Press release

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Nordic Outlook: Economic recovery but higher risks, depressed key rates and bond yields – Nordic countries well equipped for upturn

Not unexpectedly, there are persistent debt problems in many countries. The shift from one economic growth engine to another is occurring more sluggishly than desired: private consumption and capital spending are not successfully filling the void emerging as the positive effects of fiscal stimulus programmes and inventory build-up fade away. The global recovery is continuing, but its loss of momentum is creating uncertainty – despite new promises from the US Federal Reserve (Fed) of new quantitative easing measures if needed. The US economic deceleration is unwanted and risky, while Asia's deceleration is proceeding as planned. Differences in the underlying balance situation are now increasingly important to the economic and financial outlook. Within the euro zone, divergences in growth and employment are widening, creating policy challenges. Two countries have delivered upside surprises in 2010 – Sweden and Germany.

In the OECD countries, economic growth is expected to end up at 2-2.3 per cent during the next couple of years, or somewhat below trend. We estimate the probability of a new global recession at 25 per cent. Inflation will continue downward, but the world will avoid deflation. Fiscal stimulus is largely off-limits to many countries, which opens the way for continued ultra-loose monetary policy; we expect both the Fed and the European Central Bank (ECB) to keep their key interest rates at today's low levels throughout 2011. The fragile recovery and weak governments are slowing the global reform agenda, and questions about future economic and fiscal policy frameworks and regulations are being postponed.

The Swedish economy has provided upside surprises in recent months. We expect GDP growth to reach 4.7 per cent in 2010, then decelerate to 2.9 per cent in 2011 and 2.3 per cent in 2012. Lower interest rates, tax cuts and a rapid upturn in exports – combined with the absence of falling home prices – have made possible a strong rebound in both output and employment after the deep recession. Unemployment will continue to fall from today's 8 per cent. The SEK 30-40 billion in room for reforms during 2011-2014 identified by the government can be spent without affecting the credibility of Sweden's stable central government finances.

"In a short period, conditions surrounding Sweden's Riksbank have changed. An ever-larger share of idle economic resources is being placed in service, especially in the labour market. The easing and postponement of the Basel Committee's proposal for credit market standards and governance will place greater responsibility for stabilisation policy on the Riksbank," says **Robert Bergqvist**, SEB's Chief Economist. "At its next four policy meetings, we expect the bank to raise its key interest rate, which will reach 1.50 per cent by February 2011. But inflation will remain low, and the risks to economic growth are on the downside due to international uncertainty. An excessively wide spread between short-term interest rates in Sweden and other countries may also strengthen the krona too much. So the Riksbank will slow down its rate-hiking. At the end of 2011 the repo rate will be 2.25 per cent and at the end of 2012 it will be 3.00 per cent. The krona will strengthen to 9.00 per euro at year-end and to 8.75 at the end of 2011."

"Debt retirement will continue to hamper recovery in many countries. In the United States, the adjustment in household savings now seems to be happening faster than expected, with a savings ratio that will reach 8 per cent next year," says **Håkan Frisén**, SEB's Head of Economic Research and editor in chief of *Nordic Outlook*. "This will lay the groundwork for a more stable upturn ahead, but over the next couple of years it will block a normal recovery dynamic. Even though the Fed is providing back-up by promising more monetary stimulus, the US economy will continue struggling with weak labour and housing markets, hard-pressed small businesses and weak public finances both at the federal and state level. The weak economy has helped erode confidence in President Obama, and the Democrats are likely to lose ground in this autumn's congressional elections."

Germany's strong competitive position is generating high growth there, while continued debt reduction is weighing down southern Europe. The euro zone economies are out of step with each other. We expect the German economy to grow by more than 3 per cent this year, while the Greek economy will shrink by some 4 per cent, for example.

"Euro zone austerity measures announced so far total about 1 per cent of GDP annually during 2010-2012," says **Tomas Lindström**, euro zone analyst at SEB Economic Research. "The acute crisis in southern Europe has been eased by bail-out loans and the enactment of belt-tightening programmes, but these countries are still struggling with major cost problems. There are still various lingering questions as to whether countries like Greece and Spain will have the stamina to implement a belt-tightening policy. However, there are many indications that euro zone capital spending is on its way up, whereas the willingness of households to consume is an uncertainty factor. But subdued economic growth in the euro zone need not have such an adverse impact on the labour market. Our analysis shows that growth as slow as 1 per cent anually is sufficient to keep unemployment at an unchanged level – well below the level required elsewhere."

Various countries in Asia are showing signs of economic deceleration, though from high levels. So far, Chinese authorities have been very cautious about letting their currency appreciate against the US dollar.

"China is capable of cooling down growth in a controlled way to a more sustainable pace," says economist **Andreas Johnson** of SEB Economic Research. "If China should show signs of overly rapidly deceleration, fiscal policy can be reactivated, since central government finances are still very strong. The government's caution about yuan appreciation may lead to resumed currency policy tensions with the US. On the other hand, today an internal revaluation that includes rising domestic wages also seems to be under way, and this will eventually take the edge off criticism from other countries."

Estonia, Latvia and Lithuania have resumed their economic growth, sustained by strong exports after a brutal adjustment process. We believe that the Baltic countries are now capable of 4-5 per cent annual growth in the next couple of years.

"They have strengthened their competitiveness mainly by means of continued internal devaluation, including sharp wage and salary cuts, but also due to stronger currencies in their immediate vicinity and a weaker euro," says **Mikael Johansson**, Eastern European and Baltic analyst at SEB Economic Research. "But domestic demand remains depressed and unemployment high. Estonia has been given the green light to join the euro zone in 2011, which has help strengthen market confidence throughout the region and push down interest rates. There are some lingering political risks in Latvia, which holds a parliamentary election in October, and in Lithuania, but these countries are sticking to their austerity policies, which seem to be paying off."

Because of the relative strength of the Swedish economy, the government that takes office after the September 19 election will be in a solid position. We foresee falling central government debt, approaching 25 per cent of GDP. A parliamentary situation that might lead to a minority government is expected to have only a minor impact.

"The credibility and stability of Swedish government finances is based on broad political support for the now 15-year-old fiscal policy framework," says economist **Daniel Bergvall** of SEB Economic Research, whose special focus is public finances. "This reduces the risks of any uncertainty in the parliamentary situation after the election. Effects on bond yields and on the krona will probably fade quickly."

With GDP growth of 4.7 per cent in 2010, Sweden will be in a leading position. But there are also risks.

“Looking further ahead, there is reason for some concern. Household credits have continued to grow at a rapid pace, diverging from the international pattern, **Håkan Frisén** says. “Experience shows that a build-up of debt as rapid as in Sweden usually ends rather abruptly. Economic policy makers in Sweden, both in fiscal and monetary policy, face the challenge of ensuring a soft landing for credit growth and home prices, which so many countries have failed to achieve.”

In 2010 international interest rates and bond yields have fallen sharply, reaching historically low levels. The situation is beginning to resemble Japan’s. The question is how normal today’s interest rates and yields are.

“Central banks’ key interest rates can remain low for a long time, expressinmg a need to ease debt reduction and counterbalance fiscal austerity packages. Assuming continued low inflation, our analysis shows that a normal key interest rate of around 2.5 per cent is not unreasonable in the medium term,” says **Robert Bergqvist**. “A normal long-term yield may be about 1 per cent higher, that is, 3.5 per cent. On the basis of these levels, today’s interest rates and yields do not seem exceptionally low, viewed in a future perspective.”

Key figures: International and Swedish economy

International economy. GDP, year-on-year changes, %	**2009**	**2010**	**2011**	**2012**
United States	-2.6	2.6	2.2	2.9
Euro zone	-4.1	1.6	1.3	1.5
Japan	-5.2	2.5	1.5	1.5
OECD	-3.3	2.2	2.0	2.3
China	8.7	10.0	9.0	8.0
Baltic countries	-15.6	0.4	4.2	4.5
The world (purchasing power parities, PPP)	-0.6	4.4	3.8	4.3
Swedish economy. Year-on-year changes, %	**2009**	**2010**	**2011**	**2012**
GDP, working day corrected	-5.0	4.4	2.9	2.7
GDP, actual	-5.1	4.7	2.9	2.3
Unemployment, % (EU definition)	8.3	8.5	7.8	7.6
Consumer Price Index (CPI) inflation	-0.3	1.2	1.7	2.2
Government net lending (% of GDP)	-1.0	-0.5	-0.6	0.3
Repo rate (December)	0.25	1.25	2.25	3.0
Exchange rate, EUR/SEK (December)	10.24	9.00	8.75	8.80

Watch the film clip at SEB Newsroom where Håkan Frisén tells more about Nordic Outlook.
Full Report to be picked up at: www.sebgroup.com, and SEB Newsroom.

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