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Nordic Outlook

On the cusp of a global recession
Sharp interest rate cuts in Europe during 2009

SEB

SEB Economic Research

Nordic Outlook - August 2008

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International: On the cusp of a global recession

- The global credit crisis will continue to dominate events. Next year, growth in the OECD will be the lowest since the early 1990s, because the US economic slump will spread in earnest to Western Europe and Japan.
- The US economic picture will turn gloomier again as the positive impact of the federal stimulus package fades. Households are squeezed by tighter lending practices, further home price declines and continued labour market weakening. Lower energy prices will provide some growth support, but the Fed's interest rate cuts are not reaching consumers. GDP growth will be 1.6 per cent this year and 0.6 per cent in 2009. The key rate will remain at 2.00 per cent for another year.
- The resilience of emerging economies, especially in Asia, will now be genuinely tested. Secondary effects from the OECD slowdown will be larger, while domestic inflation problems will lead to further economic policy tightening. Overall, the world economy will grow by 3 per cent in 2009, in purchasing-power adjusted terms: on the borderline of a recession.
- Inflation has climbed sharply in the past six months. Inflation pressure will now ease as commodity prices fall and the increasingly synchronised slowdown gradually pushes down wages and prices even more, thus opening the door for interest rate cuts in Europe too. However, the late monetary policy response will mean that recovery will be delayed and that growth will be very modest in 2010 as well.
- Economic conditions in Western Europe are now weakening rapidly. Euro zone growth will end up below 1 per cent next year. In the UK, the slump will be even deeper. The Bank of England will gradually cut its key rate to 3.5 per cent. The ECB's dilemma of weak growth and high inflation will delay a rate cut until March. Next autumn, its key rate will be 3.50 per cent.
- The US dollar will continue to recover. Interest rate cuts in Europe will mean smaller short-term interest rate spreads 2009. Meanwhile sliding commodity prices will benefit the dollar. By the end of 2009, the EUR/USD rate will fall to 1.37. Continued weaknesses in the US economy will prevent an even clearer dollar rebound.

Sweden: Interest rate cuts and budget deficits

- The Swedish economy is decelerating rapidly. This year GDP growth will be 1.4 per cent and next year 0.9 per cent – well below trend. The labour market will weaken. Job growth will gradually slow.
- Current surpluses in public sector finances will allow an expansive fiscal policy thrust. We expect stimulus dosages of around SEK 40 billion in both 2009 and 2010. By 2010, public finances will have swung into a deficit of 1-1½ per cent of GDP.
- Inflation will soon peak but remain high in the coming year. Falling energy prices and lower labour cost pressures will cause inflation to retreat next year. The Riksbank will begin cutting its key rate in February as the economy continues to slow, slashing the repo rate to 3.50 per cent by the end of 2009 and to 3.0 per cent a few months into 2010.

Other Nordic countries and the Baltics:

- **Denmark:** The economic slowdown will deepen, weighed down by sagging domestic demand and falling home prices. The labour market will begin to weaken this autumn. GDP growth will be 0.5 per cent this year and 0.3 per cent in 2009. Fiscal stimulus will contribute to stronger growth in 2010.
- **Norway:** The economy is decelerating, as earlier interest rate hikes bite increasingly and as exports weaken. Growth in the mainland economy will more than halve to 2.9 per cent this year and fall further to 1.7 per cent in 2009. Norges Bank will hike its key rate one more time before starting rate cuts next summer.
- **Finland:** GDP growth will slow substantially to 2.2 per cent this year and weaken further to 1.6 per cent in 2009. Problems in the important forest product industry will amplify the slowdown.
- **The Baltics:** The Baltic economies are now entering a lengthy slowdown, which will be relatively deep in Estonia and Latvia. GDP will stagnate this year in Latvia and shrink by 2 per cent in Estonia. The slowdown in Lithuania will be far milder. Economic imbalances in the form of high inflation and large current account deficits will ease somewhat but remain major challenges in all three countries.

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- **Tighter credit conditions leaving their mark**
- **Synchronised slowdown**
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- **Key interest rates will be cut in Europe**
- **The US dollar will recover further**

Adjustment processes in the wake of the global credit crisis will continue to leave their mark on the economic situation. Rescue actions by central banks have eased the most acute crisis symptoms and have reduced the risk of collapse in the financial system, but tighter credit conditions and falling home prices will hamper growth ahead.

Next year, growth in the OECD countries will be the lowest since the early 1990s. The US economy will resume its slowdown late in 2008 as federal tax rebates no longer buoy up consumption. GDP growth will end up at around ½ per cent in 2009. Full-blown cyclical deceleration has now also reached Western Europe and Japan. A broad slowdown in the euro zone will push growth below 1 per cent, and the British economy will experience an even deeper slump.

To date, growth has held up well in emerging economies, especially in Asia and Eastern Europe. Now their resilience will be tested in earnest. Secondary effects from the OECD slowdown will be larger, while domestic inflation problems in some countries will require further tightening of economic policy. Overall, the world economy will grow by 3 per cent in 2009, measured in purchasing power-adjusted terms. **This level is on the borderline of what the International Monetary Fund nowadays defines as a recession at the global level.**

In the wake of rising energy and food prices, inflation has climbed sharply during the past six months. Central banks, especially in Europe, have signalled great concern. The European Central Bank and the Nordic central banks have continued to raise their key interest rates, while the Bank of England has halted its rate-cutting cycle. We now anticipate that **inflation will gradually fall**, as commodity prices continue to drop and cyclical forces make themselves felt in various respects. This will give central banks room for **rather sharp interest rate cuts next year**, which in turn will lead to falling bond yields.

A clear recovery in the world economy will take some time. Due to the credit crunch and a time lag in the response to fiscal stimulus, European growth will end up clearly below trend in 2010 as well. In the United States, however, brighter prospects will be discernible late next year. Due in part to a greater focus on growth problems in Europe, as well as shrinking interest rate gaps between the ECB and the US Federal Reserve, **the dollar will continue to recover lost ground against the euro**.

GDP growth

Year-on-year percentage change

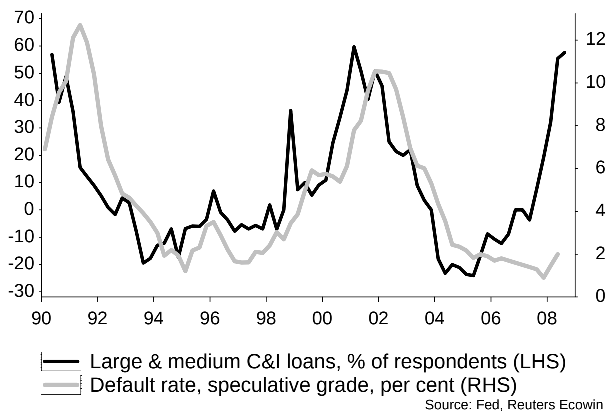
	2007	2008	2009	2010
United States	2.0	1.6	0.6	2.0
Japan	2.0	0.7	1.0	1.3
China	11.9	10.0	8.0	8.0
Euro zone	2.7	1.2	0.8	1.3
United Kingdom	3.1	1.1	0.5	2.5
Sweden	2.9	1.4	0.9	1.8
Norway	3.7	2.5	1.5	1.9
Nordic countries	3.0	1.7	1.0	1.8
OECD	2.7	1.3	0.7	1.7
World economy	5.0	3.6	3.0	3.5

Sources: OECD, SEB

Tighter credit is squeezing growth

Commercial banks, primarily American and European, have so far written off more than 500 billion US dollars. Meanwhile the banks have obtained fresh capital equivalent to USD 350 billion. The difference, USD 150 billion, represents a weakening of equity capital in the banking system that **directly affects its ability to lend nearly USD 1,900 billion** (assuming an 8 per cent capital adequacy requirement). According to IMF estimates, total write-offs may double to USD 1,000 billion.

US: Credit standards and default rates



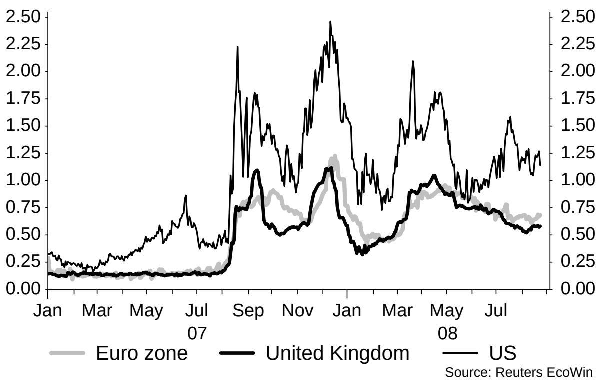
Source: Fed, Reuters Ecowin

Most surveys indicate that the banking systems in many countries will be tightening their credit conditions ahead. At present, **the credit cycle is thus at the beginning of a contraction phase**. This will strongly affect the world economy, since there is a fundamental connection between the credit cycle and the real economy. Fluctuations inevitably co-vary and reinforce each other via the impact of credit supply on share prices and other asset prices. The dynamic of this process is reinforced because declining economic growth leads to lower payment capacity among both companies and households, which in turn fuels greater credit losses. Meanwhile tighter credit tends to reinforce the downturn in asset prices, which eventually undermines the assets of the banks.

This dynamic poses severe challenges for the core of the financial system — banks and central banks. Necessary adjustments in balance sheets must be made in such a way that **the spiral of credit tightening and further declines in the value of asset portfolios** does not become too deep.

Spread between interbank rate and T-bills

Basis points, 3-months maturity



The systemic risks are probably less today than six months ago, due to the battery of measures that have been undertaken. Above all, it has been important that the regulatory authorities in charge have demonstrated that they will not hesitate to take the necessary steps to sustain the financial system.

Meanwhile we can see how financial stress has persisted. The spread between interbank and Treasury bill rates remains high both in the US and in Europe. Other important interest rate spreads have continued to increase or have remained at high levels, illustrating limitations in the power of monetary policy. Bankruptcies in the corporate sector are only at the beginning of their upturn phase and will have a greater impact on the banking system. New government interventions will probably be necessary.

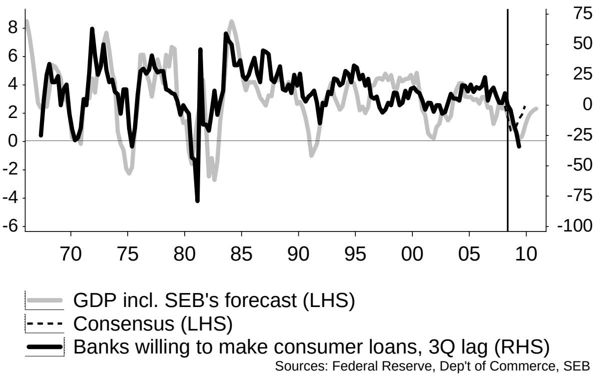
Our forecast continues to assume that the adjustment process will have a noticeable effect on the real economy during the next couple of years. However, the current deceleration does not differ so markedly from other cyclical slowdowns of the past quarter century. Strong balance sheets in the corporate sector and plenty of potential investment capital, mainly in the oil-producing countries, will help ensure that **the slowdown will not deepen, even though the financial threat scenario looks worse**.

W-shaped American growth curve

Growth in the US remained unexpectedly high during the second quarter. **Tax rebates and help from a weak dollar and decent international demand** resulted in GDP growth of 2 per cent. These forces are now weakening, and the economy is not yet ready to stand on its own feet. According to the indicators, the US labour market downturn is about to accelerate. In addition, home prices are continuing to fall. So far, the slide has totalled 20 per cent since the peak in 2006 (according to the S&P/Case-Shiller Index). Due to a large housing oversupply and a rising number of foreclosures, we foresee a further price decline of around 10 per cent as probable. The total downturn will thus be in line with our earlier forecasts.

US: GDP and credit conditions

Year-on-year percentage change, net balance



Consumers will consequently be squeezed hard by a weaker labour market, falling home wealth and sagging real income. We expect negative GDP growth during the fourth quarter of 2008 and the first quarter of 2009, which will mean that **the 2009 annual average will end up at around ½ per cent**. The downturn in residential construction will begin to level off in the next few quarters, and inflation will not undermine purchasing power to the same extent as previously; these are bright spots that will soften the downturn. Not until 2010 do we expect GDP growth to be at around the US trend level.

Economic indicators

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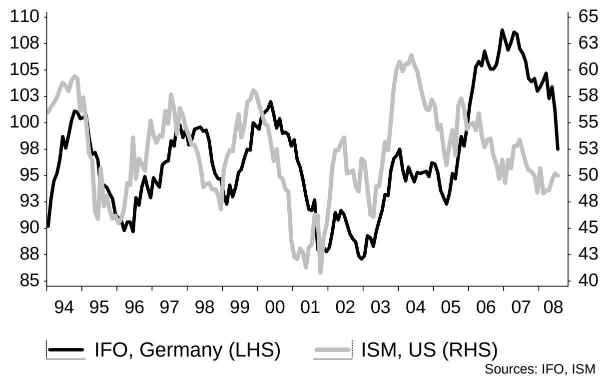
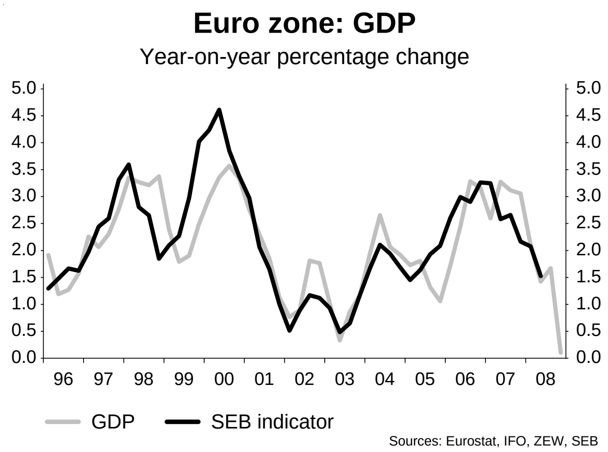


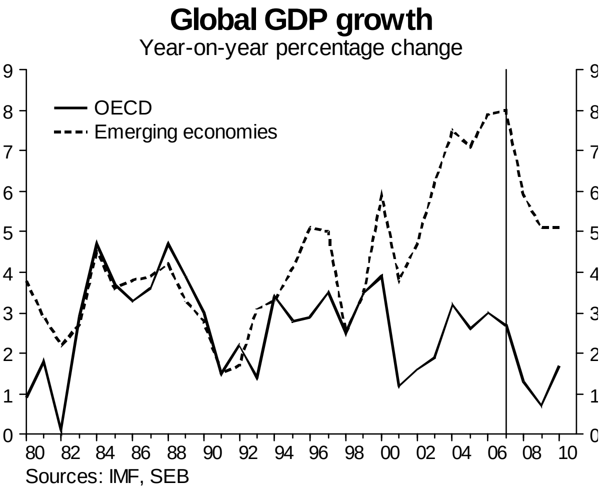
Broad slowdown in OECD countries

Because growth remained high in Europe and Asia at the beginning of the American cyclical slowdown, this fuelled the concept that a global economic "decoupling" was possible. Strong growth in the first quarter of 2008 helped to keep these hopes alive, for example among central banks. Today, however, it is increasingly clear that the entire OECD will be affected by the economic slump.

Interest rate hikes, a strong euro and high inflation have led to a sharp economic cooling in the **euro zone**. This slowdown is broadening, with a falling growth rate in Germany as well, but there are still sizeable differences between countries. GDP growth will end up at close to zero in Italy, while home price declines will have a major impact on such economies as Spain and Ireland. Overall, we expect GDP growth to reach 0.8 per cent next year, with marginally stronger growth in 2010. This forecast means that average GDP growth during 2008-2010 will actually be lower in the euro zone than in the US.



The **United Kingdom** is especially vulnerable to the adjustment processes now under way. Overvalued homes combined with a low savings ratio (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 sharp deceleration has now begun. We expect GDP growth to reach only ½ per cent in 2009.



The resilience of the **Nordic economies** is weakening as well. Home prices are now falling in Denmark and Norway. Denmark was the first country in the EU to show a recession, with falling GDP in the fourth quarter of 2007 and the first quarter of 2008. In Sweden, growth has slowed sharply and confidence indicators show a rather steep downturn in optimism. Next year, GDP growth in the region will end up at 1.0 per cent. Large public sector surpluses, which can gradually be transformed into expansive fiscal policy, will help to keep growth somewhat higher than in the euro zone.

Problems for emerging economies

To date, emerging economies have continued their expansion despite the slowdown in industrialised countries. We now expect some deceleration, but the emerging economies will continue to help sustain global growth.

There is no shortage of clouds on the horizon, however. When the slowdown in the OECD countries broadens, the secondary effects on emerging economies will become clearer. Even more important, perhaps, is that greater risks of **internal imbalances might sabotage expansion**. Rapid growth has led to high resource utilisation and great demand for certain types of labour. Wages have thereby risen faster than underlying productivity growth. When this is combined with rising energy and food prices, the result has been a broad upturn in inflation. Unlike the situation in the industrialised countries, we can thus observe **rising core inflation** in many emerging economies.

Cautious attempts at monetary tightening are now being implemented on a rather broad front in Asia. Because the rules of economic policy are unclear, however, in many cases **policymakers are intervening too late**. Concerns about political stability have contributed to a prioritisation of growth, at the expense of inflation. However, inflation has now reached such levels that it is beginning to become apparent what damage it can cause, especially by undermining the purchasing power of impoverished segments of the population.

In such countries as **India** and **Indonesia**, interest rates have been hiked relatively sharply in recent months, contributing to an upturn in currency exchange rates. In South Korea, too, a tightening has begun. This trend is expected to continue. In **China**, certain overheating risks remain, but so far the upturn in inflation has been concentrated to food prices. The authorities have signalled their concern about rapidly declining growth, so we expect economic policy to continue following a strategy of **simultaneous stimulation and tightening**.

Fiscal stimulus needed

High inflation has limited the ability of central banks to stimulate the economy, thereby increasing the need for active fiscal policy. The IMF has emphasised that such a role allocation would ease the risks of renewed financial imbalances in the form of asset market bubbles. In a situation of tightening credit and falling home prices, **fiscal stimulus programmes are probably also more effective than interest rate cuts**.

Last spring, a fiscal policy injection in the **US** that was equivalent to about 1 per cent of GDP helped sustain economic activity during the second quarter. Next year we expect a smaller stimulus package to be launched, regardless of the outcome of the November 2008 presidential election.

Most countries in Western Europe neglected to create manoeuvring room during the last economic boom. In the **UK**, **France** and **Italy**, further stimulus is hardly compatible with the EU rule that the maximum permitted budget deficit is the equivalent of 3 per cent of GDP. **Spain**, whose central government finances are stronger, launched a stimulus package last spring in response to a dramatic downturn in the economy. In **Germany**, too, there is some room for stimulus packages that may need to be utilised now that the economy is weakening.

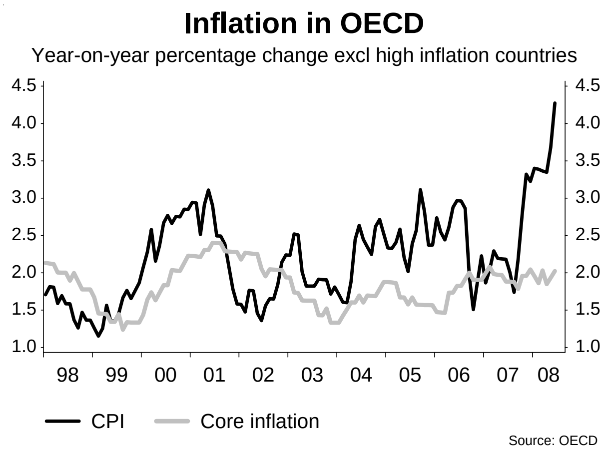
Strong public finances in the Nordic countries will allow substantial budgetary room for stimulus packages. **Sweden** and **Denmark** will now gradually take advantage of this option as their labour markets cool. In **Norway**, the government has been trying for a long time to prevent oil income from spilling over into an overly expansive fiscal policy.

Overall, we will see a **sharp increase in budget deficits** worldwide as a consequence of the economic slowdown and fiscal stimulus measures. In the US, the incoming president will face major challenges. The federal budget will be squeezed hard by the economic slowdown, the need to sustain the financial system and continued security policy challenges. In Europe, EU Stability Pact restrictions and the ECB's wait-and-see approach will lead to an excessively tight economic policy in those countries where the economic slowdown is most apparent. Although it can be argued that these problems have their roots in old shortcomings related to structural and budget policy, the outcome will be **major tensions in euro zone collaboration**.

Inflation culminating

Consumer Price Index inflation in the OECD countries is now at the highest level recorded since the 1980s. Rising energy and food prices have driven CPI inflation to undreamed-of heights.

Inflation has surged so dramatically due to several interacting factors. Persistent expansion in emerging economies has kept commodity prices high. The upturn in inflation and wages in these countries has also helped weaken the inflation-moderating role that globalisation has played over the past decade. Food prices have also been driven up by special factors such as poor harvests and the increased use of grains in ethanol production. Meanwhile many industrialised countries have experienced typical late cycle inflationary forces in the form of falling productivity growth and a certain upturn in the rate of pay increases.



The inflation upturn has sometimes been interpreted in rather melodramatic terms, as a consequence of an expansion in emerging economies that will lead to continuously climbing commodity prices. This, in turn, would force companies to compensate for rising costs with broad price increases aimed at consumers. The resulting compensation demands of employees would create a lasting upward wage-price spiral. The **stable low-inflation environment** that characterised recent decades would thus **come to an end**. Rising inflation expectations have been interpreted as a sign that economic actors have been moving towards losing confidence in central bank inflation targets.

We view these fears as exaggerated, however. Inflation will admittedly remain at a high level for another while. At the producer price level, there are indications of continued price pressure, and many companies are eager to carry out price hikes in order to limit the downturn in their profits.

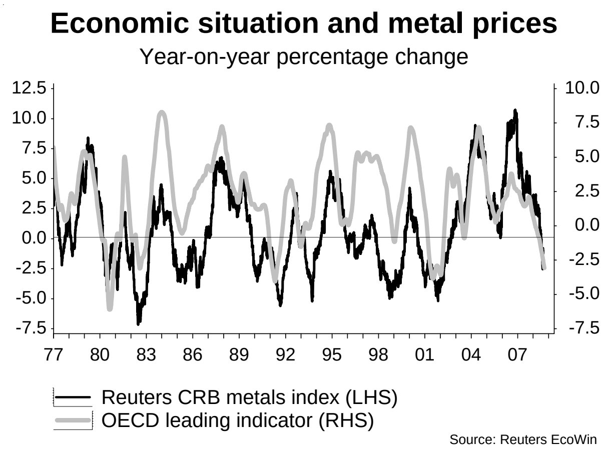
Contributions to CPI from food and energy

Percentage points

	2007	2008	2009
United States	2.1	2.4	0.6
Euro zone	1.6	1.4	0.4
Sweden	1.0	1.0	0.3

Sources: OECD, SEB

Cyclical forces will gradually make themselves felt in various ways. Our inflation forecast is based on the assumption that a slight decline in commodity prices will occur. **For example, we expect crude oil prices of around USD 100 per barrel at the end of 2009**. There will be a dramatic shift in the contribution of commodity prices to inflation as earlier price increases disappear from inflation figures. The effect will be largest in the US, where the inflation contribution of energy and food will fall from 2½ percentage points to ½ point in 2009, but it is not unlikely that the global economic slowdown will push commodity prices down even more. Trends in other areas indicate that historical correlations will finally prove valid, although the time lags are longer than previously.

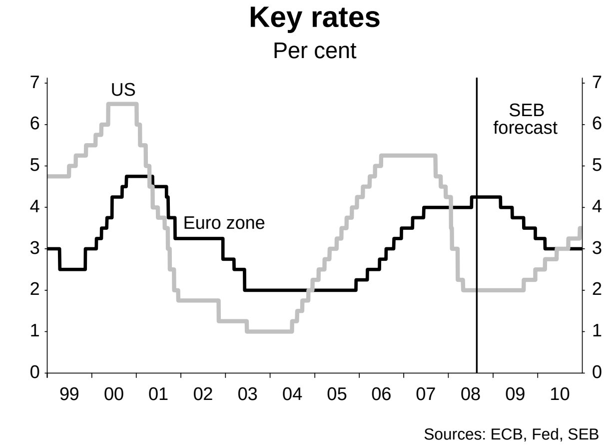


Core inflation is also decelerating for cyclical reasons. So far, pay increases in the OECD countries have climbed modestly despite a tight labour market situation. Now that we are facing a synchronised economic slowdown, it is hardly likely that employees will be able to gain compensation for higher inflation. Companies will also find it increasingly difficult to succeed in a strategy of passing on their costs to consumers. Overall, we are thus expecting a clear downturn in inflation during the course of next year. Towards the end of 2009, CPI inflation will stand at around 2 per cent both in the US and the euro zone.

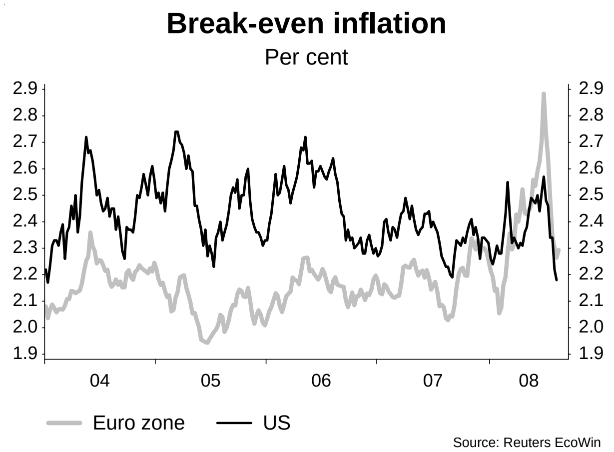
Interest rate cuts on a broader front

During the spring, when rising commodity prices drove up inflation and inflation expectations, central banks in Europe chose to assign clear priority to the battle against inflation in their rhetoric and actions. They toned down the importance of both growth risks and the fact that inflation was largely being caused by specific factors on the economic supply side. A changed tone in the international debate undoubtedly also had an impact. For example, early 2008 was dominated by the IMF's recommendations that interest rate cuts were needed on a broad front in order to combat the financial crisis. The discussion gradually shifted to the risks that low real interest rates and excessively easy monetary policy at global level was helping to fuel the commodity price upturn.

Our forecast regarding the economic cycle and inflation over the next couple of years rather clearly indicates that the reasons for sustaining economies with an **expansive monetary policy** will strengthen.



In the US, the key interest rate will remain low. The **Federal Reserve** has admittedly signalled an ambition to normalise interest rates as soon as the economic situation stabilises, but we are not yet there. The Fed wants to avoid creating bubbles again in asset markets. Due to renewed growth problems and a continued decline in the housing market, however, we expect the federal funds rate to remain at 2 per cent for at least another year, or longer than the pricing in the fixed income market now indicates. In spite of this, falling inflation will lead to a certain upturn in real interest rates.



Due to the weaknesses in the Japanese economy, the **Bank of Japan's** ambition to normalise its key interest rate will again be postponed. Inflation far above target has caused the **Bank of England** (BoE) to interrupt its interest rate cuts, halting at a repo rate as high as 5.0 per cent. Sliding home prices and rapidly falling growth will eventually lead to new rate cuts. We expect one further cut this year and foresee a lowering of the key rate to 3.50 per cent during 2009.

In recent months, the **European Central Bank** has softened its hawkish rhetoric as economic signals have shown growing weakness. We also expect the ECB to gradually tone down its worries over inflation and begin cutting its key interest rate early next year. By the end of 2009 the refi rate will be 3.25 per cent.

Early in July, Sweden's **Riksbank** signalled more interest rate hikes during the autumn. Due to falling oil prices, weak growth figures and rapidly eroding optimism, we expect the Riksbank to beat a retreat. The bank may carry out one final key rate hike in September. During 2009 it will lower its repo rate by a total of 125 basis points to 3.50 per cent, and some months into 2010 the key rate will be 3.0 per cent.

Norges Bank must take overheating tendencies in the Norwegian economy into account for another while. We expect a final hike in its sight deposit rate to 6 per cent this autumn. When unemployment turns upward and resource utilisation falls, a rate-cutting cycle will become more imminent. However, our forecast of core inflation implies that the first rate cut can occur in mid-2009 at the earliest, followed by two rate cuts to 5.25 per cent by the end of the year and probably two more cuts a few months into 2010.

Key rates

	Currently	Dec 09	Neutral
United States	2.00	2.50	4.25
Euro zone	4.25	3.25	4.00
United Kingdom	5.00	3.50	4.50
Sweden	4.50	3.50	4.25
Norway	5.75	5.25	5.25

Source: SEB

Bond yields will continue falling

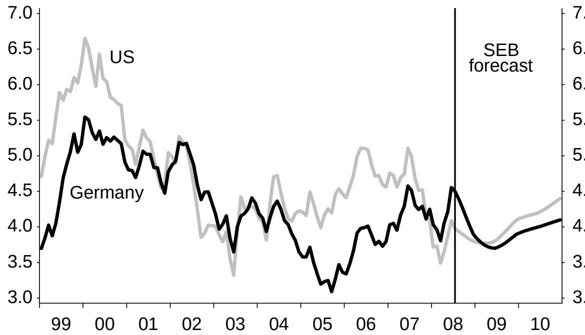
Bond yields rose sharply during the second quarter, driven by inflation worries and grim central bank rhetoric. During the past month, yields have turned dramatically downward as commodity prices have fallen and growth problems have once again become a focus of attention. Inflation expectations measured as break-even inflation have also fallen, reinforcing this trend. Our forecast of a relatively deep economic slowdown in which the Fed maintains its key interest rate at 2 per cent and interest rates are cut rather sharply in Europe implies room for a further downturn in bond yields.

Our current macro scenario nevertheless hardly justifies letting long-term yields fall as deeply as during 2003 and 2004, when the deflation threat seemed imminent. Over the next couple of years, uncertainty about inflation will presumably be greater. An increased supply of government bonds due to rising budget deficits will also help on the margin to slow the decline in yields. However, our forecast in this area indicates that the deficits will be about as large as during the previous cyclical slowdown. A reduced need for financial investments among central banks in Asia and the Middle East will also contribute to lower demand.

We expect ten-year American Treasury bonds to bottom out at 3.80 per cent a few months into 2009. In Germany, long-term yields will be squeezed downward during the first half of 2009 due to the ECB's interest rate cuts, reaching 3.70 per cent in mid-2009.

10-year government bond yields

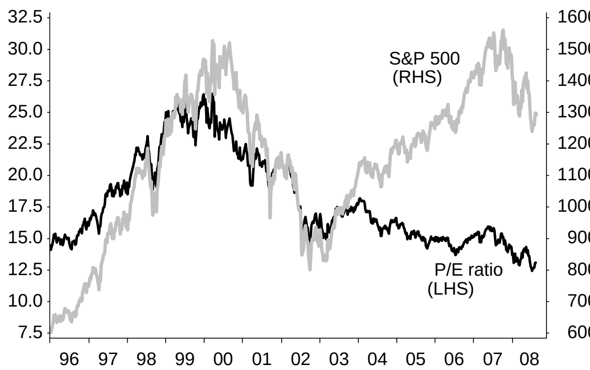
Per cent



Sources: Reuters EcoWin, SEB

The Swedish ten-year government bond will continue to fall somewhat further, reaching a 3.75 per cent yield by mid-2009. The decline will be less than for its German equivalent, so the yield spread will climb. This is because the Riksbank's key interest rate will be higher than that of the ECB during most of our forecast period and the difference in inflation compared to the euro zone will no longer benefit Sweden. Due to Sweden's rapidly falling central government debt, the upturn in the long-term yield spread will be relatively modest. Norwegian long-term yields are currently nearly 50 basis points above German ones. This spread will eventually shrink as Norges Bank begins a rate-cutting cycle next summer.

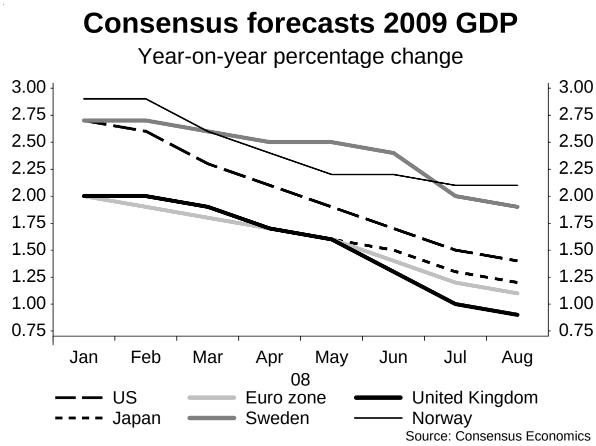
US: Stock market index and valuation



Sources: Standard & Poor's, Reuters

Continued stock market risks

Rising commodity prices and interest rates, as well as continued financial market uncertainty, helped trigger a sharp decline in world stock markets starting in mid-May. Decent quarterly reports and bright spots in markets for American manufactured goods were not enough to enable stock market optimism to prevail over a gloomier long-term macroeconomic scenario. Since mid-July, stock exchanges have recovered to some extent as commodity prices have fallen and the outlook for monetary policy easing has improved.



Our macro scenario implies further growth disappointments. Consensus forecasts of GDP growth in 2009 are also likely to continue being revised downward during the next six months, which usually pushes stock markets lower. The risks of new disappointments about profits are obvious in many industries, and profit warnings will undoubtedly come this autumn.

However, stock market valuations are historically low at the moment. When this might lead to a lasting recovery in share prices will depend on a number of factors. The American yield curve now has a clearly positive slope, which means that one important piece of the puzzle for more stable stock market performance is in place. At present, though, the yield curve must also become steeper in other parts of the world. ECB and Bank of England interest rate cuts will thus be of great importance. Meanwhile it will probably also be necessary for the situation in the financial system to clarify and for the flow of news regarding new write-offs to start drying up. Some time during the next year, our forecasts of the economic situation

One year of global credit crisis

The emergence of the global credit crisis in the summer of 2007 led to major challenges for economic and financial assessments. The consequences of the abrupt credit market shift had to be weighed against the very strong and seemingly robust economic environment that then predominated, especially in the Nordic countries. This meant that well-travelled methodological paths were abandoned in favour of more uncertain assessments of relatively untested associations between the credit market and the real economy.

Since the August 2007 issue of *Nordic Outlook*, our forecasts and analyses have been greatly affected by the view that the credit crisis would have significant long-term consequences for economic performance. This conclusion was based partly on the fact that the crisis abruptly changed the credit market climate in terms of trust, risk-taking, pricing and liquidity. In addition, we drew the conclusion that the outbreak of the credit crisis would reinforce the shift in several underlying forces that have driven growth in the industrialised countries. This is especially true of developments in the housing market, which has stimulated these economies for a long period due to large-scale construction and rising home prices.

By way of summary, it has certainly been fruitful to give the consequences of the credit crisis a central role in our analysis. Otherwise it would hardly have been possible to predict at such an early stage the underlying shift in the economic picture, especially in Western Europe, which has now obviously occurred.

In some areas, however, we have been less successful. This is most obviously true of our forecasts for the European central banks during the spring, partly because we did not foresee the sharp price increases on energy, food and various other commodities that dominated the first half of 2008. This helped reinforce the effects of traditional late cycle inflation impulses, which on the other hand were well incorporated in our forecasts.

In addition, we misjudged the reaction patterns of the European central banks in a situation of weakening economies and rising, primarily commodity-driven inflation. For a long time, we interpreted the central banks' sabre-rattling only as warning signals. We thus stuck too long to the thesis that they would avoid implementing interest rate hikes and more quickly cut rates as economic weaknesses became ever clearer.

It is still too early to carry out a final evaluation of both the accuracy of our forecasts and the consequences of the economic policies that were pursued. It is possible to note, however, that the absence of downward adjustments in interest rates has contributed to the fact that economic growth in Europe will generally be weaker than we had previously predicted. In the short term, the opposite is true of the US: federal fiscal stimulus policy has helped to keep growth higher this year than we had expected in our reports last spring.

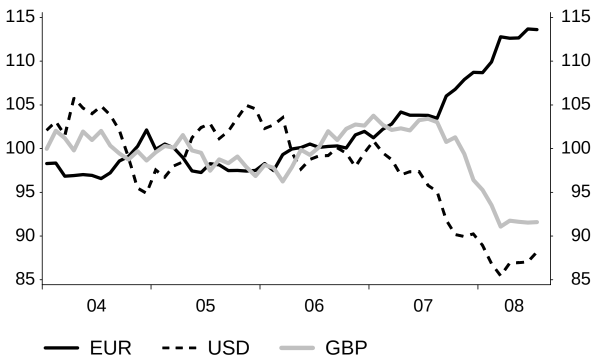
and interest rates will indicate that the preconditions for a more lasting stock market recovery may be in place.

Dollar will continue to recover

In recent years, the euro has had to bear an increasingly heavy burden in the world economy as the US and UK currencies have weakened and Japanese economic fragility has held down the yen exchange rate. 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.

Effective exchange rates

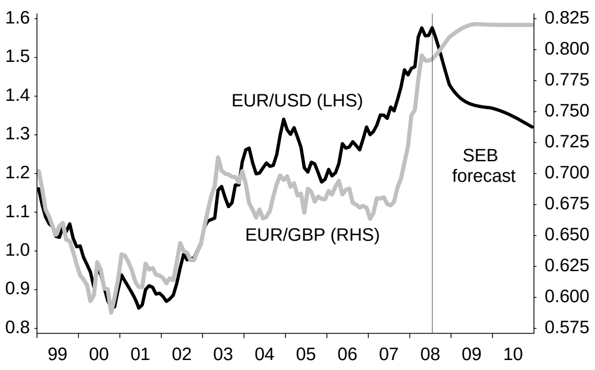
Index 2006 = 100



Source: Bank of England

Our forecasts during the past year have implied that the dollar downturn would continue until it was clear that the euro zone economy would also be strongly affected by the ongoing global slowdown. Signs of weakness during the summer, manifested in the second-quarter GDP downturn have served as a catalyst for this trend reversal. The drop in commodity prices is another contributing factor; the negative correlation between commodities and the dollar is clear.

EUR/USD and EUR/GBP exchange rates



Sources: Reuters EcoWin, SEB

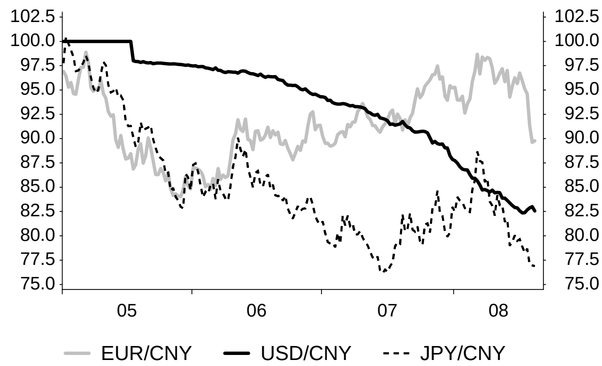
Looking ahead, most signs point to a continued dollar recovery. This is primarily due to the trend of the key rate spread. At present, the ECB's key interest rate is 225 basis points above the Fed's. We expect this spread to shrink gradually in the course of 2009, then switch late in 2010 to a situation where an American economic recovery will result in a Fed key rate somewhat higher than the ECB's. At that time the EUR/USD exchange rate will move down towards 1.30.

We expect the pound to weaken further against the euro, due to the British economy's heavy exposure to the financial market crisis and the downturn in home prices. The EUR/GBP rate will peak at 0.82 early next year. The weakening of the pound against the dollar will thus be rather dramatic; we expect the GBP/USD rate to stand at 1.66 towards the end of 2009.

The yen will undergo a moderate weakening over the next two years, to a USD/JPY exchange rate of 125. Over time, a wider interest rate spread with the US is likely to result in depreciation. We expect the Fed to begin raising interest rates next year, while the BoJ leaves its key interest rate unchanged.

China: Exchange rates

Index January 2005 = 100



Source: Reuters EcoWin

China's undervalued currency has contributed to the imbalances in global trade flows. In recent months, however, the appreciation rate of the yuan has accelerated in effective terms and is now running at about 9 per cent against the dollar, year-on-year. Meanwhile the recovery of the dollar has contributed to a 10 per cent increase in the value of the yuan against the euro and a 12 per cent increase against the yen only since last spring. It is also notable that earlier world political tensions related to the yuan seem to have eased somewhat. US Treasury Secretary Henry Paulson recently praised China by saying that the country was "moving in the right direction" in terms of currency reform.

The past few months have been characterised by greater caution on the part of Chinese authorities. We thus anticipate that CNY/USD appreciation will be slower in the future. The Chinese currency will thus become stronger in effective terms, though not at the same pace as during the late summer.

The Swedish krona will continue to be pressed by weak risk appetite in a short-term perspective. Further ahead, we expect Sweden's underlying strength in the form of large current account surpluses and higher growth than in the euro zone to benefit the krona. The EUR/SEK exchange rate will thus fall to 9.30 by December 2010. Due to the dollar's appreciation against the euro, our forecast implies a weakening of the krona in trade-weighted TCW terms in the coming year. Only in 2010 will the krona strengthen to some extent. The Norwegian krone will appreciate somewhat against the euro to 7.85 per by year-end, sustained by a larger interest rate spread. Lower oil prices and eventually also key interest rate cuts in Norway will cause the EUR/NOK rate to climb, but we expect a moderate weakening to 8.10 by the end of 2009.

Slowdown intensifying again

- **Financially squeezed households set the tone**
- **Housing market downturn will bottom out**
- **Labour market will deteriorate further**
- **Another year of 2.00 per cent key interest rate**

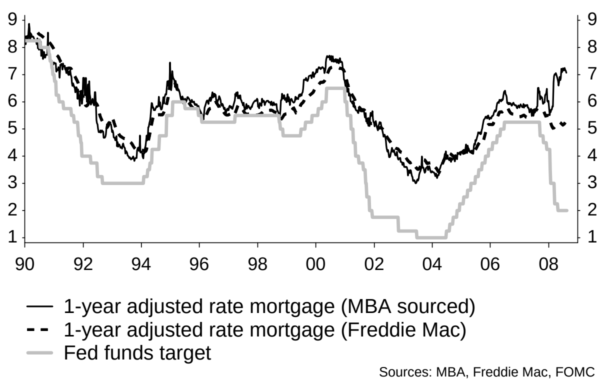
Thanks to the federal stimulus package and an unexpectedly robust contribution from foreign trade, the American economy grew more strongly than expected during the first half of 2008. **But now that the effect of the tax rebates is fading, households are under increasing financial pressure**. The combination of continued home price declines, a weakening labour market and even tougher credit conditions translates to slower GDP growth, which will turn negative around year-end. Partly offsetting this, oil prices have fallen significantly from this summer's record levels.

Despite further stimulus packages and the Federal Reserve's loose monetary policy, the economic slowdown will be rather lengthy, and the recovery will be listless. A return to the US economy's potential growth level is unlikely until home prices have stopped falling, banks have cleaned up their balance sheets and credit conditions have eased for households and companies. Taken together, this means that **GDP growth** will total **1.6 per cent in 2008, 0.6 per cent in 2009 and 2.0 per cent in 2010**.

The dollar depreciation of recent years will provide continued positive contributions from foreign trade and help keep the recession shallow, viewed in a historical perspective. But when demand from important export markets also decelerates at the same time as the dollar strengthens, these contributions will gradually diminish. The export sector is too small to maintain growth all by itself.

US: Fed funds and 1-year ARM rates

Per cent



Sources: MBA, Freddie Mac, FOMC

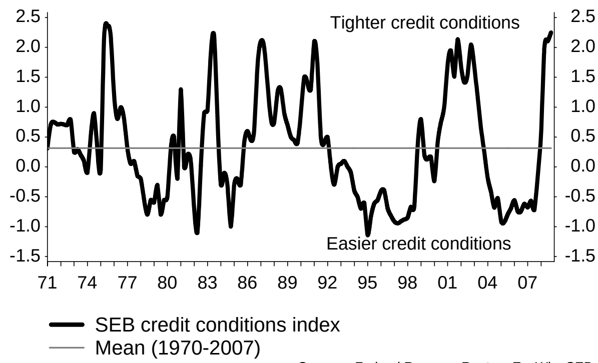
Having rapidly lowered its federal funds rate from 5.25 per cent to 2 per cent, the Fed has kept this key rate unchanged since April. The economy is now weakening again, which will help persuade the Fed to maintain the key rate at this level for a relatively long period. The central bank's **rate-hiking cycle will not begin until late 2009**, later than current pricing in the fixed income market implies.

Financial crisis will continue

The financial market crisis has now been under way for more than a year. The Fed's interest rate cuts, actions to rescue institutions important to the system and new credit facilities have boosted liquidity and improved the functioning of the financial markets. **A systemic crisis has been avoided**. But at the same time, stimulus measures have not spread widely through the economy. The interest rates on both home mortgages and corporate bonds remain at high levels, and our own credit conditions index is close to the highest levels it has measured.

US: SEB credit conditions index

Baa-spread, High-yield spread, SLO survey

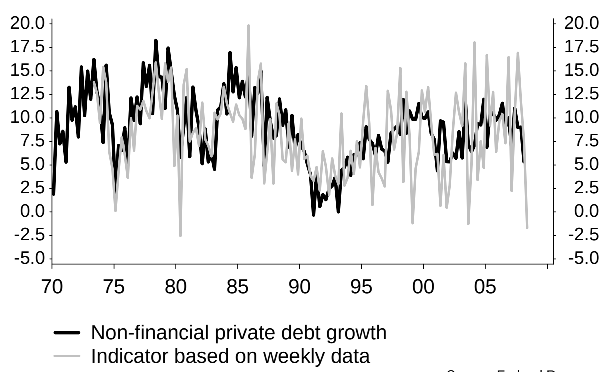


Sources: Federal Reserve, Reuters EcoWin, SEB

Since last autumn, gradually tighter credit conditions have helped dampen growth. Until fairly recently and for various reasons, however, the hard data did not show any actual slowdown in lending volumes. But in the first quarter the growth rate of non-financial private debt was the slowest since 2001. Although comprehensive data is not yet available, the weekly numbers suggest that the second quarter will look even weaker.

US: Non-financial debt growth

Annualised

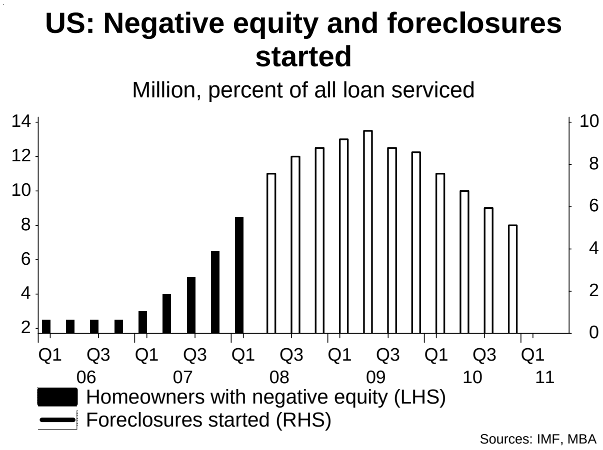


Source: Federal Reserve

The biggest real effects from tighter credit and the slowdown in lending are still ahead of us, and this contributes greatly to the gloominess of our economic scenario. According to our calculations, the **credit crunch will slow GDP growth by more than 1 percentage point during the coming year**. The International Monetary Fund (IMF) maintains that this effect may be twice as large.

Somewhat simplified, Fed interest rate cuts have not yet resulted in easier credit conditions for households and companies because housing-related losses are continuing to grow, while an over-leveraged banking system is endeavouring to reduce loan-to-value ratios and eliminate risk. Necessary capital replenishments have become both more difficult and more expensive.

Globally, banks and other financial institutions have reported about USD 500 billion in unrealised housing-related credit losses, half of which have affected American banks.



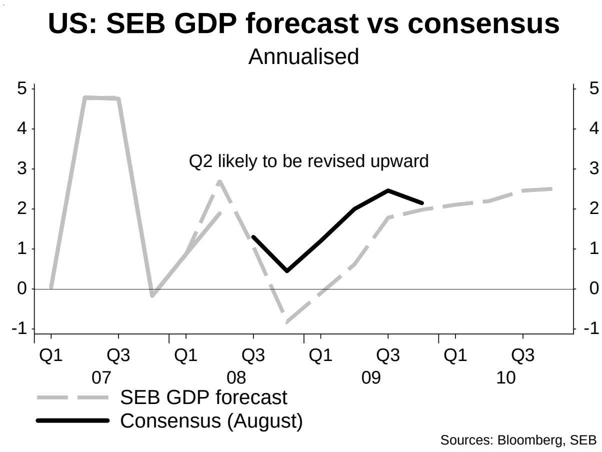
How large the losses will end up being is closely related to housing market developments and the future course of economic activity. As long as home prices continue downward, realised as well as unrealised losses will climb. One reason is that home owners with loans exceeding the value of their property often choose to abandon it, triggering a rather costly foreclosure process. Because of the decline in home prices, **about 8 million or 10 per cent of mortgage borrowers** have ended up in a negative equity situation, where **the market value of their home is less than their loan amount**. According to our forecasts, that figure will climb in the future. Even among “prime” home mortgages — those with well-documented collateral — foreclosures have increased sharply.

When the economy slows down, credit losses also increase for that reason too. Other loan structures (including commercial property loans, credit card and car loans) are exposed. Weak domestic demand squeezes corporate profits. Company bankruptcies increase.

Decelerating growth thus feeds back into the financial system. The depth and length of the financial crisis will be determined by how large the impact on the real economy will be. Our conclusion is that it will take time before the balance sheets of banks are cleaned up, capital bases are strengthened and loan-to-value ratios are reduced. These adjustment processes must take place before credit conditions will ease for households and companies. **Only in 2010 will new lending – and the economy – regain momentum**.

W-shaped growth profile

The W-shaped growth profile that we forecasted last spring looks likely to materialise. The impact of the federal income tax rebates came earlier than we thought, however, helping to generate a GDP growth rate of 1.9 per cent in the second quarter (1.4 per cent on average during the first half). But on the other hand, the downturn will probably occur faster when the effect of the tax rebates fades. We expect negative growth rates for both consumption and GDP this autumn and winter. A sluggish recovery will begin in the latter part of 2009 once the housing market has bottomed out and fundamental imbalances in the credit system have been resolved. GDP growth will return to its potential level (just above 2½ per cent) some months into 2010.



Home prices will continue to fall

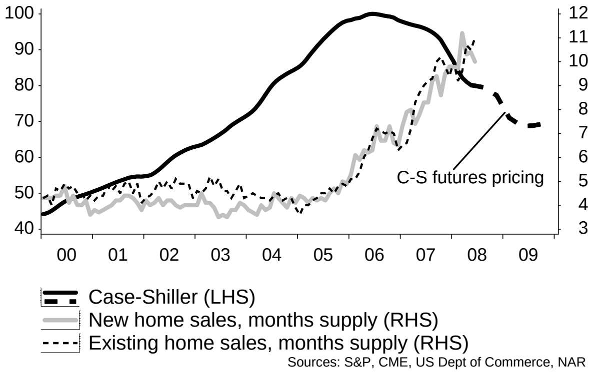
In recent months, housing market statistics have contained some points of light. New sales are a little above last spring’s bottom levels, and home prices are not falling as sharply as previously. The rate of downturn in residential investments has also slowed, and the negative contributions to GDP will gradually fade. It is also important that the federal government has guaranteed to back the mortgage institutions Freddie Mac and Fannie Mae; the market for prime mortgage loans will continue to function, which **reduces the risk of a mortgage market collapse**.

Yet our conclusion is that the housing market **turning point lies at least two or three quarters ahead in**

time. The percentage of borrowers who are behind on their mortgage payments is continuing to rise, along with foreclosures, and the mood among home builders has hit new record lows. Both construction volume and prices are squeezed by a continued overhang in supply, compared to demand. The supply of both newly constructed and existing homes is close to the highest levels measured. The **housing market** will probably **not bottom out until** these measures of **supply have reached their historical average of 6-7 months supply**.

US: House prices and housing inventory

Rebase 2006:6 = 100, months supply



By way of summary, we are sticking to our earlier assessments 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). Home price futures indicate an accumulated downturn of 32 per cent. So far, prices have fallen by around 20 per cent since mid-2006, which implies that about one third of the price adjustment lies ahead of us.

Households being tested in earnest

According to our calculations, the tax rebates lifted household consumption by about 3 per cent during the second quarter, which means that consumption would have fallen by 1.5 per cent without the stimulus package. **Now that the effect of the tax rebates is fading, a mix of factors remain that will dampen consumption**. The combination of tougher credit conditions, a poorer wealth position and a weaker labour market is also reflected in **confidence indicators, which are close to the lowest levels ever measured**. Offsetting this is the fact that oil prices have fallen.

The connection between housing wealth and consumption will be a key factor in how deep the consumption slowdown will be. Assuming a wealth effect of 5 per cent, **falling home prices may dampen consumption growth by more than 1 percentage point yearly during 2008 and 2009**. Falling share prices will have an additional impact.

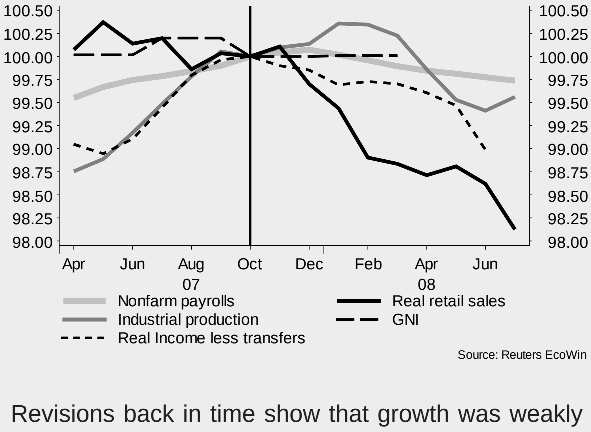
The most important source of household income — wages and salaries — is meanwhile being squeezed by

Recession or not?

Positive economic growth figures during the first half raise the issue of whether there is actually a recession in the US. The popular technical definition — declining GDP two quarters in a row — has not been met in any case.

US: Recession dating variables

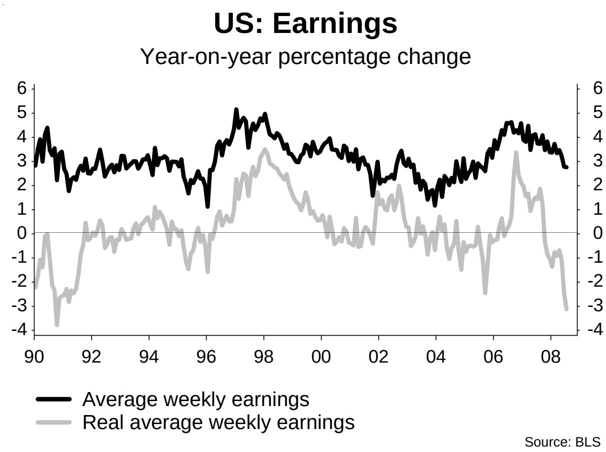
Rebase 2007:10 = 100



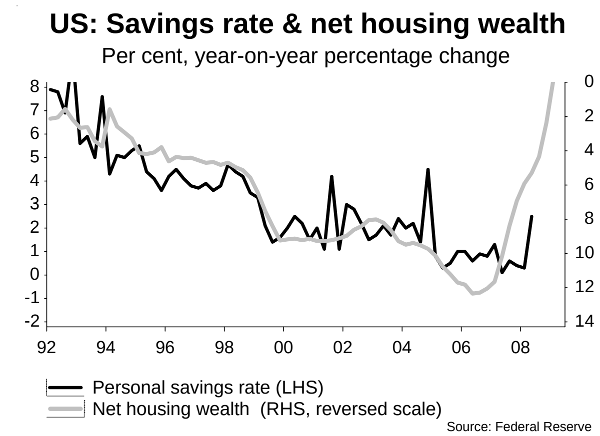
Revisions back in time show that growth was weakly negative late in 2007. Especially around turning points in the economy, the GDP measure is rather shaky and further revisions can be expected. According to one Fed study, Gross Domestic Income or GDI (which is conceptually very close to Gross Domestic Product or GDP) is instead a more robust measure of activity. During the last quarter of 2007, GDI fell by 0.8 per cent. It was then unchanged during the first quarter of 2008. If the income side of the economy is performing so much more weakly than GDP, this can be taken as an indication that growth will be revised downward as new and better information becomes available.

Other variables (industrial production, real retail sales, real income less transfers and employment), to which the National Bureau of Economic Research attaches great weight, began to fall around the turn of the year. This is another indication that the **economic cycle has peaked and is on the way down**, but normally there is a lag of between six and 24 months before the NBER issues an official opinion on the matter. Waiting for the decision is not recommended. Stocks, in classic discounting-mechanism mode, usually bottom five months before the recession ends. When the NBER makes the call traditionally we are one month away from the recession actually ending.

rapid rises in unemployment and prices. During the latest three-month period, real earnings fell at the fastest pace since the recession of the early 1990s. Since prices are falling, however, the situation is improving; pressure on real earnings will ease significantly as early as 2009, according to our forecasts. Meanwhile, continued labour market deterioration points towards rather weak nominal wage and salary increases during the forecast period.



A certain lingering effect from the tax rebates will contribute to positive consumption growth figures during the third quarter of 2008 as well. But during both the fourth quarter and the first quarter of 2009, we expect consumption to fall.



After that pressure on consumers will gradually ease, not least because inflation will be falling. Add to this the additional stimulus packages that we expect will benefit the economy during the latter part of 2009. Measured as annual averages, **consumption growth will slow from 2.8 per cent in 2007 to 1.1 per cent in 2008. In 2009 and 2010,** consumption will increase by **0 per cent and 1.4 per cent, respectively**. This forecast implies a rather modest adjustment in saving, which will climb to 3.2 per cent of disposable income towards the end of our forecast period. Judging from historical associations between household wealth and the household savings ratio, there is a risk that the adjustment will be more dramatic than this.

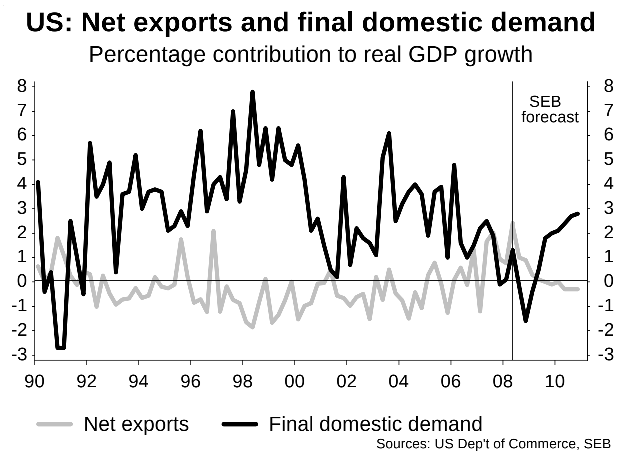
Foreign trade easing slowdown

The weakening of the dollar in recent years and resilient demand abroad have benefited American export companies. Even though the global economy is now slowing, many export markets will continue to grow at a respectable pace, especially in Asia.

We expect continued positive contributions from foreign trade during 2009: **On average, foreign trade will contribute 0.6 percentage points to GDP during the coming year**. This will help keep the economic slowdown shallow, compared to earlier American recessions. However, this forecast implies a sharp downshift compared to the record contribution of trade to GDP during the second quarter.

Looking a bit further ahead, our forecast of a stronger dollar, together with a recovery in domestic demand (which will lead to stronger import growth), implies that the contribution of foreign trade will become negative in 2010.

Resilient exports will also help ease the investment downturn, and corporate capital spending will not fall as drastically as it has during most other economic slowdowns. After several years of rapid profit growth, companies are in a position where they can finance capital spending internally, thereby at least partially avoiding the current high costs of borrowing. The demand for corporate loans, which has historically been a reasonable indicator of business investments, has held up well. This is another indication that the **capital spending downturn will be comparatively mild**. The rate of increase in construction investments outside the housing sector has climbed to double-digit figures, which also points in the same direction.



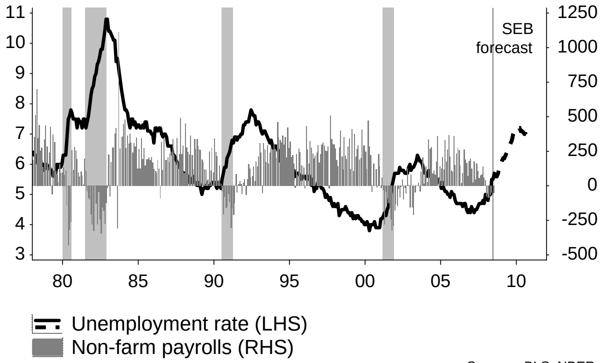
Overall, we expect **capital spending** measured as annual averages **to climb by 2.1 per cent in 2008** after having risen by 4.9 per cent in 2007. During **2009 and 2010 capital spending growth will amount to -1.9 and 6.1 per cent**.

Labour market drama

Unemployment has climbed from 4.4 per cent in March 2007 to 5.7 per cent in July 2008. This deterioration has been rapid, measured in historical terms; the upturn of 0.7 percentage points in the past three months can only be matched by the steepest upturn phases during the 1990 and 2001 recessions.

US: Unemployment rate and employment

Per cent, monthly change (thousands)



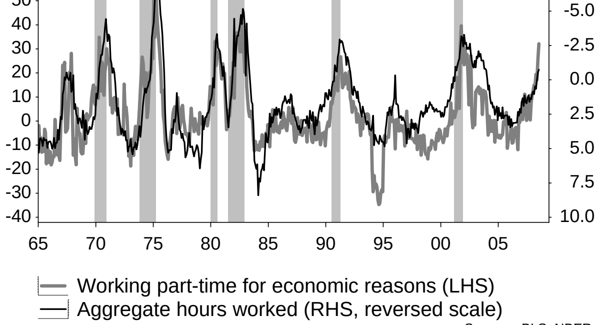
Sources: BLS, NBER

Although employment has fallen for seven months in a row and the job market has shrunk by nearly 500,000 since the end of 2007, the downturn in total jobs has been mild viewed in a historical perspective. But according to various current indicators, the **job downturn may also accelerate**.

One reason why employment has been fairly resilient may be that companies – believing that the economy will soon bounce back – have trimmed the number of hours worked instead of laying off employees. But the average work week is now at its lowest level in the 44-year history of this data series, so it can hardly become much shorter. Faced by weakening demand, there are many indications that **companies will change strategy and instead respond with lay-offs**.

US: Working part-time & hours worked

Year-on-year percentage change



Sources: BLS, NBER

People who are involuntarily working part time for economic reasons increased by 5.7 per cent between June and July and 32 per cent year-on-year, an upturn previously reserved for recessions. In recent months, employment at temporary staffing companies has also turned downward. Temp companies are usually a good leading indicator of total employment growth.

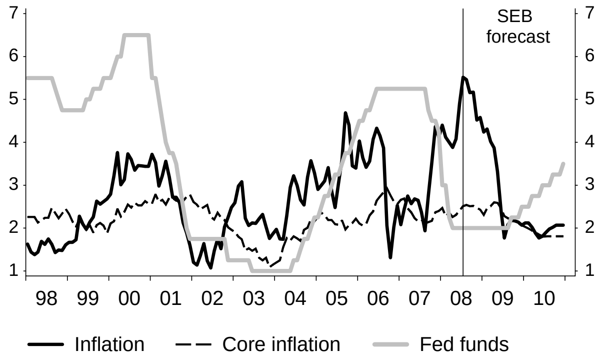
After adding the adverse trends in unemployment benefit claims, corporate hiring plans and lay-off notices, labour market prospects look rather gloomy. Because of these signals, combined with the lengthy period of below-trend growth ahead of us, we are now adjusting our forecast of the jobless rate upward. **Unemployment will rise to more than 7 per cent early in 2010**. This implies an upturn similar to the historical average during cyclical slowdowns.

Count on a new stimulus package

Fiscal stimulus packages are normally followed by additional measures. This is a natural consequence of the frequent tendency to under-estimate the depth of a cyclical slump. The economy chugged along at a decent pace during the second quarter, so a new package is hardly likely to be placed on the fast track before the November presidential election. Our forecast assumes that Congress will approve a new stimulus package in February 2009, which will benefit the US economy by around mid-year. In light of the economic policy debate that has been pursued to date, it is reasonable to expect a stimulus package equivalent to USD 50 billion: substantially smaller than the first package. We expect it to focus on long-term stimulus measures such as infrastructure investments and subsidies to state governments.

US: Inflation and fed funds target

Year-on-year percentage change, per cent



Sources: US Dept of Commerce, Fed, SEB

The costs of rescuing the federally backed mortgage institutions Freddie Mac and Fannie Mae have been estimated at USD 25 billion by the Congressional Budget Office. The final cost may be substantially larger than this, however, which might limit room for other types of support packages. If the Treasury actually uses its authority to purchase GSE debt or securities, the cost to the federal government could easily double.

As we have noted earlier, the weak economy has tilted this autumn's US presidential election towards a change of party in the White House. The role of the economic situation in determining the election outcome is also reflected in market prices. There is currently about a 60 per cent probability that Democratic candidate Barack Obama will end up as the winner; last summer when oil prices were at their highest and the stock market at its lowest, the market gauged this probability at 72 per cent.

However, public opinion surveys indicate that Republican candidate John McCain is actually gaining ground. The latest nationwide measurements show nearly a dead heat between the two candidates, yet our assessment is that Obama will win the presidency. The election outcome will have hardly any significant impact on the economic situation or on the dosage of fiscal stimulus, although in case of a Democratic victory, further tax rebates to households are likely to assume a more pivotal role in economic policy.

Altogether, this means that the federal budget deficit next year will end up at around USD 700 billion, equivalent to a historically high 5 per cent of GDP. We nevertheless do not expect the lower public saving level to interrupt the slow trend towards a shrinking US current account deficit over the next few years.

Inflation will fall

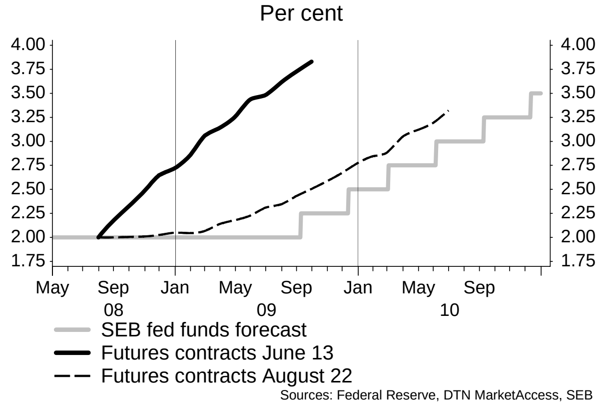
Consumer Price Index inflation has climbed rapidly during 2008, driven by energy and food prices. Inflation will peak at 5.5 per cent in July/August and then fall during the autumn. The upturn in core inflation has meanwhile been very modest. Core inflation according to the Personal Consumption Expenditures (PCE) deflator stood at 2.3 per cent in June, which is somewhat above the Fed's tolerance level.

After this summer's inflation worries, most measures of long-term inflation expectations have fallen. Our forecast also implies that inflation will slow greatly ahead. Measured as **annual averages, CPI inflation will fall from 4.6 per cent in 2008 to 2.9 per cent in 2009**. One reason is that the contribution from energy and food will fall from 2½ to ½ percentage point. Lower resource utilisation in the economy will also help push down core inflation. Both in 2009 and 2010, core inflation will be around 2 per cent.

Fed will hold off long and patiently

According to our assessment the economic recovery will take time, and new growth disappointments will come during the autumn and winter once the effect of the fiscal stimulus package fades. Our forecast, however, is that the Fed will let its key interest rate remain unchanged until the second half of 2009. Meanwhile the risk of even larger growth disappoints in the immediate future implies that short-term downside risks predominate. The minutes of the Federal Open Market Committee meeting on August 5 showed no bias towards hiking the federal funds rate, in our view.

US: Fed funds futures vs SEB forecast



Because the economic slowdown will be rather lengthy, 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**. Given our unemployment forecast, this would imply that the Fed will not raise interest rates until 2010. But we believe that, wise from earlier policy mistakes, the Fed will hike its key rate somewhat faster this time.

When the financial market situation has stabilised and home prices have stopped falling, we thus believe that the central bank will begin a cautious adjustment of its key rate. According to our forecast, the **federal funds rate will be 2.50 per cent in December 2009 and 3.50 per cent in December 2010**.

According to futures pricing, the Fed will begin hiking its funds rate well before this. As recently as a few months ago, during the worst period of inflation worries, far more aggressive hikes were priced into the fixed income market.

On the cusp of recession

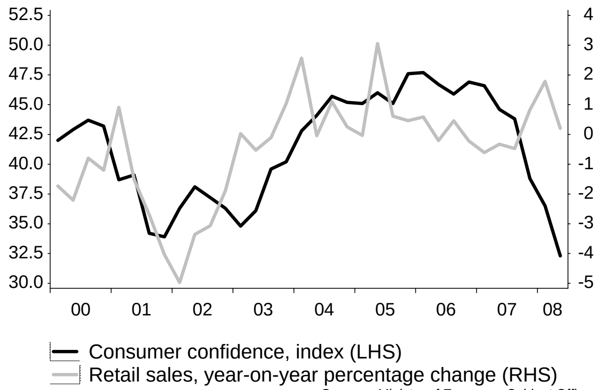
- **Free fall in the second quarter**
- **Weak exports and private consumption**
- **Unemployment and inflation climbing**
- **Stimulus package on the way**

The Japanese economy is now weakening on a broad front as a consequence of weaker demand abroad and domestic credit tightening. We anticipate that **GDP growth will cool from 2.0 per cent in 2007 to a low 0.7 per cent this year and 1.0 per cent in 2009**, a downward adjustment of 0.5 percentage points this year and 0.2 points in 2009 from our May forecast.

Like many other countries, Japan showed unexpected economic strength in the first quarter, when GDP growth totalled 4 per cent at a recalculated year-on-year rate. During the second quarter, however, **the economy shrank by a full 2.4 per cent**: the largest downturn in seven years. The outlook for the near future does not look promising. The GDP downturn is broad; all items except for stockbuilding are now declining. Exports are being pulled down by weaker sales to the US. Even more worrisome is that weaker trade with other Asian countries is contributing to **reduced resilience to the American deceleration**.

In addition, **private consumption is providing less and less support to growth**. Japanese consumer confidence is lower than it has been for a quarter century. This indicates that there will be a **significant fall in retail sales during the next few months**.

Japan: Confidence and retail sales



Sources: Ministry of Economy, Cabinet Office

The credit crisis has now sunk its claws into the Japanese economy. According to Bank of Japan statistics, lending levelled off in July. Tighter lending primarily affects medium-sized, newly established companies in great need of additional capital. A number of housing and real estate companies have gone bankrupt, and sales of both small apartments and commercial properties are sluggish due to the uncertain future outlook.

Last year's weak investment trend, caused by a temporary collapse in residential construction due to rule changes, is now being followed by an **even weaker capital spending year**. Greater uncertainty in the property market, combined with diminished interest from foreign financial institutions, is hampering construction. **Investment in machinery will also remain weak this year**, according to the Tankan business survey. Gross investments will fall about one per cent this year, then level off next year.

Unemployment has turned upward. It bottomed out at 3.6 per cent last year and stood at 4.1 per cent in June this year, slightly above the OECD's measure of the non-accelerating inflation rate of unemployment (NAIRU). The upturn will continue at a moderate pace over the next couple of years.

CPI inflation has climbed rapidly this year: from 0.7 per cent in January to 2 per cent in June. Rising inflation pressure is visible, for example, in wholesale price inflation, which noted a 27-year high in July. Recent declines in the prices of oil and other commodities, however, indicate that **producer prices will peak as early as the third quarter of this year**. We expect CPI inflation to end up averaging 1.6 per cent this year and somewhat less in 2009.

The Bank of Japan now faces a dilemma; **today's low call money rate leaves it with very little manoeuvring room**. An interest rate cut from the current 0.5 per cent level would hardly stimulate the economy to any great extent. Japan's newly appointed economic and fiscal policy minister, Kaoru Yosano, has indicated that the economy would even benefit from an interest rate hike, since this would boost the return on household savings. Such a rate hike would actually be consistent with the BoJ's previous ambition of "normalising" the key rate to an estimated 2-2.5 per cent, but it is hardly likely that the bank will venture to take a risk like this at a time when the economy is sliding and the global business cycle is weakening. We thus anticipate that the **call money rate will remain at a low 0.50 per cent until June 2010 when it is raised to 0.75 per cent**.

Late in August, the government of Yasuo Fukuda is expected to unveil the details of a **fiscal stimulus package** expected to include investments in various infrastructure projects.

Continued overheating risks

- **Strong domestic demand is driving growth**
- **Underlying price pressures are intensifying**
- **Official tightening and loosening at same time**

China's economy is still showing **no clear signs of slow-down**. Looking ahead, however, world economic deceleration combined with current and future economic policy tightening measures will result in a **gradual downshift in growth. The GDP increase will fall from 10 per cent this year to 8 per cent** annually in 2009-2010. Despite slower growth, overheating risks will remain.

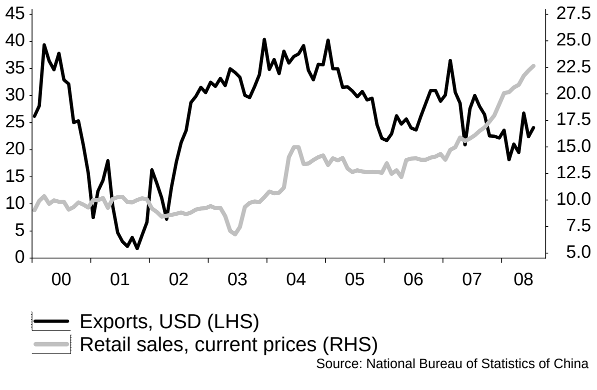
GDP rose by 10.4 per cent in the first half: only a slight deceleration compared to 12 per cent during 2007 as a whole. Growth remained rapid despite higher interest rates, stricter bank reserve requirements, yuan appreciation against the USD and administrative regulations. Nor did such factors as last winter's severe weather or the earthquake in May affect reported GDP growth. Forward indicators do not point towards any clear change in trends either.

Strong domestic demand

Rapidly growing investments are and will remain the main economic engine. **Consumption is also expanding strongly**, including accelerating retail sales during the past few years. However, the downturn in global demand has had some impact on export growth, which has slowed to 20-25 per cent in current prices. The cool-down is continuing. China's gigantic trade surplus has levelled off during the past six months. Adjusted for rising oil prices, which have driven up the country's import bill substantially, the surplus has continued to rise. In rolling 12-month figures, it is now at a record level of USD 375 billion.

China: Exports and retail sales

Year-on-year percentage change, 3-m average



Source: National Bureau of Statistics of China

The Olympic Games will probably only **provide a marginal growth stimulus**. Beijing, where most Olympic events took place, accounts for 3-4 per cent of China's GDP. According to the country's National Bureau of Statistics, preparations for the Games have added 2.5 percentage points in extra annual growth to Beijing since 2002. Recalculated, this means an accumulated contribution to the Chinese economy of about 0.5 percentage points during this period. Nor do we predict any major upturn in GDP as a result of increased tourism connected to the Games in August.

Overheating risks despite measures

Overheating tendencies persist. The average rate of wage hikes is 21 per cent, while the inflation rate stands at around 6 per cent after a slight decline during the summer. The inflation upturn is admittedly 90 per cent connected to food, but there is still a risk that it will fuel rising inflation expectations and further wage growth acceleration. A large continued influx of **speculative capital** will also help increase near-term threats to economic stability.

In our assessment, **overall inflation will now continue to fade**, due to gradually diminishing contributions from energy and food. Remaining underlying cost pressures, consisting mainly of rapid wage hikes, will nevertheless result in a relatively slow downturn in the inflation rate.

For several years, Chinese authorities have resorted to a **battery of economic tightening measures**, including interest rate hikes, regulation of capital flows and currency appreciation. Due in part to the increasingly clear international slowdown, however, the authorities have at least temporarily **chosen a strategy of both tightening and loosening their official economic policy**. In recent months, exchange controls have been tightened in order to limit the influx of speculative capital attracted by the prospect of continued yuan appreciation. On the other hand, certain subsidies have been introduced for such companies as textile exporters. Lending quotas for banks have also been increased for the purpose of stimulating lending, especially to small businesses.

This year, the central bank has halted its interest rate hikes, but we anticipate new hikes ahead. The pace of yuan appreciation against the US dollar has also slowed greatly in recent months, but the recovery of the dollar against other world currencies will keep the effective appreciation rate up.

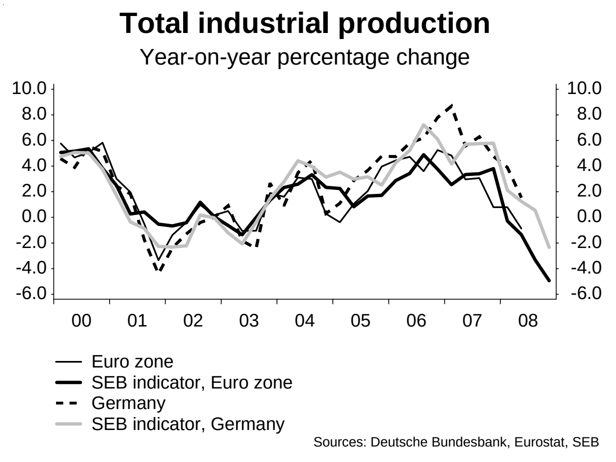
Clear deceleration

- **Risk of recession in a number of countries**
- **Upturn in unemployment this autumn**
- **Little room for fiscal stimulus measures**
- **ECB will lower its refi rate in March 2009**

The euro zone economies are now decelerating sharply after a relatively strong start this year. We anticipate that **GDP growth will reach only 1.2 per cent this year and 0.8 per cent in 2009**. The cyclical downturn, combined with falling energy prices and shrinking contributions to inflation from food, will lead to a significant drop in inflation as measured by the Harmonised Index of Consumer Prices (HICP). The European Central Bank will thus eventually ease its monetary policy and take action at long last by stimulating the economy. We expect the ECB to begin its interest rate cuts early next year, lowering the refi rate to 3.0 per cent by some months into 2010.

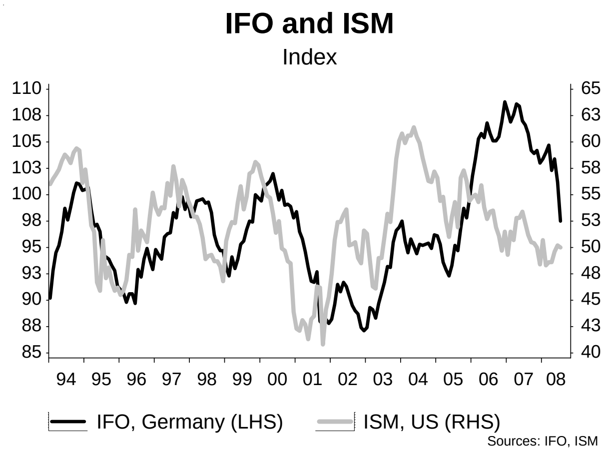
Drastic shift in sentiment

GDP growth weakened dramatically during the second quarter. GDP fell by 0.2 per cent after an unexpectedly large 0.7 per cent quarter-on-quarter upturn in the first quarter. The biggest shift occurred in Germany, where GDP growth dropped from 1.5 to -0.5 per cent quarter-on-quarter.

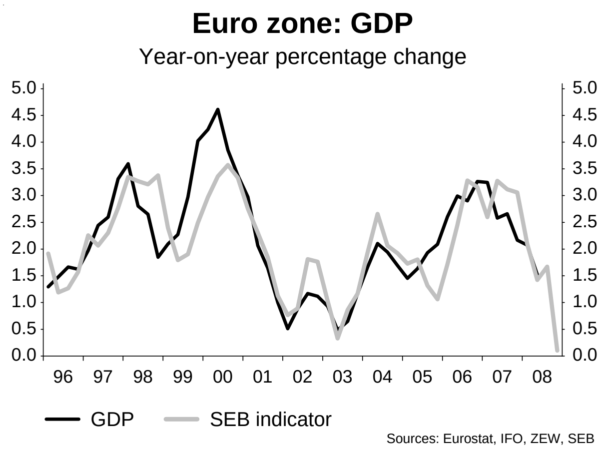


Although the swing in growth was amplified by various technical factors, such as warm winter weather that sustained activity in the construction sector during the first quarter, there is little doubt that the euro zone economies have entered a persistent deceleration. A number of indicators have fallen in recent months. In July, for example, Germany's **IFO industrial index** fell substantially more sharply than expected. Industrial production has fallen in most euro zone countries and sectors. SEB's forward-looking euro zone indicator, which predicted the summer downturn to a significant extent, also foresees **even sharper negative figures in industrial production during the rest of this year**. In that case, the downturn would be even deeper than when the IT bubble burst in 2001.

The downturn in euro zone industrial production is hardly being offset by a growing service sector. **Retail sales** fell 3 per cent in June, measured year-on-year. Current weakness in consumer confidence is pointing towards weakness in the distributive trades for some time to come. According to our private consumption indicator, the slump will be deeper than in 2001 in this sector as well.



Our conclusion is that the combined effects of the American slowdown, high inflation, tighter credit, interest rate hikes and the record-strong euro will now begin to put a serious crimp in both domestic demand and exports. We thus expect the euro zone to face a cyclical slump. **GDP growth will end up at 1.2 per cent this year, 0.8 per cent in 2009 and 1.3 per cent in 2010**: a growth trajectory that lies clearly below both the prevailing consensus view and trend growth.



We have previously listed a number of reasons why the euro zone should be better able to cope with the coming growth slump than such countries as the US and the UK. These have included relatively strong household balance sheets, vigorous demand from the fast-growing economies of Eastern Europe and Asia as well as the lack of excesses in certain housing markets, especially in Germany. These factors will of course help to blunt the slowdown. On the other hand, there are major differences between the US and the euro zone when it comes to economic policy programmes aimed at sustaining growth. The differences in interest rate policy have also led to an exchange rate trend that is easing the pain in the US but reinforcing the slowdown in the euro zone. Together with especially profound problems in southern Europe, the outcome is that we now anticipate that the euro zone will report even lower average GDP growth than the US during 2008-2010.

Little room for budget stimulus

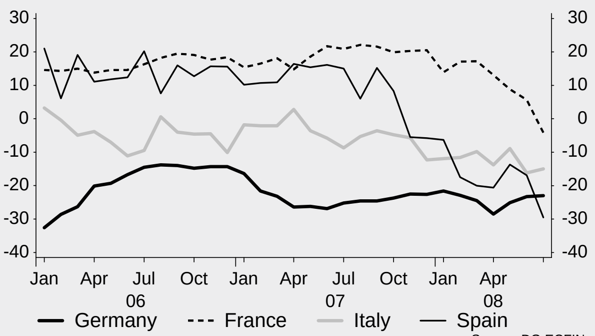
Several countries in the euro zone are facing the impending cyclical slowdown with relatively weak public sector finances, despite some attempts to create long-term improvements in their budget situation. This means that **room for fiscal stimulus is rather small.** The Stability and Growth Pact's ban on budget deficits exceeding 3 per cent of GDP limits freedom of action.

Major regional differences

Although the euro zone slump is now widening, major regional differences remain. The situation in the housing market plays a key role in the dynamic of the slowdown. In addition, the growth slump is revealing a number of structural problems in various countries that were hidden to some extent by the preceding economic boom.

Euro zone: Activity in the construction sector

Net balance



Source: DG ECFIN

In Spain, statistics from recent months indicate that home prices are falling in large portions of the country. We expect the situation to continue deteriorating, which will have adverse consequences for both consumption and construction activity. In other countries, too, the housing market has cooled noticeably; not surprisingly, this is true of countries where home price inflation has been particularly pronounced — especially in Ireland but also to some extent in Italy, France, Belgium and Austria. In contrast, home prices and the construction market have shown a stable trend in Germany, among other countries.

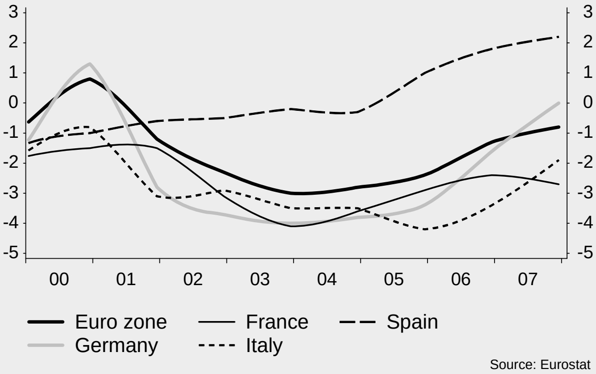
Italy's crisis now seems severe. GDP growth appears likely to end up close to zero, both this year and next. In Germany, however, we expect growth to remain at a decent level despite everything, with GDP growth reaching 1½ per cent this year and 1 per cent in 2009. In 2010, growth will pick up again to about 1.5 per cent. The French economy will grow by 1.2 per cent this year and 1 per cent in 2009.

This situation is very troublesome for the ECB. The need for interest rate cuts varies sharply between euro zone countries. This is not only due to different GDP growth. Differences in competitiveness between such countries as Germany and Italy mean that they are not equally sensitive to the exchange rate effects of interest rate policy. The crisis in many countries is rooted in the housing market, a portion of the economy that is highly sensitive to interest rates. This also helps exacerbate the problem. The restrictions on fiscal deficit measures imposed by the EU's Stability Pact also reinforce the differences in the need for interest rate stimulus.

In recent months, regional tensions and the crisis in southern Europe have been reflected in investors' view of credit risk in individual euro zone countries. The price of a credit default swap (CDS), a kind of insurance against bond default, has increased in countries threatened with the sharpest deceleration and where uncertainty about economic and political stability is greatest. This **applies especially to Greece, Italy, Portugal and Spain**, whereas France and Germany have managed relatively well to date. Yield spreads on long-term government securities can also serve as an indicator of how the market interprets the risk situation.

Budget balance

Per cent of GDP



Source: Eurostat

The situation is reminiscent of 2001-2003, when such countries as Germany and France exceeded the budget deficit target, triggering lengthy sanction processes against them. It is true that since then the Pact has been softened somewhat to allow small temporary infringements if GDP growth is negative. In spite of this, the Eurogroup (consisting of the euro zone finance ministers) is likely to be sharply critical of countries that let their budget balance deteriorate too fast.

At present the countries at greatest risk of exceeding the 3 per cent cap over the next couple of years are France, Italy, Portugal and Ireland. Other euro zone countries will also see deteriorating budget balances, albeit within the framework of the Pact.

The **German federal budget** showed a balance last year. Although 1.6 million more Germans have found jobs since Angela Merkel became chancellor in 2005, this has not been enough to generate a surplus. Early in 2008, forecasts were pointing to a positive outcome this year, but due to economic cooling we now expect the budget outcome to end up close to zero again. Next year we foresee a federal deficit of almost 1 per cent: a disappointment for the government, which has put a major effort into the budget consolidation process. The distance between this and a 3 per cent deficit is nevertheless rather large, which may lead to fiscal stimulus measures in the run-up to the Bundestag election in September 2009.

In **France**, President Nicolas Sarkozy previously resisted the EU's calls for a balanced budget by 2010, focusing instead on tax cuts in order to get the economy moving. Today the budget situation will hardly permit further stimulus measures. Sarkozy is instead trying to speed up a reform process that includes steps to improve France's competitiveness and boost efficiency in its financial system.

The large **Italian deficit shrank last year** thanks to tight fiscal policy, but the new centre-right coalition headed by Silvio Berlusconi campaigned on various proposed tax cuts. Considering the country's worsening growth prospects, it is not likely that these proposals can be implemented without pushing the budget surplus beyond 3 per cent again.

In **Spain**, the government's budget prospects look better. The reason is a consolidation process that has improved the structural budget situation. Last year the budget showed a surplus of just above 2 per cent of GDP. This year's outcome will be just above zero due to the sharp slowdown in the economy and a stimulus package of 1 per cent of GDP that the government unveiled last spring. We expect the budget situation to allow some additional stimulus measures without threatening to exceed the 3 per cent deficit cap.

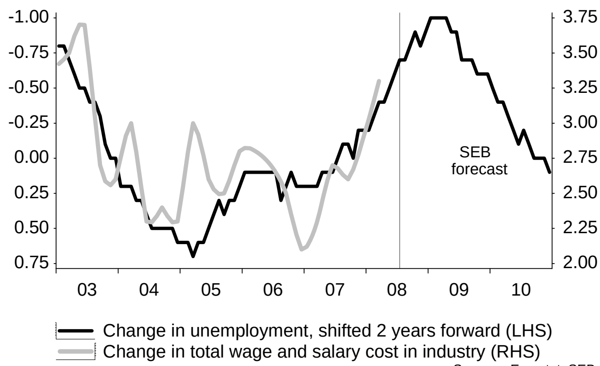
Unemployment on the way up

Unemployment in the euro zone as a whole stood at 7.3 per cent in June. It thus remained below the OECD's equilibrium measure. Considering the rapid deceleration in output and **lower hiring plans**, the jobless rate is likely to start climbing. The differences between countries are clear, however. In Spain, unemployment has already climbed sharply. In Italy too, an upturn is discernible. Yet there are **still no signs that the Germany economic deceleration has begun to cool off the labour market**. The national unemployment measure fell to a 16-year low in July. Nor has unemployment begun climbing in France.

Due to earlier labour market improvements, the rate of pay increases in the euro zone has risen from just over 2 per cent in early 2007 to around 3¼ per cent.

Euro zone: Unemployment and wages

Percentage points, per cent



Sources: Eurostat, SEB

Employee demands for compensation due to the recent surge in inflation may lead to further acceleration of pay increases. In Germany, for instance, trade union wage demands have been higher than for many years. Given rising unemployment, however, we do not believe that tendencies towards faster pay increases will be especially strong or long-lasting. A forecast based on the historical association between changes in unemployment and future pay increases indicates that hourly pay increases will peak at about 3.7 per cent during the first half of next year, then fall towards 3 per cent early in 2010.

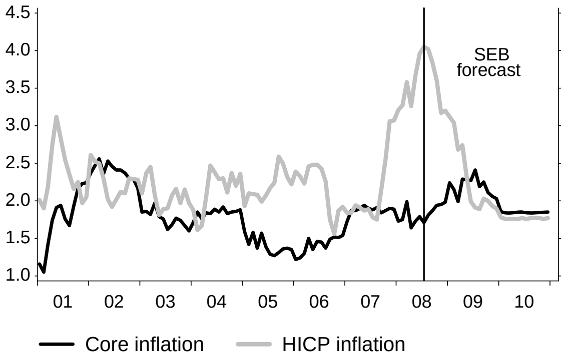
Inflation has peaked

In July HICP inflation reached 4 per cent, the highest rate since the euro was introduced. In less than one year, inflation has thus more than doubled. During the same period, core inflation has largely remained unchanged at somewhat below 2 per cent, which illustrates the decisive role of energy and food prices in the inflation upturn.

As energy prices fall and effects of food prices fade, the HICP inflation rate will now decline. At the end of 2008 it will stand at around 3 per cent and in December 2009 at 2 per cent. **HICP will average 3.6 per cent this year, 2.3 per cent in 2009 and 1.8 per cent in 2010**. We expect the contribution from energy and food to decline from 1.4 to 0.4 percentage points between 2008 and 2009. Underlying inflation will increase somewhat the coming year, but will then return to just below 2 per cent again. **Core inflation will average 1.8 per cent this year, 2.2 per cent next year and 1.8 per cent in 2010.**

Euro zone: Inflation

Per cent



Sources: Eurostat, SEB

Weaker economic performance is likely to result in slower core inflation. For example, our growth profile implies that today's nearly closed output gap – defined as the difference between actual and potential output – will widen. By the end of 2009, available economic resources will be equivalent to about 2 per cent of GDP, reducing price and wage pressure.

Meanwhile certain factors will help keep up inflation in the short term. Wage and salary increases will continue climbing for a while, and labour productivity growth will probably weaken in line with the historical cyclical pattern. According to our forecast, productivity growth will fall to 0.2 per cent early next year and then slowly creep upward towards 1 per cent late in 2010. Inflation pressure from unit labour cost will thus persist. Moreover, the euro will fall somewhat from record-strong levels, which will also contribute to inflation.

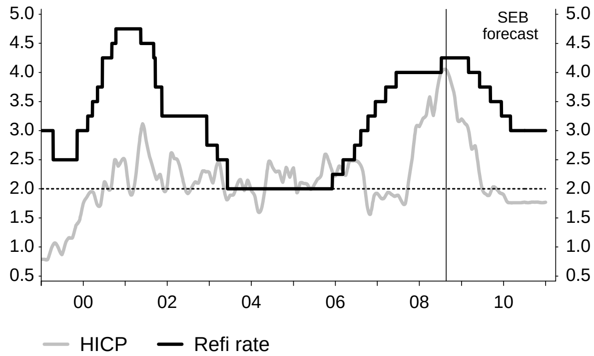
Overall, downside risks will dominate when it comes to the inflation-fuelling role of international price developments for energy and other commodities. On the other hand, there is a risk that domestic inflationary forces will linger a bit longer than we had anticipated. Our assessment is thus that the **risk picture in our inflation forecast is balanced**.

ECB will start cutting rates in March

For the time being, record-high inflation will keep the ECB from planning any interest rate cuts. Earlier, the bank stubbornly declared that interest rate cuts are out of the question in an environment of high inflation, high inflation expectations, a strong labour market and relatively fast growth in credit and money supply. Late in the spring, when inflation worries culminated, this tough rhetoric generated expectations that the ECB would deliver a series of interest rate hikes during the second half of 2008.

Euro zone: Inflation and refi rate

Per cent

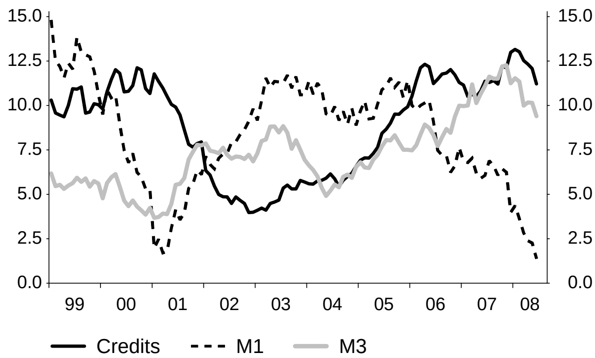


Sources: Eurostat, ECB, SEB

However, the gloomy macroeconomic performance of recent months has largely changed the playing field. With the slowdown now also broadening to Germany, the time for interest rate cuts is approaching. In recent months, the ECB has also softened its rhetoric noticeably. Even as the ECB raised its key rate in July, it wanted to tone down expectations of further rate hikes, and this message was reinforced when the bank announced its decision in August to leave the refi rate unchanged.

Euro zone: Credits and money supply

Year-on-year percentage change



Source: ECB

According to our forecast, HICP inflation will fall towards 3 per cent by late 2008 and be just above 2.5 per cent in March next year. This is admittedly higher than the ECB's target of just below 2 per cent, but history shows that the bank may very well cut its refi rate anyway. In May 2001, for example, the ECB lowered the refi rate from 4.75 to 4.50 per cent even though inflation was then running at 3.1 per cent. We thus anticipate that the combination of a clearly cooling economy and falling inflation early next year will be enough to persuade the ECB to reverse itself and begin to care more about weak economic performance than high inflation. The first interest rate cut from 4.25 to 4 per cent will come in March 2009 and will be followed by three further cuts the same year. The **refi rate will stand at 3.25 per cent at the end of 2009**.

Also helping to strengthen the arguments in favour of interest rate cuts is that credit and money supply growth (M1 and M3) have fallen somewhat in recent months and inflation expectations have again cooled, at least in a way that is discernible in the index-linked bond market. The very flat yield curve (the difference between the ten-year bond yield and the refi rate is close to zero) is usually another sign of an economic cool-down and of approaching interest rate cuts.

Full stop

- **Home prices in free fall**
- **Pound will continue to weaken**
- **Key interest rate will be cut to 3.50 per cent**

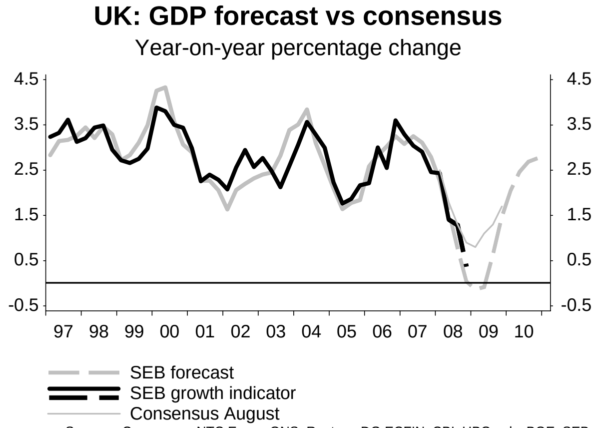
The British economic outlook has become gloomier during the summer, and **we expect negative growth during the second half of 2008**. A combination of high inflation, falling home prices, tougher credit conditions and weak real income growth will squeeze households, while the corporate sector will also retrench. **GDP growth will reach only 1.2 per cent in 2008 and 0.5 per cent in 2009.** This slowdown thus marks the end-point of a record-long period of expansion. So far, the consensus forecast is significantly higher for both years. The recovery will come only in 2010.

The housing market has collapsed and home prices are falling at a more rapid rate than in the early 1990s. The Nationwide index shows that home prices fell by 8 per cent year-on-year in July (more than 9 per cent since peaking last autumn). According to the Halifax index, prices are falling even faster. The expectations of estate agents remain at near record-low levels, according to the RICS survey, which usually provides good guidance for price trends looking ahead six to nine months. The number of mortgage loan approvals has fallen sharply, at least partly reflecting increasingly tough bank lending conditions.

According to the IMF, British home prices are over-valued by about 25 per cent. Our assessment is that **home prices will fall by 25 per cent from their autumn 2007 peak**. Sensitivity analyses indicate that this will dampen consumption by 2 per cent and GDP by 1.5 per cent during 2009. The risk is that the home price downturn will be both deeper and more prolonged, which in that case would delay the recovery and lead to larger losses in the financial system. In July, the Confederation of British Industry retail indicator fell to its lowest level in 25 years, also signalling that the **consumption boom is over this time around**.

The slowdown in the corporate sector is becoming ever clearer. The combination of ever-tighter credit conditions, weak demand and sagging productivity is squeezing profits. Company capital spending has already cooled sharply, and most signs are that this trend will continue. Confidence indicators in both manufacturing and the construction and service sectors are close to the lowest levels ever measured.

According to our own growth indicator, **GDP growth will fall by just below one per cent** (annualised) **during the third quarter**, and the fourth quarter outlook does not look much better. With GDP growing at far below trend, unemployment will climb significantly from its current very low levels.



Sources: Consensus, NTC Econ., ONS, Reuters, DG ECFIN, CBI, HBOs plc, BOE, SEB

In July, the inflation rate was 4.4 per cent. **Inflation** will probably continue **rising to around 5 per cent during the autumn**: the highest level since 1992. Rising prices and inflation expectations have blocked the Bank of England (BoE) from being able to ease the economic slowdown by means of further interest rate cuts. The weakening of the government budget balance in recent years also means that **no fiscal stimulus package can be expected**. On the contrary, the government has signalled the need for tighter fiscal policy to meet its budget target. Meanwhile the Labour government is hard-pressed by poor public opinion figures. Prime Minister Gordon Brown's personal position has been undermined, making the political situation more uncertain than for a very long time.

Late this autumn, however, inflation will begin to fall as food and energy price increases disappear from the twelve-month figures. The BoE will gain some manoeuvring room and **lower its repo rate to 4.75 per cent in November**. Further rate cuts will come next year as resource utilisation in the economy falls and the risks of secondary effects on inflation decline. **At the end of 2009, the key rate will stand at 3.50 per cent.**

Since July 2007, the pound has weakened by around 15 per cent in trade-weighted terms. **The BoE rate cuts will contribute to a continued weakening of the pound**, albeit not at the same rapid pace. Above all, we anticipate a weakening against the US dollar and thus also against dollar-pegged currencies. The **export sector** will receive continued help from foreign markets**, preventing an even deeper cyclical slump**.

Gradual cool-down

- **Exports are slowing**
- **Domestic demand is sustaining growth**
- **Signs of overheating in Russia and Ukraine**

Central and Eastern Europe is showing continued relatively strong growth, except for the stalling Estonian and Latvian economies and slowly recovering Hungary. Consumption and investments are growing at a healthy pace, though rates of increase are slowing in most countries. The global downturn is starting to be more clearly evident, however, as important Western European markets weaken. **GDP growth in the nine countries of the region covered here, including the Baltics, will slow** from 6.3 per cent this year **to 5.5 per cent in 2009 and 5.0 per cent in 2010**; we have adjusted our forecast for 2009 somewhat downward compared to the May issue of ***Nordic Outlook***.

Inflation problems have intensified. The causes are both overheating tendencies in various countries and rising energy and food prices. Late in 2008, inflation will begin to slow in most places as energy prices fall and food prices enter a calmer phase. Inflation will fall quite slowly in Russia, Ukraine and the Baltics. The reason is high wage increases. **Continued large current account deficits** are expected in many Central and Eastern European countries in the next few years, due to relatively rapid import growth, except in the Baltics.

The Russian economy will continue to grow rapidly. GDP will climb by 7.5 per cent this year, after which a gradual slowdown to 6 per cent in 2010 will occur. High oil prices are stimulating domestic demand and will continue to generate large surpluses in the budget and the current account. The slowdown in growth will primarily be due to supply-side restrictions and the cooling global economy. Inflation has nearly doubled in the past year and stands at 15 per cent. Partly due to overheating risks, the central bank has repeatedly hiked interest rates and boosted reserve requirements. The government has also introduced various types of food regulations. The rouble has continued to trend upward somewhat and the central bank is continuing its long-time policy of allowing cautious currency appreciation in order to combat inflation.

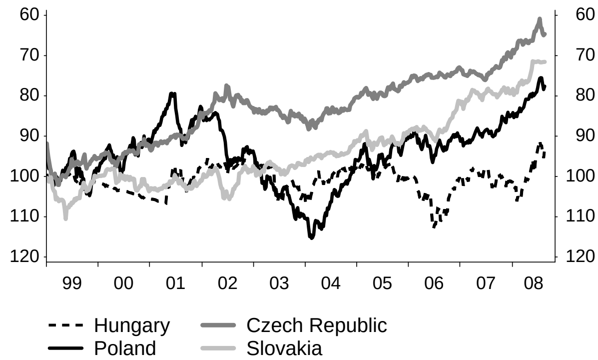
In **Ukraine**, overheating risks have intensified since last spring and political uncertainty has risen. The current account deficit has continued to rise quickly. The inflation rate is sky-high, and despite a slowdown we expect it to be around 20 per cent at year-end. Continued expansive fiscal policy, including large wage and salary increases for public sector employees, will help fuel overheating. The economy will slow as a consequence of a deterioration in purchasing power and a cool-down in commodities markets. GDP will increase by 6 per cent in 2008 and 4 per cent annually in the following two years.

In **Central Europe**, forward-looking indicators have generally pointed downward in recent months. Significantly, the declines have been largest in manufacturing, i.e. the most export-oriented sector of the economy. Service and consumer sentiment indicators have generally held up better and are still at historically high levels. Partly because of this, we regard the risk of sudden deceleration in Central Europe as relatively small. This is especially true of **the Polish economy**, whose export dependence is relatively low. Polish households have recently become less optimistic. However, retail sales have grown by a robust 15 per cent year-on-year rate. Corporate investments will also continue to benefit from large-scale EU support. Polish GDP growth will gradually slow from slightly above 5 per cent in 2008 to 4.5 per cent in 2009.

Partly due to the international slowdown, **key interest rate hikes in Central Europe will soon end**. The Czech Republic shifted its policy and lowered the key rate in August. A rate hike may occur in Poland. Next year, key rates will generally be lowered.

Central Europe: Exchange rates vs the euro

Index January 1999 = 100



Source: Reuters EcoWin

Partly because of interest rate hikes by central banks, **Central European currencies have appreciated sharply** since spring. In July-August these currencies were at record levels against the euro. Lately, there has been some weaknesses. However, we expect continued long-term underlying appreciation pressure, mainly because of lingering differences in growth rates compared to the West and a positive interest rate difference. Slovakia will launch the euro at the beginning of 2009. Its currency is now trading at close to the conversion rate against the euro (SKK 30.13) announced in July.

Baltics: Estonian-Latvian hard landing

The Baltic economies are now entering a **lengthy slowdown**. Economic conditions have deteriorated rapidly in recent months. **Estonia's** growth has fallen from 11 per cent in the fourth quarter of 2006 to minus 1.4 per cent in the second quarter of 2008, measured year-on-year. In **Latvia**, the deceleration has been even more dramatic. GDP growth, which stood at 11 per cent as recently as the third quarter of last year, cooled to 0.2 per cent during the second quarter. Expectations among Latvian households and companies have collapsed this year; in the European Commission's latest monthly measurement, the level was the lowest since 1993. In **Lithuania**, however, the economic downshift is more gentle, as confirmed by growth that remained at 5.5 per cent in the second quarter of 2008.

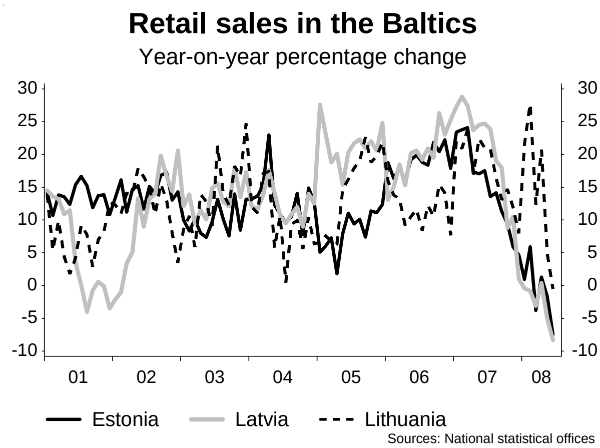
During the summer we have revised our Estonian and Latvian forecast considerably downward. We now expect Estonian GDP to shrink by 2.0 per cent this year and increase by 1.5 per cent in 2009. Latvian economic growth will be a mere 0.3 per cent this year and 1.5 per cent in 2009. Lithuania's growth will slow from 5.5 per cent in 2008 to 4.0 per cent next year. These forecasts imply downside risks. In 2010 there will be a degree of recovery in Estonia and Latvia, while the Lithuanian economy continues to slide. None of these countries will rebound to its potential growth rate of roughly 6-7 per cent.

The change in the economic climate is primarily due to **continued adjustment in property and credit markets after the previous overheating**. Corrections in these markets will continue for at least another six months before stabilisation becomes discernible. In addition, high inflation — mainly via energy and food prices — will undermine purchasing power. Taken together, this will lead to continued anaemic demand. So far, the weakening of labour markets has been modest, but we anticipate a clear upturn in unemployment ahead.

So far, export growth has held up reasonably well, but the global economic slowdown and weakened competitiveness will also cool external demand. This is especially true of Estonia, whose exports are being hampered among other things by sagging markets for electronic products. To date, Lithuania and Latvia have benefited from continued good sales in such key export industries as oil and timber products, but a weakening is on the way in these sectors as well.

The economic downturn will contribute to an easing of the imbalances that have built up during the recent overheating, most accentuated in Estonia and Latvia. The problems of **large current account deficits and high inflation** nevertheless remain **persistent challenges** for these countries.

The degree of economic policy freedom is relatively small. Unlike the situation in Central European countries, interest rate policy in the Baltics is hampered by fixed currency exchange pegs. It is also difficult to foresee any effective fiscal policy strategy in a situation where high cost increases are undermining competitiveness while rapidly weakening economic conditions will eventually create large holes in government budgets. However, Estonia is continuing to tighten its fiscal policy, among other things by proposing a freeze on public sector pay.



Given the rigidities we see in economic policy, flexibility in price and wage formation is highly important. If the export sector is to continue playing a stabilising role — contributing to growth and declining current account deficits — the rate of wage increases must rather quickly be adjusted downward.

At present, however, it is difficult to be especially optimistic. We do expect pay increases to decline greatly next year, but not enough to keep competitiveness from deteriorating. Inflation will remain relatively high. In Lithuania we expect inflation of 11 per cent in 2009, in Latvia 6 per cent.

A sharp drop in imports will help bring down the Estonia's current account deficit to about 7 per cent of GDP, a level that will enable the country to stabilise its foreign debt as a percentage of GDP. In Latvia and Lithuania, the situation looks worse. Our forecast thus implies that the imbalances in the Baltic countries will persist despite the ongoing economic slowdown. This means that the chances of adopting the euro appear distant and that some uncertainty remains regarding the sustainability of the existing exchange rate pegs.

Lengthy cyclical slowdown

- **Three years of growth clearly below trend**
- **Rising unemployment in 2009 and 2010**
- **Expansive fiscal policy and budget deficit**
- **Repo rate will be lowered to 3 per cent**

The Swedish economy is continuing to weaken. Its deceleration during the first half of 2008 was sharper than expected, leading us to a **downward revision of our GDP growth forecast for 2008 from 2.1 to 1.4 per cent**. Various forward-looking indicators now also show deterioration on a broad front. As a result, we anticipate that **growth will weaken further next year to 0.9 per cent**. In 2010, growth will climb to 1.8 per cent, among other things due to lower interest rates and fiscal stimulus packages. From a growth standpoint, 2008-2010 will thus be Sweden's weakest three-year period since the 1990s economic crisis.

Sweden: GDP growth

Year-on-year percentage change

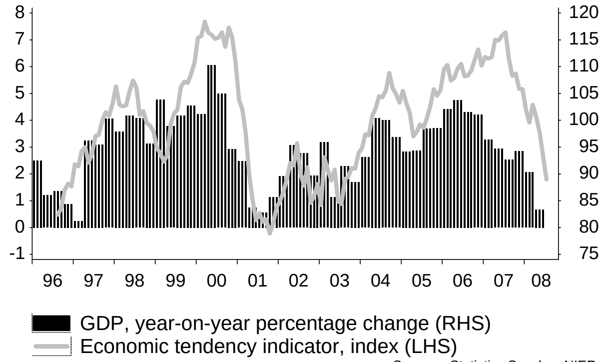
Sources: Statistics Sweden, SEB

As expected, the secondary effects of the international economic slump have become increasingly apparent. The National Institute of Economic Research's Economic Tendency Indicator, for example, has fallen steeply in recent months and is now signalling a "*much weaker than normal*" situation. In particular, the mood among households has become substantially more pessimistic in the wake of international financial turmoil, rising inflation and a falling stock market. Meanwhile various interest rate spreads have remained at high levels, indicating that **problems persist in the financial sector** and that these will continue to affect the real economy in the future.

Inflation will remain high in the coming months. Not until next spring will we see a clear downturn in Consumer Price Index inflation. Early in 2009 we also anticipate a clearer weakening of the labour market, which is supported by today's set of indicators and the normal time lag patterns between output and employment. The jobless rate will climb from slightly more than 6 per cent this year to 7 per cent in 2009, measured as annual averages.

Due to cyclical developments, the Riksbank (half of its six-member Executive Board) is backing away from the aggressive repo rate-hiking plans presented in the central bank's *Monetary Policy Report* in July. A further rate increase may be implemented in September. After that, we expect rather aggressive rate cuts beginning in February next year. At the end of 2009, the repo rate will stand at 3.5 per cent and by mid-2010 at 3.0 per cent.

Sweden: Economic tendency indicator and GDP



Sources: Statistics Sweden, NIER

While interest rate cuts will not materialise for a while, we foresee significant fiscal stimulus measures both in the government's autumn budget in September and next year, as the September 2010 election approaches. We have assumed stimulus packages equivalent to SEK 40 billion per year, i.e. substantially more than the SEK 20-30 billion the government has indicated for this year. Due to a combination of unfinanced tax cuts/expenditure increases and weakening economic performance, **public sector surpluses will shrink at a rapid pace and be replaced by a deficit equivalent to 1.5 per cent of GDP in 2010**. The overall deterioration in public sector finances in 2007-2010 will thus total about 5 per cent of GDP.

During the past year, we have presented a more pessimistic view of Swedish growth than the consensus view. This has been based on a gloomier view of the impact of the financial market crisis and the international economic situation. However, we have seen arguments for Swedish resilience in the short term and compared to other countries, including lower overheating tendencies in the construction and housing markets, relatively high household savings and significant room for fiscal stimulus measures.

Given the surprisingly rapid weakening of the Swedish economy in recent months, combined with the Rikbank interest rate hikes well into the cyclical slowdown, we now expect about the same weak growth in Sweden as in the euro zone this year and next. Only in 2010 can underlying Swedish strengths, combined with support from economic policy, lead to slightly faster Swedish GDP growth.

Weaker exports as Europe slows too

Exports have held up better than expected. Weak sales to the US have been offset to some extent by sizeable continued demand in Europe and strong sales to various emerging economies. The US share of Swedish exports has nearly halved in the past five years, and the US is now only Sweden's fifth largest export market. This downturn is not only an effect of the weak American economy and the decline of the dollar. Another reason is that Swedish exports to the US are dominated by such problem industries as cars.

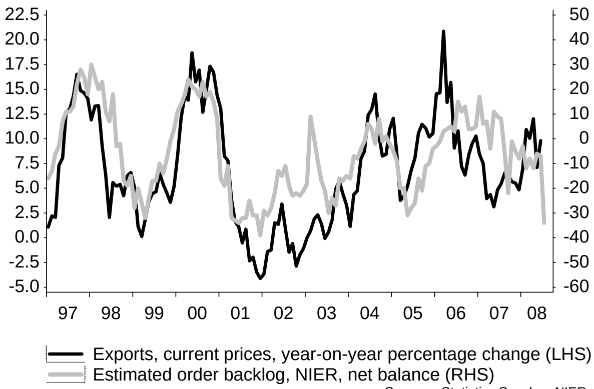
Merchandise exports, Jan-May 2008

Current prices

	2007 weight, %	Change, %	Contribution, percentage points
United States	8	-7.4	-0.6
Nordic countries	23	13.0	3.0
New EU countries	6	13.3	0.8
BRIC	5	21.2	1.1
EU-15 ex Nordic	42	9,3	3,9
Others	16	13,7	2,2
Total	100	10.4	10.4

Source: Statistics Sweden

Sweden: Exports



Sources: Statistics Sweden, NIER

Worsening economic conditions in Europe will lead to a faster slowdown in Swedish exports ahead. This is confirmed by a clear deterioration in order bookings. Continued expansion in many emerging economies will nevertheless contribute to a milder slowdown than at the turn of the millennium. At that time, the international slump was largely investment-driven, which hit Swedish exports particularly hard, and was amplified by major problems in the telecom sector.

Exports and market growth

Year-on-year percentage change

	2007	2008	2009	2010
Export-weighted GDP	3.3	1.6	1.0	1.8
Market growth	4.5	2.8	2.2	3.6
Merchandise exports	3.0	4.8	1.9	3.3

Note: Market growth refers to imports by Sweden's ten largest export markets.

Sources: Statistics Sweden, SEB

Capital spending will fall next year

After several years of rapid growth, capital spending is about to enter a major deceleration. It is true that the most recent investment survey in May signalled continued decent expansion in manufacturing, but since then companies have probably been surprised by the rapid deterioration in economic conditions. The latest NIER Economic Tendency Survey, for instance, indicates a significant cutback in expansion plans. Tougher financing conditions and poorer profitability are pointing in the same direction. We anticipate a levelling off of capital spending in the manufacturing sector this year and falling volume in 2009.

Was second-quarter growth underestimated?

Although there is no doubt that the economy is now decelerating rapidly, Statistics Sweden's report on the second quarter of 2008 raises some questions. Measured year-on-year, GDP rose by only 0.7 per cent, the weakest figure since 2001, and the quarterly change implied total stagnation in the economy. A few points provide reasons for cautious interpretation:

The quarterly figure may have been affected by difficulties in correcting for the large **calendar effect** that occurred because the Easter holidays took place during different quarters in 2007 and 2008. As a comparison, GDP growth in the whole first half was 1.4 per cent.

Demand in the Swedish economy grew clearly faster than GDP. The GDP figure was squeezed because demand was largely satisfied via higher imports rather than by domestic output. This is inconsistent with the historical pattern at the beginning of a slowdown and is one reason for cautious interpretation of the GDP figure.

The number of hours worked continued to increase at a decent pace, meaning that productivity growth is continuing to show negative figures. Slower productivity growth is natural in the current economic situation. When Statistics Sweden reports such a large gap between output and employment in its preliminary figures, since the output statistics are imperfect, it still raises questions.

The above uncertainty factors point towards a certain risk of upward revisions or a rebound during the second half. In any case, Riksbank and NIER analyses will be affected by such considerations in the coming months.

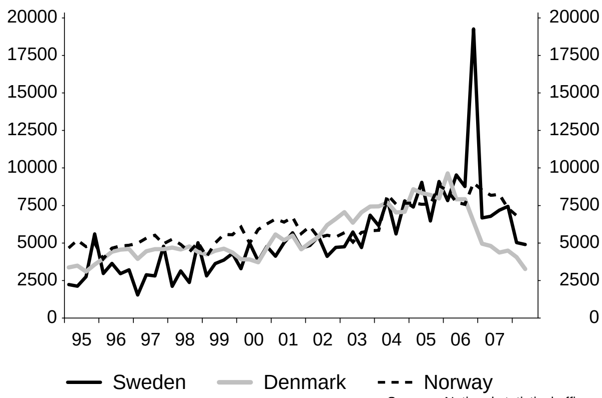
Gross fixed investments
Year-on-year percentage change

	2007	2008	2009	2010
Manufacturing sector	9.8	1.0	-4.0	0.0
Homes	8.7	-2.0	-5.0	-2.0
Total	8.0	3.5	-1.5	0.0

Sources: Statistics Sweden, SEB

Market indicators in the construction sector show a somewhat divided picture. Residential construction has slowed greatly since early 2007, and reports from construction companies describe increasingly tough market conditions and falling prices. The NIER Economic Tendency Survey, however, indicates a strong construction market. Among the reasons is continued expansive growth in civil construction and the fact that hotel and retail construction remains at a high level for the time being.

Housing starts, Nordic countries



Sources: National statistical offices

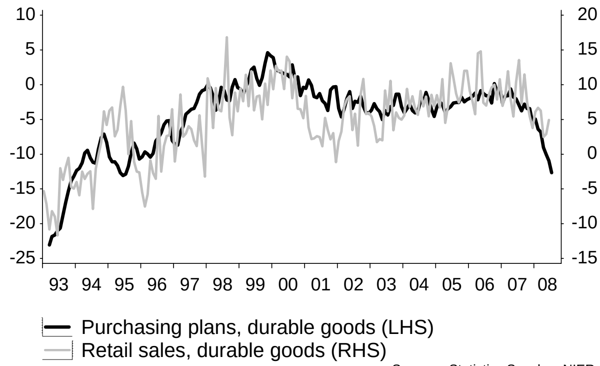
Next year, we expected construction of commercial properties to decelerate in response to weaker private consumption and tougher credit conditions. Public sector investments will continue to increase, due to spending on various types of infrastructure projects. We expect overall construction investments to decline somewhat in 2009.

Tougher times for households

Household confidence indicators have fallen rapidly during the past six months. Pessimism has increased, both when it comes to how people view the national economy and the labour market as well as their own economic situation. Plans for purchasing capital goods have fallen to their lowest level in 15 years. This rapid shift is well in line with developments elsewhere in Europe.

This growing uncertainty about the future is not entirely unfounded. After several years of very good income increases, a clear deceleration is now under way. In 2008, this is because of weaker employment growth and smaller purchasing power due to higher energy and food prices as well as rising interest expenses.

Sweden: Purchasing plans and retail sales
Year-on-year percentage change, net balance



Sources: Statistics Sweden, NIER

Next year we expect employment to decline, measured as number of hours worked, while pay increases will slow somewhat. Given inflation that is only slowly falling, this means that households' job income will nearly stagnate in real terms. Instead households will have to rely on fiscal stimulus measures, which we expect to provide added income in the range of SEK 10-15 billion in both 2009 and 2010, or the equivalent of nearly 1 per cent of disposable income.

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

	2007	2008	2009	2010
Private consumption	3.0	1.9	1.2	1.9
Real disposable income	4.3	2.4	1.5	2.0
Savings ratio, %	8.3	8.8	9.1	9.2

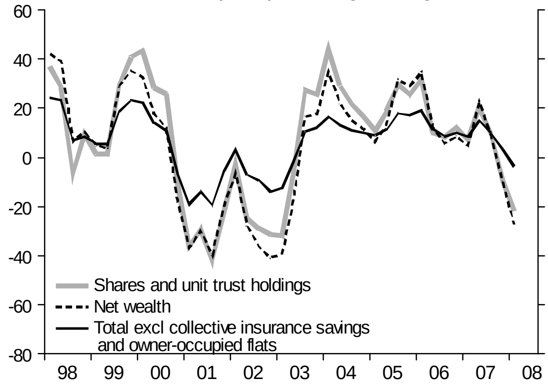
Sources: Statistics Sweden, SEB

The reasons for higher saving will strengthen as unemployment climbs and household balance sheets weaken. Between the second quarter of 2007 and the first quarter of 2008, the value of households' shares and unit trust holdings shrank by about SEK 280 billion, or nearly 20 per cent of disposable income. This downturn largely reflects the change in share value and only to a minor extent re-investments in other assets. Given the continued downturn since last spring, household shareholdings and unit trust holdings have probably declined by another SEK 80-90 billion. According to standard rules of thumb, this stock market downturn would thus pull down consumption by about 1 percentage point.

Prices in the housing market are now also beginning to weaken. So far, the softening mainly applies to owner-occupied flats, while the single-family home market has been more resilient. This is partly related to a restructuring of real estate tax that benefited single-family homes more than owner-occupied flats. According to Statistics Sweden, single-family home

Sweden: Household financial wealth

Year-on-year percentage change

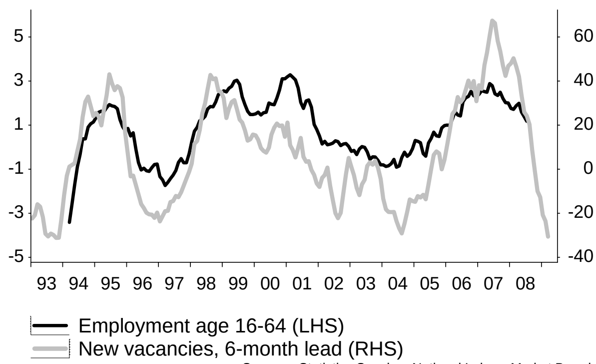


Source: Statistics Sweden

prices are still rising at around 5 per cent year-on-year, but a record-sized supply is meanwhile being reported due to an increasing number of days before homes are sold. The Swedish housing market is likely to follow the international trend towards lower prices. According to IMF calculations, Sweden does not deviate especially much from the Western European average in terms of overvaluation in the housing market. On the other hand, Sweden's long period of excessively low residential construction means that there is still a relatively large housing shortage. This will probably result in a milder downturn than in many other countries.

Sweden: New vacancies and employment

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



Sources: Statistics Sweden, National Labour Market Board

Due to a high initial savings level, we expect the upturn in saving to be relative modest. Consumption will rise by an average of slightly above 1½ per cent during the next couple of years. The risk in our consumption forecast is on the downside.

Labour market cooling

Labour market demand has held up decently so far, despite the slowdown in output. During the first half of 2008, job growth was still more than 1½ per cent year-on-year. The increase in the number of hours worked, however, has decelerated rather sharply.

Such indicators as lay-off notices, new job vacancies and company hiring plans also indicate definitively that the economic slowdown has reached the labour market. Both existing indicators and normal lag times between output and the labour market suggest that the number of jobs will begin to fall around the turn of the year. Unemployment will climb from an average of 6.2 per cent in 2008 to 7.0 per cent in 2009 and to 7.3 per cent in 2010.

Sweden: Labour shortage in business sector

Net balance

Source: NIER

Productivity growth has fallen significantly, mainly due to the cyclical time lag between output and employment. Because of the current adjustment in employment, productivity will recover to more normal growth figures of around 2 per cent in the next couple of years.

Labour market and productivity

Year-on-year percentage change, level

	2007	2008	2009	2010
GDP	2.9	1.4	0.9	1.8
Productivity	-0.7	0.1	1.7	2.0
Employment	2.4	1.2	-0.6	-0.3
Hours worked	3.5	1.3	-0.8	-0.2
Labour supply	1.7	1.1	0.4	0.1
Unemployment, %	4.6	4.4	5.3	5.6
Unemployment, %, ILO definition	6.2	6.2	7.0	7.3

Sources: Statistics Sweden, SEB

Given the upturn in unemployment, resource utilisation in the labour market will continue to fall further. According to the Economic Tendency Survey, the labour shortage has already fallen clearly and is now close to its historical average. The trend of wage formation does not indicate especially strained resource utilisation in the labour market either. According to Statistics Sweden's calculations, wages and salaries increased by only 3.3 per cent in 2007. Due to the structure of the larger collective agreements, pay increases this year will be higher, but the outcome so far this year indicates that increases above agreed pay scales may be somewhat lower than expected. Next

New measure of inflation

In its latest *Monetary Policy Report*, the Riksbank tones down the importance of the CPIX (CPI minus household mortgage interest expenditure and direct effects of changes in indirect taxes and subsidies) as an operational target for monetary policy. Meanwhile the central bank is introducing a new measure, the CPIF (CPI with a fixed interest rate), which it believes to be better at correcting for the direct inflationary effect of changes in interest rates. At the same time, the Riksbank emphasises that the CPIF will not be given the special status that the CPIX once enjoyed. Instead, a number of underlying measures will be used in the bank's analysis. This is in line with developments among other central banks. For example, Norges Bank in Norway also uses a broad arsenal of underlying inflation measures and has toned down the importance of the CPI-ATE, its official inflation target measure, which is adjusted for energy prices as well as indirect taxes and fees.

The Riksbank maintains that the phase-out of the CPIX will not have any noticeable importance to its interest rate decisions ahead. On the margin, however, it is still likely that the change will contribute to a somewhat higher key interest rate during periods when the interest rate component in the CPI is being pushed upward. Another consequence may be that the degree of monetary policy freedom will increase, possibly at the price of reduced transparency.

year, pay increases will slow as a result of the weaker labour market.

Most of the current three-year collective agreements expire during the spring of 2010. This presupposes, however, that the parties do not choose to terminate their agreements before the third year. Such a decision must be made before the end of September 2008. In our judgement, the likelihood of a renegotiation round is small in a situation when both the overall economy and the labour market have clearly entered a slowdown. The next wage round will thus begin around late 2009 and early 2010. Given our forecast scenario, this will occur in an environment of continued weakening in the labour market and falling inflation, which suggests lower pay increases than in the 2007 wage round.

Unit labour cost

Year-on-year percentage change

	2007	2008	2009	2010
Hourly pay	3.3	4.2	3.7	3.4
Productivity	-0.7	0.1	1.7	2.0
Unit labour cost	4.0	4.1	2.0	1.4

Note: Unit labour cost is calculated exclusive of employer payroll fees.

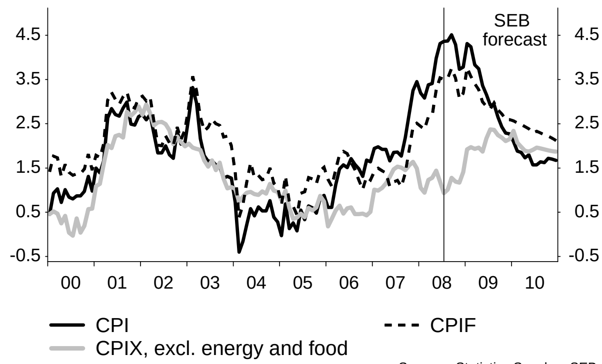
Sources: Statistics Sweden, SEB

Inflation close to peaking

Inflation reached new heights during the summer. In July, CPI inflation reached 4.4 per cent, the highest level since 1993. Interest rate hikes and rising food and energy prices are the most important explanations. Inflation will peak during the autumn. The contribution to inflation from energy and food will decline from 1.0 percentage points this year to 0.3 points in 2009 as oil prices fall and food prices increase at a significantly slower pace. A sharper fall in commodity prices is a downside risk in our inflation forecast.

Sweden: Inflation

Year-on-year percentage change



Sources: Statistics Sweden, SEB

Core inflation has not moved so much in the past year. Rising unit labour costs, mainly due to the cyclical slowdown in productivity, nevertheless mean that underlying price pressure will persist during the coming year.

The question is to what extent higher cost pressures will be passed through to consumer prices. Due to weaker demand, companies will find it harder to raise prices, but historical experience indicates that price hikes are implemented during the early stages of a cyclical downturn. At that time, companies have a greater need to offset falling volume by increasing

Sweden: Expectations regarding retail prices, excl. food

Net balance

Source: NIER

their margins, in a situation where demand has not yet weakened enough to make price increases completely impossible. Company plans for price increases according to the NIER Economic Tendency Survey, along with anecdotal information, provide some indication that we are now in this situation. We thus expect a weak upward trend in underlying inflation during the first half of 2009. After that, the overall effect of stronger productivity and lower pay increases will have a growing impact on core inflation, which will thus decline.

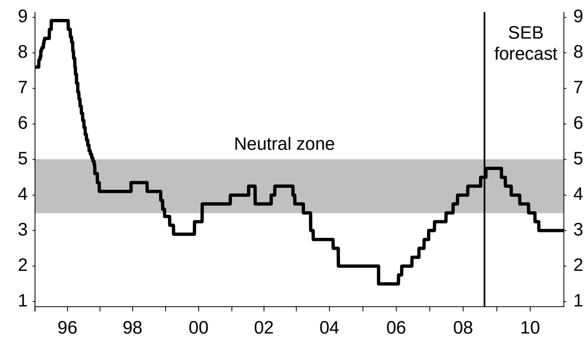
Measured as annual averages, CP inflation will gradually fall from 3.9 per cent in 2008 to 3.2 per cent in 2009 and 1.7 per cent in 2010. CPIX excluding energy and food, however, will rise from 1.2 per cent in 2008 to 2.1 per cent in 2009, then drop to 2.0 per cent in 2010.

Key rate cuts beginning in spring 2009

When the Riksbank raised its repo rate to 4.5 per cent in July, it made the surprising announcement that during 2008 — despite clear signs of slowdown and continued credit market problems — the repo rate *"will need to be raised further on a couple of occasions"*. Two rate hikes to the 5 per cent level could be deduced from the bank's interest rate path. However, three of the Executive Board's six members (Rosenberg, Nyberg and Wickman-Parak) registered their disagreement with this repo rate path. Since the July meeting, inflation has come in somewhat higher than expected, while inflation expectations have continued to climb (according to the NIER). On the other hand,

Sweden: Repo rate

Per cent



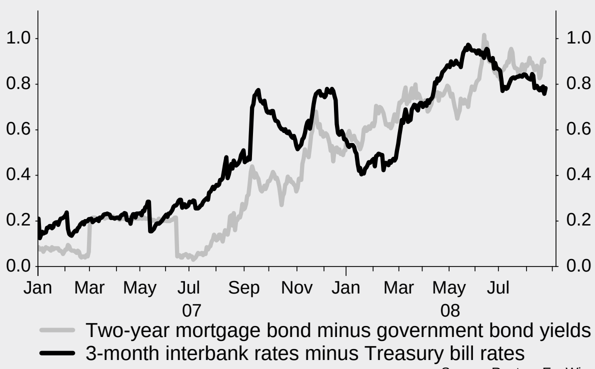
Source: Reuters EcoWin

Pro-cyclical monetary policy

Inflation expectations and real interest rates have played an increasing role in the Riksbank's analysis recently. These important concepts are also integrally related, since the Riksbank uses inflation expectations when it calculates real interest rate levels.

Sweden: TED spread and mortgage spread

Percentage change

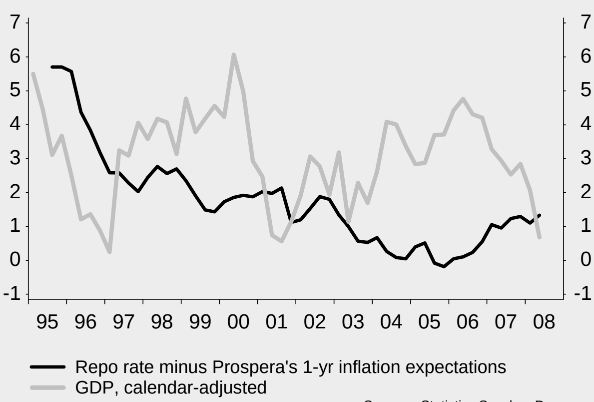


Source: Reuters EcoWin

The real interest rates actually experienced by actors in the economy may, however, deviate from the definitions the Riksbank uses. At present, several factors point to this:

- Because of the credit crisis, interest margins have increased in the past year. The nominal interest rates that households and companies face have consequently risen significantly more than the repo rate and government securities of various maturities.
- Inflation expectations have largely been influenced by the fact that high commodity prices have driven up actual inflation. Domestic prices and wage and salary expectations have not climbed to the same extent, however. In many respects, definitions of real interest rates based on these factors determine how consumption and investments are affected.

Sweden: Real interest rate and GDP



Sources: Statistics Sweden, Prospera

Real interest rates, as defined above by the Riksbank, were at their lowest when economic growth culminated in 2006 and have gradually climbed since then. If one takes into account the above distinction when it comes to both nominal interest rates and the deflator, the upturn becomes even more apparent. This reinforces the picture of a monetary policy that has tended to be pro-cyclical in recent years, thereby amplifying economic fluctuations.

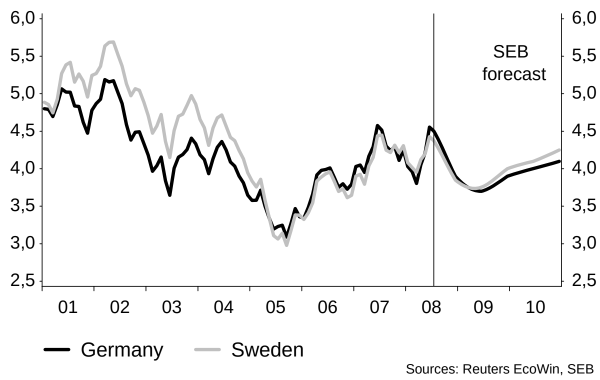
the price of crude oil has dropped by about 20 per cent. Meanwhile Statistics Sweden has published unexpectedly weak national accounts for the second quarter, and most economic indicators have come in lower than expected. The international economic picture, especially in Europe, has also deteriorated noticeably. Overall, this indicates that the Riksbank will adjust its interest rate path downward, but it is still an open question whether another interest rate hike will occur in September.

After that, we believe that all Executive Board members will focus on the rapidly worsening economic situation. We expect a delay until February before the Riksbank is ready to begin its rate-cutting cycle. By then, unemployment will have clearly increased and the inflation outlook will have brightened, which should also cause inflation expectations to fall. Because of the economic slowdown, the key rate will then be cut at a rather rapid pace. **We expect the repo rate to be lowered to 3.50 per cent towards the end of 2009. Rate cuts will then continue to 3.0 per cent some months into 2010**.

Given the weak trend in the real economy, one can argue that the Riksbank should begin its interest rate cuts earlier, but there is apparently a certain reluctance to move from rate hikes to rate cuts in too short a time; the credibility of monetary policy may be harmed if the central bank's reaction pattern appears excessively short-term. The expansive direction of fiscal policy will make it a little easier on the margin for the Riksbank to hold off on its rate cuts.

10-year government bond yields

Per cent



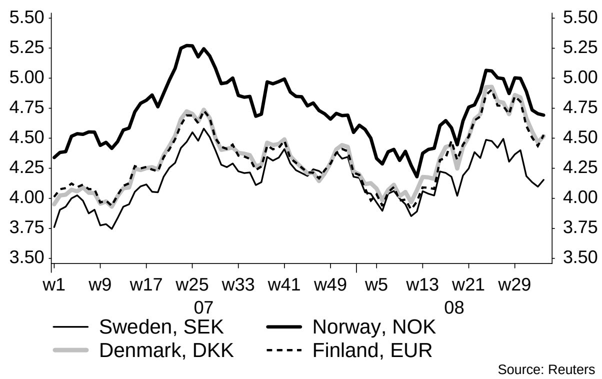
Falling long-term yields

After the sharp upturn in the spring, long-term yields have fallen back considerably. The reason is that the growth outlook has worsened on a broad front. We expect the Swedish ten-year government bond, which is somewhat below the German one at the moment, to fall to 3.75 per cent in June next year. Since the German yield will fall somewhat faster, the Swedish bond will end up higher than the German one around mid-year 2009. We estimate that the yield spread will climb from 5 basis points in June 2009 to 10 points in December the same year, and to 15 points at the end of 2010.

Swedish long-term bond yields should be somewhat higher than German ones for several reasons. For example, the Riksbank's key interest rate will be higher than that of the ECB according to our forecast, and Swedish long-term yields can no longer benefit from a clearly lower inflation rate. Shrinking central government debt due to budget surpluses and revenue from the privatisation of state-owned companies are thus not sufficient reason why Swedish long-term yields should remain lower than German ones.

Bond yields

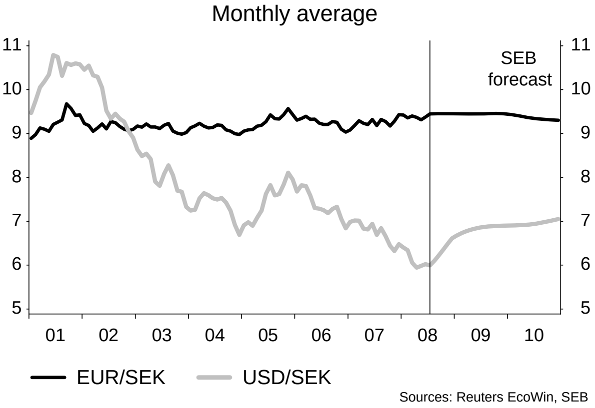
Per cent



At the end of 2009 the economy will have recovered enough for long-term yields to begin moving upward. The Swedish ten-year bond will climb to 4.00 per cent in December 2009, the German one to 3.90.

Sweden: Exchange rates

Monthly average



The Swedish krona will continue to keep pace with the euro, although it will lose some ground in the next few months, since credit and financial market turmoil and global economic deceleration have a relatively larger impact on small currencies. We anticipate that the EUR/SEK exchange rate will climb to 9.45 in December this year and that the krona will remain at that level throughout 2009. Some months into 2010, when the bottom of the economic cycle is past, Sweden's large current account surplus will again begin to help make the krona stronger. The EUR/SEK rate will then fall towards 9.35 in June 2010 and 9.30 in December 2010. The USD/SEK exchange rate will climb to 6.60 in December this year and to 6.85 in June 2009. The USD will continue upward to 6.95 in June 2010 and 7.05 in December 2010.

Budget moving towards deficit

Swedish public finances have gradually improved since 2002. Last year the surplus totalled 3½ per cent of GDP. Restraint with regard to central government expenditures combined with a stronger labour market and lower sick pay have kept the upturn going despite the government's tax cuts. This year, the central government budget has continued to show large surpluses. So far it is difficult to discern any clear effects of weaker economic conditions in the regular monthly figures. In July the surplus ended up SEK 12 billion lower than the National Debt Office had calculated, apparently due to temporary transactions of a technical nature.

Slower growth will nevertheless lead to a weaker budget. In addition, we expect fiscal programmes to

Fiscal wiggle room

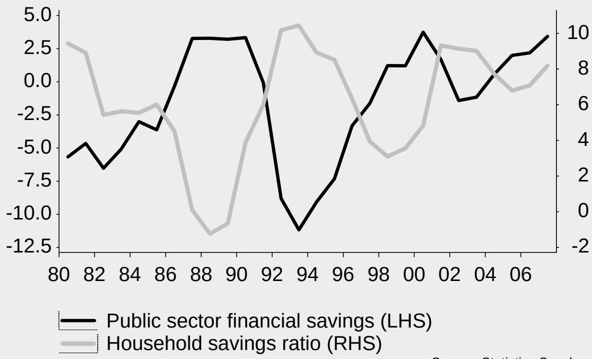
The developments we are outlining will undoubtedly entail major pedagogical and political problems, both for the government in general and Finance Minister Anders Borg in particular. A number of issues concerning the fiscal framework will come to a head. There are thus reasons to discuss the potential and room for fiscal policy measures more from the standpoint of principle.

To date, the government's analysis of the available room for fiscal initiatives has largely been based on actual annual deviations from a surplus equivalent to 1 per cent of GDP. This approach will not work in the future. Instead the government must decide how it should define its surplus target in concrete terms. Different definitions are plagued with various hazards. A definition based on the structural budget balance requires a reliance on measurements of the output gap in the economy. In the real world, however, these usually show too much instability to be manageable during the practical budget process. The government has also experimented with definitions based on a moving seven-year average. Given the large surpluses of recent years, this would leave room for financial savings well below a 1 per cent surplus during the next couple of years. If moving average figures are excessively forward-looking, credibility problems may arise if current deficits are justified by uncertain forecasts of economic recovery and fiscal restraint in the distant future. If moving average are instead backward-looking to a greater extent, this means that the average figure will be sustained by previous Social Democratic surplus years, which is naturally a political vulnerable strategy.

One important issue concerns the impact of fiscal policy on the economy and how this depends on what specific measures are used. Studies indicate that tax cuts for households are more highly effective in the short term than tax cuts for companies. An increase in public sector activity is also believed to have a greater expansive effect than tax cuts. This is because tax cuts aimed at households are partially used to increase savings. On the other hand, the "Ricardian equivalence" hypothesis implies that rational households will respond to all types of stimulus measures with an equivalent increase in saving, since these measures imply a higher tax rate in the future. During the 1990s this hypothesis was confirmed when household saving and public financial saving moved in different directions. This pattern has weakened, however, which may be interpreted as greater credibility for public finances. The fact that central government debt is now much lower than in the 1990s might be a major reason for this. By way of summary, there are many indications that the effectiveness of fiscal policy has increased.

Sweden: Public and households

Percentage of GDP, disposable income



Source: Statistics Sweden

The interplay between fiscal and monetary policy is also highly important, both when it comes to the available room for fiscal stimulus and its effectiveness. Monetary policy is normally the most important stabilisation policy instrument in an economy with flexible exchange rates. The current situation — with rapidly weakening economic conditions, large surpluses in public sector finances and highly supply side-driven inflation that makes interest rate cuts difficult — may prove an exception, however. In this situation, fiscal stimulus will have a smaller unfavourable impact on inflation than an interest rate cut, which will tend to weaken the currency and thereby drive up import prices. Measures that cut costs, for example lower employee payroll fees, are extra effective in this context.

intensify. In its spring budget bill, the government announced that there was room for unfinanced fiscal stimulus measures in the range of SEK 20-30 billion. We expect the actual dose to end up at SEK 40 billion. The government has described these measures in terms of three programme packages. The first will contain research and infrastructure investments, the second will deal with income taxes and jobs, the third with social welfare issues. These packages show that the government is moving towards a more pragmatic policy, aimed at recapturing the political middle ground.

We expect an equally large a dose of stimulus for 2010. Tensions within the Alliance government are certainly likely to become greater as the September 2010 parliamentary election approaches, and the four non-socialist coalition parties will each have their last chance to leave a genuine imprint on policy before the election. For the dominant Moderate Party, it is not only a matter of keeping the government together and trying to turn around unfavourable public opinion. The Moderates will undoubtedly also have to think about how to deal with internal opposition inside their own party and with those forces in the business community that demand more a resolute commitment to lower taxes and a better business climate.

Public finances

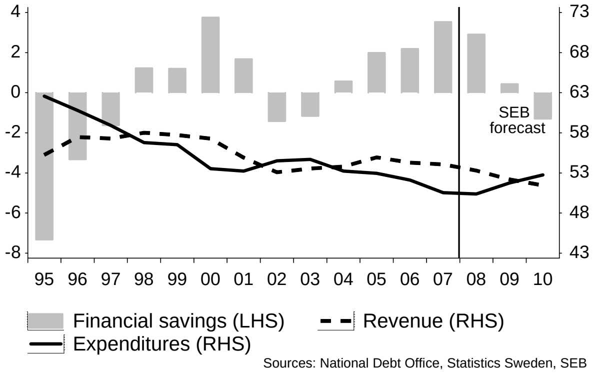
Percentage of GDP

	2007	2008	2009	2010
Revenue	53.6	52.8	51.7	50.9
Expenditures	50.0	49.9	51.3	52.3
Financial savings	3.5	2.9	0.4	-1.3
Public debt (Maastricht)	40.6	33.4	31.1	30.1
Central government debt	38.0	31.4	29.1	28.1
Central govt borrowing req., SEK bn	-103	-160	-44	5

Sources: National Debt Office, Statistics Sweden, SEB

Sweden: Public sector finances

Percentage of GDP



Sources: National Debt Office, Statistics Sweden, SEB

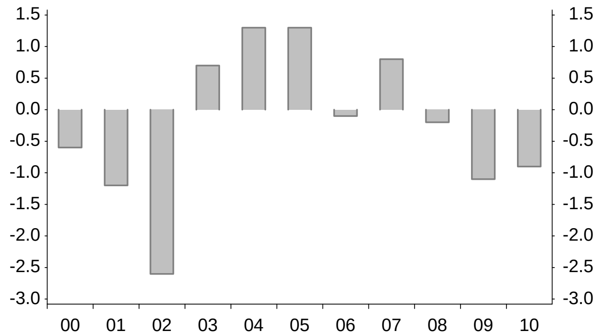
The overall effect of cyclical weakening and the government's stimulus measures will be to shift consolidated public financial saving from a surplus of **2.9 per cent of GDP this year to a surplus of 0.4 per cent in 2009. In 2010 a deficit of 1.3 per cent will be reported**. Compared to the official target of a surplus equivalent to 1 per cent of GDP, this will mean a gap of nearly SEK 20 billion in 2009 and SEK 80 billion in 2010.

The central government borrowing requirement will increase during our forecast period from SEK -160 billion (a negative requirement means a surplus) to SEK -44 billion in 2009 and SEK 5 billion in 2010. In 2010, the government will thus have to borrow again for the first time since 2004. **Central government debt will fall from 38 per cent of GDP last year to 31 per cent this year**. In 2009 and 2010 it will total slightly less than 30 per cent.

Our forecast implies a rather dramatic change in the budget environment. Viewed from a stabilisation policy standpoint, neither the thrust of fiscal policy nor the budget trend is especially remarkable. The target of a surplus equivalent to 1 per cent of GDP applies over an entire business cycle. Measured as a change in cyclically adjusted saving, our calculations indicate that fiscal policy will provide a stimulus injection equivalent to about 1 per cent of GDP in both 2009 and 2010. During the 2001-2002 economic slump, the dose of fiscal stimulus was larger.

Cyclically adjusted saving

Percentage of GDP, annual change



Sources: SCB, SEB

Close to stagnation

- **Slide in confidence indicators**
- **Super-strong labour market will weaken**
- **Weak domestic demand next year as well**

Denmark's economic slowdown is deepening, pulled down by **waning domestic demand**. Consumption growth is cooling further as the labour market begins to deteriorate, while the investment climate is now weakening. This will result in **GDP growth of a meagre 0.5 per cent this year and 0.3 per cent in 2009**. This forecast is **still clearly below the consensus view**. In 2010, GDP growth will climb to 1.4 per cent, among other things because we expect the government to enact stimulus measures.

Denmark was the first EU country to report a recession during the current cyclical slowdown. GDP fell both during the fourth quarter of 2007 and the first quarter of this year. The downturn of 0.6 per cent during the first quarter was exaggerated, however, because an early Easter resulted in fewer working days than usual in March. Our assessment is thus that there will be a **short-term rebound**. Employment and production data also indicate weakly positive GDP growth during the second quarter.

Confidence indicators nevertheless point unmistakably towards a continued economic slowdown. In manufacturing, the purchasing managers' index fell sharply last summer to its lowest level (43) since measurements began in 1994. The service sector indicator has continued trending downward, and consumer confidence is at a 15-year low.

Exports have provided surprises in the past six months, however. One reason why the global deceleration has not had a greater impact may be the Danish export industry's emphasis on less cyclically sensitive sectors such as food and pharmaceuticals. Shrinking order bookings nevertheless signal weaker growth figures ahead. Danish industry is also being squeezed by a certain erosion of competitiveness, due to faster pay hikes than in the euro zone. The negative pressure from earlier currency appreciation will ease, however, when the euro and thus the Danish krone weaken.

Capital spending was a strong driving force in GDP growth last year. Industrial expansion plans were also ambitious, according to the twice-yearly survey conducted last spring, with plans even being adjusted upward compared to October 2007. Our assessment, however, is that companies overestimated the need to expand their capacity. Due to falling capacity utilisation and a poorer economic outlook, **business investments will grow at a clearly slower pace this year** and shrink next year. **Residential investments will fall in** both years, having earlier been greatly excessive.

Private consumption growth will continue to slow. This year, earlier solid increases in real household income have been undermined by rapidly rising inflation. Although we expect inflation pressure to ease, income growth will be modest in the months ahead. So far, growing employment has helped to drive consumption, but this growth is now slowing and **next year the number of jobs will fall**. Unemployment will turn upward this autumn, after having fallen to 1.6 per cent, the lowest level since 1974. In recent months both companies and households have begun preparing for a coming shift in the labour market.

Household consumption plans are also adversely impacted by wealth effects. The Copenhagen stock market has fallen by around 25 per cent since its peak in October 2007. Home prices have declined for two consecutive quarters, year-on-year. The adjustment following the property boom will continue for some months into next year. We are sticking to our forecast that home prices will fall by an average of 5-10 per cent in 2008 and are assuming an additional price decline in 2009.

Inflation continued upward, reaching a 4.0 per cent pace in July. Rising food prices have played a key role, with a year-on-year increase rate of more than 10 per cent in July. Unlike such countries as Sweden, there are still no signs of levelling off in food prices despite the falling world market prices of recent months. **The CPI inflation rate will nevertheless decline this autumn** via base effects on food and oil. In 2009 when the labour market worsens more clearly, inflation will slow to an average rate of 2.5 per cent.

Rate hikes having an impact

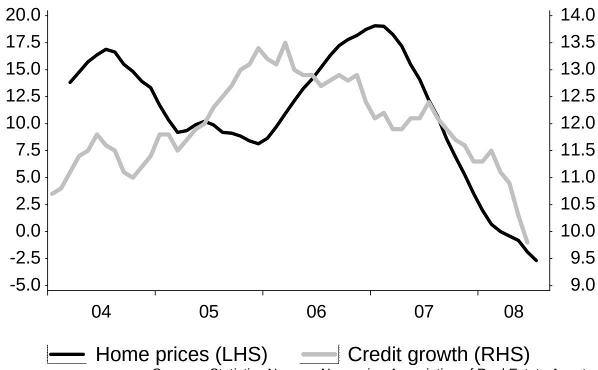
- **Economic cycle past its peak**
- **Buying spree fading – construction falling**
- **Domestic cost pressure will ease slowly**
- **Norges Bank will be last to cut interest rates**

The Norwegian economy is now entering a substantially calmer growth phase after four years when growth in the mainland economy (excluding offshore oil and gas) averaged a full 5 per cent. The weaker housing market and a more subdued buying mood among households indicate that higher interest rates are biting more and more. The international economic slowdown is also helping to cool off the heated Norwegian economy. **GDP growth in the mainland economy will more than halve this year to 2.9 per cent and then weaken further to 1.7 per cent in 2009**. Due to a continued rise in domestic inflationary pressure, Norges Bank will deliver a further interest rate hike and will not begin its rate cutting cycle until next summer. At the end of 2009, the sight deposit rate will be 5.25 per cent.

Clear deceleration of domestic demand

Domestic demand now seems to be responding increasingly to the central bank's monetary policy tightening. Retail sales have decelerated from growth rates of around 8-9 per cent during the first half of 2007 to about 3 per cent in the second quarter of this year. Household expectations have also turned downward, albeit not as clearly as in other countries. The consumption slowdown reflects weaker income growth. In 2008 this is primarily due to substantially higher inflation, while weaker job growth will be the main factor behind flatter income growth in 2009.

Norway: Credits to households and home prices
Year-on-year percentage change



Sources: Statistics Norway, Norwegian Association of Real Estate Agents

An upward adjustment of today's negative savings ratio also implies that consumption will increase more slowly than income. The relatively dramatic cool-off in the housing market points in the same direction.

Home prices are now falling year-on-year, after having increased by 12 per cent annually during the past four years. Meanwhile credit growth is subsiding, both as an effect of lower demand and somewhat tighter lending practices. The price downturn in the housing market has gone hand in hand with weaker construction growth. New housing starts have rapidly fallen. Commercial construction is also about to decelerate due to dampened expectations about the rental market trend and tighter credit conditions. The construction sector is thus facing a broad slowdown during the next couple of years.

Various confidence surveys are also clearly indicating weaker growth ahead. In manufacturing, for example, the sentiment index has fallen to its lowest level since the second quarter of 2003 and is thus below its trend level. The export outlook has weakened, due to an unexpectedly rapid cyclical slowdown in Western Europe. Rising labour costs, a comparatively strong krone and less favourable terms of trade are also squeezing Norway's competitiveness. A combination of constraints on profitability and less restricted capacity utilisation will slow future capital spending by manufacturers.

Further stimulus from oil

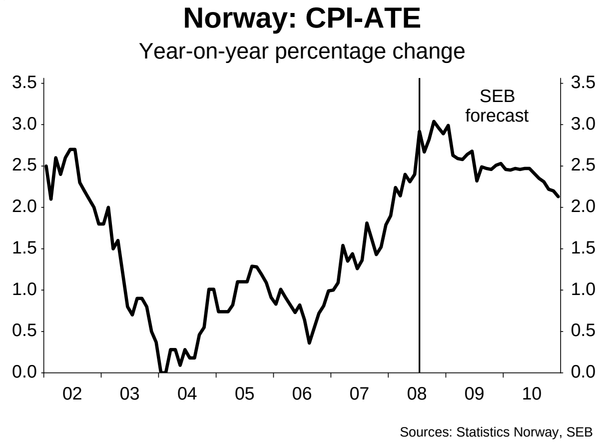
High investment activity in the oil and gas sector is likely to continue during the next couple of years. Although we expect oil prices to fall somewhat, the level will remain historically high. Meanwhile the chances of implementing planned investments will improve when capacity restrictions in civil construction ease. The latest Statistics Norway capital spending survey indicates volume increases in the range of 8-10 per cent over the next few years. This means that substantial growth impulses will carry over into the rest of the economy. According to Norges Bank, about one third of the companies included in the central bank's regional network are affected by demand from the oil sector, and nearly 15 per cent of industrial sales are tied to this sector. The oil industry will thus serve as a counterforce as growth weakens in other parts of the economy. Meanwhile rising oil income will provide greater room for fiscal stimulus measures. The revised government budget from last spring indicates an expansive fiscal policy, including sizeable increases in public sector consumption during the next couple of years.

The Norwegian labour market remains very tight, but **unemployment has levelled off**. Especially in the construction sector, but also in manufacturing, a certain increase has already been noted. Unemployment has bottomed out partly because job growth has fallen, but also due to a surprisingly large increase in labour supply. Various indicators such as hiring plans and job vacancies point towards a continued **dampening of job growth ahead**. How much this slowdown will push up unemployment will depend partly on immigration trends and to what extent foreign workers will leave Norway when the labour market weakens. In the United Kingdom, which like Norway has received many immigrants from Eastern Europe, the trend has been clear. Offsetting this is the high wage and salary level in Norway and the fact that the labour market is also weakening in some of the immigrants' home countries, especially in the Baltics.

The tight labour market has resulted in rising pay increases in recent years. This year's agreement between the Norwegian Confederation of Trade Unions and private sector employers indicates pay hikes of more than 5½ per cent. Since public sector pay is rising significantly faster, or by nearly 6½ per cent, total wage and salary increases will end up at about 6 per cent in 2008. If so, this would be the highest rate of pay increases since 1998. Next year, we anticipate that weaker profitability and weakening demand for labour will slow pay hikes to about 5 per cent.

No inflation downturn for some time

At the same time as wage inflation has risen, productivity growth has greatly decelerated, leading to a sharp upswing in unit labour cost. The inflation rate measured as CPI-ATE, which excludes energy and indirect taxes and fees, has climbed in the space of one year from 1.4 per cent to 2.9 per cent in July. This also means that inflation is exceeding Norges Bank's target for the first time since 2002. Besides, other inflation measures used by Norges Bank are even higher than CPI-ATE. Domestic core inflation was running at above 4 per cent in July. Our assessment is that underlying inflation pressure will persist during most of next year, and we cannot expect a clear easing until 2010. **Measured as annual averages, CPI-ATE will reach 2.6 per cent both this year and next**. CPI inflation will be significantly higher in 2008 and 2009, primarily due to rising electricity prices.



Key interest rate close to peaking

When Norges Bank published its latest *Monetary Policy Report* in late June, it hiked the sight deposit rate to 5.75 per cent. The interest rate path published at that time indicated a 50 per cent probability of another key rate hike to 6 per cent in October. Inflation in July then came in significantly higher than expected. The central bank's own assessment of the core inflation level is that it now totals about 3½ per cent, i.e. significantly higher than the bank's 2½ per cent target. Meanwhile, expectations of interest rate hikes in other countries have declined substantially. All else being equal, this is an argument against further rate hikes. In addition, the growth outlook has weakened, especially with regard to the economic cycle in Western Europe. This means that the tension between continued high domestic cost pressure and a weaker international economic trend will persist in the near future. Our assessment, however, is that the upward trend in inflation is so strong that it is pointing towards an additional key rate hike during the autumn.

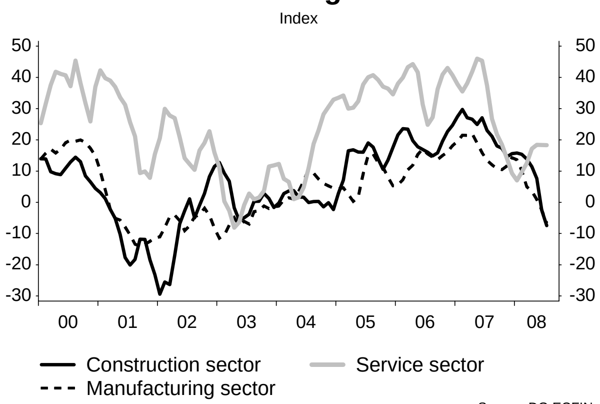
After that, we believe that the focus will shift increasingly towards the weaker economic trend. As unemployment turns upward and resource utilisation falls, a rate-cutting cycle will move closer. However, our forecast for core inflation implies that a first cut will take place in late June 2009 at the earliest. After that there will be two additional cuts to 5.25 per cent by the end of the year and then probably some further cuts in 2010.

Deceleration this autumn

- **Construction and manufacturing slowdown**
- **Forest product industry being squeezed**
- **Continued tight labour market**
- **High inflation this year – lower in 2009**

So far the Finnish economy has coped relatively well, despite the global slowdown and the strong euro. But this summer's harvest of statistics indicates that a **deceleration is on the way**. Corporate confidence has weakened in the construction and manufacturing sectors. The more pessimistic mood seems largely due to weakening demand, which has led to growing inventories of finished goods. There is thus reason to assume a lengthier slowdown. We anticipate that **GDP growth will slow from 2.2 per cent this year to 1.6 per cent in 2009 and 1.7 per cent in 2010** – clearly below the prevailing consensus view.

Finland: Leading indicators



Source: DG ECFIN

To date, the success of Finland's telecom and engineering sectors has helped keep its exports up. Nokia and engineering companies such as Metso and Wärtsilä have managed to offset weaker sales in Europe and the US with their sales success in Asia and South America. **It is also clear that the Finnish economy is still benefiting from the upswing in Russia.** Early in 2008, transit traffic in Finnish ports increased by a record 40 per cent.

Finland's resilience will diminish, however, as the international slowdown broadens to more countries and regions. We expect cutbacks in key sectors such as forest products and telecoms during the autumn. **Forest product companies will be squeezed from two sides: both cyclical retrenchment and higher costs due to Russian wood tariffs**. The government has announced plans to impose charges on all cargo shipments to and from Russia via Finland, in order to compensate forest product companies for the losses generated by the Russian wood tariffs. However, this entails a number of problems: such state subsidies may violate EU competition law, and it is difficult from a purely practical standpoint to introduce a charge that targets only Russian long-haul rigs.

Overall, we anticipate that **export growth will slow from nearly 5 per cent in 2007 to just above 2.5 per cent this year and even lower in 2009**. A slight recovery will occur in 2010. Capital spending growth will also decelerate: from about 7.5 per cent last year to just above 3 per cent annually during 2008-2010.

Stable domestic demand will help sustain economic activity. In the service sector, **optimism has also resurged after a downturn late last year**. Retail sales slipped noticeably around mid-year, however, signalling weaker consumption growth ahead. After a consumption boom with increases of 4 per cent annually in recent years, we expect yearly consumption increases of around 2-2½ per cent during our forecast period.

The labour market situation remains rather strained. The number of job vacancies is continuing upward, especially in the private service sector, and employers have difficulty in finding qualified labour. So far this year, unemployment has fallen. It now stands at 6.3 per cent. We expect a levelling off during the coming months and a minor upturn in joblessness by the end of 2008. **Unemployment will average 6.4 per cent next year and 6.7 per cent in 2010**.

Wages and salaries are rising relatively fast, due to the continued rather strained resource situation in the labour market. We predict that **hourly pay in the economy as a whole will increase by 5.2 per cent this year and 4.4 per cent in 2009**. The high rate of pay increases will generate inflationary pressure, especially since productivity growth is predicted to slow. **HICP inflation has climbed faster than expected in recent months** and we now expect it to average 3.9 per cent this year and 2.8 per cent next year. Core inflation is currently just below 1.5 per cent and we expect it to remain around this level during our forecast period.

According to its budget proposal for 2009, the government is planning certain tax cuts ahead. Both lower income tax and a higher earned income allowance may materialise. We expect Finland's budget surplus to decrease from 4.2 per cent of GDP to 3.6 per cent in 2009. Central government debt as a share of GDP, which is relatively low in an EU perspective, will fall from just above 35 per cent of GDP last year to less than 29 per cent in 2010.

Nordic key economic data

DENMARK

Yearly change in per cent

	2007 level, DKK bn	2007	2008	2009	2010
Gross domestic product	1,696	1.9	0.5	0.3	1.4
Private consumption	841	2.7	1.0	0.7	1.3
Public consumption	420	1.7	1.5	1.9	2.2
Gross fixed investment	389	6.2	0.5	-2.0	1.5
Stockbuilding (change as % of GDP)		-0.4	0.0	0.0	0.0
Exports	884	3.8	3.5	1.5	3.7
Imports	865	5.7	4.3	1.5	4.0
Unemployment (%)		2.8	2.0	3.5	4.5
Consumer prices, harmonised		1.7	3.6	2.5	2.2
Wage cost		3.8	4.6	4.5	4.0
Current account, % of GDP		1.2	1.2	0.7	2.2
Public sector financial balance, % of GDP		4.4	4.3	3.5	2.8
Public sector debt, % of GDP		26.0	22.0	20.0	19.0

FINANCIAL FORECASTS	Aug 21	Dec 08	Jun 09	Dec 09	Jun 10	Dec 10
Deposit rate	4.60	4.60	4.10	3.60	3.35	3.35
10-year bond yield	4.46	4.15	3.90	4.05	4.10	4.20
10-year spread to Germany, bp	31	25	20	15	10	10
USD/DKK	5.00	5.21	5.40	5.44	5.52	5.64
EUR/DKK	7.46	7.45	7.45	7.45	7.45	7.45

NORWAY

Yearly change in per cent

	2007 level, NOK bn	2007	2008	2009	2010
Gross domestic product	2,277	3.7	2.5	1.5	1.9
Gross domestic product (Mainland Norway)	1,715	6.2	2.9	1.7	2.2
Private consumption	946	6.4	2.4	1.9	2.5
Public consumption	449	3.6	3.5	3.5	3.1
Gross fixed investment	473	9.3	5.4	-0.4	1.4
Stockbuilding (change as % of GDP)		-0.2	0.6	0.0	0.0
Exports	1,043	2.8	2.0	1.1	1.7
Imports	686	8.7	4.6	1.5	2.5
Unemployment (%)		2.5	2.6	3.2	3.7
Consumer prices		0.8	3.8	3.1	2.1
CPI-ATE		1.4	2.6	2.6	2.4
Wage cost		5.4	6.0	4.9	4.2
Current account, % of GDP		16.3	20.0	18.0	16.2
Public sector financial balance, % of GDP		17.3	19.5	18.0	15.9

FINANCIAL FORECASTS	Aug 21	Dec 08	Jun 09	Dec 09	Jun 10	Dec 10
Sight deposit rate	5.75	6.00	5.75	5.25	4.75	4.50
10-year bond yield	4.63	4.40	4.15	4.30	4.35	4.50
10-year spread to Germany, bp	47	50	45	40	35	40
USD/NOK	5.32	5.49	5.83	5.91	6.04	6.21
EUR/NOK	7.92	7.85	8.05	8.10	8.15	8.20

Nordic key economic data

Nordic Outlook - August 2008

SWEDEN

Yearly change in per cent

	2007 level, SEK bn	2007	2008	2009	2010
Gross domestic product	3,074	2.7	1.7	0.7	2.1
Gross domestic product, working day adjusted		2.9	1.4	0.9	1.8
Private consumption	1,435	3.0	1.9	1.2	1.9
Public consumption	796	1.1	0.5	1.5	1.9
Gross fixed investment	582	8.0	3.7	-1.5	0.0
Stockbuilding (change as % of GDP)	24	0.7	-0.3	0.0	0.2
Exports	1,609	6.0	5.2	2.4	3.7
Imports	1,373	9.7	5.5	2.8	3.4
Unemployment, (%)		4.6	4.4	5.3	5.6
Unemployment, (ILO definition) (%)		6.2	6.2	7.0	7.3
Employment		2.4	1.2	-0.6	-0.3
Industrial production		2.9	1.6	1.2	2.4
Consumer prices		2.2	3.9	3.2	1.7
CPIX		1.2	2.8	2.5	1.8
Wage cost		3.3	4.2	3.7	3.4
Household savings ratio (%)		8.3	8.8	9.1	9.2
Real disposable income		4.3	2.4	1.5	2.0
Trade balance, % of GDP		4.6	4.4	4.1	4.1
Current account, % of GDP		8.3	7.8	7.5	7.5
Central government borrowing, SEK bn		-103	-160	-44	5
Public sector financial balance, % of GDP		3.5	2.9	0.4	-1.3
Public sector debt, % of GDP		41	33	31	30

FINANCIAL FORECASTS	**Aug 21**	**Dec 08**	**Jun 09**	**Dec 09**	**Jun 10**	**Dec 10**
Repo rate	4.50	4.75	4.00	3.50	3.00	3.00
3-month interest rate, STIBOR	5.12	5.27	4.42	3.97	3.47	3.47
10-year bond yield	4.09	3.85	3.75	4.00	4.10	4.25
10-year spread to Germany, bp	-7	-5	5	10	10	15
USD/SEK	6.27	6.61	6.85	6.90	6.93	7.05
EUR/SEK	9.35	9.45	9.45	9.45	9.35	9.30
TCW	123.5	125.1	125.2	125.3	124.1	123.9

FINLAND

Yearly change in per cent

	2007 level, EUR bn	2007	2008	2009	2010
Gross domestic product	179	4.4	2.2	1.6	1.7
Private consumption	90	3.7	2.2	2.3	2.0
Public consumption	38	0.8	1.3	1.5	1.5
Gross fixed investment	36	7.6	3.1	3.3	3.0
Stockbuilding (change as % of GDP)		0.2	0.1	0.0	0.0
Exports	81	4.8	2.7	2.2	3.2
Imports	72	4.1	3.0	4.0	4.3
Unemployment (%)		6.9	6.2	6.4	6.7
Consumer prices, harmonised		1.6	3.9	2.8	2.2
Wage cost		3.3	5.2	4.4	3.7
Current account, % of GDP		4.1	3.5	2.5	2.3
Public sector financial balance, % of GDP		5.3	4.2	3.6	3.1
Public sector debt, % of GDP		35.4	31.1	29.2	28.6

International key economic data

EURO ZONE

Yearly change in per cent

	2007 level, EUR bn	2007	2008	2009	2010
Gross domestic product	8,926	2.7	1.2	0.8	1.3
Private consumption	5,025	1.6	0.6	0.9	1.2
Public consumption	1,790	2.3	1.5	1.6	1.5
Gross fixed investment	1,945	4.4	2.8	1.6	2.5
Stockbuilding (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	3,670	6.0	3.6	3.0	3.8
Imports	3,540	5.3	3.9	3.9	4.4
Unemployment (%)		7.4	7.3	7.5	7.9
Consumer prices, harmonised		2.1	3.6	2.3	1.8
Household savings ratio (%)		9.9	9.8	9.6	9.5

US

Yearly change in per cent

	2007 level, USD bn	2007	2008	2009	2010
Gross domestic product	14,031	2.0	1.6	0.6	2.0
Private consumption	9,893	2.8	1.1	0.0	1.4
Public consumption	2,743	2.1	2.5	3.4	2.6
Gross fixed investment	2,092	-1.8	-3.5	-3.3	5.2
Stockbuilding (change as % of GDP)		-0.4	-0.4	-0.1	0.0
Exports	1,760	8.4	8.0	4.6	4.7
Imports	2,457	2.2	-2.1	0.5	4.8
Unemployment (%)		4.6	5.4	6.6	7.1
Consumer prices		2.9	4.6	2.9	2.0
Household savings ratio (%)		0.6	1.1	2.5	3.2

LARGE INDUSTRIAL COUNTRIES

Yearly change in percent

	2007	2008	2009	2010
GDP				
United Kingdom	3.1	1.1	0.5	2.5
Japan	2.0	0.7	1.0	1.3
Germany	2.5	1.5	0.9	1.6
France	2.1	1.2	1.0	1.5
Italy	1.4	0.2	0.2	0.5
Inflation				
United Kingdom	2.3	3.7	2.7	1.8
Japan	0.1	1.6	1.5	1.4
Germany	2.3	3.0	2.2	2.0
France	1.6	3.3	2.3	2.0
Italy	2.0	3.7	2.9	2.0
Unemployment (%)				
United Kingdom	5.4	5.5	6.2	6.4
Japan	3.8	4.1	4.3	4.5
Germany	8.4	7.3	7.6	7.9
France	8.3	7.7	7.9	8.1
Italy	6.2	6.6	6.8	7.7

International key economic data

Nordic Outlook - August 2008

CENTRAL AND EASTERN EUROPE

	2007	2008	2009	2010
GDP, yearly change in percent				
Czech Republic	6.5	4.3	4.0	4.0
Estonia	7.1	-2.0	1.5	4.0
Hungary	1.3	2.3	3.2	3.8
Latvia	10.3	0.3	1.5	4.0
Lithuania	8.8	5.5	4.0	3.0
Poland	6.6	5.2	4.5	5.0
Russia	8.1	7.5	6.5	6.0
Slovakia	10.4	7.0	6.2	5.0
Ukraine	7.3	6.0	4.2	4.0
Inflation, yearly change in per cent				
Czech Republic	3.0	6.4	3.8	3.6
Estonia	6.6	10.5	4.0	3.5
Hungary	7.9	6.4	4.5	3.2
Latvia	10.1	16.1	8.6	5.9
Lithuania	5.8	11.5	8.0	11.0
Poland	2.6	4.3	3.5	3.0
Russia	9.0	13.5	10.0	8.0
Slovakia	1.9	3.5	3.6	3.6
Ukraine	12.8	22.0	15.0	10.0

FINANCIAL FORECASTS

		Aug 21	Dec 08	Jun 09	Dec 09	Jun 10	Dec 10
Official interest rates							
US	Fed funds	2.00	2.00	2.00	2.50	3.00	3.50
Japan	Call money rate	0.50	0.50	0.50	0.50	0.75	0.75
Euro zone	Refi rate	4.25	4.25	3.75	3.25	3.00	3.00
United Kingdom	Repo rate	5.00	4.75	4.00	3.50	3.50	3.50
Bond yields							
US	10 years	3.83	3.80	3.80	4.10	4.20	4.40
Japan	10 years	1.42	1.42	1.45	1.50	1.55	1.60
Germany	10 years	4.16	3.90	3.70	3.90	4.00	4.10
United Kingdom	10 years	4.57	4.30	3.90	4.00	4.20	4.50
Exchange rates							
USD/JPY		108	115	120	120	125	125
EUR/USD		1.49	1.43	1.38	1.37	1.35	1.32
EUR/JPY		162	164	166	164	169	165
GBP/USD		1.88	1.77	1.67	1.66	1.65	1.61
EUR/GBP		0.79	0.81	0.82	0.82	0.82	0.82

GLOBAL KEY INDICATORS

Yearly percentage change

	2007	2008	2009	2010
GDP OECD	2.7	1.3	0.7	1.7
GDP world	5.0	3.6	3.0	3.5
CPI OECD	2.3	3.8	2.6	2.0
Export market OECD	6.7	4.5	2.6	5.8
Oil price, Brent (USD/barrel)	73.0	112.5	105.0	95.0

Economic Research available on Internet

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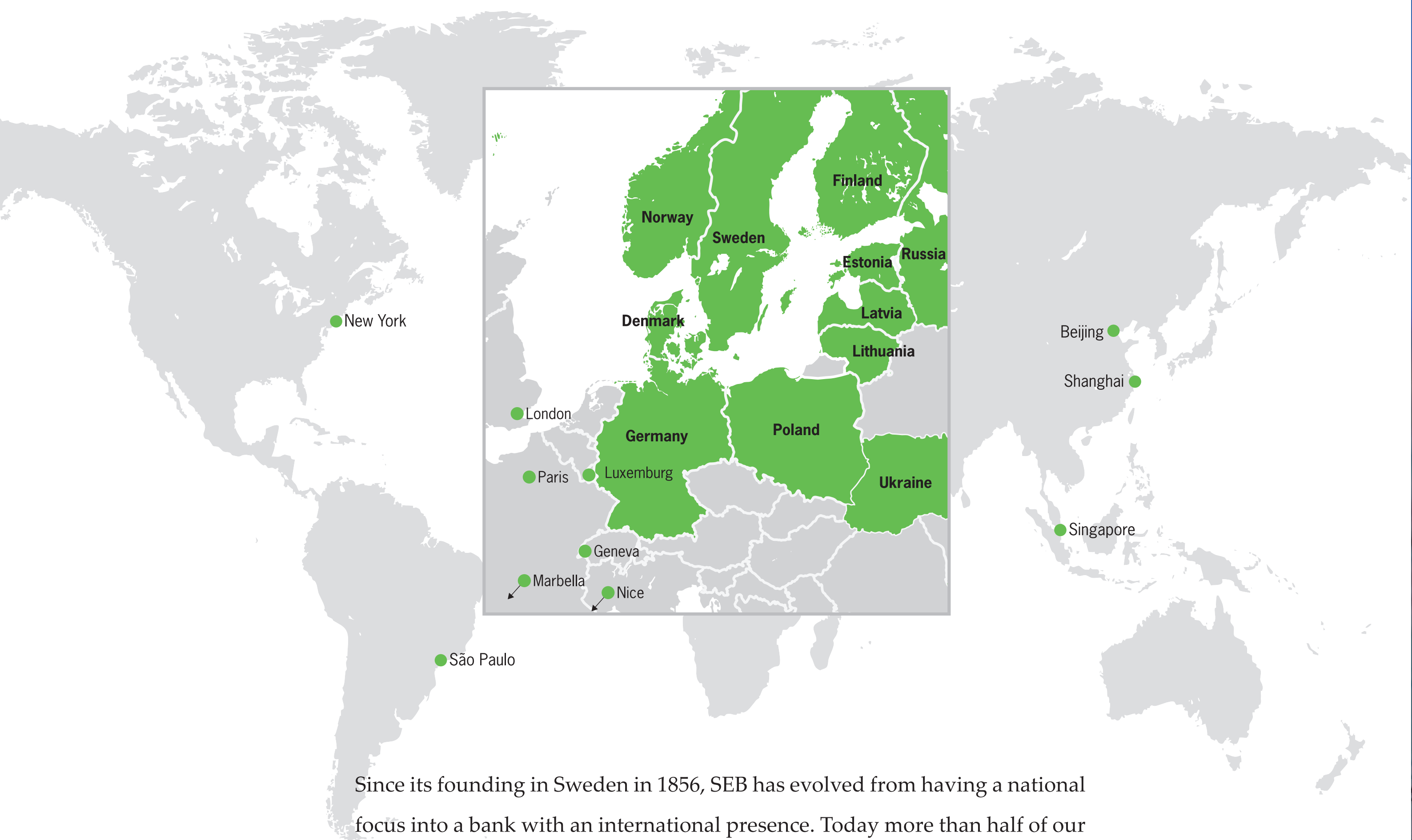

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One of the key publications from the Economic Research unit is the quarterly Nordic Outlook, which presents analyses covering the economic situation in the world as well as Europe and Sweden. Another publication is Eastern European Outlook, which deals with Central and Eastern Europe including Russia and appears twice a year.