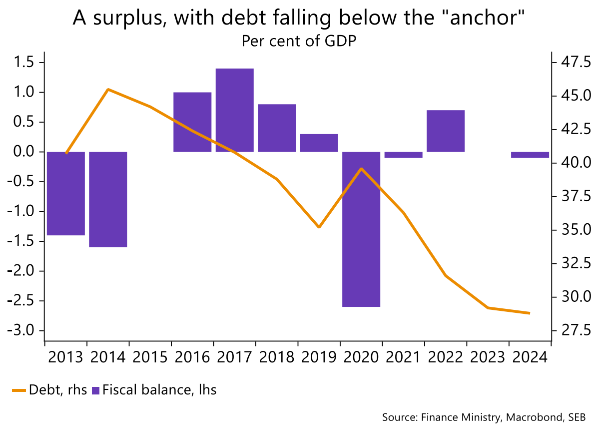
Because of Sweden's gloomy economic growth outlook, falling home prices, a weak krona and high inflation, the Riksbank's dilemma will continue. Although inflation is now very likely to decline, monthly price increases over the next six months will remain higher than normal. The Riksbank's February policy meeting will mark the debut of both Governor Erik Thedéen and Deputy Governor Aino Bunge, and there is little information about their views on monetary policy. Hawkish signals from the ECB and other central banks are putting pressure on the Riksbank, and especially Mr Thedéen, to show that they are taking the fight against inflation seriously. We thus believe that the Riksbank will raise its key interest rate by another 50 bps in February – thus by more than the 25 bp hike indicated at the bank's November meeting. The Riksbank rate path is quite likely to indicate a high probability of a further hike in April. Yet we still believe that the relatively sharp GDP downturn, combined with gradually clearer signs of falling inflation, suggest that the key rate will remain flat after the February hike. Once inflation falls more clearly in 2024, we expect the Riksbank to cut its key rate by 75 bps to 2.25 per cent.



The Riksbank is likely to sell government bonds. The Executive Board has decided that bond purchases will now cease completely. Because of the short average maturity of its bond holdings, the Riksbank's balance sheet will shrink rapidly. But over the next couple of years, it will mainly be mortgage and municipal bonds that mature, while Riksbank holdings of government bonds are rather evenly distributed over the next 10 years. In a recent speech, Deputy Governor Martin Flodén argued that the Riksbank should consider whether it should actively sell government bonds with long maturities. Such divestments would push up interest rates on longer-dated bonds, tightening monetary policy without significantly affecting household mortgages, which mainly have maturities of less than two years. Divestments might also attract foreign buyers and thereby help strengthen the krona. We believe the Riksbank is likely to start actively selling government bonds starting in the second half of 2023.

Cautious fiscal policy

Fiscal policymakers face a balancing act in terms of the need to soften the impact of the economic downturn without making it harder for monetary policymakers to fight inflation. Swedish government finances have been strong over the past year. The Swedish National Debt Office reports that in 2022 there was a surplus of SEK 164 billion, or 2.7 per cent of GDP. One reason for the size of the surplus is that the government's promised electricity price subsidies have not yet been disbursed. Also, the Riksbank repaid a loan amounting to SEK 60bn last year. High inflation, bloated energy prices and rising employment have driven up tax revenues. The spending plans unveiled in the autumn budget were also unexpectedly small, for several reasons for this. The Tidö Agreement between the three non-socialist coalition parties and the Sweden Democrats, on which the government relies for a parliamentary majority, will take time to implement. Some political leaders are also worried about making it harder for monetary policymakers to combat inflation and repeating last autumn's British mini-budget debacle.



Practical obstacles, but more fiscal stimulus on the way. Electricity subsidies will eventually be put in place, and additional stimulus will probably be rolled out as the economy slows. For example, we expect targeted support for those who are under the greatest financial pressure and increased central government grants to the local government sector, which has warned of growing deficits in 2023 and 2024. The next government budget (for 2024) will probably include new tax cuts. Measures to ease the downturn in construction are also possible, although the government will probably want to avoid direct subsidies. There will also be spending pressure due to high inflation in various fields with indexed payments. Even with the extra spending that we have included in our forecast, the central government budget will be in balance, while government debt will continue to fall well below the official "debt anchor", which is 35 per cent of GDP. Such a feat is remarkable during an economic downturn, indicating that Swedish fiscal policy is rather cautious at present. We may see more fiscal stimulus measures once the downturn in inflation has come a long way, which we regard as an upside risk to our GDP forecast.

Theme:

A burden on households

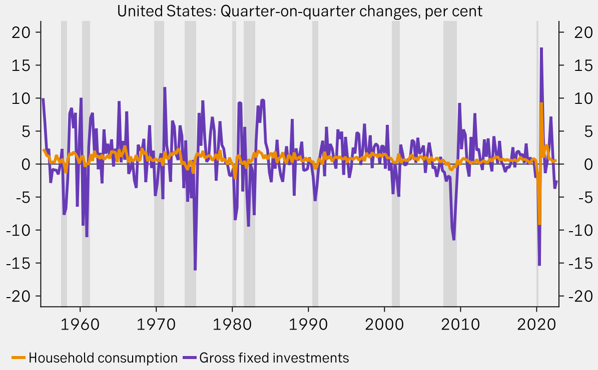
Consumer-led recession in 2023

Sharply rising inflation and interest rates are a heavy burden on households. But despite a lack of optimism, the resilience of the economy has been surprisingly robust so far, probably reflecting a strong desire to return to a more normal life after the long period of COVID-19 pandemic lockdowns. Due to continued high inflation, shrinking savings buffers and less vigorous post-pandemic demand, however, we expect an economic slowdown in 2023: probably stronger in Sweden than in the euro area. Consumer-driven recessions are relatively rare. For various reasons, this one will be milder but also more protracted than crises caused by investment excesses or financial imbalances.

The unusual dynamic of the coming GDP decline. It is quite unusual for consumers to lead an economic downturn. Until the mid-1980s the economy was driven mainly by investment cycles, especially in the manufacturing sector. Variations in the competitiveness of economies have also created major differences in the amplitude of ups and downs. Starting in the 1990s, economic crises have instead been of a financial nature, where imbalances ultimately lowered broader economic activity. Consumption was also affected after a time lag, but it was not the main driver.

A milder recession when consumers are the driving force. Now that consumption looks set to become the main driver of the recession, its inherent inertia means that the downturn is likely to be mild and rather protracted. Households are a very heterogeneous group with different reaction patterns. This contributes to greater stability in overall consumption. Fiscal stimulus measures will also smooth the way for consumers. Crises driven by financial imbalances and investment cycles are instead characterised by faster processes and larger co-variations between different parts of the economy.

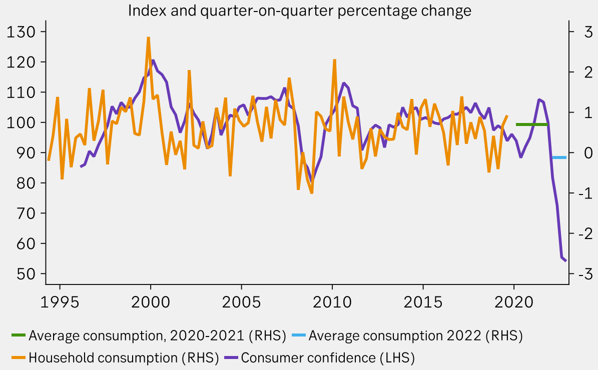
Greater fluctuations in investments than consumption
United States: Quarter-on-quarter changes, per cent



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

Gloomy households pay for what they want. Consumer confidence in Europe and the US fell during the latter part of 2022 to the lowest levels ever recorded, but historical correlations between sentiment and consumption have been significantly weaker than normal. One reasonable explanation is that households have had a strong desire to return to a normal life after the pandemic, despite general uncertainty about the future. Consumption has held up so far in nominal terms while levelling off in terms of constant prices. There are major differences between different categories. Consumption of durable goods has fallen sharply from the high levels that prevailed during the pandemic. Consumption of food is more stable, but some gradual moderation is discernible as consumers try to buy less or cheaper foods. On the other hand, rising demand for services has helped to keep overall consumption up. For example, households are prioritising services such as travel and entertainment after two years of sharply limited consumption opportunities.

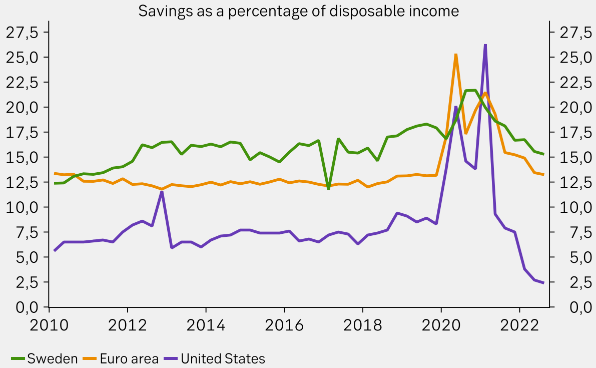
Consumer confidence and consumption
Index and quarter-on-quarter percentage change



Source: Swedish National Institute of Economic Research, Statistics Sweden (SCB), Macrobond, SEB

Savings are on the way down. In recent years, variations in savings have affected the structure of consumption to a greater extent than usual. Savings rose sharply during the pandemic when consumption opportunities were limited. Since then, savings have fallen as households have spent the buffers they built up during the pandemic. It is likely that for a while, savings will drop below previous norms and may even become negative. The unequal distribution of savings and wealth also has important consequences. A study by the European Central Bank shows that 45 per cent of wealth build-up during the pandemic ended up being held by the tenth of the population with the highest incomes. In the US, where income gaps are substantially wider, fiscal stimulus was more clearly targeted to lower income groups, which also had the fastest wage and salary growth. One result is that the savings ratio fell especially far in the US during 2022. The Federal Reserve estimates that at their peak, accumulated surplus savings totalled USD 2.3 trillion (10 per cent of GDP) and that they had shrunk to USD 1.7 trillion by mid-2022.

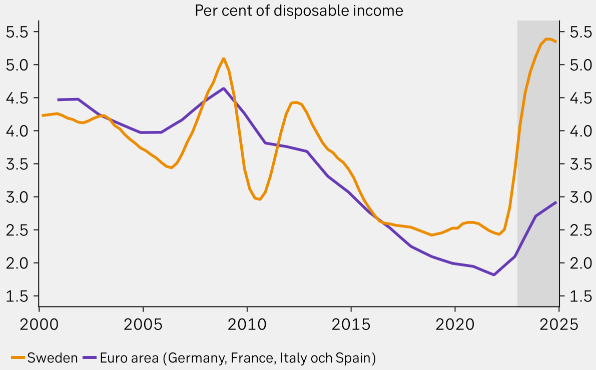
Sharp fluctuations in the household savings ratio
Savings as a percentage of disposable income



Source: U.S. Bureau of Economic Analysis (BEA), Eurostat, Macrobond, SEB

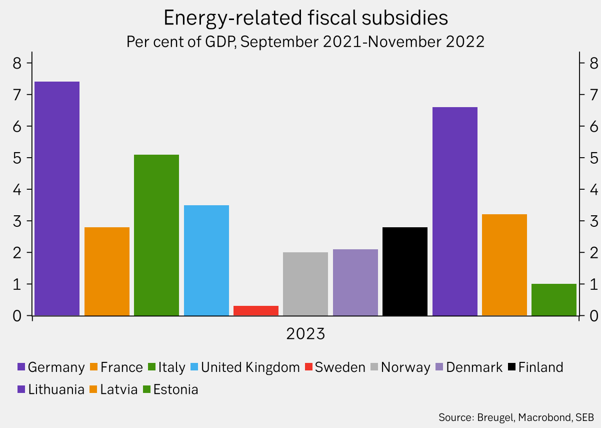
Large variations in interest rate sensitivity. In the euro area and the US, fixed interest rate periods for household mortgages are significantly longer than in Sweden. This means that central banks' key interest rate hikes have an impact only after a long delay and suggests that the related drop in household consumption will be faster and larger in Sweden. Also reinforcing this effect is a faster decline in Swedish home prices, which leads to a consumption slowdown via wealth effects.

Rising interest expenses
Per cent of disposable income

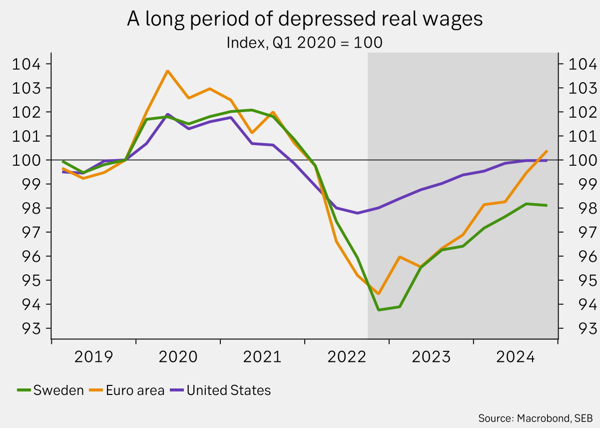


Source: Macrobond, SEB

Large differences in electricity price subsidies. During the pandemic, large-scale fiscal stimulus programmes helped to boost savings in most countries. The electricity price subsidies that European households are now receiving are instead softening the downturn in their savings. *Bruegel*, a think tank based in Brussels, has tried to compare the scale of the various subsidies. The differences between countries are very large, with Germany at the top with subsidies totalling more than 7 per cent of GDP over a period of 15 months. Sweden is at the bottom, reflecting the long delay in payments. But even under the proposals have now been presented, Swedish energy price subsidies will be relatively low in international terms. Also notable is that households in the euro area – as in the case of interest expenses – have energy contracts that delay the impact of price - changes in electricity markets compared to Sweden, for example.



Sluggish recovery in real wages. When households can manage on their own will be determined by real wage and employment trends. High inflation in 2022 ate up several years of wage and salary growth in most countries. In the US and the UK, tight labour markets have contributed to faster wage growth than in the EU, easing the decline in real wages and purchasing power. As inflation falls again, real wages will start to recover, although it will take a long time before they revert to their previous trend in the EU. The number of hours worked is also important for income and consumption. The challenges differ from one economy to another. The squeeze on labour supply in the US and the UK has helped to push key interest rates rapidly higher, limiting the potential for rising employment and thus also future consumption. In the euro area, too, the number of people with jobs was maintained during the pandemic, but meanwhile their average working time fell sharply. Although it has partially recovered, there is potential for a continued upturn that may drive incomes and consumption.

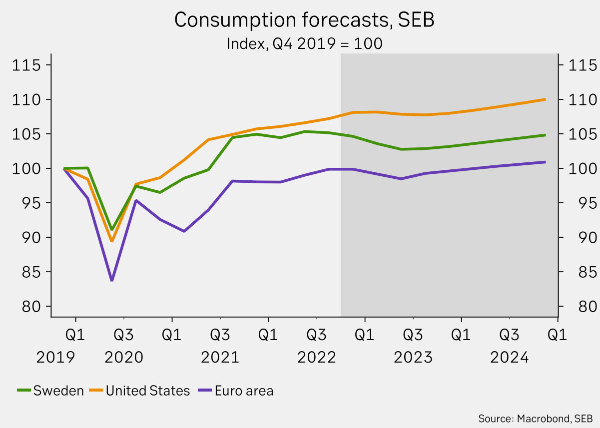


Consumption, year-on-year percentage change

	2022	2023	2024
United States	2.9	0.5	1.0
Euro area	4.1	-0.1	1.3
Sweden	4.0	-1.5	2.0

Source: SEB

A relatively large consumption decline in Sweden. When we weigh together the various economic drivers, we end up concluding that the consumption downturn will be milder in the US than in Europe. Due to a faster impact from higher interest rates and electricity prices, sharper home price declines and less extensive subsidies, the downturn will be especially sharp in Sweden, even though the actual increase in energy prices is smaller than in the euro area. But because of a faster recovery in 2021, accumulated economic growth since the outbreak of the pandemic has been stronger in Sweden than in the euro area.



Norway
A delayed, but steeper, slowdown expected

Growth in mainland GDP has held up better than feared, but economic activity indicators still point to a recession ahead. Households are unable to sustain current consumption. Falling home prices and cautious businesses will weigh on mainland investments. An abrupt slowdown in mainland GDP growth combined with a peak in core inflation in early 2023 means that Norges Bank is probably done hiking its key rate. We expect rate cuts starting in Q1 2024.

Norway's mainland economy has passed a cyclical peak. Growth in mainland GDP has nonetheless held up better than feared, despite widespread pessimism among households. Meanwhile, economic activity indicators have deteriorated further, pointing to a recession ahead. Though the slowdown will materialise later than envisaged in November's *Nordic Outlook Update*, it will be sharper. Private consumption has been supported by solid job growth and large household savings buffers. This is unsustainable because of a further squeeze in household real disposable income, falling home prices and substantially lower savings. Tight monetary and fiscal policy will produce further headwinds for growth this year. We predict negative growth in mainland GDP in H1 2023. As a result, GDP will fall by 0.5 per cent this year after climbing by 3.5 per cent in 2022. A rebound in mainland capital spending, combined with key rate cuts, will lift mainland GDP growth to 1.1 per cent in 2024. Total GDP will be supported by petroleum investments, with growth of 0.6 and 2.0 per cent in 2023 and 2024, respectively.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	3.9	3.1	0.6	2.0
Mainland GDP	4.1	3.5	-0.5	1.1
LFS unemployment*	4.4	3.2	3.6	3.8
Wages and salaries	3.5	3.9	4.7	3.8
CPI-ATE inflation	1.7	4.0	5.2	3.1
Key interest rate, %	0.50	2.75	2.75	2.00

*Per cent of labour force. Source: Macrobond, SEB

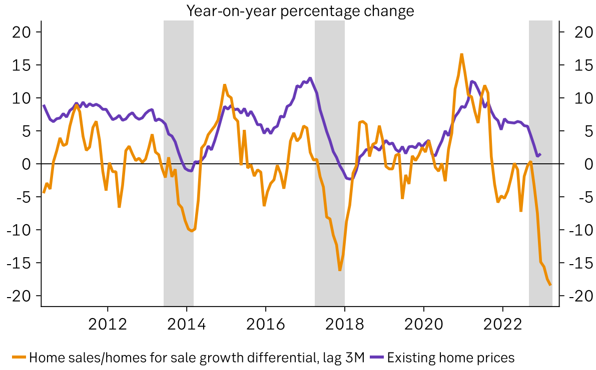
A cyclical upturn in petroleum investments

Petroleum capital spending likely reached a trough last year, with an expected cumulative decline of 11 per cent since end-2019. A large number of new projects will lead to a cyclical upswing from 2023. Several plans for development and operation (PDO) were submitted to the government in December before temporary tax breaks expired. This will lift operators' investment estimates for 2023 notably in Statistics Norway's upcoming oil investment survey for Q1. Higher petroleum capital spending should underpin output and investment in petroleum-related manufacturing, as visible in various sentiment surveys. The outlook for manufacturers of traditional goods is weighed down by weak foreign demand, strong cost inflation and generally high uncertainty. After vivid growth in business investments in 2022, we forecast a fall by 0.8 per cent in 2023. Partly due to a further decline in residential investments during 2023, mainland capital spending will be a drag on mainland GDP growth this year, but such investments will rebound thereafter.

Home prices to fall 5-10 per cent

Existing home prices rose 5.0 per cent in 2022, but a trend-shift occurred during autumn, and the outlook for 2023 is bleak. Prices have fallen 2.6 per cent from their peak in August. The supply of existing homes has rebounded sharply as legislatively related bottlenecks, which lowered supply in the first half of the year, have eased. Higher mortgage lending rates, restrictive bank lending and households' expectations of home price declines are weighing on housing demand. The deterioration in the demand-supply balance points to large monthly price declines in the near term. We expect a 5-10 per cent peak-to-trough fall, with prices bottoming out around next summer. Annual growth in existing home prices will fall 4.2 per cent in 2023, followed by a 2.1 per cent rebound in 2024. Structural imbalances and a slight easing in mortgage lending regulations reduce the risk of a larger price correction.

A negative demand-supply balance points to a further decline



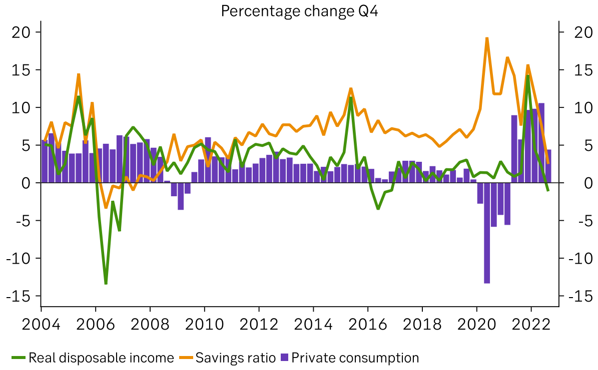
Source: Real Estate Norway (Eiendom Norge), Macrobond, SEB

Unsustainably high consumption growth

Private consumption has held up surprisingly well considering the cost-of-living shock facing households. Robust employment growth, solid household savings buffers and a desire to return to normal habits after the pandemic have underpinned consumption. Moreover, goods consumption has been temporary boosted this autumn by deliveries of autos which were ordered before new tax changes applied in January 2022. Current consumption growth is unsustainable. The household savings ratio declined to 2.3 per cent in Q3 from 15.7 per cent by the end of 2021, while household real disposable income fell by a cumulative 14.1 per cent. Nominal pay increases will rise, but despite improving terms of trade and tough demands in this spring's wage and salary negotiations, real wage growth will remain negative. We expect sharply weaker household consumption in early 2023 and forecast private consumption growth of -0.5 and 1.4 per cent in 2023 and 2024, respectively.

Households digging into savings to uphold consumption

Percentage change Q4



Source: Statistics Norway, Macrobond, SEB

Gradually higher unemployment

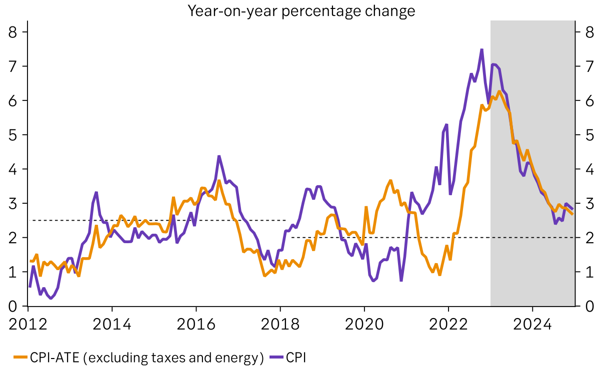
Though unemployment seemingly has bottomed, the expected gradual upturn will probably materialise later than previously envisaged. Short-term indicators still point to a cooling, with inflows of job seekers and the number of short-term unemployed rising. Hiring plans are moderating, albeit from high levels. According to Norges Bank's regional network, many employers will assess the need for staff reductions, suggesting that joblessness could start rising gradually from early 2023. The upturn will be moderate, with registered unemployment rising from 1.6 to 2.6 per cent by end-2024.

Inflation to peak early this year

CPI-ATE (CPI excluding taxes and energy) accelerated from low levels in late 2021 to almost 6 per cent by end-2022, but the upturn showed signs of losing steam – driven by falling food prices. Prices for other goods and services continued to accelerate. Base effects from strong price increases a year ago will produce headwinds for the inflation rate. But continued strong increases in both producer and import prices for consumer goods suggest that CPI-ATE will accelerate further in early 2023. Inflation normally moderates during the second half of the year, and weaker international and domestic demand indicates that inflation will begin to approach target in 2024. On average, we predict CPI-ATE will increase by 5.2 and 3.1 per cent in 2023 and 2024, respectively.

Core inflation approaches target in 2024

Year-on-year percentage change



Source: Statistics Norway, Macrobond, SEB

Strong electricity price subsidies to households will limit the impact on CPI from big shocks in market prices. Partly due to higher indirect taxes, CPI inflation will temporarily rise to 7 per cent in early 2023, but we predict a rapid moderation starting this spring – with inflation averaging 3.0 per cent in 2024.

Norges Bank eyeing a final hike in March

Norges Bank slowed the pace of tightening in November after three consecutive 50 basis point rate hikes. Monetary policy is having a clear tightening effect on the Norwegian economy, and the central bank wants to avoid amplifying the downturn by tightening policy too much. However, as inflation has continued to surprise on the upside and bearish forward-looking indicators are not yet visible in activity data, Norges Bank is eyeing a final key rate hike in March. We find the central bank's projections optimistic, and we are forecasting a steeper downturn this winter and an earlier closing of the output gap. The timing and extent of the expected slowdown in economic activity, combined with inflation developments, will be decisive for the near-term rate outlook. We predict that the key rate has peaked at 2.75 per cent, although risks are skewed toward a final increase in March. Strong household interest rate sensitivity and a negative output gap will open the way for rate cuts in 2024, with the key rate reaching 2.00 per cent by the end of the year.

Denmark
Still resilient

Denmark's GDP saw marginal growth of 0.3 per cent in Q3, and despite a challenging Q4 due to peak energy prices, we now expect growth to be better than initially feared. We are thus lifting our GDP estimates for 2022 and 2023, keeping 2024 unchanged.

GDP was still growing in Q3. Q3 national accounts data were not quite as strong as the preliminary GDP indicator had suggested, but the modest 0.3 per cent growth was still better than the marginal decline we had expected. Falling liquefied natural gas (LNG) prices also suggest that the energy crisis will be milder than feared. While we still expect a decline in GDP over the winter, we now foresee a milder recession with unchanged GDP in 2023 following growth of 3 per cent in 2022.

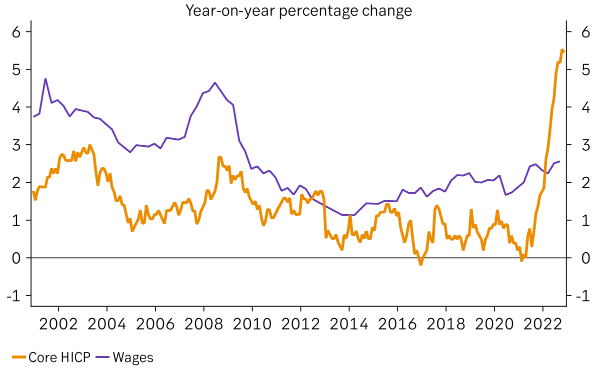
Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	4.9	3.0	0.0	2.5
CPI	1.9	7.7	3.8	1.6
Wages and salaries	2.3	2.5	2.6	3.3
Public sector fiscal balance*	2.6	3.0	2.0	2.5
Public sector debt*	40.0	35.0	34.0	32.0
Current account*	8.3	14.0	10.0	8.0
Key interest rate (CD rate), %	-0.60	1.75	3.00	2.25

*% of GDP. Source: Statistics Denmark, DØRS, SEB

Consumer spending held back. The near-term outlook for domestic demand remains challenging. Household spending power continues to be undermined by high inflation, and while headline inflation has peaked, core inflation is still rising and outpacing wage inflation by an unusual margin. We expect consumption to remain muted in H1 2023 but to return as a growth driver in H2 2023, with growth of 0.5 per cent for the full year.

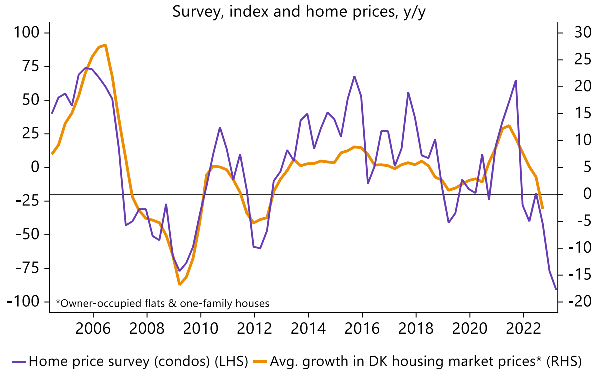
Real wages decline as inflation rises
Year-on-year percentage change



Source: Statistics Denmark, Eurostat, Macrobond, SEB

Households and businesses under pressure. Broad credit conditions continued to tighten according to the Danmarks Nationalbank (DNB) lending survey, and conditions are now approaching 2008-2009 levels. Lending standards are being tightened and demand for credit is falling both in the household and business sectors. A combination of tightening credit standards and pay-back of value-added tax (VAT) from COVID-19 support packages has led to the highest number of bankruptcies since 2010.

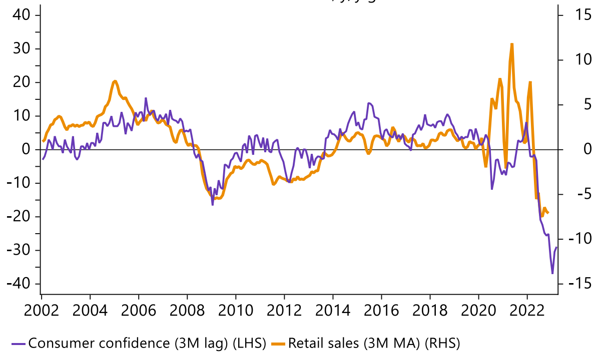
Declining home prices since summer
Survey, index and home prices, y/y



Source: Statistics Denmark, Danish Association of Chartered Estate Agents (DE), Macrobond, SEB

Because of higher interest rates and tighter credit, Q3 2022 saw the lowest number of real estate transactions in a decade. Prices of both houses and apartments have declined by 5-10 per cent since the summer. At the same time construction activity remains challenged. Q3 2022 saw housing starts decline to 2015 levels, adding downward pressure to housing investment, which is likely to see double-digit declines in H1 2023.
With headwinds from falling real wages, lower home prices and tighter credit conditions, it is not surprising that consumer confidence reached a new all-time low at minus 37 in October, before recovering slightly as energy prices started receding towards the end of Q4.

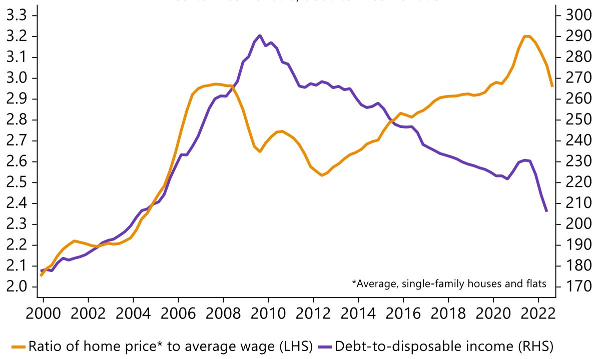
Slight recovery for consumer confidence after all-time low
Index and retail sales, y/y growth



Source: Statistics Denmark, Macrobond, SEB

Positive signs for 2023. Over the past month, the European LNG price has come down by more than 50 per cent. This is likely to lead to a further improvement in confidence in the first months of 2023. However, with unemployment now starting to move higher, we expect demand to remain weak through the winter. Unemployment will peak at 5.2 per cent in the second half of 2023, up from a low of 4.2 per cent in Q2 2022.

Debt-to-disposable income extends decline
Price-to-income ratio, debt-to-income ratio



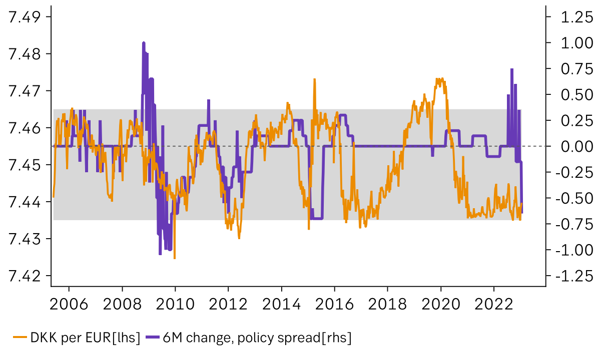
Source: Statistics Denmark, Macrobond, SEB

Furthermore, while falling home prices are negative for spending, the financial risks are very different from when this last happened in 2008-09. At the peak, home prices relative to wages were higher than during the global financial crisis, but the debt-to-disposable income ratio has declined almost 40 per cent since then. The debt ratio declined sharply in 2022, most likely reflecting home owners refinancing long-term callable loans into higher coupon loans and thus reducing their outstanding debt.

Current account lifted by shipping. Denmark's current account surplus surged in 2022, peaking at an annual level of almost 20 per cent of GDP in the late summer. In our view, this explosive upturn was a delayed reaction to the sharp increase in container freight rates in the wake of the pandemic. This suggests that the surplus will move back below 10 per cent of GDP in 2023. As this is mainly a price effect, it does not impact real GDP growth to a large degree. Export volumes are likely to stagnate in 2023 before rebounding with European demand in 2024.

Stable policy outlook. After a prolonged negotiation period, Denmark got a widely expected broad-based government led by incumbent prime minister Mette Frederiksen (Social Democratic Party), including the Liberal Party and the new Moderate Party, led by former PM and LP leader Lars Løkke Rasmussen. The new government is likely to be even more stability-oriented in economic policy than its predecessor.

DKK still too strong
DKK/EUR, per cent



Source: Macrobond

The DNB hiked its deposit rate by 50 basis points in December, matching the pace of the European Central Bank (ECB) and thus keeping the rate spread unchanged after widening it by 15 basis points at the October meeting. There has been no confirmed foreign exchange intervention since then, and we expect the DNB to keep the deposit rate spread unchanged as the ECB completes its rate hiking cycle.

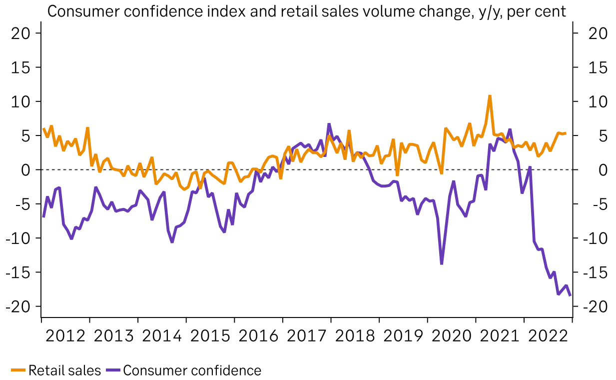
Finland
The good times are over

The Finnish economy has fared relatively well so far, relying on strong domestic demand and resilient exports. As households grow deeply pessimistic and export orders dwindle, this good fortune cannot be sustained. The economy will go through a shallow recession. We expect GDP to decline by a marginal 0.3 per cent in 2023. Growth will rebound in 2024 but remain at a modest 1.4 per cent.

Low consumer confidence has not stopped sales. Increasingly high inflation and a worsening general economic outlook have pushed consumer sentiment to its lowest level ever recorded, but low faith in the economy has not prevented households from increasing their consumption, and growth in retail sales has accelerated. Yet people have become more hesitant about major purchases, which is reflected for instance in low car sales. We expect negative sentiment to show up in lower spending soon. Private consumption will marginally decrease this year.

Low consumer confidence indicates sales will fall

Consumer confidence index and retail sales volume change, y/y, per cent



Source: Eurostat, Statistics Finland, Macrobond, SEB

Inflation converging to the euro area average. Finnish headline inflation remained well below the average in the euro area for a long period, but in recent months this gap has been closing. Due to lower energy prices, inflation marginally eased in December, but core inflation jumped to 4.8 per cent from 4.4 per cent in November. Base effects and more stable energy prices will start to bring inflation down, and on average HICP will increase by 4.5 per cent in 2023. It will slow in 2024 to only 1.5 per cent.

Industry running out of luck. While manufacturing has been ailing in many countries, Finnish industry has withstood these trends and continued to exhibit strong growth. But not anymore. In November, industrial production fell by 2.4 per cent year-on-year – the first decline since early 2021. New orders are also in decline. The first layoffs have occurred, but they are far from being widespread. As capital investments dwindle across the globe, Finnish exports will decline by 0.5 per cent this year.

So far so good in the labour market. Despite a changing economic climate, unemployment has continued to decline in recent months. Employment expectations have generally worsened, but as the labour market has become very tight, layoffs will be postponed as long as possible. High inflation in times of an uncertain economic outlook make pay negotiations tricky, and we expect wages and salaries to grow somewhat faster in 2023-2024 than in previous years. We forecast that unemployment will increase to 7.1 per cent this year, while wage and salary growth will climb to 4.0 per cent.

Capital expenditures to decrease. As in neighbouring Sweden, the Finnish housing market is cooling, but the decline in the number of transactions as well as prices has not been as steep. Uncertainty will nevertheless hold back new projects. On the corporate investment side, new lending was surprisingly strong in the second half of 2022, but the current uncertainty will make businesses more cautious.

Government trying to bring down inflation. The government has been busy trying to tackle the rising costs of living ahead of the April parliament elections. So far, its actions have been rather timid. Among new controversial measures, the government is trying to levy a windfall tax on the profits of energy companies. At the same time, balancing the books remains an issue. Spending cuts and tax hikes are likely after the election.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	3.0	2.0	-0.3	1.4
Private consumption	3.5	2.4	-0.2	1.5
Exports	5.4	3.0	-0.5	2.0
Unemployment*	7.6	6.8	7.1	6.9
Wages and salaries	2.3	2.6	4.0	3.0
HICP inflation	2.1	7.2	4.5	1.5
Public sector fiscal balance**	-2.7	-1.8	-2.7	-2.0

*% of labour force **% of GDP. Source: Eurostat, SEB

The Baltics

Lithuania | page 48

Lower exports will lead to a brief recession in early 2023, but GDP growth will be just above zero for the full year. Household consumption will strengthen this year as inflation falls. The labour market will remain strong, despite signs of shakiness.

Estonia | page 50

The labour market is in good shape, making domestic consumption resilient. Increased exports in the second half of 2023 will also help to avoid a GDP decline, although weak Nordic construction activity is hampering Estonian production and exports.

Latvia | page 49

Exports are strong despite headwinds, which are partly due to weaker ties with Russia. But a downturn is on its way. Consumption faces challenges and home prices are falling. Because of tumbling energy prices, inflation is starting to slow.

Lithuania
Mission possible: Slight growth in 2023

Surprisingly strong exports helped the economy to show fairly strong growth in 2022, but exports started weakening at the end of the year and that trend will continue during first half of 2023. Inflation peaked in September and will keep falling rapidly this year. Private consumption growth will remain negative in the first two quarters. The labour market will stay strong, but there are signs of coming weakness.

The economy managed to avoid a technical recession in 2022. But we still assume that Lithuania will not avoid a shallow recession in the first half of 2023. Manufacturers were responsible for around two thirds of overall GDP growth in 2022 but falling export orders clearly indicate that at least the first half of 2023 will be weak for this sector. Trade, transport and construction will not contribute much to GDP in 2023. Our forecast is that GDP growth will decelerate from 2.2 per cent in 2022 to 0.1 per cent in 2023 and recover to 3.5 per cent in 2024.

Key data
Year-on-year percentage change

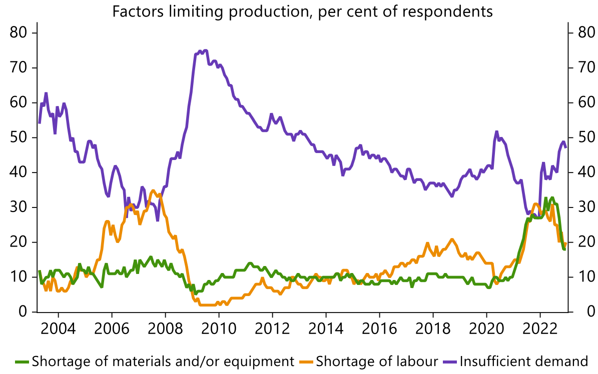
	2021	2022	2023	2024
GDP	6.0	2.2	0.1	3.5
Household consumption	8.1	1.0	0.0	3.8
Exports	17.0	12.5	0.4	4.4
Unemployment*	7.1	5.9	6.9	6.8
Wages and salaries	10.5	13.0	9.0	6.5
HICP inflation	4.6	18.9	9.0	2.0
Public sector fiscal balance**	-1.0	-0.5	-4.0	-1.6

*% of labour force **% of GDP. Source: Eurostat, SEB

Private consumption is likely to recover in the second half of 2023, based on the assumption that by then inflation will have fallen to single digits. Consumer confidence unexpectedly recovered in Q4 2022 due to the announcement of government stimulus measures for 2023 and relief that inflation has already passed its peak.

The labour market has started showing initial signs of weakening. The number of job vacancies dropped from its peak and unemployment slightly increased late in 2022. We are maintaining our assumption that this year's increase in unemployment will be minor: it will rise from 5.9 to 6.9 per cent. Average wages and salaries increased by 13 per cent last year in a tight labour market situation. In 2023 average pay growth will be smaller, but still supported by such factors as another hike in the minimum monthly wage. Lithuania remains one of the EU leaders in growth of nominal unit labour costs, reducing the country's competitiveness.

Weaker demand suggests production dip in early 2023
Factors limiting production, per cent of respondents



Source: Statistics Lithuania, Macrobond, SEB

Inflation will fall to 9 per cent in 2023. Such factors as lower energy prices and base effects have started pushing inflation down. We assume that core inflation also peaked in December, but it will fall at a slower pace than headline inflation. In late 2022, food price inflation of 35 per cent got the most public attention. Annual food price inflation will decelerate, too, but will end this year in double digits.

Property prices will face a minor correction in 2023. The housing market was weak in Q4 2022 as the number of transactions dropped to the 2017 level. Residential property prices fell very marginally. At least a small price decline in the first half of 2023 is unavoidable, considering the sharp jump in interest rates and the fact that property prices rose more than 40 per cent in the past two years.

Fiscal policy will be expansionary in 2023. The most recent data indicate that the budget deficit was smaller in 2022 than in 2021. This year it will increase to nearly 4 per cent of GDP due to stronger fiscal stimulus measures, but this is a smaller deficit than in government projections due to lower expenses for energy price compensation. This year EU funds, including the Recovery and Resilience Facility, will have a strong positive impact on the Lithuanian economy – leading to much higher public investments in 2023.

Latvia
High uncertainty

This will be a year of high uncertainty and a complex, fast-changing environment. Inflation and energy supply disruption and new geopolitical upheaval risks will linger. The economy is entering a recession that will reach its lowest point during the first half of 2023. We expect it to be short-lived. GDP will grow by 0.4 per cent in 2023 and climb to 2.7 per cent in 2024. Energy price trends indicate that inflation has peaked and will start to decelerate.

In the third quarter, GDP fell by 0.6 per cent year-on-year, led by decreases in construction and wholesale trade. Manufacturing rebounded by 5.3 per cent year-on-year and retail sales by 10.7 per cent in November, partly reflecting earlier pandemic effects that will still be in play in the first quarter of 2023. This underlines that there is bumpy road ahead. In December, manufacturing sentiment improved. In retail and services, sentiment even turned positive, but in construction the business environment worsened. We expect that the lowest point in the economic cycle will be during the first half of this year. Growth should then recover during the second half of the year.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	4.1	1.6	0.4	2.7
Household consumption	8.5	8.4	1.0	3.5
Exports	5.9	9.8	2.8	3.7
Unemployment*	7.6	7.0	7.4	7.2
Wages and salaries	11.8	7.3	7.5	6.7
HICP inflation	3.3	17.1	9.0	2.9
Public sector fiscal balance**	-7.0	-5.2	-2.9	-2.5

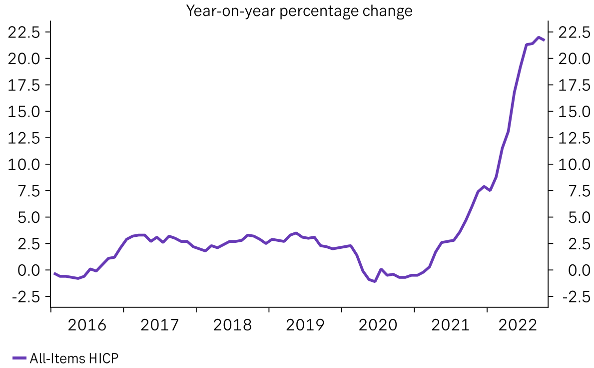
*% of labour force **% of GDP. Source: Statistics Latvia, SEB

Export growth is normalising from high levels. In November it was still 20 per cent. Despite headwinds, growth in exports could be maintained. We expect more negative impact from the Russian economy as ties so far have barely decreased. The most challenging thing will be to revive construction. With cost pressure easing and bureaucracy adapting, activity should gradually thaw as pressure increases to start spending EU funds. Despite the first negative monthly reading in two years (-0.5 per cent) the year-on-year inflation rate was 20.8 per cent in December. Falling energy and commodity prices will set the stage for a faster decrease in inflation down the road, especially during the second half of 2023. Our inflation forecast is 9 per cent this year and 2.9 per cent in 2024.

Near-term challenges for consumption. But receding inflation and compensation measures for households should favour consumption. The real estate market will switch to a wait-and-see mood and some segments will face price decreases of up to 10 per cent. Widespread setbacks are not expected, since the supply of new projects is scarce and price growth in recent years has been quite mediocre.

The labour market is cooling. In Q3 2022, unemployment increased slightly to 6.9 per cent. Layoffs could intensify somewhat early in 2023 and then stabilise. Business owners will be cautious about hiring. The number of vacancies is decreasing, but it is still relatively high. The job seeker rate at the end of 2023 is forecast at 7.3 per cent. Cooling labour market will lower wage pressure. In Q3 2022, wages and salaries rose by 6.3 per cent. It appears as if businesses are hesitant to compensate employees for the surging cost of living. In 2023, average pay growth is forecast at 7.5 per cent. Part of this will be driven by a minimum wage increase. Purchasing power may start to recover in Q3.

Inflation has peaked
Year-on-year percentage change



Source: Eurostat, Macrobond, SEB

A new government: In December, New Unity, United List and National Alliance signed an agreement to establish a coalition government. With the largest number of parliamentary seats, the NU is represented by seven ministers, including Prime Minister Krišjānis Kariņš. The NA and the UL hold four ministerial posts each.

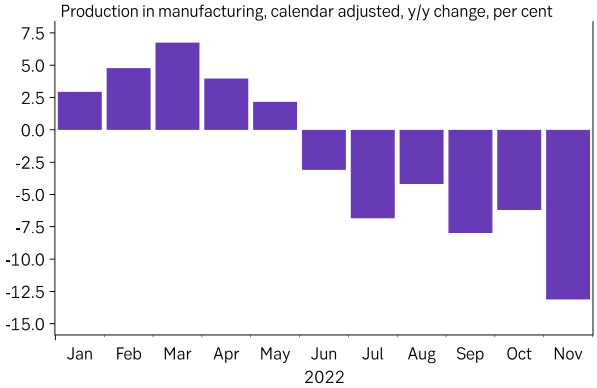
Estonia
Weak exports are leading the recession

The 2.4 per cent drop in GDP in Q3 2022 was a negative surprise, but this figure will probably be revised higher. However, a lower base makes achieving positive GDP growth in 2023 more likely in the prevailing uncertain economic environment. We expect the economy to grow by 0.2 per cent in 2023, supported by resilience in domestic demand and improving exports during the second half of the year. After two years of stagnation, a broad-based upturn of 3.5 per cent will follow in 2024.

Manufacturing is in trouble. For now, the biggest problems have emerged in the manufacturing sector. A downturn in Nordic real estate markets, especially in Sweden, has seriously dented demand for important Estonian export items such as prefabricated houses and furniture. Industrial production has been declining since June, and in industries such as wood processing and furniture manufacturing the drop in output has reached 20 per cent year-on-year. While the global economy is expected to improve during the second half of 2023, it will take much longer for Nordic housing markets to improve. Due to that, exports will stagnate in 2023 but will improve by 4.5 per cent in 2024.

A large decline in manufacturing output

Production in manufacturing, calendar adjusted, y/y change, per cent



Source: Eurostat

Slowdown in the real estate market. The housing market has also decelerated in Estonia. Apartment sales in the capital Tallinn decreased by 30 per cent in Q4 2022 and sales are expected to fall even further. In some segments, prices have been adjusted downward, but a large drop will probably be avoided since real estate developers are well capitalised and wages continue growing at a healthy pace. Also, household indebtedness in Estonia remains far below the levels seen in the Nordic countries, making it less vulnerable to rising interest rates.

Domestic demand continues to show resilience. After falling for three consecutive months, retail sales unexpectedly increased in November by 1.9 per cent on a month-to-month basis. Consumer sentiment has improved slightly but remains at a very low level in historical terms. As long as the labour market is still in relatively good shape, the demand for goods and services will persist. We expect private consumption to increase by 0.3 per cent in 2023 and 3.5 per cent in 2024.

Change of tides in the labour market. The situation in the labour market is good for the time being, but unemployment has started to increase. In December, registered unemployment reached 8.0 per cent, which is the highest level since May 2021. Employment expectations have worsened in recent months and the jobless rate will continue to climb higher in 2023. At the same time, the number of vacancies remains relatively high, meaning that at least for some, the period of unemployment will be short-lived. We expect unemployment to reach 7.5 per cent in 2023, before falling back to 6.0 per cent in 2024.

Inflation has hit a plateau. Inflation, which averaged 19.4 per cent in 2022, has finally eased. In December, consumer prices even slightly decreased on a monthly basis. The difference in prices compared to early 2022 nevertheless remains high. We expect an annual inflation of 8.5 per cent in 2023.

Elections on the agenda. Parliamentary elections will be held in early March. The outcome remains unclear, depending on the number of parties that are able to surpass the electoral threshold. The personal income tax has become a topic of debate, which could lead to some changes in the current system.

Key data
Year-on-year percentage change

	2021	2022	2023	2024
GDP	8.0	-0.4	0.2	3.5
Private consumption	6.3	2.6	0.3	3.5
Exports	19.9	4.6	0.0	4.5
Unemployment*	6.2	5.8	7.5	6.0
Wages and salaries	6.9	8.6	7.5	6.5
HICP inflation	4.5	19.4	8.5	2.0
Public sector fiscal balance**	-2.3	-2.0	-3.5	-3.0

*% of labour force **% of GDP. Source: Eurostat, SEB

Global key indicators

Yearly change in per cent

	2021	2022	2023	2024
GDP OECD	5.7	2.9	0.7	1.7
GDP world (PPP)	6.0	3.3	2.5	3.3
CPI OECD	4.0	9.6	6.4	2.6
Oil price, Brent (USD/barrel)	71	99	110	100

US

Yearly change in per cent

	2021 level, USD bn	2021	2022	2023	2024
Gross domestic product	23,315	5.9	2.0	0.5	1.2
Private consumption	15,903	8.3	2.9	0.9	1.2
Public consumption	3,354	1.3	-0.3	1.6	1.2
Gross fixed investment	4,940	5.6	0.4	-1.8	1.7
Stock building (change as % of GDP)	-19.1	0.2	0.6	-0.4	0.0
Exports	2,540	6.1	6.5	1.0	2.6
Imports	3,401	14.1	7.8	-2.3	2.7
Unemployment (%)		5.4	3.6	4.0	4.9
Consumer prices		4.7	8.0	3.5	2.2
Core CPI		3.6	6.1	4.4	2.2
Household savings ratio (%)		12.0	4.0	4.2	4.4
Public sector financial balance, % of GDP		-10.9	-4.0	-5.5	-6.5
Public sector debt, % of GDP		128	122	124	127

Euro area

Yearly change in per cent

	2021 level, EUR bn	2021	2022	2023	2024
Gross domestic product	12,314	5.3	3.4	0.0	1.9
Private consumption	6,289	3.8	4.1	-0.1	1.3
Public consumption	2,718	4.3	1.1	1.0	1.9
Gross fixed investment	2,702	3.6	4.7	3.8	2.8
Stock building (change as % of GDP)		0.3	0.4	-0.4	-0.2
Exports	6,070	10.5	7.5	4.4	4.0
Imports	5,591	8.3	9.0	7.3	3.8
Unemployment (%)		7.7	6.7	6.9	7.9
Consumer prices		2.6	8.4	5.3	1.2
Core CPI		1.5	3.9	4.3	2.5
Household savings ratio (%)		15.3	9.0	11.0	12.0
Public sector financial balance, % of GDP		-5.1	-3.9	-3.0	-2.5
Public sector debt, % of GDP		95.4	95.9	94.8	93.5

Other large countries

Yearly change in per cent

	2021	2022	2023	2024
GDP				
United Kingdom	7.6	4.0	-1.2	0.7
Japan	2.1	1.9	1.8	1.3
Germany	2.6	1.8	-0.3	2.4
France	6.8	2.5	0.5	2.5
Italy	6.7	3.8	0.3	1.8
China	8.1	3.0	5.5	4.9
India	8.3	6.8	6.0	6.2
Brazil	4.8	3.0	0.8	2.0
Russia	4.7	-4.0	-3.0	1.5
Poland	5.7	4.5	1.0	2.5
Inflation				
United Kingdom	2.6	9.1	7.6	2.7
Japan	-0.2	2.5	4.3	2.3
Germany	3.2	8.7	4.7	1.2
France	2.1	5.9	4.4	1.3
Italy	1.9	8.7	7.7	1.3
China	0.9	2.0	3.0	2.4
India	5.1	6.8	5.2	4.5
Brazil	8.3	10.2	8.0	6.0
Russia	6.7	14.0	8.0	10.0
Poland	5.1	13.7	10.0	4.0
Unemployment (%)				
United Kingdom	4.5	3.8	4.8	5.3
Japan	2.8	2.6	2.5	2.4
Germany	3.6	3.0	3.0	3.7
France	7.9	7.3	7.3	7.9
Italy	9.5	8.1	8.2	8.2

Financial forecasts

Official interest rates	21-Jan	Jun-23	Dec-23	Jun-24	Dec-24
US	4.50	4.75	4.50	3.50	3.00
Japan	-0.10	0.20	0.30	0.30	0.30
Euro area, deposit rate	2.00	3.25	3.25	3.00	2.50
United Kingdom	3.50	4.00	4.00	4.00	3.50
Bond yields, 10 year					
US	3.39	3.40	3.00	2.90	2.80
Japan	0.41	0.25	0.25	0.25	0.25
Germany	2.02	2.30	2.00	2.00	1.90
United Kingdom	3.30	3.50	3.20	3.00	2.70
Exchange rate					
USD/JPY	128	128	125	123	120
EUR/USD	1.08	1.06	1.08	1.10	1.12
EUR/JPY	139	136	135	135	134
EUR/GBP	0.81	0.89	0.91	0.92	0.93
GBP/USD	1.33	1.19	1.19	1.20	1.20

Sweden

Yearly change in per cent

	2021 level, SEK bn	2021	2022	2023	2024
Gross domestic product	5,450	5.1	2.9	-1.2	1.1
Gross domestic product, working day adjustment		4.9	3.0	-1.0	1.1
Private consumption	2,394	6.0	2.9	-1.7	1.2
Public consumption	1,409	2.8	-0.3	0.4	-0.2
Gross fixed investment	1,397	6.4	5.5	-3.1	-0.3
Stock building (change as % of GDP)	16	0.3	1.2	-0.7	0.0
Exports	2,479	7.9	4.2	-2.0	4.0
Imports	2,246	9.6	6.9	-4.3	2.6
Unemployment, (%)		8.8	7.5	8.1	8.5
Employment		0.9	2.8	0.0	-0.4
Industrial production		7.4	0.7	0.0	2.5
CPI		2.2	8.4	9.1	2.5
CPIF		2.4	7.7	6.2	1.6
Hourly wage increases		2.6	2.7	4.5	3.2
Household savings ratio (%)		15.5	11.9	12.3	11.9
Real disposable income		3.1	-0.3	-2.5	1.8
Current account, % of GDP		6.3	3.5	4.5	4.0
Central government borrowing, SEK bn		-78	-164	-10	10
Public sector financial balance, % of GDP		-0.1	1.2	0.4	-0.7
Public sector debt, % of GDP		36.3	31.5	29.8	30.8

Financial forecasts	21-Jan	Jun-23	Dec-23	Jun-24	Dec-24
Policy rate	2.50	3.00	3.00	2.75	2.25
3-month interest rate, STIBOR	2.86	3.05	3.05	2.80	2.35
10-year bond yield	1.85	2.30	2.20	2.20	2.10
10-year spread to Germany, bps	-0.17	0.00	0.20	0.20	0.20
USD/SEK	10.37	10.05	9.49	9.23	8.97
EUR/SEK	11.19	10.65	10.25	10.15	10.05
KIX	125.2	118.8	114.0	112.6	111.1

Finland

Yearly change in per cent

	2021 level, EUR bn	2021	2022	2023	2024
Gross domestic product	252	3.0	2.0	-0.3	1.4
Private consumption	128	3.5	2.4	-0.2	1.5
Public consumption	62	3.2	2.7	0.8	1.0
Gross fixed investment	60	1.6	3.8	-1.0	2.0
Stock building (change as % of GDP)	1	0.3	1.3	0.0	0.5
Exports	99	5.4	3.0	-0.5	2.0
Imports	99	6.0	6.9	-3.5	2.0
Unemployment, OECD harmonised (%)		7.6	6.8	7.1	6.9
CPI, harmonised		2.1	7.2	4.5	1.5
Hourly wage increases		2.3	2.6	4.0	3.0
Current account, % of GDP		0.7	-3.5	-0.8	0.3
Public sector financial balance, % of GDP		-2.7	-1.8	-2.7	-2.0
Public sector debt, % of GDP		72.4	71.5	72.5	73.0

Norway

Yearly change in per cent

	2021 level, NOK bn	2021	2022	2023	2024
Gross domestic product	3,595	3.9	3.1	0.6	2.0
Gross domestic product (Mainland)	3,193	4.1	3.5	-0.5	1.1
Private consumption	1,572	4.5	6.6	-0.5	1.4
Public consumption	949	4.9	-0.1	1.6	2.3
Gross fixed investment	939	-1.2	4.6	0.2	3.6
Stock building (change as % of GDP)		-0.3	0.1	0.0	0.0
Exports	1,176	5.5	1.1	4.4	3.0
Imports	1,167	1.7	6.9	1.0	7.0
Unemployment (%)		4.4	3.2	3.6	3.8
CPI		3.5	5.8	5.4	3.0
CPI-ATE		1.7	3.9	5.2	3.1
Annual wage increases		3.5	3.9	4.7	3.8

Financial forecasts	**21-Jan**	**Jun-23**	**Dec-23**	**Jun-24**	**Dec-24**
Deposit rate	2.75	2.75	2.75	2.50	2.25
10-year bond yield	2.81	2.95	2.60	2.55	2.45
10-year spread to Germany, bps	79	65	60	55	55
USD/NOK	9.93	9.43	9.03	8.77	8.62
EUR/NOK	10.72	10.00	9.75	9.65	9.65

Denmark

Yearly change in per cent

	2021 level, DKK bn	2021	2022	2023	2024
Gross domestic product	2,504	4.9	3.0	0.0	2.5
Private consumption	1,106	4.3	-2.1	0.1	2.8
Public consumption	608	4.2	0.9	0.6	0.8
Gross fixed investment	566	6.5	4.6	2.2	6.0
Stock building (change as % of GDP)		0.0	0.5	0.0	0.0
Exports	1,494	8.1	7.0	1.0	4.1
Imports	1,315	8.2	3.5	2.3	4.9
Unemployment, OECD harmonised (%)		4.6	4.8	5.2	4.6
CPI, harmonised		1.9	7.7	3.8	1.6
Hourly wage increases		2.3	2.5	2.6	3.3
Current account, % of GDP		8.3	14.0	10.0	8.0
Public sector financial balance, % of GDP		2.6	3.0	2.0	2.5
Public sector debt, % of GDP		40.0	35.0	34.0	32.0

Financial forecasts	**21-Jan**	**Jun-23**	**Dec-23**	**Jun-24**	**Dec-24**
Deposit rate	1.75	3.00	3.00	2.50	2.25
10-year bond yield	2.28	2.55	2.25	2.25	2.15
10-year spread to Germany, bps	26	25	25	25	25
USD/DKK	6.90	7.03	6.91	6.78	6.66
EUR/DKK	7.44	7.45	7.46	7.46	7.46

Lithuania

Yearly change in per cent

	2021 level, EUR bn	2021	2022	2023	2024
Gross domestic product	56	6.0	2.2	0.1	3.5
Private consumption	33	8.1	1.0	0.0	3.8
Public consumption	10	0.9	0.5	0.6	0.0
Gross fixed investment	12	7.8	2.0	4.0	5.0
Exports	45	17.0	12.5	0.4	4.4
Imports	43	19.9	12.2	1.3	4.7
Unemployment (%)		7.1	5.9	6.9	6.8
Wages and salaries		10.5	13.0	9.0	6.5
Consumer prices		4.6	18.9	9.0	2.0
Public sector financial balance, % of GDP		-1.0	-0.5	-4.0	-1.6
Public sector debt, % of GDP		43.7	38.0	40.9	39.7

Latvia

Yearly change in per cent

	2021 level, EUR bn	2021	2022	2023	2024
Gross domestic product	32.9	4.1	1.6	0.4	2.7
Private consumption	18.0	8.5	8.4	1.0	3.5
Public consumption	6.6	4.4	1.9	2.7	2.5
Gross fixed investment	7.8	2.9	1.1	2.5	3.0
Exports	21.0	5.9	9.8	2.8	3.7
Imports	21.7	13.5	11.0	4.1	4.0
Unemployment (%)		7.6	7.0	7.4	7.2
Wages and salaries		11.8	7.3	7.5	6.7
Consumer prices		3.3	17.1	9.0	2.9
Public sector financial balance, % of GDP		-7.0	-5.2	-2.9	-2.5
Public sector debt, % of GDP		43.6	41.4	40.0	39.6

Estonia

Yearly change in per cent

	2021 level, EUR bn	2021	2022	2023	2024
Gross domestic product	31	8.0	-0.4	0.2	3.5
Private consumption	15	6.3	2.6	0.3	3.5
Public consumption	6	4.0	0.2	3.0	1.0
Gross fixed investment	9	2.8	-13.7	-2.0	5.0
Exports	25	19.9	4.6	0.0	4.5
Imports	25	21.0	4.1	-3.0	4.0
Unemployment (%)		6.2	5.8	7.5	6.0
Wages and salaries		6.9	8.6	7.5	6.5
Consumer prices		4.5	19.4	8.5	2.0
Public sector financial balance, % of GDP		-2.3	-2.0	-3.5	-3.0
Public sector debt, % of GDP		17.6	18.5	20.5	22.0

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This report was published on January 24, 2023.
Cut-off date for calculations and forecasts was January 20, 2023.