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Nordic Outlook

Economic slowdown is spreading
Bumpy road back to balance

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Global: Economic slowdown is spreading – bumpy road back to balance

- The global credit crisis is moving into a new phase. Lending terms are tightening as the financial sector adjusts balance sheets to a new credit and growth environment. Due to further cooling in consumption and investment, the slowdown will bottom out in 2009. No country will escape it, but resilience in emerging economies will sustain global growth.
- Stubborn inflation, mainly driven by higher energy and food prices, risks seriously affecting inflation expectations and wage formation. The whiff of stagflation now in the air poses serious dilemmas for central banks. But economic deceleration and easing pressures from energy and food will cause inflation to slow towards the end of 2008.
- The US recession will be prolonged, but relatively mild. A further 10-15 per cent decline in home prices will slow consumption and delay financial sector recovery. Credit problems and high oil prices will blunt the effects of interest rate and tax stimulus measures. GDP will grow by 1.0 per cent this year and 0.7 per cent in 2009. The key interest rate will be 1.5 per cent at the end of 2008.
- The cool-down in Western Europe is increasingly evident. GDP growth in both the euro zone and the UK will slow to some 1½ per cent this year and weaken further in 2009. The Bank of England will cut its key rate gradually to 3.5 per cent some months into 2009. The ECB’s dilemma – a mixed growth picture and high inflation – will delay a rate cut until October. By autumn 2009, the refi rate will be 3.0 per cent.
- The euro will remain strong for a while as the dollar and pound are squeezed. We expect the euro to reach at least USD 1.60, after which mounting euro zone problems will stop its rise. Despite inflation worries and a larger bond supply, we expect long-term yields to fall in the wake of weak growth, continued credit turmoil and key rate cuts.

Sweden

- A clear slowdown is around the corner for both exports and domestic demand, after good growth early in 2008. GDP will increase by just over 2 per cent in 2008 and 1.3 per cent in 2009. The labour market will weaken; job growth will gradually slow and unemployment will rise by autumn. Strong government finances and decelerating growth will allow room for fiscal stimulus in the autumn budget, equivalent to SEK 30 billion for 2009.
- Inflation will remain high all year. Falling energy prices and fading labour cost pressure will trigger a retreat in inflation next year. The Riksbank will wait until December before starting to cut interest rates. Next autumn the repo rate will be 3.25 per cent.

Other Nordic countries and the Baltics

- **Denmark:** The economic slowdown is continuing. Domestic demand is cooling in the wake of falling home prices. GDP growth will reach only 1.0 per cent in 2008 and 0.7 per cent in 2009. Resource shortages are easing, but wage and inflation pressure will remain relatively high.
- **Norway:** The economy is slowing from record growth. Resource shortages and weaker international performance will slow mainland GDP growth to 3 per cent in 2008 and 2 per cent in 2009. Inflation risks and a tight labour market will force Norges Bank to hike its key rate once more. Next year it will cut the sight deposit rate from 5.75 to 4.75 per cent.
- **Finland:** Growth will slow, partly due to problems in the forest product industry, but telecoms and engineering will help the economy stay resilient ahead. GDP will rise by 2.5 per cent this year and 2.0 per cent in 2009.
- **The Baltics:** All three economies are decelerating significantly after earlier overheating. GDP growth in Estonia and Latvia will drop to 3 per cent both this year and next. Domestic demand is fading, while exports put up a decent resistance to the global slowdown and weakened competitiveness. High inflation will culminate during 2008.

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Slowdown bottoming in 2009

- **Tighter credit conditions will have an impact**
- **Prolonged inflation spike will cause headaches**
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- **Renewed US dollar weakness**

The theme of our last few editions of ***Nordic Outlook*** has been that the path to renewed global financial stability will be neither easy nor painless for banks, households and companies. Following in the wake of the global credit crisis will be a number of adjustment processes, some of them now still in their infancy. We can thus expect tightening credit conditions that will exacerbate the negative impact on households of falling home prices and a weaker labour market. This can be expected to prolong the economic slump. The credit crisis and the US recession will gradually work their way through the economies of both Western Europe and Asia, but in varying degrees.

Rescue efforts by central banks have successfully softened the most acute crisis symptoms in the credit market, reducing the risk of collapse in the financial system. Meanwhile fiscal policy serves as a further line of defence against the slowdown. But high commodity and food prices and continued risk premiums in the interbank market and elsewhere have limited the impact of stimulus measures, forcing central banks to make interest rate decisions amidst great uncertainty.

GDP growth
Year-on-year percentage change

	2006	2007	2008	2009
United States	2.9	2.2	1.0	0.7
Japan	2.4	2.1	1.2	1.2
China	11.6	11.9	10.0	8.5
Euro zone	2.9	2.6	1.4	1.1
United Kingdom	2.9	3.0	1.5	1.3
Nordic countries	3.8	3.0	2.2	1.4
OECD	**3.2**	**2.7**	**1.3**	**1.1**
The world	5.0	4.9	3.8	3.5

Sources: OECD, SEB

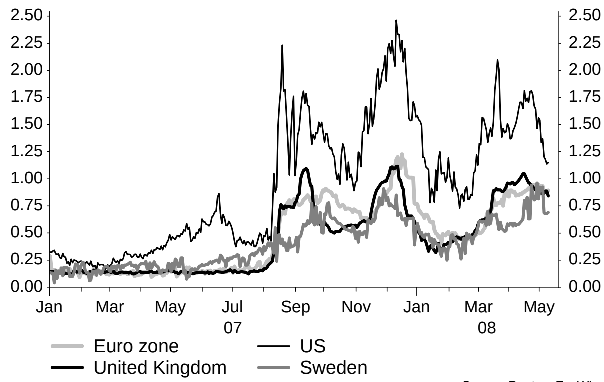
The focus is now on 2009. Our forecast implies that GDP growth in the United States will average around 1 per cent in both 2008 and 2009. This means that the economy will decelerate towards zero growth year-on-year around the end of 2008. Western Europe is entering a slowdown. In the euro zone and the United Kingdom, growth will halve this year to 1½ per cent, and then weaken further in 2009. In Japan, too, the economy will cool noticeably to just above 1 per cent annually. Our conclusion is that the global slowdown will not bottom out until 2009.

The resilience of the fast-growing economies in Asia and Eastern Europe will now be tested in earnest. To date, their growth has held up nicely. But a degree of cooling is on the way, though most indications are that the domestic dynamic – consumption and capital spending – is sufficiently strong that GDP growth can remain relatively high even during an OECD slowdown.

The world economy is thus characterised by different forces: on the one hand, strong underlying expansion in emerging economies; and on the other hand, a relatively powerful adjustment process in the OECD following earlier credit market excesses. The final result will be decent global growth measured in purchasing power-adjusted terms, but an OECD slowdown.

In this environment, many companies and sectors – with their strong balance sheets – can emerge relatively unscathed from the slowdown by taking advantage of the strengths in the global economy. But Western economic policy will be greatly tested by a complex mix of weak growth, mounting cyclically related credit losses, rising inflation and – in some countries – weak, cyclically sensitive government finances.

Spread between interbank rate and T-bills
3 months



Source: Reuters EcoWin

Credit crisis moving into a new phase

The credit crisis that began with the collapse of the American sub-prime mortgage market has now been underway for nearly one year. A lack of information and knowledge has caused certain credit products to record unprecedented – and sometimes exaggerated – price declines. Central banks, especially the Federal Reserve, have carried out various rescue actions:

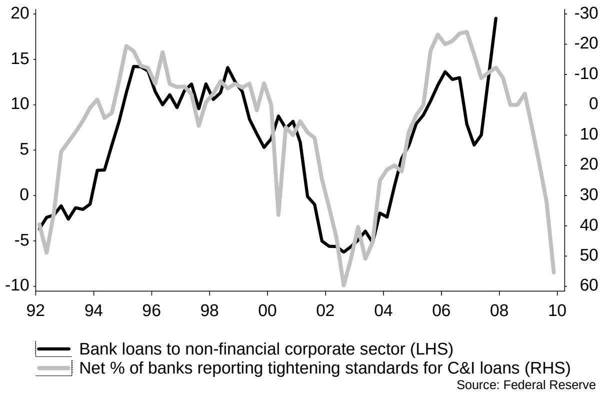
- Gigantic liquidity injections.
- Exchanges of credit instruments for government bonds.
- Financial support for the take-over of the investment bank Bear Stearns.

These actions have improved market functioning and have clearly soothed worries about a collapse of the US financial system. We are probably close to the point where the rate of increase in unrealised losses, connected to falling market prices on credit product, will decline. But this does not mean that the financial crisis is over. Despite numerous steps to improve liquidity in the financial system, there is still widespread mutual mistrust among banks. The spread between the interbank rate and interest on Treasury bills remains high both in the US and Europe.

Other important interest rate spreads have continued to increase or remain at high levels. The Fed's aggressive rate cuts have not pushed down interest rates on mortgage loans or corporate bonds, thus illustrating the limited reach of monetary policy. It thus seems natural that the Fed is now focusing on steps to reduce uncertainty in the financial market, thereby restoring the potency of the interest rate weapon.

US: Bank lending

Year-on-year percentage change, net balance

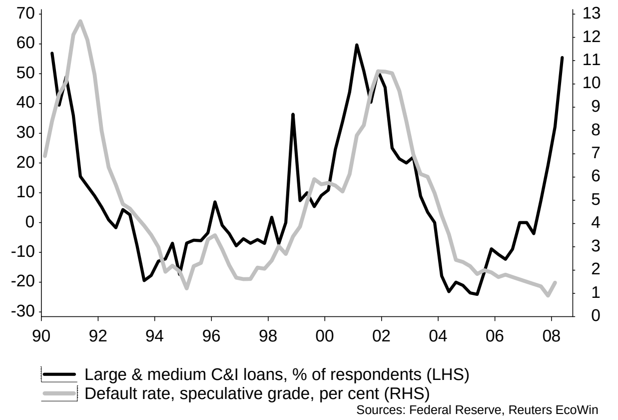


Our assessment is that the credit crisis is now entering a phase where its impact on the real economy will be more clearly apparent. The total assets and capital buffers of banks have shrunk due to lower valuations. Meanwhile bank lending to companies has increased sharply. By borrowing from banks – via previously agreed credit facilities – companies have been able to avoid the effects of higher funding costs in the capital market. The overall balance sheet of the banking sector (both the asset and liability side) has changed in ways that have been beyond its control. To restore their balance sheets and to strengthen their capital base, some banks may require capital injections or profits that will boost their equity, and/or a cutback in assets that represent an excessive credit risk.

We expect this balance sheet restructuring in the banking sector to result in tougher credit conditions. Consumers and companies will thus also be affected by changed market conditions and higher-priced risk.

This adjustment process may curb consumption and capital spending more visibly than to date, causing an increase in bankruptcies in the corporate sector from the current record-low level. The housing market will also be exposed to further pressures, due to both a weaker labour market and tighter credit terms. US home prices have already fallen more than 15 per cent since their 2006 peak (according to the S&P/Case-Shiller index), and a further downturn of the same magnitude probably lies ahead. The US economy is thus on its way into a phase where the real economy and the financial system will expose each other to major mutual strains. To a lesser and varying degree, we expect the same trend in Western Europe.

US: Credit standards and default rates

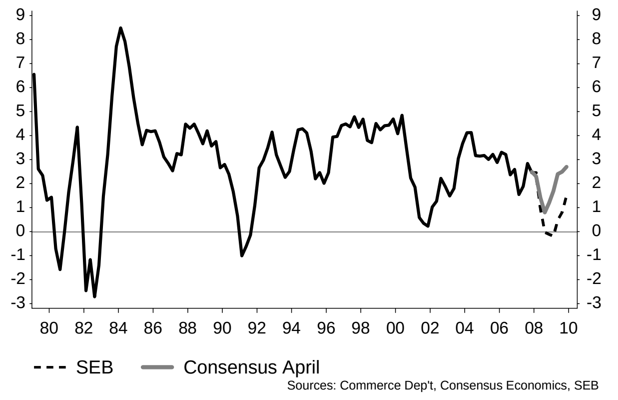


No decoupling, but divergent effects

The deceleration in the American economy has already been under way for about six months. Consumers are tightening their belts, and capital spending activity is cooling even outside the residential sector. We expect the economy to take another year or so to recover to its trend growth rate. The government's fiscal stimulus package will provide a temporary bounce, but then growth will fall again, resulting in a W-shaped growth curve. High oil prices will contribute greatly; a price hike of USD 20 per barrel will offset a tax cut of about USD 100 billion.

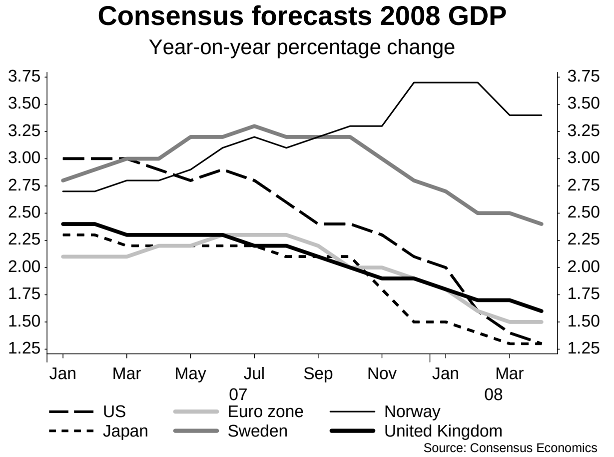
US: SEB vs consensus GDP forecast

Year-on-year percentage change



Our forecast implies that the current US slowdown will be somewhat deeper than in 2001, but milder than the recessions of the 1980s and 1990s. The prevailing consensus forecast, however, indicates that the US will escape with an even milder recession than in 2001. If the consensus proves correct, this means that popping the American housing and mortgage bubble will be compatible with the mildest economic downturn ever.

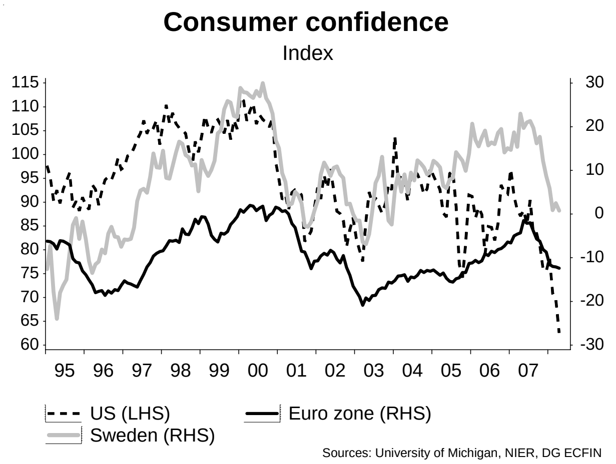
At the beginning of the American deceleration phase, the impact on other countries was very limited. In Asia and Europe, 2007 growth was even gradually revised upward in the course of last year. This fuelled the concept of a global economic "decoupling". Since the outbreak of the credit crisis, this pattern has partly changed. The consensus forecast sees a relatively parallel downgrading of the growth outlook for 2008 in the larger OECD economic regions (see chart).



The degree to which different countries and regions are affected by the global slowdown depends on several key factors, including the size of their direct trade with the US. Also of importance is the housing market situation in terms of construction as a percentage of the economy, the magnitude of overvalued home prices and mechanisms for home financing. The resilience of a given economy also depends on the level of household saving and the degree to which public finances will allow room for fiscal stimulus.

Our analysis indicates that the **United Kingdom** is in the risk zone in several respects. Extremely overvalued homes combined with low saving (both by households and the public sector) threaten to trigger a painful correction. Another factor is the major importance of the financial sector to the British economy. A deceleration has now begun. We expect a halving of GDP growth to less than 1½ per cent.

In the **euro zone**, the picture is divided. The housing market is facing major downturns in such countries as Spain, the Netherlands and Ireland, while Germany essentially avoided earlier excesses. Household saving in the euro zone is generally at a high level, thereby providing greater resilience. In the euro zone, we also expect GDP growth of nearly 1½ per cent this year and a further cooling towards 1 per cent next year. Due to the sharp appreciation of the euro against both the US dollar and the British pound, the deceleration of growth in the euro zone will be almost as sharp as in the US and the UK despite stronger underlying conditions in a number of respects.



To date, the **Nordic economies** have shown greater resilience in the face of the international slowdown. One factor is an economic structure that benefits from the continued commodities boom. The Nordic countries also have strong public finances that will allow them to gradually ramp up expansive fiscal policy. However, we expect supply side restrictions and weaker housing markets, especially in Denmark and Norway, to contribute to a noticeable cool-down, although GDP growth in the Nordic countries will remain higher than in the euro zone.

High growth in emerging economies

Emerging economies are also facing slower economic expansion. The deceleration in the OECD countries will be reflected by both a tougher outlook for exports and a smaller influx of investment capital, due to tighter credit conditions. Another factor behind lower growth will be mounting risks of overheating, especially in China, leading to more intensive tightening of economic policies. High oil and food prices will also hamper some emerging economies.

Conditions nevertheless remain favourable for continued fairly high growth, which will have a stabilising effect on global demand. Solid external balances – large surpluses in China and Russia, balanced foreign trade in India and Brazil, and limited direct exposure to the US mortgage market – will help emerging economies resist the effects of international financial disruptions. Public finances are now in good shape in most of these countries, increasing their ability to respond to threatened slowdowns with economic stimulus.

Worrisome inflation tendencies

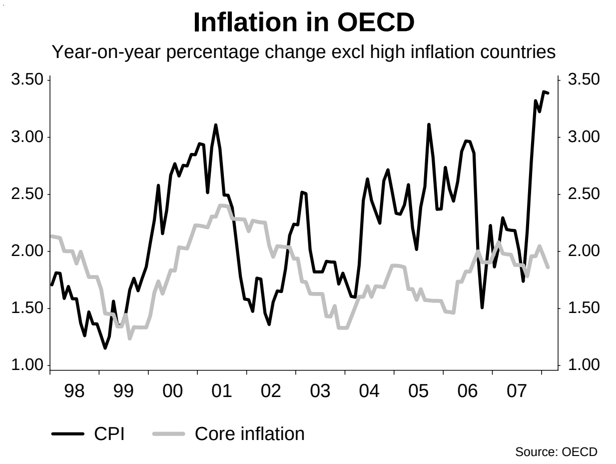
The upturn in global inflation has been more dramatic than we had previously expected. This is largely due to rising commodity prices, especially energy and food. Among OECD countries, the largest impact is in the US, since the weakening of the dollar softens price effects in other countries. Overall, higher food and energy prices contributed 2 percentage points to US headline inflation in 2007; this year we expect the effect to be more than 1½ percentage points. In the euro zone, the effect will be about ½ percentage point lower per year.

But the inflationary impulse from energy and food prices is now about to culminate. We expect the rate of food price increases to gradually decline. Producer prices are still climbing at record speed in many countries, however, indicating upside price risks at the consumer level as well. As for energy prices, we expect a sharply declining contribution to inflation towards year-end, due to base effects of earlier hikes.

However, there is a risk that the price upturn has been dramatic enough to trigger clear secondary effects. We can already foresee price hikes in a number of sectors with large input costs related to energy and food, for example transport and restaurants. Inflation expectations have also climbed somewhat even in the long term. There is consequently a risk of demands for compensatory wage and salary hikes, which would further prolong the high-inflation period.

An easing of the global price squeeze on **consumer goods** will also contribute to higher inflation risks ahead. Protectionist measures, in the wake of global imbalances and strengthened by rising unemployment, may contribute to weaker global competition and eventually lead to a higher inflation rate.

But although numerous risks are apparent, there are still strong reasons for predicting a continued low-inflation environment. To date, pay increases in the OECD countries have not deviated from what can be expected in the prevailing economic situation. The increase in OECD core inflation has also been moderate. It is thus likely that global inflation will turn downward once the effects of rising energy and food prices culminate and cyclical inflation-slowing forces make themselves felt.



Contribution to CPI from food and oil

Percentage points

	Petrol/oil		Food		Total	
	2007	**2008p**	**2007**	**2008p**	**2007**	**2008p**
United States	1.4	0.9	0.7	0.6	2.1	1.6
Euro zone	0.8	0.4	0.8	0.8	1.6	1.2
Sweden	0.5	0.3	0.6	0.7	1.0	0.9

Sources: OECD, SEB

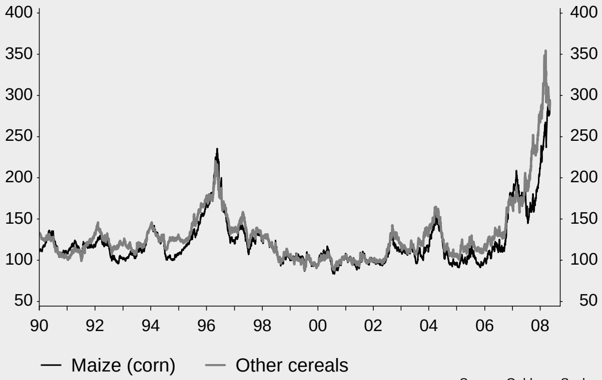
Food price explosion

The global food market has changed rapidly. In a short time, the pendulum has swung from problems connected to oversupply and price dumping to severe shortage symptoms and skyrocketing prices.

World market prices for many types of cereals have more than doubled, compared to 2005. This upturn spread first to producer prices of more highly processed foods, but in the past six months, price hikes have reached the consumer level.

World market prices of cereals

Index 100 = 2000, USD



Source: Goldman Sachs

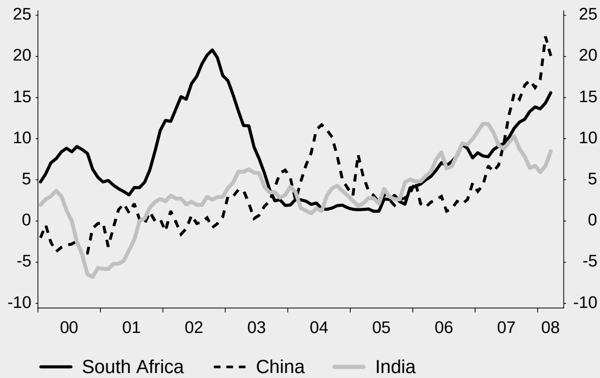
The problem is especially acute in many developing countries, where rising commodity prices have a greater impact at the consumer level because food accounts for a significantly higher percentage of total consumer purchases than in the OECD countries. In addition, large portions of Asia and Africa are net food importers and thus largely lack sectors that are benefiting from the price upturn.

There are several factors behind the food price upturn.

- Greater prosperity in many fast-growing countries, especially China and India, is leading to increased demand for more processed foods. Producing them requires larger quantities of commodities (such as crops).
- For many crops, the price upturn is also attributable to development of biofuel. Although biofuel accounts for less than 1½ per cent of transport fuel production, as much as 20-50 per cent of certain crops produced in industrial countries goes to biofuel.
- Greater protectionism is also contributing to the price upturn. Some countries are aiming to keep domestic prices down by imposing export bans or tariffs. This creates disruptions in international trade and may thus push up prices further in the world market.
- Rising oil prices also indirectly affect food prices through higher transport costs and more expensive oil-based fertiliser. In the short term, price movements may also be amplified by elements of speculation. Investors hold commodities futures as a complement to other asset classes. The sharper drop in some prices during the past month illustrates the volatility that this can create.

Food prices

Year-on-year percentage change in CPI



Sources: National statistical offices

Delayed reactions

The political debate on biofuels is already shifting focus. The consequences of rising food prices in many poor countries may lead to a fairly rapid change in political priorities, among other things after criticism from the United Nations and the poor countries that are affected. However, it will take time before this has an impact on pricing. The US and the EU have adopted far-reaching plans to increase their biofuel consumption. In the US, the ambition is to quintuple the use of biofuels during the next 15 years. The EU has decided that 10 per cent of vehicle fuel production must be biologically based by 2020, which also presupposes huge increases in production.

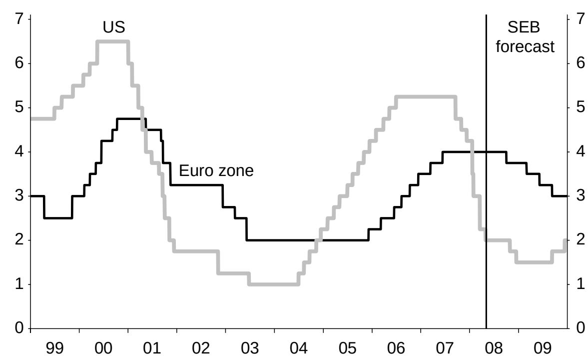
The supply of food, like that of most commodities, is rather inflexible. Relatively small changes in demand may thus trigger large price movements. Within a few years, however, high prices will stimulate new investments in the agricultural sector, both in rich and poor countries, and this will help push down food prices.

Our forecast is that the rate of food price increases will slow significantly next year. The price level will remain high, however, and in the short term there are mainly upside risks. Looking further ahead, a combination of supply side investments and changes related to biofuels will probably normalise food prices.

Key interest rate cuts on a broad front

During the past six months, central banks have been squeezed between the threat that the credit crisis will seriously harm economic growth and the risk that the upturn in rising inflation will become chronic, thus influencing inflation expectations and wage formation.

The actions of the various central banks have been determined by how they have weighed these risks against each other in the specific situations they have faced. Differences in the tasks of central banks and their formulation of targets have also been a factor.



In the US, risks to the financial system have been the most acute. The **Federal Reserve** has not hesitated to accord higher priority to them than to other problems in the economy. Having slashed the federal funds rate by 325 basis points in the space of seven months, the Fed has now signalled a pause. It wants to evaluate the effects of this powerful dose of interest rate medicine. Meanwhile the federal fiscal stimulus package will hopefully begin to have an impact. However, we expect that growth disappointments will cause the Fed to lower the key rate another 50 points by year-end. It will not be ready to begin interest rate hikes until late in 2009.

In Western Europe, central banks have acted differently. Rising inflation, in a situation characterised by high resource utilisation, has created a general unwillingness to cut interest rates. The **Bank of England** (BoE) has admittedly lowered its repo rate by a total of 75 basis points since December in response to financial problems and the risks of a housing market slide. Meanwhile BoE executives have also expressed great concern about inflation trends. Due to the increasingly critical situation in the financial service sector and in the housing market, we expect the BoE to cut its key rate at a faster pace than market pricing indicates. Our forecast is that the BoE will deliver another 100 points this year and then lower its key rate to 3.50 per cent some months into 2009.

For a long time the **European Central Bank** has vigorously signalled that it is not considering interest rate cuts, given the prevailing inflationary environment. The unexpectedly strong resilience of the German economy, in particular, has also contributed to the ECB's stubborn policy. But the economic slowdown is becoming increasingly evident. Due to high inflation, the ECB will hold off for another six months. Only in the fourth quarter of 2008 will the forward-looking inflation analysis be sufficiently reassuring to allow the ECB to begin rate-cutting. We then expect the bank to gradually lower its refi rate to 3.0 per cent by autumn 2009.

The Nordic central banks are likely to hold off on their rate cuts even longer. Sweden's **Riksbank** will hardly begin to signal any need for rate-cutting before this summer. Strong GDP growth early in 2008, combined with continued decent job growth and high inflation, will postpone the process. In addition, the government's response to lower economic growth in its autumn budget may affect the actions of the Riksbank. Key interest rate cuts will be delayed longer than we previously anticipated. Only in December do we expect the economy to have weakened enough for the Riksbank to be ready to reverse its February rate hike. By autumn 2009, the repo rate will stand at 3.25 per cent. In Norway, **Norges Bank** will need to take overheating risks into account for significantly longer than its European colleagues. We expect a further hike in the sight deposit rate (to 5.75 per cent). Rate cuts will not begin until 2009.

Due to weaknesses in the Japanese economy, the **Bank of Japan's** ambition to normalise its key interest rate will be postponed. Given a sharp strengthening of the yen and greater international economic risks, interest rate hikes seem very distant. In **China**, overheating risks are increasingly apparent. Tightening of economic policy, including interest rate hikes, will intensify after the Beijing Olympics.

Key rates

	Currently	Autumn 09	Neutral
United States	2.00	1.50	4.25
Euro zone	4.00	3.00	4.00
United Kingdom	5.00	3.50	4.50
Sweden	4.25	3.25	4.25
Norway	5.55	5.00	5.00

Source: SEB

Fiscal policy will have a limited role

The International Monetary Fund has recently emphasised that fiscal policy should also play an active role in stabilisation policy – an unusual recommendation from the IMF. One reason is that economies are less responsive to interest rate stimulus amidst credit tightening and home price declines. Another argument for more active fiscal policy is that excessively low interest rates may cause renewed imbalances.

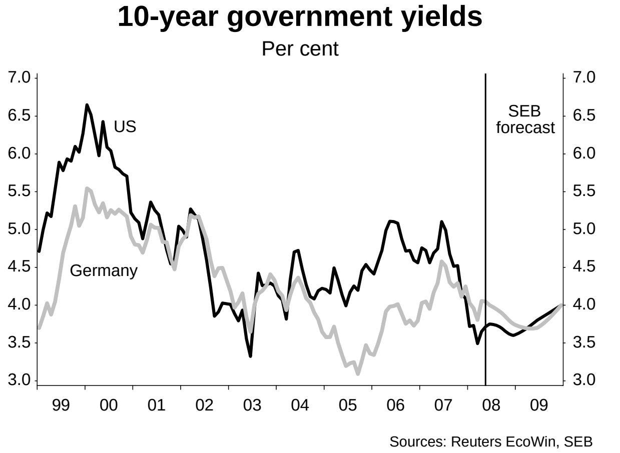
In the US a sizeable fiscal stimulus, equivalent to about 1 per cent of GDP, is now on its way out into the economy. Despite relatively large public sector financial deficits, we expect that further fiscal stimulus packages – regardless of the new president's political background – will be launched next year. The Fed has also underscored the importance of rapid fiscal stimulus in the prevailing crisis situation, even though it has previously criticised the structural weakness in US public finances.

In Europe, the situation is a bit different. The focus is still on the EU's Stability Pact. Most countries neglected to create fiscal manoeuvring room during the latest economic expansion. Spain is one exception. That country is now launching a stimulus package equivalent to about 2 per cent of GDP in response to the economic slowdown and the collapse of the construction market. Strong public finances in the Nordic countries also allow room for stimulus, but so far the strained resource situation has persuaded governments to hold off.

The US has already implemented both monetary and fiscal policy measures, which partly reflects the more acute crisis situation there. But the ECB's focus on inflation, combined with the Stability Pact's constraints on deficit spending may ultimately lead to an overly passive economic policy in Europe, which may risk prolonging and deepening the slowdown.

Bond yields will fall once again

In recent months, bond yields have bounced upward, driven by increased inflation worries as well as signals from central banks that earlier expectations of interest rate cuts were exaggerated. Another contributing factor has been less uncertainty about the stability of the financial system. Given our forecast of a rather prolonged cyclical slowdown and the need for interest rate cuts on both sides of the Atlantic, we see potential for a renewed downturn in bond yields.

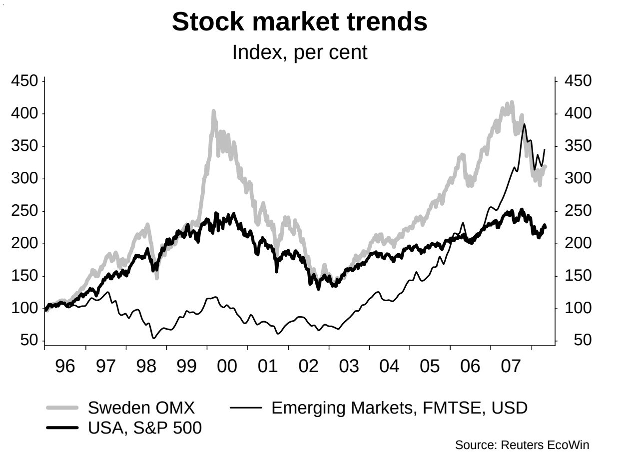


A higher inflation rate will, however, raise the floor for long-term yields compared to 2003 and 2004, when the threat of deflation seemed imminent. The weakening of public sector financial saving, especially in the US, will also lead to a rather large increase in the supply of government securities, which will push up interest rates somewhat on the margin.

We expect US 10-year Treasury bond yields to bottom out at 3.60 per cent by year-end. In Germany, long-term yields will remain under pressure next year as well, due to the ECB's interest rate cuts – reaching 3.70 per cent by mid-2009. In Sweden, the Riksbank's interest rate cuts will largely coincide with those of the ECB. This will contribute to small movements in the long-term yield spread. However, we expect a return to normal conditions, with a certain positive yield spread between Sweden and Germany. Rapid privatisation of state-owned companies will keep the spread down, however. Due to the strong Norwegian economy, the yield spread between Norway and Germany will remain positive. Next year, how-ever, the spread will gradually shrink towards 30 basis points as Norges Bank begins its rate-cutting cycle.

Low valuations, but continued risks

In recent months, stock markets have recovered some of the losses they incurred earlier following the outbreak of the credit crisis. This may be viewed as a consequence of the reduced likelihood of a deep recession due to the financial system crisis in the US. The rebound has been most apparent in the stock markets of rapidly growing economies, but industrial firms in the OECD countries have also benefited from relatively strong global demand. US stock markets are receiving continued support from the weak dollar.



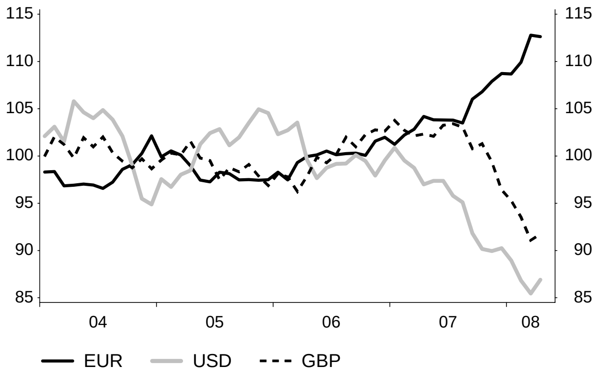
In recent quarters, disappointments have nevertheless predominated in corporate reports. Our macro scenario implies further growth disappointments both this year and next, and this implies risks of continued disappointments about profits. We thus expect the stock market climate to remain unsettled in the months ahead. Stock market valuations are historically low, however. The relatively steep American yield curve that we are now seeing has also historically indicated stronger stock market performance.

EUR/USD exchange rate close to peak

In the past year, currency movements have largely reflected the various phases of the credit crisis and variations in growth prospects and risk appetite. A periodically weak risk appetite has strengthened such defensive currencies as the Japanese yen and Swiss franc, despite low interest rates. The US economic crisis and the Fed's aggressive interest rate cuts have squeezed the dollar. Gloomier prospects and worries about the UK economy and financial system have led to a major weakening of the British pound. But cautious optimism during the past two months has enabled the dollar to regain some of its strength.

Effective exchange rates

Index 2006=100



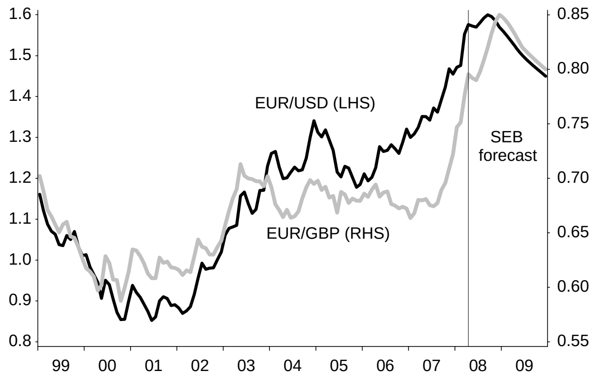
Source: Bank of England

In a larger perspective, it is fair to say that the euro has had to bear an increasingly heavy burden in the world economy as the US and UK currencies have weakened. In this context, the accelerated appreciation of the Chinese yuan against the dollar is a meagre consolation. Because the dollar has weakened, the outcome has still been a weaker yuan against the euro.

Over the next six months, we expect the actions of central banks to be the most important driving force in the foreign exchange market. This means that the euro will appreciate against the dollar as the interest rate spread between the ECB and the Fed continues to widen. The EUR/USD exchange rate will peak at 1.60 during the autumn. The movement of the euro against the pound will be even sharper, and we expect the EUR/GBP rate to peak at 0.85 by year-end. In a historic perspective, and converting EUR into German marks, this means that the pound is relatively close to the record-low levels recorded against the D-mark in the late 1970s and mid-1990s.

However, the focus will gradually shift to the weaknesses in the euro zone and the ECB's key interest rate cuts. The exaggerated strength of the euro means that there is rather large potential for setbacks. On the other hand, all OECD countries will plagued by chronic economic weaknesses in 2009, making it difficult to foresee any other world currency skyrocketing. We expect a gradual normalisation of relationships between currencies in the course of the year. The EUR/USD rate will stand at 1.45 and the EUR/GBP rate at 0.80 towards the end of 2009.

EUR/USD and EUR/GBP exchange rates



Sources: Reuters EcoWin, SEB

Given a shaky world economy without clear risk appetite movements, we believe that the Japanese yen will continue to gain strength against the dollar during the rest of 2008. Towards year-end, the USD/JPY exchange rate will stand at 92. This forecast is based, among other things, on the steepening of the US yield curve that we foresee; in recent years such a curve has been a very reliable sign of a weaker USD/JPY rate.

The Swedish krona will have difficulty appreciating against the euro in the prevailing uncertain international environment, despite strong fundamentals. The EUR/SEK exchange rate will remain around 9.30-9.40 during the rest of 2008. Next year we nevertheless expect stronger growth and a somewhat higher short-term interest rate spread to support the appreciation of the krona to 9.10 per euro. Given the weakening of the dollar and the pound, however, in competitively weighted terms, the strengthening of the krona will be significant. Measured by the TCW index, the krona will reach its strongest level since 2000.

The Norwegian krone will be supported by a larger interest rate spread and higher oil prices. We thus expect it to strength in the next few months. Further ahead, however, the krone will encounter a less favourable environment and we expect the EUR/NOK rate to reach 8.10 by the end of 2009.

Slower recovery from recession

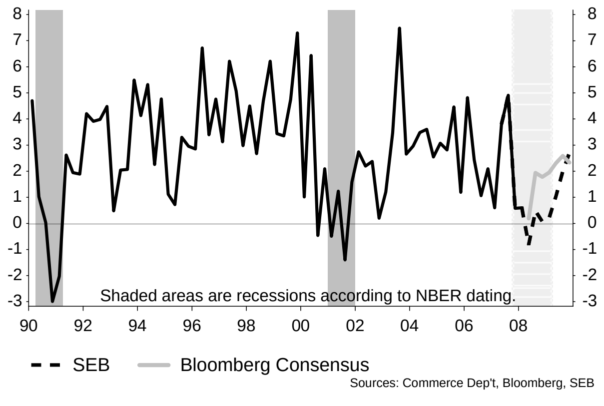
- **Sharply declining home prices**
- **Households under pressure from many sides**
- **Temporary fiscal stimulus to growth**
- **Key interest rate will be cut to 1.50 per cent**

The American economy has now entered a recession. Despite a fiscal stimulus package and the Federal Reserve's aggressive interest rate cuts, the recession will be relatively prolonged. A return to potential growth level does not appear likely until home prices have stopped falling and mortgage loan-related losses stop growing. The recovery will thus not materialise until the second half of 2009. **We expect GDP growth to average only 1.0 per cent this year and 0.7 per cent in 2009**.

The weak dollar will result in continued positive contributions from foreign trade, thereby easing the economic slump. Stimulus policies will also help to keep the recession mild from a historical perspective. Our forecast implies that the slowdown will be somewhat deeper than the one in 2001 but shallower than the three recessions of the early 1980s and 1990s. The prevailing consensus forecast implies the shallowest recession in modern history.

US: SEB vs consensus GDP forecast

Annualised



Having rapidly lowered its federal funds rate from 5.25 to 2 per cent, the Fed has signalled that rate cutting is over this time around. Presumably, the central bank now wants to await the effects of the monetary and fiscal policy measures that have already been undertaken. Our growth profile implies that the economy will weaken again during the autumn, when the temporary effect of the fiscal stimulus package has faded. We then expect the Fed to cut its key rate to **1.50 per cent and keep it at that level until the end of 2009**.

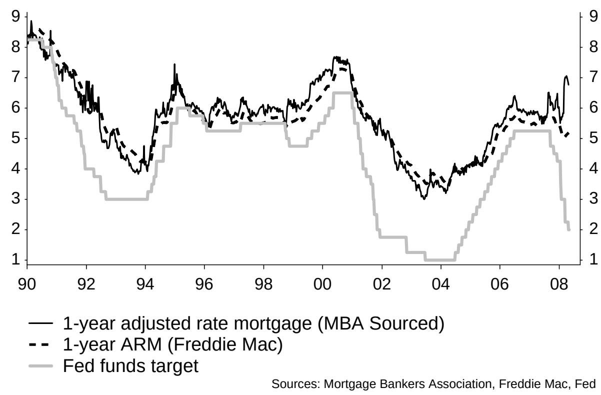
Financial crisis will continue

Banks and other financial institutions have now reported an estimated one half of total housing-related credit losses. These losses total USD 500 billion, according to our assessment. But it is reasonable to assume that losses on car and credit card loans, as well as on loans for commercial construction projects, will also climb sharply in the months ahead. According to the IMF's assessment, these losses may end up totalling another USD 400 billion.

The task of cleaning up balance sheets of banks and other financial institutions will thus continue. This means that tough credit conditions for consumers and companies will not ease in the short term. New lending will not take off again until most of the losses are reported, capital bases have been strengthened and loan-to-value ratios have been lowered. Due in part to ongoing adjustment processes, the Fed's sharp interest rate cuts have not succeeded in pushing down interest rates on either home mortgages or corporate bonds. On certain types of loans, interest rates today are even higher than before the Fed began slashing interest rates last autumn.

US: Fed funds and 1-year ARM rate

Per cent



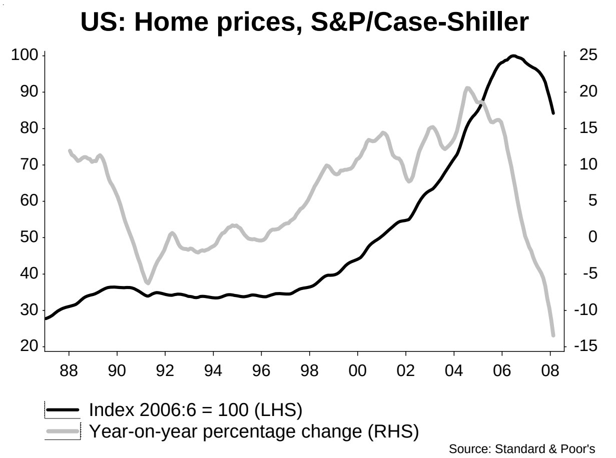
The most **acute risk of a systemic collapse has meanwhile been avoided**; after the rescue action for Bear Stearns, the market knows that the Fed will not allow the failure of institutions important to the system, while innovative new credit facilities (TSLF and PDCF) established by the central bank have improved the functioning of financial markets. The banks that reported the biggest losses have quickly replenished their capital bases, also contributing to a more positive mood.

Meanwhile the crisis in the financial system is having an increasingly clear impact on the real economy. For example, the downturn in home prices is becoming deeper and lengthier, which in turn is further fuelling the crisis in the form of a continued rise in mortgage-related losses. With the economy having now entered a recession, corporate profits will also be under continued pressure. Corporate bankruptcies will rise. The **financial crisis** is entering a **new phase whose depth will be determined by how big its impact on the real economy will be** and how long the recovery will be delayed.

Negative spiral in the housing market

Although housing starts have more than halved since their peak in 2006, the oversupply of homes has not decreased. There were more than one million unsold homes in the market during the first quarter, which is the highest level ever measured. This indicates that housing starts will continue to decline. Given the current downturn rate, only late in 2008 will housing investments as a percentage of GDP drop below the lowest historical level. However, the pace of the downturn will slow somewhat, thereby gradually easing its negative contributions to GDP.

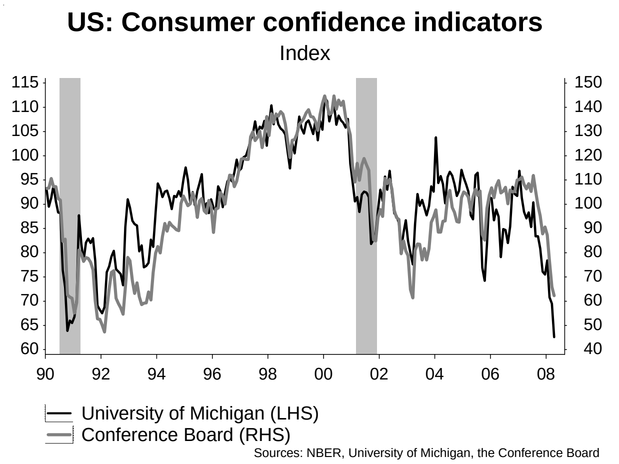
The home price decline has accelerated in recent months, while excess supply has grown. We are thus now estimating that **home prices will fall by a total of 25-30 per cent** as measured by the S&P/Case-Shiller home price index (which reflects all types of borrowing structures). In February, we estimated that home prices would fall by only 15-20 per cent. So far the downturn has totalled just over 15 per cent since mid-2006, which means that about half the price adjustment still lies ahead. Our judgment is supported by home price futures which indicate an accumulated downturn of 30 per cent.



The Fed's interest rate cuts have had no major impact on mortgage rates, which is evident in a number of ways. Even households with good credit scores are now facing tighter lending standards. This, in turn, has contributed to a continued growth in the percentage of borrowers who have fallen behind on their payments. At present, 6 per cent of all mortgage borrowers (17 per cent of sub-prime borrowers) are behind on their payments. One consequence is that foreclosures will probably climb further from today's record levels. **Aside from causing new losses for banks and other credit institutions**, this will contribute to a deeper, more prolonged adjustment in home prices, since the housing supply will increase. The home price decline has also meant that **around 8 million borrowers**, or 10 per cent of those who have taken out mortgage loans, have ended up in a situation where the **market value of their home is lower than their loan amount**. It remains to be seen if the various measures now being taken to limit the negative dynamic in the housing market will have an effect.

Households squeezed from many sides

The combination of tougher credit conditions, a weaker labour market, falling home prices and rising petrol prices is now clearly visible in household confidence indicators. These have fallen sharply during the spring and are now at levels consistent with negative consumption growth.



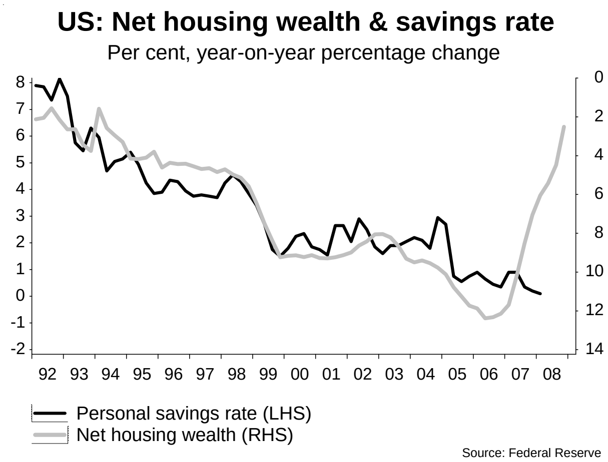
The fact that the economic slowdown is related to such a great extent to the household sector diverges from the recession of 2001, which was mainly driven by an adjustment of corporate sector capital spending. The recession that the US has now entered is thus more reminiscent in various respects of the downturn during the early 1990s. At that time there was also a marked deceleration in the housing market, which contributed to a significant but rather brief downturn in consumption.

The connection between housing wealth and consumption will be a key factor in how deep the consumption slowdown will be. IMF estimates indicate that about 13 per cent of net housing wealth shows up as increased consumption. This is a high figure compared to traditional estimates, which usually indicate a wealth effect of around 5 per cent. The reason for this upgraded sensitivity is that during the "good years" American households took major advantage of the opportunity to obtain new consumption loans using their homes as collateral. Using a wealth effect of 5 per cent, our calculations indicate that **falling home prices will dampen consumption**

growth by more than 1 per cent yearly during 2008 and 2009. The IMF's estimate thus indicates that the impact might be more than twice this large.

Pressure on household finances is also coming from other directions. A weaker labour market is holding down income, while rising energy and food prices are also helping undermine purchasing power. In April, average hourly earnings in the private sector rose by 3.4 per cent year-on-year. Since inflation remains at around 4 per cent, **real earnings are thus falling**. Overall, our forecast means that real income will grow by 1.9 per cent this year and by 1.8 per cent in 2009.

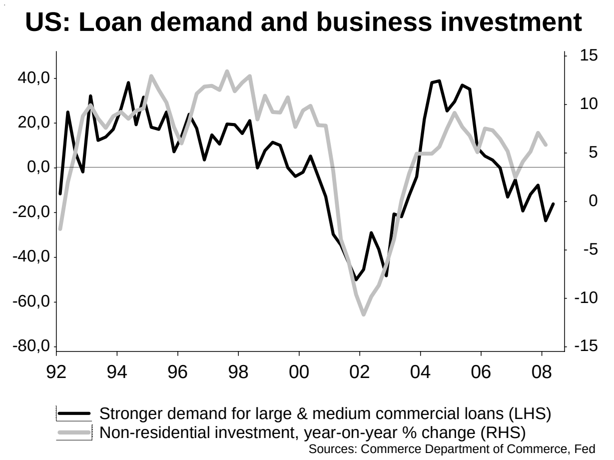
We expect household consumption to fall in real terms during the second quarter. Thanks to the federal fiscal stimulus package, however, consumption will show weakly positive growth figures during the second half and then slow again early in 2009. Measured as annual averages, **consumption growth will cool from 2.9 per cent in 2007 to 1.4 per cent in 2008.** In 2009 consumption growth will average 0.7 per cent. This forecast implies a rather modest adjustment in saving, which will climb to 2.5 per cent of disposable income towards the end of our forecast period. Judging from historical associations between housing wealth and the household savings ratio, however, there is a risk that the adjustment will be more dramatic than this.



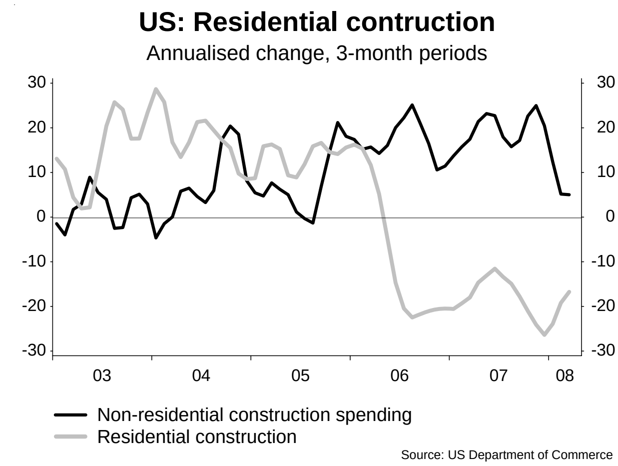
Slowdown in business investment

Corporate confidence indicators have weakened somewhat, though not at all to the same extent as household indicators. The manufacturing sector has slowed due to a weaker domestic market. Continued decent growth in other countries and the very weak dollar are still offsetting this. After several years of rapid profit growth, companies are also in a position to finance capital spending internally, thereby at least partially avoiding the current high costs of borrowing. This reduces the risk of a sharp **investment downturn**. The demand for corporate loans, which has historically been a reasonable indicator of business investments, has fallen but has not collapsed. This is another indication that the capital spending downturn will be comparatively mild.

The same factors that drove residential investments to unsustainable levels have also contributed to a boom in corporate capital spending on construction, which has offset the decline in residential investments during the past few years. Now that corporate construction spending has begun to fall, this will probably mean higher credit losses for banks and negative effects on employment and growth.



Gradually waning demand from important export markets will slow the near double-digit growth in US exports during the past few quarters. This, in turn, will contribute to lower capital spending needs. We can probably count on further adjustments in profit forecasts over the coming six months, which is another important reason why we are revising our investment forecast downward. Overall, we expect corporate capital spending measured as annual averages to decrease by 0.3 per cent in 2008, after having climbed by 4.7 per cent in 2007. This capital spending slowdown is relatively mild in historical terms. Since the level of capital spending is relatively low at the outset, this indicates that the need to lower it is less today than during previous downturns.

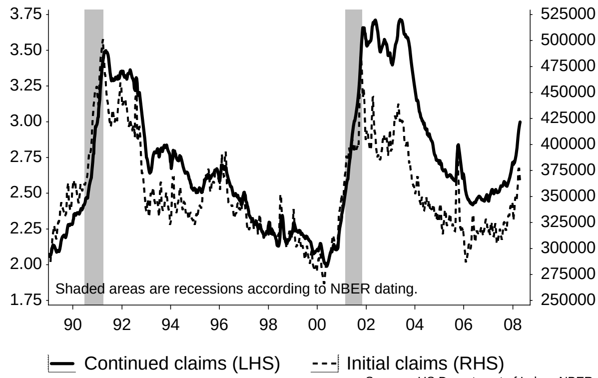


Weakening labour market

The labour market now seems to be moving towards significant deterioration, in line with the forecasts in our last ***Nordic Outlook***. Private sector employment has fallen by an average of 78,000 per month since January. The historical norm has been for employment to fall by at least an average of 200,000 per month during the most intensive period of retrenchment in a recession. According to sentiment indicators, employment may also fall at a faster pace in the months ahead.

US: Initial and continued claims

4-week moving average



Sources: US Department of Labor, NBER

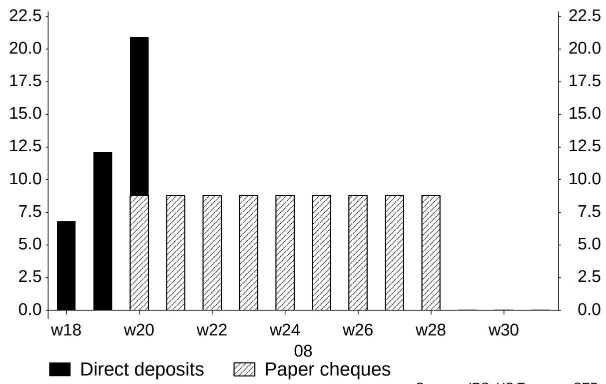
However, there are strong reasons why the downturn need not be quite as dramatic this time. Companies have been more restrained in both their investment and hiring decisions during the latest economic cycle. Since companies appear likely to maintain reasonable profit levels during the recession, the need for cutbacks in the workforce may not be so large. Nor does a given slowdown in employment necessarily have as large an impact on the jobless rate as during earlier cyclical downturns, since underlying trend growth in the labour supply seems to have been slower in recent years. We are thus sticking to our earlier assessment that **unemployment will peak at 6.5 per cent** during the latter part of 2009.

Fiscal policy will lead to temporary growth impulse

The federal government has started sending out tax rebates to American households. How much of this USD 110 billion stimulus package goes towards consumption will be crucial to the short-term economic growth pattern. Of the 2001 stimulus package, around 40 per cent was consumed within 9 months, but that stimulus was combined with a "permanent" marginal tax cut, which probably amplified its effectiveness. In addition, the household savings ratio was not as depressed as today. On the other hand, research indicates that low- and middle-income earners are more inclined to spend than high-income earners, which may mean that the 2008 stimulus package will have a greater impact. **Our overall assessment is that about 30 per cent of the package will go towards consumption**. The package will result in a temporary growth surge, especially during the third quarter. Towards year-end, the effects will fade and economic growth will again fall. Petrol prices have reached record levels, which will also reduce the effects of the fiscal stimulus package.

US: Flow of stimulus payments

USD billion, payments by week number

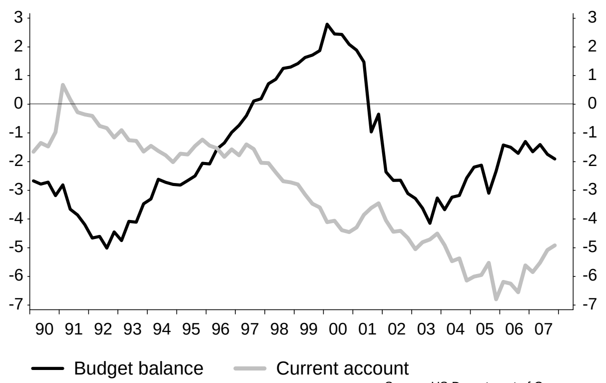


Sources: IRS, US Treasury, SEB

The US public financial deficit will now increase at a rapid pace. Both the fiscal stimulus package and a cyclical slowdown due to decreased tax revenue will contribute to the downturn. We are also assuming that additional stimulus packages will be implemented during 2009 irrespective of the result in the general election. Altogether, this means that the federal budget deficit will increase to about 5 per cent of GDP. We do not, however, expect declining public sector saving to interrupt the trend towards a slow reduction in the US current account deficit. The weak dollar combined with a sharp cooling in domestic demand provides a sufficient counterforce.

US: Current account and fiscal balance

Per cent of GDP

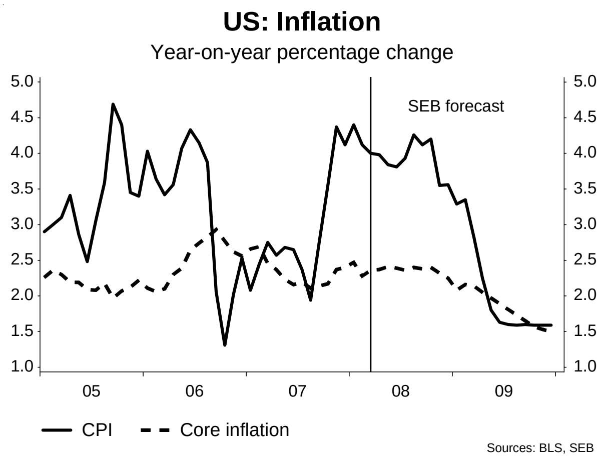


Source: US Department of Commerce

Inflation will persist

CPI inflation has climbed rapidly, driven by energy and food prices. During the next six months, headline inflation will be 4-4½ per cent. In the short term, even larger petrol price hikes pose an upside risk.

The upturn in core inflation has been modest. The rate of core inflation now stands at 2.4 per cent, after a small downswing early in the year. In spite of this, certain measures of long-term inflation expectations have begun to rise, which has undoubtedly contributed to the Fed's decision to signal a pause in its rate cuts.



In our judgement, both CPI and core inflation will fall in the coming months, partly as an effect of the economic slowdown. Our overall forecast is that core inflation will remain somewhat above 2 per cent as an average for 2008 and then slow further in 2009. Core inflation according to the Personal Consumption Expenditures (PCE) deflator is trending a little lower than core inflation, so it is likely that this measure will end up averaging slightly below 2 per cent in 2008.

Meanwhile the historical association indicates that core inflation reacts to a change in unemployment with a lag of about one year. With unemployment rising by 0.6 percentage points since bottoming out in March 2007, available resources will gradually open up and domestic inflation pressure will ease. We expect this inflation process to be more slow-moving than normal, however. This is because secondary effects from rising energy and food prices cannot be entirely avoided.

Fed rate cut to 1.5 per cent this autumn

Our assessment is thus that the economic recovery will be delayed and that we will see new growth disappointments once the effect of the fiscal stimulus package fades. In light of this, the Fed is likely to cut its key interest rate further this autumn in order to counteract the downturn in the economy. Our forecast is that the fed funds rate will be lowered a **further 50 basis points to 1.50 per cent**. A simple Taylor rule and our unemployment and core inflation forecasts are consistent with such action.

Because the economic slowdown will be prolonged, it will take a relatively long time before the Fed begins to normalise its monetary policy. During the post-war period, the Fed has **never begun a rate-hiking cycle until unemployment has peaked**. We do not believe it will do so this time either. Nor do we believe that the Fed will raise its key rate before home prices have stopped falling, which is not likely until well into 2009. Our assessment is thus that the **Fed will not raise its key interest rate until the end of 2009.**

No key rate hikes in sight for the next year

Unemployment peaks	Fed begins rate hikes	Time lag, months
Sep 1954	Jan 1955	+4
Jul 1958	Aug 1958	+1
May 1961	Aug 1961	+3
Dec 1970	Apr 1971	+4
May 1975	Jun 1975	+1
Jul 1980	Aug 1980	+1
Dec 1982	May 1983	+5
Jun 1992	Feb 1994	+20
Jun 2003	Jun 2004	+11
Sep 2009*	Oct 2009*	+1*

*SEB forecast

Financial markets currently expect the Federal Reserve to raise its key interest rate late in 2008 and to make further hikes next year, bringing the federal funds rate up to 3.00 per cent by the end of 2009. This diverges from our forecast that the Fed will cut its key rate during 2008 and begin a rate-hiking cycle only at the end of 2009.

Our interest rate forecast is based on our view of growth and especially the labour market. Over the past five decades, unemployment has been an excellent leading indicator of shifts in monetary policy. During this period, the Fed has never begun a rate-hiking cycle before unemployment has peaked. According to our forecast, unemployment will peak at 6.5 per cent in September 2009 and the Fed will initiate its rate-hiking cycle shortly afterward. Our forecast nevertheless implies a relatively moderate upturn in unemployment in a historical perspective. During recessions, unemployment usually climbs more than the approximately 2 percentage points we are expecting, and the upturn phase often lasts longer than we have forecasted this time.

It is also unlikely that the Fed will raise interest rates before home prices have stopped falling. According to our assessment, American home prices will not bottom out until well into 2009. The home price adjustment may very well prove more prolonged than we have assumed. Various OECD countries have experienced real declines in home prices over the past four decades. On average, home prices have fallen by 30 per cent in real terms and the adjustment has continued for 6 years.

Muddling through

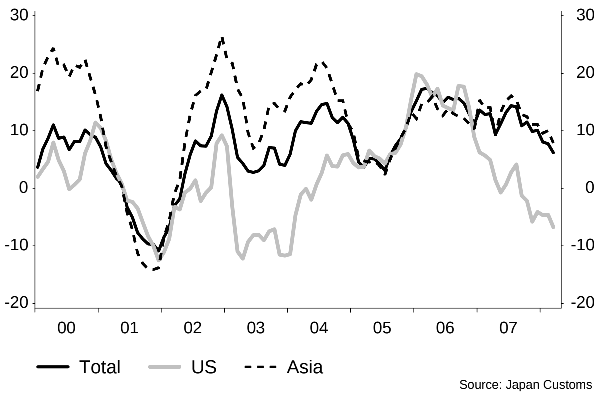
- **Resilience of exports is eroding**
- **Continued moderate consumption growth**
- **Weak underlying upturn in inflation**

Japan is entering a calmer growth phase after four relatively strong years. Weaker external demand and high commodity costs are hampering exports and investments, but consumption is showing continued decent growth. **GDP will increase by 1.2 per cent in both 2008 and 2009**, which is somewhat below the 1.5 per cent trend. We have adjusted our growth forecast for next year slightly downward. **Inflation pressure remains weak**, despite certain lingering tendencies towards labour shortages.

Japanese export growth slowed modestly this past winter, despite weak sales to the United States. Meanwhile imports were restrained by sluggish domestic demand. Net exports will thus continue to provide a relatively large contribution to GDP growth early in 2008. **Exports are benefiting from altered foreign trade patterns.** During the 21st century, Japan's trade with the rest of Asia has increased rapidly. China (including Hong Kong) now makes up as large an export market as the US; in 2007 the two countries each accounted for about 20 per cent of total exports. Effects of the earlier improvement trend in competitiveness are also helping sustain exports.

Japan: Exports

Year-on-year percentage change, 3-month moving average



Source: Japan Customs

Export growth is gradually showing a clearer slowdown, however. Demand from Asia is cooling. In addition, the movement towards a stronger currency that began last summer will continue during 2008. The impact on exports is not likely to be so great, since the yen still seems somewhat undervalued.

Capital spending fell during in 2007 after a number of strong years. This was partly due to a temporary collapse in residential construction caused by a rule change. Construction is now recovering somewhat but is not reverting to its previous strong trend, since greater uncertainty in the property market is restraining demand. Volume has fallen, partly due to decreased interest from foreign financial institutions in the wake of the global credit market crisis. Corporate investments in machinery will remain relatively weak, judging from the significant downward revision in plans reflected by the Tankan business survey.

Household consumption is a pillar of the Japanese economy. Consumption is chugging along at modest annual growth rate of 1¼ per cent. Wage and salary increases have recently accelerated somewhat, and we expect a continued fairly strong labour market. A good wealth position will also support a certain upturn in consumption. A rapid decline in optimism poses a downside risk in the forecast, but this indicator is difficult to interpret; retail sales, for example, have strengthened during the same period.

The inflation rate has risen from around zero last summer to 1.2 per cent, its highest level in a decade, yet it is not possible to speak of a definitive end to Japan's long deflationary period. **Demand-driven inflation remains weak**, despite years of growth above potential and a decline in unemployment to what is probably a long-term equilibrium level. Excluding energy and food, price changes are only slightly above zero, with a weak upward trend since last summer. Continued low underlying price pressures can be expected.

Interest rates and policy on hold

Combined with negative global risks, this means that the Bank of Japan (BoJ) – even under its new governor, Masaaki Shirakawa – will choose to leave its low **call money rate of 0.50 per cent untouched for another year**. The BoJ's objective has been to "normalise" its key rate to an estimated 2.0-2.5 per cent. One argument has been that excessively low interest rates may feed financial and real-economy bubbles. This should, however, fade during the ongoing financial adjustment.

Fiscal policy is also on hold. Improved growth has allowed room for a degree of fiscal easing during the past year, but the situation will become more troublesome as growth wanes. The budget deficit has shrunk to more modest levels, but Japan's enormous central government debt remains. The government of Yasuo Fukuda, in office for more than seven months, is also hampered to some extent by the opposition-dominated upper house of Parliament.

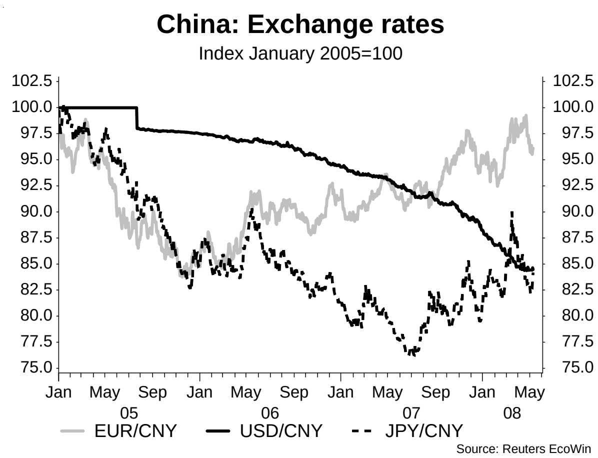
Gradual cool-down

- **Exports will eventually decelerate**
- **Underlying price pressures are expected to rise**
- **Tightening measures will intensify**

There are still few signs of a cool-down in the Chinese economy. The first quarter GDP growth rate was still as high as 10.6 per cent, despite a severe winter that helped dampen economic activity. The rate of increase in exports has bounced back after a minor slowdown late in 2007, and domestic demand remains robust.

Looking ahead, though, we expect global deceleration along with economy policy tightening to **gradually slow GDP growth** from 12 per cent in 2007 to **10 per cent this year and 8.5 per cent in 2009**.

Export demand will cool, since the US slowdown will spread to some extent to the rest of Asia and the EU. This will also slow the rise in the income of export sector employees, which will restrain consumption somewhat. China's rapid economic expansion over the past five years has turned **consumption** into an **important engine of growth**. Last year household consumption made as large a contribution to GDP growth as investments. Weaker international demand will also slow the increase in investment next year. Tighter economic policy, for example continued hikes in bank reserve requirements (most recently in late April) and higher interest rates will gradually also have a greater effect.



The growth pattern is also being affected by the Beijing Summer Olympics. Aside from the economic stimulus attributable to major investment projects, the Games will contribute to somewhat higher GDP growth this year, since foreign visitors will generate increased service exports.

The inflation rate has climbed steeply to around 8 per cent in recent months, the highest level in 12 years, but **the upturn** is still **concentrated on food prices**, mainly pork prices. Core inflation, excluding food and energy, is still only about 1 per cent. Producer price pressure on durable consumer goods also remains low. **Rapidly rising wages**, combined with higher inflation expectations, nevertheless threaten to build up underlying inflation pressure in the future. In the booming province of Guangdong, for example, wages will increase by at least 12 per cent this year.

Intensified economic policy tightening

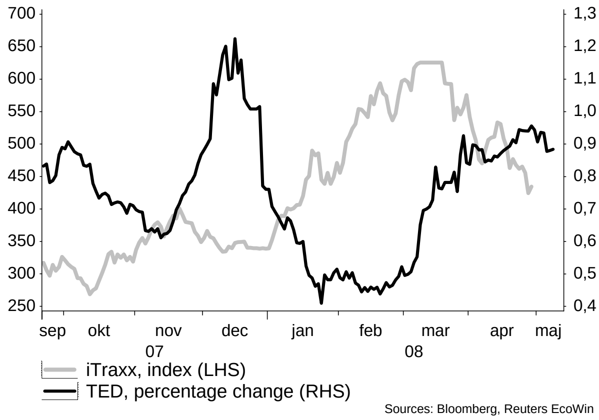
Due to rising inflation and increasingly clear resource restrictions, the Chinese regime is now **intensifying its efforts to tighten economic policy** with the aim to bringing GDP growth down to a more sustainable 7-8 per cent. Once the Olympics are over, the government will probably be more inclined to risk temporarily pushing growth below this long-term level. During its preparations for the Olympics, the government has probably decided that the political costs and the losses of prestige that might result from popular discontent aimed at austerity policy and slower growth would be too great. But the government is meanwhile continuing its supply side-related spending; for example, it has indicated that annual infrastructure investments will remain at around 7 per cent of GDP.

Exchange rate policy plays a pivotal role in China's economic tightening. So far this year, the appreciation rate of the yuan against the US dollar has accelerated and now stands at nearly a 10 per cent year-year. Meanwhile the falling dollar has meant weaker yuan appreciation against other major currencies. For example, the yuan has weakened by nearly 15 per cent against the euro since the beginning of 2006. Measured in effective terms, its overall appreciation since the dollar peg was removed in July 2005 has been a modest 5 per cent. Looking ahead, we expect **yuan appreciation against USD to slow somewhat**. But since we expect the weakening of the dollar against other world currencies to end soon and be replaced by gradual appreciation, there will be a clear speed-up in the effective strengthening of the yuan.

Weak growth next year

- **Growth below trend this year, further weakening in 2009**
- **Record-high inflation this year, lower in 2009**
- **Refi rate of 3 per cent by autumn next year**

Last year, euro zone GDP rose 2.6 per cent – well above trend growth of about 2 per cent – but the negative effects of the US slowdown and credit market problems have gradually become clearer. We anticipate that **growth will drop to 1.4 per cent in 2008 and further to 1.1 per cent next year**. This represents a small upward revision for this year, but a downward revision of nearly half a percentage point in 2009.



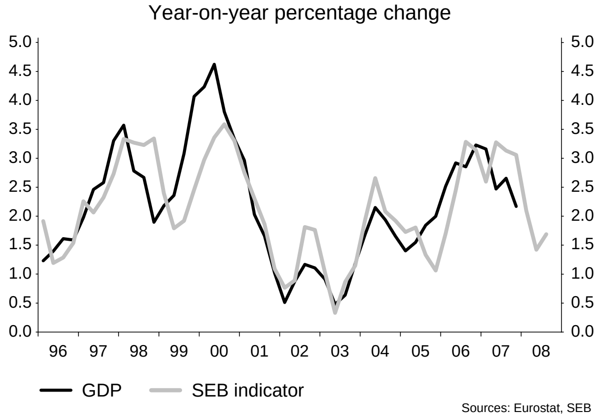
Inflation has accelerated more sharply than expected, and HICP is now at record-high levels. This will delay interest rate cuts by the European Central Bank. Towards year-end, however, we expect a more noticeable cyclical slowdown to start pushing down inflation. The ECB will then have sufficient motives to begin supporting the economy with interest rate cuts. We expect a refi rate of 3 per cent during the autumn of 2009.

Financial squeeze will continue

The European banking system, too, is struggling with difficulties, which seem to be lasting longer than expected. It is true that the functionality of various markets has been restored after this past winter's paralysis, but the Treasury Eurodollar (TED) spread – the difference between the London Interbank Offered Rate (LIBOR) and the Treasury bill rate – has again widened. This illustrates fundamental problems in the financial system. We expect the problems experienced by a number of major European banks will gradually have growing negative effects on private consumption and corporate capital spending.

Weaker growth in 2009

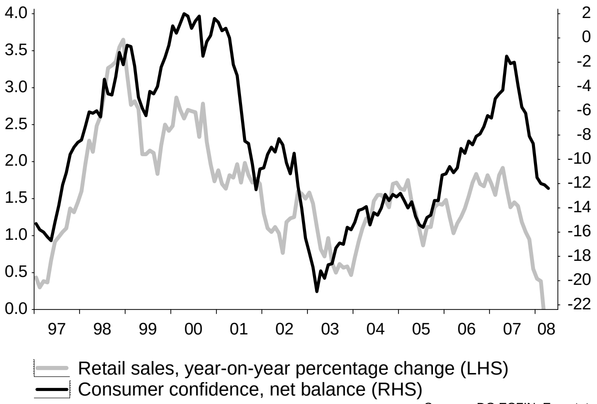
In recent months, the flow of statistics has provided a mixed picture of euro zone resilience. The outlook for Spain and Italy has worsened dramatically, while sentiment indicators for Germany recovered early in 2008. The latest monthly figures for both the IFO industrial index and the ZEW financial indicator were a disappointment, however. SEB's own growth indicator foresees euro zone GDP growth ending up at around 1.5 per cent in the next few quarters.



Euro zone exports are being restrained by the global economic deceleration and the stronger euro. Nominal exports to the United States have slowed since their peak in January 2006, when they were climbing by a full 16 per cent, to a fall of 10 per cent in early 2008, but increasing trade with fast-growing economies in Asia and Central and Eastern Europe is serving as an important counterforce. For example, euro zone exports to Russia and the CEE4 countries (the Czech Republic, Hungary, Poland and Slovakia) have risen from about 10 per cent of the total in 2000 to a current level of more than 15 per cent. Nominal export growth to this region has admittedly also decreased, but still stands at between 3 and 4 per cent year-on-year. Looking ahead, the British slowdown combined with a sharp downturn in the pound is also likely to have an impact. Euro zone exports to the UK are larger than to the US: about 15 per cent of total exports compared to 12 per cent. Overall, we expect export growth to slow from 6 per cent in 2007 to less than 4 per cent in 2008.

Weak euro zone retail sector figures and falling household confidence in recent months make it unlikely that consumption will take over as an economic engine. The shaky residential market in a number of countries, especially Spain and Ireland, will also contribute to greater caution by households. We nevertheless expect a more stable trend in the euro zone housing market as a whole than in the US, due among other things to a different structure in the mortgage lending market.

Euro zone: Retail sales and confidence



Sources: DG ECFIN, Eurostat

The high household savings ratio in the euro zone is another stabilising factor when it comes to the impact of the ongoing credit crisis on the real economy. Thus the risks of a sharp downturn in consumption are smaller than in the US and the UK. Overall, we expect household consumption growth to slow from 1.5 per cent in 2007 to 1.3 per cent in both 2008 and 2009.

Gross investments are also slowing as a consequence of global economic deceleration and weaker euro zone export growth. To some extent, tighter credit conditions have also begun to bite. We expect growth in gross fixed investments to cool from last year's 4.2 per cent to just below 3 per cent this year.

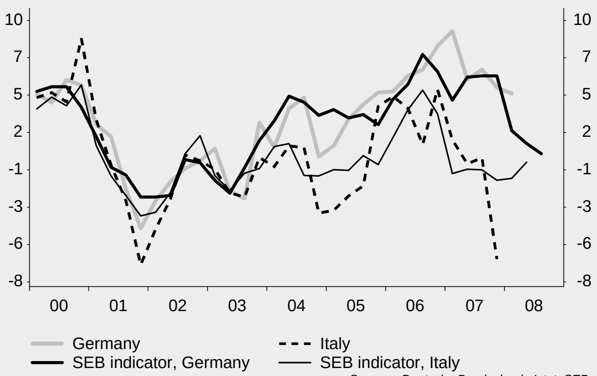
The euro zone is thus following the US into a growth slump, but the downturn will be milder and arrive after a somewhat longer delay than the historical norm. **In the euro zone as a whole, growth will reach only 1.4 per cent this year and 1.1 per cent in 2009** – a marginal upward revision this year, but a clear downward revision for 2009 compared to our

Greater tensions as SEB industrial indicator points downward

So far Germany's manufacturing sector has resisted such strains as the strong euro, the credit market crisis and sagging US demand. Industrial production rose with unexpected vigour at the beginning of 2008 and optimism has been relatively uninterrupted. To some extent, this reflects the impressive adjustment process that German manufacturers have undergone since the long slump following reunification – an adjustment implemented under the restrictions imposed by the common currency. During the darkest years of the early 21st century, it seemed a nearly impossible task to implement this adjustment without the help of a devaluation, especially given interest rates that seemed too high by German standards for years.

Industrial production, total

Year-on-year percentage change



Sources: Deutsche Bundesbank, Istat, SEB

Now a mirror-image discussion of this issue seems to be emerging. Cost-effective German industry seems capable of handling both a strong currency and relatively high interest rates. In contrast, Italian industry is grappling with major problems caused by an unfavourable product mix and a high cost situation. Another source of tension is major differences in the pathology of euro zone housing markets. These differences have contributed to large differences in the spreads on 10-year government bonds – possibly a reflection of a growing mistrust in the ECB's long-term ability to bridge over the different needs in the currency union.

Our new industrial production indicator shows that differences in manufacturing sector performance are persisting to some extent. The indicator is based on information compiled from a number of areas, such as exchange rates, energy prices and sentiment indicators. Tensions are easing, however, since German industry also seems to be on its way towards a slowdown. Meanwhile the SEB indicator is pointing towards a certain rebound in Italy after a sharp decline late in 2007. Germany, but also France, will continue to have faster growth in manufacturing than Italy and Spain (see the table below), but the greatest disappointment risks are now found in Germany and France.

Industrial production

Year-on-year percentage change

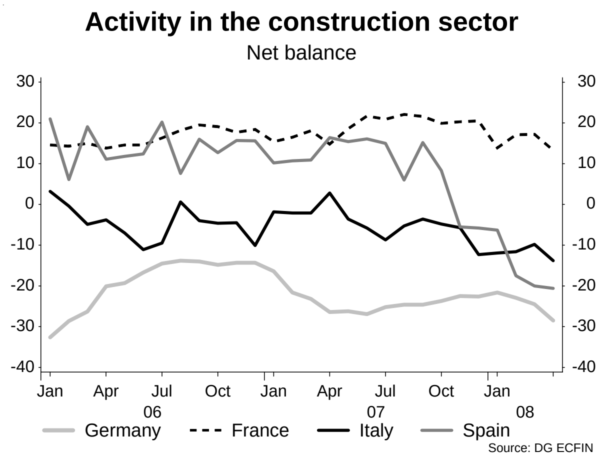
	2006	2007	2008	2009
Euro zone	4.0	3.4	1.8	2.0
Germany	6.0	5.8	2.7	2.7
France	1.3	1.8	1.4	1.5
Italy	2.6	-0.2	-0.5	1.0
Spain	3.7	2.3	1.1	1.4

Sources: Eurostat, SEB

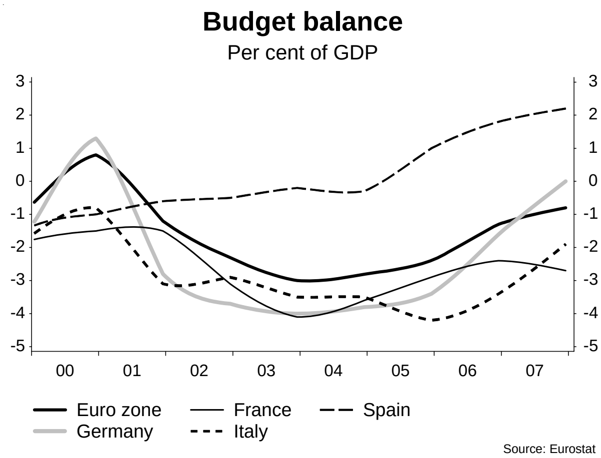
February forecast. German GDP growth will end up at 1.6 per cent this year and somewhat lower in 2009.

Little room for fiscal stimulus

The economic slowdown is having an impact on budget trends. Estimates indicate that 1 percentage point lower GDP growth weakens the budget balance by about 0.5 percent of GDP. Government finances are weakening at a stage when the consolidation process following major deficits early in the decade has not progressed especially far.



The German federal budget showed a small surplus last year. Its improvement in recent years has not only been a result of stronger economic performance. The reform of the social insurance system also represents a lasting improvement. However, despite rising tax revenues during the first quarter of 2008, we think this year's budget is likely to show a small deficit.



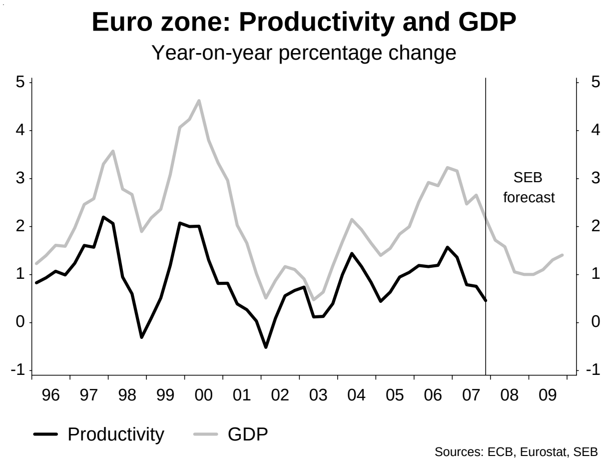
In France, the situation looks worse. The budget is in deficit and moving towards further deterioration. In Italy, decent economic performance combined with tax hikes – pushed through with great courage by Romano Prodi's former centre-left government – has improved the country's precarious budget situation to some extent. With Silvio Berlusconi back in power, it is likely that economic policy will move in a more expansive direction. Spain has the strongest central government finances of any large country in the euro zone. A relatively large fiscal package now on the way will counter downward economic tendencies.

Overall, we can draw the conclusion that weak fiscal policy during the previous economic expansion is now leading to economic policy problems. The euro zone as a whole is moving into an economic slowdown with a deficit in public finances. There is thus little room for fiscal stimulus, especially in light of EU Stability Pact restrictions. For countries hard hit by the economic slowdown, this may turn into a significant problem, especially if the ECB delays its interest rate cuts because of lingering inflation risks.

Strong labour market for another while

Unemployment in the euro zone has continued to fall. Developments in the German labour market have been especially impressive, while an upturn in unemployment has been noted in such countries as Spain since the beginning of 2008. The slowdown in GDP growth will now gradually have an effect on the labour market. We expect euro zone unemployment to continue downward for another two more months or so, then begin to climb during the second half. As an annual average, unemployment will be 7.1 per cent this year and somewhat higher in 2009.

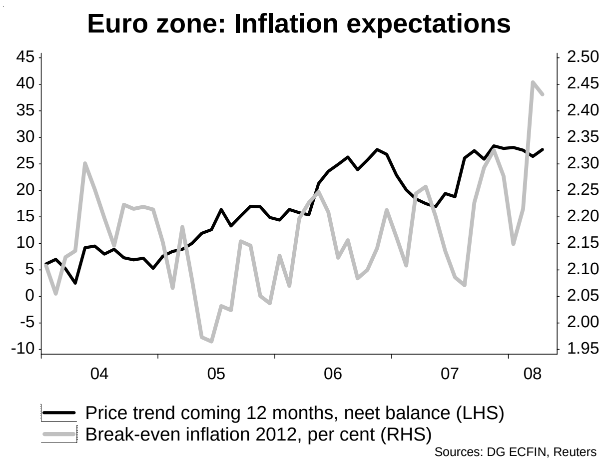
A continued strong labour market will mean a tendency towards accelerating wage and salary increases, especially in an environment where employees may want compensation for rising food and energy prices. We also expect hourly wage increases in the euro zone to accelerate from today's 2.5 per cent to about 3.5 per cent next year. The upturn will be about the same in Germany. A number of German pay agreements signed in 2007 were at a higher level than for many years. This tendency has continued during 2008. In February, for example, the large IG Metall union signed an agreement that provides pay hikes of more than 5 per cent.



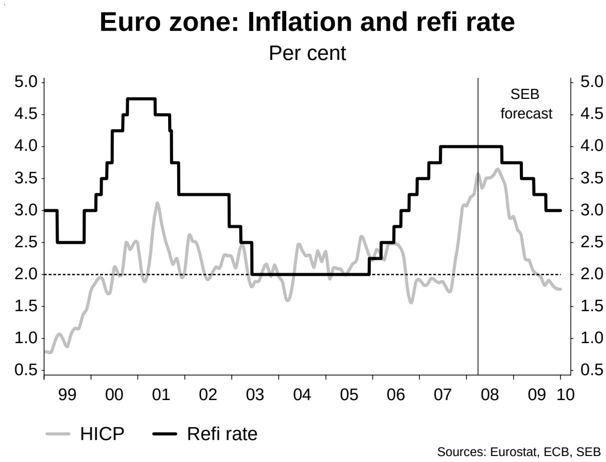
Relatively strong productivity growth in recent years has helped keep cost pressure low, but in the course of 2007 the increase in unit labour costs rose from 1 to 2 per cent. There are signs that the upturn in productivity has been driven by greater utilisation of the existing labour force, rather than by real technological progress. Our conclusion is that it has actually been a cyclical productivity upturn, which may reverse again when the economy decelerates.

Record inflation this year, lower in 2009

In March, the Harmonised Index of Consumer Prices (HICP inflation) stood at 3.6 per cent, its highest level since the euro was introduced in 1999. Inflation is mainly being driven by increases in food, oil and other commodity prices. Core inflation has been relatively stable at just below 2 per cent for the past year, but in March it climbed to 2.0 per cent, its highest level since April 2003. Core inflation, too, is indirectly affected by rising energy and food prices. According to a breakdown of inflation statistics by sectors, transport (excluding petrol) and the hotel and restaurant trade show the largest price increases.



We expect the HICP inflation rate to remain above 3 per cent for another six months or so. During November 2008-June 2009 we believe that inflation will decelerate clearly, ending up around 2 per cent. This inflation profile implies that **HICP inflation will average 3.4 per cent this year and 2.1 per cent in 2009**.



High resource utilisation means risks of even higher short-term inflation. Looking further ahead, however, downside risks – connected to the possibility of the credit crisis having a larger impact on the real economy than in our main scenario – weigh heavier.

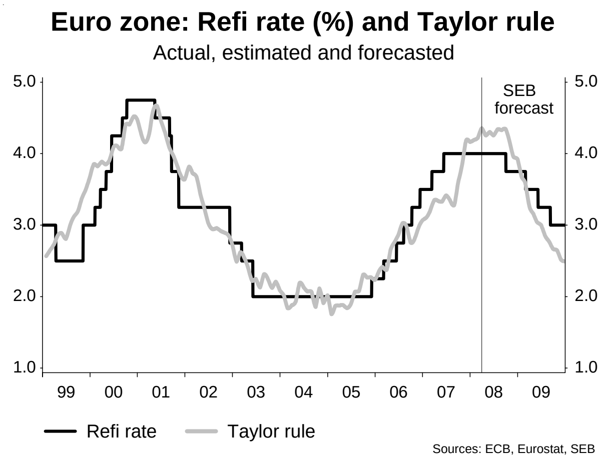
ECB will cut key rate before year-end

So far the ECB has declared that interest rate cuts are out of the question in the prevailing environment. With record-high inflation, rising inflation expectations, a continued strong labour market and rather high levels of credit and money supply growth, the ECB has instead signalled that further rate hikes are not inconceivable. Early in 2008, the ECB had difficulty persuading the financial markets that such a strategy was sustainable. In recent months, however, fixed-income market pricing has indicated that expectations of key rate cuts have largely vanished.

Yet the ECB is in a troublesome situation. The euro zone growth outlook has gradually worsened, as reflected not least in the bank's own forecasts. In October 2007, the midpoint of GDP forecasts for 2008 by ECB staff stood at 2.3 per cent. By March this forecast had been revised to 1.7 per cent. Add to this the special difficulties of exporters in coping with the strong euro and major housing market strains in several countries. Viewed from a cyclical perspective, there are thus not so many pieces of the puzzle missing before the ECB shifts course. Given another moderate downward revision of GDP prospects for 2008 and 2009 by the ECB, it is clear that a resource gap is in the process of opening up in the economy.

As for inflation, it is likely that the ECB will want to wait for clear signs of a downturn which confirm that secondary effects – for example in the form of demands for pay hikes to compensate for inflation – will not grow too strong. Our forecast points towards a significant downturn in inflation starting in November. It is possible that the ECB will not lower its key rate before this actually occurs.

Our overall conclusion is that the economic trend will gradually persuade the ECB to shift towards a policy of interest rate cuts in the course of 2008. Clearer signs of slowdown combined with stabilisation in inflation expectations and wage pressures are enough for the ECB to feel certain that the next step should be an interest rate cut.



Considering the ECB's current inclination to focus on high inflation and to tone down cyclical risks, however, the shift is likely to take another six months or so. We are thus expecting the first refi rate cut during the fourth quarter, following by further cuts to 3 per cent during 2009.

The consequences of labour market and inflation outcomes and forecasts can be illustrated by the reaction pattern of the Taylor rule. For a long time, this rule signalled that the ECB had room to cut its key rate, but the recent upswing in inflation combined with a continued fall in unemployment have contributed to a shift: The Taylor rule now indicates a substantially higher interest rate in the short run (see chart). Given our forecast of somewhat higher unemployment and a drop in inflation, the estimated association nevertheless provides a clear signal that interest rate cuts are on their way.

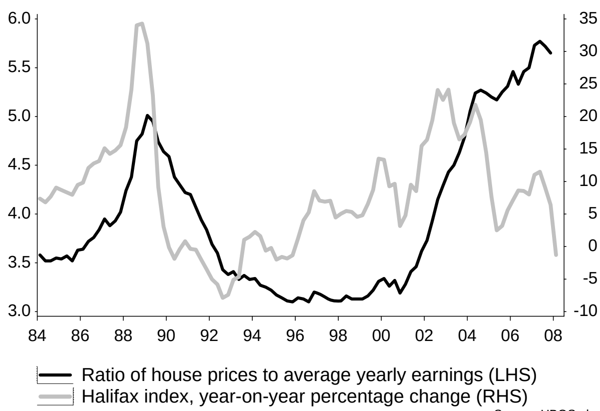
Deeper deceleration

- **GDP growth will halve this year**
- **Home prices will fall by 20 per cent**
- **The key rate will be cut to 3.50 per cent**

The British economy is decelerating. Tighter credit conditions and relatively high interest rates have begun to bite, given a combination of inflated home prices and highly indebted households. GDP growth will slow to 1.5 per cent this year, a halving of the 2007 rate. A significant, rather drawn-out adjustment process in the housing market will help keep growth at a modest 1.3 per cent in 2009. **We have thus lowered our forecast for 2009 by 0.5 percentage point** since the February ***Nordic Outlook***. The Bank of England (BoE) will continue to ease its monetary policy, **cutting the repo rate to 4.0 per cent by year-end and to 3.50 per cent some months into 2009**.

As in the US, the housing market plays a major role in economic performance. Home prices are now rapidly weakening. The price expectations of estate agents according to the RICS survey – a good leading indicator of home prices – are now at record-low levels. According to the Halifax House Price Index, home prices are now falling year-on-year. Higher borrowing costs and tightening credit terms combined with **clear over-valuation** are pointing towards a significant price adjustment. We expect an accumulated **downturn of about 20 per cent**. An even larger price slide cannot be ruled out, among other things in light of the IMF's estimate that British home prices are over-valued by close to 30 per cent.

United Kingdom: House prices



Source: HBOS plc

Tighter credit and falling home prices mean that the **consumption boom is over this time around**. Consumption has grown by an average of 0.7 per cent faster than disposable household income in the past five years, pushing down saving to record-low levels. A rising household savings ratio, combined with smaller income increases, will slow consumption growth from 3.1 per cent in 2007 to 1.4 per cent this year and 1.1 per cent in 2009.

The sharp **weakening of the pound** will help prevent an even deeper economic slowdown. The previously hard-pressed export sector is thus getting some much-needed help. Looking ahead, we expect a continued decline in the pound to result in positive contributions from foreign trade despite lower demand in important export markets. But **a cooling is also under way in the manufacturing sector**. Productivity growth is on the way down. Combined with waning demand and tighter credit conditions, this will restrain profit growth. As a result, companies will become more cautious about capital spending and hiring decisions.

The downturn in the housing market is not being driven by a weaker labour market, and this is a divergence from the historical pattern. Employment has continued to rise, while the jobless rate remains at its lowest levels since the 1970s. Given GDP growth clearly below trend, however, a cooling of the labour market is on the way. We expect unemployment to climb from today's levels.

The weakening of the pound, as well as rising energy and food prices, will push **inflation well above the official target of 2.0 per cent this year**. Inflation will remain high for a while. Next year, however, lower resource utilisation combined with the disappearance of the food and energy price hikes from the 12-month statistics will cause inflation to gradually drop below target.

High inflation expectations and very low unemployment will place restrictions on how fast the BoE can lower its key interest rate to support the economy. Our assessment is that growth risks will weigh increasingly heavily. The BoE will thus **lower its repo rate** from today's 5.0 per cent to **4.0 per cent late in 2008** and then to 3.50 per cent some months into 2009. Due to weak public finances, we do not expect fiscal stimulus packages. Unlike the US, the task of stimulating the British economy will thus rest entirely with the central bank.

Due to shrinking interest rate spreads, the pound will weaken further against the euro during 2008. However, the pound will regain part of this downturn in 2009, when the ECB also carries out a clear easing of euro zone monetary policy. On the other hand, both this year and the next the pound will weaken against the US dollar.

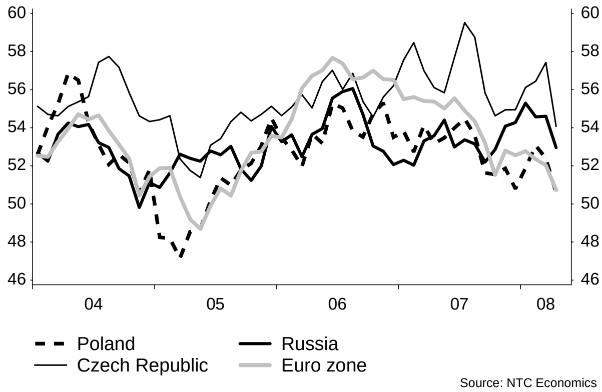
Resilience for another while

- **Continued strong domestic demand**
- **Inflation proving difficult to bring down**
- **Russia growing fastest**

Central and Eastern Europe is showing strong growth, despite the international slowdown. This is mainly due to **dynamic domestic demand** and little exposure to the US in foreign trade. So far, exports have held up well in most of these countries. **Eventually, however, the slowdown in Western Europe combined with subdued capital inflows will contribute to a cooling** of GDP growth.

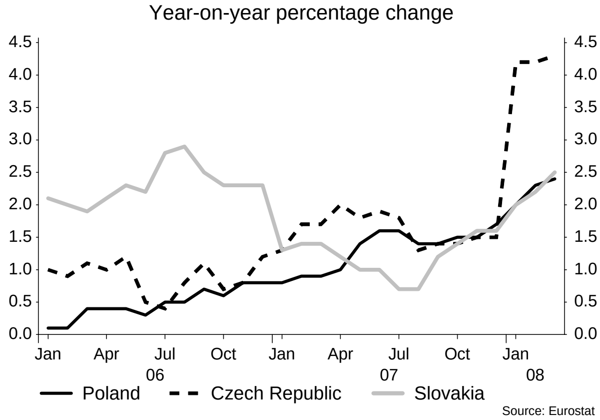
GDP growth in the nine countries of the region covered here, including the Baltics, will slow from 7.4 per cent in 2007 to **6.3 per cent in 2008 and 5.8 per cent in 2009**.

The Baltic countries have already begun a clear deceleration, following dramatic overheating in recent years. The Baltics, as well as several other economies in the region, are plagued by **sizeable imbalances** in the form of large current account deficits and/or high inflation pressure. These economic imbalances are very persistent.



Russia will enjoy this year's fastest growth among the countries of Central and Eastern Europe. GDP will rise by 7.3 per cent in 2008 and 6.5 per cent in 2009. Domestic demand is the engine. High commodity prices will remain a strong underlying driving force for another while, but they will fade somewhat over time. Fiscal policy will also provide support, especially this year. The central bank will try to counteract endemic high inflation by allowing a certain apprecia-tion of the rouble.

Ukraine is benefiting from high steel prices. Mean-while pressure for change is under way in the econo-my, contributing to rising consumption and invest-ments. However, risks of overheating increase. GDP growth will slow gradually to 5.5 per cent in 2009. Inflation, currently above 20 per cent, will remain double-digit in 2009. Growing demands for higher wage increases and subsidies can be expected.



In **Central Europe**, the growth rate is gradually falling from high levels in Poland, Slovakia and the Czech Republic. The slowdown is helping to calm inflationary impulses from high resource utilisation. The Hungarian economy is slowly recovering after the government's earlier fiscal tightening.

Key interest rate hikes in Central Europe will continue in the near future. In Poland we expect an additional 50 basis points altogether, and in the Czech Republic and Hungary 25 points. Slovakia is adjusting its key rate to the ECB level in the run-up to euro zone accession in 2009. The emphasis of its interest rate cuts will be on late 2008, in order to limit inflation.

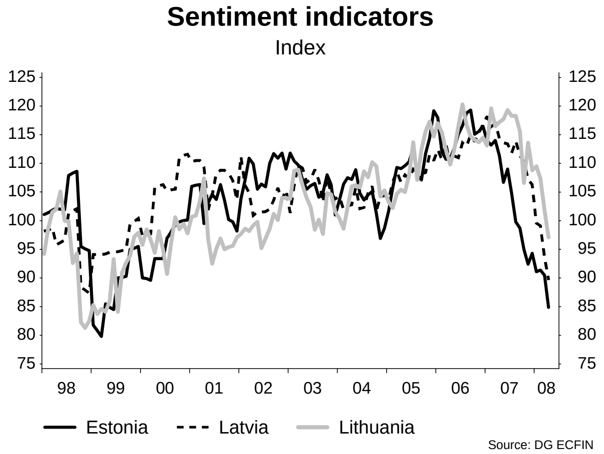
The Polish zloty will continue to appreciate this year, sustained by key interest rate hikes and relatively good economic performance. We also believe that the government may deliver positive surprises when it comes to structural reforms. The Czech koruna is moving sideways in the short term, due to less advantageous capital flows than before. The Hungari-an forint will continue to slip after a temporary recovery recent months; the currency is weighted down by large budget and current account deficits as well as greater political risk.

Baltics: Latvia will decelerate faster

The Baltic economies are decelerating after their overheating in recent years. **The slowdown is domes-tically led and most accentuated in Estonia and Latvia**, the countries with the largest imbalances.

In Estonia, the economic cooling that has been under way for more than a year is now intensifying. In Latvia, the process is even more dramatic. **The two economies will growth at well below potential**, which is around 6-7 per cent, both this year and next.

Slower credit expansion and weakened international demand will help restrain growth. The deceleration is also a consequence of resource shortages and a shift in earlier unrealistically high expectations among households and companies.



Baltic exports are putting up a decent resistance to both the global slowdown and weakened competitiveness, thereby helping to keep growth up. Low real interest rates as well as relatively strong central government finances, which have allowed some room for fiscal stimulus measures, are also having a stabilising effect. The risk in our growth forecast is on the downside, however.

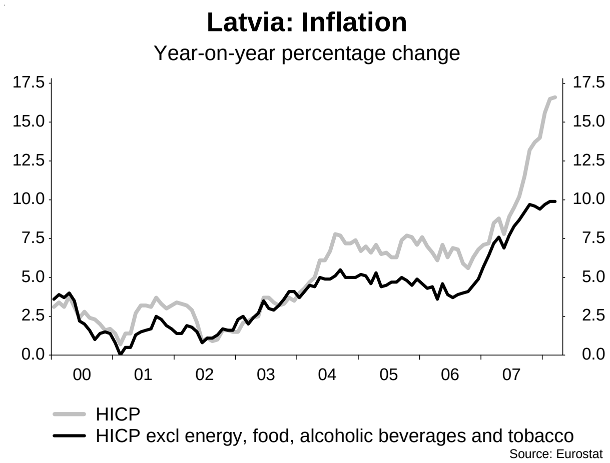
Imbalances will ease only a bit

Imbalance problems in the form of current account deficits and inflation will persist, but large current account deficits will ease as high import growth winds down – a process that has already begun. We expect Latvia's current account deficit to shrink from 23 per cent of GDP to 16 per cent in 2009. In Estonia, the deficit will fall from 16 to 12 per cent during the same period. Very high wage and salary increases – about 20 per cent in Estonia and Lithuania and more than 30 per cent in Latvia during 2007 – have probably culminated and will slow further in the months ahead. **However, it will take another quarter before the high inflation rate** (11 per cent in Estonia and Lithuania, 17 per cent in Latvia) **turns downward**. Inflation is being driven both by underlying price pressures on the wage side and the effects of high energy and food prices. Energy and food weigh relatively heavily in the consumer price indices of these countries.

Competitiveness has been undermined by the accelerating pay increases of recent years, combined with relatively rapid appreciation of the Baltic currencies, which are all pegged to the euro. This deterioration is greatest in Latvia and Estonia. Losses of market share have been minor to date. If cost pressure does not ease, there is a risk that competitive problems will eventually become more severe. Pressure on fixed exchange rates might then arise, but our main scenario is that **the euro pegs will survive**.

Estonia's growth will slow from 7.1 per cent last year to 3 per cent in the next couple of years. Adjustment to the previous property market bubble will continue until the end of 2008 at least. The labour market began to weaken last winter, and unemployment will climb from an average of 4.7 per cent in 2007 to 6.5 per cent this year. We do not anticipate a larger upturn, among other things because in our experience, Estonian service sector companies have not implemented especially larger staffing changes during cyclical fluctuations. Inflation will fall from 8 per cent this year to 4 per cent in 2009.

Latvia's economy is now decelerating faster than expected. The overall EU sentiment indicator, based on a survey of companies and households, is now close to its level during the Russian financial crisis ten years ago. Another sign of cooler economic activity is that credit growth has decreased perceptibly. Signs of waning domestic demand are clear. The retail sales declined somewhat during the first quarter year-on-year, while the property market continued to worsen. We are revising our GDP forecast for 2008 downward from 7 per cent in our last ***Nordic Outlook*** to 3 per cent and for 2009 from 5.5 to 3 per cent. In spite of this, our inflation forecast for 2008 remains at 14 per cent. We expect inflation to drop to 7 per cent in 2009.

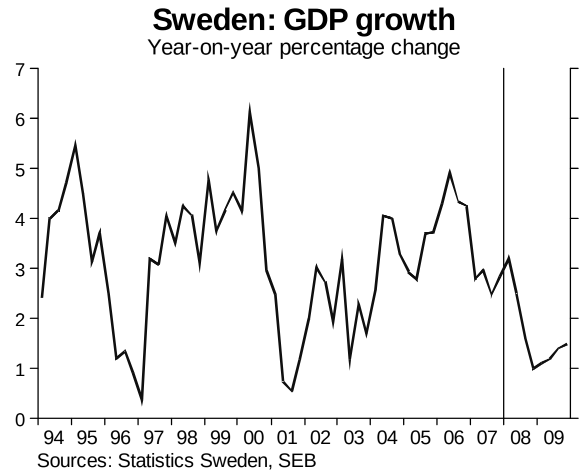


Lithuania's economy is downshifting more gently. Overheating tendencies have not been as pronounced as in Estonia and Latvia. During the domestic demand boom of the past six years, both home prices and credits have risen at a more modest pace in Lithuania. This means that the downward adjustment in the Lithuanian property market will be milder. GDP growth will cool from 8.8 per cent in 2007 to 5.0 per cent in 2009, a slight downward revision from our last forecast.

Continued weakening in 2009

- **Temporary improvement in exports**
- **Domestic demand will lose momentum**
- **Fiscal policy will ease the slowdown**
- **Inflation will exceed 2 per cent this year**
- **Riksbank will cut key interest rate by year-end**

The Swedish economy is continuing to decelerate, but most signals indicate continued healthy performance in the immediate future. An upward surge in merchandise exports will probably lead to strong GDP growth in the first quarter. Our overall estimate is that **GDP growth will slow from 2.8 per cent in 2007 to 2.1 per cent this year, adjusted for the number of work days. Next year, growth will decline further to 1.3 per cent.** This implies a change in the growth profile compared to our last ***Nordic Outlook***. The economy will be more resilient in the short term, but the increasingly gloomy international economic outlook will gradually affect Sweden more and more. The slowdown will thus bottom out only in 2009.



To date, the international financial market crisis has primarily affected the Swedish economy via a weaker dollar and reduced exports to the United States. A falling stock market has also weakened the wealth position of households, dampening their optimism. **We anticipate a gradually broader weakening of international demand as well as more noticeable effects via tighter credit conditions.** Thus both exports and domestic demand will cool.

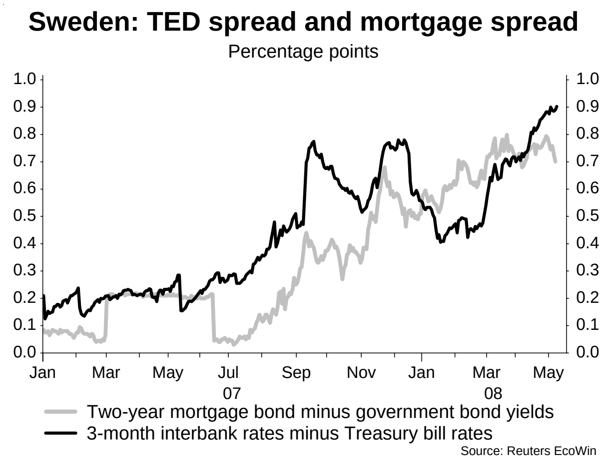
Our forecast implies that accumulated growth in 2008 and 2009 will be about 1 percentage point higher in Sweden than in the euro zone, and nearly 2 percentage points higher than in the US. Strong public sector finances, high household savings and low residential construction are factors that will contribute to Sweden's relative resilience. Because of strong public finances, stimulus measures can now be mobilised to soften the slowdown. We have assumed a stimulus package equivalent to 1 per cent of GDP next year.

Employment is still growing relatively fast. Although such indicators as new job vacancies are pointing towards a clear slowdown, there will be a further lag before employment begins to decrease and the jobless rate climbs. Inflation will remain at high levels during the coming year, mainly due to sharp price increases on energy and food. The labour market cool-down will help ease price pressures ahead.

Due to somewhat stronger growth and higher inflation than in our February outlook, we now anticipate that the **Riksbank will wait until the end of 2008 before beginning its interest rate cuts**. By then, the economic slowdown will have progressed so far that its effects on the labour market will begin to be clear. Meanwhile inflation will have stabilised and the two-year inflation forecasts will signal room for an easing of monetary policy. By autumn 2009 we expect the repo rate to stand at 3.25 per cent.

Continued financial stress

In a number of respects, the Swedish financial system seems to be resisting the international credit crisis better than many other countries. But the impact of the crisis is apparent even here. The "TED spread" – the difference between the interbank rate and the Treasury bill rate – has followed the trend in the euro zone and the UK relatively well. The spread between mortgage bond and government bond yields has also continued to widen, affecting the interest costs of Swedish homeowners.



Bank lending to households has slowed somewhat, while lending to the corporate sector has accelerated. Increased corporate borrowing from banks is probably a reflection of more expensive and difficult terms for direct funding in the capital market. Our conclusion is that credit market problems will also have a clear impact on the real Swedish economy.

Sweden: Lending to companies
Year-on-year percentage change

Sources: Statistics Sweden, Riksbank

Temporary rebound in exports

Weaker market growth led to a sharp deceleration in Swedish exports during 2007. Exports to the US continued their downward trend, but sales to the EU market also lost momentum. This deceleration was accentuated by industry-specific problems in such sectors as pharmaceuticals, vehicles and telecoms. Exports were also hampered by capacity restrictions, especially in commodity sectors. During the past six months, new capacity seems to have gone into service, contributing to a clear recovery in exports late in 2007 and early in 2008. This has resulted in an upward revision of our 2008 full-year forecast.

However, we anticipate that the international slow-down will soon have an impact in the form of lower export growth. We expect the American recession to be prolonged, which implies greater secondary effects on Sweden's most important export markets in the Nordic countries and elsewhere in Western Europe. The situation in 2009 thus looks gloomier than before. Overall, we predict that merchandise exports will increase by 4 per cent in this year and less than 2½ per cent next year.

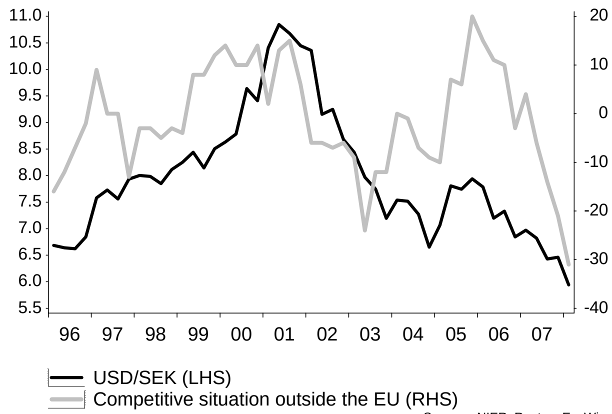
2007 merchandise exports
Current prices

	2007 weight, %	Change, %	Contribution, percentage points
United States	8	-14.3	-1.3
Nordic countries	23	8.0	1.8
New EU countries	6	12.9	0.8
BRIC	6	14.8	0.7
Others	57	4.8	2.7
Total	1.0	4.7	4.7

Sources: Statistics Sweden

Rising exports to expansive emerging markets will help keep the slowdown in export growth relatively mild in a historical perspective. The "BRIC" countries (Brazil, Russia, India, China) nevertheless still account for no more than 6 per cent of Swedish exports. Despite an increase of a full 15 per cent in exports to these countries last year, their contribution to the total export increase was just above ½ percentage point. The strength of the krona against the US dollar also means weaker competitiveness in many markets outside Europe. The appreciation of the krona has also been accentuated by the downward drift of the British pound, which has pushed Sweden's trade-weighted TCW index to its strongest level in nearly eight years.

Sweden: Exchange rate, competitiveness



Sources: NIER, Reuters EcoWin

Capital spending has peaked

After four years of rapid expansion in capital spend-ing, we anticipate a clear slowdown this year. Rising unit labour costs, high commodity prices and an ever-weaker dollar mean a squeeze on profitability. Lower stock market valuations and tighter credit conditions are also making it more difficult for companies to obtain financing, but strong balance sheets that boost chances for internal financing of capital spending serve as a stabilising force, especially for small and medium-sized companies.

According to the Statistics Sweden investment survey, companies still have rather ambitious plans, but the historical pattern indicates that companies overesti-mate actual outcomes during a cyclical slowdown. We thus expect capital spending by manufacturers to largely level off during 2008. Long-term expansion plans in certain commodity sectors will be completed, but certain capital spending being planned in other industrial sectors will be postponed.

Gross fixed investments
Year-on-year percentage change

	2007	2008	2009
Manufacturing sector	9.8	1.0	-4.0
Homes	8.7	-1.0	-5.0
Total	8.0	3.5	-1.5

Sources: Statistics Sweden, SEB

The increase in residential construction has gradually slowed during the past two years. The removal of central government subsidies for new residential construction makes the statistics difficult to interpret, but actual housing starts probably stagnated completely during 2007. Looking ahead, however, we expect a downturn. This is confirmed by construction company plans in the Economic Tendency Survey of the National Institute of Economic Research (NIER). Corporate reports have also signalled a rather dramatic weakening in the construction market during the past few months.

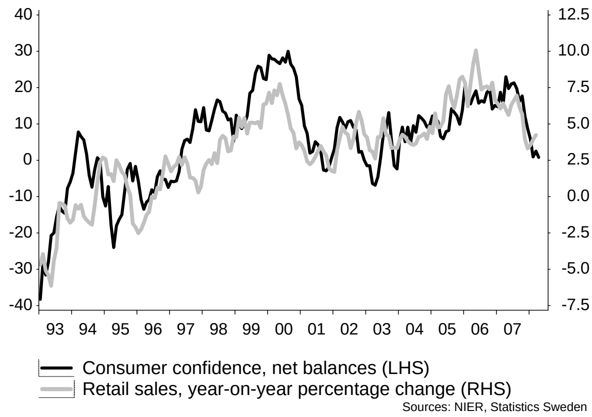
In less cyclically sensitive sectors, capital spending is continuing to rise. Investments in the energy sector are rapidly growing as the distribution network is expanded, nuclear power plants are upgraded and wind power facilities are added. The government is also increasing its infrastructure spending. Overall we estimate that **capital spending will climb by nearly 4 per cent this year and fall slightly in 2009**.

More cautious households ahead

Household consumption increased by more than 3 per cent last year. Sharply rising employment, strong real wage growth and tax cuts helped real disposable household income to rise significantly more than consumption, or by nearly 4½ per cent. Household saving thus increased as well. Real household income will continue to climb at a fairly rapid pace due to higher pay increases and fiscal stimulus measures, but weaker employment and higher inflation will lead to more moderate growth than in 2007.

The stock market downturn and international turmoil have probably helped dampen household expectations for the future during the past six months. This has also resulted in more cautious consumption behaviour. Retail sales growth has decelerated and car sales have fallen in recent months.

Household wealth has been eroded by the stock market downturn. We estimate that this is equivalent to nearly 20 per cent of disposable household income. A common rule of thumb is that the effect on consumption is equivalent to about 5 per cent of a change in wealth. In that case, the stock market downturn could curb consumption by roughly one percentage point.



There are partly conflicting trends in the housing market. Prices of owner-occupied flats fell during the autumn, but there appears to have been some recovery early in 2008. The price trend for single-family homes has been more stable but in the past six months prices have shown signs of levelling off, according the Real Estate Barometer. Meanwhile construction companies are signalling a significantly tougher market situation. We expect that a levelling off in home prices, and possibly also slightly falling prices ahead, are the most likely scenario. In this case, the trend of household wealth, which has served as a stimulating factor for consumption in recent years, will now have a restraining effect.

Overall, relatively good income growth is sustaining consumption. On the other hand, reduced wealth and the gradual weakening of the labour market will lead to higher saving. During the last economic slowdown, saving climbed rather sharply, but at that time the dot-com/IT craze had led to significantly more depressed savings than at present. Our conclusion is that **consumption growth will gradually slow, but the upturn in saving will be rather moderate**.

Economic situation of households
Year-on-year percentage change/level

	2006	2007	2008	2009
Private consumption	2.5	3.1	2.4	1.9
Disposable income	2.6	4.3	3.1	2.3
Savings ratio, %	7.1	8.2	8.8	9.2

Sources: Statistics Sweden, SEB

Higher unemployment next year

The number of people with jobs, and especially the number of hours worked, has continued to climb at a healthy pace despite slower production growth.

Indicators now point to a slowdown in the labour market. The influx of new job vacancies has slowed significantly, the number of termination notices has risen somewhat from low levels, and companies' hiring plans are less expansive. Given growth that will fall below trend during the next few quarters, employment will level off and then turn downward late in 2008. Next year's annual average employment will fall, leading unemployment to rise by more than ½ percentage point.

Sweden: New vacancies and employment

Year-on-year % change, 3-month moving average

Sources: Statistics Sweden, National Labour Market Board

Productivity growth is currently very weak. **This is a signal that companies may need to adjust their employment levels fairly radically** in order to preserve their profit levels. We anticipate a gradual recovery in productivity growth to a normal level of around 2 per cent. The adjustment in employment levels and productivity will occur partly by normalising the number of hours worked per employee after the sharp upturn of recent years. Such an adjustment in average working hours also occurred during the last cyclical slowdown at the beginning of the 21st century.

Labour market and productivity

Year-on-year percentage change/level

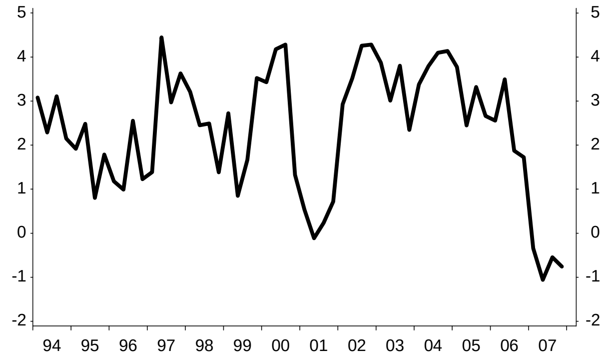
	2006	2007	2008	2009
GDP	4.4	2.8	2.1	1.3
Productivity	2.7	-0.7	0.8	1.9
Employment	1.8	2.4	1.3	-0.3
Hours worked	1.7	3.5	1.3	-0.6
Labour supply	1.2	1.7	1.0	0.4
Unemployment, %	5.4	4.6	4.3	5.0
Unemployment, %, ILO definition	7.1	6.2	5.9	6.6

Sources: Statistics Sweden, SEB

While unemployment has begun to show signs of bottoming out, the **labour shortage seems to have eased**. According to the Business Tendency Survey, a clear downturn in labour shortage figures occurred in the first quarter of 2008, after the shortage had levelled off during the second half of 2007.

Sweden: Productivity

Year-on-year percentage change



Source: Statistics Sweden

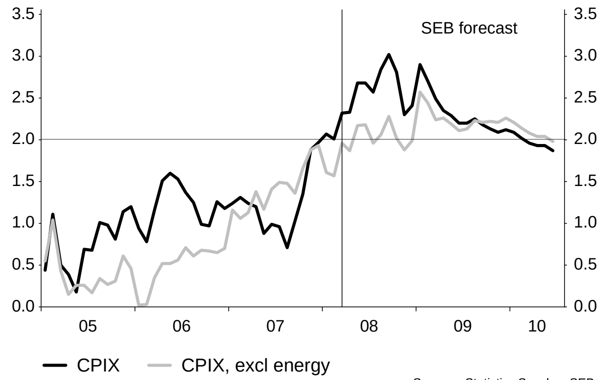
A slightly cooler labour market may have contributed to somewhat lower pay increases in 2007 than expected. Due to the structure of collective agreements, however, wages and salaries will increase more this year than in 2007. This applies especially to public sector pay, with the Municipal Workers' agreement providing large pay rises in January 2008. As the labour market situation deteriorates, pay increases will also gradually slow from about 4½ per cent in 2008 to around 4 per cent in 2009.

Inflation will culminate this autumn

Inflation has climbed rapidly since last summer. The Consumer Price Index (CPI) has increased from just below 2 per cent to 3-3½ per cent in recent months. Underlying inflation, measured as CPIX (CPI minus household mortgage interest expenditure and direct effects of changes in indirect taxes and subsidies) is now somewhat above 2 per cent. The CPI surge is largely due to higher food and energy prices. The Riksbank's rate hikes have also helped boost CPI.

Sweden: Underlying inflation

Year-on-year percentage change



Sources: Statistics Sweden, SEB

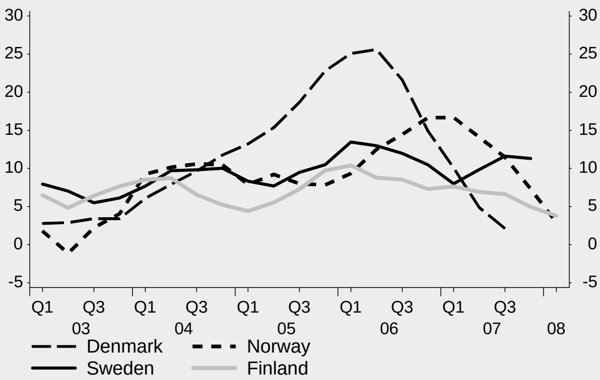
Weakening Nordic housing market

One central issue is to what extent the Nordic countries will suffer a downturn in the housing market similar to what we are now seeing in the US and various other countries.

The IMF's review in its latest *World Economic Outlook* indicates that home prices in Sweden, Norway and Denmark are somewhat more overvalued than the average for the countries studied. It also pointed out that their home financing systems, as in the US and the UK, are characterised by high flexibility and sophistication. This has contributed to a stronger connection between home prices and private consumption. The loan-to-value ratio is also relatively high in the Nordic countries. A rather large proportion of Nordic households own their home, especially in Norway and Denmark, which increases the exposure of these economies.

Home prices in the Nordic countries

Year-on-year percentage change



Sources: National statistical offices

A slowdown in residential construction has been under way for some time in all of the Nordic countries. Denmark and Norway experienced abnormally high residential construction, and these countries are also where we see the most dramatic downturns. Finland has also had fairly extensive residential construction in recent years, while the level in Sweden remains historically low.

Denmark has progressed furthest in the housing cycle. The price downturn for flats has been under way for a long time, and during the first quarter of 2008 year-on-year prices of single-family homes also fell (according to the Association of Danish Mortgage Banks). The supply of unsold houses has increased sharply, while the number of flats starting construction has plummeted.

In Norway, home prices fell during most of 2007 during consecutive periods. According to estate agent statistics, prices have fallen slightly year-on-year, but a certain recovery in consecutive-period figures is discernible. New housing starts have also slowed substantially.

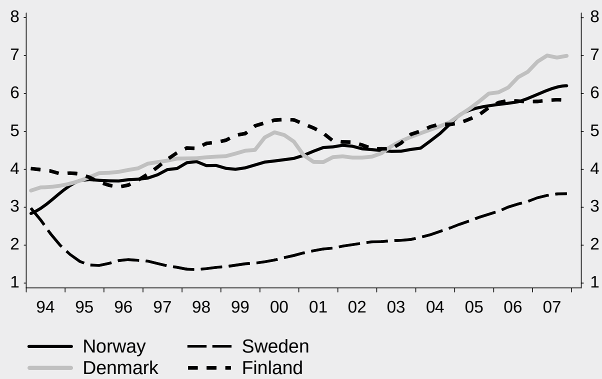
In Finland, the upturn in home prices has cooled during the past two years, but prices are still increasing at about 5 per cent year-on-year. Construction has slowed more noticeably, and the level of housing starts indicates falling residential investments this year.

Home prices in Sweden have held up relatively well, both in an international and a Nordic comparison. According to the Real Estate Barometer published by the National Land Survey of Sweden, prices were still climbing 9 per cent year-on-year in the first quarter of 2008, although there has been a deceleration in the last six months. The market for flats has been cooler, however, and figures related to new sales by construction companies point towards a major cool-down ahead.

Our conclusion is that all of **the Nordic countries are facing an adjustment in the housing market** and that Norway and Denmark are more exposed than Sweden and Finland. However, we believe that the IMF is exaggerating the risks in the Nordic countries in several respects. For example, the study is based on the situation in 1997, when prices – especially in Sweden – were still depressed following the housing crisis of the early 1990s. The IMF also underestimates the importance of **high saving both in households and the public sector**, which **increases their resilience** in the face of a downturn, for example by allowing fiscal stimulus measures. In Sweden's case, many years of depressed residential construction will also help to limit downside risks, both in terms of prices and volume.

Nordic residential investments

Percentage of GDP



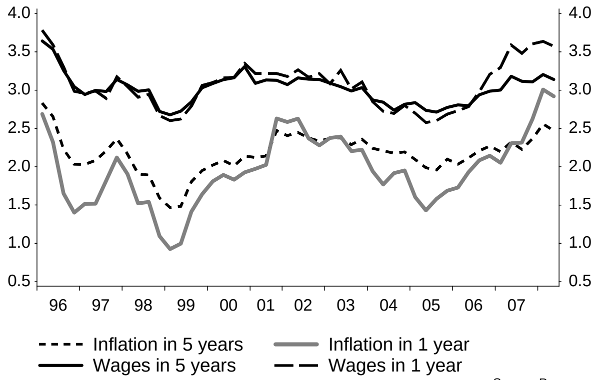
Sources: National statistical offices

The dramatic weakening in productivity growth during 2007 meant a sharp rise in unit labour cost, accentuated to some extent by a higher rate of pay increases. This year there will be some recovery in productivity growth, but wages and salaries will meanwhile climb more than in 2007. A clear slow-down in unit labour cost increases will not occur until next year. Given a certain lag between domestic cost pressure and inflation, underlying inflation pressure will probably remain relatively high during the coming year. Such indicators as producer prices and expecta-tions in the retail sector also point towards continued upward price pressure in the short term.

We expect inflation to climb a bit further in the coming months. CPIX will increase by an average of 2.5 per cent in 2008 and 2.3 per cent in 2009. Our corresponding forecast for CPI is 3.4 and 2.6 per cent, respectively. Aside from being affected by the Riksbank's changes in interest rates, CPI will also reflect a weakly positive net contribution from indirect taxes in 2009. The core inflation measure – CPIX excluding food and energy – is still as low as 1¼ per cent. It will remain rather stable during the next six months or so and then rise to about 2 per cent towards year-end.

Sweden: Wage and inflation expectations

Per cent



Source: Prospera

High CPI inflation risks boosting inflation expecta-tions among households and companies. These expectations have also risen in the past year. The upturn has been clearest with regard to short-term expectations, which largely follow actual inflation. Long- and medium-term expectations are crucial to the credibility of the Riksbank. Inflation expectations looking ahead five years have admittedly risen but are still well inside the Riksbank's target interval. Nor have expectations of future wage increases increased especially much; they are well in line with the official inflation target.

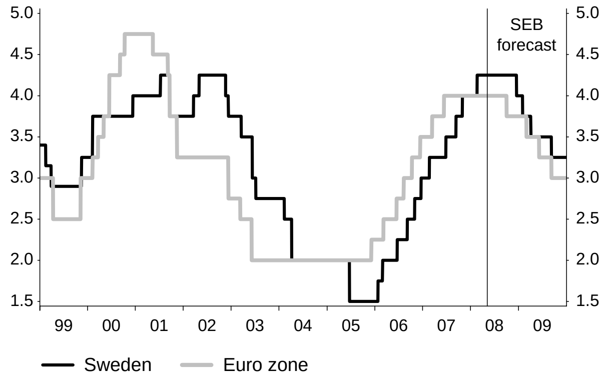
Key interest rate cut in December

In February, the Riksbank raised its repo rate to 4.25 per cent. Although the rate hike largely followed the central bank's own optimal interest rate path, the decision came as a big surprise in light of the prevail-ing international financial market turmoil. Meanwhile the Riksbank announced that it regarded an unchanged key interest rate for the next few years as the most likely scenario.

At the time of its April interest rate decision, the Riksbank stuck to an optimal repo rate path that remained rather constant at around 4.25 per cent for the foreseeable future. International economic condi-tions have weakened faster than the bank had counted on, leading to repeated downward revisions of the bank's global growth forecast. A continued strong labour market and inflation that will remain high for some time to come were sufficient reasons for the Riksbank to adopt a neutral stance concerning the direction of its next interest rate change.

Key rates

Per cent



Sources: Reuters EcoWin, SEB

As earlier, our assessment is that the international economic deceleration and credit market problems will lead Sweden into a slowdown that will make interest rate cuts natural. The date when these cuts begin will be determined by the dynamic of the slowdown and how the delayed impact on the labour market and inflation plays out.

There are many indications that we will see a strong GDP figure for the first quarter of 2008, mainly driven by vigorous exports. This will influence the message in the Riksbank's Monetary Policy Report early in July. In a situation where inflation will apparently remain at a high level and resource utilisation will still be strained, it will probably be too early for the Riksbank to soften its interest rate path and signal future rate cuts. High inflation expectations – in a situation where employer organisations and employee unions face strategic decisions about re-negotiating their current collective agreements – will probably also contribute a degree of caution. Another factor pointing in the same direction is that the government is about to shift to a more expansive fiscal policy.

By autumn it is likely that the growth outlook will have had time to become gloomy enough for the Riksbank to begin signalling interest rate cuts. In light of this, we foresee the Monetary Policy Report in December as the most likely timing of the first rate cut. By then the labour market will probably have weakened sufficiently for the Riksbank to dare to rely on forward-looking predictions that inflation will fall towards target level.

It cannot be ruled out that the Sweden and other European countries are now on their way into a phase in which the credit crisis will have more dramatic effects on the real economy than implied in our forecast. In such a situation the Riksbank, like other European central banks, may choose to slash interest rates earlier in order to avoid a deeper slump. But such a turn of events appears too speculative to serve as our main scenario at present.

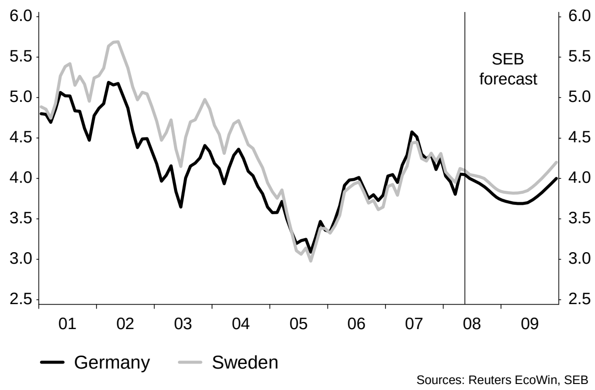
Lower long-term yields, wider spread

In recent months, bond yields have rebounded as a consequence of rising concern about inflation. Also contributing to this development is that the Fed has signalled a pause and the ECB has clearly declared that interest rate cuts are not in its current plans. However, we anticipate that yields will once again turn downward as the growth outlook worsens.

Looking ahead, Swedish bond yields will probably be a bit higher than German ones. The Riksbank will have a somewhat higher key rate, according to our forecast, and Swedish long-term yields will no longer be able to benefit from a clearly lower inflation rate. Rapidly shrinking central government debt is not sufficient reason for the historically unusual situation of lower Swedish long-term yields to continue.

10-year government bond yields

Per cent



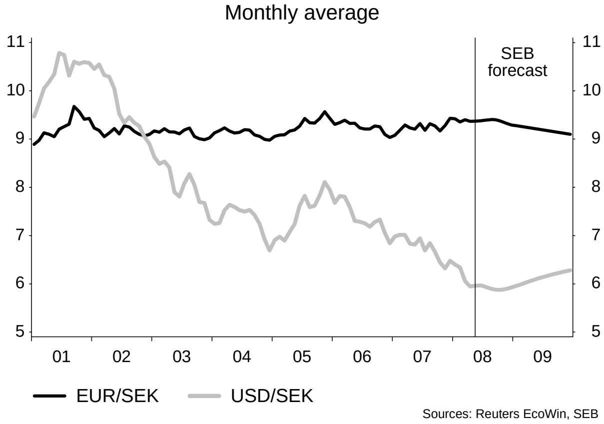
Sources: Reuters EcoWin, SEB

We anticipate that the 10-year spread against Germany, which at present is zero, will climb to 10 basis points in December 2008 and 20 points in December next year. Yields will rise somewhat towards the end of 2009, when the economic slowdown begins to bottom out. We estimate that the Swedish 10-year government bond will be at 4.20 per cent in December 2009 and the German one at 4.00.

The krona will continue to more or less keep pace with the euro for the next six months, but it will appreciate somewhat towards the end of 2008 and even more next year. Strong public finances and a continued very large current account surplus will help sustain the krona; we expect the EUR/SEK exchange rate to stand at 9.30 in December this year and 9.10 in December 2009. Over the next six months, the krona will again strengthen against the dollar. The USD/SEK exchange rate will bottom out at 5.88 in September this year. After that, the dollar will gradually strengthen and will stand at SEK 6.28 in December next year.

Sweden: Exchange rates

Monthly average



Sources: Reuters EcoWin, SEB

Strong finances for the time being

The Swedish central government budget showed a **surplus of SEK 103 billion in 2007**, while the public saving surplus was equivalent to 3 per cent of GDP. Strong economic conditions, tight fiscal policy and rapidly declining expenditures for sick pay contributed to this outcome. The budget balance was also strengthened by privatisation proceeds.

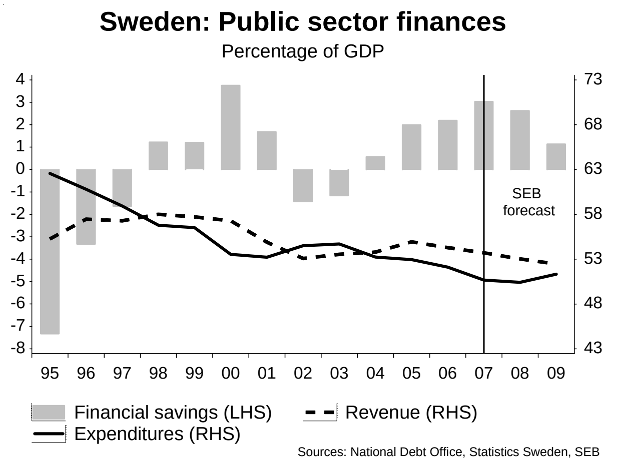
Public finances

Percentage of GDP

	2006	2007	2008	2009
Revenue	53.8	53.2	52.5	52.0
Expenditures	51.6	50.2	49.9	50.8
Financial savings	2.2	3.0	2.6	1.1
Public debt (Maastricht)	45.9	40.6	34.3	31.5
Central government debt	43.8	38.0	32.3	29.5
Central govt borrowing req, SEK bn	-18	-103	-128	-58

Sources: National Debt Office, Statistics Sweden, SEB

Tax revenue continued to provide upside surprises early in 2008, and so far there are no signs of any economic slowdown in central government finances. However, it appears unlikely that government finances, which are sensitive to economic cycles, will escape unscathed from the slump that the economy is moving into. We predict that the consolidated public sector's **financial saving will fall from 3.0 per cent of GDP last year to 2.6 per cent this year and 1.1 per cent in 2009**. The surplus will thus end up nearly SEK 50 billion above the official target of 1 per cent of GDP this year, but only SEK 5 billion above target in 2009. Our calculations assume that fiscal stimulus measures equivalent to about SEK 30 billion will be unveiled in the government's autumn budget for 2009.

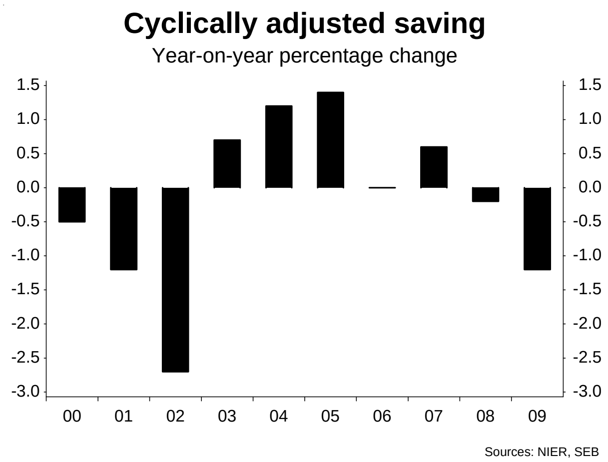


In its borrowing requirement forecast in February, the National Debt Office assumed that the central government will fulfil its plans to sell state-owned companies worth SEK 50 billion per year in 2008-2009. However, as early as April the alcoholic beverages company Vin & Sprit was unexpectedly sold to Pernod Ricard for SEK 55 billion. Despite difficulties in the prevailing uncertain environment in selling off government shares in the financial service companies Nordea and SBAB and in the property company Vasakronan, we are now assuming privatisations equivalent to some SEK 80 billion this year and SEK 50 billion in 2009.

Total privatisations during the period 2007-2009 would thus end up at SEK 150 billion, which matches the government's original ambition.

This year's spring budget bill contained no concrete proposals. Instead the government will unveil its economic policy in the autumn budget. A new phase in the non-socialist Alliance's policy was nevertheless discernible. After the government's earlier tight focus on influencing the driving forces behind an increased labour supply, we will now see more emphasis on the corporate sector. On the expenditure side, the budget will also concentrate on such areas as **pensions, infrastructure, health care and schools**. The government is moving towards a broader, more pragmatic policy aimed at recapturing the political middle ground.

The government is likely to gradually increase the dose of fiscal stimulus programmes next year, and especially during the election year 2010, in response to weaker economic growth. In such a situation, budget surpluses can melt away relatively fast. Finance Minister Anders Borg must then clarify whether it is ultimately the actual budget balance or the need to stimulate demand that determines the scope for fiscal policy: a difficult pedagogical challenge, both inside the four-party coalition government and externally.



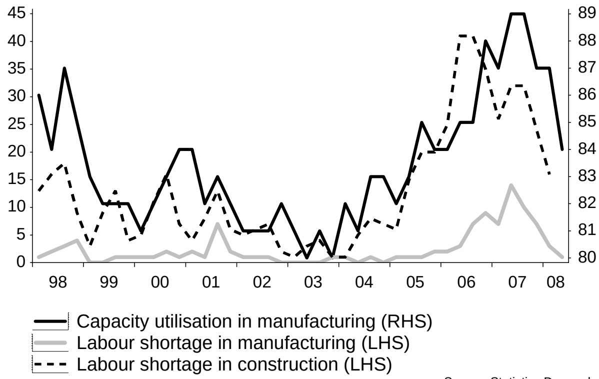
Resource shortages will ease

- **Falling home prices…**
- **…will weaken domestic demand**
- **Pay increases will level off next year**

Denmark's economic slowdown is continuing. After three strong years, growth decelerated last year to its trend level of just below 2 per cent. We expect **GDP growth of 1.0 per cent this year and 0.7 per cent in 2009**. **The resource shortages** in the economy **are now gradually fading**, but wage and inflation pressure will remain relatively high next year as well.

Denmark: Shortages and capacity utilisation

Net balance and per cent, respectively



Source: Statistics Denmark

The economic deceleration is largely due to a continued adjustment in the property and construction markets after the earlier boom. In the first quarter, Denmark recorded its first nationwide price decline for single-family and detached homes in 13 years: 0.4 per cent year-on-year. A growing supply supports our earlier assessment that **home prices will fall by an average of 5-10 per cent in 2008**. Consumption and capital spending will cool further as a consequence.

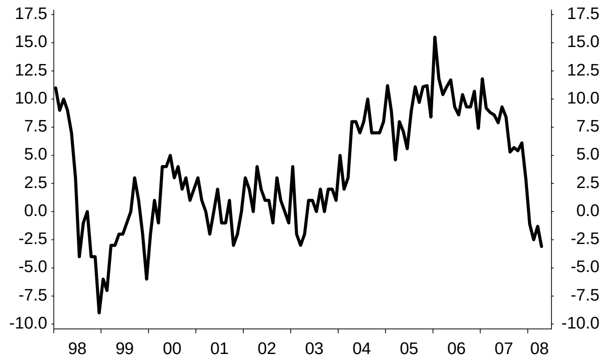
So far the slowdown has been broad-based, with an emphasis on exports and capital spending. Exports to the US have plummeted, but sales to the German market are also down. Exports to the other Nordic countries have held up nicely, however. The export rebound discernible early in 2008 was temporary. **Looking ahead, Danish exports will be squeezed** by **weaker demand** on a broader front, as well as by **some erosion of competitiveness** in the wake of pay increases and a strong currency.

Capital spending is moving towards **stagnation**. Residential investments are continuing to fall from their excessive levels of 2006-2007.

Private consumption growth has slowed, but the impact of the shaky property market and falling share prices has not yet been especially apparent. A strong labour market and decent income growth have helped sustain consumption. Looking ahead, household worries about losing jobs will intensify. Meanwhile the interest burden will increase further in the short term, due to the higher funding costs of financial institutions. High inflation will also undermine much of the year's pay increases. Taken together, these factors will lower consumption growth. Such a slowdown is being clearly signalled by Denmark's **household confidence indicator, which has fallen significantly** this year.

Denmark: Consumer confidence (CCI)

Net balance



Source: Statistics Denmark

This past winter, unemployment continued downward to a record-low 2 per cent. It will start rising during the second half of 2008, but will increase more clearly only next year. So far only the manufacturing sector, and to some extent the construction industry, are planning to trim their workforce.

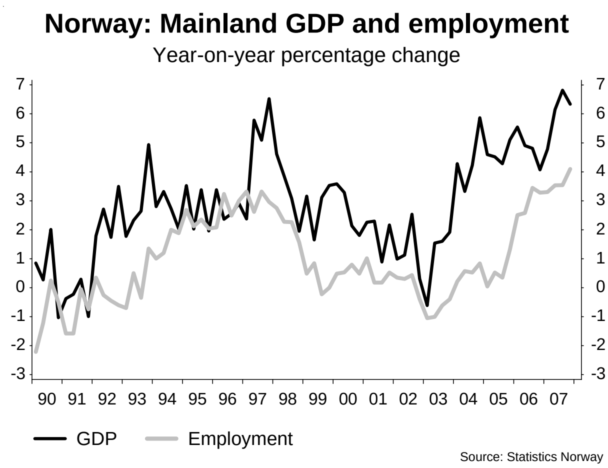
The rate of pay increases has risen on a broad front in the past year, due to the tighter labour market and higher agreements. Wages and salaries will rise by about 4.5 per cent annually in 2008-2009. Inflation has also climbed, but the sharp acceleration in HICP – from 1 per cent last summer to 3.3 per cent in March 2008 – is mainly due to rising food and energy prices. Core inflation has climbed from 1 per cent to nearly 2 per cent. However, our assessment is that late-cycle effects including weak productivity growth will make themselves felt in 2009 as well. **In 2009, inflation is expected to reach a relatively high 2.5 per cent**, despite fading base effects from oil and food.

Denmark's public sector finances are strong. The government may take advantage of this to address the economic slowdown. Further fiscal stimulus, beyond income tax cuts and the like, is likely to materialise.

Deceleration under way

- **Halving of record-high growth**
- **More wary households, cooler housing market**
- **Rising inflation pressure will gradually ease**
- **Key interest rate peak near, cuts in 2009**

After several years of vigorous growth, there are mounting indications of deceleration in the Norwegian economy. A cooler housing market, slower real wage growth, a negative savings ratio and much less optimistic households signal that the consumer buying spree will fade. Due to poorer international performance, weaker profits and somewhat tighter credit conditions capital spending is about to shrink. Due to extremely high capacity utilisation, supply-side restrictions will also increasingly hold back growth. Productivity growth has slowed and unemployment has reached historically low levels. As a result, **GDP growth in the mainland economy (excluding offshore oil and gas) will halve from 6 per cent in 2007 to slightly more than 3 per cent this year and then fall further to less than 2 per cent in 2009.**

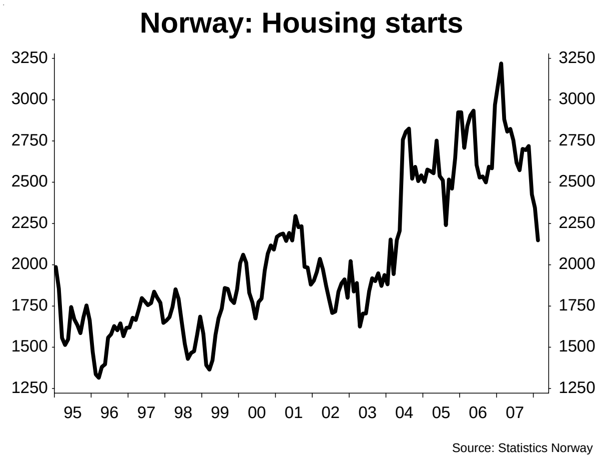


Norges Bank must weigh the increasing downside risks to growth against continued tight resource utilisation and intensifying domestic inflation pressure. We expect the bank to **raise its key interest rate once more to 5.75 per cent** this summer. As the international slowdown increasingly impacts the Norwegian economy, however, monetary policy will shift and a **rate-cutting cycle will begin next year**. By the end of 2009, the sight deposit rate will stand at 4.75 per cent.

Rising household saving ahead

High pay increases, low inflation and sharply rising employment enabled real household income to increase by 5½ per cent during 2007. Consumption rose even more, however, which meant that the household savings ratio turned negative last year. Several factors will now contribute to significantly **more sedate consumption growth ahead**. Income will increase at a slower pace as inflation rises and job growth cools. Higher interest rates due to Norges Bank's rate hikes and the international credit crunch will curb the borrowing appetite of households.

Short-term consumption indicators are also pointing towards a slowdown from high levels. Merchandise consumption growth has decelerated, and the household confidence indicator has fallen. The period of rising home prices also now appears to have ended, which will probably help bring about to an upward adjustment in household saving. According to estate agent statistics, home prices fell during consecutive periods in the second half of 2007. During the first quarter of 2008, prices also fell year-on-year, but on the other hand there was a slight price recovery in consecutive terms.



The supply of unsold homes and new housing starts also indicate a clear slowdown in the housing market. Residential construction is at historically high levels, which can partly be explained by strong underlying demand due to a sharp population increase in recent years. Nevertheless we expect residential construction to decline in the next couple of years, which will contribute to a slowdown in capital spending ahead.

We also anticipate that increased financing costs, a weaker economic picture and falling profitability will help dampen capital spending in the business sector. Market growth for Norwegian exports will weaken significantly during our forecast period. High cost increases combined with a stronger krone will probably also cause manufacturers to lose market share. This year traditional export growth will more than halve compared to 2007. Last year the prices of Norwegian export products, excluding oil and gas, increased somewhat more slowly than those of imported goods following several years of sharply improved terms of trade. This is also squeezing profitability.

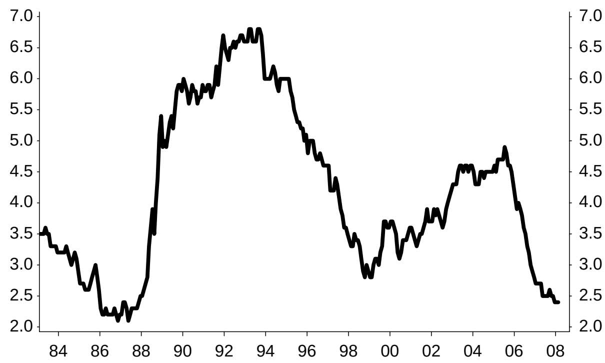
Continued price increases for oil and gas, and thus continued upward revisions in longer-term oil price forecasts, have nevertheless sustained the investment climate in the oil and gas sector. This should be weighed against the strained capacity situation in the sector. It will probably be difficult to achieve larger volume increases than 5-10 per cent during the next couple of years.

Unemployment about to bottom out

In the first quarter of 2008 employment increased by more than 4 per cent, the strongest growth since the mid-80's. The labour supply has also risen sharply, thanks to both the influx of labour from abroad and a higher participation rate. Yet unemployment has gradually fallen and now stands at levels not recorded since the boom years of the late 1980s. The trend of recent months indicates that unemployment is about to level off, however.

Norway: Unemployment

Per cent



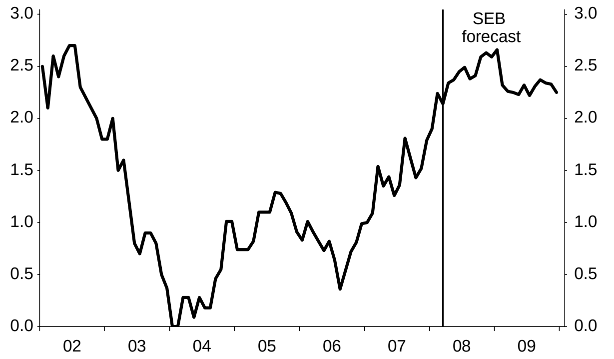
Source: Statistics Norway

During the course of 2008, we also expect job creation to slow as output growth weakens and unemployment slowly begins to climb. The labour market situation will nevertheless remain very tight in the coming year. The wage and salary agreement between the Norwegian Confederation of Trade Unions and the employer side implies pay hikes of more than 5½ per cent this year. Given higher salary increases for white collar employees in line with the trend of recent years, and somewhat higher agreements in the public sector, total pay increases are likely to end up close to 6 per cent this year, compared to less than 5½ per cent in 2007. Rising unemployment next year will cause the rate of pay increases to slow to just below 5 per cent.

Rising pay increases combined with a cyclical slowing of productivity growth imply that domestic cost pressures will remain high over the next year. As a result, we anticipate a continued upturn in underlying inflation during the course of 2008. Our overall assessment is that underlying inflation (CPI-ATE) will end up somewhat above Norges Bank's 2½ per cent inflation target towards the end of 2008. Using a broader picture of underlying inflation, however, Norges Bank maintains that inflation is already above target. Our inflation path is also higher than the one presented by Norges Bank, which is a strong contributing factor behind our prediction that one more interest rate hike will occur before autumn.

Norway: CPI-ATE

Year-on-year percentage change



Sources: Statistics Norway, SEB

Among factors pointing towards no further key rate hikes is that the market has already done part of Norges Bank's job by raising interest rates on loans to companies and households more than the bank's rate hikes. As the global slowdown increasingly impacts the Norwegian economy, we also believe that **Norges Bank next year will shift its focus from domestic overheating risks to downside growth risks**. Given our forecast of interest rate cuts in other countries, the risk of a sharp krone appreciation will also help justify lowering the sight deposit rate next year.

In the short term, the interest rate spread above other countries and skyrocketing oil prices will support the krone. We thus expect a certain appreciation to NOK 7.75 per euro and NOK 4.94 per dollar. When it becomes increasingly clear that Norges Bank will stop hiking interest rates, and as oil prices fall, the krone will also weaken.

Moderate slowdown

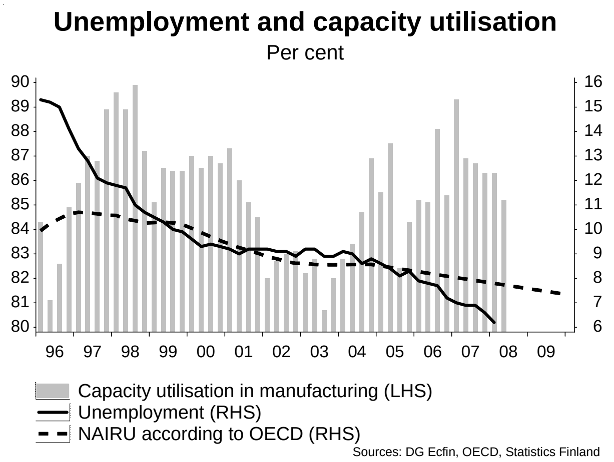
- **Problems for the forest product industry, but telecoms and engineering still performing well**
- **Export growth decelerating**
- **Recruitment problems despite high jobless rate**
- **High pay increases in 2008-2009**
- **Tax cuts in 2009**

The Finnish economy is still relatively resilient in the face of global deceleration and ongoing credit and financial market turmoil. Weaker export and domestic demand nevertheless mean that **GDP growth will slow to nearly 2.5 per cent this year and 2.0 per cent next year**.

In 2007, both the domestic economy and the export sector contributed to unexpectedly high growth of 4.4 per cent. The telecom and engineering sectors have continued their export success during the first quarter of 2008. Nokia boosted its telephone revenue by 30 per cent despite **plunging US sales**, and engineering companies such as Metso and Wärtsilä managed to offset weaker sales in Europe and the US with export success in Asia and South America.

Weaker international demand and tighter credit conditions will gradually affect Finnish companies, however. Capital spending will be postponed, and companies will re-assess their production structure. We expect clear cutbacks in key sectors during the next six months. **Particularly hard hit will be the forest product industry, due to both cyclical retrenchment and Russian wood tariffs. Export growth will slow from nearly 5 per cent in 2007 to about 2.5 per cent this year.**

Private consumption, which has risen by nearly 4 per cent annually in recent years, will gradually decelerate. We anticipate that **consumption will increase by 2.7 per cent this year and 2.3 per cent in 2009**. Consumption will be stimulated by high pay increases – we predict that **hourly pay in the economy as a whole will rise by 5.3 per cent this year and 4.6 per cent next year**. This is faster than the euro zone average, which is worrisome from a competition perspective, especially since productivity growth is decelerating.



Wages and salaries are rising so fast due to the strained labour market situation. Even though unemployment is a high 6.2 per cent at present, many companies are reporting difficulties in recruiting suitable employees. This indicates matching problems in the Finnish labour market. We anticipate that **unemployment will fall to an average of 6.1 per cent this year**.

HICP inflation reached only 1.6 per cent last year but has now taken off, due to rising energy and food prices. Also contributing to the higher inflation are higher indirect taxes on alcoholic beverages and energy. **We estimate that HICP inflation will average 3.3 per cent this year** and 2.6 per cent in 2009, an upward revision from our February forecast. Underlying inflation, which fell unexpectedly towards the end of 2007, rose to 1.4 per cent in March. We expect it to continue climbing. Weaker growth, higher unemployment and lower pay increases, however, are likely to slow core inflation late in 2008 and in 2009.

Large public sector surpluses will make an expansive fiscal policy possible. The most important elements will consist of lower value-added tax on food and income tax cuts. Together with weaker growth, this will shrink the budget surplus from last year's 5.3 per cent of GDP to less than 4 per cent in 2009.

Nordic key economic data

Nordic Outlook - May 2008

DENMARK

Yearly change in per cent

	2007 level, DKK bn	2006	2007	2008	2009
Gross domestic product	1,696	3.6	1.9	1.0	0.7
Private consumption	841	4.1	2.7	1.8	1.5
Public consumption	439	2.0	1.7	1.7	1.9
Gross fixed investment	389	14.2	6.2	0.2	-0.5
Stockbuilding (change as % of GDP)		0.7	-0.4	0.0	0.0
Exports	884	8.9	3.8	2.5	1.5
Imports	865	14.2	5.7	3.2	2.2
Unemployment (%)		3.9	2.8	2.5	3.5
Consumer prices, harmonised		1.9	1.7	3.0	2.5
Wage cost		3.1	3.8	4.6	4.5
Current account, % of GDP		2.9	1.2	0.7	1.0
Public sector financial balance, % of GDP		4.8	4.4	3.0	2.2
Public sector debt, % of GDP		30.4	26.0	22.0	20.0

FINANCIAL FORECASTS	May 8	Jun 08	Sep 08	Dec 08	Jun 09	Dec 09
Deposit rate	4.25	4.25	4.25	4.00	3.50	3.25
10-year bond yield	4.31	4.25	4.10	3.90	3.80	4.10
10-year spread to Germany, bp	25	25	20	15	10	10
USD/DKK	4.84	4.75	4.66	4.75	4.97	5.14
EUR/DKK	7.46	7.45	7.45	7.45	7.45	7.45

NORWAY

Yearly change in per cent

	2007 level, NOK bn	2006	2007	2008	2009
Gross domestic product	2,289	2.5	3.5	2.8	1.9
Gross domestic product (Mainland Norway)	1,709	4.8	6.0	3.2	1.9
Private consumption	946	4.7	6.4	3.3	2.1
Public consumption	447	2.9	3.2	3.0	3.0
Gross fixed investment	474	7.3	9.6	6.0	1.8
Stockbuilding (change as % of GDP)		0.6	-0.6	0.4	0.0
Exports	1,063	0.4	3.2	2.0	1.7
Imports	685	8.1	8.6	4.7	2.5
Unemployment (%)		3.5	2.5	2.5	2.9
Consumer prices		2.3	0.8	3.2	2.4
CPI-ATE		0.8	1.4	2.4	2.3
Annual wage		4.1	5.4	6.0	4.8
Current account, % of GDP		17.3	16.3	17.0	16.5
Public sector financial balance, % of GDP		18.0	17.5	19.0	19.5

FINANCIAL FORECASTS	May 8	Jun 08	Sep 08	Dec 08	Jun 09	Dec 09
Sight deposit rate	5.50	5.50	5.75	5.75	5.25	4.75
10-year bond yield	4.48	4.45	4.30	4.15	4.00	4.30
10-year spread to Germany, bp	43	45	40	40	30	30
USD/NOK	5.11	4.94	4.91	5.10	5.40	5.59
EUR/NOK	7.88	7.75	7.85	8.00	8.10	8.10

SWEDEN

Yearly change in per cent

	2007 level, SEK bn	2006	2007	2008	2009
Gross domestic product	3,074	4.1	2.6	2.4	1.2
Gross domestic product, working day adjusted		4.4	2.8	2.1	1.3
Private consumption	1,435	2.5	3.1	2.4	1.9
Public consumption	796	1.5	0.8	1.3	1.5
Gross fixed investment	582	7.7	8.0	3.5	-1.5
Stockbuilding (change as % of GDP)	24	0.2	0.7	-0.3	0.0
Exports	1,609	8.9	5.6	5.2	2.9
Imports	1,373	8.2	9.5	4.7	2.8
Unemployment (%)		5.4	4.6	4.3	5.0
Unemployment (%) (ILO definition)		7.1	6.2	5.9	6.6
Employment		1.8	2.4	1.3	-0.3
Industrial production		5.5	2.4	2.9	1.8
Consumer prices		1.4	2.2	3.4	2.6
CPIX		1.2	1.2	2.5	2.3
Wage cost		3.1	3.5	4.5	4.0
Household savings ratio (%)		7.1	8.2	8.8	9.2
Real disposable income		2.6	4.3	3.1	2.3
Trade balance, % of GDP		5.8	4.6	4.3	4.3
Current account, % of GDP		8.5	8.3	7.5	7.5
Central government borrowing, SEK bn		-18	-103	-128	-58
Public sector financial balance, % of GDP		2.2	3.0	2.6	1.1
Public sector debt, % of GDP		46	41	34	31

FINANCIAL FORECASTS	May 8	Jun 08	Sep 08	Dec 08	Jun 09	Dec 09
Repo rate	4.25	4.25	4.25	4.00	3.50	3.25
3-month interest rate, STIBOR	4.94	4.84	4.74	4.54	4.04	3.79
10-year bond yield	4.07	4.05	4.00	3.85	3.85	4.20
10-year spread to Germany, bp	1	5	10	10	15	20
USD/SEK	6.03	5.97	5.88	5.92	6.13	6.28
EUR/SEK	9.29	9.38	9.40	9.30	9.20	9.10
TCW	122.3	123.2	122.8	121.7	121.5	120.8

FINLAND

Yearly change in per cent

	2007 level, EUR bn	2006	2007	2008	2009
Gross domestic product	179	4.9	4.4	2.4	1.9
Private consumption	90	4.1	3.7	2.7	2.3
Public consumption	38	0.6	0.8	1.4	1.5
Gross fixed investment	36	4.7	7.6	3.1	3.3
Stockbuilding (change as % of GDP)		-0.7	0.2	0.0	0.0
Exports	80	11.8	4.8	2.7	3.1
Imports	72	7.8	4.1	3.0	4.4
Unemployment (%)		7.7	6.9	6.1	6.3
Consumer prices, harmonised		1.3	1.6	3.3	2.6
Wage cost		3.0	3.3	5.3	4.6
Current account, % of GDP		4.6	4.6	3.4	2.3
Public sector financial balance, % of GDP		4.1	5.3	4.4	3.9
Public sector debt, % of GDP		39.2	35.4	33.3	32.1

SEB

International key economic data

Nordic Outlook - May 2008

EURO ZONE

Yearly change in per cent

	2007 level, EUR bn	2006	2007	2008	2009
Gross domestic product	8,873	2.9	2.6	1.4	1.1
Private consumption	4,991	1.8	1.5	1.3	1.3
Public consumption	1,785	2.0	2.2	1.6	1.7
Gross fixed investment	1,926	5.3	4.2	2.6	2.4
Stockbuilding (change as % of GDP)		-0.2	0.0	-0.2	0.0
Exports	3,651	8.1	6.0	3.8	3.1
Imports	3,518	7.8	5.2	4.3	4.4
Unemployment (%)		8.2	7.4	7.1	7.3
Consumer prices, harmonised		2.2	2.1	3.4	2.1
Household savings ratio (%)		10.0	9.9	9.7	9.4

US

Yearly change in per cent

	2007 level, USD bn	2006	2007	2008	2009
Gross domestic product	14,074	2.9	2.2	1.0	0.7
Private consumption	9,937	3.1	2.9	1.4	0.7
Public consumption	2,764	1.8	2.0	3.2	3.6
Gross fixed investment	2,082	2.9	-1.9	-6.2	-4.4
Stockbuilding (change as % of GDP)		0.1	-0.3	-0.1	0.0
Exports	1,738	8.4	8.1	7.0	4.4
Imports	2,447	5.9	1.9	1.4	2.3
Unemployment (%)		4.6	4.6	5.4	6.4
Consumer prices		3.2	2.9	4.0	2.1
Household savings ratio (%)		0.4	0.4	1.0	2.5

LARGE INDUSTRIAL COUNTRIES

Yearly change in percent

	2006	2007	2008	2009
GDP				
United Kingdom	2.9	3.0	1.5	1.3
Japan	2.4	2.1	1.2	1.2
Germany	2.9	2.5	1.6	1.4
France	2.2	1.9	1.3	1.4
Italy	1.9	1.6	0.4	0.4
Inflation				
United Kingdom	2.3	2.3	2.6	2.2
Japan	0.2	0.1	0.9	0.6
Germany	1.8	2.3	2.5	1.9
France	1.9	1.6	2.5	1.8
Italy	2.2	2.0	2.9	2.1
Unemployment (%)				
United Kingdom	5.5	5.4	5.5	5.8
Japan	4.1	3.8	3.9	4.0
Germany	9.8	8.4	7.3	7.6
France	9.2	8.3	7.7	7.8
Italy	6.8	6.1	6.1	6.2

International key economic data

CENTRAL AND EASTERN EUROPE

	2006	2007	2008	2009
GDP, yearly change in percent				
Czech Republic	6.4	6.5	4.5	5.0
Estonia	11.2	7.1	3.0	3.0
Hungary	3.9	1.3	2.1	3.2
Latvia	12.2	10.3	3.0	3.0
Lithuania	7.7	8.8	5.5	5.0
Poland	6.1	6.5	5.4	5.0
Russia	7.4	8.1	7.3	6.5
Slovakia	8.5	10.4	7.0	6.5
Ukraine	7.0	7.3	6.0	5.5
Inflation, yearly change in per cent				
Czech Republic	2.1	3.0	6.4	3.8
Estonia	4.4	6.6	8.0	4.0
Hungary	4.0	7.9	5.5	4.5
Latvia	6.7	10.1	13.8	7.0
Lithuania	3.8	5.8	8.5	7.0
Poland	1.3	2.6	4.2	3.4
Russia	9.7	9.0	13.0	10.0
Slovakia	4.3	1.9	3.5	3.6
Ukraine	9.1	12.8	20.6	13.4

FINANCIAL FORECASTS

		May 8	Jun 08	Sep 08	Dec 08	Jun 09	Dec 09
Official interest rates							
US	Fed funds rate	2.00	2.00	2.00	1.50	1.50	2.00
Japan	Call money rate	0.50	0.50	0.50	0.50	0.50	0.50
Euro zone	Refi rate	4.00	4.00	4.00	3.75	3.25	3.00
United Kingdom	Repo rate	5.00	4.75	4.50	4.00	3.50	3.50
Bond yields							
US	10 years	3.78	3.75	3.70	3.60	3.80	4.00
Japan	10 years	1.67	1.60	1.55	1.50	1.55	1.65
Germany	10 years	4.06	4.00	3.90	3.75	3.70	4.00
United Kingdom	10 years	4.61	4.45	4.20	4.00	3.80	4.00
Exchange rates							
USD/JPY		104	103	97	92	97	104
EUR/USD		1.54	1.57	1.60	1.57	1.50	1.45
EUR/JPY		160	162	155	144	146	151
GBP/USD		1.96	1.99	1.95	1.85	1.83	1.81
EUR/GBP		0.79	0.79	0.82	0.85	0.82	0.80

GLOBAL KEY INDICATORS

Yearly percentage change

	2006	2007	2008	2009
GDP OECD	3.2	2.7	1.3	1.1
GDP world	5.0	4.9	3.8	3.5
CPI OECD	2.4	2.5	3.3	2.0
Export market OECD	8.9	6.1	4.2	3.5
Oil price, Brent (USD/barrel)	64.8	73.0	109.0	102.0

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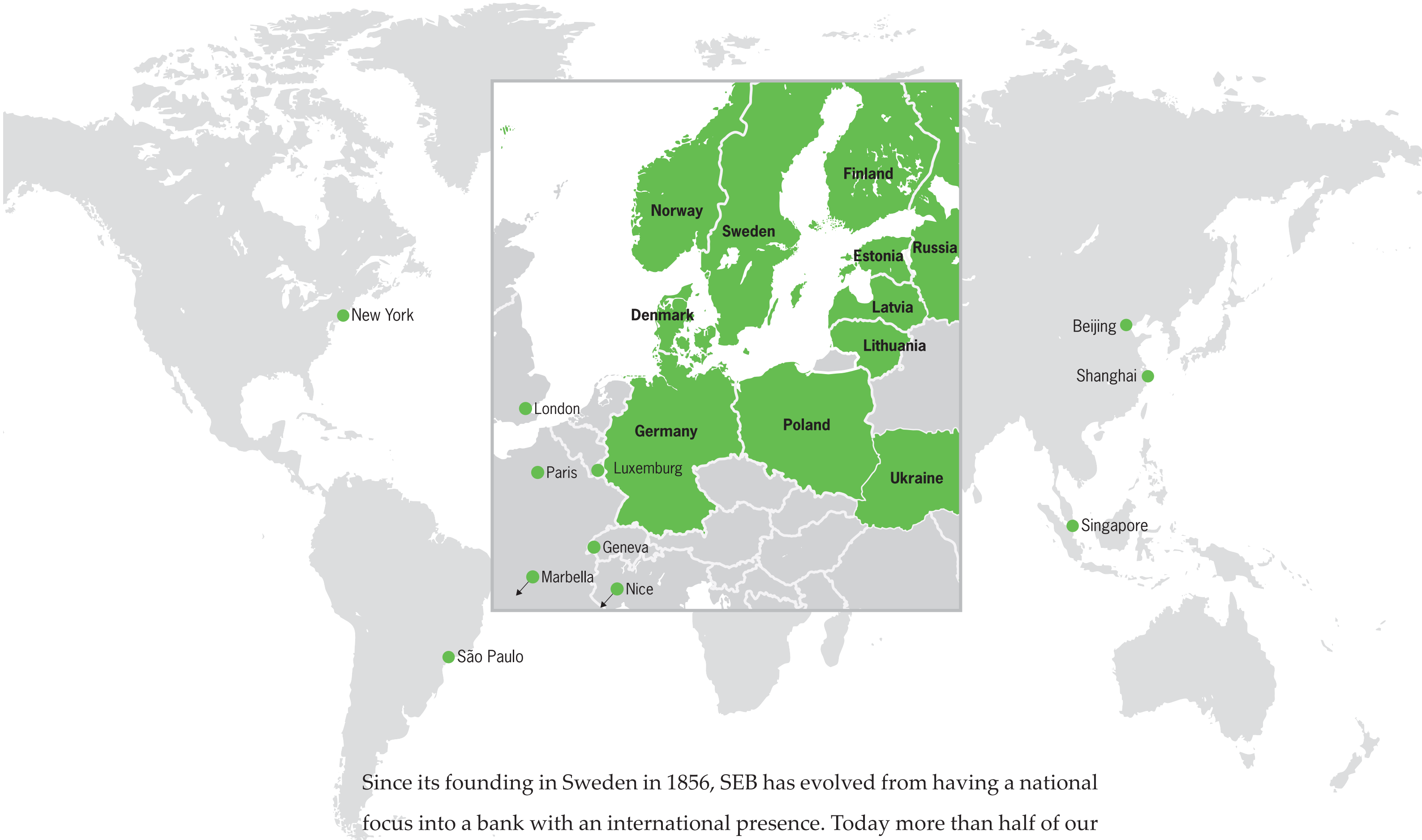

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