Press release

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Nordic Outlook: A world economy that is staggering under demanding debt burdens and political tensions

The global economic situation is serious but not unmanageable. Amid a sluggish economic climate in the next couple of years, the **OECD countries will achieve annual GDP growth of only 1-2 per cent**. Perceived economic risks are tilted towards the downside, with a **recession risk of 30 per cent**. Unemployment, especially among young people, will get stuck at high levels in many countries and will be a source of social and political unrest. One bright spot in this economic gloom is **growth in China and elsewhere in Asia**. The region will be affected by the weakening of the US and European economies, but given the absence of major debt problems its economic policy makers will have room for flexibility. The outcome will be **annual growth close to trend (6-8 per cent)**. A number of important decisions, which must be made in the near future, will determine whether the recession risk increases or decreases. Both when it comes to long-term budget austerity and short-term stimulus measures, the US Congress's willingness to work together will be tested. The euro zone countries must approve the July 21 crisis agreement, after which their capacity to take decisive action on common sovereign debt and fiscal policy issues will also be tested. In addition, decision makers will have to address issues related to government debt restructuring. Meanwhile a weakened banking sector must regain its strength through recapitalisation.

There is **no quick fix** that will resolve these issues. The world has to deal with deep-seated systemic problems, which will require systemic solutions transcending national boundaries. The necessary adjustment processes will continue for another few years. The world economic situation **deteriorated this summer** due to negative interactions among various problems: 1. a continued need for sovereign and household **debt reorganisation**; 2. a **loss of economic dynamism** due to the fading effects of the enormous 2009-10 stimulus measures, plus the increasing negative impact of shrinking wealth; 3. an almost **empty economic policy toolkit**; 4. **incomplete repairs** in financial sector balance sheets following the global recession, and 5. signs of **weak political resolve** at both the national and international levels. This makes today's set of problems more complex than the ones prevailing before the autumn 2008 crisis.

The future of the euro is being questioned, mainly in light of the currency union's institutional weaknesses. The German economy has underlying strengths, but because of the international slowdown it will show below-trend growth. This will increased the strains on the euro and the need for aid from the Group of 20 and the International Monetary Fund. **The choice today is between increasing supranational authority or scrapping the euro**. Every step that the euro zone political system takes towards federalism without enlisting the support of the citizenry for this whole concept will increase the risk of a severe political and democratic hangover.

There is increasing pressure on central banks to maintain historically low, near-zero interest rates as financial reorganisation policies are approved and implemented. The inflation rate is falling in Western economies, giving the central banks a degree of freedom to enact further stimulus measures. **We expect both the US Federal Reserve (Fed) and the European Central Bank (ECB) to leave their key interest rates unchanged during the rest of 2011 and throughout 2012**. The Fed will not raise its key rate during 2013 either. Further stimulus measures will be carried out using unconventional methods; for example, we expect the Fed to buy an additional USD 1 trillion worth of government bonds during the coming six months. The effects of these unconventional methods are unclear, but such policies are not especially risky in the current economic environment. Nor can it be ruled out that regulatory instruments will be used for the purpose of ensuring credit flows to needy economic sectors. Combined with low inflation pressure, this implies that long-term bond yields will remain very low. We expect only a minor upturn from today's exceptionally depressed levels.

Because of growing global problems, **Sweden faces a new situation that will alter the assumptions underpinning its economic policies**. Due in part to the country's cyclically sensitive export sector, growth will reach only **1.4 per cent in 2012 and then climb somewhat to 2.6 per cent in 2013**. Unemployment will thus stop falling during 2012 and will level out at a troublingly high 7 per cent. The government's latest economic forecast thus strikes us as too optimistic in a somewhat longer perspective. In the space of a few months, the circumstances surrounding Sweden's 2011-12 wage round has changed. As a result, pay increases in 2012 will now be 3.5 per cent, or half a percentage point lower than in our previous forecast. The credit and housing markets have decelerated faster than expected. **We expect home prices to fall by 10 per cent** during the next two years, afrer a 200 per cent upturn since 1995. History shows a downside risk in home prices, and this normally also has rather large consequences for consumption and growth. The focus of economic policy will thus be on stabilising the housing market, rather than on cooling it off.

Swedish government finances will remain strong, but will be somewhat weaker than previously estimated. Privatisations of state-owned enterprises will be on hold during 2012. General government gross debt will fall to 30 per cent of GDP in 2013. Fiscal policy will be less expansionary, and there will be gradually increasing pressure on the Riksbank to be cautious about hiking its key interest rate. Inflation expectations are troublingly high, which is one reason why the Riksbank wants to await further signals of economic slowdown before ending its current rate hiking cycle. But due to below-trend growth, downside risks in the housing market, controlled low inflation and low key interest rates in other countries, after a hike to 2.25 per cent this autumn the Riksbank can keep its repo rate unchanged at that level throughout 2012. During 2013 it will hike the key rate further to 2.75 per cent. The krona is stable and has room to strengthen to SEK 8.70 per euro, which implies that the krona remains undervalued.

The other Nordic countries have relatively good overall potential to show resilience in the face of the international slowdown by virtue of their strong economic fundamentals. In **Denmark**, growth will be slow in the near future, but a more expansionary fiscal policy and pent-up consumption and capital spending needs will lead to gradually rising economic activity and GDP growth of 1.7 per cent in 2012 and 2.3 per cent in 2013. The **Finnish economy** is sensitive to variations in global demand, but falling unemployment will result in stronger potential consumption, lifting GDP growth to around 2.5 per cent annually in 2012 and 2013. The **Norwegian economy** has the best growth potential among the Nordic countries thanks to solid public finances, oil income, capital spending and a strong labour market. We estimate that Norway's GDP growth in Norway will be just above the 2.5 per cent trend level both in 2012 and 2013.

After surprisingly strong growth in the three Baltic countries during the first half of 2011, we foresee continued gradual recovery over the next two years. A fading export boom will be replaced by a cautious upturn in domestic demand. We expect Estonia and Lithuania to implement some fiscal stimulus measures as inflation slows, which will stimulate purchasing power. **GDP growth in Estonia, Latvia and Lithuania will end up in the range of 4-5 per cent annually in 2012 and 2013**.

Key figures: International and Swedish economy

International economy. GDP, year-on-year changes, %	2010	2011	2012	2013
United States	3.0	1.5	1.8	2.7
Euro zone	1.7	1.7	1.0	1.5
Japan	4.0	-0.6	2.9	2.2
OECD	2.9	1.7	1.8	2.1
China	10.3	9.2	8.4	8.8
Nordic countries	2.9	2.6	1.9	2.6
Baltic countries	1.4	5.7	3.7	4.4
The world (purchasing power parities, PPP)	5.1	4.0	3.5	3.9
Swedish economy. Year-on-year changes, %	**2010**	**2011**	**2012**	**2013**
GDP, actual	5.7	4.3	1.4	2.6
GDP, working day corrected	5.4	4.3	1.8	2.6
Unemployment, % (EU definition)	8.4	7.4	7.1	7.1
Consumer Price Index (CPI) inflation	1.2	3.1	2.1	1.9
Government net lending (% of GDP)	-0.2	0.6	0.2	0.4
Repo rate (December)	1.25	2.25	2.25	2.75
Exchange rate, EUR/SEK (December)	8.98	9.15	8.85	8.70

For further information, please contact
Robert Bergqvist, +46 70 445 1404
Håkan Frisén, +46 70 763 8067
Daniel Bergvall, +46 8 763 8594
Mattias Bruér, +46 8 763 8506
Olle Holmgren, +46 8 763 8079
Mikael Johansson, +46 8 763 8093
Andreas Johnson, +46 8 763 8032
Tomas Lindström +46 8 763 8028

Press contact
Elisabeth Lennhede, Press & PR
+46 70 763 9916
elisabeth.lennhede@seb.se

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