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Nordic Outlook

Global: Credit market turmoil slows growth and softens central banks
Nordics: Continued economic strength and higher inflationary pressures

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SEB

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The global economy: Credit market turmoil slows growth, softens central banks

- **The world economy will not avoid secondary effects** from the US home mortgage loan crisis, which is expected to continue for at least another six months. The negative GDP growth effect will be 0.3-0.5 per cent, yet the world economy will keep growing above trend during the next couple of years.
- **The long growth period is now leading to inflationary tendencies**, noticeable in the Nordic and Baltic countries, the UK, China and elsewhere. Central banks must weigh these partly late-cyclical phenomena against greater global growth risks, while getting some help from tight credit conditions to achieve an often welcome deceleration.
- **The US slump will be more protracted**. GDP growth will reach only about 2 per cent both this year and next. The housing market recovery will take time. Greater uncertainty about growth and a weaker labour market will force the Federal Reserve to speed its interest rate cuts, despite lingering inflationary risks. A year from now, the federal funds rate will stand at 4.0 per cent.
- **Euro zone growth is chugging along, helped by the German economy**. Rising private consumption, bolstered by strong labour markets, will help sustain growth in 2008 as well. The European Central Bank will raise its refi rate to 4.25 per cent, but the strong euro will prevent further hikes.
- **Companies will be forced to decide between price hikes and/or lower profit margins**. The economic picture and interest rate scenario will sustain a favourable stock market trend. Downward revisions of the profit outlook pose a risk.
- **The US dollar will lose its short-term interest rate support in the coming year**, forcing the EUR up to USD 1.44. The euro must bear a heavy burden since Asian currencies remains at low valuations. China's yuan will be slowly revalued, while structural flows and low interest rate policy will help keep the yen weak.

Sweden: Riksbank will continue to raise key rate

- GDP will grow by **3.6 per cent in 2007** and **3 per cent in 2008**. Export growth is slowing a bit, due in part to weaker American growth, but large capital spending needs and higher purchasing power will drive domestic demand, helping the economy resist the slowdown.
- Employment will continue upward. This year, job creation will reach 100,000, while in 2008 the rate of increase will slow to 60,000 and **unemployment will fall to 3½ per cent**. More sectors will have labour shortages. Cost pressures will rise as pay increases accelerate to more than 4½ per cent next year, while productivity growth slows.
- Underlying inflation will exceed 2 per cent by the end of 2008. We expect the **Riksbank** to continue hiking its key interest rate, despite more uncertain international conditions. At the end of 2007 the repo rate will be 4.0 per cent, and in mid-2008 it will reach 4.5 per cent. When the Riksbank closes the interest rate gap, the krona will appreciate.
- **Central government finances keep improving**. Public sector saving will far exceed the target, 1 per cent of GDP. The labour market situation is an argument against further fiscal stimulation, but the Finance Ministry will probably find it increasingly hard to resist pressure for further tax cuts or expenditure reforms, given the prevailing budget situation.

Other Nordic countries and the Baltics: Intensive economic boom

- **Denmark**: The economy is entering a calmer phase. Consumption is decelerating due to cooling in the property market. Greater resource shortages are also restraining growth and driving up inflation.
- **Norway**: The boom will soon culminate. After nearly 5 per cent growth this year, a slowdown will occur in 2008. Record-low unemployment and rising pay increases will drive domestic cost pressure. Norges Bank will raise its key rate to 5.75 per cent next year.
- **Finland**: Growth will soon peak, but GDP will increase at a healthy pace next year too. The labour market will continue to improve, and inflation will rise from a low level.
- Growth will slow modestly in the **Baltic countries**, but overheating risks remain. Although credit growth has eased slightly, inflation and current account deficits remain at high levels.

Contents

Serious challenges

- **Good growth, but slower due to credit crisis**
- **Fed's rate cuts will make adjustment easier**
- **European central banks will slow pace of hikes**
- **US dollar will weaken again**

Today the global economy is being subjected to strains. The secondary effects of the American home mortgage loan crisis have become clear in the global financial system. The US Federal Reserve is signalling markedly greater concern about the impact of this financial crisis on the real economy.

We assume that **the world's central banks will continue to put in place effective measures** that will counter the most acute paralysis generated by credit market instability. The crisis will still have a real impact, however, since more cautious lending and reduced risk appetite will slow the pace of investments and eventually also consumption.

GDP growth

Year-on-year percentage change

	2006	2007	2008	2009
United States	2.9	1.9	2.1	2.8
Japan	2.2	2.4	1.9	2.0
China	10.7	11.0	10.0	9.0
Euro zone	2.9	2.6	2.4	2.1
United Kingdom	2.8	2.9	1.9	2.2
Nordic countries	3.8	3.4	2.9	2.3
OECD	3.1	2.6	2.5	2.7
World economy	5.4	5.1	4.7	4.7

Sources: OECD, SEB

The impact will be clearest in the United States, where we expect a negative GDP effect of ½ percentage point. **The rest of the world will also be affected**, one reason being that various financial players are exposed to the American home mortgage market. Other indirect reasons will be lower demand from the US and a weaker dollar. We expect that the negative GDP effect in Western Europe will ultimately be limited to ¼ percentage point, for example.

What complicates the picture for many central banks is that the threats posed by the credit crisis must be weighed against a situation in which rising capacity shortages and mounting inflationary pressures point towards continued tightening of economic policy. This is true in many OECD countries as well as rapidly growing economies, especially China.

The global economy has continued to demonstrate impressive growth. The combination of new technology, globalisation and credible central banks provides underlying strength. These forces are contributing to a positive interaction between mature industrialised countries and new, fast-growing economies, mainly in Asia and Eastern Europe.

Strong household and corporate balance sheets, modestly valued share prices and rather cautious capital spending behaviour by companies to date are other stabilising forces. **Overall, we predict a mild deceleration of the world economy**, although the cyclical movements in various regions will be larger.

Measured as global GDP in purchasing power-adjusted terms, the slowdown will be moderate; GDP growth will decline gradually from 5.4 per cent in the peak year of 2006 to 4.7 per cent in 2009. **This may give an exaggerated impression of stability, however.** Using this increasingly established statistical convention, rapidly growing economies are assigned greater weight than their importance to financial trends would otherwise warrant, for example.

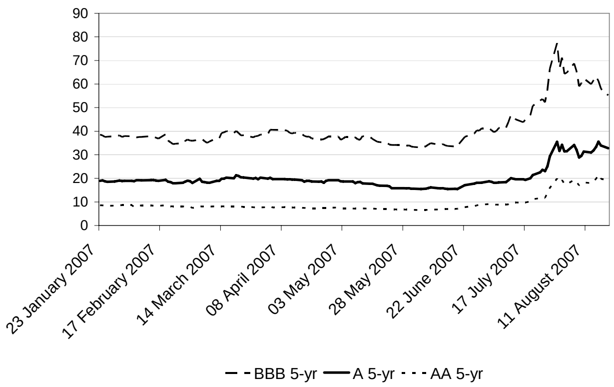
Hangover in the credit market

The problems in the American home mortgage loan market have proved larger than feared. The effects of previously **very low interest rates** combined with aggressive marketing of devious, **incomprehensible mortgage structures** are now becoming evident.

A credit market correction was expected, because in recent years spreads have narrowed in a way that has not corresponded to the risks that lenders have taken. However, this correction has strangled financing even to institutions and companies that would otherwise have had no problems. A large number of planned securities issues have had to be postponed, which shows how quickly the appetite for lending has changed.

Credit spreads in various risk classes, 2007

Basis points



Sources: Markit, SEB

Everyone naturally has a limited overview of various risks positions in an era of explosive financial growth, especially in the hedge fund industry. However, it is becoming increasingly apparent how loan losses stemming basically from the America sub-prime mortgage market have proliferated in the global financial system. As home mortgage institutions operating in this market have collapsed, many investors have been hurt. In many cases, exposure to the sub-prime market was wrapped inside loan derivative products that were incomprehensible even to the parties involved. A number of funds that have been deeply implicated have had to shut their doors completely, and losses in the banking sector are beginning to surface.

Minor consequences in real economy

Dramatic fluctuations in the credit environment and risk appetite may lead to more or less serious scenarios. When more and more market players become worried about their own risk-taking, fear and caution spread.

If trust vanishes and a "credit crunch" process begins, **the real economy is unfailingly affected**. Tighter credit directly affects economic activity by reducing capital spending and merger/acquisition activity. The effects then spread to the rest of the economy. Households are initially hit by tighter credit conditions, but eventually home prices and the labour market are also affected. In the next stage, companies that at first looked solvent and strong may be harmed by the general downward spiral in the economy.

Historical experience may serve as the basis for various scenarios for future developments.

- **The vanishing scenario:** Most bad patches in the financial markets prove to be relatively short-lived. So far, the stock market correction has been no larger than the one that occurred last spring. One conceivable scenario is that the actions of central banks will have the desired effect and the consequences will be minor. US home prices will be squeezed a bit further and credit spreads in certain risk categories will end up at more reasonable levels.

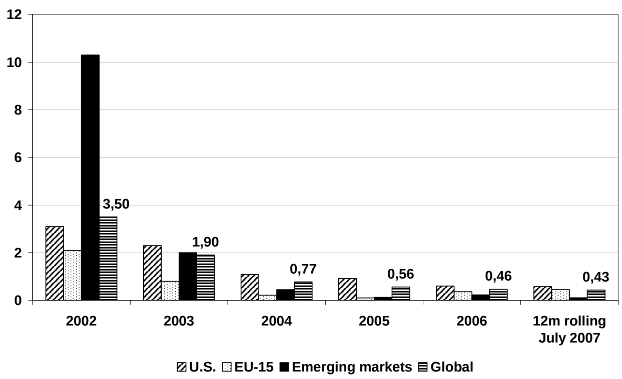
- **The interest rate adjustment scenario:** Credit market worries remain. The trend towards unstable share prices and confidence indicators will deepen. The risk of effects in the real economy will be significant. Central banks must intervene with interest rate adjustments in order to embolden economic players. There are various historical examples of how confidence can return rather quickly under the right circumstances. The events of 1998 in conjunction with the Russian financial crisis and the LTCM crash are one example. This scenario implies that interest rate adjustments, perhaps combined with fiscal stimulation, will limit the long-term impact on the overall economy and the stock market.

- **The recession scenario:** An even deeper downturn, where tendencies towards instability that we now see are the beginning of the end of the upturn that has dominated the world economy in the past four years. Such a scenario represents parallels with developments after the turn of the millennium. At that time, interest rate cuts were only able to slow the negative dynamism in the real economy and financial markets. The American economy slid into recession, with a global slowdown as a consequence. The stock market slump was long and deep.

In our judgement, **current problems are of a more serious nature** than those that have scared the markets on a number of occasions in recent years. These were often initiated by the perception that macroeconomic threats had become more likely. The outcome included short-term profit-taking, which pushed down stock markets, but no fundamental changes in economic conditions had occurred. This time, it seems obvious that the economic playing field has changed more clearly. The **vanishing scenario** thus does not seem especially probable.

Default rates

Per cent



Source: Standard & Poor's

However, we see a number of reasons why the effects of the current problems will be limited and why a recession can be avoided. This perception is based on an analysis of both the credit market situation and of the underlying shock absorbers in the financial and real economic environment.

Despite the turbulence of recent weeks, the fundamental creditworthiness of companies remains good. One bit of evidence is that the number of corporate bankruptcies is at historically low levels. During the first half of 2007, globally only 11 companies with ratings from Standard & Poor's have gone bankrupt. This is one important difference compared to the credit market instability just after the turn of the millennium.

The direct loan losses caused by problem households in the American residential market which cannot meet their obligations appear manageable for the financial system. Despite all the diffusion mechanisms that are now becoming apparent, ultimately the size of the fundamental problem should be of some importance in determining the likelihood of a recession.

It is also worth mentioning several factors in the underlying financial markets and real economy that will help reduce the risks of widespread secondary effects:

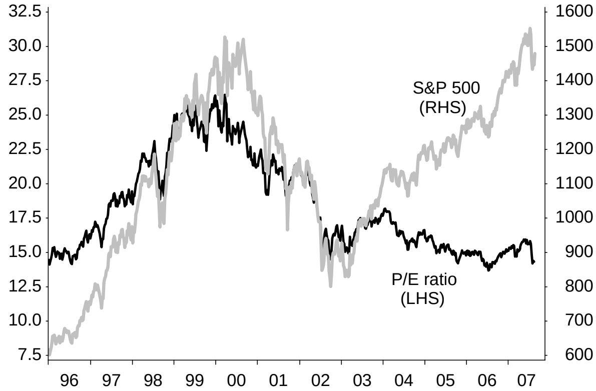
Lack of capital spending excesses: Strong corporate balance sheets combined with a relatively low level of capital spending represent an important source of resilience. In this respect, there is a significant difference compared to the turn of the millennium, when excessive capital spending in itself was among the causes of the subsequent downturn.

Moderate stock market valuation: The modest valuation of Western European and US stock markets, with price-earnings ratios in the 12-15 range, also represents a stabilising force. Here, too, the situation is different from the turn of the millennium.

Financially solid households: The wealth position of households is strong. Saving is at a relatively high level in most countries, with the US and the UK as important exceptions. It would probably require a rather large decline in home prices and a major weakening of the labour market to undermine household consumption as a stabilising force in the world economy.

Global driving forces: Stabilising forces in the form of dynamic growth in new economies and inflationary pressures in old economies are also important. At least for the moment, it looks as if the expansion in rapidly growing economies has reached a more mature phase, where the risks of recurring turbulence are less than they were a decade ago.

US: S&P 500 and P/E ratio



Sources: Standard & Poor's, Reuters

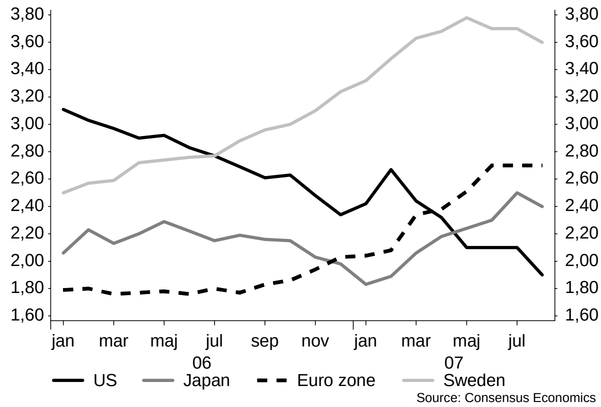
Our conclusion is that an **"interest rate adjustment scenario"** is currently the most likely alternative. This implies interest rate cuts in the US and, all else being equal, small rate hikes in Europe. The main risks that might trigger a recession scenario are if we now see a rapid downturn in profit expectations. This would push down share prices and undo the above valuation analysis. Another risk is that inflationary pressure will be unexpectedly strong. Central bank adjustments of interest rates might then create major credibility problems and jeopardise economic stability.

Continued upturn in Europe and Asia

The trend of consensus forecasts in the past year clearly illustrates **the decoupling that has occurred between different parts of the world economy**. Although forecasts for the US have continuously been lowered, growth prospects in Europe and Asia have not only held up but have gradually been raised. We have previously pointed to factors that have helped reduce the secondary effects from the American slowdown, for example that the downturn has had specifically American causes, while it has affected sectors with very little import content. However, the events of recent weeks have shown that if the crisis severely affects the financial system, global integration is too strong for its effects to be limited to the US only.

Consensus GDP forecast 2007

Year-on-year percentage change



Source: Consensus Economics

This decoupling means that **different parts of the world economy are now in different phases**. Whereas capacity utilisation is falling in the US, it is continuing to rise in Europe and in large parts of Asia. This trend brings with it **both risks and opportunities**. If the rest of the world can resist the ongoing American slowdown, the opportunities for high long-term global growth will increase once the American locomotive gets moving again.

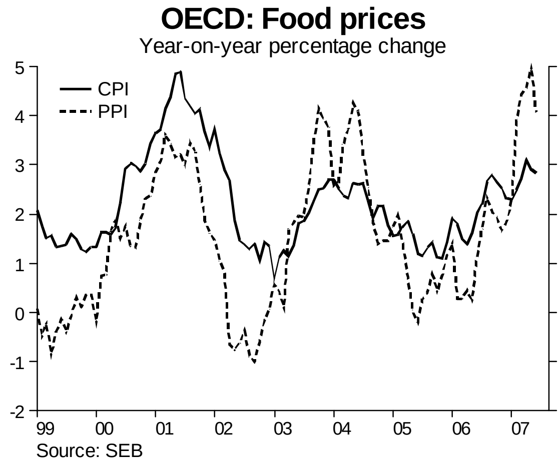
Our main forecast assumes that such interaction will occur:

- For more than a year, **the American economy** has grown well below trend. The problems in the housing sector are continuing to hamper the economy. Household consumption will decelerate in the wake of stagnating home prices and a weaker labour market. Corporate capital spending and rising exports will nevertheless enable the US to avoid a recession. GDP growth will end up at around 2 per cent both this year and next, or clearly below trend. Towards the end of next year, we anticipate a recovery, lifting growth towards its trend level in 2009.

- **Euro zone** growth still looks strong, despite some disappointment with second quarter GDP figures. The positive dynamic that dominates the economy will help lengthen the upturn and reduce the impact of credit market problems. Household consumption has still not got under way in earnest, but sustained by high employment and rising income, a thaw is on the way. Despite rising interest rates and a strong euro, we believe that the economy will continue to grow above trend next year. We expect GDP growth of 2.6 per cent this year and 2.4 per cent in 2008.

- High resource utilisation is the main obstacle to continued expansion in many **newly fast-growing economies**. Although both economic policy decision makers and forecasters are on unfamiliar ground, we foresee little risk of a sharp slowdown in growth in the next couple of years. **Eastern Europe and Asia** will thus continue to stimulate the world economy. The improved status of the **Japanese economy** will also provide support to the fast-growing countries of Asia.

- The **Nordic economies** will continue to grow robustly. Resource utilisation in **Denmark** and **Norway** has risen rapidly, and unemployment has reached record-low levels. A combination of capacity constraints and rising interest rates will lead to slower growth in 2008. In **Sweden** and **Finland**, growth will be strong both this year and next, but cyclical obstacles will gradually emerge in these countries as well.



Mounting inflationary risks

Inflationary pressure is now increasing for several reasons. Commodity prices have continued to rise. Rising resource utilisation in most countries will mean higher wage pressure. Meanwhile productivity growth has levelled off in many places, intensifying cost pressures. Over the past six months, food prices have climbed markedly around the world. In addition, there has been continued rapid money supply and credit expansion.

On the other hand, disinflationary forces in the world economy have remained powerful. Our assessment is that these, along with interest rate hikes, will suffice to **prevent a sharp upturn in inflation**. American core inflation has fallen, and euro zone inflation is being slowed by rising productivity growth, which will also help moderate the inflationary threat. In this respect, the euro zone deviates in an interesting way from the main trend in the OECD countries.

Fed cuts, continued hikes in the Nordics

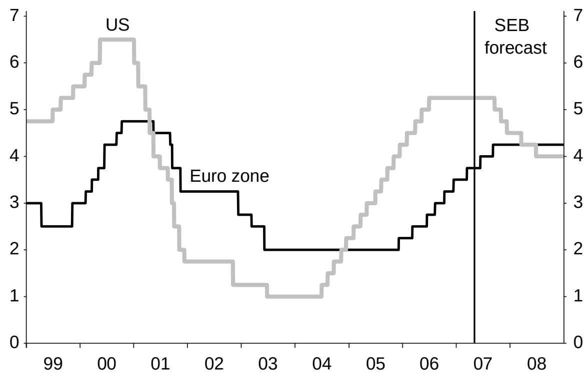
Most central banks have acted preventively to ward off inflationary tendencies. In particular, the central banks in Europe have continued their march towards higher interest rates at a fairly rapid pace. Good growth and mounting underlying inflationary pressure provide reasons for further rate hikes, while the impact of credit market instability may cause central banks to become more cautious.

Yet it is likely that for as long as possible, the banks will want to maintain the distinctions between the various tools at their disposal. All else aside, some of the adjustments in risk-taking that we are now seeing are changes that the central banks view as desirable. This implies that liquidity measures will mainly be used to ease the effects of credit market problems, while interest rate policy will continue to be governed by growth and the inflation outlook. However, in our assessment, credit market instability will change the growth and inflation trend in such a way that interest rate policy will also be affected:

The **Federal Reserve** has already acted by injecting liquidity into the financial system and by slashing its discount rate (the interest rate at which banks may borrow from the central bank). We expect the Fed to follow this up by cutting its most important and broadest key rate, the federal funds target. This autumn, it will lower the funds rate by 75 basis points, and next spring it will follow this up with a further 50 points, once the weakening of the labour market becomes more evident. The key rate will thus stand at 4.00 per cent by mid-2008.

Key rates

Per cent



Sources: ECB, Fed, SEB

The **European Central Bank will probably raise its refi rate to 4.25 per cent in September**. The ECB, too, has injected liquidity into the credit market. But the bank regards falling unemployment and inflationary threats further ahead as sufficient reasons to carry out one more rate hike. Due to the impact of the US deceleration and credit tightening, combined with continued rather low actual inflation, however, we believe that the ECB will carry out no further rate hikes.

The **Bank of England** will abstain from further repo rate hikes. In the prevailing international climate, the sizeable 125 basis point dose of interest rate hikes that the BoE has delivered in the past year should suffice to cool off the UK housing market and consumption, and eventually also high inflation.

The **Bank of Japan** will raise its key rate at a very cautious pace. Deflationary risks have emerged again, but continued economic recovery will probably weigh more heavily in the BoJ's scales. We anticipate hikes equivalent to 50 basis points per year, which should result in a level of 1.25 per cent by the end of 2008.

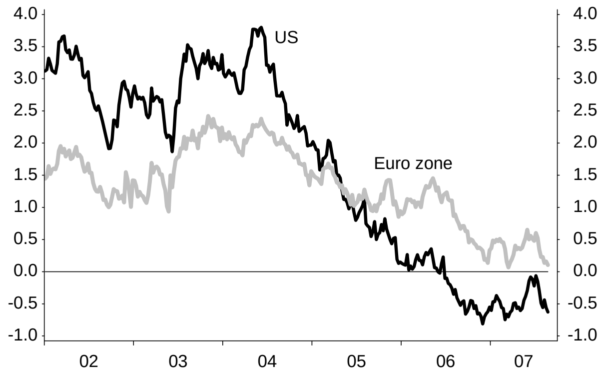
The Nordic central banks will continue to raise their key interest rates. Their economies are growing fast, and labour markets are becoming stronger. **Norges Bank**, which is battling increasingly clear overheating tendencies in Norway, will raise its sight deposit rate to 5.75 per cent during 2008. Last spring Sweden's **Riksbank** reversed its previously relaxed interest rate policy. We expect that the domestic reasons pointing towards continued normalisation of interest rates will prevail and that the Riksbank will keep raising the repo rate, reaching 4.50 per cent by mid-2008.

Long-term yields up slightly in Europe

The macroeconomic decoupling between the US and the euro zone has led to smaller spreads between their interest rates, both short- and long-term. Euro zone bond yields have trended higher in the wake of ECB rate hikes. Entirely in line with our forecast, the spread between German and American 10-year yields has narrowed from about 110 basis points a year ago to around 40 at present.

Slope of the yield curve

Differential between 10-year yield and key rate, %-points



Source: Reuters EcoWin

The actions of central banks will continue to be the most important driving force for long-term yields. In the US, the main trend will be downward for the next six months or so, as the Fed's key rate cuts begin, while the movement of German yields will be small once the ECB's key rate flattens out.

10-year government yields

Per cent

Sources: Reuters EcoWin, SEB

In the past year, the yield curve has had a **negative slope in the US**, while it is now **almost completely flat in the euro zone**. It is reasonable to assume rather flat yield curves in a somewhat longer perspective as well. The disinflationary forces of globalisation and the credibility of central banks in battling inflation will help keep down long-term yields. Finally, pension funds need to invest in long-term government securities. Taken together, this means that long-term yields both in the US and Germany will stay a bit **below 5 per cent** range during our forecast period.

In the Nordic countries, bond yields will be higher than in the euro zone. The negative spread between Swedish and German 10-year yields has nearly been eliminated in recent months. We anticipate that in the months ahead, economic strength and faster hikes in key interest rates will help push **Swedish long-term yields 10-15 basis points above German yields**. Norwegian long-term yields are now a full 60 points above Germany. The hot Norwegian economy also justifies significantly higher long-term yields, even though the spread may narrow somewhat. Towards the end of 2008, **the Norwegian 10-year yield will be 50 points** above the corresponding German yield.

Moderate valuation, but greater risks

The long global boom has benefited the world's stock exchanges. Low interest rates and good liquidity have driven up risk appetite. In some respects, this has led to bubble-like pricing. For example, some credit spreads have reached levels that do not reflect the risk that lenders have taken. A greatly improved awareness of these matters will now lead to higher risk premiums.

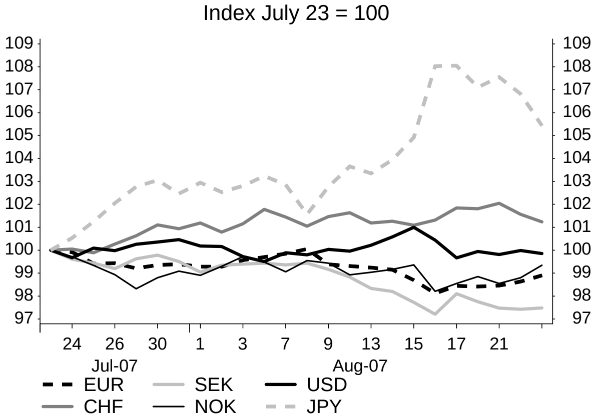
Stock markets will be dominated by continued instability for another while. Uncertainty about the secondary effects of the credit market tightening will weigh down prices. Also contributing to volatile stock market performance will be the fact that the risk of profit disappointments generally also rises as an economic expansion becomes more mature.

The trend of profits in the second quarter of 2007 provided positive surprises, however. This is especially true of the US, where the economic slowdown thus did not affect profitability. Meanwhile, stock market valuations are generally rather moderate, and after the correction of recent weeks, P/E ratios have come down further. Combined with our relatively favourable macroeconomic scenario, this implies **relatively good prospects for a favourable stock market trend in a slightly longer perspective**. The biggest risk that might precipitate a global stock market slide is a possible **escalation of the credit market crisis**, combined with cyclical cost pressure leading to **major downward revisions of the profit outlook**.

Underlying currency trends will continue

In the past year, our currency analysis has been guided mainly by short-term interest rate spreads. These spreads have driven a flow of funds into currencies with higher interest returns (carry trade). To some extent, changes in short-term interest rates can be interpreted as a re-evaluation of the medium-term growth potential of different regions, which has also affected currencies. Global imbalances in trade flows have also played a certain role for currency movements.

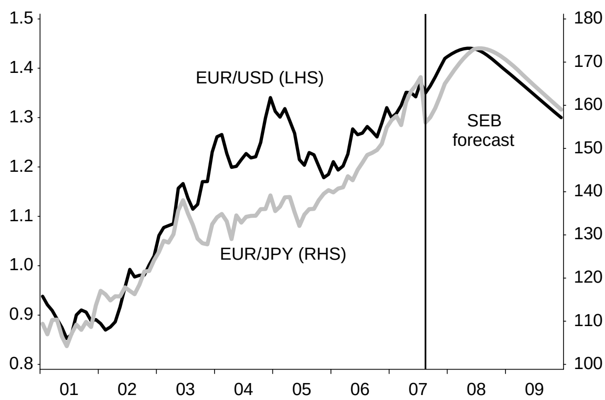
Exchange rates during recent market turmoil



Source: Reuters EcoWin

In recent weeks, financial market instability has meant that other driving forces have assumed the upper hand. **Reduced risk appetite has led to unwinding of carry trade positions**, which has strengthened currencies in typical low interest rate countries like Japan and Switzerland. In this climate, the USD and GBP have performed reasonably well, while such currencies as the euro, the Swedish krona and the Norwegian krone have weakened slightly.

Exchange rates EUR/USD and EUR/JPY



Sources: Reuters EcoWin, SEB

In the near future, these forces of instability may continue to dominate the foreign exchange market. In a longer time perspective, however, **the underlying driving forces will again assume the upper hand**. Interest rate spreads between the US and the euro zone will rapidly shrink. We then expect the strengthening of the euro to resume and anticipate that the yen will again weaken (see box). We expect the euro to be

Undervalued yen will remain weak

Right now the trend of the Japanese yen is a source of frustration to many people. Its real effective exchange rate reached record-low levels during the summer. Meanwhile Japan is continuing to generate current account surpluses of around 4 per cent of GDP. The yen thus appears fundamentally undervalued in a number of respects.

Japan: Nominal effective exchange rate

Source: J.P. Morgan

Against this backdrop, the yen appreciation of recent weeks seems natural. However, our view is that the forces that have pushed down the Japanese currency are of a relatively long-term nature:

- **Low interest rates:** Low interest rates make it attractive for Japanese exporters to re-invest their foreign currency revenue abroad. International investors also take out yen-denominated loans and invest in more high yielding assets, such as American government securities (carry trade).
- **Portfolio diversification:** Japanese households traditionally keep a large proportion of their wealth in low-yielding bank deposits. A deregulation of the banking sector is providing greater opportunities to improve returns by investing in foreign assets, including shares.
- **Increasing direct investments:** The increasingly strong ties between Japan and such Asian emerging economies as China and India are leading to rising direct investments in these countries.
- **Rising commodity prices:** The rising commodity prices of recent years have also pushed down the yen. Japan's import prices have increased much faster than its export prices (deteriorating terms of trade).

In the long term, the yen is thus likely to remain weak in an environment characterised by good global growth, high commodity prices and almost non-existent Japanese inflation. In this perspective, the BoJ's normalisation of monetary policy is too slow to push up the yen. Nor is an excessively large appreciation in the best interest of Japanese authorities, in light of the underlying domestic problems that the Japanese economy is still grappling with.

worth USD 1.44 by mid-2008. After that, the dollar will strengthen perceptibly when the American economy bounces back. The USD/JPY exchange rate will revert to around 120 by the middle of next year. This means that we are predicting a record-high EUR/JPY exchange rate of around 173 by mid-2008.

One theme in the May issue of ***Nordic Outlook*** was that exchange rate policy tensions are tending to rise. During the coming year, the **European currencies, mainly the euro, must bear the burden** in a world characterised by an American slowdown, lingering deflationary risks in Japan and China's unwillingness and inability to revalue its currency to a valuation based more on fundamentals. This could create an environment with rising protectionism, constituting a downside risk for global growth.

Extended slump

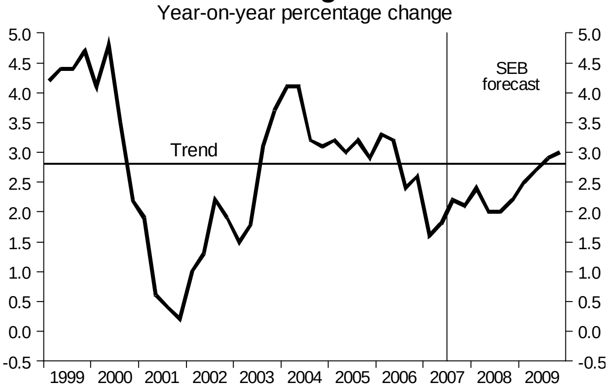
- **Growth of around 2 per cent again next year**
- **Housing sector will be economic drag anchor**
- **Higher unemployment but persistent inflation**
- **Fed will speed up interest rate cuts**

The problems in the American mortgage loan market have worsened. Their impact on the real economy is also being amplified by secondary effects via global financial markets, which to some extent influence economic activity on a broader front. Even if the acute crisis has largely been resolved, the economy will be hampered by a continued fall in residential construction, while household consumption will slow as the labour market weakens a bit.

We expect annual average GDP growth to end up at 1.9 per cent this year and 2.1 per cent next year. This implies that growth will remain **clearly below trend in both years and that the output gap will gradually widen**. Only in 2009 will growth revert to its long-term trend. In August, the consensus forecast for 2008 was still as high as 2.6 per cent, but this is likely to be adjusted downward at a rapid pace over the next few months.

US: GDP growth

Year-on-year percentage change



Sources: BLS, SEB

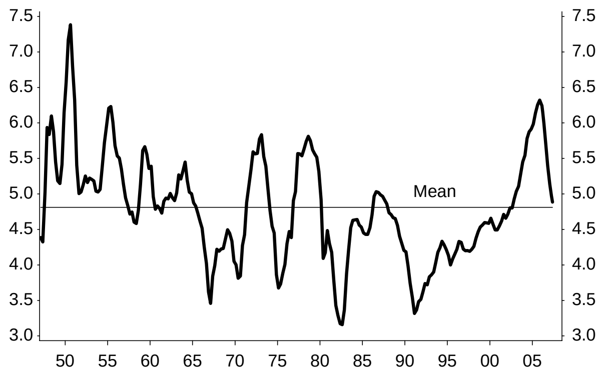
The deepening of the credit and mortgage loan crisis as well as increased risks to the entire global financial system quickly persuaded the Federal Reserve to express significantly greater concern about the real economic outlook. The Fed has already acted: first by injecting liquidity into the financial markets and then by cutting its discount rate (the interest rate at which banks can borrow from the Fed). We expect the Fed to follow up these measures by cutting the important federal funds rate in September and then slashing it by another 50 basis points before year-end. After that, the US central bank will cut its key rate by an additional 50 points to 4.0 per cent by mid-2008.

However, the late-cyclical patterns now evident in the economy imply a difficult balancing act for the Fed. Productivity growth has slowed. Along with continued high resource utilisation, rising commodity prices and a weak US dollar, this means that inflationary risks are still apparent. The forces behind the inflation worries that previously dominated the Fed's risk scenario are likely to linger behind the scenes for some time to come.

Recent American economic trends have been far from crystal-clear. The manufacturing sector recovered during the spring and summer. Large inventories, which hampered production, have been drawn down in many industries. Meanwhile the weak dollar, combined with a strong international economic situation, has benefited US exports. In the second quarter of 2007, net exports contributed more to economic growth than for many years. The long-term trend towards ever-larger US current account deficits has come to at least a temporary halt.

US: Residential construction

Per cent of GDP

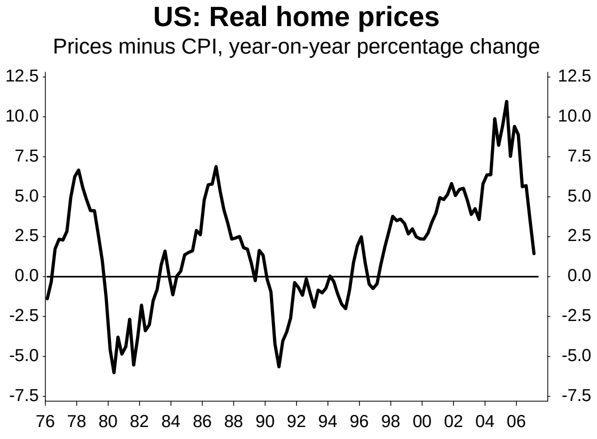


Source: US Department of Commerce

Meanwhile it is obvious that the renewed confidence in the manufacturing sector will have a hard time spreading to the rest of the economy, as long as problems persist in the housing sector. The fall in **residential construction has now been under way for more than a year**. The adjustment has progressed quite far. Residential construction as a percentage of GDP has dropped to levels on a par with the historical average. Most indicators point towards a continued downturn for a year or so. The adjustment process after a boom as vigorous as the one that we have seen in recent years will reasonably include a phase during which construction is well below the historical average.

Continued squeeze on home prices

The trend of home prices will be crucial in determining to what degree the weaknesses in the housing market will spread to the rest of the economy. So far the national statistics from the Office for Federal Housing Enterprise Oversight (OFHEO) have not reported any home price declines, but the rate of price increases has fallen steadily and stood at 4 per cent year-on-year during the first quarter of 2007. Estate agent statistics have indicated negative figures, although this less refined source of statistics also shows greater volatility.



Source: The Office for Federal Housing Enterprise Oversight

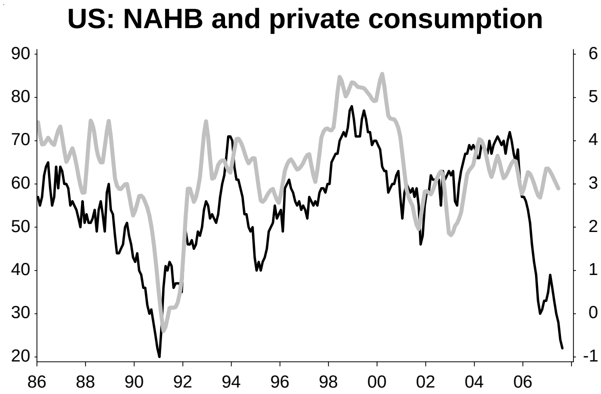
In the same way as with sales volume, there is also additional room for price declines. To date, US home prices have never fallen at the national level. Earlier price corrections have occurred in a higher-inflation environment, however, which meant that relative prices could be adjusted without nominal price declines. Some adjustment in the relative price of homes now seems very likely. In the current low-inflation environment this probably also implies nominal price declines. It is thus likely that year-on-year price changes as reported by the OFHEO will fall below zero in the coming year. However, in viewing the impact of this on the real economy, we should bear in mind that in the past five years, American home owners have enjoyed a 50 per cent increase – plus 5,500 billion dollars – in the net value (market value minus debts) of the American residential property market.

We expect the Fed's actions to help resolve the acute crisis in the residential mortgage lending market and thereby prevent a sharp price decline. The large quasi-governmental mortgage lenders Fannie Mae and Freddie Mac are now applying for permission to expand their credit volume, which also indicates that there are other ways of keeping the housing market alive.

Divergent consumption trends

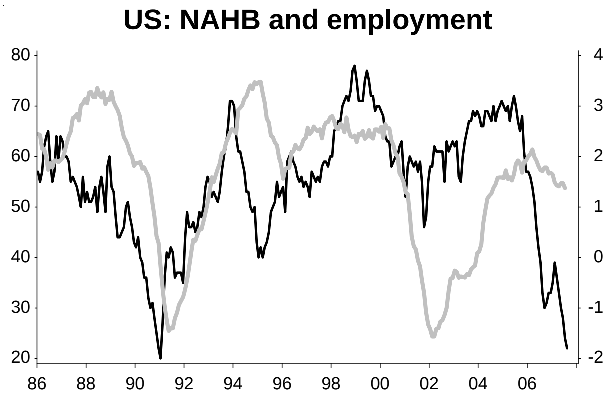
The secondary effects of lower residential construction will gradually become more evident. On the capital spending side, there will be less need for infrastructure investments, while the lower demand for interior fitting products will restrain consumption. So far, however, household consumption as a whole has held up relatively well; measured year-on-year, the rate of increase is still nearly 3 per cent.

The stable historical link between residential construction – measured as construction industry confidence – and household consumption has thus ended (see chart). This is probably attributable to the general economic dynamic in place since the millennium crash. Extremely low interest rates during 2002-2004 helped sustain demand in the most interest rate-sensitive portions of the economy, in which the housing sector plays a key role. The volume and price trend that we are now seeing is largely a mirror image of the pattern during these pump-priming years.



National Association of Home Builders market index (LHS)
Private consumption,year-on-year percentage change (RHS)
Sources: NAHB, US Department of Commerce

The housing sector has thereby become disconnected from the general economic cycle, in a way that diverges from the historical pattern, where residential construction has been closely linked to the trend of employment, for example. In the current situation a strong labour market, but also earlier increases in stock market and real estate wealth, are offsetting the consumption-restraining effects emanating from the housing sector in a historically abnormal way.



National Association of Home Builders market index (LHS)
Employment, per cent (RHS)
Sources: NAHB, US Department of Commerce

The forces that have sustained consumption will continue operating to some extent, although they have weakened to some extent. The Fed's interest rate cuts and traditional fiscal expansiveness in the run-up to the 2008 presidential election will also serve as a cushion. Our forecast implies that consumption growth will gradually slow, from 3.1 per cent in 2006 to less than 1.7 per cent in 2008 and then accelerate again somewhat in 2009. This reflects a slight adjustment to the low US household savings ratio, which will reach slightly more than 3 per cent next year.

Cautious capital spending behaviour

Capital spending outside the housing sector has shown varying development trends in recent months. Due to the expansion in many service sectors, especially retailing, there has been a rapid increase in the construction of commercial space. Lower demand for construction resources in the housing sector is certainly also playing a role for the upturn in other construction. However, machinery investments in manufacturing do not seem to be taking off in earnest. Considering the upswing in the industrial purchasing managers' index, this is a little surprising.

A number of basic prerequisites indicate that rising capital investments may help offset weaker consumption in the months ahead. Capital spending is at a historically low level. Meanwhile capacity utilisation is high and corporate balance sheets and profitability are in good shape. In addition, it looks as if American manufacturers will benefit from both the general strength of the world economy and a weak dollar.

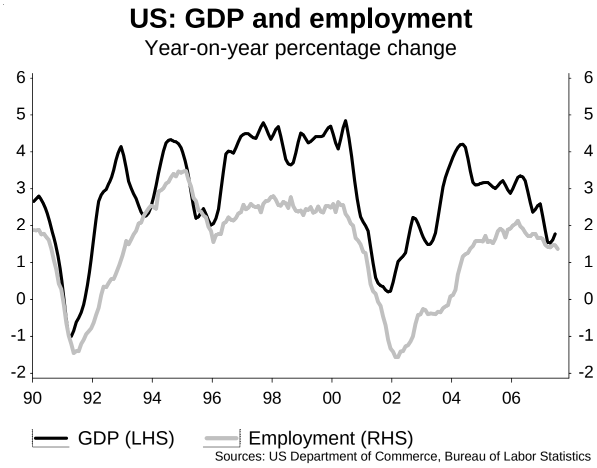
Our overall conclusion is that the American slowdown will be more protracted and deeper than we had previously thought, and even more so compared to the consensus scenario. Rising capital spending and stronger foreign trade should help the US to avoid a recession, but the downside risks have increased significantly.

Weaker labour market

During the past six months, the labour market has shown resistance to weaker growth. The jobless rate has hovered around 4½ per cent and employment growth has continued at a decent pace, although the year-on-year rate has slowed somewhat.

There are now various signs that the labour market is starting to lose ground. For some time, the US Labor Force Survey (LFS) has shown a downward trend in job growth. Meanwhile, early signs of rising unemployment are evident. The indicators are not unequivocal, however. The number of people newly registered as unemployed remains low and the Fed's Beige Book reports continued strong demand for labour.

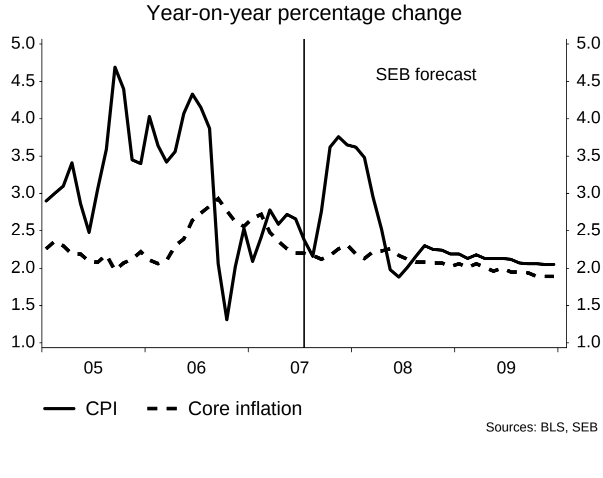
Our conclusion is that according to most indicators, employment will slow further in the months ahead. As the chart below indicates, the association between employment and GDP growth is rather stable. A GDP increase of around 2 per cent implies that employment growth will slow to 50,000 new jobs a month (100,000 new jobs are regarded as the equilibrium level), which means that unemployment will continue upward.



Meanwhile the downward trend in labour supply growth has **become increasingly clear**. This weakening of the labour supply means that **potential US growth has fallen**. Our perception is that potential US growth has declined from about 3½ per cent during the 1990s to below 3 per cent today. Lower potential growth **limits the room for interest rate cuts**.

Inflationary threat not eliminated

Base effects from variations in oil prices dominate short-term CPI trends. This coming autumn and winter, CPI will rise sharply, when prevailing high prices are compared to the relatively low price levels of last autumn. Meanwhile the global trend towards higher food prices has been clearer in the US than anywhere else. This has added 0.3-0.4 percentage points to CPI inflation. Altogether, this means average CPI inflation will remain at around 3 per cent in 2007.



Core inflation, however, fell unexpectedly fast this past spring. The downturn was broad and affected goods, services and the interest rate-related “shelter component”. It led to lower inflationary expectations, for example measured as break-even inflation.

However, it is too early to write off inflationary risks, despite the clear economic slowdown. The pressure from high **unit labour costs** has intensified as productivity growth has slowed. The rate of increase is now above 4 per cent. High costs of input goods are another source of inflationary pressure. The weaker dollar is also helping to drive up costs.

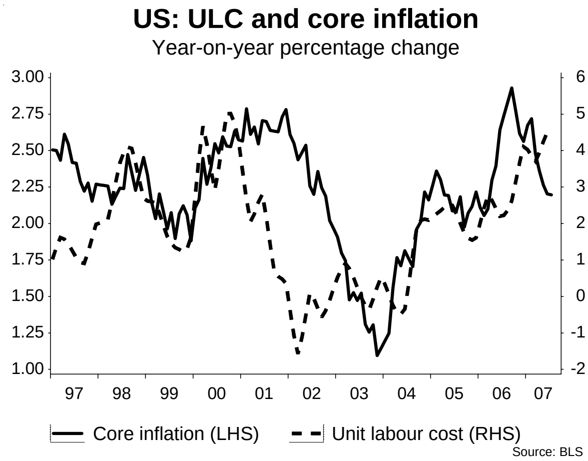
Our forecast is that core inflation will remain somewhat above 2 per cent during the next couple of years. The Fed’s favourite core inflation measure – the Personal Consumption Expenditures (PCE) deflator – is trending a little lower than core CPI, so it is likely that this measure will end up averaging somewhat below 2 per cent in 2008.

Key rate will be cut to 4 per cent

As recently as its latest Federal Open Market Committee (FOMC) meeting on August 7, the Fed was sticking to the view that inflationary risks posed the clearest threat to balanced economic growth. After that, obviously the financial market crisis rather drastically changed the Fed’s assessment.

The rapid shift in risk analysis undoubtedly raises a number of questions. One interpretation is that the Fed has had a certain bias towards toning down the risks to the real economy. For a long time, financial market movements appeared to represent a desirable trend towards more sensible risk-taking. Before there were sufficiently clear indications that the growth outlook would actually be affected, the Fed did not wish to fuel expectations that it would ease interest rates.

Our interpretation is that the Fed is now ready to lower the federal funds rate and will do so rather quickly. We expect the key rate to be cut by 75 basis points during the rest of 2007, then by another 50 points to 4.0 per cent during the first half of 2008.



The Fed will continue to face difficult dilemmas. During the next six months, the actual trend of inflation and underlying cost pressure will not justify interest rate cuts. The long-term rate of increase in the labour supply is also slowing, which is another reason for the Fed to be cautious about cutting interest rates. However, these factors weigh rather lightly in an environment where the residential mortgage crisis is weighing down the economy and threatening the stability of financial markets.

Factors that determine Fed action:

Variable	Direction	Importance
Growth	Cut	**
Unemployment	Cut	**
Financial stability	Cut	***
Housing market	Cut	**
Labour supply	Wait and see	*
Inflation	Wait and see	**

Continued upturn

- **Exports and capital spending strongest driving forces**
- **Lower jobless rate will sustain consumption**
- **Higher interest despite low inflation, weak yen**

Japan's economic upturn is continuing. So far, this expansion has mainly been driven by exports and capital spending. Given the improved labour market, indications are that households will now gradually open their wallets, boosting consumption. **GDP will rise by 2.4 per cent this year and by almost 2 per cent in 2008**. Deflationary forces have proved more stubborn than expected. The Bank of Japan (BoJ) will thus raise its key rate cautiously to 1.25 per cent by the end of next year. Continued low interest rates along with some structural outflows of capital will contribute to a renewed weakening of the yen, after the rebound seen in recent weeks.

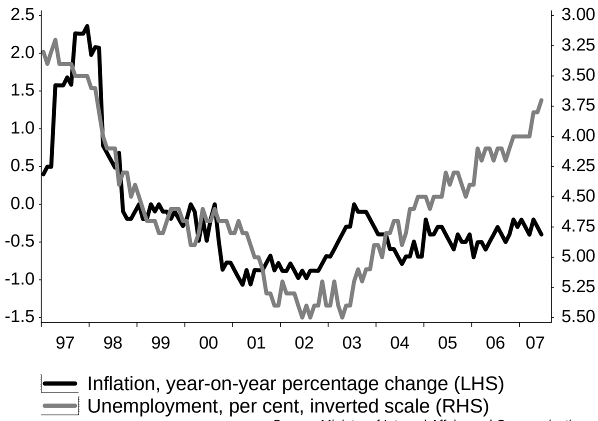
We have revised our growth forecast for 2007 upward by ½ percentage point, mainly due to a stronger GDP figure for the first half. However, the indicators provide no clear support for greater optimism about growth. We thus expect relatively weak growth over the next few months, followed by a slight recovery towards year-end. Capital spending will regain its momentum at that time, sustained by high capacity utilisation, strong profit growth and robust exports.

The weak link in Japanese expansion is household consumption. Although the upturn in exports and capital spending has had an increasingly clear impact on the labour market, consumer confidence has fallen. Meanwhile retailing is still weak. Wages and salaries remain depressed. However, an increasingly tight labour market should eventually result in faster pay growth, which will sustain consumption. The very robust financial situation of households also provides potential for an upswing in consumption.

Unemployment is continuing downward. In June, it reached its lowest level in nearly a decade. Yet **inflation remains a bit below zero** following last year's cautious upward trend. Due to good productivity growth and pressure on wages and salaries, unit labour costs are continuing to fall. The wage squeeze is being strengthened to some extent by structural changes in the labour market, since many well-paid older employees are retiring and being replaced by lower-paid younger employees. Sometimes older employees are also rehired at substantially lower pay after their formal retirement. Other forces that are countering an upturn in inflation are the high price level and increased competition in relatively protected and inefficient domestic sectors. Overall, we expect inflation to remain around zero during the rest of 2007 and then slowly rise to above one half per cent during the next couple of years.

As long as Japan's economic recovery continues, deflationary tendencies do not seem to pose an obstacle to the BoJ's normalisation of monetary policy. Instead, the central bank is emphasising the risk that inflation will resurge full force once unemployment has reached a critically low level. This justifies preventive interest rate hikes. The BoJ is also afraid that excessively low interest rates will lead to financial imbalances. Our interpretation is that **the BoJ will continue to hike its key interest rate by 50 basis points per year**, with the key rate thus reaching 1.25 per cent by the end of 2008 and then rising to 1.75 per cent during 2009. What might dissuade the BoJ from continued hikes in the short term is if global credit market instability intensifies. This in turn might lead to further unwinding of carry trade positions, thus triggering a continued strengthening of the yen.

Japan: Inflation and unemployment



Source: Ministry of Internal Affairs and Communications

Stinging defeat for Abe in upper house election

The recent election to the upper house of the Diet (Japanese Parliament) represented a stinging defeat for the governing Liberal Democratic Party (LDP) in general, and for Prime Minister Shinzo Abe in particular. The election outcome can be viewed more as an expression of dissatisfaction with the Abe government than as a mandate for the victorious Democratic Party of Japan (DPJ). Although the election weakened the position of the LDP, the party still has a stable majority in the lower house, which chooses the government. So what will be important are internal events in the LDP and who will succeed Abe if he is eventually forced to resign. One likely effect of the election, however, will be slower fiscal policy consolidation. For example, any consumer tax increase will probably be further postponed. Abe is likely to find it hard to implement his plan to rewrite Japan's pacifist constitution, as well as his ambitions to increase Japan's international commitments. To the extent that the almost populist DPJ gains more influence, this will have a negative impact on the government's reform policies.

Uncomfortably fast growth

- **Economic braking measures have little effect**
- **Food prices driving up inflation**
- **New leaders to be appointed at party congress**

China's GDP grew at nearly a 12 per cent rate during the second quarter of 2007, significantly faster than the government's 7.5 per cent targeted average for the period 2006-2010. **Despite new tightening measures, we are raising our annual growth forecasts** somewhat **in 2007-2008, to 11 and 10 per cent, respectively**. The 2008 Beijing Olympics will add an extra push to domestic demand. Only in 2009 will GDP growth fall below 10 per cent.

Investments, which totalled 41 per cent of GDP last year, will remain the prime mover in China's economy. The capital spending boom has contributed to **sharp productivity increases**, thus holding down unit labour costs despite rapid wage increases in some sectors. Meanwhile, many government-mandated investments are not justifiable either from the standpoint of business or the public interest.

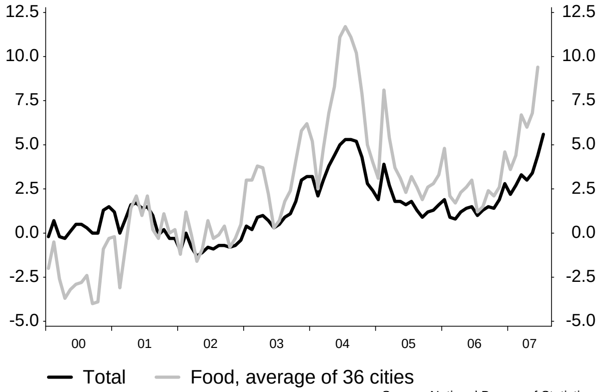
Net exports are also continuing to contribute greatly to growth. We expect the current account surplus to end up around 9 per cent of GDP this year. The large influx of capital increases the risks of overinvestment. Private consumption has grown at an accelerating pace for some years but still contributes relatively little to China's economic growth.

Food prices behind inflation upturn

Inflation has climbed rapidly this year. In July, CPI inflation was 5.6 per cent, the highest rate since 1997. This has once again triggered debate on overheating in China. In our judgement, however, **the inflation upturn is not, in itself, a clear sign of overheating**, since it is largely driven by volatile food prices.

China: Inflation

Year-on-year percentage change



Source: National Bureau of Statistics

There are nevertheless clear reasons for a continued policy of economic tightening. Over the past year, the People's Bank of China has raised its key interest rate four times. More hikes will probably come, with at least one this year. Yet because of rising inflation, real interest rates have still fallen to negative figures. **Extremely low real interest rates** will lead domestic investors to search for alternative investments. But in an undeveloped financial service system there are few alternatives. This is one contributing factor behind the large influx of funds into the stock market, with the resulting major risks of bubbles. Aside from interest rate hikes, the government has tried to slow this trend by cutting its tax on interest income from 20 to 5 per cent in order to make bank savings more attractive.

Accelerated yuan appreciation

Over the past year, the **appreciation rate** of the yuan has increased to about 5 per cent against the US dollar (in trade-weighted terms the yuan has strengthened by about the same amount). Looking ahead, we expect this pace to **accelerate by another percentage point or so**. China has also taken various administrative steps aimed at slowing and broadening growth, including a recent hike in bank reserve requirements.

Party congress faces major challenges

This autumn the Chinese Communist Party will hold its 17th congress. This will establish general economic policy guidelines for the next five years. The main task of the congress will be to deal with the major challenges resulting from rapid growth. The party is likely to continue focusing on agriculture, education and health care programmes, with the aim of counteracting tendencies towards social unrest – among other things by helping narrow the gaps between urban and rural areas in terms of wages and other living conditions. Another goal is to stimulate consumption so that China can reduce its heavy dependence on the manufacturing sector.

For President Hu Jintao, the congress will provide a crucial opportunity to reshuffle the country's leadership structures. If China follows its previous informal 70-year retirement age, this will be Hu's final five-year period in power. One of the most important questions is thus whether the president's successor will be indirectly appointed, which may provide clear signals about political strategies in a longer-term perspective.

There appears to be a keen and widespread awareness in China of the major challenges and problems that the economic revolution has brought. The Communist Party clearly still has the ambition of continuing to run what increasingly looks like a market economy using command economy methods. Time will tell whether this is feasible.

Good growth despite dangers

- **Growth above trend in 2008 as well**
- **Rising income will boost consumption**
- **Inflation will stay at around 2 per cent**
- **ECB will stop rate hikes at 4.25 per cent**

Growth in the euro zone is now **a bit above its long-term trend**. The positive dynamic now permeating the economy is sufficient to sustain such growth next year as well, despite the US slowdown, a stronger euro and higher interest rates. We expect **growth of 2.6 per cent this year and 2.4 per cent next year**. Credit and financial market turmoil will leave a mark on economic developments for some time to come, undermining the European Central Bank's arguments for continuing to tighten euro zone monetary policy after a September hike in the refi rate to 4.25 per cent. However, a gradual decline in available resources and strong credit and money supply growth are sufficient reasons **for the ECB to avoid interest rate cuts**.

Exports holding up well despite euro

In recent years, the euro zone has seen vigorous growth due to exports. This is especially true of Germany, which reported **export growth of a full 13 per cent** in 2006. This year we expect a 9 per cent rise despite a stronger euro. In the euro zone as a whole, exports will be over 6 per cent higher in 2007.

One current effect of the downtrend in the share of exports going to the US is heightened resistance to American economic weaknesses. German exporters in particular are benefiting from the rising share of products going to rapidly growing economies in Eastern Europe and Asia. Large exports to oil producing countries are stimulating growth, too, especially as oil prices climb towards new record heights. German exports also continue to benefit from a favourable product mix, including a large share of investment goods.

Euro zone: Retail sales and confidence

Sources: Eurostat, DG ECFIN

For many years, Germany's competitiveness has been strengthened by the country's low cost increases. Large corporate profits, along with high capacity utilisation, are benefiting capital spending growth. **Total capital spending in the euro zone will climb by 6 per cent this year and more than 4 per cent in 2008**. In Germany the increases will be even higher: 6.6 and 5.8 per cent, respectively.

Despite the improvement in the labour market, euro zone consumers remain cautious. During the first half of 2007, retail sales stagnated almost completely. Yet **a stronger labour market and rising confidence in the future are also finally likely to lead to more robust growth in consumption** (see box). We expect private consumption to increase by 1.1 per cent this year and then rise by 1.6 per cent next year.

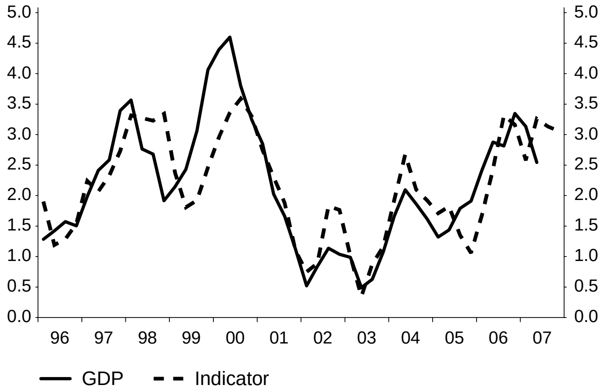
Upswing will continue

There are now various signs that **growth has peaked in the current cycle**. GDP figures for the second quarter of 2007 were a disappointment, and industrial production in Germany seems to be entering a calmer phase. It is worth adding that the recent credit and financial market turmoil is souring the mood in various confidence surveys and, on the margin, will probably slow exports, capital spending and consumption.

In spite of this, we see prospects of continued fairly strong growth. For example, SEB's overall growth indicator points towards **potential for upside surprises during the second half** of 2007. Also contributing to our optimism is that the disappointing German GDP figure for the second quarter was partly attributable to de-stocking and the effects of weather on construction.

Euro zone: GDP and SEB indicator

Year-on-year percentage change



Sources: Eurostat, SEB

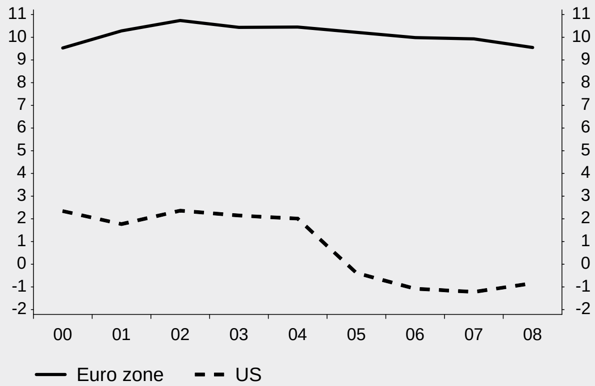
We estimate that growth in the euro zone as a whole will reach 2.6 per cent this year, 2.4 per cent next year and a bit above 2 per cent in 2009. German growth will end up at 2.6 per cent this year, buttressed by exports and investments, and then decline

Rigged for stronger consumption

The anaemic increase in consumption raises the question of why euro zone households are so cautious, especially compared to American ones.

Households savings ratio

Per cent

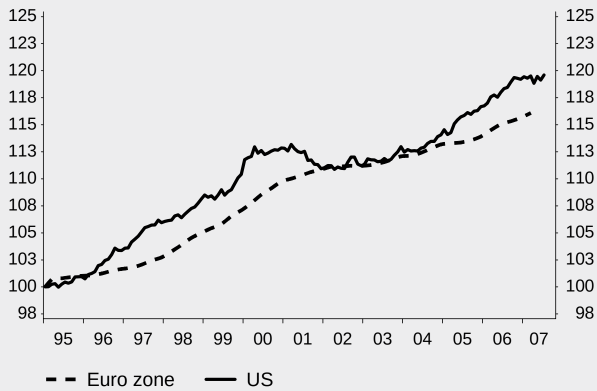


Source: OECD

The household savings ratio (saving as a percentage of disposable income) has traditionally been higher in the euro zone than in the US and the UK. This may be due to greater uncertainty about future income, but it is also connected to differences in definitions and social systems. In recent years a slower increase in home prices, combined with less widespread share ownership, has resulted in a slower increase in wealth in the euro zone. This has helped widen the gap in savings ratios, since the need to save current income has been greater in the euro zone than in the US and many other countries.

Employment

Index 1995=100

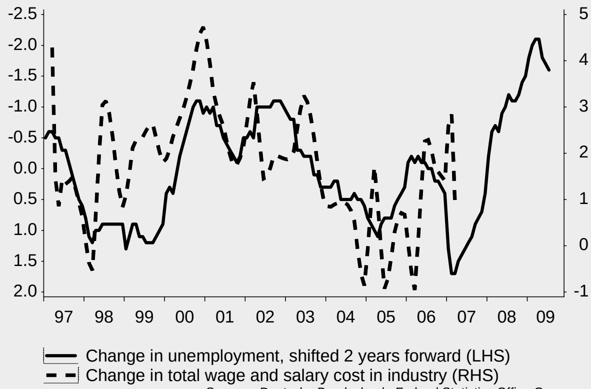


Sources: Bureau of Labor Statistics, Eurostat

Another explanation is that the income of euro zone households has not increased as much as that of American ones, reflecting poorer growth in both employment and hourly pay. Although the link between income and consumption need not be so strong in the short term, the way that households perceive their long-term room for income and consumption has influenced them to adopt a more cautious approach in the euro zone.

Germany: Unemployment and wages

Percentage and per cent



Sources: Deutsche Bundesbank, Federal Statistics Office Germany

The American labour market took a greater beating than the euro zone labour market during the crisis years soon after the turn of the millennium, but then bounced back vigorously. In recent months, however, employment growth has decelerated in the US, while it has taken off extra vigorously in the euro zone.

The chart above indicates that **falling unemployment will create significant potential for pay hikes** in the next couple of years. Although the experiences of other countries provide evidence that globalisation and greater competitive pressure have made the rate of wage and salary increases less sensitive to falling unemployment, an upturn in earned income is most likely now under way. In Germany, there are various examples of collective pay agreements concluded at higher levels than in many years. Now that Eastern European labour costs are rising as well, this will probably also reduce nominal wage and salary pressure in Germany.

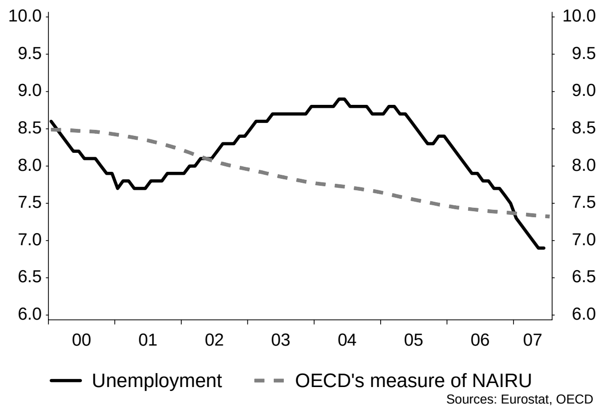
Our overall conclusion is that euro zone households will open their wallets a bit more once rising confidence in the future and falling unemployment have also been supplemented by higher income. A more growth-oriented economic policy in France may lead to greater optimism and faith in the future. Although we do not anticipate any dramatically high growth in consumption in an international perspective, a consumption upswing is an important ingredient in our forecast of a relatively strong economic upturn in the euro zone.

to 2.4 per cent in 2008 and 2.2 per cent in 2009. The French economy will grow by 2.1 per cent this year, strongly sustained as usual by the household sector, and a bit above 2 per cent in 2008 and 2009.

Developments in recent months have implied **increasing downside risks in our forecast**. The US slowdown, a flare-up of financial market instability and uncertainty about the German consumption upturn are important sources of insecurity. Certain regional factors, such as the extreme run-up in Spanish housing market prices, pose a risk.

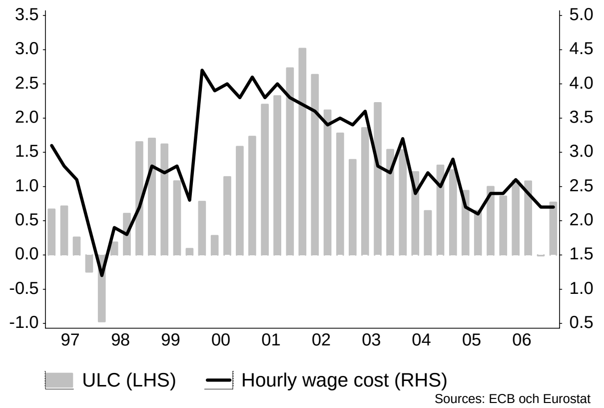
Higher resource utilisation

The jobless rate has now fallen below the traditional measure of equilibrium unemployment – the non-accelerating inflation rate of unemployment (NAIRU). According to our forecast, unemployment will fall to just above 7 per cent as an annual average in Germany in 2009, 7.5 per cent in France and a bit below 6 per cent in Italy.



So far, however, it is **difficult to detect any increase in underlying cost pressure** from the labour market. Unit labour cost (ULC) is rising at only a slow pace. This is largely because euro zone productivity growth is continuing upward – unlike most other Western countries, where fading productivity growth has led to a clear upturn in ULC.

One conceivable reason why low unemployment has not had an obvious impact on the cost trend is that traditional equilibrium measures have not yet taken into account improvements in the way the economy functions. Increased global competition, EU enlargement and labour market reforms are factors that may have helped push down NAIRU.



Due to the prevailing uncertainty, it is important to look at different measures of resource utilisation. The output gap – the difference between actual and potential output – also indicates rising inflation risks. According to the chart below, core inflation seems to

Stronger public finances

The favourable economic trend is **strengthening public sector finances in the euro zone**. Most countries will surpass last spring's forecasts. However, it is difficult to know how much of their government revenue enhancement represents an underlying structural improvement and how much is due to the economic cycle. True to form, Joaquin Alumnia, the EU's Commissioner for Economic and Monetary Affairs, has thus repeated his demand that member countries should eliminate their deficits as soon as possible, in order to prepare themselves for poorer economic conditions and for future budget problems associated with their ageing populations.

The EU has also called for member countries to balance their government budgets by 2010, but French President Nicolas Sarkozy is resisting this. He would prefer to cut taxes in order to stimulate the French economy, which is currently growing at a slower pace than the euro zone average. France has not shown a budget surplus since 1980.

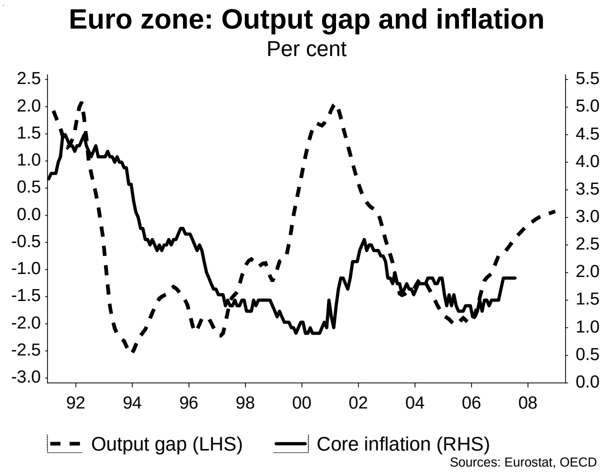
According to our forecast (see table below), the budget situation will gradually improve during our forecast period in most countries, but it is still unlikely that the euro zone countries as a whole will balance their budgets in 2010. **Germany nevertheless looks set to show a balanced budget as early as this year**.

Budget balance, per cent of GDP

	2006	2007	2008	2009
Euro zone	-1.6	-0.8	-0.5	-0.4
Finland	3.9	3.8	3.7	3.2
France	-2.5	-2.4	-1.8	-1.7
Germany	-1.7	-0.1	0.2	0.4
Italy	-4.4	-2.1	-2.1	-2.0
Portugal	-3.9	-3.5	-3.1	-2.8
Spain	1.8	1.4	1.1	1.0

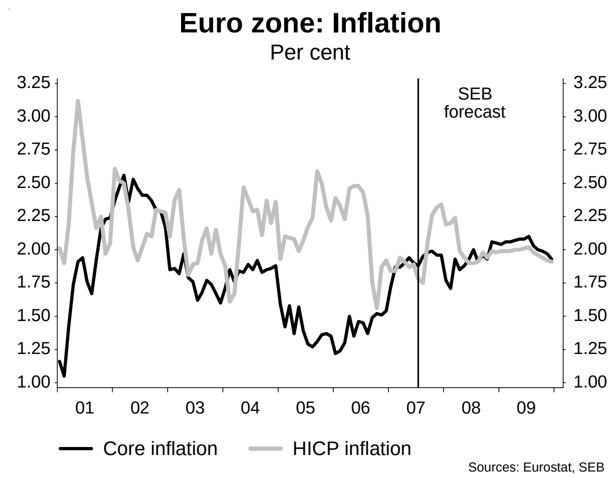
Sources: European Commission, SEB

react – with a one- to two-year lag – to a change in the output gap. However, it is worth underscoring that the upturn in inflation early in 2007 was largely an effect of January's value-added tax (VAT) hike in Germany, making it more difficult to interpret as a consequence of a lower output gap.



Inflation in line with ECB target

In the past year, the Harmonised Index of Consumer Prices (HICP inflation) in the euro zone has fluctuated in response to energy-related base effects and Germany's VAT increase. In recent months, however, it has been stable at around the ECB targeted inflation rate level of close to, but not above, 2 per cent. Base effects from energy prices will continue to play a large role in the inflation trend over the next six months. First they will lower the inflation rate somewhat in August, but then push it upward rather rapidly again to 2.3 per cent at year-end.



Rising resource utilisation will eventually exert cost side inflationary pressure, but a stronger euro and a continued favourable productivity trend will pull in the other direction. Core inflation will average 1.9 per cent this year and next, and 2.0 per cent in 2009. **Average HICP inflation will remain unchanged at 2.0 per cent throughout our forecast period.**

ECB will hike key rate to 4.25 per cent

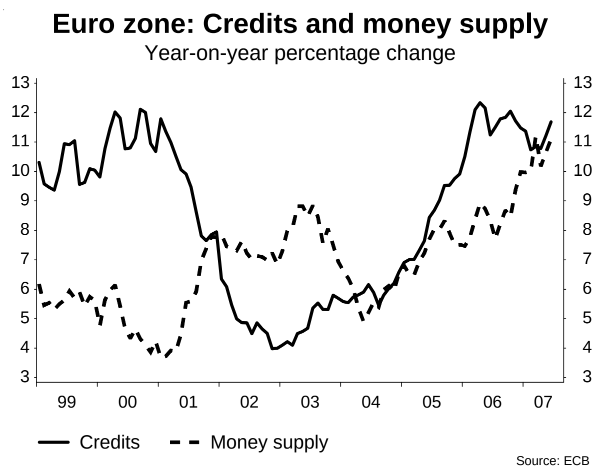
For a long time, the European Central Bank has embraced the view that growth risks are on the downside and inflationary risks are on the upside. The forecast and interest rate strategy that, in our assessment, the ECB established this past June pointed towards two refi rate hikes during the second half of 2007. The ECB has also provided some signals it will raise the key rate to 4.25 per cent at its September meeting.

The problems that have occurred in the credit market are likely to change the playing field a bit, however. We believe that clearer effects in the form of loan losses, a stronger euro and certain adjustments in growth will be instrumental in persuading the ECB not to hike its key rate any further than 4.25. Continued modest inflation and actual declines in inflationary expectations point in the same direction.

On the other hand, our forecast calls for continued good growth and rising resource utilisation. Meanwhile the ECB's concern about the long period of monetary expansion must also be taken into account. This indicates that the ECB will not deliver the interest rate cut early next year that the market is now assuming. The risk in our interest rate forecast is instead on the upside.

Factors that determine ECB actions

Higher key rate	Wait and see
Good GDP growth	Credit market turmoil
Lower unemployment	Modest inflation
Monetary expansion	Stronger euro
Higher wage pressure	

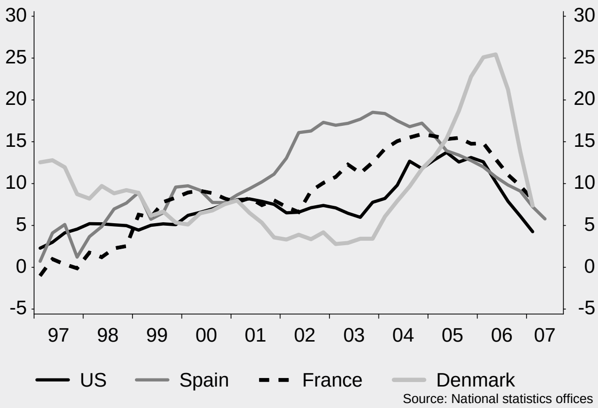


More stable euro zone housing market

The downturn in the American housing market raises questions about the risks of a similar European trend. For a long time, the driving forces in housing markets were regarded as national, or perhaps to an even greater extent as regional. In recent years, the IMF has pointed to the existence of a global home price cycle, where the position of various countries in the interest rate cycle is important.

Home prices in selected countries

Year-on-year percentage change



Source: National statistics offices

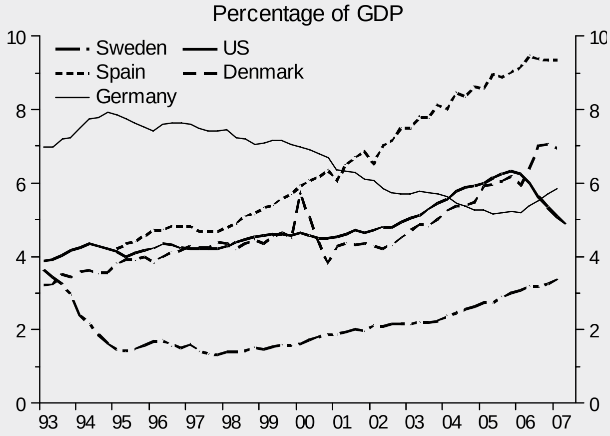
One conclusion from such a line of reasoning is that the downturn in the US, which is early in the interest rate cycle, should foreshadow a general slowdown in Europe. To some extent, such signs are visible. Countries like France and Spain have shadowed the US price trend relatively well, albeit at different levels. In the Nordic countries, we see a clear slowdown in Denmark, while the home price upturn has continued in Norway and Sweden. Germany diverges from the general pattern, since home prices stood still during the boom that occurred elsewhere, but they are now rising slightly.

The labour market situation, the financial position of households and the relative size of the construction sector determine how sensitive a country will be to real effects in the form of lower home construction and lower consumption resulting from a housing market downturn.

There are several reasons to believe that the economic impact on the euro zone and on Western Europe generally will be less than in the US, both in terms of price trends and real economic consequences:

Residential investments

Percentage of GDP



Sources: National statistics offices

- **Household saving are significantly higher**, due among other things to more cautious savings behaviour. Partly due to differences in residential financing systems, European households have taken less advantage of their property wealth to pay for consumption than have American households. Nor is there a large quantity of outstanding loans to economically weak households, equivalent to the American sub-prime market.
- **In Germany, home prices are only now beginning to rise**. Such a clear divergence from the global home price cycle reduces the risks of a major economic impact in the euro zone as a whole.
- **Residential construction as a percentage of GDP** was generally lower in Western Europe during the peak of its housing market boom. Although the price trend in many countries has easily matched the American trend, construction volume did not explode in the same way as it did in the US from 2002 to 2005.

Certain countries are vulnerable, however. The clearest example is Spain. Home prices there have climbed very high in relation to income, while the construction sector accounts for a disproportionately large percentage of the economy. To date, the cool-down has not had any clear impact on the real economy, which indicates that Spain has a significant adjustment ahead of it.

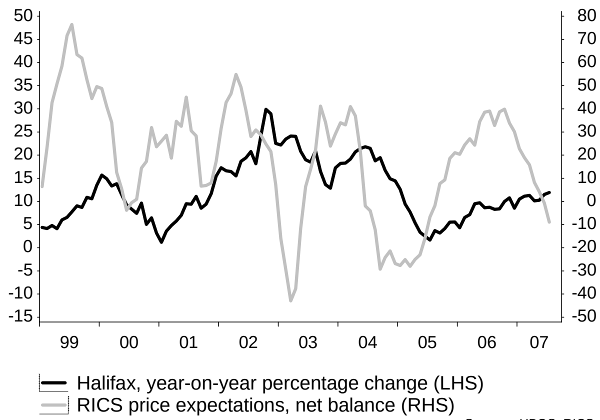
Soft landing in 2008

- **High resource utilisation**
- **Early signs of cooling in housing market**
- **Repo rate has peaked**

The British economy will remain strong for another six months or so. Next year it will begin to weaken, due to **monetary tightening** and the US slowdown. The Bank of England (BoE) has hiked the repo rate by 125 basis points (to 5.75 per cent in July) within one year. This tightening will help cool the property market and household consumption in 2008. Meanwhile over time the past year of pound strengthening is expected to undermine the competitiveness of UK exporters. **GDP growth will slow from nearly 3 per cent in 2007 to some 2 per cent annually in 2008-2009**, thus helping to ease inflationary pressure.

Since late 2005, the UK growth rate has been stable at somewhat above its 2.5 per cent potential level. Companies are showing continued optimism, while household confidence has resurged after a two-year slump, partly due to a brighter labour market. Most signs thus point towards continued near-term strength.

United Kingdom: House prices



Sources: HBOS, RICS

However, there are indications that higher interest rates are beginning to cool off the hot UK housing market. For example, new home mortgage applications have fallen rapidly. Home prices are admittedly continuing to rise at more than 10 per cent year-on-year, but we expect a sizeable cool-down in 2008. One clear signal of slower price increases is that **price expectations of estate agents** (RICS survey) have cooled over the past six months and now point towards a **levelling off**; this survey has proved a good indicator of price trends six months ahead in time.

Although the wealth position of households with residential property remains strong, **household consumption is probably sensitive** to weaker price appreciation. The interest burden has risen rapidly. Debt is high and the household savings ratio has fallen to 2 per cent – its lowest level in nearly 50 years. We expect savings to rise in the next couple of years; the average savings ratio since 1995 has been about 6 per cent. This will squeeze the annual rate of increase in consumption from 2½ per cent in 2007 to 2 per cent.

Persistent inflationary risks

Due to high resource utilisation and rapid money supply growth, inflationary risks will persist for another while. During the past six months, the labour market has recovered. Companies are also signalling a greater shortage of qualified employees. The jobless rate has fallen from 5.7 to 5.5 per cent, close to an equilibrium level. Our forecast is that **unemployment will fall a bit further** in the coming months and level off next year. **Wage and salary hikes have remained modest** despite the tight labour market situation. One reason is that increased immigration has eased bottleneck problems in the labour market.

Despite modest pay hikes, the **upturn in inflation has been relatively broad**. Due to strong demand, companies have been able to pass on cost increases, for example higher commodity prices, to consumers. The actual inflation rate has admittedly fallen from above 3 in the beginning of the year to an unexpectedly low 1.9 per cent in July, helping dampen the high inflationary expectations that greatly worried the BoE after last winter's sharp upturn. However, the trend of underlying inflation has continued upward, which is one reason we predict a sluggish downturn in inflation. In the short term, the impact of this past summer's floods will also contribute to rising food prices. The BoE's **2 per cent inflation target will be achieved only in 2008**. This means that the UK will exceed the inflation target for the second straight year.

The BoE is traditionally activist and often responds early to new conditions, especially international ones. Despite some lingering inflationary risks, the BoE will not hike interest rate further this autumn. The reason is a growing downside risk in global economic growth after the credit turmoil. When the domestic slowdown has started, and the Fed has delivered several rate cuts, the BoE is likely to begin moving towards a more neutral monetary policy stance. We expect an **initial rate cut in February 2008** and a repo rate of 5.00 per cent by the end of 2008. These rate cuts will contribute to a gradual weakening of the pound.

We expect fiscal policy to be mildly contractive. Although corporate and income taxes will be cut somewhat starting in April 2008, these steps are almost entirely financed. A snap election in 2007-2008 would probably not change government economic policies.

High growth – high inflation

- **Domestic demand still powering the economy**
- **Labour markets gaining strength**
- **Fiscal policy expansive despite inflation risks**

The **economic strength** of Central and Eastern Europe is continuing despite weaker growth elsewhere. Trade with the US is small and the region – especially the Central European economies – is benefiting from the continuing upturn in Germany. But it is mainly **consumption and capital spending** that **are driving growth**. **GDP** in the nine countries of the region covered here, including the Baltics, will increase by an unweighted average of **7 per cent this year**, then slow marginally to **6½ and 6 per cent, respectively, in the next two years**. Latvia and Ukraine will grow the fastest. Our forecast for 2007 and 2008 has been revised upward compared to ***Nordic Outlook*** in May, although downside risks have increased in recent times due the global credit instability. High inflationary pressure will ease marginally.

Russia's growth rate during the first half of 2007 was 8 per cent. A slowdown to below 7 per cent will occur in a two-year perspective in the wake of mounting supply side constraints. During the coming year, the economy will continue to be stimulated by high commodity prices and expansive fiscal policy. Capital spending will continue upward, after a robust recovery last year. However, the investment level is still relatively low, especially in industry. We anticipate no major change in policy direction after the parliamentary election in December 2007 and the presidential election in March 2008. Russia's reform process will continue at an unchanged slow pace. WTO accession in 2008 is still within reach. This would lower industrial and agricultural tariffs and open the service sector to foreign competition.

In **Ukraine**, GDP also grew by 8 per cent during the first half, and growth is expected to remain in this vicinity during the foreseeable future. High commodity prices are benefiting the economy. Retailing and construction are growing rapidly. Inflation will reach double digits this year. Public opinion in Ukraine is unclear in the run-up to the early parliamentary election in September. If the party group around Yulia Timoshenko, prime minister at the beginning of the "orange revolution" a few years ago, again joins forces with President Viktor Yushchenko, they will enjoy somewhat more support than the more Russian-friendly Prime Minister Viktor Yanukovich.

In Central Europe, **Poland** is heading towards yet another year of more than 6 per cent growth, well above its potential level. Domestic demand remains strong, partly stimulated by large sums from the EU structural funds. Continued tensions in the governing coalition are creating a messy political situation and probably an early election this autumn. This does not threaten the positive economic trend. If anything prospects for economic reforms will improve.

Slovakia will join the euro zone in 2009 as planned. Inflation remains low, despite strong growth. This is due to both a better-functioning economy than elsewhere in the region after the implementation of reforms and an appreciating currency.

Hungary is tightening its fiscal policy in order to shrink its large budget and current account deficits. This will lead to a deep slump in growth during 2007. Later the economy will slowly recover.

Resources in short supply

Unemployment in Central and Eastern Europe has, without exception, fallen to relatively low levels and will be squeezed **further downward in the near future**. In the Baltic countries, labour shortages are already apparent, partly due to the wave of emigration to the West in recent years. However, this trend looks set to slow in the coming years, since wages and salaries have climbed rapidly. In Poland, the Czech Republic and Russia, so far it is mainly the construction sectors that are having difficulty recruiting labour, but the problems are broadening. This is paving the way for high pay increases. Meanwhile, industrial capacity utilisation is high.

High resource utilisation means that inflationary risks have generally increased, although the upturn in inflation during the past six months can partly be explained by poor harvests and food price increases.

In spite of this, we are assuming that **economic austerity measures will be mild**:

- In the Baltics, only Latvia is tightening its fiscal policy somewhat.
- Poland and the Czech Republic have raised their key interest rates. We expect further hikes to 5.25 and 3.75 per cent, respectively, early next year. No fiscal tightening is on the horizon in Poland, but in the Czech Republic an economic reform package has been approved by parliament recently, including a certain fiscal consolidation.
- In Russia and Ukraine, interest rates will not change much and fiscal policy will remain expansive. Russia's central bank will continue its tricky balancing act. The bank wants to avoid excessively strong rouble appreciation due to oil revenue and at the same time wants to push down inflation. It will be difficult to bring inflation down to the 8.0 per cent benchmark by year-end.

Baltic overheating will ease marginally

The rapid, partly credit-driven **growth** in the Baltic countries, which is unsustainable in the long term, **will slowly fade** over the next couple of years. As a result, **imbalances will also slowly shrink.**

Consumption will continue to be stimulated by rapid pay hikes, low real interest rates and – in Estonia and Lithuania – also by income tax cuts. Capital spending will be fuelled both by extremely high capacity utilisation and money from the EU structural funds. Meanwhile there are indications that the economic cycle is about to pass its peak. Growing supply side constraints, combined with higher nominal lending interest rates and tighter lending practices, will cool growth. In Latvia, tighter fiscal policy is another contributing factor.

We anticipate that growth will slow modestly. In Estonia, growth will fall from 8 per cent this year to 6.5 per cent in 2009; in Latvia, from 10 to 8 per cent; and in Lithuania from 8 to 6 per cent. The three economies will thus move down towards their potential level of 6-7 per cent. But since they have grown at such high speed for many years, they have already had time to build up imbalances. Over the past couple of years, **Latvia and Estonia** have shown clear signs of **overheating**. To date, Lithuania has not exhibited equally obvious imbalances.

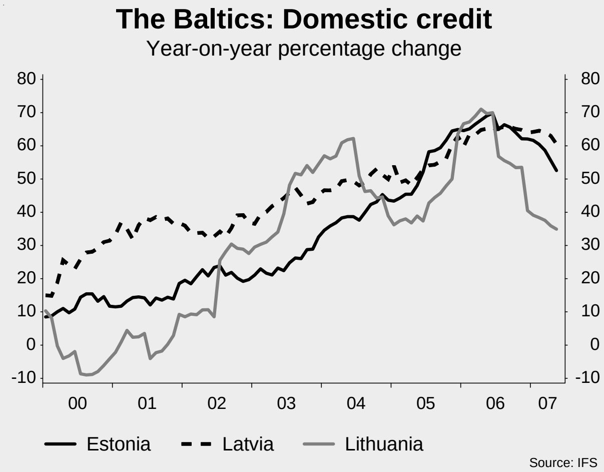
In recent years, the current account balances in the Baltics have swelled to very high levels, especially in Latvia and Estonia. Inflation has accelerated and is now far above the euro zone level. This is especially true in Latvia, where inflation is close to 9 per cent.

For some time, our main scenario has been a **soft landing** in the Baltic economies. Last spring we emphasised in several reports that such a development **presupposes** a continued **deceleration** of **rapid credit growth**, and perhaps also a fiscal tightening in Estonia. Since the central banks with their fixed exchange rate systems have limited potential to cool the economies, we also emphasised the important role of commercial banks when it comes to credit expansion.

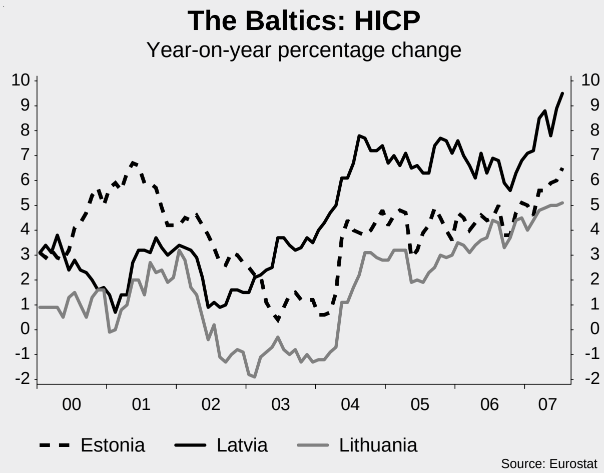
Not much has changed in the economic picture, if we look at final figures and surveys for the **first half** of 2007:

1. GDP growth has slowed only in Estonia. The future outlook there, as perceived by households and companies, has also trended downward although it still remains at historically high levels.

2. The extremely high **increase in credit** to the private sector has begun to cool in all three countries. In Estonia and Latvia, this is partly connected to early signs of weakening in the property market. The Latvian credit growth is likely to slow further in the short term due to stricter lending practices implemented in July. This change was part of the government's anti-inflation plan, which was unveiled in March after foreign exchange market turbulence in February.



3. As for **inflationary pressure**, however, the situation has instead worsened. We have thus raised our inflation forecasts for all three countries. Although there will be some easing of inflation next year, none of the countries will end up with an annual average below 4 per cent. Pay increases of 20-30 per cent this year and somewhat lower next year are fuelling price pressure. In Estonia, increases in value-added tax will also prevent inflation from falling faster in 2008.



4. The current account deficit has decreased somewhat in Estonia. In Latvia, it remains unchanged at a very high level, while it has increased in Lithuania.

Our overall assessment is that the **threat of overheating** in the Baltic countries **remains**, although a **soft landing** is still our **main scenario**.

Buoyant despite US slowdown

- **International turmoil means lower growth…**
- **…but robust domestic demand will keep GDP above trend**
- **Strong labour market, rising resource shortage**
- **Riksbank will normalise key rate**
- **Public sector surpluses keep growing**

Increased financial risks and weaker international growth, combined with a Swedish economy that is showing robust strength – and where risks of resource shortages and overheating are starting to emerge – make it difficult to assess the situation. Our conclusion is that **the Swedish economy will be affected in various ways by international instability**, yet the domestic economy is strong enough to keep GDP growth above trend. This will further strengthen the labour market upturn. **The need for normalisation of interest rate policy remains.**

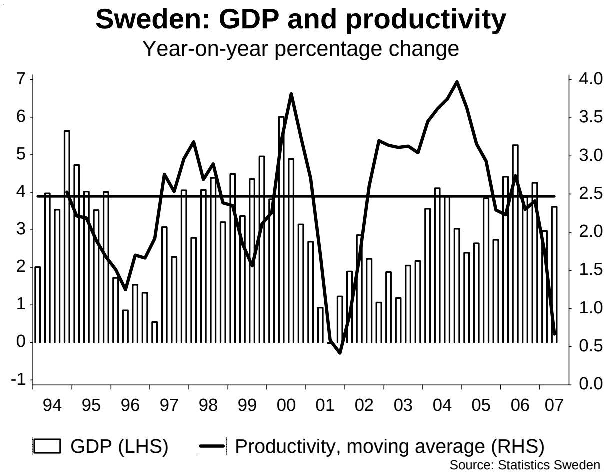
Global financial market instability and a deeper US downturn have led us to revise our forecast of Sweden's growth in 2008 downward by a quarter of a percentage point. This year's GDP figure will be affected to a lesser degree, but given the unexpectedly weak outcome for the first half, it will be about half a percentage point lower than in our previous forecast in May. We are now anticipating growth of **just above 3½ per cent this year** after adjustment for working days, slowing to **3 per cent in 2008**.

The domestic economy continues to show signs of strength. Capital spending activity is very expansive, especially in manufacturing. This will lay the groundwork for continued export expansion by easing bottleneck problems that have hampered manufacturing output. Sharply accelerating income and an increasingly strong labour market indicate that a surge in consumption is under way, although stimulation from wealth increases will fade.

Employment is continuing to rise at a rapid pace, while productivity growth is slowing. **Unemployment will fall to 3½ per cent by late 2008**. Accelerating wages and salaries combined with waning productivity growth will lead to rising domestic cost pressure. Inflation will thus gradually rise, and the Riksbank's **UND1X underlying inflation measure will exceed two per cent in 2009**.

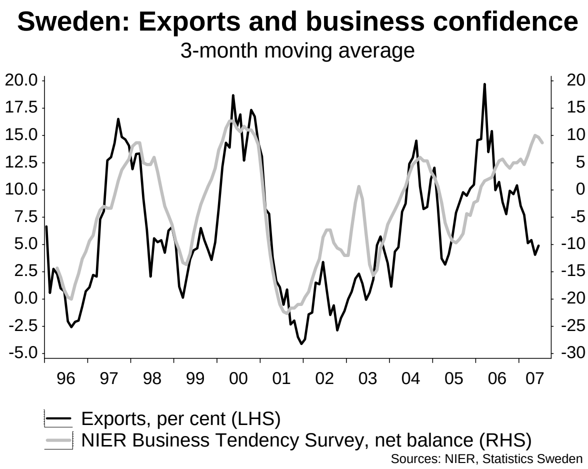
The Riksbank is caught in a dilemma. In a world of major financial market risks and somewhat weaker international demand, interest rate hikes may seem out of place. Meanwhile it is difficult to foresee changes in the domestic growth and inflation picture large enough to prevent the central bank from continuing its path towards normalising the repo rate. We thus expect the Riksbank to keep raising the repo rate until it reaches 4.50 per cent by mid-2008, or somewhat above a neutral level.

Public finances have improved at a faster pace than expected. The surpluses over the next couple of years appear likely to end up well above target. This will result in a gradual shift towards a more expansive fiscal policy the closer we get to the September 2010 parliamentary election. In our main scenario, this is an additional reason for normalisation of interest rates. If the international downturn should deepen, this fiscal policy flexibility will instead serve as a useful cushion for the economy.



Export capacity problems

Export growth culminated in 2006. This year, market growth slowed from 10 to 6 per cent. So far in 2007, merchandise exports have weakened more than this, probably due to production capacity shortages. Since company reports, the National Institute of Economic Research Business Tendency Surveys and production statistics still point upward, we must be cautious in interpreting the export figures from Statistics Sweden.



Sweden's fastest export growth is now to such former East bloc countries as Poland and Russia, but the other Nordic countries and the euro zone remain expansive markets. Exports to the US continue to fall, and somewhat surprisingly also those to China.

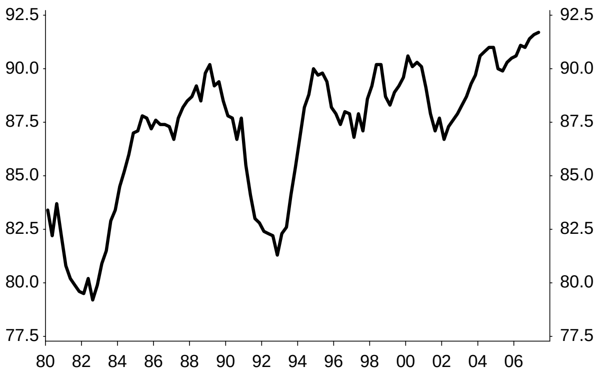
In the next couple of years, export growth will decelerate further. This will be due to generally weaker international demand, especially in the important Nordic markets, where overheating tendencies – and higher interest rates – will slow expansion.

Capital spending boom

High capacity utilisation will contribute to **very expansive capital spending plans in manufacturing**. We expect a volume increase of nearly 15 per cent this year, the sharpest rise since the mid-1990s. Capital spending will also increase in other parts of the economy. Expansion plans are the most ambitious in the energy sector, where investments in wind power and improvements in the electricity grid will help push increases up to the 35 per cent range. Residential construction also appears likely to expand rapidly this year. In addition, central government infrastructure spending will drive up public sector investments.

Sweden: Manufacturing capacity utilisation

Per cent



Source: Statistics Sweden

The capital spending expansion in manufacturing will eventually fade. Residential construction, too, will probably decelerate next year due to a labour shortage, rising construction costs, higher interest rates and the delayed impact of lower subsidies for construction of rental housing. Overall capital spending growth will slow from 11 per cent this year to less than 5 per cent in 2008.

Home prices have continued to climb. Unlike the downturn in various other countries, no clear signs of a slowdown are apparent. Lower interest rates than elsewhere and a late start for the rate-hiking cycle will help lengthen the housing market upturn. The abolition of the wealth tax and the lower real estate tax have also had a clear impact.

Looking ahead, home prices will slow and stagnate in Sweden as well. In the short term, credit market instability will contribute to a cool-off. In a somewhat longer perspective, higher interest rates and slower job growth will also leave their mark.

Delayed consumer spending spree

A number of conditions are in place for **a surge in private consumption.** Due to rising pay increases, strong job growth and lower income taxes, real household income will rise by more than 5½ per cent this year and by an average of 3½ per cent in 2007-2009. Meanwhile unemployment is rapidly falling and household optimism is at record-high levels.

Economic situation of households

Year-on-year percentage change

	2006	2007	2008	2009
Private consumption	2.8	3.2	3.7	3.0
Disposable income	2.2	5.7	2.8	2.7
Savings ratio, % level	8.3	10.6	9.7	9.3

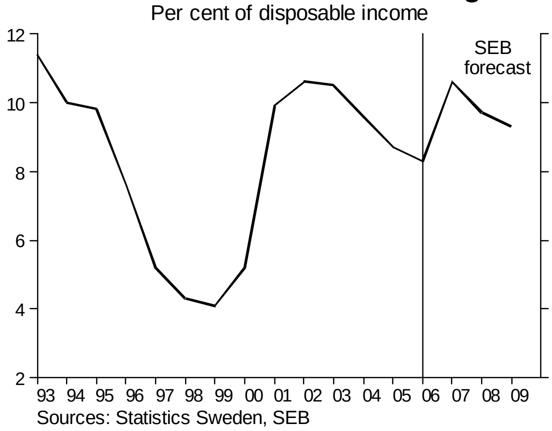
Sources: Statistics Sweden, SEB

Yet consumers have not really opened their wallets. In the first half of 2007, consumption rose a mere 2½ per cent. However, we are sticking to our forecast of accelerating consumption, although we have made a slight downward adjustment for 2007. We are now expecting growth of 3.2 per cent this year and 3.7 per cent in 2008.

Since around 2001, household savings have remained at a relatively stable level, despite an increasingly strong wealth position and lower unemployment. An increased need for savings due to greater uncertainty about future pensions is certainly one important reason for this caution. Also contributing to our forecast of continued high savings is that the wealth increase in the form of homes and shares is slowing.

Sweden: Household saving

Per cent of disposable income



Sources: Statistics Sweden, SEB

Unemployment continuing downward

The demand for labour remains very strong. According to the National Labour Market Board (AMS), the number of job vacancies has increased sharply. Hiring plans according to the NIER Business Tendency Surveys are expansive. The employment upturn is broad-based and includes most economic sectors. The manufacturing sector is now also adding jobs. On average, we expect an employment upturn of 2½ per cent or 100,000 people this year. Next year the increase will slow to about 60,000 people.

Labour market and productivity

Year-on-year percentage change

	2006	2007	2008	2009
GDP	4.5	3.6	3.0	2.5
Productivity	2.5	0.8	1.6	1.6
Employment	1.9	2.4	1.3	0.7
Hours worked	2.0	2.8	1.4	0.9
Labour supply	1.3	1.3	0.7	0.5
Unemployment, level %	5.4	4.3	3.7	3.5

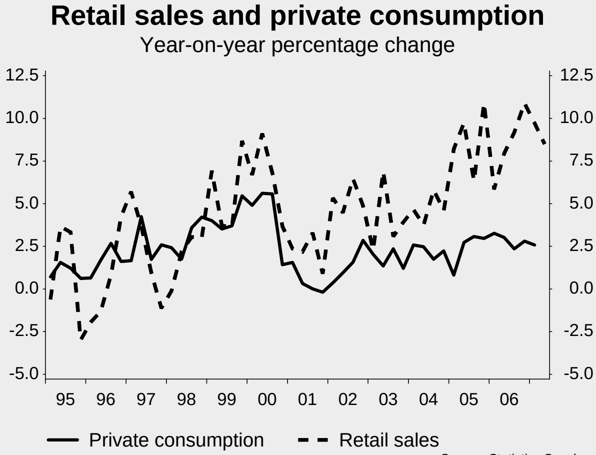
Sources: Statistics Sweden, SEB

Sources: Labour Force Survey (LFS), Labour Market Board (AMS)

Because of rising employment, the jobless rate has continued to fall despite major cutbacks in AMS-sponsored "labour market policy programmes" (employment training and temporary jobs) during this past winter and spring. In July, seasonally adjusted unemployment was 4.2 per cent according to the Labour Force Survey (LFS), while the AMS figure was as low as 3.2 per cent. Thus most indications are

Why not higher consumption?

Despite all the factors that ought to stimulate a spending spree, consumption growth has not really taken off, unlike developments elsewhere in the Nordic region, for example. Yet retail sales in Sweden have expanded far more robustly than in neighbouring countries, making the consumption figures even more puzzling. Granted, the retail sector only accounts for one third of private consumption, but historically there has been a rather good co-variation between retail sales and consumption.



Source: Statistics Sweden

In recent years, retail sales have grown even faster than during the millennium boom. Total consumption did not reach the same growth levels, among other things because purchases of cars and services have instead grown far more slowly.

Private consumption by purpose

Percentage change

	2004-2006	1998-2000
Retail sector (36%)	5.2	4.4
Cars (4%)	3.1	11.9
Energy (6%)	-3.1	-1.3
Other goods (4%)	-0.5	-1.5
Services incl homes (51%)	2.1	3.3
Consumption abroad (4%)	7.0	11.9
Consumption by foreigners (-5%)	14.4	7.4
Total	2.5	3.8

() = weight in 2005

Source: Statistics Sweden

The tourism trend also helps explain the gap between the retail sector and private consumption. Consumption by foreigners in Sweden is included in the various product categories, but is then subtracted from total private consumption. This grew significantly faster in 2004-2006 than in 1998-2000. The opposite is true of consumption abroad by Swedes. The net effect is a slowing of consumption growth by 0.5 percentage points in 2004-2006.

Although we can thus identify various explanations for the moderate consumption upturn, we find it hard to see how the underlying driving forces will not finally result in higher consumption.

that the annual average will end up below the Riksbank's forecast of 4¾ per cent. However, it is worth pointing out that the summer months are difficult to interpret, among other things due to a change in seasonal patterns in the LFS. The AMS statistics probably also exaggerate the downturn to some extent, for example because of reduced incentives for students to sign up as job seekers at AMS employment offices.

Sweden: Labour shortage

Share of firms in per cent

Sources: NIER, SEB

Unemployment will continue to fall next year. Job growth will admittedly decelerate, but the labour supply will meanwhile be slowed somewhat by demographic factors, as well as a slight increase in labour market policy programmes. By the end of 2008, unemployment will have dropped to 3½ per cent.

Rising shortages, higher pay increases

The increasingly tight labour market situation has already made it more difficult for companies to recruit suitable staff. Assuming a continued downturn in unemployment, recruitment problems will worsen in the near future.

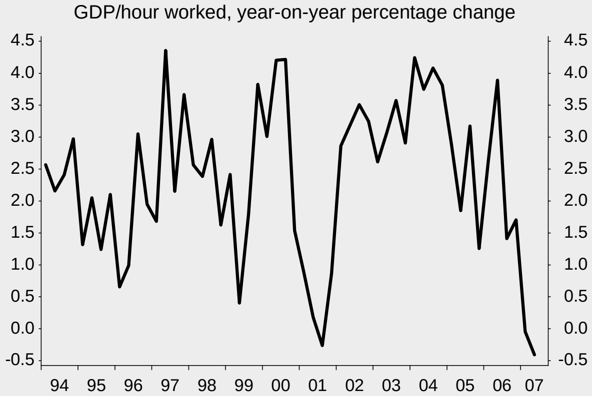
It is hard to assess the extent to which this will result in greater wage and salary pressure, since it has been a long time since unemployment was down to levels of around 3½ per cent. Experiences from such countries as Norway and Denmark, where unemployment has already fallen to or below these levels, are somewhat mixed. In Denmark, pay increases have been surprisingly restrained. Despite unemployment of only 3½ per cent at present, wages and salaries are expected to increase by 4 per cent this year. In Norway, unemployment has fallen to 2½ per cent;

Productivity growth is slowing but has not collapsed

Productivity growth has slowed dramatically in the past two quarters. The second quarter even witnessed a decline of nearly half a per cent, which is the weakest growth in decades.

Sweden: Productivity

GDP/hour worked, year-on-year percentage change



Source: Statistics Sweden

Basically, it is logical and in line with our forecasts that productivity growth slows when the economic cycle enters a more mature phase. The potential for increasing production without new hiring has largely been exhausted. Growth is becoming more domestically driven, shifting the emphasis towards labour-intensive service sectors. In addition, there are structural effects in the labour force. New hires largely consist of younger, inexperienced people. Meanwhile, efforts to increase incentives to join the labour market mean that people with lower-than-average productivity will begin to work.

We thus expect **productivity growth to halve** from 3 per cent in 2004-2006 to about 1½ per cent in 2007-2009.

Our forecast assumes, however, that the figures from the most recent quarters provide an overly dramatic picture of the productivity growth slowdown. These quarterly figures are traditionally volatile. If we look closely at the material we can find temporary factors that exaggerate the decline. The increase in the number of hours worked during the second quarter was by far the largest observed since measurement began in 1970, partly due to underlying job growth, but average working hours also rose sharply. This was attributable to a sharp decline in use of paid holidays and the phase-out of the previous government's "sabbatical year" programme. These factors should be regarded as temporary and have hardly affected GDP.

Experience also shows that the GDP figure is often adjusted upward later when similar imbalances occur between employment and demand data in the economy. As indicated by earlier sections, both exports and consumption are hot candidates for upward revision on the demand side.

wages and salaries there seem to be increasing significantly more, by about 5½ per cent. Underlying inflation in both countries is only 1½ per cent, though trending upward.

The 2007 wage round is moving towards its final phase. Late last spring, the largest union in the local government sector concluded a collective pay agreement at a level similar to other female-dominated unions such as the Commercial Employees' Union. These agreements provide pay hikes about one percentage point above the manufacturing sector.

Pay increase
Percentage change

	2006	2007	2008	2009
Manufacturing	3.2	4.0	4.5	4.5
Construction	3.4	4.4	4.8	4.8
Business sector	3.2	4.3	4.6	4.7
Public sector	3.1	4.0	4.9	4.7
Total	**3.1**	**4.2**	**4.7**	**4.7**

Sources: Statistics Sweden, SEB

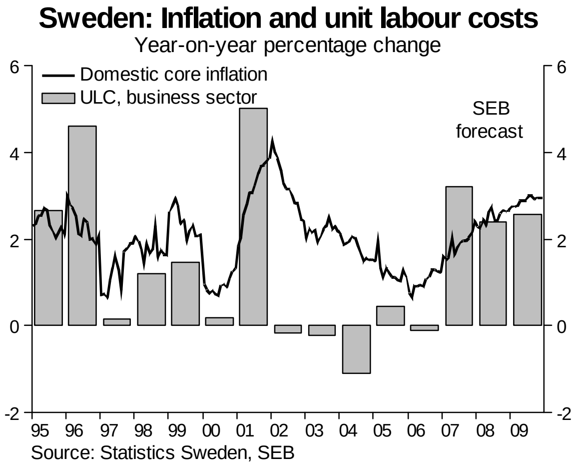
A few large contract areas remain, for example in the central government sector and among teachers. Our assessment is that **wage and salary increases will accelerate** from just over 3 per cent a year during the previous contract period to more than 4½ per cent during 2007-2009.

So far this year, pay increases have been relatively low according to official wage statistics, but the data only cover the period until the end of May. The outcome of this year's wage round will not show up in the statistics until this autumn. The slower pay increases may also be due to the structural effects discussed in the productivity section. Rapid job expansion means that newly hired employees have lower than average wages and salaries. This creates a downside risk in the pay forecast.

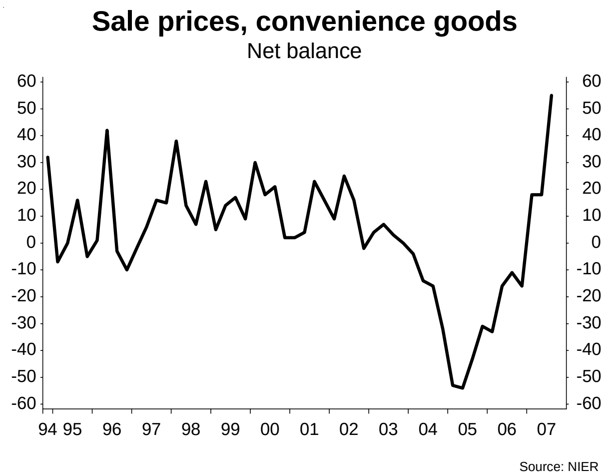
Gradually higher inflation

UND1X (CPI minus mortgage interest and changes in indirect taxes and subsidies) has been relatively stable at around one per cent this year. We expect inflation to move gradually upward. Towards the end of next year, UND1X will be somewhat above 2 per cent. The most important reason is that domestic cost pressure will accelerate as productivity slows and pay increases speed up. The shift in unit labour cost will be relatively dramatic. Having been largely unchanged over the past five years, it will increase by almost 3 per cent annually, we estimate. This will gradually impact domestic inflationary pressure.

This change already seems to have spread to inflationary expectations. Households and companies, as well as financial market players, have **adjusted** their **inflationary expectations** upward. They are now **well above two per cent**.



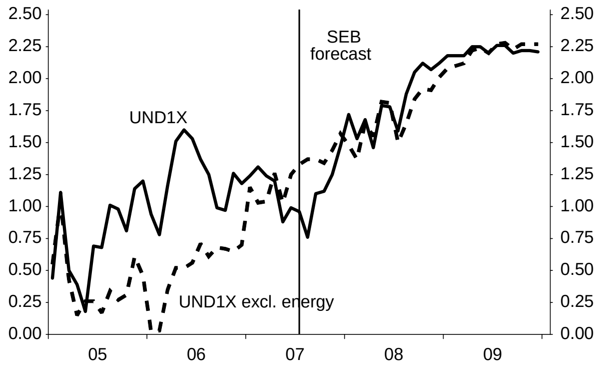
Rising food prices are now also pushing up inflation. There is an international trend towards higher food prices, and the downward price squeeze in the convenience store sector has eased. The percentage of companies planning to raise prices has increased dramatically, both in the food processing industry and at the retail level, according to the NIER Business Tendency Survey. Rents are also contributing to higher inflationary pressure, although the upturn will be gentler due to the lower real estate tax on blocks of flats in 2008.



The picture of price trends on imported goods is mixed. On the one hand, there are signs that the international price squeeze on consumer goods is in the process of fading. Meanwhile we expect the krona to appreciate during our forecast period, which will pull in the opposite direction. Certain rule changes will help hold UND1X inflation down next year. These include the public dental care reform and the cut in employer social insurance contributions in the service sector. Altogether, **UND1X inflation will reach 1.1 per cent this year, then rise to 1.8 per cent in 2008 and 2.2 per cent in 2009.**

Sweden: Underlying inflation

Year-on-year percentage change



Sources: Statistics Sweden, SEB

Due to continued hikes in the Riksbank's key rate and generally higher interest rates, the Consumer Price Index will increase faster than UND1X. Higher taxes on energy and tobacco, a new tax on car insurance premiums and the restoration of the traffic congestion tax in Stockholm will also contribute to an upturn in CPI inflation this year. Next year, indirect taxes will have the opposite impact, due to the abolition of the central government real estate tax and lower dental care fees. CPI inflation will average 2.1 per cent this year, 2.4 per cent in 2008 and 2.5 per cent in 2009.

Riksbank key rate hike to 4.50 next year

In its Monetary Policy Report in June, the Riksbank communicated a significant change in its view of the need for future interest rate hikes. Its optimal repo rate path, looking ahead a few years, was raised from a peak of 3.75 per cent in the February report to 4.40 per cent, while interest rate policy became clearly more front-loaded. The Riksbank justified the change mainly by citing new conditions affecting the inflation forecast, in the form of higher oil prices, sharply falling productivity growth, unexpectedly high collective pay agreements and more expansive fiscal policy.

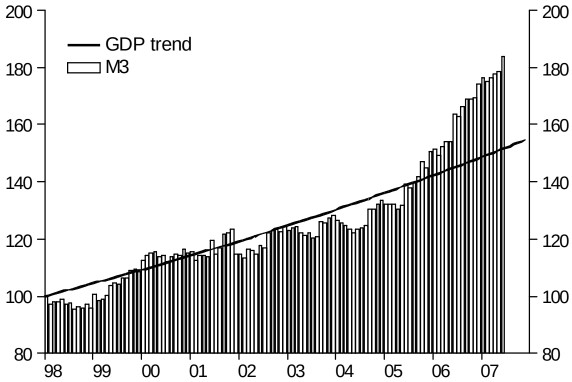
In actuality, what probably played a decisive role was a re-evaluation of the fundamental prerequisites concerning **resource utilisation and overheating risks**. This is also apparent from various Riksbank speeches and meeting minutes. Stopping at an interest rate of 3.50-3.75 per cent well into an economic boom period, in contrast with the policies of other central banks, eventually became an increasingly untenable position.

Since June, the Riksbank has also confirmed that it sees certain upside inflation risks, among other things due to faster improvement in the labour market. Before the recent bout of credit market instability, market sentiment had shifted towards our previous scenario of repo rate hikes climbing to 4.75 per cent.

Looking ahead, the Riksbank is likely to be affected by the international market instability. In the short term, general uncertainty about where the world economy is headed will increase. In a situation where the US Federal Reserve is cutting rates considerable, other central banks will be more cautious about carrying out rate hikes. In a somewhat longer perspective, growth and inflation forecasts are likely to be affected. On the margin, this will help reduce the need for rate hikes. Meanwhile credit spreads are not expected to revert to their previous very low levels, which in itself represents a certain tightening.

Sweden: GDP and money supply (M3)

Index 100 = Jan 1998

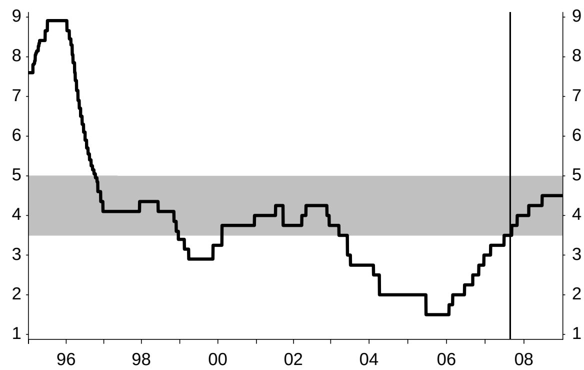


Sources: Statistics Sweden, The Riksbank

At present, it is difficult to foresee the revisions being so large that they will alter the fundamental picture of the Swedish economy. **GDP growth will remain above trend and labour market shortages will become ever clearer.** Meanwhile it is obvious that higher pay increases and decelerating productivity growth will lead to rising inflationary pressure on the cost side. Rising inflationary expectations and high money supply growth – which several Riksbank Executive Board members have recently begun to single out – also reinforce the picture of interest rate normalisation as something natural.

Sweden: Repo rate

Per cent



Source: Reuters EcoWin

We thus expect the Riksbank to continue raising its repo rate to 4 per cent in December and 4.50 per cent by mid-2008.

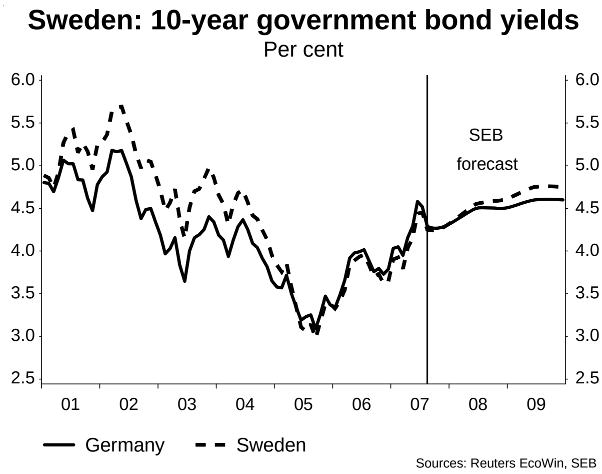
The Riksbank's working method may also be of importance in keeping the policy shift from being so large. Anchored by its inflation target, and with the ambitious, detailed forecast in its Monetary Policy Report as its main tool of communication, the bank assigns great importance to domestic and real economic factors. Comments on changes in international risk assessments admittedly crop up often in Riksbank speeches and minutes, but as long as these are not clearly weighed into the bank's main forecast, **in the end they are rather light-weight compared to the final forecast** of growth and inflation.

The Riksbank will also weigh in threats to financial market stability. The bank is likely to emphasise that Sweden's exposure to the American residential mortgage market is limited and that the Swedish residential mortgage market has no equivalent to the American sub-prime market. It is also likely to stress that generally speaking, Swedish companies have good balance sheets and good liquidity, which should help credit spreads to remain relatively favourable.

The secondary effects of the American home mortgage crisis are likely to include losses in the Swedish financial system. In our main global scenario, however, it is hardly likely that these will be a large enough problem to prevent the Riksbank from further hikes.

Widening spread against Germany

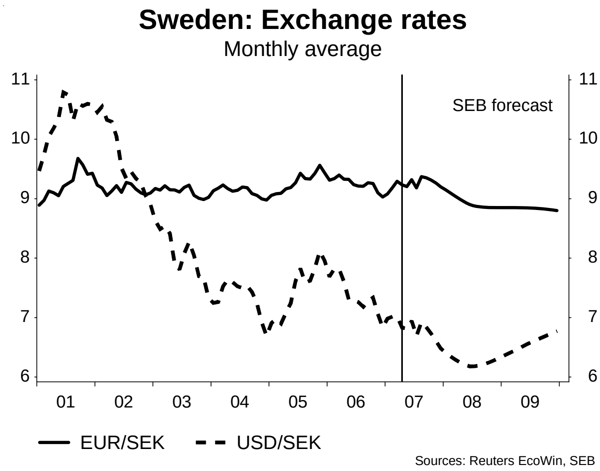
Swedish government bond yields rose rapidly last spring. The upturn followed the general Western European pattern, but it was also strengthened by increasingly robust Swedish economic performance and the tougher tone of the Riksbank.



Since the Riksbank will be raising interest rates at a faster pace than the European Central Bank this year and next, while inflation rates in Sweden and the euro zone are converging, Swedish bond yields will rise somewhat faster than German ones. This means that we will revert to a "normal situation" with **somewhat higher bond yields in Sweden than in Germany**.

The rapid decline in Swedish central government debt, however, will have the opposite effect. We predict that the spread against Germany will be at 10 basis points at the end of next year.

The krona lost value sharply and quickly when financial market instability accelerated, mainly because the US dollar strengthened. In a long-term perspective, we believe that Sweden's good economic outlook and strong external balance along with a normalisation of the Riksbank's key interest rate will strengthen the krona. In addition, there is continued interest among long-term foreign investors in increasing their krona exposure. Our forecast is that at the end of 2007 the EUR/SEK exchange rate will be 9.20, and at the end of 2008 8.85. Our corresponding forecast for USD/SEK is 6.48 and 6.32, respectively.



To the extent that the Stockholm Stock Exchange performs better in the future than a global index, however, this may counteract the appreciation of the krona. Swedish portfolio managers may then be forced to reduce their Swedish equity holdings so that these will not represent too large a proportion of portfolios, resulting in an outflow of kronor.

Labour market boosting public finances

Public sector finances have once again provided upside surprises. The central government budget surplus looks set to end up at SEK 130 billion this year and about SEK 120 billion next year. The effects of the stronger economy, in the form of higher tax revenue and lower expenditures for unemployment, are large. As in previous cyclical upturns, these effects also appear to have been underestimated for a long time. In addition, efforts to bring down employee absences due to illness are leading to **lower sick pay costs**: an expenditure item that normally increases during a cyclical upturn.

The privatisation of state-owned companies will contribute some SEK 150 billion to public finances during 2007-2009. Stock market instability may help delay the government's privatisations, although the final total will not necessarily be affected.

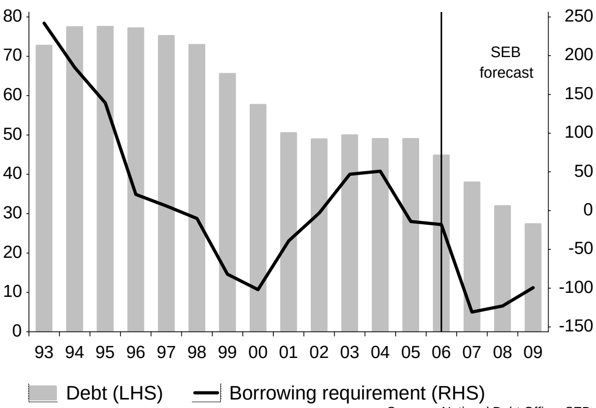
Public finances
Percentage of GDP

	2006	2007	2008	2009
Revenue	55.2	53.9	53.1	52.4
Expenditures	52.8	51.7	51.0	50.3
Financial savings	2.4	2.2	2.2	2.1
Public debt (Maastricht)	46.9	39.5	34.0	29.4
Central government debt	44.8	38.0	32.0	27.4
Central govt borrowing req, SEK bn	-18	-131	-123	-99

Sources: National Debt Office, Statistics Sweden, SEB

Financial savings are estimated to reach 2.2 per cent of GDP this year and next. Since last spring, this has excluded the premium pension system, resulting in an adjustment of the official budget surplus target over an economic cycle from 2 to 1 per cent of GDP. Public sector revenue and expenditures will decrease as a percentage of GDP, and central government debt will fall from about 45 per cent of GDP in 2006 to a bit below 30 per cent in 2009. Consolidated public debt (Maastricht definition) will also fall below 30 per cent in 2009.

Central government debt and borrowing requirement
Percentage of GDP and SEK billion



Sources: National Debt Office, SEB

The non-socialist coalition government that took office in October 2006 got off to a roaring start. The overall consequences of the far-reaching taxation and labour market programmes it has implemented or proposed are still difficult to analyse. There are many indications that **the 2008 budget bill the government unveils this autumn will be something of an off-year budget**. The most important proposals are likely to concern the second stage of the earned income tax credit reform, which will cost SEK 11 billion.

To date, not all programmes have been fully financed. The government has been forced to back down from its plans to finance parts of its tax cuts by tightening the rules for employees who call in sick. There is also some uncertainty about how to finance the abolition of the central government real estate tax and whether the proposed second unpaid day during sick leaves will be enacted. This indicates that fiscal policy may prove somewhat more expansive during the coming year. Meanwhile it is difficult to see any major risks in doing so, as long as the budget surplus keeps increasing and government policies improve the functioning of the economy in many respects.

Political tensions emerging

Looking ahead, however, strong public finances combined with a hot labour market may lead to a **fiscal policy tug-of-war**. The prime minister and the finance minister face a goal conflict between resource utilisation on the one hand and their targeted surplus on the other. Resource utilisation is rising despite supply side reforms, which is an argument against pursuing an even more expansive fiscal policy. On the other hand, high public savings that exceed the targeted surplus by a wide margin will allow even looser fiscal policy.

Looking ahead, most indications are that we will see **an increasingly expansive fiscal policy the closer we get to the 2010 election**. Strong surpluses strengthen the argument that the tax burden in Sweden is unnecessarily large, while ever-shrinking central government debt weakens the argument that it is necessary to keep setting aside money for a rainy day. The Confederation of Swedish Enterprise, for example, advocates significantly further-reaching tax cuts and clearer expressions of political willingness to change the business climate. In addition, as the election approaches, all four parties in the ruling Alliance for Sweden coalition – perhaps pressured by poor public opinion figures – will undoubtedly want to take advantage of the budget surplus to enact programmes related to their own respective signature issues.

Fiscal policy is thus likely to be even more expansive in 2009. In our forecast, we have assumed **new programmes equivalent to about SEK 30 billion**, or one per cent of GDP. The third stage in the earned income tax credit reform will probably be enacted. Family policy reforms, such as an extra earned income tax credit for the lower-paid spouse and a home child care allowance, are likely to be next.

The new fiscal policy council

During the summer, Finance Minister Anders Borg appointed **a fiscal policy council with the task of examining and evaluating the government's policies**.

The membership of the council is weighted towards researchers in the labour market field. This probably means that the council will attach greater importance to long-term structural issues than to short-term budget and cyclical issues.

The council is certain to present its projections of the impact of various types of rule changes, especially in areas affecting the labour market. This will probably imply **greater use and legitimacy for calculations of "dynamic effects"**, i.e. consequences of behavioural changes due to new decisions.

If these effects are counted as sources of financing, this would imply an acceptance of a more expansive fiscal policy to the extent that this has "worthy" structural policy purposes. Because of bad experiences from the major tax reform of the early 1990s, so far the government has chosen to abstain from such a strategy.

On the other hand, the council will probably also **help increase discipline in enforcing the expenditure ceiling**, for example, and help the finance minister in his struggle against big-spending government ministers. This may reduce the tendency to utilise the budgeting margin for permanent expenditure hikes or to formulate proposals in such a way that higher expenditures can be classified as tax cuts.

Moderate years ahead

- **Slower housing market and consumption**
- **Mounting resource shortage**
- **Clearly higher inflation in 2008**

The Danish economy is slowing to a calmer pace after two years of GDP growth above 3 per cent. **Growth** will be nearly 2.5 per cent this year but will end up a bit **below the 2 per cent trend in 2008 and in 2009**. This deceleration will occur on both the demand and supply side. Consumption is now losing strength due to cooling in the housing sector. Looking ahead, an increasingly large resource shortage will impede growth – and boost inflation.

The weakening household consumption trend is clear. Retail growth has fallen in 2007, with stagnating summertime sales year-on-year. Car sales have fallen since spring. Except for shrinking residential construction, the business sector's capital spending has continued to expand rapidly this year. Export growth has also stayed robust, though its year-on-year pace has been hampered by statistical base effects.

Forward-looking surveys tell the same story. Retail sector confidence has been further undermined since spring. Household confidence has also fallen, though modestly due to the strong labour market. In construction, expectations have hardly budged since earlier declines. Manufacturing optimism has improved; the latest purchasing managers' index is at a historical high. Export order books are well filled.

Our main scenario is a **slowdown driven by households**. Private consumption growth will fall moderately from 3.4 per cent in 2006, averaging 1¾ per cent annually in 2007-2009. Real pay will rise decently and new income tax cuts may be delivered. But higher interest rates and continued housing market weakening will make households boost their savings.

A year ago, **home prices** were rising at 20-25 per cent year-on-year. Since then a **clear slowdown in sales and prices** has occurred. In the second quarter, prices of owner-occupied flats fell 2 per cent year-on-year; in central Copenhagen they dropped more than 10 per cent. Single-family home prices were largely unchanged in Copenhagen but rose 8 per cent in Denmark as a whole. The abrupt shift in Copenhagen is probably due to a combination of excessive and continued increase in supply. We predict a slight overall decline in residential market prices next year.

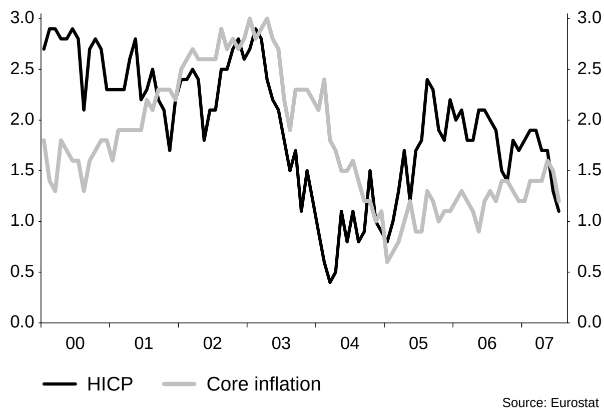
Danish **resource utilisation** is increasingly strained. In manufacturing, capacity utilisation has risen during 2007 to its highest level in 20 years. **Unemployment** has fallen further than expected, to 3.5 per cent, its **lowest level in more than 30 years** and well below the 4.5 per cent regarded as structural. Manufacturing and construction sector shortages remain at high levels, after a marginal downturn since last spring. In our judgement, unemployment will fall slightly further over the next six months. A historically large share of manufacturing companies intends to hire new employees. Distributive trades are also still expansive, even though they passed their peak about a year ago.

Given this backdrop, **pay increases** have been **surprisingly modest**, rising from a 3 per cent rate last year to 3.25 per cent in the first quarter of 2007. The trend has been the same in manufacturing and distributive trades, while construction wage growth has remained at 3.75 per cent. But acceleration is in the cards, since the increased authorised by last spring's major pay agreements have not yet worked their way through. Falling unemployment and weakened productivity growth also point towards a **late-cyclical jump in wages**. Pay will increase by 4 1/4 per cent in 2008.

On the surface, inflation still appears calm. The rate of broad HICP inflation fell from nearly 2 per cent early in 2007 to just above 1 per cent in the summer. But this was due to volatile energy and food prices and related base effects. Core inflation has trended upward. Also notable is that the producer price increase on Danish goods has remained high, nearly 5 per cent.

Denmark: Inflation

Year-on-year percentage change



Source: Eurostat

Due to **rising underlying inflationary pressure**, we still predict that HICP will average close to 2.5 per cent in 2008 despite recent downside surprises.

The upturn in inflation is not expected to affect the confidence in Danish krone or bonds. But given the combination of rising cost pressure and continued krone appreciation in the wake of a stronger euro, Danish exports risks eventually starting to lose market share again. We also predict that the country's relatively large current account surplus will shrink to more modest levels over the next few years.

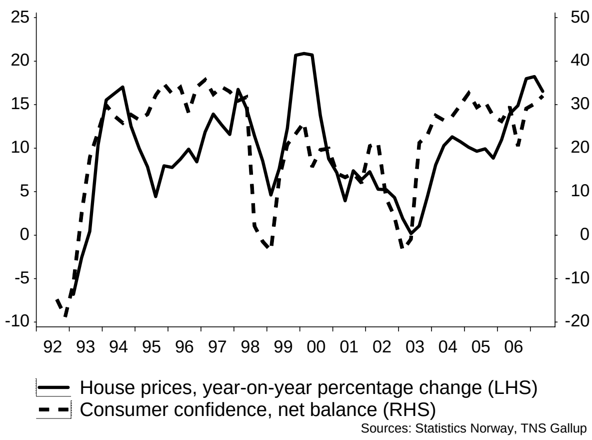
Economic boom culminating

- **High real wage growth – consumption boom**
- **Even lower jobless rate, accelerating pay hikes**
- **Supply side constraints will cool 2008 growth**
- **Norges Bank will raise key rate to 5.75 per cent**

The Norwegian economy continues to steam ahead and looks set for **a fourth year of growth above 4 per cent in the mainland economy** (excluding offshore oil and gas). The cyclical upswing is broadly based. Sharply rising income is fuelling consumption, as good profits and high capacity utilisation drive companies' capital spending. Meanwhile exporters are benefiting from a strong global commodities market, and high oil prices are helping lift investments in the oil and gas sector to new heights.

There are many signs that this vigorous growth can persist for some time into 2008. The indicators are very strong in most places, but resource utilisation is meanwhile becoming increasingly strained. **Unemployment** has fallen to its **lowest level in 20 years**, pay increases are accelerating and domestic inflation is on the way up. Norges Bank is thus continuing to raise its sight deposit rate, though the recent global financial market instability has increased the uncertainty concerning the pace of interest rate hikes. We expect the key rate to be raised by another 100 basis points to 5.75 per cent next year. This will help cool down Norway's hot economy, but more importantly, supply side restrictions will become more and more evident. **Mainland economic growth will thus slow from 4.9 per cent this year to 2.8 and 2.3 per cent, respectively, in the next two years**.

Norway: House prices and consumer confidence



Sources: Statistics Norway, TNS Gallup

Broad growth in domestic demand

Optimism in the household sector is close to its historical peak. The labour market is super-strong and the wealth position of households is solid. This year, various factors will also combine to help sharply boost income in the household sector. Wages and salaries will increase by 5½ per cent, while factors such as steeply falling electricity prices will limit inflation to only a bit above ½ per cent. In addition, employment will rise by 3 per cent and fiscal policy will ratchet up income further. Altogether, private consumption will increase by 6 per cent in 2007.

In the next couple of years as well, households can count on good real wage and salary increases, although noticeably higher inflation will undermine part of their purchasing power. Meanwhile job growth will decelerate, and higher interest rates will begin to bite. We also expect the trend towards a deceleration in the pace of residential price increases to intensify. Considering that homes are clearly over-priced according to many valuation models, there is some risk of a significantly sharper, faster price correction than we have assumed. This, in turn, implies a downside risk for consumption.

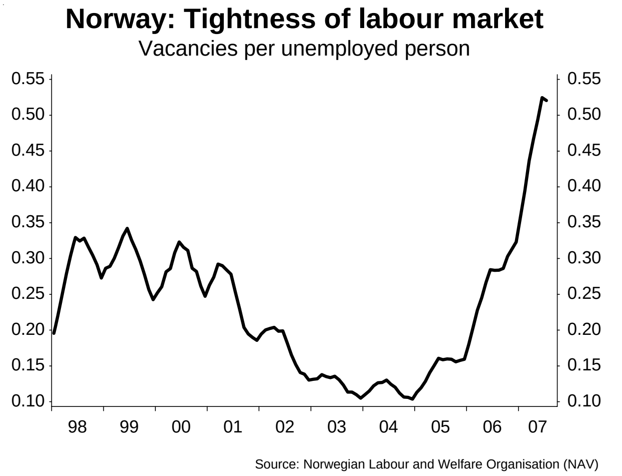
In the corporate sector, too, there is great optimism. Capacity utilisation is unusually high and capital spending plans in the business sector are expansive. Residential construction is also continuing at a healthy pace. Over the next two years we expect a deceleration in mainland capital spending, including a slowdown in home construction. An abnormally high capital spending level, higher interest rates – as well as rising wage and salary costs and the stronger krone eating away at profitability – are contributing factors.

Even tighter labour market

Employment has continued upward in 2007, after last year's record increase of more than 3 per cent. Unemployment has been squeezed to historically very low levels. In June, unemployment was 2.5 per cent according to Statistics Norway's Labour Force Survey. The downturn has begun to level off, however – not due to falling demand for labour but instead because it has become increasingly difficult to match vacancies with job seekers. We believe that unemployment can now hardly fall much further. A continued upturn in employment will thus depend on how much the labour supply can increase.

One key issue, for example, is how much the immigration of labour can increase in the future. The upturn has continued this year, but increased future demand for labour in immigrants' home countries is likely to be a restraining factor. Labour force participation can probably not rise so much more, though the trend towards greater participation among older people is likely to result in a certain increase.

The tight labour market situation has had an increasingly clear effect on pay increases. In the first quarter of 2007, business sector wages and salaries rose by about 6 per cent year-on-year. Although large bonus payments contributed to this high rate of increase, there are many indications that **average pay** may **rise by as much as 5½ per cent** both this year and next. The effects of this year's high collective pay agreements have not yet made their way into the statistics, for example. Due to continued very low unemployment, next year's wage round will also take place in a very strained labour market situation.



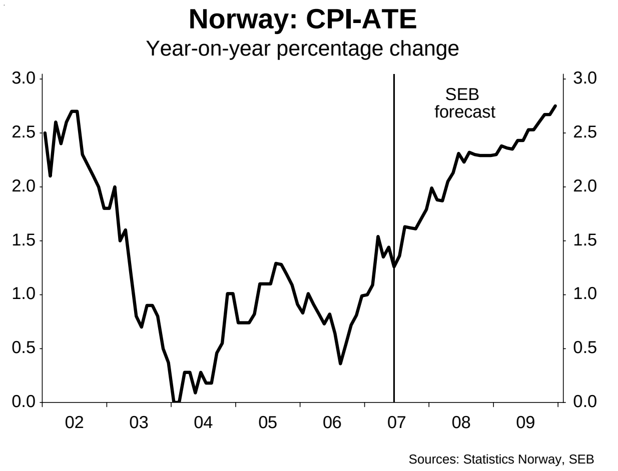
Domestic inflation on the way up

Underlying inflation (CPI-ATE) is still low. In July the rate was 1.4 per cent. However, domestically generated inflation is clearly on the way up. Between the third quarter of 2006 and July 2007, domestic inflation rose from 0.8 to 2.9 per cent. This trend will strengthen as the effects of rising pay hikes increasingly contribute to domestic cost pressure. Productivity growth, which has been strong to date, will also probably slow as the economic cycle enters a more mature phase. Increasing producer prices also confirm that inflationary pressure is on the way up.

Low import prices are continuing to restrain inflation, but we expect the downward pressure on international prices to fade. This will reduce the deflationary effects of import prices. Overall, we expect **underlying inflation to increase from 1.4 per cent this year to 2.2 per cent in 2008** and 2.5 per cent in 2009.

Although inflation is still low, the risk that Norges Bank will not achieve its inflation target of 2½ per cent has greatly diminished. The central bank has thus attached increasing importance to trying to stabilise the real economy. Strained resource utilisation, especially in the labour market, is an unequivocal sign that interest rates will continue upward.

After raising its sight deposit rate from 4.50 to 4.75 per cent on August 15, the central bank's communication contained little to indicate a pause in its interest rate hikes. Meanwhile the financial market turbulence of recent weeks has increased uncertainty. The Fed's policy reversal, and our forecast that the ECB will not go any further than 4.25 per cent, is a restraining factor for Norges Bank. Although uncertainty about monetary policy has increased, we still believe that the bank will continue to raise its sight deposit rate at a relatively rapid pace. Our forecast is that the key rate will peak at 5.75 per cent next year.



Expansive budget, despite observance of the fiscal policy rule

The "fiscal policy rule" stipulates that four per cent of the expected return on the Government Pension Fund – Global (formerly the Petroleum Fund) may be spent yearly. However, this rule also leaves room for divergences depending on the economic situation and/or large fluctuations in Fund assets. If the four per cent rule is observed, the strong growth in Fund assets would imply significant economic stimulation over the next few years. Considering Norway's high resource utilisation, the economy would hardly be well served by such extra stimulation.

The government has thus expressed an ambition to use less oil money than the four per cent rule allows. The 2007 budget means that for the first time since the fiscal policy rule was introduced in 2001, the amount spent will end up somewhat below four per cent. **Fiscal policy** will nevertheless continue to be **weakly expansive**. Nor is any fiscal tightening to be expected in the next couple of years, even though the government will continue to spend less oil money than the fiscal policy rule allows. The burden of economic stabilisation will thus fall entirely on monetary policy.

Good, well-balanced growth

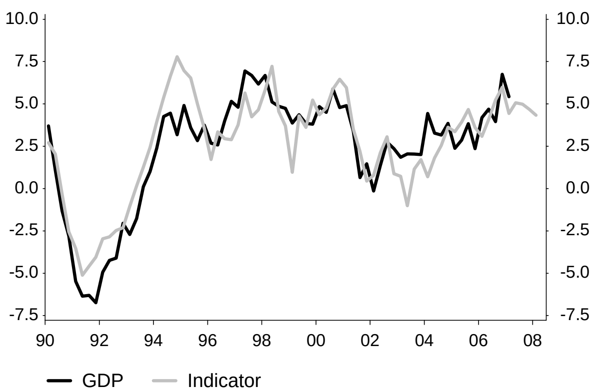
- **Strong expansion this year too, but slower pace**
- **Low unemployment, sound finances**
- **Accelerating wages, risk of higher inflation**

Finland is continuing to grow at a good pace. In 2006, GDP growth ended up at 5 per cent, partly due to a rebound after the paper industry shutdown the year before. The economy has chugged along at a healthy pace so far in 2007. Growth remains balanced. Private consumption will climb by nearly 4 per cent this year, capital spending somewhat faster, and foreign trade will contribute to growth, although gradually less.

Our growth indicator, based on various confidence survey data and our own forecasts, nevertheless shows that **growth peaked in the fourth quarter of 2006**. Manufacturing output, which has slowed so far this year, also indicates that growth has passed its peak. The ongoing economic slowdown will be undramatic according to the indicator with GDP growth ending up at 4-5 per cent year-on-year for each remaining quarter of 2007. Due to the financial and credit market instability of recent weeks – which is not tracked by the indicator – we foresee **growth of nearly 4 per cent this year**, which is an unchanged forecast compared to our May issue.

Households will continue to increase their consumption at a healthy pace next year. Exports will benefit from both a favourable product structure as well as strong global demand, climbing more than 5 per cent a year. GDP growth will slow to 3.6 per cent next year and to a bit above 3 per cent in 2009.

Finland: GDP and indicator
Year-on-year percentage change



Source: SEB

Because of Finland's strong growth, more production resources will be placed in service. Employment, which rose by slightly more than 40,000 people in 2006, will continue upward. In June, nearly 60,000 more people were working than one year earlier.

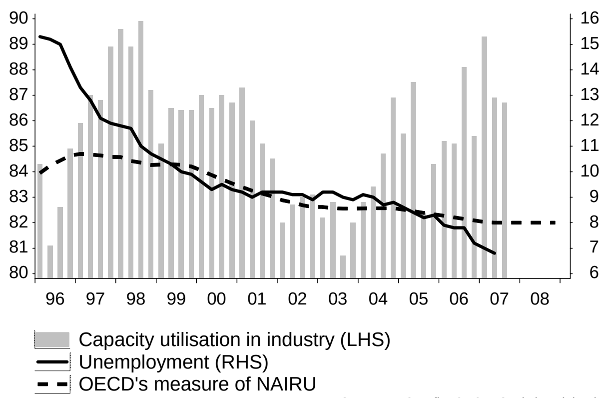
Seasonably adjusted unemployment is continuing downward and now stands at 6.6 per cent – the lowest level since May 1991. Hiring plans remain expansive, and we anticipate an increase of nearly 2 per cent in jobs this year, which is an upward adjustment of our May forecast. Unemployment is currently well below the OECD's equilibrium measure. In spite of this, unemployment will continue downward to a bit above 7 per cent this year and about 6.5 per cent in 2008.

Gradual acceleration in pay hikes

So far, there are no clear signs of rising wage and salary inflation, but we expect pay levels to accelerate when the labour market situation becomes tighter. Hourly pay hikes will speed up from 3 per cent last year to 3.2 per cent this year and about 4 per cent in 2008 and 2009. Inflationary impulses will be neutralised somewhat by relatively strong productivity growth, which will keep unit labour costs down.

HICP inflation, which has been among the lowest in the euro zone for a long time, will remain slightly below 2 per cent this year but accelerate somewhat in response to resource utilisation and upward pressures on pay. Inflation will end up at 2 per cent next year and a little higher in 2009.

Unemployment and capacity utilisation
Per cent



Sources: DG Ecfin, OECD, Statistics Finland

Finland's budget surplus amounted to 3.9 per cent of GDP in 2006, very much thanks to tax payments from companies. Looking ahead, certain tax cuts, lower tax revenue and a calmer pace of economic growth will hold down the surplus; we expect it to reach 3.8 per cent of GDP this year, 3.7 per cent in 2008 and just above 3 per cent in 2009.

DENMARK

Yearly change in per cent

	2006	2007	2008	2009
Gross domestic product	3.3	2.4	1.7	1.6
Private consumption	3.4	2.0	1.5	1.7
Public consumption	1.6	1.3	1.0	1.3
Gross fixed investment	13.0	6.5	4.0	3.0
Stockbuilding (change as % of GDP)	0.4	0.0	0.0	0.0
Exports	10.1	7.0	4.8	4.0
Imports	14.5	7.9	5.3	4.5
Unemployment (%)	4.5	3.5	3.6	3.9
Consumer prices, harmonised	1.9	1.8	2.4	2.2
Wage cost	3.1	3.8	4.3	4.4
Current account, % of GDP	2.4	2.0	1.5	1.7
Public sector financial balance, % of GDP	4.2	3.8	3.4	3.2
Public sector debt, % of GDP	30.2	24.0	20.0	19.0

FINANCIAL FORECASTS	Aug 23	Dec 07	Jun 08	Dec 08	Jun 09	Dec 09
Deposit rate	4.25	4.50	4.50	4.50	4.50	4.50
10-year bond yield	4.39	4.30	4.50	4.50	4.65	4.65
10-year spread to Germany, bp	11	0	0	0	5	5
USD/DKK	5.49	5.25	5.17	5.32	5.52	5.73
EUR/DKK	7.44	7.45	7.45	7.45	7.45	7.45

NORWAY

Yearly change in per cent

	2006	2007	2008	2009
Gross domestic product	2.9	3.4	2.8	1.9
Gross domestic product (Mainland Norway)	4.6	4.9	2.8	2.3
Private consumption	4.3	6.1	3.2	2.8
Public consumption	2.2	2.8	3.0	2.7
Gross fixed investment	8.9	6.9	3.9	0.9
Stockbuilding (change as % of GDP)	0.8	0.4	0.0	0.0
Exports	1.5	3.1	2.9	1.9
Imports	9.1	7.3	4.2	3.0
Unemployment (%)	3.5	2.5	2.6	2.9
Consumer prices	2.3	0.7	3.0	2.5
CPI-ATE	0.8	1.4	2.2	2.5
Wage cost	4.1	5.5	5.6	4.8
Current account, % of GDP	16.4	15.3	14.7	14.0
Public sector financial balance, % of GDP	19.3	19.0	18.5	17.5

FINANCIAL FORECASTS	Aug 23	Dec 07	Jun 08	Dec 08	Jun 09	Dec 09
Sight deposit rate	4.75	5.25	5.50	5.75	5.75	5.25
10-year bond yield	4.88	4.90	5.10	5.05	5.10	5.10
10-year spread to Germany, bp	60	60	60	55	50	50
USD/NOK	5.86	5.56	5.42	5.64	5.93	6.15
EUR/NOK	7.95	7.90	7.80	7.90	8.00	8.00

Nordic key economic data

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SWEDEN

Yearly change in per cent

	2006	2007	2008	2009
Gross domestic product	4.2	3.5	3.2	2.5
Gross domestic product, working day adjusted	4.5	3.6	3.0	2.5
Private consumption	2.8	3.2	3.7	3.0
Public consumption	1.8	1.6	1.4	1.4
Gross fixed investment	7.9	11.0	4.7	2.0
Stockbuilding (change as % of GDP)	0.0	0.3	0.0	0.0
Exports	8.7	5.9	5.4	4.8
Imports	7.9	8.6	5.9	4.8
Unemployment (%)	5.4	4.3	3.7	3.5
Employment	1.9	2.4	1.3	0.7
Industrial production	5.6	4.4	4.0	3.0
Consumer prices	1.4	2.1	2.4	2.5
UND1X	1.2	1.1	1.8	2.2
Wage cost	3.1	4.2	4.7	4.7
Household savings ratio (%)	8.3	10.6	9.7	9.3
Real disposable income	2.2	5.7	2.8	2.7
Trade balance, % of GDP	5.5	5.0	4.9	4.9
Current account, % of GDP	6.9	6.4	6.3	6.4
Central government borrowing, SEK bn	-18	-131	-123	-99
Public sector financial balance, % of GDP	2.4	2.2	2.2	2.1
Public sector debt, % of GDP	47	40	34	29

FINANCIAL FORECASTS	Aug 23	Dec 07	Jun 08	Dec 08	Jun 09	Dec 09
Repo rate	3.50	4.00	4.50	4.50	4.50	4.50
3-month interest rate, STIBOR	4.00	4.40	4.85	4.85	4.85	4.85
10-year bond yield	4.23	4.30	4.55	4.60	4.75	4.75
10-year spread to Germany, bp	-6	0	5	10	15	15
USD/SEK	6.90	6.48	6.18	6.32	6.56	6.77
EUR/SEK	9.37	9.20	8.90	8.85	8.85	8.80
TCW	127.4	123.5	118.8	118.6	119.3	119.5

FINLAND

Yearly change in per cent

	2006	2007	2008	2009
Gross domestic product	5.0	4.1	3.6	3.3
Private consumption	4.3	3.8	3.1	2.6
Public consumption	1.0	1.3	1.2	1.1
Gross fixed investment	4.1	4.5	4.3	4.3
Stockbuilding (change as % of GDP)	0.2	0.0	0.0	0.0
Exports	10.4	6.4	5.8	5.5
Imports	8.3	5.1	4.9	4.5
Unemployment (%)	7.7	7.1	6.6	6.2
Consumer prices, harmonised	1.3	1.8	2.0	2.1
Wage cost	3.0	3.2	3.9	4.0
Current account, % of GDP	5.8	6.1	6.3	6.5
Public sector financial balance, % of GDP	3.9	3.8	3.7	3.2
Public sector debt, % of GDP	39.1	37.0	35.3	35.3

International key economic data

EURO ZONE

Yearly change in per cent

	2006	2007	2008	2009
Gross domestic product	2.9	2.6	2.4	2.1
Private consumption	1.8	1.1	1.6	1.9
Public consumption	2.0	1.9	2.0	2.0
Gross fixed investment	5.1	5.7	4.3	4.0
Stockbuilding (change as % of GDP)	-0.1	0.2	0.0	0.0
Exports	8.4	6.2	5.4	4.8
Imports	8.0	6.0	5.2	5.7
Unemployment (%)	7.9	6.9	6.5	6.3
Consumer prices, harmonised	2.2	2.0	2.0	2.0
Household savings ratio (%)	10.0	9.9	9.7	9.4

US

Yearly change in per cent

	2006	2007	2008	2009
Gross domestic product	2.9	1.9	2.1	2.8
Private consumption	3.1	2.8	1.7	2.6
Public consumption	1.8	1.7	0.6	0.6
Gross fixed investment	2.4	-2.4	3.4	6.2
Stockbuilding (change as % of GDP)	0.1	-0.4	0.0	0.1
Exports	8.4	6.5	6.9	6.1
Imports	5.9	2.0	3.4	6.0
Unemployment (%)	4.6	4.6	5.2	5.5
Consumer prices	3.2	2.8	2.5	2.1
Household savings ratio (%)	0.4	1.1	2.9	3.3

LARGE INDUSTRIAL COUNTRIES

Yearly change in percent

	2006	2007	2008	2009
GDP				
United Kingdom	2.8	2.9	1.9	2.2
Japan	2.2	2.4	1.9	2.0
Germany	2.8	2.6	2.4	2.2
France	2.2	2.1	2.2	2.1
Italy	1.9	1.9	1.8	1.6
Inflation				
United Kingdom	2.3	2.5	2.0	2.0
Japan	0.2	0.0	0.4	0.7
Germany	1.8	1.9	2.0	2.0
France	1.9	1.5	1.9	2.0
Italy	2.2	1.8	1.9	2.0
Unemployment (%)				
United Kingdom	5.4	5.4	5.4	5.6
Japan	4.1	3.8	3.5	3.3
Germany	10.8	8.9	8.2	7.1
France	9.0	8.2	7.8	7.5
Italy	6.8	6.3	6.0	5.8

International key economic data

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CENTRAL AND EASTERN EUROPE

	2006	2007	2008	2009
GDP, yearly change in per cent				
Czech Republic	6.4	5.6	5.0	4.7
Estonia	11.4	8.0	7.0	6.5
Hungary	3.9	2.3	2.8	3.0
Latvia	11.9	9.7	8.2	7.8
Lithuania	7.5	8.0	6.5	6.0
Poland	6.1	6.5	5.5	5.0
Russia	6.7	7.5	7.0	6.5
Slovakia	8.3	8.7	7.2	6.8
Ukraine	7.1	7.5	8.0	8.0
Inflation, yearly change in per cent				
Czech Republic	2.1	2.8	3.2	2.7
Estonia	4.4	5.0	4.0	3.5
Hungary	4.0	7.0	4.3	3.8
Latvia	6.6	7.7	6.5	5.3
Lithuania	3.8	4.5	4.0	3.5
Poland	1.3	2.3	2.8	2.5
Russia	9.7	8.5	8.3	8,0
Slovakia	4.3	2.5	2.3	2.3
Ukraine	9.1	11.0	10.0	9,0

FINANCIAL FORECASTS

		Aug 23	Dec 07	Jun 08	Dec 08	Jun 09	Dec 09
Official interest rates							
US	Fed funds	5.25	4.50	4.00	4.00	4.00	4.00
Japan	Call money rate	0.50	0.75	1.00	1.25	1.50	1.75
Euro zone	Refi rate	4.00	4.25	4.25	4.25	4.25	4.25
United Kingdom	Repo rate	5.75	5.75	5.25	5.00	5.00	5.00
Bond yields							
US	10 years	4.65	4.40	4.30	4.50	4.60	4.70
Japan	10 years	1.60	1.90	2.00	2.10	2.20	2.30
Germany	10 years	4.28	4.30	4.50	4.50	4.60	4.60
United Kingdom	10 years	5.04	5.15	5.20	5.20	5.30	5.30
Exchange rates							
USD/JPY		116	116	120	122	122	122
EUR/USD		1.36	1.42	1.44	1.40	1.35	1.30
EUR/JPY		158	165	173	171	165	159
GBP/USD		2.01	2.04	2.00	1.94	1.88	1.81
EUR/GBP		0.68	0.70	0.72	0.72	0.72	0.72

GLOBAL KEY INDICATORS

Yearly percentage change

	2006	2007	2008	2009
GDP OECD	3.1	2.6	2.5	2.7
GDP world	5.4	5.1	4.7	4.7
CPI OECD	2.5	2.2	2.1	2.0
Export market OECD	8.9	6.5	7.3	7.8
Oil price, Brent (USD/barrel)	64.9	67.0	69.0	68.5

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