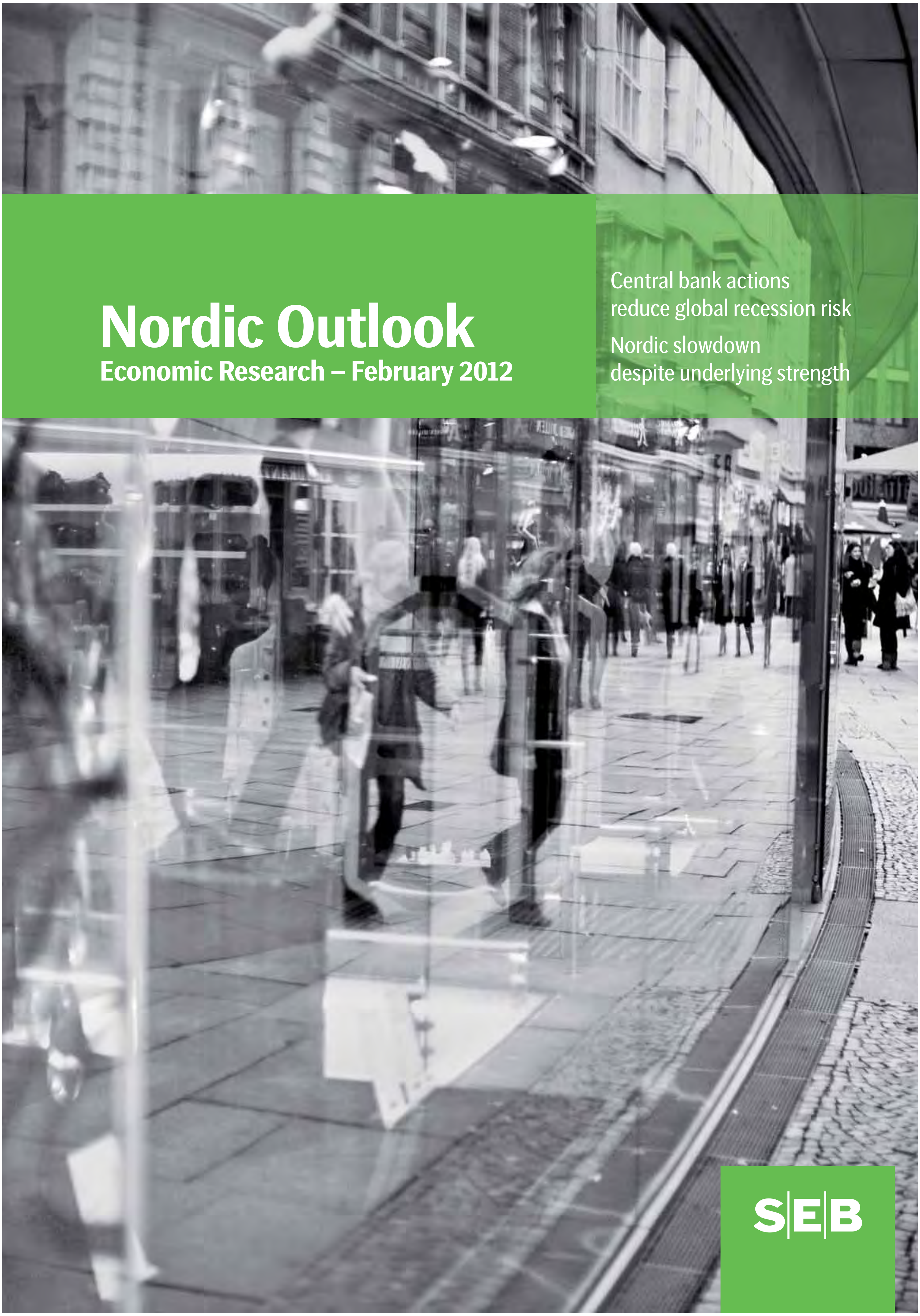
Nordic Outlook

Economic Research – February 2012

Central bank actions reduce global recession risk

Nordic slowdown despite underlying strength



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Calmer waters, but only a weak tailwind

- **Massive central bank actions inspire hope**
- **Recession unavoidable in the euro zone**
- **US growth will be around trend**
- **Nordic slowdown despite fundamentals**
- **Increased focus on fiscal coordination**
- **Growth gaps will drive EUR/USD to 1.20**

In recent months, the world economic situation has stabilised. Supportive measures from central banks have eased stress symptoms in the financial system, especially the European Central Bank (ECB) and its offer of unlimited three year loans to the banking sector, known as the long-term refinancing operation (LTRO). The euro zone countries have taken steps – though hesitant ones – towards **greater fiscal coordination and deeper integration**. Meanwhile **discussion on the role of fiscal policy at the global level has become more nuanced**, which implies less risk of strongly synchronised fiscal tightening in the next couple of years. Concurrently with these policy changes, favourable economic signals – especially in the United States – have decreased worries about a global recession. Rising share prices have helped to repair damaged balance sheets and boost optimism among households and businesses.

There are still major risks, however. The euro zone crisis persists, and southern European economies are shrinking on a broad front. Although stress levels in financial systems have diminished, they remain at high levels in many cases. **Our main scenario is still that the euro zone can be kept together**, although the future of Portugal and especially Greece in the currency union is very uncertain. We also believe there is a major risk that Spain will need a bail-out. Generally speaking, political uncertainty will remain high as long as the task of developing the new institutional framework for the euro project is under way. Fundamental problems related to competitiveness and trade flows also remain unsolved, both at the global level and in the euro zone. The actions of central banks have thus created a breathing space, but leave many difficult trade-offs and critical choices to be made.

Developments in the real economy are showing divergent trends. The euro zone moved into recession in the fourth quarter of 2011. Although certain leading indicators have stabilised in the past few weeks, the growth outlook has continued to be adjusted downward. We expect GDP to fall by 0.8 per cent in 2012 as a whole. Southern Europe is facing a rather deep recession, while Germany is keeping itself just above zero growth. Contagion to other parts of Europe will be significant. The United Kingdom and the Nordic countries will barely dodge recession. Growth will decelerate sharply in Eastern Europe, although two of the largest economies in the region – Russia and Poland – will show resilience.

The global effects will be more limited. In the US, signals of recovery on a relatively broad front have contributed to an upward revision in our 2012 growth forecast from 1.7 to 2.5 per cent. Emerging market economies have lost momentum, yet their resilience has been confirmed; we have revised our GDP forecast marginally upward. **We have revised our overall forecast of global GDP growth, adjusted for purchasing power parities (PPP), upward from 3.2 per cent to 3.5 per cent in 2012**. We have adjusted our 2013 forecast higher: from 3.8 to 4.0 per cent.

Global GDP growth

Year-on-year percentage change

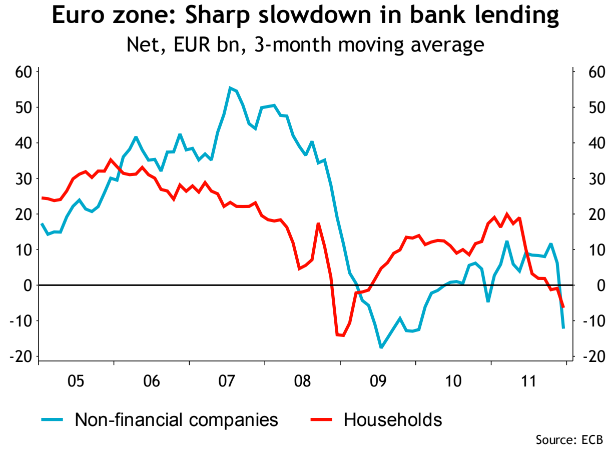
	2010	**2011**	**2012**	**2013**
United States	3.0	1.7	2.5	2.5
Japan	4.5	-0.6	1.7	1.2
Germany	3.6	3.0	0.4	1.3
China	10.4	9.3	8.7	8.9
United Kingdom	2.1	0.9	0.3	1.4
Euro zone	1.8	1.5	-0.8	0.7
Nordic countries	2.9	2.5	0.9	1.8
Baltic countries	1.1	6.0	2.0	3.2
OECD	**3.1**	**1.7**	**1.4**	**1.9**
Emerging markets	7.3	6.2	5.7	6.0
World, PPP*	**5.2**	**3.9**	**3.5**	**4.0**
World, nominal	4.5	3.2	2.8	3.3

Source: OECD, SEB * Purchasing power parities

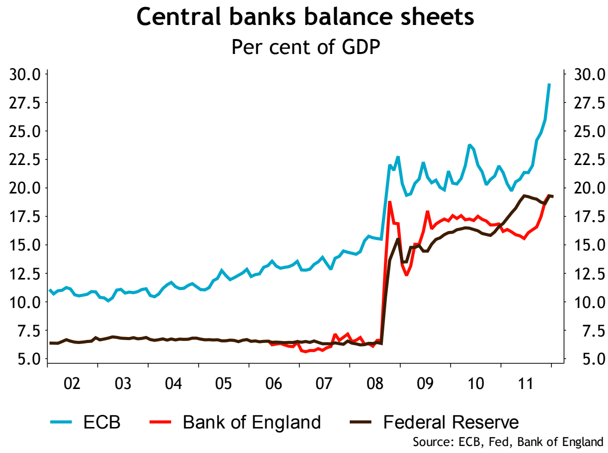
Monetary policy completely crucial

Late in 2011, the euro zone was moving towards an increasingly severe credit crunch, which is evident from bank lending statistics that are now available. One main theme of November's *Nordic Outlook* was that various actors such as national governments, the ECB and commercial banks had become trapped in destructive deadlocks. This situation threatened to generate a deep recession not only in the euro zone, but throughout the world economy. Another important conclusion was that this impasse was impossible to resolve without powerful initiatives by the ECB – probably of a nature that would test the limits of the central bank's manoeuvring room according to the treaty under which it operates.

Since then, central banks have taken a number of steps. The ECB's introduction of unlimited three year LTRO loans is probably the most important. In addition, the US Federal Reserve signalled a continued low key interest rate for nearly three more years and the possibility of further quantitative easing (QE). The International Monetary Fund (IMF) aims to add around USD 500 billion to its lending capacity, with the help of various central bank currency reserves as well as swap agreements between central banks (unlimited exchanges of currency liquidity). These are also important elements in erecting the firewalls that are needed in order to stabilise the international financial system and reduce the risk of contagion. At present, **an analysis of the effects of various available central bank strategies is vital to ensuring real economic growth**. In our separate theme article, we examine in detail the consequences and risks of LTRO and other measures.



LTRO undeniably represents a **powerful source of support to the banking sector** and has thus reduced the risk of refinancing problems and a severe credit crunch. In some respects, LTRO is more radical and potent than pure quantitative easing programmes like those launched earlier by the central banks in the US, Japan and the UK. One reason is that the **ECB's refinancing operations are demand-driven, rather than based on the central bank's supply decisions**. The expansion of the ECB's balance sheet illustrates how dramatic this development is.

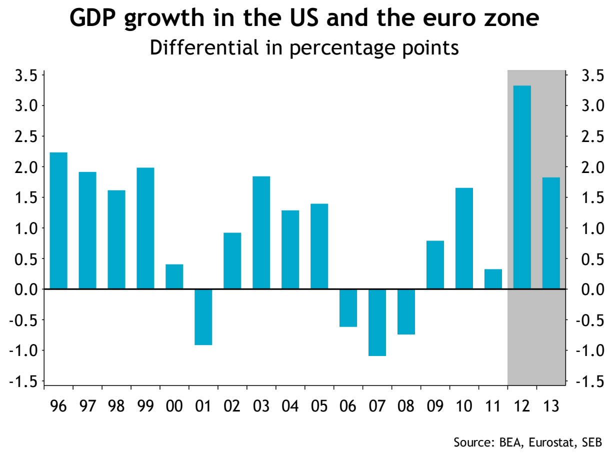


Yet there are a number of questions about the effectiveness and risks of the ECB's actions. So far the ECB's balance sheet expansion has not led to an increased money supply in the economy. It thus remains to be confirmed that LTRO will be an indirect way to achieve this. The problems of the European banking sector are also being postponed since LTRO, unlike the Fed's QE programmes, does not lift problem assets out of the banking system. There are also questions about the quality of the collateral the ECB receives in exchange for its cheap three year loans. Another issue concerns the ECB's own increased credit risk when it buys sovereign bonds from crisis-hit countries in exchange for euro system deposits. Even at a more general level, the seeds of credibility problems can be found in the ECB's actions. This is especially true of the long-term consequences of letting the ECB and the political system indirectly encourage banks to expand their portfolios of government securities with the aid of cheap central bank financing.

Our overall assessment is that the ECB will continue along the path it has embarked upon and that its second loan operation in February will be followed by others. **We do not, however, believe that the ECB will introduce a more ordinary QE programme.** We expect the Fed and the Bank of England (BoE) to continue expanding their QE programmes. Obvious recession risks and rapidly falling inflation justify looser monetary policy in the UK. Despite higher US growth, we see reasons for the Fed to deliver additional stimulus in order to make doubly sure that the recovery will not derail. Because of lingering deflation risks, a weak housing market and excessive unemployment, we foresee a rather high probability that the Fed will **launch QE3 after the summer, when the previous programme ends**. In Japan, too, growth will be kept at a decent level, but a combination of stubbornly falling prices and an overvalued currency points towards new stimulus measures. Despite the risk of international criticism, new foreign exchange (FX) market interventions are very likely.

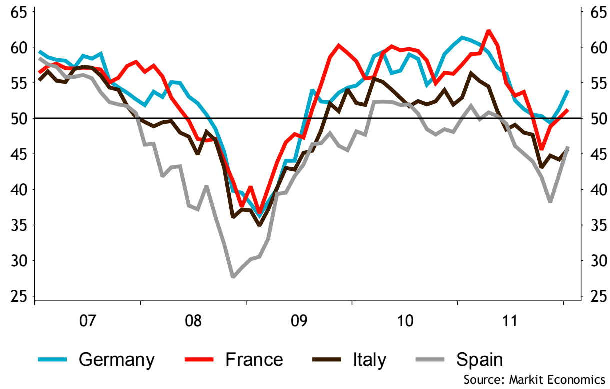
Calmer waters, but only a weak tailwind

Recently there has been a focus on the wide growth differential between the US and the euro zone. Our forecast for 2012 implies that GDP growth in the US will be more than 3 percentage points higher than in the euro zone. This is the widest gap since the mid-1990s, when the euro project began to take shape. The gap will also be wide in 2013. Our experience from the past decade indicates that decoupling forecasts have not been especially successful, in light of the strong links in the international economy. Below, however, we discuss some of the reasons why we believe such exceptional differentials will occur.



During the autumn, the euro zone economic outlook gradually deteriorated. Austerity programmes, credit contraction, continued market scepticism and a lack of decisiveness at the euro zone level had an impact on both sentiment indicators and hard data. We still do not believe that the consensus forecast has fully adjusted to these conditions. Our forecast of a 0.8 per cent downturn in euro zone GDP in 2012 is thus somewhat below the consensus scenario. Compared to our earlier forecast, the outlook for Italy (-2.3 per cent) and for Spain (-1.6 per cent) explains our downward adjustment.

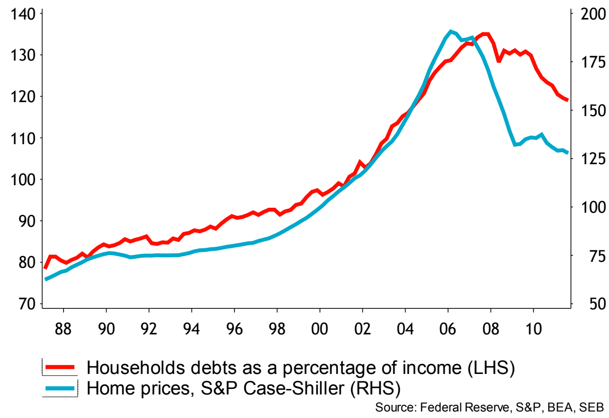
Recovery for purchasing managers' indices
Composite PMI, index



Because of diminished financial stress and some recovery in leading indicators, further downward adjustments are improbable, however. Current indicators such as purchasing managers' indices (PMIs) are at levels compatible with a recession, in line with our forecast, but they also provide a welcome signal that the euro zone economies are not in free fall. In addition, recent data from Germany have been quite hope-inspiring in various respects. The PMI, the IFO business sentiment index and labour market figures all indicate that the German economy will avoid recession.

The US economy has shown predominantly positive surprises during the past six months. Recession risks have gradually faded. This has been very important to the stabilisation of financial markets, especially when it comes to the recovery in risk appetite and share prices. In the current situation, there are also **good reasons why US growth will be well above euro zone growth**. The US has a significantly higher underlying growth rate than the euro zone. Meanwhile resource utilisation is currently far lower, implying larger potential for a cyclical rebound. In addition, earlier experience indicates that the US is usually ahead of the euro zone in the economic cycle. During more normal recoveries, the euro zone lag is usually six to nine months. This time around, though, we must also keep in mind the historical pattern in which the US has found it easier to regain its footing after deep crises. One explanation for this is that crises in Europe tend to be more complex, with financial crises being intertwined with political tensions between different countries. Differentials between the US and the euro zone may thus be larger and more long-lasting than normal.

US: Home prices and debts



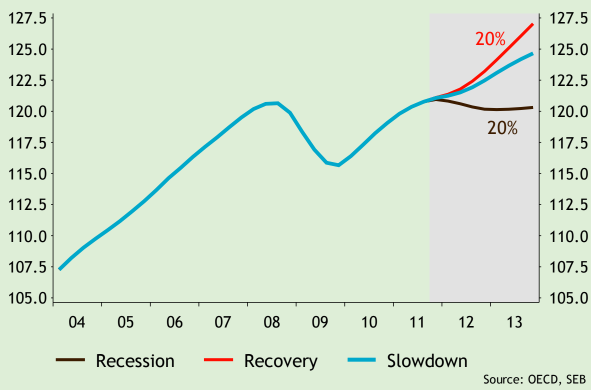
Our forecast is that the **US economy will grow by around 2.5 per cent both in 2012 and 2013**, which is close to trend. Despite recent signals of a faster labour market recovery, we still foresee major impediments in a medium-term perspective. The above chart shows a clear association between the level of home prices and debts as a share of disposable income. After the dramatic home price slide of 2007-2009, debt deleveraging

More balanced risks

To summarise, the risk picture has shifted in a positive direction. Our main scenario is still that the euro zone will move into recession during 2012, but that the 34 countries of **the Organisation for Economic Cooperation and Development (OECD) as a whole will muddle through, with slow but positive growth**. We previously thought that the probability of a relatively deep recession was significantly higher than the chance of upside surprises. **We are now making a more symmetrical risk assessment** and are assigning both alternative scenarios a 20 per cent probability, compared to 60 per cent for our main scenario.

As previously, a deeper euro crisis is the most important likely driving force behind a possible recession in the OECD countries as a whole, but the risks of escalating instability in the Middle East and rising oil prices have also increased. The main upside potential is that the American economy may experience a more normal recovery dynamic, with contagious effects on the whole world economy. Upside potential is limited, however. If underlying growth forces should strengthen to a clearly greater degree than expected, central bank stimulus measures will be withdrawn and the pace of public sector consolidation will increase. The OECD countries thus seem condemned to a rather lacklustre period of growth as long as the healing process after the financial crisis and earlier debt build-up is under way.

More balanced growth prospects ahead
Index 2000 = 100



seems to have progressed about halfway. Continued deleveraging requirements will dampen consumption over the next couple of years, especially in light of renewed home price declines. Fiscal policy will also hamper growth in the medium term. Although it is likely that Congress can resolve acute problems in the near future, large deficits will unavoidably lead mainly to fiscal tightening during our forecast period.

Emerging market countries remain resilient

Both economic expansion and inflation pressure are now easing in **Asian emerging markets, and GDP growth will end up just below trend in 2012**. Yet the region will continue to serve as an engine for the world economy, with growth far higher than in the OECD countries. **We expect growth to bottom out during the first half of 2012** and then accelerate again. **Strong central government finances and relatively stable financial systems will make these economies resilient** and help sustain private consumption and capital spending as external demand fades. Falling inflation pressure will also allow the authorities room to stimulate their economies with looser monetary policy. Some countries have already begun to lower their key interest rates, and **monetary policy will be eased further during 2012**. Risks of sharp declines in growth have decreased, although the threat of a serious downturn in the Chinese residential property market cannot be ruled out.

Nordic growth far below trend

The small open Nordic economies are being relatively hard hit by the euro zone recession. Trade with southern Europe is comparatively small, but this has been little solace in an environment where even the German economy has experienced a serious loss of momentum. **Relatively good government finances and strong external balances provide some resilience but cannot prevent growth from falling well below trend this year.** In Denmark, Finland and Sweden, GDP growth will end up at around 0.5 per cent this year. Growth will be somewhat stronger in 2013 but will not reach the trend rate. In Norway, domestic demand will hold up better, and GDP will grow by more than 2 per cent both in 2012 and 2013.

Despite the decline in growth, because of their good fundamentals the **Nordic countries have strengthened their appeal as investment alternatives during the latest crisis**. This is manifested, not least, in low sovereign bond yields. Swedish and Danish government bond yields have been lower than Germany's. Norwegian government bond yields are at record low levels, although the spread to Germany is higher today than one year ago. Finland, along with the Netherlands, has been the euro zone country that has managed to maintain the lowest yield spreads against Germany. The currencies of Norway and Sweden have appreciated against the euro during the crisis, in sharp contrast to the pattern in 2008-2009.

To some extent, the Swedish and Norwegian central banks are thus facing challenges that usually characterise hard currency countries. There are also major differences between these two countries. We expect that because of inflation that is far below target, low resource utilisation and falling home prices, **Sweden's Riksbank will cut its key interest rate from today's 1.75 per cent to 1.00 per cent by mid-2012**. In Norway, however, Norges Bank must respond to overheating risks in both the labour and housing markets. We thus expect the bank to hike its deposit rate in 2013 from its current level of 1.75 per cent to 2.50 per cent.

GDP growth, Nordic and Baltic countries

Year-on-year percentage change

	2010	2011	2012	2013
Sweden	5.6	4.3	0.5	1.7
Norway	0.7	1.3	2.1	2.4
Denmark	1.3	1.1	0.5	1.4
Finland	3.6	2.7	0.5	1.7
Nordics	**2.9**	**2.5**	**0.9**	**1.8**
Estonia	3.1	7.5	1.5	2.5
Latvia	-0.3	5.0	2.5	4.0
Lithuania	1.3	5.8	2.0	3.0
Baltics	**1.1**	**6.0**	**2.0**	**3.2**

Source: OECD, SEB

Export-dependent Baltics will slow down

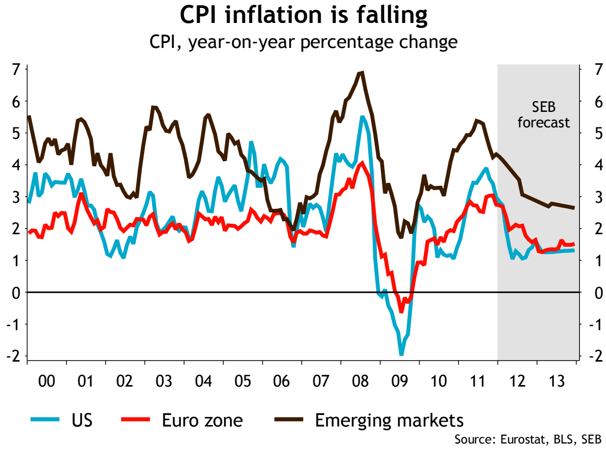
The Baltic countries are now better equipped to withstand international shocks than during the credit crisis and recession of 2008-2009. **Painful austerity policies and dynamic exports led to reduced imbalances.** But these countries are far from immune to the euro zone crisis and the global slowdown. The reason is their heavy dependence on exports, especially Estonia and Lithuania. **The export boom is now rapidly fading.** This is occurring at a time when domestic demand has not quite gained momentum after its cautious recovery of the past year. High unemployment, which has admittedly eased, is an impediment to growth as well as a major political challenge.

Estonia is heading towards a sharp deceleration from 7.5 per cent growth in 2011 to 1.5 per cent this year, followed by 2.5 per cent in 2013. Lithuania's growth will slow from 5.8 per cent in 2011 to 2.0 and 3.0 per cent, respectively. Latvia, which has lagged somewhat in its recovery, will decelerate more gently from a GDP increase of 5.0 per cent in 2011 to 2.5 per cent this year, followed by a rebound to 4.0 per cent in 2013. Our forecasts imply that growth in the Baltic economies will remain somewhat below trend next year as well. Latvia's acceleration in 2013 will be partly due to higher investments in the run-up to its expected euro zone accession, as planned, in 2014.

Inflation on its way down

The inflation rate is now on its way down at a fairly resolute pace in all parts of the world economy, as earlier upturns in commodity prices disappear from the 12-month figures. We believe that Consumer Price Index (CPI) inflation in the OECD countries will fall to about 1½ per cent during the coming year and then level out. Our composite measure of CPI in important emerging market countries points to a gradual downturn of more than 2 percentage points during 2011-2013.

Underlying inflation is also on its way down. In the US, we foresee a rather clear downturn in core inflation (CPI excluding food and energy) during 2012, after an upturn in 2011. The absence of wage pressure will help push core inflation below one per cent towards the end of 2012. In the euro zone, the trend is less clear; pay increases seem to be holding up to a relatively large extent, while inflation is also being pushed upward, since increases in indirect taxes are one element of the austerity policies of many countries.



On the whole, **the slowdown in inflation will provide welcome support to the economy** by allowing greater household purchasing power and more manoeuvring room for central banks. In the short and medium term, downside risks will dominate, since low resource utilisation over a long period may create stronger deflationary forces.

Conflicting demands on fiscal policy

Ever since the financial crisis broke out in 2008, **economic policy has been characterised by fundamental ambivalence**. On the one hand, there is an ambition to address the roots of the excesses that caused the crisis. This includes restructuring the financial system, for example by strengthening the resilience of the banking system through higher capital adequacy requirements (Basel III etc.). This element of economic policy leads in various ways to deleveraging of private sector debt. Another key element is to wind down public sector debt, in order to improve the credibility of long-term public commitments and reduce vulnerability to economic fluctuations. **If both the private and public sectors are retiring their debts, however, the impact on overall demand will be sizeable.** The world economy will risk a deep recession that creates major social and political tensions, both nationally and internationally. The period right after the First World War and the years immediately after the 1929 stock market crash provide examples of such synchronised debt reductions.

Alongside their **pedagogical elements**, economic policies also aim at **easing the adjustment** in various ways. This includes the efforts of central banks to use exceptionally low key interest rates and non-conventional monetary policy to prevent private deleveraging from occurring too fast. Such international organisations as the IMF and the OECD have also increasingly emphasised the importance of **ensuring that overall fiscal policies at the global level do not become too tight**. For some years, the Group of 20 (G20) countries have included international role allocation on their agenda, emphasising the need for expansionary policies in countries with large current account surpluses. These issues have nevertheless been conspicuously absent from public discourse. One important reason is that countries enjoying trade surpluses have often interpreted this as a result of their responsible economic policy, not as part of global imbalance problems. This has been clear, for example, in German and Swedish government statements.

We believe that **issues related to the coordination of fiscal policies will receive more attention in the future**. As countries in southern Europe are forced to implement large-scale austerity measures that threaten their political stability, it will be increasingly important to demonstrate a consistent policy at the global level that helps avoid a destructive spiral, in which austerity measures lead only to slower growth and worsening debt problems. The IMF, for example, has pointed out that under certain circumstances, further austerity measures may worsen – not improve – market confidence in the sustainability of economic policy.

Geopolitical risks will keep oil prices high

Oil prices have remained high despite slower economic growth and falling prices for other commodities. Since October, the price of Brent crude has fluctuated within a ten dollar interval: USD 105-115 per barrel. Recently the continued strength of the Chinese economy and the stabilisation of manufacturing sentiment in many countries have helped sustain oil prices. Growing political risks in the Middle East and Africa have also been of major importance. This is especially true of domestic and foreign policy tensions affecting three important oil producing countries – Iran, Iraq and Nigeria – but prices also indirectly reflect the escalating crisis in Syria.

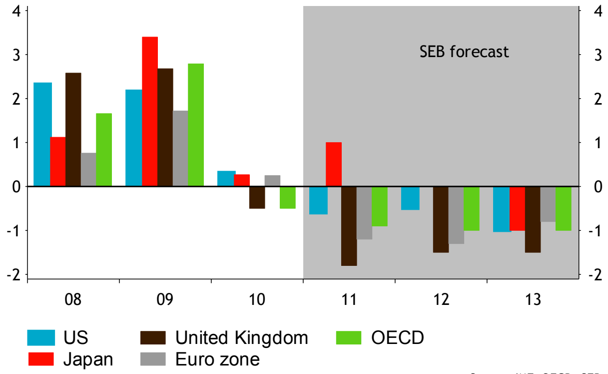
New production capacity being added in Iraq, Libya, Brazil and North America represents a potential for lower oil prices. But the tensions in the Middle East and Libya are holding back investments. Furthermore, Saudi Arabia is motivated to keep oil prices above USD 100/barrel. The country implemented fiscal stimulus measures, among other things aimed at lowering the risk of revolutionary movements like the one in Egypt, thereby increasing its need to keep oil revenue high. Our overall forecast is that **Brent oil prices will climb a bit more this year to an average of USD 114/ barrel, and to USD 120 in 2013**.

The risks of higher oil prices are mainly connected to the threat that the tensions surrounding Iran's alleged nuclear programme will escalate further. A total blockage of oil shipments through the strategically important Strait of Hormuz would probably lead to a surge in oil prices above earlier historical peak levels of around USD 150/barrel. As much as one fifth of the world's oil is exported through the Strait of Hormuz. Iran is also an important oil producer, accounting for 4-5 per cent of global production. Turkey is the country most dependent on Iranian oil, which makes up some 50 per cent of its oil imports, while in countries like China, India, Japan, South Korea, Italy and Spain the figure is around 10-15 per cent. At present, the situation is especially sensitive since global oil stocks are relatively small after last year's draw-downs.

In this context, **Germany plays a special key role**. After a long period of large current account surpluses, Germany has large net receivables in relation to other countries, especially other euro zone countries. Meanwhile Germany has shown relatively large budget deficits during the past decade, resulting in central government debt equivalent to 80 per cent of GDP; private sector savings has thus been very high. Calls for Germany to set an example by meeting the standards of the European Union's stability pact, yet meanwhile pursue an expansionary fiscal policy that will ease imbalances – globally and in the euro zone – are incompatible and imply latent tensions surrounding German economic policy.

Fiscal tightening ahead

Year-on-year change in structural net lending, % of GDP



Source: IMF, OECD, SEB

As a group, the OECD countries began a tightening of their fiscal policies in 2010, following their coordinated fiscal stimulus measures during the initial phase of the crisis. **The dose of austerity is now gradually becoming stronger and will reach about 1 per cent of GDP in 2012 and 2013.** The European debt crisis will put continued pressure on various countries to implement front-loaded cost cutting measures – especially the countries that are receiving bail-out loans from the euro zone and the IMF. Italy and Spain are also continuing their front-loaded cost cutting policies in order to stabilise their debts.

General government net lending and gross debt

Per cent of GDP

	2010	2011	2012	Debt*
United States	-10.1	-9.0	-8.0	111
Japan	-9.3	-10.3	-11.0	250
United Kingdom	-9.4	-8.0	-7.0	94
Euro zone	-6.2	-4.4	-3.7	95
OECD	-7.7	-6.6	-5.9	108

* Gross debt in 2013

Source: European Commission, OECD, SEB

Meanwhile we anticipate a shift in a less contractive direction. This means that the most vulnerable countries – Greece, Italy, Ireland, Portugal and Spain (GIIPS) – will continue their existing austerity programmes but that deteriorating growth prospects will not lead to further cost cutting requirements. The cost cutting programmes in Italy and France are still under way, but despite the downgrading of their credit ratings not much more will be done in the short term. On the other hand, it is uncertain whether Germany will formally loosen its fiscal policy. It is more likely that Germany will instead be inclined to contribute money to various bail-out programmes once the new fiscal pact is in place. **In the euro zone, the austerity dose will thus be about 1 per cent of GDP annually both in 2012 and 2013.**

The US and Japan have more leeway to hold off on reducing their public sector deficits. We expect rather modest tightening measures over the next couple of years. This implies continued budget deficits above the euro zone average, leading to a continued rapid rise in government debts and thus more room for private sector deleveraging.

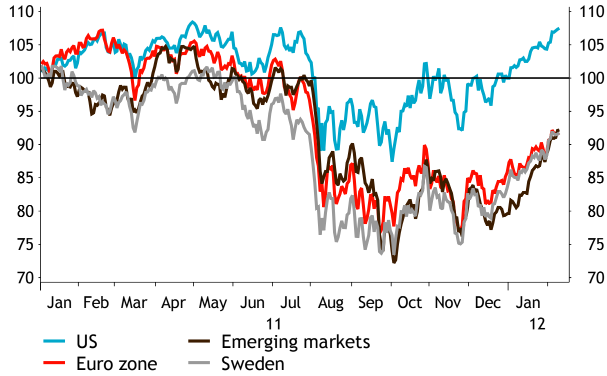
Further stock market recovery, but big risks

World stock markets have recovered strongly in recent months. **Compared to the October upturn in equities, this time around the recovery is more firmly rooted in fundamentals.** Looser monetary policy globally, an improved US economic outlook and a smaller risk of a hard landing in China have provided support. Especially important are the bright spots in the American labour market that are now discernible and the fact that the stabilisation of PMI indicators in Europe offer hope of a rather mild, brief recession in the euro zone. During the coming year, it is likely that the stock market recovery will continue, given our economic scenario as well as continued extremely loose monetary policy and relatively cautious stock market valutions at the outset.

Meanwhile there are plenty of warning flags. The normalisation of the stock market climate has also been surprisingly rapid in other respects. The VIX volatility index is far below its historical average, which is hardly compatible with the lingering risks in the world economy. So far, rising oil prices have not slowed the stock market upturn, but if turmoil in the Middle East should cause oil prices to continue climbing, this may be a factor that severely hampers the recovery.

US stock exchanges leading the upturn

Index 100 = 2011



Source: Reuters EcoWin, SEB

Nordic stock exchanges have been swept along by the positive climate, after having generally lost ground during 2011. Measured since the beginning of 2012, for example, the NASDAQ OMX Stockholm has performed more strongly than the broad equity indices in the US and the euro zone. Since bottoming out last autumn, Stockholm share prices have climbed 25 per cent – in line with the upturn in emerging market economies.

Looking ahead, there are many indications that the Nordic stock exchanges have good potential to perform more strongly than those of Western Europe generally. The Nordic economies will avoid a GDP decline in 2012, thereby supporting domestic sectors. Given a more stable economic environment, the more cyclical exposure of the NASDAQ OMX Stockholm, for example, will also turn into an advantage. Meanwhile the restraining effect that limited liquidity had on smaller stock exchanges during the most intensive phase of the crisis will be eliminated.

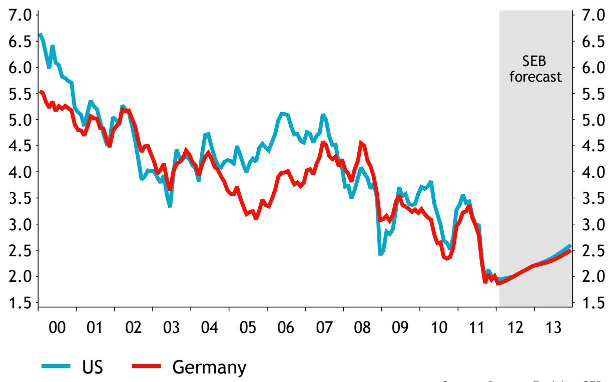
Continued very low long-term yields

After their sharp downturn last summer, US and German 10-year government bond yields have mainly moved sideways. They noted a rebound at the time of last October's stock market upturn. In Germany, bond yields also rose in conjunction with market worries after an unsuccessful bond issue in late November, **but during recent months of increasing risk appetite and share prices, yields have not moved upward**.

According to our yield forecast, **10-year German and American government bonds will trade in an interval around 2 per cent during the next six months**. Even though the economic outlook will continue to stabilise, it is difficult to see reasons for higher long-term yields in an environment where inflation is falling and where the Fed and other central banks are still providing exceptional monetary policy stimulus. The continued relatively high probability that the Fed will launch a QE3 programme after the summer is especially instrumental in keeping American yields down. **Late in 2012 and during 2013, we expect a slow upward movement as we approach the time for some normalisation in monetary policy.** At the end of 2012, German 10-year yields will stand at 2.20 per cent and at the end of 2013 they will be 2.50 per cent. The upturn in American yields will be marginally bigger.

10-year government bond yields

Per cent



Source: Reuters EcoWin, SEB

Because yields remain close to historical lows, it is too early to rule out the possibility of a continued downward trend towards Japanese levels. This is especially true in light of the Fed's signals that it is prepared to extend the period of near-zero key interest rates. However, our **inflation forecast implies that a deflationary trend can be avoided** and that the central bank can retain the credibility of its inflation target in a medium-term perspective. Under such conditions, it is difficult to foresee much further room for lower yields in the US and Germany.

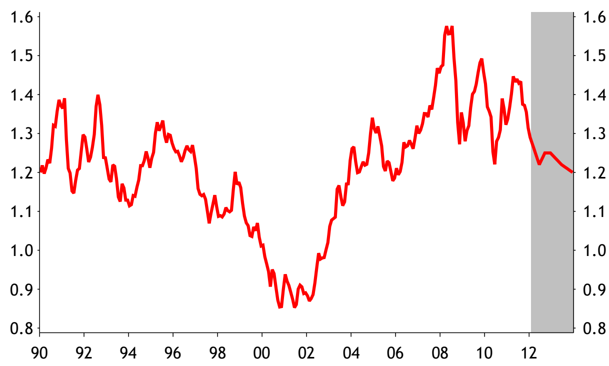
Growth gaps will drive EUR/USD to 1.20

In recent months, **favourable economic signals have driven the foreign exchange (FX) market**. This has benefited cyclical and commodities-sensitive currencies, including the Scandinavian ones. Because of increasing risk appetite, fundamental factors such as current account surpluses and good government finances have also paid off. **Our overall scenario is that fundamentals will continue to drive the FX market**. This implies that currencies that are already at high valuations will be subjected to further appreciation pressure. The European debt crisis may periodically flare up, however, which would mean that the liquidity situation would again become an important driving force.

The US dollar traditionally declines during periods of increased risk appetite, but over the past six months this association has been weak. We **expect the EUR /USD exchange rate to continue its downward trend even in an environment of gradually more stable economic conditions**, driven by the large **growth gap between the US and the euro zone**. At the end of 2012, the EUR/USD rate will stand at 1.25 and at the end of 2013 it will be 1.20.

The dollar will continue to appreciate against the euro

EUR/USD



Source: Reuters EcoWin, SEB

Since 2005 the Chinese yuan has gained around 25 per cent against the dollar. Last year's appreciation totalled less than 5 per cent. Because of lower inflation pressure and somewhat slower growth, Chinese authorities are not inclined to speed up the pace, despite political pressure from other countries, especially the US. With the dollar continuing upward according to our forecast, the traded-weighted appreciation of the yuan will also be larger than against the dollar. We expect an **annual CNY/USD appreciation rate of 3-5 per cent in 2012-2013**.

The Swedish krona has been quite resilient in the face of recent turbulence and seems to have gain **higher status as a safe haven currency**. We therefore believe that the krona may continue to appreciate against the euro, despite **weak growth and a declining export outlook in the near term**. At the end of 2012, the EUR/SEK exchange rate will be 8.50 and at the end of 2013 it will be 8.40, which is well in line with our long-term equilibrium calculations. The krona will, however, weaken somewhat against the dollar, with the USD/SEK rate reaching 7.00 at the end of 2013. To a large extent, **strong fundamentals favour the Norwegian krone**. An increasingly wide key interest rate gap and high oil prices are additional factors. The EUR/NOK rate will fall towards 7.35 by the end of 2013.

The ECB's LTRO – long-awaited but two-edged weapon

- **"Firewalls" are now in place**
- **Increased concentration of risk at the national level and in the banking system**

The European Central Bank's new three year loans (Long-Term Refinancing Operations, LTROs) will greatly reduce refinancing risk for the euro zone banking system and indirectly for euro zone governments with serious credibility problems. They also lower the risk of a severe, uncontrolled credit contraction and destabilisingly high yields on sovereign debt. They help the euro zone economy and create political manoeuvring room to deal with big problems: solvency, competitiveness and growth.

The ECB's long-term loan operations in December and February, the anticipated USD 500 billion expansion of the IMF's emergency fund (aided by various central banks' currency reserves) and swap agreements between central banks (unlimited exchanges of currency liquidity) **together form the necessary "firewalls"**, which are hopefully robust enough to prevent contagion in the global banking system. The balance sheets of central banks will thus be a tool for resolving liquidity problem while the euro zone economic, financial and political system grapples with major credibility problems.

The strategies chosen by various central banks in recent years illustrate the different techniques that are available. By changing its own balance sheet, a central bank can change the private sector's balance sheet – its mirror image – and thereby influence financial prices and liquidity in the banking system. For example, the Swiss and Japanese central banks expand their own currency reserves through FX market interventions and add liquidity to the banking system. The US and UK central banks expand or change their portfolios of domestic securities (for example by purchasing government and mortgage-backed securities) in exchange for new dollars and pounds in the system and a depressed yield curve. The ECB differs from other central banks, since its actions were previously not allowed to lead to a larger quantity of euros in the system, but its new three year loans are providing an **enormous and unlimited quantity of new euro liquidity to the banks**, which indirectly has a positive impact on credit and money supply growth.

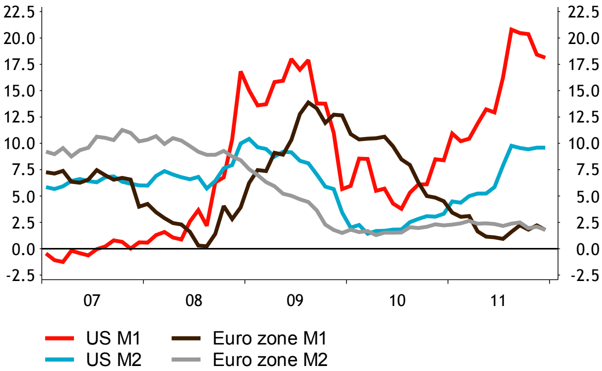
The ECB's first three year refinancing operation (LTRO 1) totalled nearly EUR 500 billion, but the liquidity injection was smaller than this, since LTRO replaced other loan operations. The second LTRO will take place on February 29. This loan will probably exceed EUR 500 billion. Banks are being encouraged by public authorities and political leaders to participate; the stigmatisation of borrowing is thus modest. In principle, the ECB has now demonstrated to the international capital market that it possesses a tool whose power is nearly unlimited. After LTRO 1 and 2, there may well be an LTRO 3 and an LTRO 4. Theoretically, the ECB has no restrictions on its balance sheet. There may be restrictions for the banks that must provide ECB-approved collateral in order to borrow money. But when it launched LTRO 1, the ECB announced that it was lowering credit quality requirements for the collateral provided, thereby increasing the room for ECB lending to the banks.

However, not all central banks in the euro zone seem entirely pleased that the ECB is now accepting significantly lower credit quality in the collateral supplied by banks in various countries. On the table is the question of whether national banks should manage this collateral, not the ECB. Such an option implies that **credit risk will be nationalised, not elevated to the supranational level**. The result may be increased concentration of credit risk in national central banks and banking systems.

LTRO loans carry a floating interest rate determined by the ECB refi rate's historical averages. A three year loan may be repaid early after one year. T**he ECB's main motive for implementing LTRO is to improve the monetary policy transmission mechanism.** This is achieved by providing support to the banking system so it can maintain or expand its lending to euro zone households and businesses. The loan amount may be said to reflect the refinancing needs of the banks over the next three years. LTRO increases the monetary base and thus represents an important contribution to expansion of euro zone money supply. The trend of money supply differed greatly between the US and the euro zone during 2011.

Divergent money supply trends

Year-on-year percentage change



Source: ECB, Federal Reserve

One positive effect of LTRO is that borrowing cheaply from the ECB enables banks to improve lending margins and earnings, making it easier for them to meet tougher requirements (such as Basel rules) without shrinking their balance sheets. **An undesired credit contraction would be especially devastating in the euro zone**, where some 85 per cent of credit is supplied by banks. It will hopefully also reduce the risk that banks will cut back operations in Eastern Europe, for example, but the risk of a euro zone credit crunch cannot be ruled out yet.

For the banking system, holdings of government securities are associated with a different risk picture today than a year ago or earlier. To varying degrees, euro zone government securities today entail higher credit, interest rate and liquidity risks. There is also some likelihood that they will involve currency risk, if it turns out in the future that the euro in its current form will cease to exist and will be replaced by something else.

Another, more controversial motive is that banks are being encouraged to buy government securities. In this way, the ECB avoids directly propping up individual governments via its monetary portfolio. But it is a matter of interpretation whether LTRO is violating two fundamental principles of the euro project: 1) there shall not be any collective liability for central government debts of individual countries and 2) the ECB shall not use its balance sheet to finance budget deficits and/or government debts. These two principles may explain why the ECB finds it difficult to participate in a Greek debt write-down together with the private sector. One alternative, which implies retaining at least the second fundamental principle, is that the European Financial Stability Facility (EFSF) should take over the ECB's Greek government bonds, then carry out a write-down.

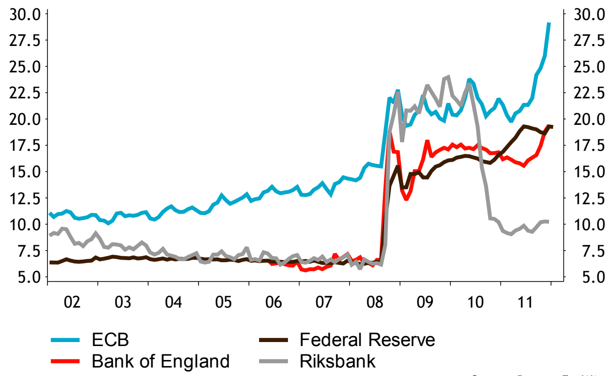
The yield curve in the euro zone is being affected right now in slightly different ways. The short-term segment will benefit from countries expected to end up with a stronger currency in case of any change in the composition of the euro. For example, German short-term yields are now benefiting because any return to the D-mark would probably result in a currency that may be 20 per cent stronger than today's euro. Meanwhile the 2-3 year segment of the yield curve is depressed by the fact that banks will be buying this maturity of government securities. Beyond three years, however, there is a risk of upward pressure due to increased credit risk when LTRO money is no longer available to banks/governments (unless the ECB chooses to continue its long-term lending). In itself, this may have the undesired effect that governments will choose, to a greater extent, to shorten the average maturity of their borrowing portfolios (which stand at about 6.5 years in the G20 countries) at a time when the uncertain situation indicates, if anything, that a lengthening of maturities would be desirable.

The ECB's operations also imply other structural changes. **An increased concentration of government securities risk represents a kind of nationalisation of central government debts in many euro zone countries.** This will increase, not decrease, mutual dependence between the problems of the banking system and governments. These concurrent problems are among the major challenges the euro zone must manage in order to regain financial stability. On the other hand, increased "nationalisation" of countries' government debts means less risk of contagion between countries. A problem government will be more of a national problem, not an international one.

In the last *Nordic Outlook*, we forecasted that the ECB would expand its Securities Markets Programme (SMP) by around EUR 500 billion. Our conclusion was based on the need for the international capital market to reduce its holdings of euro zone bonds. Even if the ECB continues to expand its SMP portfolio, which totals about EUR 225 billion today, the ECB has chosen another strategy. The implication is thus that instead of gathering risk in the ECB's balance sheet, risk will instead end up in national banking systems.

Central banks balance sheets

Per cent of GDP



Source: Reuters EcoWin

In a broader perspective, we can also point out the dangers of unconventional monetary policy. The change in central bank balance sheets is historically unprecedented. In recent years, the central banks of developed economies have seen a doubling of their balance sheets to USD 8-9 trillion (more than 20 per cent of GDP). This policy involves a number of risks:

1. These securities portfolios may lose value and jeopardise the capital base, credibility and independence of central banks.
2. Although the money supply need not lead to inflation, expectations of rising prices due to "money printing" may lay the groundwork for higher inflation.
3. At some point in the future, a central bank's securities holdings will be "transferred" to the private sector; the timing and execution may have a major impact on prices, for example currency and interest rate effects.
4. The availability of money may create conditions for a new wave of credit expansion that increases the risk of financial instability.
5. The banking system may become too dependent on central bank financing, causing the market to function more poorly.
6. There is a credibility conflict between the need for an independent central bank and a political system that encourages banks, for example, to increase their holdings of government securities with the help of central bank financing.

We nevertheless believe that these risks are manageable when compared to the problems that Western economies are grappling with right now, such as low resource utilisation and high unemployment, as well as excessive debt that must be brought down to more manageable levels.

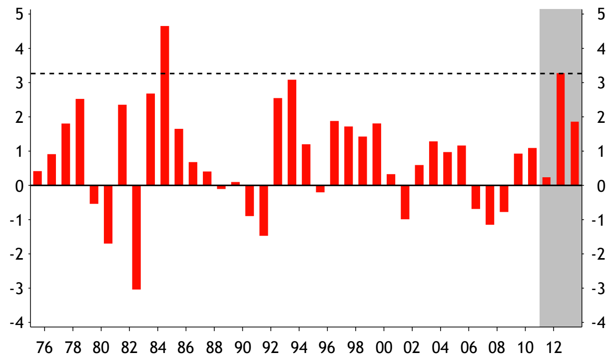
American economy showing resilience

- **US decoupling from European recession...**
- **...but growth will stay at around trend rate**
- **Home prices will stabilise this year**
- **With inflation falling, Fed will stimulate**

The US will avoid being drawn into Europe's recession. In the fourth quarter of 2011, the American economy grew by 2.8 per cent on an annualised basis, in line with our forecast in the November issue of *Nordic Outlook*. Meanwhile GDP growth fell in several important European countries. Although the US is affected via trade, tighter financial conditions and lower bank lending, judging from the predominantly positive macroeconomic statistics of the past few months, contagion is apparently limited. We are revising our 2012 forecast of the American economy upward a notch, but one ominous statistic is that the growth gap between the US and the euro zone has rarely been as wide as it is projected to be this year.

Huge but not unprecedented divergence in '12

U.S. GDP growth less euro zone GDP growth, per cent



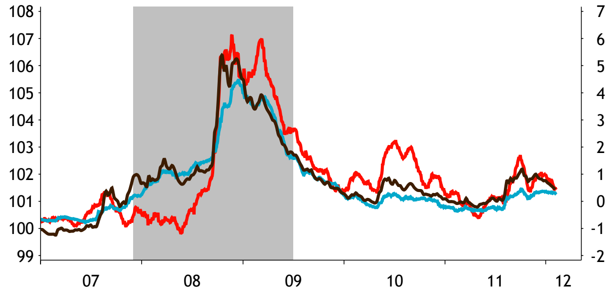
Source: Reuters EcoWin, SEB

The European debt crisis nevertheless creates obstacles to a normal American recovery process. In addition, debt deleveraging in the household sector will continue to hold back growth. After the latest spending agreement in Washington, federal fiscal policy looks likely to be less contractive this year, but the headwinds will be more severe in 2013. After 1.7 per cent growth last year, the **American economy will grow by 2.5 per cent both this year and in 2013**. GDP growth will be slightly above trend, and **we expect unemployment to drift slowly downward throughout our forecast period**. At the end of 2013 the unemployment rate will be 7.3 per cent.

Inflation ended up above the Federal Reserve's targeted level last year but is expected to drop below target both this year and in 2013. **Core inflation will fall** to 1.2 per cent by late 2012. This opens the way for a further Fed bond purchasing programme, probably focusing on mortgaged-backed securities (MBS). Although it is a close call we believe that the **Fed's new bond purchasing programme will be launched after the summer**.

Euro zone crisis is having an impact

Index



Financial Conditions Index (LHS)
Credit Restraint Index (RHS)
St. Louis Financial Stress Index (RHS)

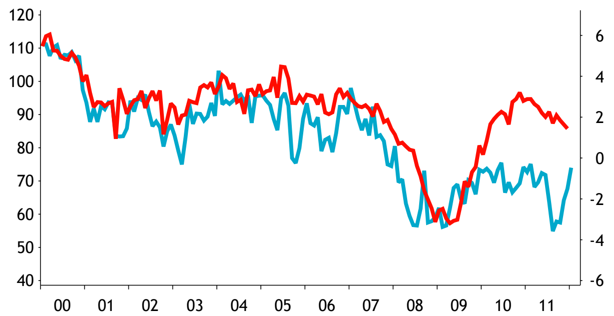
Source: Reuters EcoWin, SEB

More optimistic households

Household confidence indicators have steadily pointed upward since they bottomed out at around the time of Congress's debt ceiling agreement in August. A more positive labour market outlook is probably the most important explanation for the upturn, but falling petrol prices have also contributed. At the same time, it is difficult to translate what current index levels mean in terms of consumption growth, since historical associations have cease to be valid in recent years. One explanation may be that rising government transfer payments to households have propped up consumption, while household optimism has been affected more by weak underlying income growth.

Spending outpacing sentiment

Index, year-on-year percentage change



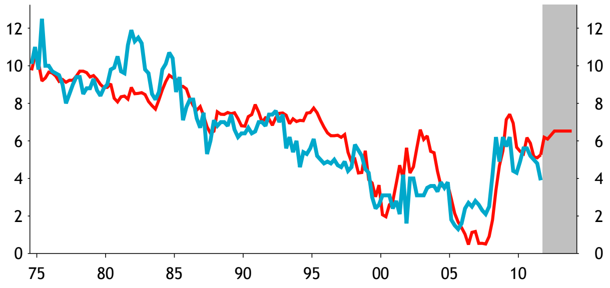
Michigan consumer sentiment (LHS)
Real consumer spending (RHS)

Source: BEA, University of Michigan, SEB

Households cut back dramatically on their saving during the second half of 2011, which helped sustain consumption. Looking ahead, however, we expect the household savings ratio to bottom out and then rebound, so that it will instead be income that drives consumption. **Household consumption will grow by an average of just above 2 per cent in 2012-2013**. The savings ratio will climb to 5 per cent by the end of 2013. Our model-based estimates, which include other factors such as wealth position, indicate a larger savings upswing, which is thus a downside risk to our consumption forecast.

Fundamentals suggest that the savings ratio should rise

Per cent of disposable income

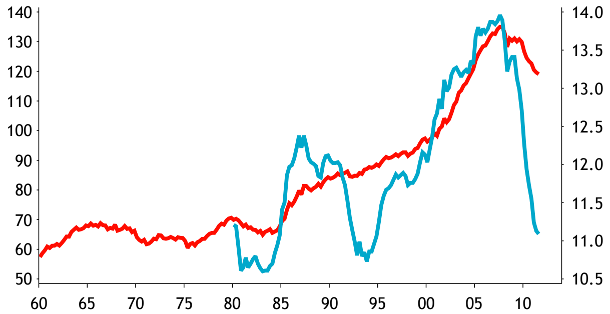


Source: BEA, Federal Reserve, SEB

In recent years, home prices have been the main culprit in undermining household wealth. Home prices are still falling on a broad front, according to the S&P/Case-Shiller index. Although there are factors pulling in both directions, our assessment is that **home prices will stabilise this year**. Measures of what households can afford are showing that homes have rarely been priced more affordably than today, and the decline in price has wiped out earlier overvaluations. Meanwhile the flow of foreclosure sales means that supply still exceeds demand.

Ongoing deleveraging is holding back growth

Per cent of disposable income, percent



Source: Federal Reserve, BEA, SEB

Household debt as a share of disposable income has fallen to 119 per cent. Since peaking in 2006, home prices have fallen by 33 per cent to their 2002 level, when indebtedness stood at 108 per cent. This indicates that deleveraging in the household sector will also continue during the next couple of years, but since the household debt service ratio has fallen sharply, **deleveraging will not interrupt the recovery**.

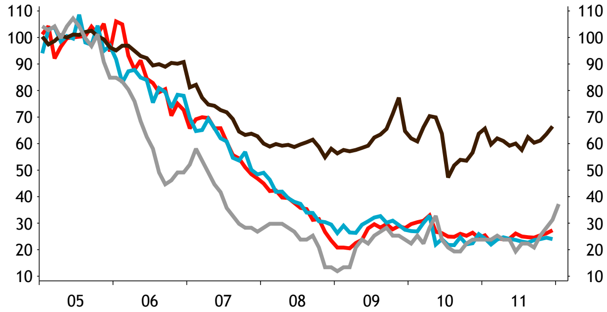
Housing market wounds are healing

Six years after the home price bubble burst, there are signs that the **housing market is improving**. In January, confidence among home construction companies climbed to the highest level since 2007, while housing starts and home sales rebounded during the autumn from deeply depressed levels.

The construction sector share index has climbed by 80 per cent since hitting bottom in October, but it remains nearly 75 per cent below previous highs. **Construction investments will grow by an average of more than 8 per cent in 2012-2013**, according to our forecasts. Yet construction investments represent only 2 per cent of GDP nowadays, compared to 6 per cent in 2006. Because of this low level, their contribution to GDP growth will be a mere 0.2 percentage points in 2012.

Housing indicators bottoming out

Rebase 2005 = 100



Source: Reuters EcoWin, SEB

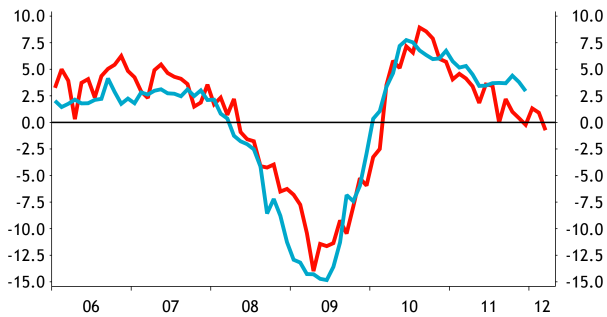
Manufacturing sector chugging along

One key question is whether the American manufacturing sector is strong enough to cope with the downturn in the euro zone. The ISM purchasing managers' index in manufacturing turned upward last autumn, contrary to the trend in many other countries. Small business confidence has also climbed steeply since August but is still below the level that prevailed one year ago. Order bookings slowed sharply late in 2011, however. The overall picture is that the US **corporate sector will be resilient to the international deceleration**, while the need for replacement investments will persist following several years of reversals. **Corporate capital spending will grow by an average of more than 8.5 per cent in 2012-2013**.

Manufacturing expansion will also decelerate slightly this year, as indicated by the Ceridan-UCLA Pulse of Commerce index and other forecasts. **Industrial production will increase by 3.5 per cent on average during 2012-2013, according to our forecasts**.

Industrial activity showing signs of sputtering

Year-on-year percentage change



Source: Reuters EcoWin, SEB

Rising employment, lower unemployment

The labour market has exceeded expectations in recent months. Although job creation has accelerated, the **decline in**

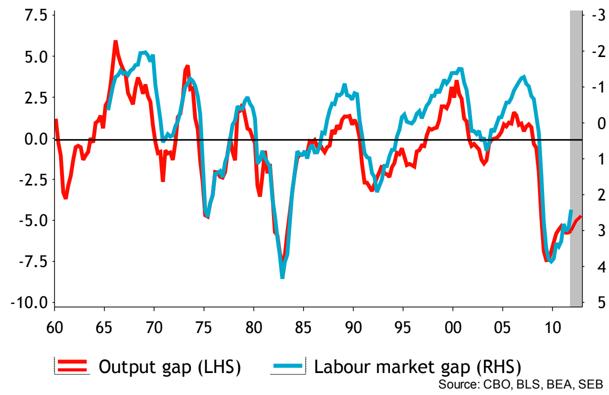
unemployment last autumn is the most encouraging development, in our judgement. The jobless rate is now at 8.3 per cent, which means that it has fallen by around one percentage point over the past year. Part of the downturn is explained by the fact that many people left the labour force, especially in the first half of 2011. But during the autumn, most of the decline in unemployment was due to rapid job creation, according to the household survey from which the unemployment figures are generated. The employment upturn is significantly faster than indicated by the better-known company payrolls survey. The household survey has repeatedly proved faster in capturing turning points in the economy. That was true both after the 2001 recession and before the 2008-09 downturn.

At the same time, the downturn in unemployment is difficult to explain from a growth perspective. Our estimated association between GDP growth and changes in unemployment (Okun's Law) shows that when growth falls one percentage point below trend, unemployment increases by about 4/10. One possible explanation is that GDP growth during the second half of 2011 will be revised upward. Since GDP will increase by slightly above the trend rate in 2012-13, our forecast is that **unemployment decline slowly during the next couple of years**. At the end of our forecast period, the jobless rate will stand at 7.3 per cent.

In terms of unemployment benefit claims, the trends are also pointing in the right direction, although this statistic may be difficult to interpret around the turn of the year. The four-week average has fallen clearly below the 430,000 level, which is compatible with zero employment growth. Current levels indicate a job creation rate of around 170,000, which exceeds the trend rate of increase in the labour force, which is slightly above 100,000. Meanwhile more pessimistic signals are coming both from the Fed's *Beige Book* and new hire statistics from outplacement consultants Challenger, Gray & Christmas.

US output gap slowly shrinking

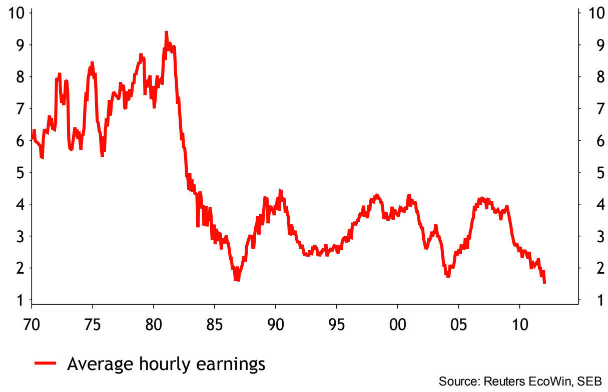
Per cent of GDP



Viewed in a longer perspective, the American economy is characterised by **large output and labour market gaps**. Getting back to the 2007 employment peak will require around 30 months of growth in the 200,000 range. The labour market gap has contributed to the downward curve in wages and salaries. Real median income has actually fallen by more than 5 per cent since the economic recovery began in 2009, and average hourly earnings have rarely been trending lower than today.

Wages are under pressure

Year-on-year percentage change



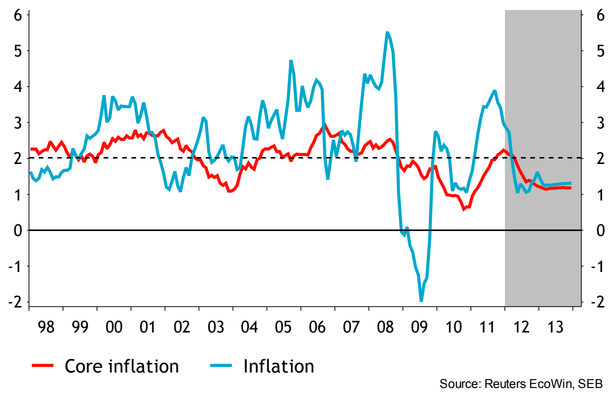
Most of the 2008-09 upturn in unemployment was cyclical, in our assessment. But the longer joblessness remains high, the bigger is the risk that it will be permanent. Other factors also contribute to our assessment that **equilibrium unemployment has climbed by about 0.5 percentage points** to 5.5 per cent. Several years of home price declines may have reduced labour mobility. Matching problems between vacancies and jobseekers, as well as long unemployment benefit periods, may have helped push up equilibrium unemployment to some extent.

Inflation on the decline

While overall inflation has already culminated and has begun to fall, core inflation is close to its year-on-year peak. Looking ahead, core inflation will also decline significantly, according to our forecasts. Underlying wage pressure is very weak, and estimated costs of intermediate goods in recent company surveys are pointing downward. The Fed's *Beige Book* is also indicating negligible cost and wage pressures. Core inflation will fall to 1.2 per cent by the end of 2012. **As annual averages, core inflation will end up at 1.7 per cent in 2011-12 and 1.2 per cent in 2013.**

Inflation is falling below the Fed's target

Year-on-year percentage change



Fiscal policy uncertainty will dominate 2012

According to the federal law now in force, extended unemployment benefits and payroll tax cuts to households will expire at the end of February. Our forecast assumes that these measures will be extended until year-end 2012, but a solution to this issue will probably not come until the last minute. This spring the federal budget process will begin, but there are many indications that trench warfare between Democrats and Republicans in the run-up to the November presidential election will lead to delays in a new budget for the fiscal year that starts on October 1.

After the election, however, Congress must deal with several inflammatory issues in order to avoid a blast of fiscal winter in 2013. Before year-end, a decision must be made on whether to extend the Bush administration's tax cuts, which will otherwise automatically expire. Any further extension of long-term unemployment benefits and payroll tax cuts for households must also be approved before the newly elected members of Congress take office in January 2013. The US will also probably bump up against its debt ceiling again by late autumn. Add the automatic spending cutbacks – equivalent to 0.6 per cent of GDP – which go into effect in January 2013 according to the debt ceiling agreement of last August. Altogether, we estimate that **fiscal tightening will total nearly 0.5 per cent of GDP in 2012 and 1 per cent in 2013**. According to these assumptions, the budget deficit will decrease from a peak of 10.9 per cent in 2009 to 7.7 per cent in 2013. This means that the general government debt will reach 111 per cent of GDP in 2013.

The situation is naturally uncertain, but our forecast assumes that most of the Bush tax cuts will be extended and that Congress will also reverse its decision on automatic federal consumption cutbacks. Since defence programmes would also be hard hit by any cutbacks, there are many indications that such a proposal will gain traction even in Republican circles.

As the presidential election approaches, much remains uncertain, including who will be the Republican candidate. According to betting-company odds, however, Mitt Romney is still the favourite. In the eleventh hour Rick Santorum has emerged as the main challenger and the duel will probably be lengthy. That is good news for President **Barack Obama,** who is now the clear **favourite to be re-elected in November**.

Monetary policy will ease again

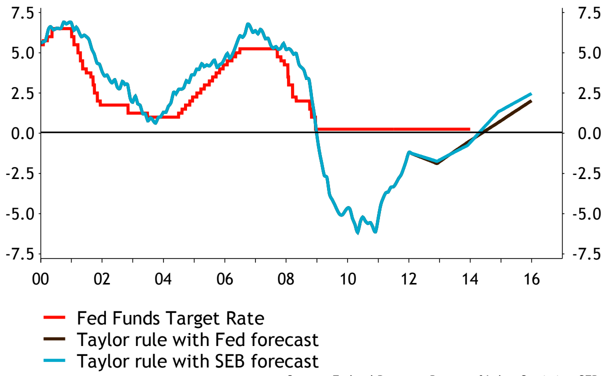
Although the unemployment rate is declining, it is still far above the Fed's 5.2 to 6.0 per cent "central tendency" estimate of the structural rate. Thus there still is a large amount of slack in the economy, which helps explain the downward trends in wage and price inflation. The positive macroeconomic news recently may well have reduced the urgency for additional easing, but we still believe that a **bond purchasing programme totalling around USD 700 billion** will be launched after July 1.

Low government bond yields, combined with the key role of the housing market in the economic recovery dynamic, indicate that purchases of mortgage-backed securities (MBS) will be the focus this time around. First, however, the Fed must complete its current programme of extending the maturity of its balance sheet by selling short-term securities and purchasing longer-term ones (Operation Twist).

Fed Chairman Ben Bernanke has encouraged the **trend towards greater monetary policy transparency**. At the Federal Open Market Committee's January meeting, for the first time the Fed published the committee members' own key interest rate forecasts. A guide to how the Fed expects its balance sheet to change will be published along with the FOMC minutes. According to the FOMC members' median forecast, the federal funds rate will not be raised before the end of 2014. The Fed's current reaction function thus seems a bit more dovish than it has historically been, based on the Taylor rule using the central bank's forecasts, which indicate that the initial rate hike should come in June 2014. If we instead use our own forecasts, historical associations indicate that **the key interest rate will be hiked** a few months earlier, **in April 2014.**

The Taylor rule suggests first hike in Q2 2014

Per cent



Source: Federal Reserve, Bureau of Labor Statistics, SEB

At the January FOMC meeting, for the first time the Fed also published a strategy document that included a **formal inflation target of 2 per cent**, measured using the personal consumption expenditures deflator. A few years ago, the Fed often mentioned an inflation target of 1-2 per cent. The central bank has now decided to set a target at the upper end of this interval, probably reflecting the fact that inflation risks are more symmetrical today than before the financial crisis. According to theory, the inflation target should form a basis for long-term inflation expectations, which in turn may give the Fed greater monetary policy manoeuvring room. Since Bernanke is a longtime advocate of inflation targets, this is a big feather in his cap.

Trade deficit raises structural questions

- **Reconstruction is helping sustain growth...**
- **... as is fiscal stimulus**
- **Strong yen + deflation = BoJ action**

Japan's economic recovery is continuing, but historical revisions show that last year's decline was deeper than estimated. **GDP fell 0.6 per cent in 2011**, the weakest growth in the G7 countries. Sharply expansionary fiscal stimulus and the task of reconstruction after the natural disasters of last March are sustaining demand, which will spill over into decent growth figures in 2012. **GDP will increase by 1.7 per cent this year and 1.2 per cent in 2013**: slightly below consensus in both years. The uncertainty of forecasts can be illustrated by the fact that the most pessimistic forecasters expect 0.7 per cent growth in 2012 and the most optimistic 3.5 per cent.

At the end of our forecast period, there will still be plenty of idle resources in the economy, and **deflation will remain endemic**. We expect both headline and core inflation to end up at below zero in 2012. This means four straight years of falling prices. Nor will Japan achieve price stability during our forecast period according to the central bank's definition: 1 per cent core inflation. As **annual averages, inflation will end up at -0.1 per cent in 2012 and 0.1 per cent in 2013**.

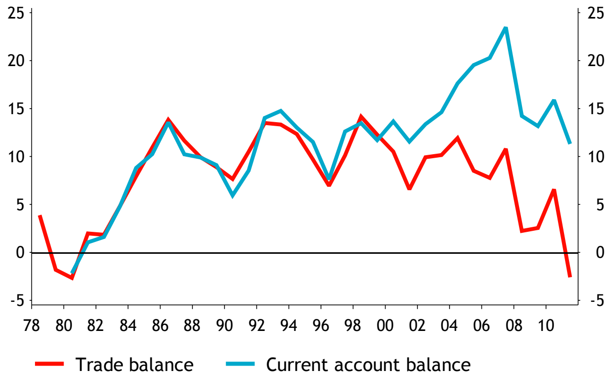
We still believe that Japan's economy can avoid contagion from the euro zone recession. Leading indicators signal above-trend growth in the next six months. And after a few months of weak economic statistics**, recent outcomes have been an upside surprise**. Industrial production grew robustly in December, and manufacturing PMI indicates continued expansion. But neither exports nor industrial output has recovered from the March disasters. Japan's strong currency, combined with chillier global demand, is holding them back. Exports to China, Asia and the EU are falling at around 15 per cent year-on-year. Meanwhile exports to the US, which we see as the most important market, are up 4 per cent on a year ago. Overall, **trade will contribute negatively to growth in 2012 and be neutral in 2013**.

Household confidence indicators have climbed out of last spring's cellar, but still remain low. Retail sales have shown a saw-toothed pattern in recent months, and the year-on-year trend has segued into positive territory. Unemployment rose last year but remains one per cent below its 2009 peak. **The jobless rate will fall slowly**, averaging 4.4 per cent in 2012 and 4.2 per cent in 2013. Slow income growth is being offset by fiscal stimulus aimed at households. **Household consumption will increase by an average of 0.7 per cent in 2012-2013**: consistent with the average during the 2000 decade.

For the first time in 31 years, Japan showed a trade deficit last year. This raises important questions about the prevailing economic structure, with large current account surpluses and net savings. In the next couple of years current account deficits seem unlikely, however, since other components generate such huge surpluses. If that assessment is wrong, the consequences may be dramatic since Japan would be forced to import capital to finance its enormous sovereign debt. Such a scenario would probably also have a major impact on the fixed income market.

First trade deficit since 1980

JPY trillion



Source: Ministry of Finance, IMF, SEB

An expansionary fiscal policy in the wake of reconstruction work is a strong contributor to our relatively optimistic growth picture. **The budget deficit**, which totalled 10.3 per cent of GDP last year, **will exceed 11 per cent in 2012-2013 according to our forecasts**. Government debt, which amounted to more than 220 per cent of GDP in 2010, will grow to 250 per cent of GDP in 2013.

A combination of stubborn deflation and the extremely strong yen point toward **further monetary easing**, but such signals were absent from the latest monetary policy meeting in January. But both the ECB and the Fed are easing monetary policy this year. This implies a relatively tighter monetary policy in Japan, with a risk of **yen appreciation**. If the yen approaches record-strong levels, there will probably be new foreign exchange market interventions, despite loud international criticism. One alternative is for the Bank of Japan (BoJ) to radically expand its purchases of long-term government bonds. Our forecast is that the yen will stabilise and gradually strengthen. The currency is sharply overvalued according to our equilibrium ratios. **In December 2013, the USD/JPY exchange rate will stand at 90**.

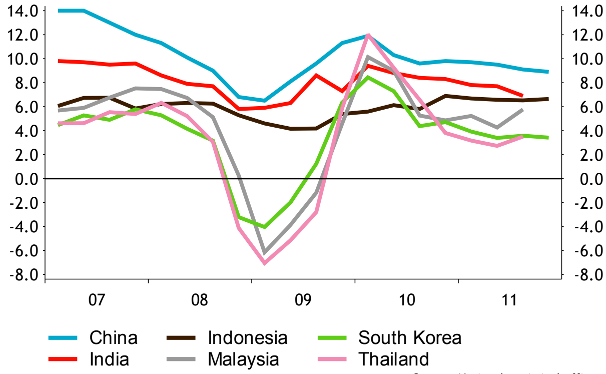
Slowdown, but still a global growth engine

- **Growth somewhat below trend in 2012**
- **Soft landing in China, but lingering risks in the housing market**
- **Limited stimulus potential in India**

Both economic expansion and inflation pressure are now easing in Asia's emerging economies. GDP **growth will end up just below trend in 2012**. Yet the region will continue to serve as an engine for the world economy, with growth far above that of the OECD countries. Increasing confidence in the region is reflected in Asian stock exchanges, which started off 2012 strongly and have risen more than those in Europe and the US.

Continued slowdown in Asian growth

GDP, year-on-year percentage change



Source: National statistical offices

Growth is expected to bottom out during the first half of 2012 and then accelerate again. **Strong finances and relatively stable financial systems will make these economies resilient** and help sustain private consumption and capital spending when external demand cools. The risks of an abrupt decline in growth have decreased somewhat, although the threat of a sharp downturn in the Chinese housing market cannot be ruled out.

Inflation will slow in 2012, driven by falling growth rates and lower commodity and food prices. Falling inflation pressure will allow room to stimulate the economy by loosening monetary policy. Some countries have already begun lowering key interest rates, and **monetary policy will be eased further in 2012**. Some economies face difficult policy choices, however. One example is Vietnam, where exports are being hampered by heavy dependence on Europe, while continued high inflation is making it impossible so far to loosen monetary policy.

The change of leadership in North Korea has increased the political uncertainty in the region but has not led to any concrete troubles. The Iran conflict is another source of worry, especially since Iran is the third largest oil exporter to China.

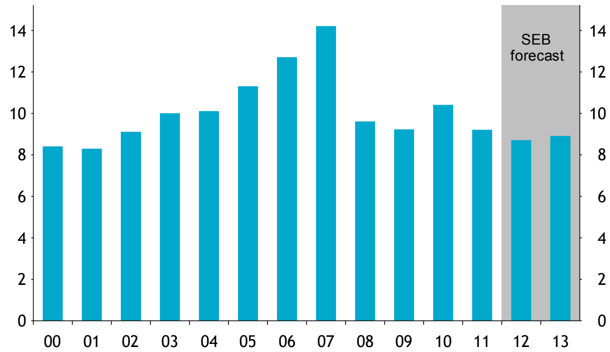
Looking further ahead, there is a risk that China's increasing geopolitical ambitions will lead to greater tensions in its relations with both the United States and other Asian countries.

China: Growth and inflation are slowing

The slowdown in Chinese economic growth is continuing. In the fourth quarter of 2011, year-on-year GDP growth ended up at 8.9 per cent. It is true that this slowdown was less than expected, which indicates resilience in the face of falling external demand and reduces the risk of a hard landing. The growth rate has nevertheless declined four quarters in a row and was the lowest since 2009. In 2011 as a whole, GDP rose 9.3 per cent, compared to 10.4 per cent in 2010.

Growth will slow further in 2012

GDP, year-on-year percentage change



Source: IMF, SEB

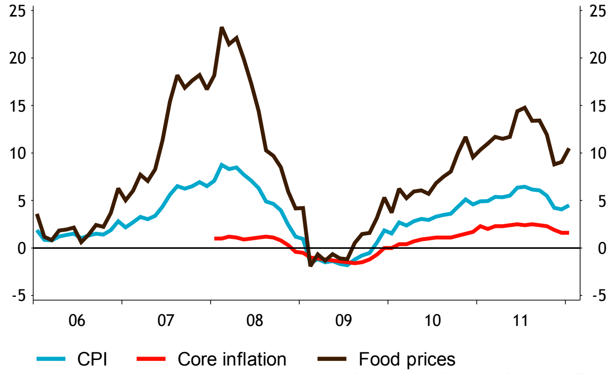
We expect GDP growth to bottom out during the first half of 2012, then accelerate again in the second half. But measured as annual averages, growth will decelerate further in 2012 compared to 2011. **We foresee GDP growth of 8.7 per cent in 2012 and 8.9 per cent in 2013**. Slower growth is in line with China's latest five year plan, which sets a 7 per cent target.

Leading indicators have accentuated the risks of weaker growth. The purchasing managers' index in manufacturing weakened sharply during the autumn. Despite a recovery to 50.5 in January, it is far below the historical average. Consumer confidence is also at a low level. On the other hand, this has not left any clear mark on the hard data. Retail sales are continuing at a healthy pace, and industrial production has also held up relatively well, though the rate of increase has slowed a bit in recent quarters.

Capital spending has cooled, mainly because of reduced government investments. Both **export and import growth has clearly slowed** in recent months. Exports to the euro zone suffered a blow in the autumn but have recovered somewhat since then. Growth is expected to be weak, and the **increase in exports will be halved to around 10 per cent in 2012**.

The inflation rate fell to 4.1 per cent in December but accelerated to 4.5 per cent in January driven by rising food prices. This still represents a significant slowdown in inflation since it peaked at 6.5 per cent in July. For 2011 as a whole, inflation was 5.4 per cent, well above the official 4 per cent target. **In 2012 inflation is expected to be 4.4 per cent, and in 2013 at 4.5 per cent**. Core inflation has also fallen and is below 2 per cent, but food inflation accelerated in December and January. Food prices usually climb in the run-up to the Chinese New Year, which occurred in late January.

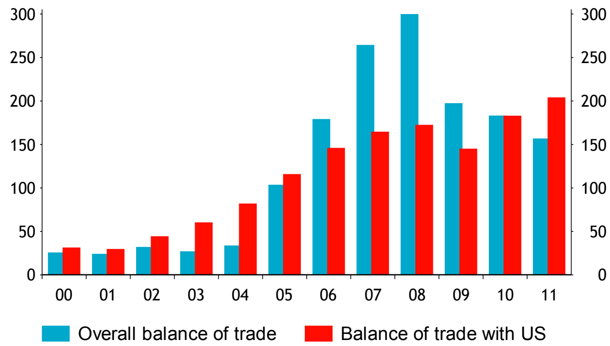
The inflation rate has fallen
Year-on-year percentage change



Source: National Bureau of Statistics of China

With the inflation rate having fallen, the economic policy focus is shifting towards growth-support measures rather than inflation control. Monetary policy is already being eased; in late November, the authorities lowered reserve requirements for the largest banks by 50 basis points. Further cuts of 50 basis points are expected in the first and second quarters of 2012. The **key interest rate is expected to remain at 6.56**; the required reserve ratio is the main policy tool for monetary policy.

China's overall trade surplus is shrinking, but its surplus against the US is growing
USD billion



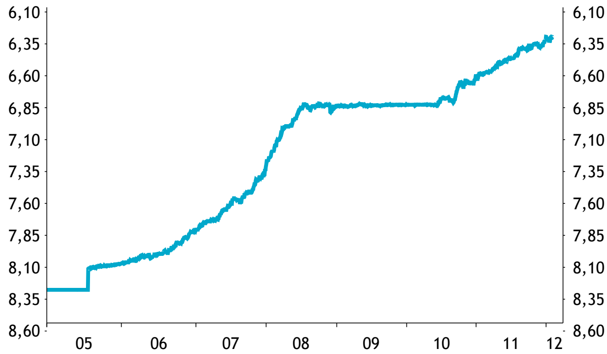
Source: National Bureau of Statistics of China

There may also be reason for more expansionary fiscal measures aimed at sustaining growth. The 2011 budget deficit was just above 1 per cent of GDP, compared to 2.5 per cent in 2010. The deficit was less than anticipated thanks to unexpectedly high tax revenue, which bolsters arguments for **a more expansionary fiscal policy**. But the shape of stimulus measures is expected to be different from 2009, China carried out large-scale infrastructure investments. There are now many signs that the emphasis will be on tax cuts for households and small businesses. The **reshuffle at the top of the Communist Party in late 2012 is expected to decrease the probability for large policy shifts and reforms** as officials have little incentive for risking alienating supporters.

China's trade surplus shrank for the third straight year, ending up at USD 155 billion, but the politically sensitive trade deficit against the US has climbed during the past three years. Although the rhetoric between the two countries has occasionally been sharp, so far these tensions have not resulted in any serious trade sanctions.

The trade surplus will depend on the exchange rate trend. The yuan has continued to appreciate against the USD; in 2011 it gained nearly five per cent. Late in December, the US Treasury Department abstained from officially labelling China a currency manipulator, meanwhile communicating that yuan appreciation is moving too slowly. Because of its growth slowdown, along with a lower inflation rate, China is even less inclined to accelerate appreciation. **In our assessment, the USD/CNY exchange rate will be 6.00 by the end of 2012 and at 5.82 by the end of 2013**. This is equivalent to appreciation of slightly below 5 per cent in 2012 and 3 per cent in 2013.

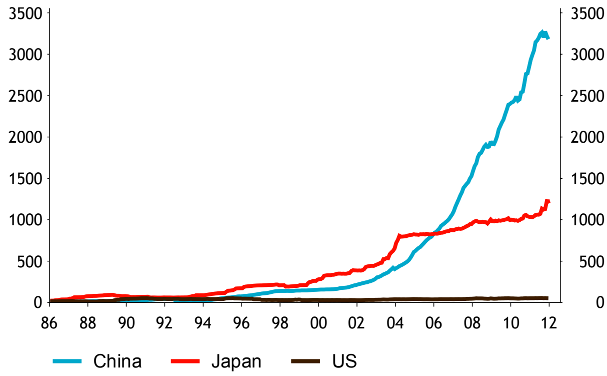
Continued yuan appreciation against the USD
USD/CNY



Source: Reuters EcoWin

The growth rate of China's enormous currency reserve cooled noticeably last autumn. The reserve shrank by over USD 20 billion in the fourth quarter, fuelling worries about capital flight. But many factors affect capital flows. As the yuan continues to appreciate and the trade surplus shrinks, it is natural for the currency reserve to grow at a slower pace as well. In addition, the size of the reserve, nearly USD 3.2 trillion, is much larger than can be justified from a monetary policy perspective.

China's currency reserve stops growing
USD billion



Source: The People's Bank of China, Ministry of Finance Japan, Federal Reserve US

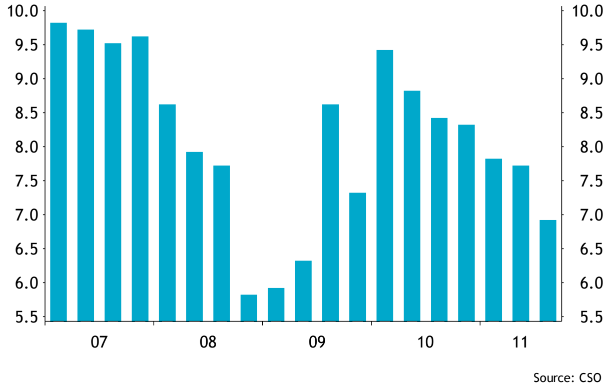
The housing market slowdown is continuing. According to statistics based on developments in 100 cities, prices fell on a monthly basis in January for the fifth straight month. The annual rate of increase slowed to 1.7 per cent. The number of property transactions and land sales fell sharply.

Yet the authorities have deliberately tried to cool off the housing market. Steps taken earlier – including higher down payment requirements, limits on the number of homes a household may buy and tighter lending – have had an impact, but there is a risk that the authorities **may have underestimated the impact of their austerity measures**. The cool-down is having an especially dramatic effect on companies in the construction and property sector (around 7 per cent of GDP), and thus also on capital spending in these sectors.

Meanwhile highly indebted local authorities are seeing their revenue shrink as the number of land sales declines. China has instructed its banks to roll over loans to local authorities to avoid defaults. Small businesses in general have had a hard time gaining access to loans. If the housing sector slowdown is too abrupt, the authorities will probably ease some of their austerity measures. Housing sector activity has been stimulated for some time by a large-scale project to build homes for low-income households. **Our main scenario is that the housing market slowdown will indeed reduce GDP growth, but that a hard landing can be avoided**.

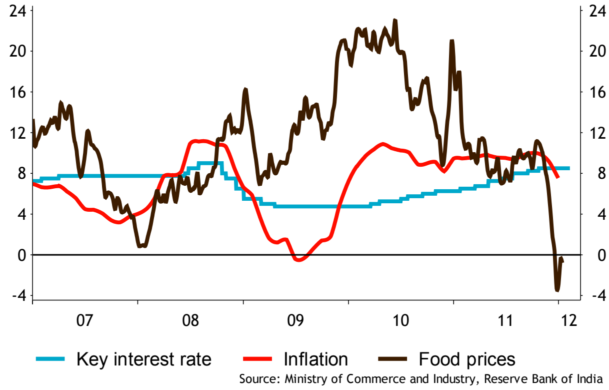
India: Weak policy response to slowdown

In the third quarter of 2011, India's annual GDP growth rate fell for the sixth straight quarter, ending up at 6.9 per cent. **Growth is approaching lows reached during the 2008-2009 crisis**. This slowdown has been driven mainly by weaker domestic demand, but export growth has also decelerated. There are, however, certain signs that growth has now bottomed out. The composite purchasing managers' index has recovered, reaching 53.4 in December. Despite the recovery, this is still well below the long-term average. Industrial production was a downside surprise in December. Overall, GDP is estimated to have grown by 7.3 per cent in 2011. **In 2012 GDP will rise by 7.6 per cent and in 2013 by 7.8 per cent**.



The inflation rate has finally begun to slow. In December, India's inflation rate was 7.5 per cent: the lowest since late 2009. Looking ahead, the slowdown is expected to continue, driven by falling food prices and base effects. This downturn is offset to some extent by the sharp weakening of the rupee late last year, although the currency has recently appreciated.

Slower inflation will create opportunities for the Reserve Bank to begin easing monetary policy. The bank hiked its key rate seven times in 2011, but since late October the rate has been 8.50 per cent. The measure of core inflation that the central bank uses as a policy variable remains at a high level. **We expect the key rate to remain at 8.50 per cent during 2012. However, the required reserves ratio (RRR) is expected to be cut by 50 to 75 basis points during the first half of 2012.** But the potential for monetary stimulus is substantially worse than in 2008-2009, when the inflation rate fell to record-low levels.



Due to weak government finances, India cannot use fiscal policy to stimulate its economy. The slowdown has increased the budget deficit, and the target of reducing the deficit to 4.6 per cent of GDP in 2012 will be tough to achieve.

Looking a bit further ahead, India's growth is being hampered by significant structural problems. Corruption problems are both well known and widespread. Because of poor infrastructure, a large percentage of food is destroyed during transport. **Necessary reforms have been shelved or delayed due to a tricky political situation**, with a weak government hampered by corruption scandals combined with an aggressive opposition that has successfully blocked a number of reform proposals. One example is the planned deregulation of the fragmented retail sector. This important reform ran into strong political opposition and protests from various interest groups and has now been postponed. **Without far-reaching reforms, India will not be able to resume its previous growth figures of around 9 per cent.**

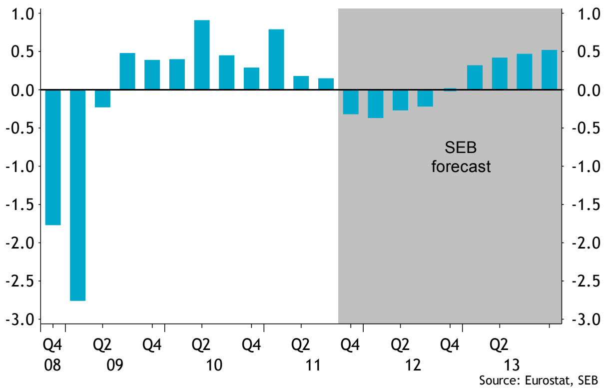
Making difficult choices in order to save the euro

- **Recession, but not so deep**
- **International demand and weak euro will stimulate exports**
- **Germany will avoid recession**
- **ECB will expand its rescue efforts**

Euro zone GDP fell during the fourth quarter and will continue to shrink during most of 2012. Measured as an annual average, **we expect GDP to fall by 0.8 per cent in 2012**, a downward revision by 0.4 percentage points compared to the last *Nordic Outlook*. **In 2013 we expect a weak recovery, with GDP climbing by 0.7 per cent, still well below trend growth**.

GDP growth

Quarter-on-quarter, per cent



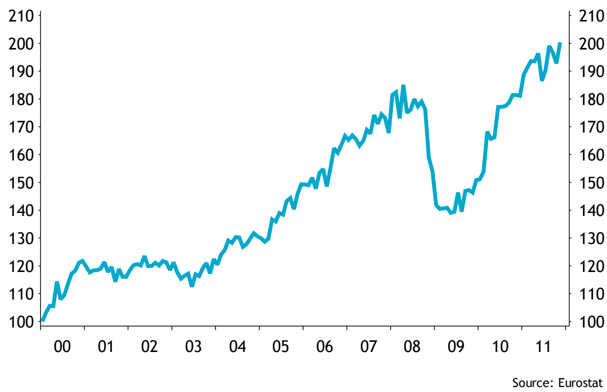
A shrinking economy makes it more difficult to restore confidence in the currency union. Euro zone countries face painful choices ahead. Unless offset by expansionary measures from Germany and the European Central Bank (ECB), additional fiscal tightening in crisis-hit countries will risk deepening the crisis and escalating political tensions – both within the euro zone and in its relations with other countries. If the deadlock should worsen, the euro zone risks a significantly deeper recession. The situation in Greece is still very serious, with further downward revisions in economic forecasts.

Meanwhile reform work is moving very sluggishly, leading to greater mistrust from international lenders and a persistent risk that Greece will leave the euro project. Portugal's situation has also worsened recently; there are growing concerns that a debt write-down will be needed there too.

At the same time, there are also **clear signs of stabilisation in various respects**. In many cases, incoming statistics have provided upside surprises, and leading indicators have bottomed out. Growth in the US and Asia seems likely to be sustainable, which will help stabilise external demand. There are also bright spots in the economic policy field. **The ECB's three year loans** are easing pressure on the banking sector. This has **reduced the risks of a sharp credit contraction**, while the inclination of banks to cut back on their government securities portfolios is not as prominent. Germany and France have also indicated openness to slower implementation of the Basel III rules, further easing financial stress. In addition, there has been some fiscal policy progress, with preparations for more in-depth cooperation among euro zone countries and stricter budget controls. Reform-minded governments with strong support in public opinion have taken over in Italy and Spain. Our overall assessment is thus that **the risks of a deep euro zone recession have decreased**. **The main scenario is that the euro zone can be held together** but it cannot be ruled out that Greece and Portugal will leave.

Exports well above their crisis level

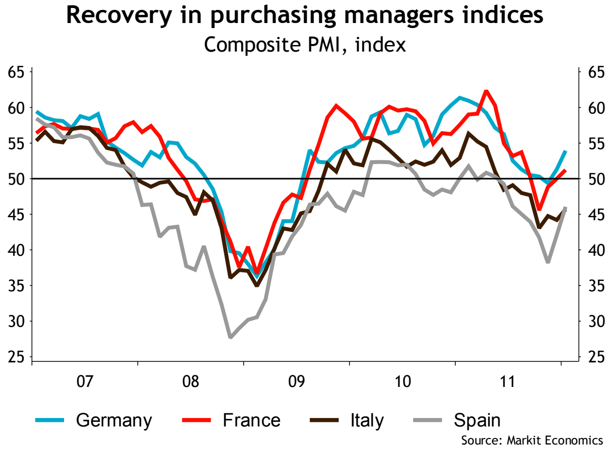
Index 2000 = 100



Further divergence within the euro zone

We have revised our growth forecasts for the US and Asia upward compared to November's *Nordic Outlook*. This faster growth provides welcome support to the euro zone in a situation where domestic demand is being squeezed by austerity measures and by further labour market weakening. Exports are also receiving extra stimulus from the weaker euro. Euro zone exports have recovered from the decline in September and October, rising in November by nearly 4 per cent compared to the previous month. We expect exports to continue upward, which will help GDP growth begin creeping higher towards year-end.

It is mainly the German economy that can take advantage of more favourable international conditions, because of its large export-dependence and good competitiveness. This will widen growth disparities within the euro zone. We still expect that Germany can avoid a recession. Indicators have improved in recent months: the IFO business sentiment index has climbed three months in a row and the manufacturing purchasing managers' index (PMI) rose to 50.9 in January. Unemployment has continued to fall, and the January jobless rate was a low 6.7 per cent. SEB's forecast is that **German GDP will grow by 0.4 per cent in 2012 and by 1.3 per cent in 2013**, unchanged from November's *Nordic Outlook*.



PMIs have also stabilised in other important euro zone countries, although the levels in Italy and Spain are so low that they still indicate a significant decline in GDP. Spain will also be forced to implement further belt-tightening, since the 2011 budget deficit turned out to be larger than expected. Compared to November's *Nordic Outlook*, we have thus **adjusted our growth forecasts for Italy and Spain further downward**. We have also revised our forecasts for smaller crisis-plagued countries somewhat downward, based on incoming data and expanded fiscal austerity measures.

GDP

Year-on-year percentage change

	2010	2011	2012	2013
Germany	3.7	3.0	0.4	1.3
France	1.4	1.6	-0.4	0.6
Italy	1.4	0.4	-2.3	0.2
Spain	-0.1	0.7	-1.6	0.3
Greece	-4.4	-6.1	-4.4	-0.2
Portugal	1.3	-1.7	-3.8	-1.0
Ireland	-0.4	1.0	-0.3	1.0
GIPS* countries	**-0.7**	**-0.6**	**-2.1**	**0.2**
Euro zone	**1.8**	**1.5**	**-0.8**	**0.7**

Source: Eurostat, SEB *Greece, Ireland, Portugal, Spain

Finance Pact will change the playing field

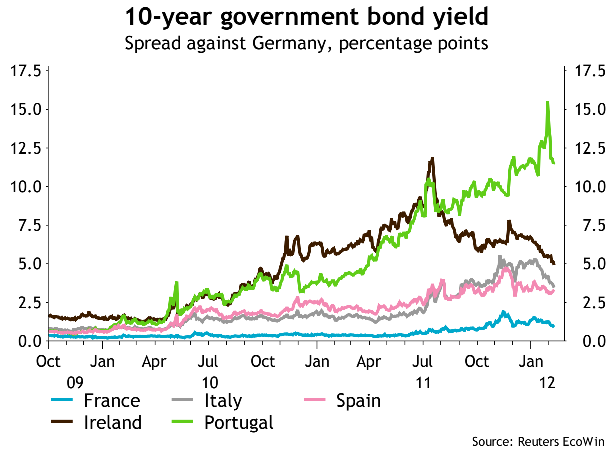
The efforts of Germany and France to expand fiscal policy co-operation and strengthen budget discipline took a step forward when the EU summit approved the Finance Pact on January 30. Twenty-five of the 27 European Union member countries have expressed their willingness to participate (the UK and the Czech Republic will probably not join). Increased budget discipline will not solve the crisis in the short term, but it may have a positive impact on confidence. When the Pact is in place, there is a greater likelihood of further German support in the form of expanded resources/guarantees for EFSF/ESM. The ECB should also be able to act more aggressively ahead, once the budget discipline mechanisms have become firmer.

On the other hand, too much focus on budget discipline entails a short-term risk that budget-tightening in countries that are solvent will reduce the already weak growth dynamic in the euro zone. Considering the current situation, the Pact is more of a tool for ensuring that when the crisis eases, debts will be kept down in order to prevent future crises.

Weak growth continues to squeeze budgets

Meanwhile the sovereign debt crisis continues. The ECB's large-scale three-year loan programme has eased the pressure on banks to cut back their exposure to European government securities. **Italy and Spain** have recently carried out several successful bond and treasury bill issues, and **yields on their borrowing have fallen somewhat.** The new governments in Italy and Spain – led by Mario Monti and Mariano Rajoy, respectively – **have a clear focus on economic reform**. Yet worsening growth prospects are forcing crisis-plagued countries into further austerity measures. The situation of Greece remains critical, and recently **Portugal has also ended up in the spotlight**. Portuguese bond yields have climbed sharply during 2012, and the ECB has been obliged to intervene in bond markets, since **there are increasing worries that Portugal will be forced to write down its debt**. A Portuguese debt write-down would sabotage the promise that such a write-down will only be needed in Greece.

Although crisis-hit countries are still focusing largely on austerity measures, there is a dawning realisation that growth-boosting measures must also be used. Such reforms have proved difficult to implement, however; Greece is the clearest example. It remains to be seen how the ambitious reform plans unveiled in Italy and Spain can be carried out in practice.



Greece's situation remains very problematic. Another austerity package representing 1.5 per cent of GDP has been approved by the Greek parliament. The package is necessary in order for Greece to receive the next tranche of the bail-out loan and avoid defaulting in March. The austerity package is also a condition for reaching a debt write-down agreement for private lenders. A write-down of around 70 per cent would mean that there is a chance of stabilising Greek sovereign debt at around 120 per cent of GDP by 2020, but Greece's problems are far from resolved. Reforms are continued to move very slowly, while already low growth forecasts are being revised downward. It is thus **likely that Greece will continue to face tough demands and that it must actually carry out its commitments** and speed up reforms in order to receive future tranches of the bail-out loan. Another source of concern is the parliamentary election to be held later in the spring.

The new technocratic regime in **Italy** got off to a roaring start, implementing both tax hikes and structural reforms. A property tax will be introduced, and VAT will be hiked. Leaders are also preparing a new constitution that will prevent Italian governments from financing budget deficits by borrowing. Labour laws have been changed to increase hiring. The target of a balanced budget by 2013 appears likely to be met.

Although **Portugal** seems to have achieved its target of reducing the budget deficit to 5.9 per cent of GDP by 2011, it did so with the help of one-off effects from transfers of bank's pension assets to the state. **This year will be very tough**. As in Greece and Spain, a worsening growth outlook seems likely to compel Portugal to undertake further austerity measures, even though many such measures and reforms have already been carried out. Dramatic fiscal tightening, totalling nearly 6 per cent of GDP, will be needed in order to achieve Portugal's deficit target of 4.5 per cent this year. There is also a risk that resistance from special interests will sabotage reform efforts, resulting in toothless reforms.

Ireland has fulfilled its commitments to reduce budget deficits, and the economy is also being strengthened by export driven growth, but now that the economic outlook has worsened, Ireland's export-dependence will cause a rapid deterioration in the budget outlook. Despite a stable political situation, fulfilment of its budget commitments and structural reforms, the more challenging international environment will compel Ireland to undertake **further austerity measures** to achieve its deficit target of 8.6 per cent of GDP in 2012.

Partly because of expanded austerity programmes, budget forecasts now look somewhat better than in the last *Nordic Outlook*. Meanwhile, further downward revisions of economic prospects are pulling in the other direction, reflecting the difficult dilemma that southern European economies are grappling with. In the euro zone as a whole, budget deficits were an estimated 4.4 per cent of GDP in 2011. **In 2012 we expect euro zone budget deficits to shrink to 3.7 per cent and in 2013 to 3.2 per cent. We expect government debt to climb from 85.4 per cent in 2010 to 94.5 per cent in 2013**.

Public budget balance, selected countries

Per cent of GDP

	2010	2011	2012	2013
Germany	-4.3	-1.1	-0.9	-0.6
France	-7.1	-5.9	-5.4	-4.7
Italy	-4.6	-4.1	-3.0	-2.3
Spain	-9.3	-8.2	-6.8	-6.3
Greeece	-10.6	-9.6	-7.0	-6.2
Portugal	-9.8	-6.2	-4.8	-3.5
Ireland	-31.3	-10.5	-8.6	-7.2
Euro zone	**-6.2**	**-4.4**	**-3.7**	**-3.2**

Source: European Commission, SEB

Continued labour market weakening

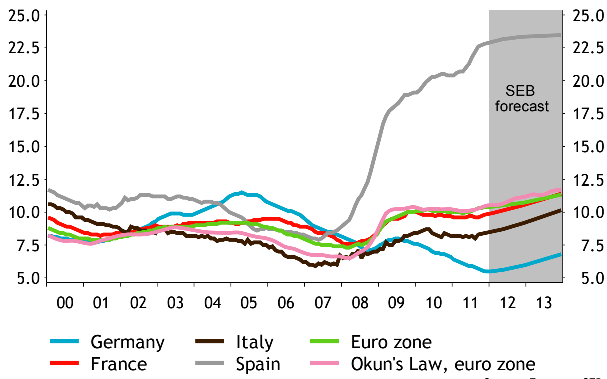
The effects of the new economic crisis are now starting to show up in the labour market. Germany, an important exception, is continuing to show strength so far. German unemployment has continued to fall and stood at 5.5 per cent at the end of 2011, according to Eurostat's harmonised measure. This favourable trend is explained to some extent by the fact that companies retain employees despite weaker demand – so-called labour hoarding. However, we still expect the weak economic situation to push up the jobless rate in the first quarter of 2012. Measured as annual averages, **German unemployment will be 5.7 per cent this year and 6.4 per cent in 2013**.

In France and Italy, we have recently seen a modest upturn in the jobless rate. In France, December unemployment was close to 10 per cent, the highest level since early 2010. We expect a continued upturn to more than 11 per cent by the end of 2013. The Italian labour market is also continuing to deteriorate; unemployment will climb to about 10.5 per cent in December 2013. In Spain, the upturn will continue to new catastrophic record levels. Average unemployment is now above 22 per cent, and youth unemployment exceeds 45 per cent. Aside from burdening public finances, this leads to long-term economic damage, for example in the form of emigration by highly qualified younger workers.

Measured as annual averages, **euro zone unemployment will be 10.6 per cent this year and 11.1 per cent next year**, well above equilibrium unemployment, which is estimated at 8.5 per cent. The weak labour market situation, combined with the need to lower the cost situation in southern Europe, will **hold back pay demands**, and we expect euro zone wage and salary increases of only 2-2.5 per cent annually in 2012-2013.

Unemployment will continue climbing

Per cent



Source: Eurostat, SEB

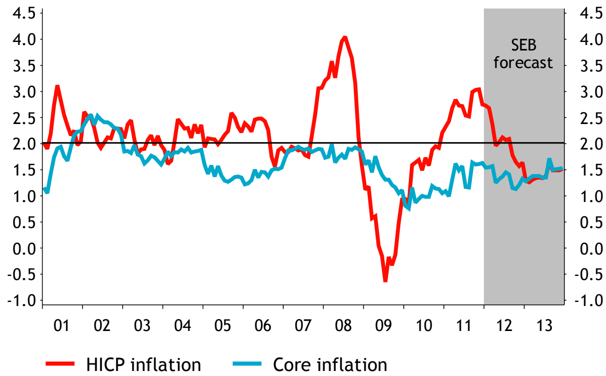
Inflation will slow

Harmonised Index of Consumer Prices (HICP) inflation in the euro zone averaged 2.7 per cent in 2011 and was largely driven by rising commodity and food prices. These increases are now vanishing from the 12-month figures, causing inflation to slow. The inflation rate fell to 2.7 per cent in December, compared to

3.0 per cent the preceding month. The downturn in economic activity will also help slow price increases**. In 2012, we expect inflation of 1.9 per cent. In 2013 the rate will fall further to 1.4 per cent**, far below the ECB target. Core inflation will bottom out at just above 1 per cent during the autumn of 2012 and stand at 1.5 per cent at the end of our forecast period.

Inflation will decelerate in 2012

Year-on-year percentage change



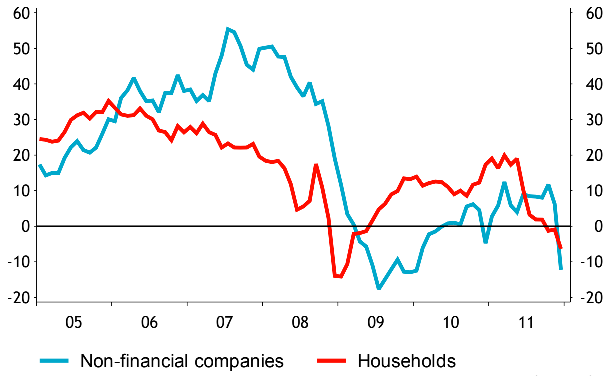
Source: Eurostat, SEB

ECB will continue stimulus on broad front

The liquidity problems of banks hurt euro zone growth by slowing down lending to both businesses and households. Lending fell significantly during late 2011. The ECB's latest quarterly *Bank Lending Survey* points out that credit conditions tightened markedly during the fourth quarter. The banks expect a further tightening of conditions, but at a slower pace, in the first quarter. This tightening was widespread across a number of euro zone countries, but Germany is cited as an exception. During the fourth quarter, net demand for loans to non-financial companies meanwhile decreased.

Downturn in bank lending

Net basis, EUR bn 3-month moving average



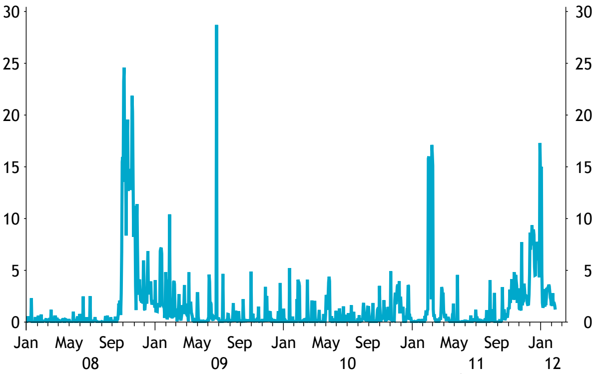
Source: ECB

To counteract liquidity problems and the slowdown in lending, the ECB introduced unlimited three year loans. These loans have proved successful in reducing pressure on the banking sector. The ECB's Marginal Lending Facility indicates that these three year loans led to an improvement in the functioning of the interbank market compared to the situation in late 2011, although the banking sector is still under significant pressure, viewed from a long-term perspective. **We expect the ECB to continue offering three year loans in order to provide support to the banking sector**. The next such loans will be offered on February 29.

As expected, the ECB lowered its refi rate to 1.0 per cent at the December monetary policy meeting. At the same time, it revised its euro zone growth forecast downward. The ECB's assessment is that inflation will fall below 2 per cent in 2012, but at its January and February meetings the bank unveiled no expansions of stimulus programmes and pointed to certain signs of economic stabilisation.

ECB Marginal Lending Facility

EUR billion



Source: Reuters EcoWin

It is unlikely that the ECB will cut its refi rate below 1 per cent. The arguments against this are that further interest rate cuts from an already low level will only have limited stimulus effects, while they may hamper the functioning of the financial system. Because of increasing growth convergence between Germany and the euro zone's crisis-hit countries, interest rate cuts will become an increasingly blunt stimulus tool. The ECB's statements about signs of stabilisation in the euro zone economy also indicate that the central bank will leave the refi rate at 1.0 per cent, but there has recently been mounting pressure from the IMF, the OECD and others on the ECB to continue cutting its key rate. It is thus not out of the question that the ECB will first hold off to ensure that crisis-hit countries do not slow the momentum of their fiscal consolidation efforts and then carry out further refi rate cuts.

Looking ahead, however, the refi rate trend will be of minor importance. As our theme article indicates, we expect the ECB to act on a broad front. **The ECB's most important measures, aside from a continued low refi rate – in the form of three year loans and interventions in the bond markets of crisis-hit countries aimed at keeping sovereign bond yields in check – are expected to continue.** The theme article also describes the dangers that unconventional monetary policy and the sharp increase in the ECB's balance sheet may give rise to.

On the brink of recession

- **Inflation will fall below target**
- **More Bank of England quantitative easing**
- **Summer Olympics will stimulate economy**

The euro zone recession, combined with fiscal austerity, is hampering the British economy, which is balanced on the brink of recession. According to preliminary figures, GDP fell 0.2 per cent in the fourth quarter of 2011. Full-year growth was 0.9 per cent: the next lowest in the G7 after Japan. This year will also be gloomy for the economy. **We predict GDP growth of 0.3 per cent in 2012 and 1.4 per cent in 2013:** slightly below both consensus and IMF estimates. Unemployment, which climbed last autumn, will gradually rise above **9 per cent in 2013.**

During the 2008-09 recession, GDP fell more than 7 per cent. Although the recovery has been under way for nine quarters, GDP remains 4 per cent below its previous peak. The output gap is enormous; we estimate that the GDP level is more than 10 per cent below its long-term trend. Low resource utilisation, combined with favourable base effects (the 2011 VAT hike will vanish from 12-month figures), points to a sharp slowdown in inflation. Inflation is already one percentage point below its 5.2 per cent peak of last September. **Inflation will be cut in half, ending up at 2.6 per cent this year and 1.3 per cent in 2013**, i.e. clearly below target. The door to new quantitative easing is ajar, and the **Bank of England (BoE) will launch additional bond purchase programmes**.

A combination of today's high inflation, fiscal tightening programmes and rising unemployment is reflected in depressed household confidence and weak actual consumption growth. After falling 0.6 per cent last year, **consumption will continue slightly downward this year**. It will not rebound until 2013, when pay growth exceeds inflation. Home prices moved sideways last year. In the wake of higher unemployment, there is an obvious risk that a new wave of home price declines will contribute to a deeper consumption downturn than in our forecast.

Since the euro zone is the UK's most important trading partner (buying 30 per cent of British exports), foreign trade cannot lift the economy. Yet **there are bright spots in industry**; after being at recession levels last autumn, manufacturing PMI rose above the neutral 50 mark in January. The confidence curve is also pointing upward in services and construction. Meanwhile the OECD's leading indicator paints a darker picture. Taken together, **indicators are compatible with a stagnating economy**, in our judgement. This summer's Olympic Games in London will nevertheless help to sustain growth in various sectors, and the stimulus potential may possibly be greater than we have counted on in our basic forecast.

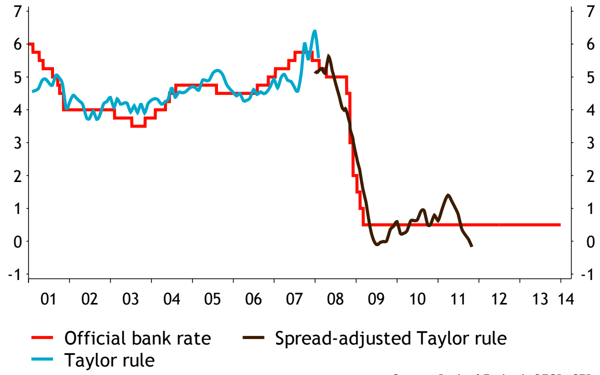
The euro zone crisis has aggravated political tensions between the UK and Germany/France. The economic consequences of this are difficult to foresee, but the UK financial sector would benefit if the euro zone followed France's proposal and introduced a tax on financial transactions (Tobin tax).

Looking a bit further ahead, there is also reason for growth optimism. The long-term GDP trend has been about the same since the 1920s. Productivity has always recovered from previous shocks. When the effects of austerity and financial turmoil begin to ease, we thus see potential for the GDP gap to begin closing due to a lengthy period of above-trend growth.

The budget deficit, estimated at 8 per cent of GDP in 2011, will **fall to 7 per cent this year and 5.3 per cent in 2013, according to our forecast**. The austerity dose will be equivalent to around 1.5 per cent of GDP in 2012 and 2013 respectively. The current fiscal path has probably helped the UK retain its AAA credit status while many euro zone countries have been downgraded. We expect the UK to keep its top credit rating in the next couple of years. This will help keep government bond yields low in a climate of subdued growth prospects, low inflation expectations and continued BoE bond purchases. Our Taylor rule suggests that the policy gap is comparable to 2009, when BoE purchased GBP 200 billion worth of government bonds under QE1. Consequently, further extensions beyond the already announced GBP 125 billion under QE2 looks likely (the BoE extended the bond-buying program at its February meeting).

Taylor rule: Similar policy gap to 2009

Per cent



Source: Bank of England, OECD, SEB

The pound is at its strongest in 9 months in trade-weighted terms, partly because the growth outlook has weakened relatively more in the euro zone. Viewed in a long-term perspective, however, the pound remains close to record lows. We expect only minor movements and **at the end of 2102, the EUR/GBP exchange rate will be 0.84.**

Increasingly divided picture due to varied conditions

- **Russia and Poland showing resilience**
- **South-east in credit squeeze from West**
- **Currency appreciation, but a bumpy ride**

Eastern (including Central) European economies also began losing momentum in the second half of 2011. In many countries, including heavyweights Russia and Poland, the slowdown is mainly limited to manufacturers facing lower foreign demand. The region's GDP growth continues to weaken, but the pattern is uneven. **Exports and capital spending will slow, while consumption will hold up relatively well.** Because of comparatively low public debt – with Hungary an exception at around 80 per cent of GDP– large budget deficits need not be corrected as sharply and quickly as in Western Europe. Unemployment will climb again, but household purchasing power will strength due to lower inflation than last year. **Economic developments in Eastern Europe** are thus becoming **more and more polarised**. Roughly speaking, the northern parts will continue to cope with the euro zone crisis relatively well, while some central and especially southern parts will be harder hit. These **differences** are due, among other things, to **the size of exports and different degrees of exposure to euro zone banks**. Three categories can be singled out as regards the impact of the euro zone crisis and global slowdown.

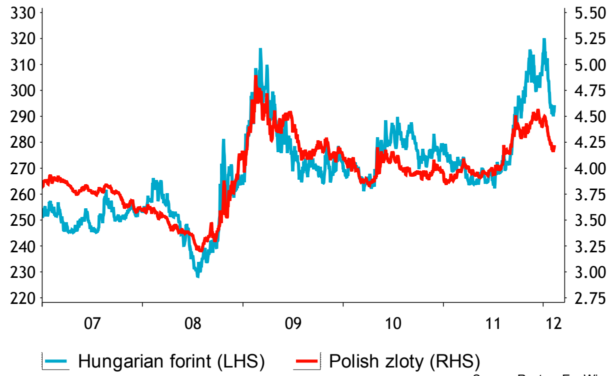
"Least hard hit": This includes **Russia** and **Poland**. Exports are equivalent to a modest 30-40 per cent of GDP. Dependence on financing via euro zone banks (interbank loans as a percentage of a country's GDP) is marginal in Russia and modest in Poland. Foreign currency loans are also relatively small in relation to GDP. Russian growth will slow from 4.3 per cent in 2011 to 3.8 per cent in 2012, Polish growth from 4.3 to 2.9 per cent. Russia is riding on high oil prices and to some extent last summer's WTO accession, which will strengthen foreign trade and investments ahead. Polish growth is getting an extra push from the 2012 European Football Championship.

"Medium hard hit": This category includes **the Baltic countries** and **the Czech Republic**. All are highly export-dependent. The Czech Republic is also closely tied to Germany. This will lead to a relatively sharp decline in Czech growth: from an already low growth to a weak recession. The Baltics have little financing via euro zone banks, but a lot via Swedish banks. These countries are financially less vulnerable than a few years ago, after correcting current account and wage formation imbalances as well as stabilising their banking systems. The Czech Republic has modest bank borrowing via the euro zone: about the same percentage of GDP as Poland.

"Hardest hit": This includes **Hungary** and **Ukraine**, but also countries like **Croatia, Bulgaria** and **Romania**. They are heavily affected via financial channels. The Hungarian and Croatian banking sectors have very large interbank financing via the euro zone; Bulgaria and Romania stand out too, while Ukraine's exposure is more modest. We expect Hungary and Croatia to show weak GDP declines this year, while the others will achieve weak growth. Hungary and Croatia both have relatively large export sectors, especially Hungary. This is also true of Ukraine. All three countries also suffer from a severe crisis of confidence among investors. CDS prices (which reflect worries about defaults) are inflated, although they have recently fallen a bit. Ukraine has moderate imbalances in government debt levels and budget and current account deficits, but worries are probably based on the country's long-term political direction. This underlying uncertainty has been fuelled in the past year by open tensions in Ukraine's relations with the IMF and the EU. We expect continued uncertainty but foresee an agreement between Ukraine and the IMF before year-end. We expect Hungary to reach agreement in the next few months with the EU/IMF on a new multi-year stand-by loan. This is important to ensure international confidence, since it will increase pressure on Hungary to deal with its debts and implement reforms.

Rapid recovery for Eastern European currencies

EUR/PLN and EUR/HUF exchange rates



Source: Reuters EcoWin

Eastern European currencies fell sharply early last autumn due to general risk aversion and growing fears of a Hungarian collapse. In the past two months, they have recovered significantly, helped by improved risk appetite generated by the actions of major Western central banks. The zloty has regained around half its decline. The forint has also appreciated rapidly. In the **short term, the risk of a correction has increased, but we expect Eastern European currencies to gain more strength later**. But it risks being a bumpy ride, since economies are decelerating and the euro zone debt crisis is unresolved.

Rapid deceleration from fast to slow growth

- **Better resilience after painful austerity**
- **Persistently high unemployment**
- **Latvia will join euro zone as planned in 2014**

The Baltic countries have **bounced back nicely after a deep 2009 recession**. This is very much due to **dynamic, competitive exports and aggressive budget-tightening**. Year-on-year GDP began to rise in mid-2010. In the past year, domestic demand has started taking over after an initially export-driven upturn.

Imbalances have greatly diminished. The very large current account deficits of 2007-2008 have largely been eliminated, although Lithuania is showing moderate deficits. The temporary problems of vanishing competitiveness have been corrected; wages and salaries are growing at a modest pace after sharp pay cuts in both the private and public sectors in 2009-2010. The big budget deficits in Latvia and Lithuania are shrinking and moving towards more sustainable levels this year; these countries have also managed to stabilise public sector debt at a modest level. Unemployment has gradually decreased, especially in Estonia, although it remains very high and is expected to stabilise this year at double-digit levels (11 per cent in Estonia, 14 per cent in Latvia and Lithuania). This unemployment is partly an expression of widespread structural problems in the labour market. Along with a negative demographic trend, it is a persistent and difficult challenge.

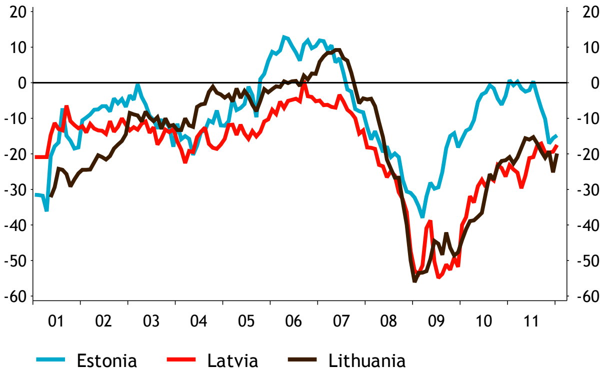
Public sector finances
Per cent of GDP

	2007	2008	2009	2010	2011	2012
Budget balance						
Estonia	2.4	-2.9	-2.0	0.2	0.0	-2.5
Lithuania	-1.0	-3.3	-9.5	-7.0	-4.5	-3.5
Latvia	-0.4	-4.2	-9.7	-8.3	-4.2	-2.6
Public sector debt						
Estonia	3.7	4.5	7.2	6.7	6.0	6.0
Lithuania	16.8	15.5	29.4	38.0	40.4	40.6
Latvia	9.0	19.8	36.7	44.7	44.5	44.0

Source: European Commission; 2011-2012, SEB forecast

Overall, the Baltic economies are now better equipped to withstand external shocks than when the global credit crisis and recession struck in 2008-2009. But this is far from making them immune to the euro zone crisis and global economic slowdown. This is because they are **highly export-dependent, especially Estonia and Lithuania. GDP growth is clearly being hurt now that the export boom is quickly fading** because of shrinking demand in Western Europe. Greater uncertainty will also lead to the postponement of some capital spending and consumption decisions. Taken together, this will hasten an end to the labour market recovery. Although domestic portions of the Baltic economies have stabilised and gained strength in the past year, **consumption and capital spending have not yet really gained momentum**. Domestic demand is being hampered not only by high unemployment, but also by continued private debt deleveraging and a sluggish housing market recovery. European Commission sentiment indicators show a certain stabilisation and rebounding manufacturing sector optimism in Estonia and Lithuania in recent months, after sharp downturns since last summer. In Latvia, which has lagged somewhat in its economic upturn, this manufacturing indicator has fallen in small steps without dramatic shifts. Household optimism has faded over the past six months, especially in Estonia.

Sagging consumer confidence
Net balances



Source: European Commission

Overall, we are making **further minor downward adjustments in our growth forecasts** for the Baltic countries, compared to the latest *Nordic Outlook*. The main reason is the poorer outlook for Western Europe. The Baltic economies **will grow by 1.5-2.5 per cent in 2012. A slight recovery will occur in 2013**, but growth rates will remain somewhat below trend. We still believe that all three countries will avoid recession, despite pressure from lower exports. There are **several positive counterweights**, aside from improved fundamentals. Demand from Russia, which buys a respectable 10-15 per cent of Baltic exports and is Lithuania's biggest market, remains good. Cyclically sensitive construction and housing markets as well as capital spending are already depressed after earlier corrections. Harsh austerity policies are now past, though Latvia and Lithuania will continue budget-tightening this year. There is also pent-up consumer demand after the crisis.

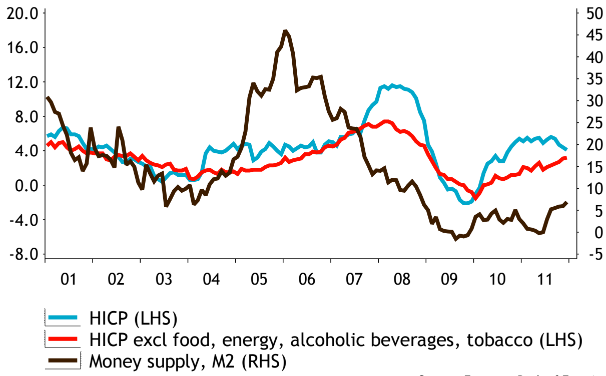
Estonia: Stagflation tendencies

Estonian GDP rose somewhat more than expected in 2011 – by 7.5 per cent – despite slowing to 4.0 per cent in the fourth quarter. This was the fastest expansion in the EU and a sizeable acceleration from 2.3 per cent in 2010. Yet Estonia faces a powerful downdraft. Exports are equivalent to a full three fourths of GDP, with heavy exposure to Finland and Sweden. Late in 2011, Estonia noted a decline in exports to Western Europe, while retail sales growth slowed. Indicators point towards continued rapid deceleration in the economy. **GDP will grow by 1.5 per cent in 2012 and 2.5 per cent in 2013.** This has labour market implications. High export-led job growth will fade and the downturn in unemployment will end.

Despite clearly lower economic activity, **inflation will remain relatively high**: 4.0 per cent this year and 5.0 per cent in 2013. During 2011, inflation averaged 5.1 per cent after falling towards year-end. Price increases were mainly driven by food and beverages as well as energy-related items like electricity, fuel and space heating, but prices also climbed in other areas. Core inflation, adjusted for energy, food, alcoholic beverages and tobacco products, rose from a year-on-year rate of just over 2 per cent last summer to more than 3 per cent in December. These broad inflationary tendencies are worrisome, considering that GDP will only reach its pre-2008 crisis level in 2013 and that wages and salaries are increasing at a modest pace compatible with productivity growth. In Estonia's small economy, inflation has proved to have a relatively close link with changes in money supply. The money supply has also expanded recently, but no rapid acceleration can be expected in 2012 as credit pressure remains weak. Money supply growth may, however, become a more serious inflation factor further ahead as the economy and credit demand regain strength; stability and competitiveness may then be threatened.

Estonia: Money supply affects inflation

Year-on-year percentage change



Source: Eurostat, Bank of Estonia

Latvia: Euro zone accession in 2014

Latvia's GDP grew somewhat more strongly than expected last year, by 5.0 per cent, after gradually accelerating to 5.7 per cent in the third quarter followed by a slight cooling towards year-end. Rising capital spending was the main growth engine, while net exports were negative due to an upswing in imports. The economy will now decelerate, but more gently than in Estonia and Lithuania. This is because Latvia is less export-dependent (exports are equivalent to less than 50 per cent of GDP) and because of good Russian transit trade. Construction also continues to perform well. **GDP growth will slow to 2.5 per cent this year and climb to 4.0 per cent in 2013.** The acceleration will be partly due to higher capital spending in the run-up to expected euro zone accession in 2014. Inflation, which rose to 4.2 per cent last year, will fall to about 2.5 per cent in 2012. Underlying inflation will remain subdued.

This year will be the last in a tough multi-year fiscal austerity process. The budget deficit will shrink from 4 per cent of GDP in 2011 to just over 2.5 per cent this year. This will **enable Latvia to qualify for the euro zone in 2014** in the EU/ECB evaluation expected in the spring of 2013. Our forecast is that Latvia will also meet the other criteria, such as low inflation. The 2012 budget was adopted by Parliament with the same deficit and growth assumptions as in our forecast. If the budget trend should worsen, the government will take further steps.

Lithuania: Balanced, but a clear slowdown

Lithuanian growth was 5.8 per cent in 2011. The forces of growth were balanced, with a bit of an upside surprise related to private consumption and a downside one related to the modest upturn in capital spending. Growth will slow this year as external demand declines and fiscal policy is tightened after a relatively neutral policy in 2011. On the expenditure side, there will be cutbacks on a broad front. The revenue side will strengthen, among other things due to a new tax on "luxury properties", while hotel VAT is being raised. **GDP growth will be a mere 2.0 per cent this year and climb a bit to 3.0 per cent in 2013.** Last year inflation averaged 4.1 per cent, largely driven by energy and food prices. This year it will slow to 2.5 per cent and in 2013 it will climb to 3.0 per cent.

The tightness of the 2012 budget was somewhat surprising, but the government will still have difficulty in pushing down the public sector deficit from about 4.5 per cent of GDP last year to its target of 3 per cent. To meet this target, new tax hikes may be needed, even though this might make the government unpopular in the run-up to next autumn's election.

The government is targeting euro adoption in 2014. According to our opinion it may be tough to fulfil booth the budget and inflation criteria in the coming year for qualification already in 2014 and we forecast **Lithuanian euro membership in 2015**. Yet the government is eager to bring its deficit below 3 per cent of GDP this year so as not to violate EU deficit rules. It also wants to signal to capital markets that Lithuania remains on the right track and is determined to bring public finances under control. Since the deficit is still large and the public sector debt has climbed from 16 per cent of GDP in 2008 to about 40 per cent, Lithuania is dependent on decent borrowing conditions in the market. In late January, Lithuania carried out a successful, amply oversubscribed bond issue. The goal is to continue borrowing in the market, but Lithuania's finance minister and central bank governor signalled late last year that the country may apply for a special loan from the IMF if contagion from the euro zone crisis to Lithuanian sovereign bond yields, which has been modest so far, should become much worse and lead to excessive market borrowing costs.

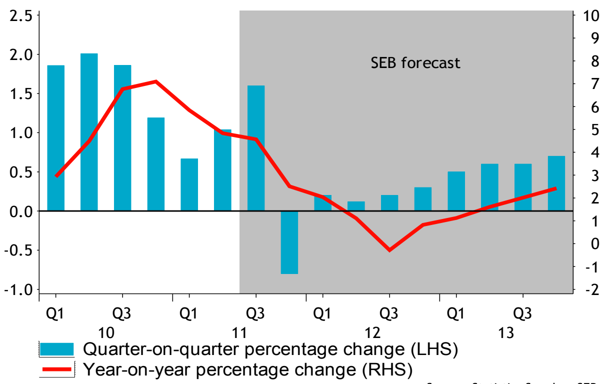
Krona appreciating despite sharp economic slowdown

- **Falling GDP during fourth quarter of 2011**
- **Labour market will gradually weaken**
- **Home prices will fall by 10-15 per cent**
- **Currency appreciation despite slowdown**
- **Cautiously expansionary fiscal policy**

Sweden is now clearly being pulled into the international deceleration. A sharp slowdown in exports, combined with households being squeezed by falling home prices, contributed to an expected GDP decline of 1 percentage point during the fourth quarter of 2011. This downturn was partly a reaction to a very strong third quarter, but it still confirms the picture of **a clear economic slump during 2012**. We predict that **GDP growth will average 0.5 per cent in 2012 and then climb to 1.7 per cent during 2013**: still below trend.

Because of rising unemployment and low inflation pressure, the **Riksbank will continue to cut its key interest rate to 1.00 per cent by July of this year**, then leave it untouched at least until the end of 2013. Given its desire to protect Sweden's strong budget, combined with a complicated parliamentary situation, the government will be very cautious about tax cuts during the next couple of years. Fiscal policy will focus to a greater degree on labour market and local government programmes. Unlike the situation in many countries, the **direction of fiscal policy will be slightly expansionary**. This will help avoid a recession and will enable Sweden to grow at about the same pace as other northern European countries like the UK, Germany, Denmark and Finland.

Clear economic slowdown in 2012



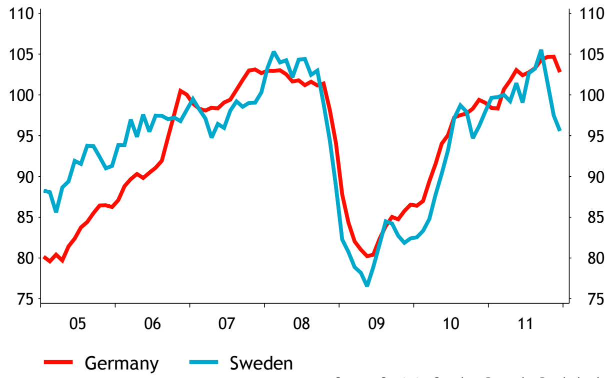
Source: Statistics Sweden, SEB

Sudden plunge in exports

The sharp decline in merchandise exports late in 2011 illustrates the risks of very weak export performance during 2012, but the signals in the manufacturing sector are mixed. Manufacturing sentiment indicators have stabilised in recent months in line with international trends. The purchasing managers' index (PMI) has even climbed into expansionary territory above 50. The relatively stable performance of German exports, which have historically co-varied strongly with Swedish exports, also indicates that the fourth quarter decline exaggerates the underlying trend. We thus expect a degree of recovery early this year. Manufacturing PMI in Sweden and Germany has continued to co-vary, a fact that supports this interpretation. We have nevertheless adjusted our export forecast downward and expect merchandise exports to fall by an average of about 1 per cent during 2012. Due to slightly rising service exports, total exports will be unchanged.

Exports have decelerated abruptly but will recover

Index 2008 = 100, 3-month moving average



Source: Statistics Sweden, Deutsche Bundesbank

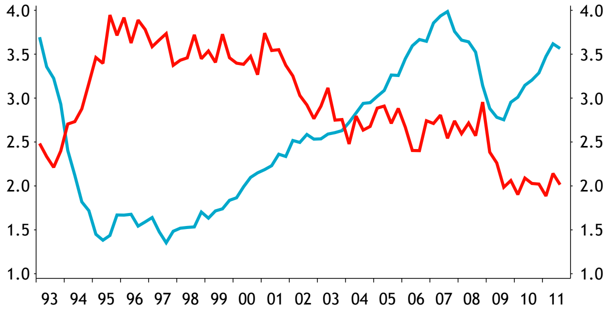
Industrial capital spending will level out

According to Statistics Sweden's October survey, industrial firms were planning relatively large capital spending in 2012. Despite a sagging economic outlook, these companies planned to increase their fixed investments by seven per cent. In an environment dominated by shrinking demand and growing uncertainty, some investments will be cancelled or postponed, but since their level is depressed after a major decline in 2009, a renewed downturn is unlikely. We thus expect industrial investments to level out this year.

In the past year and a half, residential investments have regained their entire decline since 2008, mainly stimulated by the introduction in 2009 of a temporary tax deduction for home repairs and renovations. New housing starts have also recovered somewhat, mainly due to increased construction of tenant-owned cooperative units. After a very long period of low housing construction, activity can probably be kept going. On the other hand, this trend will be hampered by falling home prices and risks of a downturn after the very rapid upswing in repair and renovation. The smaller number of housing starts during the third quarter indicates that negative forces will predominate and that residential investments will fall by a total of 15 per cent during 2012. Taken together, this means that **fixed investments will be unchanged in 2012 and will increase by 3 per cent in 2013**.

Residential investments will fall in 2012

Per cent of GDP



Source: Statistics Sweden

Consumption losing momentum

After a strong first half of 2011, retail sales and new car registrations stabilised, contributing to weak consumption growth. Short-term indicators are mixed: signals from retail sales remain weak, while household confidence has rebounded somewhat in the wake of the stock market recovery. Due to low inflation and accelerating wages and salaries, **household purchasing power will increase by 2 per cent annually** in real terms, even though employment will fall slightly. The favourable income trend and high household savings ratio at the outset will help avoid a downturn in consumption, despite a weak labour market and falling home prices.

Continued upturn in consumption

3-month moving average

Source: Statistics Sweden

Household income and consumption

Year-on-year percentage growth

	2010	2011	2012	2013
Consumption	3.7	2.0	0.8	1.5
Income	1.6	3.0	2.2	2.1
Savings ratio, % of disp. income	10.6	11.5	12.5	13.0

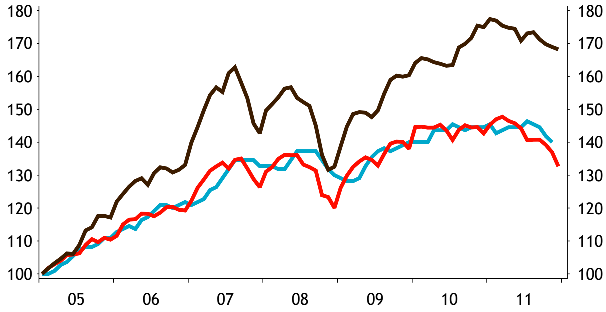
Source: Statistics Sweden, SEB

Home prices will continue to fall

Most indicators now show a clear decline in home prices. So far, the downturn has been around 5 per cent, according to the Statistics Sweden single-family home survey, while the decline for cooperative units has been somewhat larger. Early in 2012, certain short-term indicators – for example SEB's home price indicator – stabilised, but at a level that points towards continued price declines. We are sticking to our forecast of an **accumulated decline of 10-15 percent during the period 2011-2013**. If the price decline is limited to this level, experience indicates that it is possible to avoid a downward spiral of falling consumption, further labour market weakening and increasing strains on the banking system. The risks of larger price declines are obvious, though. The experiences of other countries indicate that a soft landing in home prices is unusual.

Continued decline in home prices

Index 2005 = 100



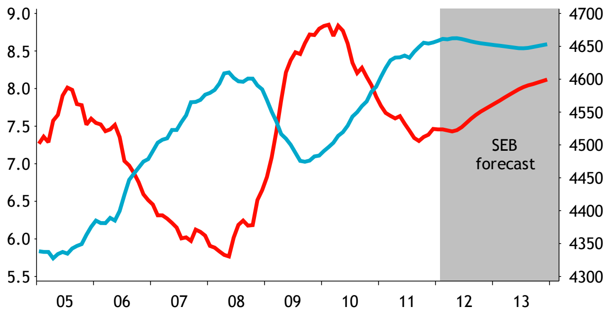
Source: Statistics Sweden, Valueguard

Jobless rate will start climbing this spring

The impact of the economic slowdown on the labour market has been modest so far. Unemployment levelled out late in 2011, but this was primarily because the labour supply increased more than expected. Meanwhile employment has continued to rise, albeit at a slower pace than before. Short-term indicators, such as the number of job vacancies at the Public Employment Service and company hiring plans, indicate that these trends will continue during the next few months. GDP growth that is well below trend nevertheless indicates that employment will eventually decline. We believe that **the unemployment rate will gradually rise by about 1 percentage point to more than 8 per cent by late 2013**.

Unemployment will gradually rise

Three-month moving average



Source: Statistics Sweden, SEB

Labour market
Percentage change

	2010	2011	2012	2013
Employment	1.0	2.1	0.3	-0.2
Labour supply	1.1	1.2	0.4	0.3
Unemployment, %	8.4	7.5	7.6	8.0
Average hours worked	0.8	-0.4	0.2	0.2
Productivity, GDP	3.4	2.5	-0.1	0.7

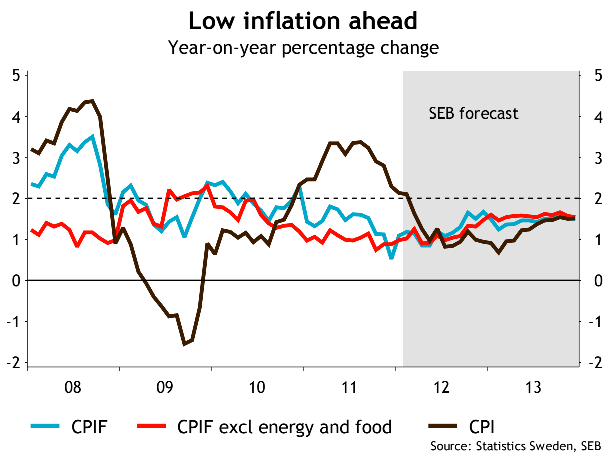
Source: Statistics Sweden, SEB

This year's wage round will thus take place in a climate of gradual labour market weakening. The important industrial collective agreements reached late in 2011 will result in a 2.6 per cent annualised pay increases during a 14-month period. Contractual wages and salaries will probably be somewhat higher in domestic sectors with historically low wage drift, such as retail and wholesale, restaurants and the public sector. Negotiations are now at a stage where the tone of discourse between the two sides is fairly harsh, but we do not believe there will be any large-scale labour disputes. Instead the relative labour market calm of the past 20 years will continue.

The pay adjustment profile during the second half of 2011 will push average pay increases upward this year, but our forecast of 3.5 per cent pay increases during 2012 still seems reasonable. Higher unemployment may well cause the rate of pay increases to fall slightly during 2013.

Lower CPI inflation and below-target CPIF

Consumer Price Index (CPI) inflation fell sharply late in 2011 and was just above 2 per cent in December. The downturn was driven by fading base effects from the preceding year's upturn in energy prices and home mortgage interest rates. Underlying inflation showed a falling trend throughout 2011. Both CPIF (which excludes interest rate changes) and core inflation – which also excludes the effects of energy and food – are now below one per cent.

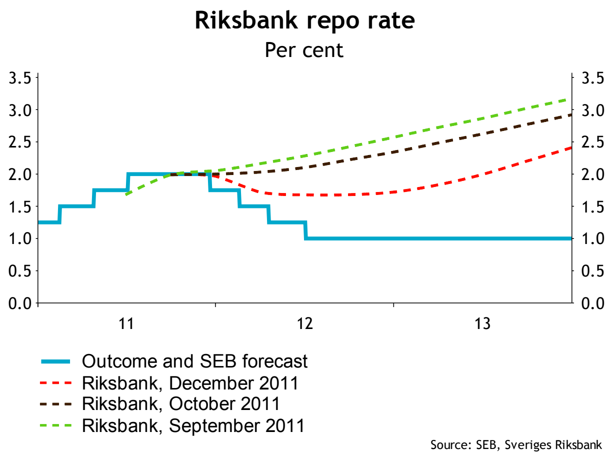


Inflation will remain low in the next couple of years and will be well below 2 per cent. Because of the Riksbank's key interest rate cuts, the mortgage interest component will change direction in 2012 and push CPI inflation below 1 per cent by mid-year. Due to accelerating pay increases and fading downward pressure from the sharp appreciation of the krona in 2010, underlying inflation will climb slightly. CPIF inflation will nevertheless remain well below 2 per cent during the next couple of years.

A major shift in commodity and energy prices is the largest downside risk for inflation in the coming year. However, commodity prices have stabilised in recent months and there is instead an upside risk for oil prices, considering the unfolding of the Iran conflict. Overall, this means that the **risk picture in our inflation forecast is more balanced than in late 2011**.

Riksbank will continue its key rate cuts

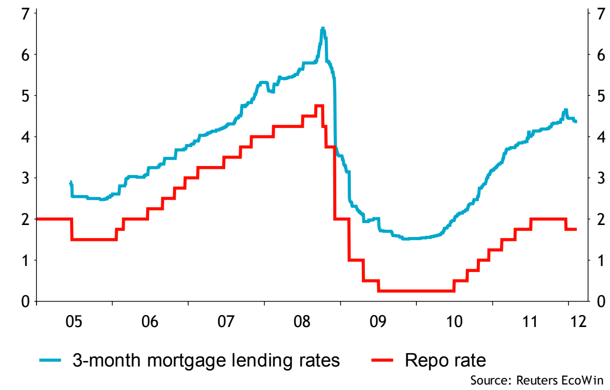
The Riksbank lowered its repo rate by 25 basis points to 1.75 per cent in December, meanwhile unveiling a rate path that indicates only a 30 per cent probability of a further rate cut. **Yet there are many indications that the Riksbank cut key rate again**. Our assessment is that the central bank needs to adjust its GDP and labour market forecasts further downward. Even with relatively limited adjustments, it is still increasingly clear that over the next couple of years the Swedish economy will be characterised by resource utilisation far below normal and by inflation that is well below target. In a world with exceptionally low key interest rates, it is thus **difficult to see justifiable arguments why the Riksbank should abstain from further rate cuts**. Our forecast is that the **Riksbank will cut its repo rate at every monetary policy meeting during the first half of 2012 until it reaches 1.00 per cent in July**.



Slight decline in mortgage lending rates

The Riksbank's key interest rate cuts will ease the impact of rising unemployment on the housing market. However, the **previous strong correlation between the repo rate and mortgage lending rates has weakened** in the past two years, decreasing the effectiveness of monetary policy. There are various reasons for the widening spread between the repo rate and floating mortgage rates. This spread between government bond yields and the borrowing costs of banks has widened significantly for both short and long maturities. In addition, the rules on how banks should refinance mortgage loans have changed. As a result, banks are refinancing floating mortgage loans with borrowing that has longer maturities than previously, which has led to higher borrowing costs. Finally, banks have raised their margins.

The association between repo and mortgage lending rates has weakened



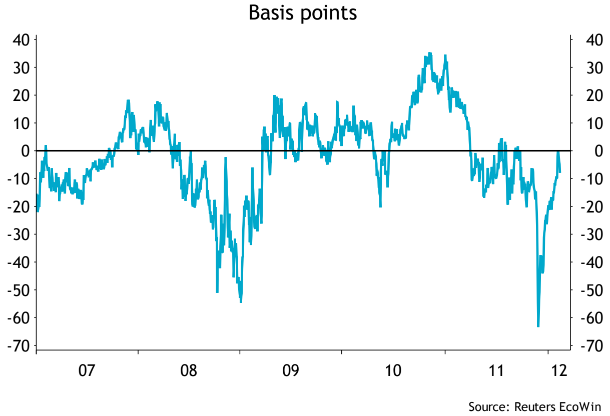
There are many indications that the spread between government bond yields and mortgage lending rates has culminated. The main reason is that the spread between government bond yields and mortgage bonds will not widen any more, but will instead shrink. Our forecast is that short-term mortgage lending rates will fall somewhat faster than the repo rate during the coming year. The trend of the past month supports this assessment.

Has Sweden become a safe haven?

Recent financial market developments are raising a question: To what extent is **Sweden being reclassified as a "safe haven" economy**. Typical countries in this category, such as Japan and Switzerland, are characterised by an appreciating currency as well as extra strong downward pressure on yields during troubled times. In the past year, we have seen a clear tendency: strong government finances have helped make Sweden attractive to international investors, especially central banks. This has created downward pressure on long-term bond yields in particular, whereas the trend on the currency side has not been equally clear.

Negative yield spread against Germany

Basis points



Ever since the autumn of 2010, Sweden's sovereign bond yield spread against Germany has shown a downward trend. In November, Sweden's negative yield spread against Germany reached a record level of more than 60 basis points. However, this exceptional level was largely a consequence of an upturn in German yields due to a crisis of confidence connected to problems with a government bond issue. Since then, the yield spread has again narrowed amid an environment of strong risk appetite. Looking ahead, the small supply of Swedish sovereign bonds, as well as growing interest among international market players in also investing in small countries with AAA credit status, indicates that the **yield spread against Germany will remain negative**. In an environment of slightly rising international yields, this means that Swedish 10-year bond yields will reach 2.10 per cent at the end of 2012 and 2.45 per cent at the end of 2013.

Potential for an even stronger krona

In the past quarter, the krona has appreciated against the euro despite gloomy growth prospects. There are several reasons behind this increased stability, which is in clear contrast to developments in 2008-2009. Because of Sweden's AAA credit rating, global asset managers are continuing to seek krona investments as an alternative to the more established reserve currencies. Another reason is that currency hedging by Swedish export companies, which was previously an important driving force behind the cyclical sensitivity of the krona, is changing. Companies seem to be currency hedging to an decreasing extent. When they do so, it is done for shorter durations.

The question is how far the reclassification of the krona as a safe haven can go. One important driver for safe haven currencies is that domestic investors choose to repatriate assets in times of uncertainty. Large current account surpluses since 1995 indicate that Sweden has built up large assets abroad, leading to substantially rising factor income, but the picture is complicated by the fact that official statistics still show a negative external position. The relative cyclical sensitivity of Swedish industry is another argument against such a reclassification, along with the low liquidity of the krona.

Sweden thus has a long way to go before problems with upward pressure on its currency to extreme levels in times of trouble, like those that Japan and Switzerland face, become a serious headache. Yet the pattern of declines in the krona during economic slowdowns seems to have ended. We thus believe that the krona may continue to appreciate despite Swedish economic stagnation. **At the end of 2012, the EUR/SEK exchange rate will be 8.40**. A strengthening of the US dollar against the euro will cause the USD/SEK rate to move sideways to 7.00 at the end of 2013.

Slowdown squeezing government finances

After two years (2010-2011) of near-balance or surplus, general government finances will be in negative territory in 2012 and 2013. The deficit is small, however, and taking the economic cycle into account, the numbers are compatible with the official target of a long-term surplus totalling one per cent of GDP.

In 2011 the central government budget surplus was SEK 68 billion, but given economic developments it will be close to zero this year and next. Deterioration on both the revenue and expenditure side is behind this trend. We continue to expect that due to the uncertain financial environment, plans for divestments of state-owned companies will be shelved during our forecast period, despite the stock market stabilisation of recent weeks. **The overall central government budget surplus will be SEK 5 billion in 2012 and SEK 2 billion in 2013**.

Given the marginal deficit in the general government sector, combined with Sweden's avoidance of recession, both general government and central government debt will continue to fall as a percentage of GDP, though at a somewhat slower pace. **By late 2013, the general government debt ratio will be close to 35 per cent of GDP and central government debt just above 30 per cent of GDP.** The general government debt ratio is low, both in an international perspective and historically in a national perspective.

Public finances
Per cent of GDP

	2010	2011	2012	2013
Net lending	0.0	0.4	-0.3	-0.3
Gen. gov't gross debt	39.0	36.4	35.6	34.4
Central gov't debt	35.9	33.2	32.5	31.4
Borrowing req., SEK bn	1	-68	-5	-2

Source: Statistics Sweden, SEB

Cautiously expansionary fiscal policy

So far the government has chosen to prioritise strong public sector finances and the **need for safety margins instead of measures to stimulate demand that would ease the economic slowdown**. Strong public sector finances have also been a contributing factor behind greater international interest in making financial investments in Sweden. Considering how much political prestige has been invested in demonstrating fiscal responsibility, it is difficult to believe that there will be a clear fiscal policy shift in a more expansionary direction. This cautious attitude is also accentuated by disunity within the four-party Alliance government on what measures should actually be prioritised.

In an environment of flagging economic growth and rising unemployment, however, opposition criticism will increase and become more difficult to manage. This is especially true in light of international recommendations that countries with budget manoeuvring room and large current account surpluses should contribute to global stability by loosening their fiscal policy restraints. Even within the Alliance government, today's cautious policy is likely to create tensions, especially considering the weak public support for the coalition's two smallest parties, the Centre and Christian Democrats.

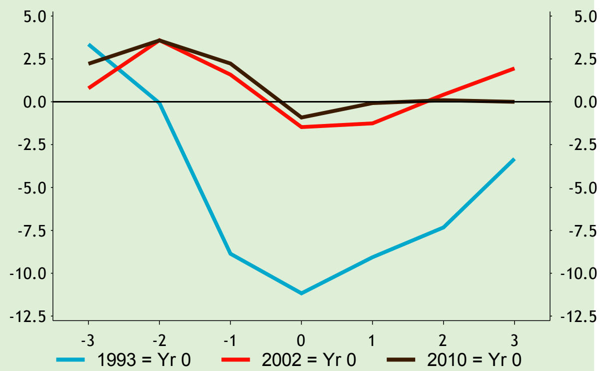
Further tax cuts are likely to be extra controversial until the September 2014 election. Having all chosen new party leaders, the opposition Social Democrats, Green Party and Left Party will probably escalate their political rhetoric and position themselves with new political agendas that put the government under pressure. To avoid defeats in Parliament, where it lacks a majority, the government may focus on an uncontroversial policy of modest stimulus measures in areas that the opposition will find it difficult to vote against. With support from the Greens, the government may possibly push through tax cuts for small business owners in exchange for higher energy taxes or similar measures.

Our overall forecast assumes that the upcoming spring budget bill will include an additional SEK 5 billion in reforms, with a focus on the labour market and education. In the autumn budget bill for 2013, we expect a further SEK 15 billion in stimulus measures, even divided between tax cuts and expenditure increases. On the whole, this means that **fiscal policy will be weakly expansionary, equivalent to 0.2 per cent of GDP in 2012 and 0.3 per cent in 2013**.

How sensitive are Swedish public finances?

Because of Sweden's large public sector, public finances have traditionally been relatively sensitive to economic cycles, but in recent years changes in the expenditure and revenue system have decreased this sensitivity somewhat. According to a rule of thumb from the OECD, net lending weakens by 0.5-0.6 percentage points when GDP declines by 1 per cent. However, such sensitivity depends on what elements of demand and output are affected. If the decline in GDP is due to lower exports or output that has little impact on the labour market, the impact is less than if highly taxed domestic demand or labour-intensive production is affected. The economic slowdown we foresee during our forecast period will have an impact on the government budget that is consistent with the OECD's main rule for Sweden. The main risk factor for a more negative trend in public finances is connected to a sharp price decline in the housing market, which would put pressure on domestic demand and the labour market. Further weakening in the international economic situation, mainly affecting the export industry, would have smaller consequences.

Net lending during cyclical turnarounds
Per cent of GDP



Source: Reuters EcoWin

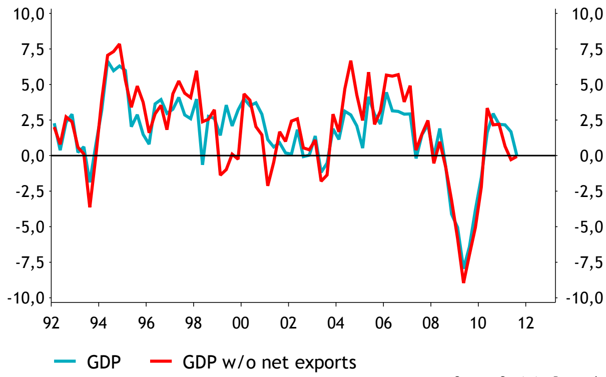
Fiscal policy the only growth driver in 2012

- **Slow exports and consumption**
- **Fiscal stimulus watered down**
- **Private deleveraging continues – well positioned to deal with fallout**

Danish growth slowed in the second half of 2011 as exports waned and both private and public consumption fell. We expect **growth of 0.5 per cent in 2012 as fiscal stimulus takes over as the growth driver – followed by a sluggish recovery to 1.4 per cent in 2013.**

GDP with and without trade

Year-on-year percentage change

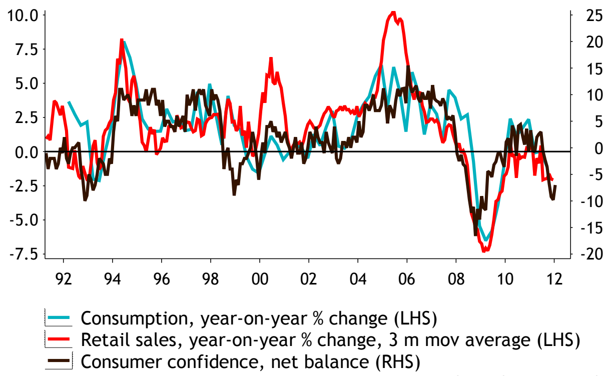


Source: Statistics Denmark

Private demand still soft

Private consumption continued to fall in Q3 and retail sales are waning, since employment has not picked up. Forthcoming wage agreements are on track to entrench the slow wage growth of recent years. With consumer confidence still falling, **consumption is likely to remain subdued**. One offsetting factor is low mortgage rates, which have followed key interest rates down in the second half of 2011. Also, one-off transfers from a retirement reform will support consumption in 2012.

Consumer confidence points at subdued consumption ahead

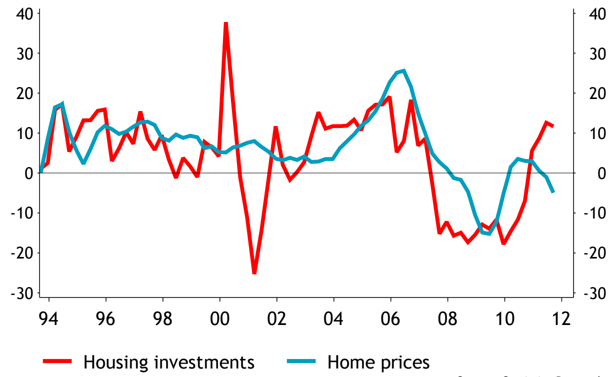


Source: Statistics Denmark

After a big capital spending surge in Q2, companies scaled back in Q3 and are likely to stay in a wait-and-see stance, not releasing pent-up demand until global growth troughs. After housing investments picked up in the first half of 2011, **activity stalled again. Home prices have resumed their decline.**

Home prices are falling again

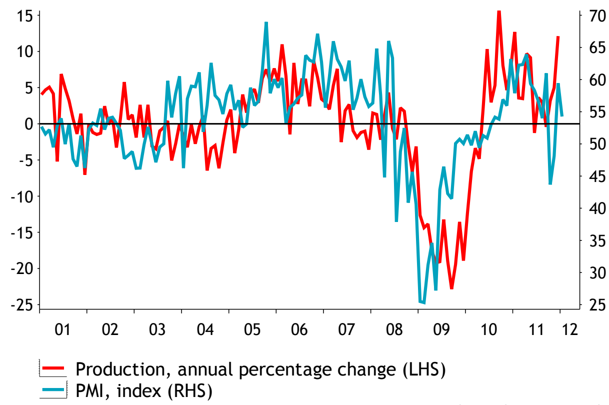
Year-on-year percentage change



Source: Statistics Denmark

The purchasing managers' index (PMI) has recovered in line with the global trend and **manufacturing activity has recovered. This highlights the divergent short-term and medium-term dynamics**, but the more lacklustre underlying trend is likely to gain the upper hand in the second quarter.

Production in manufacturing sector has improved



Source: Statistics Denmark

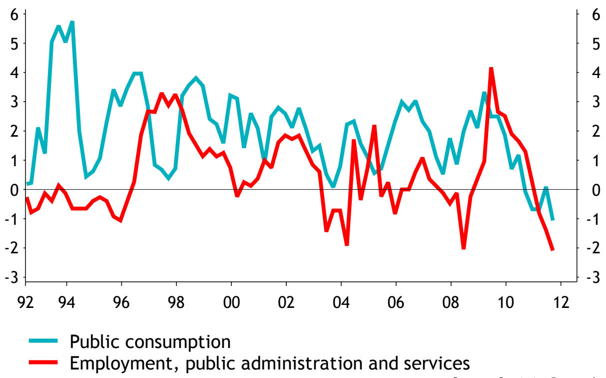
Policy less expansionary than earlier forecast

After budget retrenchment in 2011, fiscal policy will take over as the growth driver in 2012 due to public investments and one-off transfers from a retirement reform. But the stimulus looks set to be smaller than originally estimated. **We are thus revising our forecast for 2012 consumption and capital spending downward** relative to November's *Nordic Outlook*.

The **public sector deficit looks set to end 2011 significantly smaller than the government initially forecast**, due to higher than expected revenue from taxes on pension capital gains – and might drop below the EU threshold of 3 per cent of GDP. The official forecast is for the deficit to rise to 5.5 per cent in 2012, but budget deficits have repeatedly ended up lower than forecast. The increase in deficit is not expected to be a concern for financial markets, given the large current account surplus (expected at 7 per cent of GDP in 2012) and low public debt to GDP level (in the mid-40s as a percentage of GDP).

Public sector downsizing to end

Year-on-year percentage change



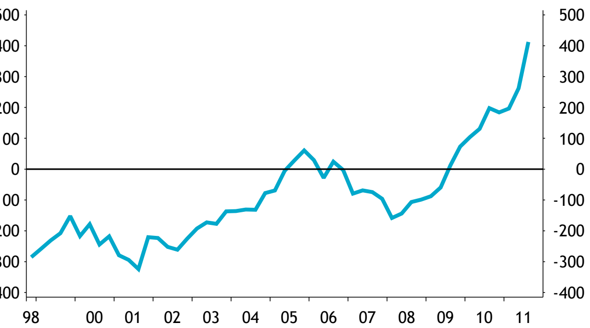
Source: Statistics Denmark

Private deleveraging continues

High **household debt levels and falling home prices continue to provide significant growth headwinds** as bank credit conditions tighten. Bank Package 4, which facilitates consolidation before failures materialise, has been used again in the merger of regional banks Vestjysk Bank and Aarhus Lokalbank. The head of the financial regulatory agency recently warned that a number of smaller banks, representing 3 per cent of the sector, risk insolvency within 12-18 months. Further consolidation in the banking sector is expected.

From debtor to creditor: Rising net financial assets

DKK billion

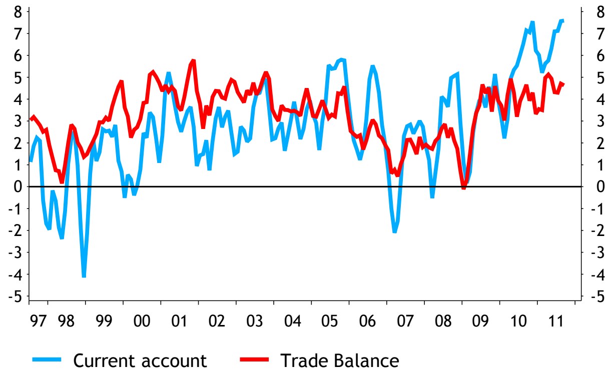


Source: Danmarks Nationalbank

Unlike most European countries, Denmark is well positioned to deal with this problem. Denmark recently made the transition to positive net foreign wealth. The government holds financial assets equal to outstanding debt, and household net financial assets are also respectable in an international comparison. Hence, **the debt problem is primarily one of internal redistribution**: household wealth is mainly tied up in pensions while liabilities are mortgage loans that need ongoing servicing (and may not be held by the same people). Until debtors have adjusted to lower home prices, the financial system will be vulnerable to economic shocks. Low mortgage rates make the problem less acute, but the adjustment will hamper demand for several more years even if it progresses smoothly.

Huge external surpluses

Per cent of GDP, 3 month moving average



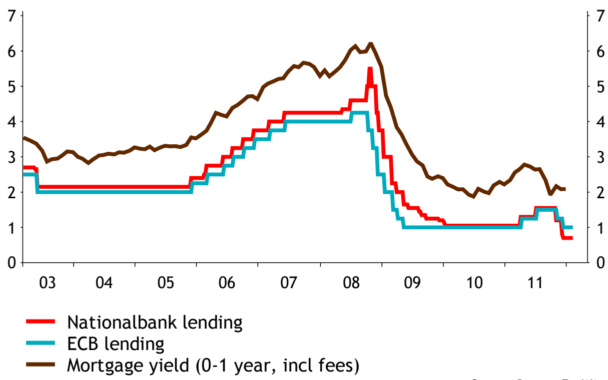
Source: Statistics Denmark

Krone under positive pressure

Recently the combination of a large current account surplus and euro zone jitters have put upward pressure on the krone vs. the euro as investors have diversified into strong Danish balance sheets. Denmark's 10-year government yield has dropped below that of Germany. **The central bank has continuously intervened, and the lending rate is now 30bp below the ECB.** The central bank has also followed the ECB in offering three-year loans and has expanded the eligible collateral.

Nationalbank lending rate below ECB:s also ahead

Per cent



Source: Reuters EcoWin

Large chronic current account imbalances are not compatible with a currency peg over time. Low public sector debt, falling home prices, private sector deleveraging and continuing bank failures suggest that the current account surplus is being inflated by overly weak domestic demand. **Expansionary fiscal policy would seem the appropriate response to the pressure on the peg** when no more rate cuts are possible: the government could take advantage of cheap funding by launching significant investments in infrastructure and education, **addressing long-term productivity problems and offsetting weak private demand** due to private sector deleveraging. With the moderate expansionary fiscal policy currently planned we expect growth to remain positive but below trend in 2012.

Oil-driven acceleration

- **Overall growth accelerating in 2012**
- **Home prices a medium-term concern but supported by fundamentals for now**
- **Norges Bank on hold until 2013**

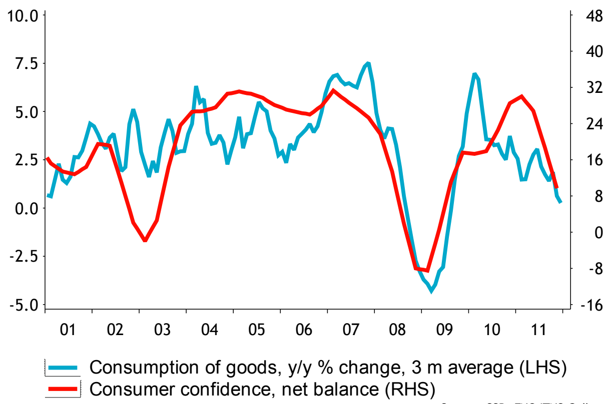
The Norwegian economy lost momentum in late 2011 as private consumption remained soft and the deceleration abroad lowered exports of non-oil goods. However, the main features of our expectations for the current year remain intact, and **growth in overall GDP should accelerate from 1.3 per cent in 2011 to 2.1 per cent in 2012**. A continued very strong investment cycle in the oil sector will be helpful and stimulate some manufacturing, while other sectors will continue to feel headwinds from the continent in early 2012.

Meanwhile we have **lowered our growth forecast for mainland GDP** – excluding oil/gas and shipping – compared to November's *Nordic Outlook* **to 2.3 per cent in 2012**, a bit slower than in 2011, but we are **leaving the 2013 forecast at 2.9 per cent**.

Soft consumption despite strong income

Private consumption was surprisingly soft for most of 2011. Spending on goods rebounded in the spring after a first quarter decline, but the monthly indicator for goods consumption stagnated over the second half of 2011 and full-year growth on this metric slowed from 3.9 per cent in 2010 to 1.5 per cent.

Confidence suggests stronger consumption



Source: SSB, FNO/TNS Gallup

Much of the slowing was due to smaller spending on electricity as temperatures "normalised", while auto sales increased less than in 2010. Nonetheless, the overall softness was surprising considering favourable fundamentals. In particular, average real household disposable income surged more than 5 per cent year-on-year in the first three quarters of 2011, or by twice the rate of consumption, thus lifting the savings ratio 3 percentage points to a historically high 9.1 per cent.

However, fears of repercussions from the intensifying euro zone sovereign debt crisis affected Norwegian consumers disproportionately last autumn. The quarterly confidence index thus slipped below its long-term average in late 2011, consistent with sub-par consumption growth, due to more negative expectations for the Norwegian economy. A monthly survey in December registered the weakest level since the financial crisis of 2008, but it did recover a bit in January.

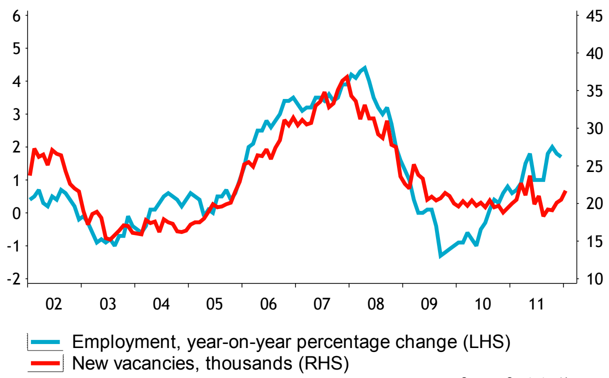
Absent a new turn for the worse in Europe, we expect still-solid fundamentals to reassert themselves. **Private consumption should thus grow by 2.6 per cent in 2012**, which would still lag the expected gain in real household disposable income.

Labour market still in good shape

The labour market remains in good shape. Momentum in employment slowed late last year, though, with the quarterly gain falling from an above-trend 0.8 per cent in the third quarter to 0.3 per cent in the fourth, but totalling a solid 1.7 per cent year-on-year. Employment is thus above its pre-recession peak, although both the employment-to-population ratio and the participation rate are lower. At the same time, the labour force increased more strongly in the fourth quarter, lifting the Labour Force Survey (LFS) unemployment rate from 3.2 per cent in Q3 to 3.4 per cent, which is still low by any standards.

Demand for labour holding up

3-month moving average



Source: Statistics Norway

In January, registered unemployment showed the biggest monthly decline in six years to its lowest level since early spring 2009 (when it was rising sharply). At the same time, new vacancies have re-accelerated over the past few months, suggesting some mismatch in parts of the labour market. Indeed, the fourth quarter Business Tendency Survey from Statistics Norway saw investment goods manufacturers noting a shortage of available skilled workers as a factor restraining production. In all, still-rising demand for labour contrasts with other indicators of softer growth momentum around the turn of the year. However, we are still forecasting that the LFS **unemployment**

rate will inch up marginally from 3.3 per cent on average in 2011 to 3.4 per cent for all of 2012.

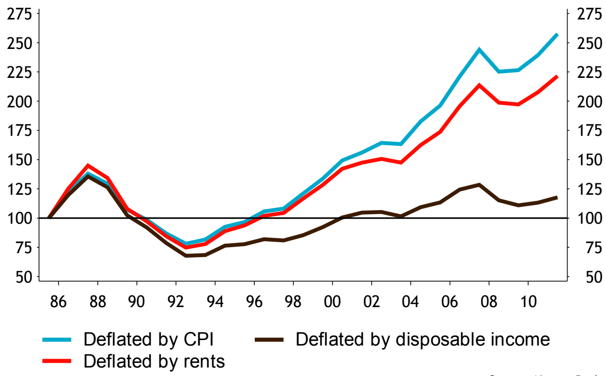
Fundamentals supporting home prices

The relentless rise in Norwegian home prices has raised concerns that a bubble is brewing, especially since gross household debt remains at a historic 200 per cent of disposable income. In our view, home prices are a medium-term concern but are underpinned by strong fundamentals.

Existing home prices were up 8.4 per cent year-on-year in January to more than one third higher in nominal terms than at the trough in late 2008 and record-high levels in inflation-adjusted terms as well. Prices seem inflated relative to rents, building costs and consumer prices, but the deviation is much smaller in relation to the very strong income growth households have enjoyed in recent years.

Home prices look inflated

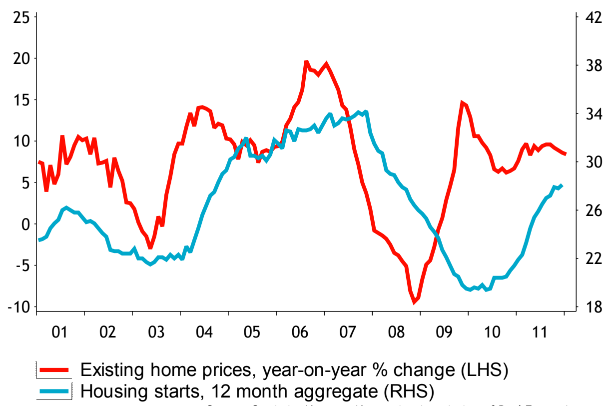
Index 1985 = 100



Source: Norges Bank

The starting point of any comparison certainly matters, and home prices have risen some 20 per cent more than income since 1985 or 2000. More recently, however, nominal disposable income surged by about 38 per cent over the five years to the third quarter of 2011, or by some ten percentage points more than home prices during the same period.

Housing starts turn upward



Source: Statistics Norway, Norwegian Association of Real Estate Agents

Moreover, the housing market is still characterised by very tight supply/demand conditions. The number of days it takes to sell a property continues to shorten on a trend basis, while the stock of homes for sales remains at rather low levels. More fundamentally, although the cycle has turned upward noticeably in the past couple of years, housing starts are lagging well behind what demographics would suggest, given still-strong labour immigration (and internal migration). Hence, prices will be underpinned by fundamentals as long as these imbalances persist, while interest rates remains at very low levels and the labour market holds up.

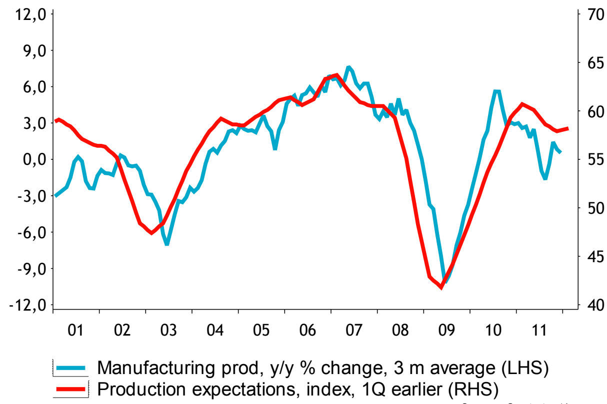
Banks tightened household lending standards in late 2011 and expect them to remain tight in early 2012. This tightening follows stricter guidelines for prudent residential mortgage lending from the Financial Supervisory Authority of Norway (Finanstilsynet) amid discontent with lofty home prices and household debt. Among other things, the recommended loan-to-value ratio was lowered from 90 to 85 per cent.

Even stricter lending practice might put a lid on credit to households and thus home prices for a time. However, assuming that other fundamentals remain intact, the tightening is by itself unlikely to have a lasting effect on prices once the home market finds a new equilibrium (unless, of course, authorities go on tightening further).

Manufacturing beats fears of slowdown

Manufacturing output – excluding energy – showed a moderate 0.9 per cent sequential gain in the final quarter of 2011, which admittedly owed to a stronger trajectory during the previous quarter, to show a similar growth rate for the full year. However, as oil and gas extraction eased in the fourth quarter and electricity production slumped after surging in the previous two quarters, overall industrial production dropped 4.3 per cent in 2011, for its third consecutive annual decline.

Manufacturers expect ongoing growth



Source: Statistics Norway

The manufacturing sector shows signs of a split between producers affected by the slowdown abroad and those benefiting from relatively healthy domestic demand, in particular the very strong investment cycle in the oil sector. Exports of traditional goods – i.e. excluding oil/gas, ships and oil platforms – thus showed a second quarterly decline in volume terms in late 2011, and the fourth quarter Business Tendency Survey saw producers of export-oriented intermediate goods reporting weaker order inflow and a bleaker outlook. At the same time, however, producers of investment goods reported a continued increase in orders late last year, with further gains expected in early 2012.

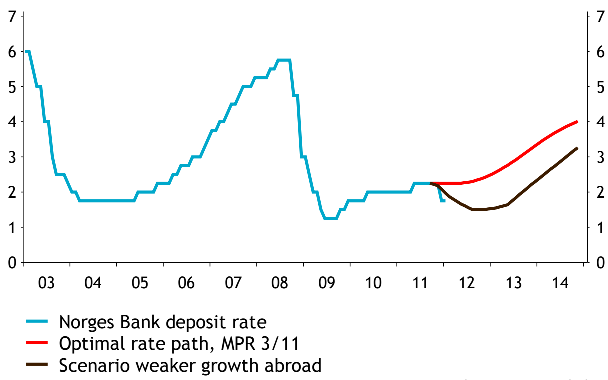
On balance, “soft” indicators have been holding up despite the headwinds from abroad. Manufacturing sentiment actually improved a bit late last year to above the long-term average, which should be consistent with slightly above-trend growth in activity. Meanwhile, manufacturing PMI was extremely volatile around the turn of the year, setting a 26-month low in December but surging more than 8 points to 54.9 in January, the highest since last July. Despite this volatility, the survey still gives an impression of resilience in manufacturing.

Key interest rate on hold until 2013

Norges Bank cut its deposit rate 50 basis points to 1.75 per cent in December. This marked an abrupt shift from the October Monetary Policy Report, which called for an unchanged key rate until autumn 2012. The deeper-than-expected cut was, first and foremost, motivated by the global slowdown and ongoing sovereign debt stress in Europe. The Board thus wanted to "take measures to mitigate effects of a particularly adverse outcome on the economy". The central bank also took note of persistently high money market premiums: in the event, short-term rates have declined quite a lot since then.

Norges Bank should stay put through 2012

Per cent



Source: Norges Bank, SEB

Developments abroad will be of particular importance for monetary policy in the near term. We expect the ECB to keep its key rate unchanged going forward. If so, it would take a marked deterioration in domestic economic conditions for Norges Bank to cut its deposit rate further. While momentum in mainland GDP has slowed and core inflation remains well below the 2.5 per cent medium-term target without showing signs of any imminent upturn, unemployment remains low and job creation is slightly above trend. While rising risk premiums mean lending rates are higher than the level of the key interest rate would suggest, it is hard to argue that they are restraining lending. After all, lending to households was running at a solid 7.3 per cent year-on-year increase in December (if anything a bit too high for comfort) and lending to non-financial businesses was rising at a healthy 5.3 per cent pace.

It is more uncertain what Norges Bank would do if the ECB opted for a rate cut in the near term. Considering the arguments provided for its deep cut in December, Norges Bank may favour following the ECB's lead if the euro zone situation should worsen. However, we believe that domestic conditions do not warrant lower key rates. In fact, continued low rates might encourage the creation of a bubble at home. Our base scenario is thus that **Norges Bank will keep the deposit rate at 1.75 per cent throughout 2012 before hiking it cautiously to 2.50 per cent by end-2013**.

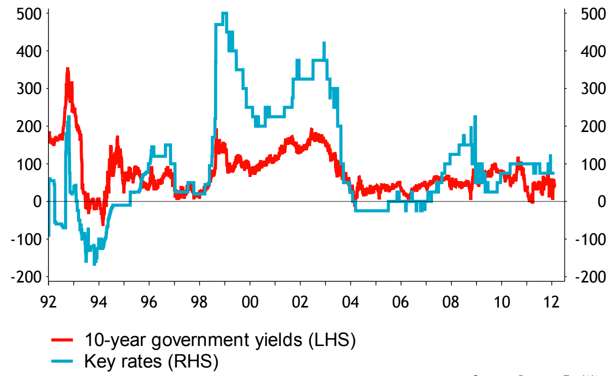
Foreigners continue diversifying to Norway

Norwegian government bonds have been on a roller coaster so far this year. Demand from foreigners has been solid, with global currency reserve managers continuing to diversify into countries with strong credit quality. Norway is an obvious beneficiary of such flows, with foreign holdings of government bonds increasing from just above 50 per cent to 70 per cent over three years. As a result, Norwegian 10-year bonds were at parity with their German counterparts early this year. However, tight pricing and a marked increase in government bond supply resulted in an equally sharp rebound, with bonds underperforming.

Looking ahead, with the key rate spread vs. the ECB expected to remain unchanged and with supply being more evenly distributed during the remainder of the year, bonds should again trade at historically expensive levels vs. Germany. We forecast a 10-year spread of 55 basis points by end-2012, resulting in a 10-year yield of 2.75 per cent In 2013, Norges Bank's key rate hikes should result in Norwegian bonds underperforming vs. Germany and the 10-year yield rising modestly to 3.10 per cent.

High price for high credit quality

Spread vs. Germany



Source: Reuters EcoWin

Despite being backed by superb fundamentals and a relatively strong growth outlook, the krone has underperformed many sound currencies, since the central bank is guarding against any appreciation. However, with monetary policy turning neutral and the flow outlook gradually improving, the trade-weighted krone should make up for lost ground. We expect a **EUR/NOK exchange rate of 7.40 by end-2012**. EUR weakness on back of the debt crisis will continue to favour the USD, pushing the USD/NOK rate higher to 5.92 at end-2012.

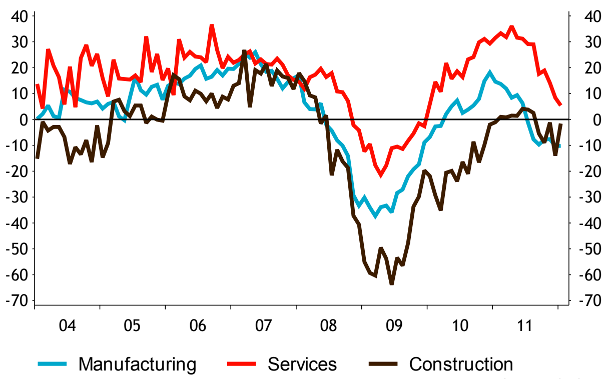
Weak cyclical exports will pull down growth

- **Labour market is about to weaken**
- **Inflation is falling**
- **No austerity needed in next couple of years**

The Finnish economy provided a positive surprise in the third quarter of 2011, but leading indicators show a clear weakening in the fourth quarter. Such bright spots as continued labour market stability and rising real household incomes will be incapable of resisting the effects of the euro zone crisis. Looking ahead, exports will weaken and the crisis will spill over into declining optimism among households and domestically oriented companies. We are revising our overall growth forecast and now expect **GDP growth of 0.5 per cent in 2012 and 1.7 per cent in 2013**. Given this forecast, GDP will regain its pre-crisis level only at the end of our forecast period.

Continued decline in leading indicators

Net balances

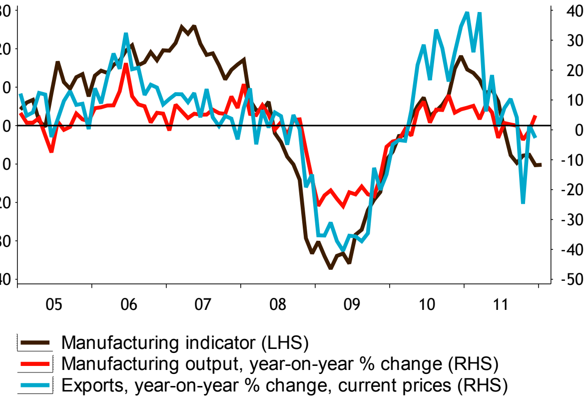


Source: DG ECFIN

Leading indicators fell on a broad front in 2011. The downturn began among internationally exposed manufacturers, while domestic sectors resisted for a while. The GDP indicator (from Statistics Finland) worsened in 2011, and along with other indicators it signals weak GDP growth ahead.

Exports are equivalent to about 40 per cent of GDP, which in itself is not especially much for a small open economy. But the structure of Finnish exports – with a large proportion of machinery, electronics and forest products – makes the economy extra sensitive to international cycles. In the third quarter, exports fell 3 per cent in current prices. We expect an equally large downturn in the fourth quarter. One factor offsetting this is that Finland's exports, to a greater extent than those of other Nordic countries, go to expansive markets such as Russia (9 per cent of exports) and China (5 per cent). Since the euro has weakened against the krona, the Finnish forest product industry has also improved its position compared to Swedish competitors.

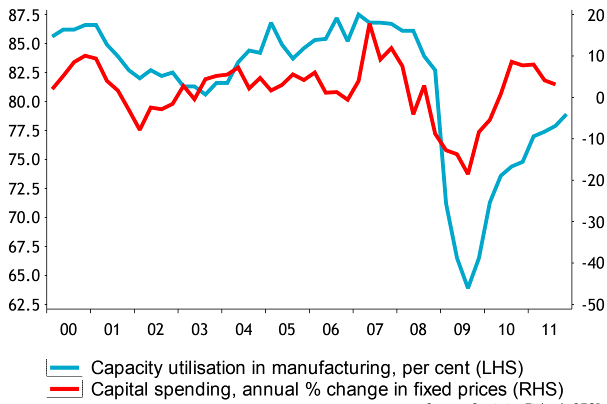
Weak cyclical exports will pull down growth



Source: Statistics Finland

Fixed investments rose in 2011 and, together with household consumption, provided by far the largest contributions to GDP growth. Construction spending rose relatively sharply, especially since residential construction regained lost ground. In manufacturing, too, capital spending rose, even though capacity utilisation had still not recovered after the financial crisis. Due to a poorer future outlook, however, manufacturers are now postponing investments, while deteriorating household optimism is lowering the demand for new homes. Taken together, **capital spending growth will only reach 2 per cent this year and 4 per cent in 2013**.

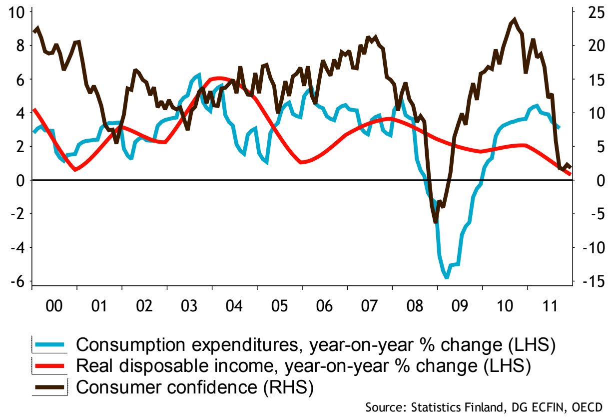
Capacity utilisation and capital spending



Source: Statistics Finland, OECD

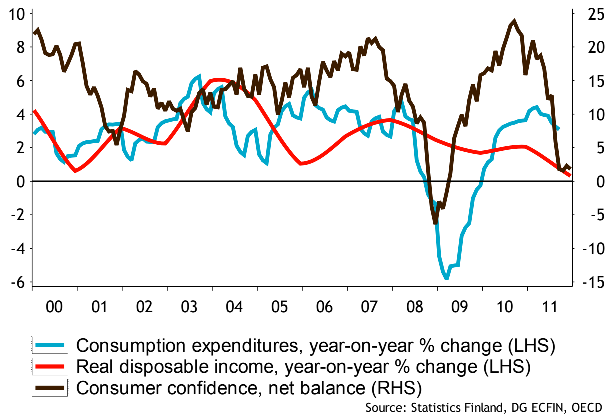
The poorer outlook is also affecting consumption. Retail sales growth gradually slowed in 2011 and consumer confidence has fallen sharply. High inflation has held back real income growth, which has nevertheless benefited from falling unemployment. Looking ahead, these forces will shift in the opposite direction. **Household consumption expenditures will climb by 1.6 per cent in 2012 and 2.0 per cent in 2013**.

Households expect rising unemployment



The poorer outlook will eventually also affect the labour market. Household concerns about the labour market situation have clearly increased, even though the favourable trend during most of 2011 and even though the number of vacancies still is at a relatively good level. In recent weeks, job creation has also slowed and unemployment has shown signs of levelling out, after having fallen from 8.1 per cent in early 2011 to 7.5 per cent in December. Employment growth in manufacturing was weak during 2011, and the export slowdown will further adversely impact jobs in this sector. Overall, we expect unemployment to turn upward during the first half of 2012. As an annual average, **unemployment will increase marginally to 8.0 per cent in 2012 and then remain at that level in 2013 as well**.

Households expect rising unemployment

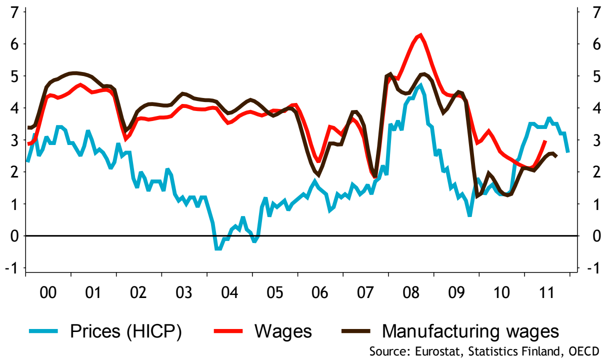


The crisis has gradually pushed down the rate of pay increases. In 2011, wages and salaries rose by a bit more than 2 per cent, compared to an average increase of about 4 per cent during 1998-2007. The manufacturing sector, which has been especially hard hit in recent years, has seen somewhat heavier pressure on pay than other economic sectors. Because of high inflation in 2011, **real wage growth was very weak**, and for some groups even negative. **Wage and salary growth will climb to about 3 per cent yearly in 2012 and 2013**. Together with falling inflation, this will lead to rising real wages.

Inflation peaked in mid-2011 and is now falling noticeably. Higher commodity prices and indirect tax hikes drove up HICP inflation to 3.7 per cent at its highest in July 2011, but the rate fell towards the end of the year to 2.6 per cent. Excise tax and VAT hikes will create some upward inflation pressure this year as well. The labour market slowdown, in a situation of large idle resources at the outset, will nevertheless translate to low underlying inflation pressure. Measured as **annual averages, HICP inflation will fall from 3.3 per cent in 2011 to 2.2 per cent in 2012 and 2.0 per cent in 2013**.

Lower inflation will mean decent real wage increases

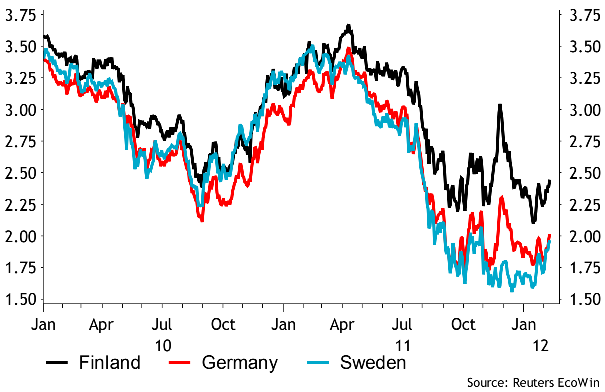
Year-on-year percentage change



Like the other Nordic countries, Finland's **relatively good public sector finances have contributed to economic stability and confidence**. Major austerity programmes have thus been avoided. With a general government budget deficit of 2.5 per cent of GDP in 2010 and a debt ratio that rose from 34 per cent of GDP in 2008 to 48 per cent in 2010, the situation is relatively stable. Quarterly data also indicate that the deficit is on its way down to just above 1 per cent of GDP in 2011. Government debt will only increase slightly. **The weaker outlook will put pressure on revenue and expenditures**, but not enough to push net lending below around 1.5 per cent of GDP in 2012. In 2013 the public balance will improve somewhat to 0.5 per cent of GDP. General government debt will be around 50 per cent of GDP the whole forecast period.

Low yields but spread to Germany has increased

Per cent



Less tolerance among investors for high sovereign debt, especially in countries that lack their own central bank, has not hurt low-indebted Finland. Finnish long-term bond yields have fallen to historically low levels, although the yield spread to Germany has widened from about 15 to about 40 basis points.

Economic data

DENMARK

Year-on-year percentage change

	2010 level, DKK bn	2010	2011	2012	2013
Gross domestic product	1,754	1.3	1.1	0.5	1.4
Private consumption	850	1.9	-0.5	0.5	1.5
Public consumption	510	0.3	-0.5	0.5	0.0
Gross fixed investment	305	-3.7	-0.5	2.0	3.0
Stockbuilding (change as % of GDP)		0.8	0.3	0.0	0.0
Exports	883	3.2	7.0	0.5	3.0
Imports	791	3.5	5.0	1.0	3.0
Unemployment (%)		4.2	4.0	4.3	4.2
Consumer prices, harmonised		2.2	2.6	1.7	1.8
Hourly wage increases		2.3	1.7	1.5	1.5
Current account, % of GDP		5.5	7.0	7.0	7.0
Public sector financial balance, % of GDP		-2.7	-3.0	-4.5	-2.5
Public sector debt, % of GDP		43.6	44.0	47.0	47.0

FINANCIAL FORECASTS	Feb 9th	Jun 12	Sep 12	Dec 12	Jun 13	Dec 13
Lending rate	0.70	0.60	0.60	0.60	0.60	0.60
10-year bond yield	1.96	1.90	2.03	2.15	2.25	2.45
10-year spread to Germany, bp	-5	-10	-7	-5	-5	-5
USD/DKK	5.59	6.09	5.94	5.94	6.10	6.20
EUR/DKK	7.43	7.43	7.43	7.43	7.44	7.44

NORWAY

Year-on-year percentage change

	2010 level, NOK bn	2010	2011	2012	2013
Gross domestic product	2,373	0.7	1.3	2.1	2.4
Gross domestic product (Mainland Norway)	1,911	1.9	2.5	2.3	2.9
Private consumption	1,065	3.7	2.2	2.6	3.3
Public consumption	540	1.7	0.8	2.3	2.3
Gross fixed investment	489	-5.2	7.5	5.2	5.1
Stockbuilding (change as % of GDP)		1.9	-0.4	-0.6	0.0
Exports	946	1.8	-1.4	1.4	2.1
Imports	726	9.9	1.3	2.4	4.9
Unemployment (%)		3.6	3.3	3.4	3.3
Consumer prices		2.5	1.2	1,5	2,0
CPI-ATE		1.4	0,9	1,6	1,9
Annual wage increases		3.7	4.2	3.9	4.2

FINANCIAL FORECASTS	Feb 9th	Jun 12	Sep 12	Dec 12	Jun 13	Dec 13
Deposit rate	1.75	1.75	1.75	1.75	2.00	2.50
10-year bond yield	2.40	2.40	2.55	2.75	2.85	3.10
10-year spread to Germany, bp	39	40	45	55	55	60
USD/NOK	5.75	6.15	6.12	5.92	6.02	6.13
EUR/NOK	7.63	7.50	7.65	7.40	7.35	7.35

SWEDEN

Year-on-year percetage change

	2010 level, SEK bn	2010	2011	2012	2013
Gross domestic product	3,305	5.6	4.3	0.5	1.7
Gross domestic product, working day adjusted		5.3	4.3	0.9	1.7
Private consumption	1,604	3.7	2.2	0.8	1.5
Public consumption	890	2.1	1.5	0.9	0.8
Gross fixed investment	589	6.6	8.0	0.0	3.0
Stockbuilding (change as % of GDP)	20	2.0	0.7	-0.7	0.0
Exports	1,652	11.1	8.2	0.2	3.3
Imports	1,452	12.7	7.7	-1.0	3.3
Unemployment (%)		8.4	7.5	7.6	8.0
Employment		1.0	2.1	0.3	-0.2
Industrial production		9.6	9.1	0.0	2.5
Consumer prices		1.2	3.0	1.3	1.2
CPIF		2.0	1.4	1.2	1.4
Hourly wage increases		2.6	2.5	3.5	3.3
Household savings ratio (%)		10.6	11.5	12.5	13.0
Real disposable income		1.6	3.0	2.2	2.1
Trade balance, % of GDP		2.5	2.6	2.7	2.9
Current account, % of GDP		6.3	7.5	7.1	6.8
Central government borrowing, SEK bn		1	-68	-5	-2
Public sector financial balance, % of GDP		0.0	0.3	-0.4	-0.3
Public sector debt, % of GDP		39.0	36.4	35.6	34.4

FINANCIAL FORECASTS	Feb 9th	Jun 12	Sep 12	Dec 12	Jun 13	Dec 13
Repo rate	1.75	1.25	1.00	1.00	1.00	1.00
3-month interest rate, STIBOR	2.52	2.20	2.05	1.90	1.80	1.70
10-year bond yield	1.97	1.85	1.95	2.10	2.20	2.45
10-year spread to Germany, bp	-5	-15	-15	-10	-10	-5
USD/SEK	6.63	6.97	6.92	6.80	6.93	7.00
EUR/SEK	8.80	8.50	8.65	8.50	8.45	8.40
TCW	121.1	119.0	120.7	118.3	117.8	117.1

FINLAND

Year-on-year percentage change

	2010 level, EUR bn	2010	2011	2012	2013
Gross domestic product	180	3.6	2.7	0.5	1.7
Private consumption	98	2.7	2.6	1.6	2.0
Public consumption	44	0.6	0.5	0.3	0.3
Gross fixed investment	34	2.8	6.5	2.0	4.0
Stockbuilding (change as % of GDP)		0.6	0.1	0.0	0.0
Exports	73	8.6	0.0	4.0	5.1
Imports	70	7.4	0.2	6.6	6.2
Unemployment (%)		8.4	7.8	8.0	8.0
Consumer prices, harmonised		1.7	3.3	1.8	1.9
Hourly wage increases		2.6	2.4	2.9	3.0
Current account, % of GDP		1.8	2.5	2.0	2.0
Public sector financial balance, % of GDP		-2.5	-1.5	-1.7	-0.5
Public sector debt, % of GDP		48.3	50.0	50.5	49.0

EURO ZONE

Year-on-year percentage change

	2010 level, EUR bn	2010	2011	2012	2013
Gross domestic product	9,189	1.8	1.5	-0.8	0.7
Private consumption	5,301	0.8	0.1	-1.1	-0.1
Public consumption	2,014	0.6	0.1	-0.4	0.0
Gross fixed investment	1,764	-0.8	1.9	-1.1	1.7
Stockbuilding (change as % of GDP)		0.5	0.1	-0.1	0.0
Exports	3,734	11.3	6.9	3.4	3.9
Imports	3,613	9.5	4.9	3.0	3.1
Unemployment (%)		10.1	10.1	10.6	11.1
Consumer prices		1.6	2.7	1.9	1.4
Household savings ratio (%)		9.6	9.3	9.1	9.2

US

Year-on-year percentage change

	2010 level, USD bn	2010	2011	2012	2013
Gross domestic product	14,755	3.0	1.7	2.5	2.5
Private consumption	10,417	2.0	2.2	2.2	2.1
Public consumption	3,020	0.7	-2.1	-1.5	-1.0
Gross fixed investment	1,818	2.6	6.6	8.1	8.9
Stockbuilding (change as % of GDP)		1.6	-0.2	0.1	0.0
Exports	1,935	11.3	6.8	4.5	5.9
Imports	2,436	12.5	5.0	3.1	5.0
Unemployment (%)		9.6	9.0	8.1	7.7
Consumer prices		1.7	3.1	1.6	1.3
Household savings ratio (%)		5.3	4.4	4.4	5.1

LARGE INDUSTRIAL COUNTRIES

Year-on-year percentage change

	2010	2011	2012	2013
GDP				
United Kingdom	2.1	0.9	0.3	1.4
Japan	4.5	-0.6	1.7	1.2
Germany	3.7	3.0	0.4	1.3
France	1.4	1.6	-0.4	0.6
Italy	1.4	0.4	-2.3	0.2
Inflation				
United Kingdom	3.3	4.5	2.5	1.7
Japan	-0.7	-0.3	-0.1	0.1
Germany	1.2	2.5	1.8	1.7
France	1.7	2.3	1.7	1.5
Italy	1.6	2.9	2.4	1.8
Unemployment (%)				
United Kingdom	7.9	8.0	8.8	9.0
Japan	5.1	4.5	4.4	4.2
Germany	7.1	5.9	5.7	6.4
France	9.8	9.7	10.3	11.1
Italy	8.4	8.3	9.3	10.2

EASTERN EUROPE

	2010	2011	2012	2013
GDP, year-on-year percentage change				
Estonia	2.3	7.5	1.5	2.5
Latvia	-0.3	5.0	2.5	4.0
Lithuania	1.4	5.8	2.0	3.0
Poland	3.9	4.3	2.9	3.6
Russia	4.0	4.3	3.8	4.1
Ukraine	4.2	4.7	3.2	4.2
Inflation, year-on-year percentage change				
Estonia	2.7	5.1	4.0	5.0
Latvia	-1.2	4.2	2.4	2.0
Lithuania	1.2	4.1	2.5	3.0
Poland	2.7	3.9	3.2	2.8
Russia	6.9	8.5	5.5	6.0
Ukraine	9.4	8.0	8.0	7.5

FINANCIAL FORECASTS

		Feb 9th	Jun 12	Sep 12	Dec 12	Jun 13	Dec 13
Official interest rates							
US	Fed funds	0.25	0.25	0.25	0.25	0.25	0.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	1.00	1.00	1.00	1.00	1.00	1.00
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	0.50
Bond yields							
US	10 years	2.04	2.00	2.10	2.20	2.35	2.60
Japan	10 years	0.99	1.00	1.10	1.20	1.20	1.20
Germany	10 years	2.02	2.00	2.10	2.20	2.30	2.50
United Kingdom	10 years	2.23	2.20	2.40	2.60	2.70	2.90
Exchange rates							
USD/JPY		78	79	80	85	90	90
EUR/USD		1.33	1.22	1.25	1.25	1.22	1.20
EUR/JPY		103	96	100	106	110	108
GBP/USD		1.58	1.47	1.54	1.52	1.49	1.43
EUR/GBP		0.84	0.83	0.81	0.82	0.82	0.84

GLOBAL KEY INDICATORS

Year-on-year percentage change

	2010	2011	2012	2013
GDP OECD	3.1	1.7	1.4	1.9
GDP world	5.2	3.9	3.5	4.0
CPI OECD	1.5	2.5	1.6	1.2
Export market OECD	12.0	5.8	3.7	5.4
Oil price, Brent (USD/barrel)	79.9	111.0	114.0	120.0

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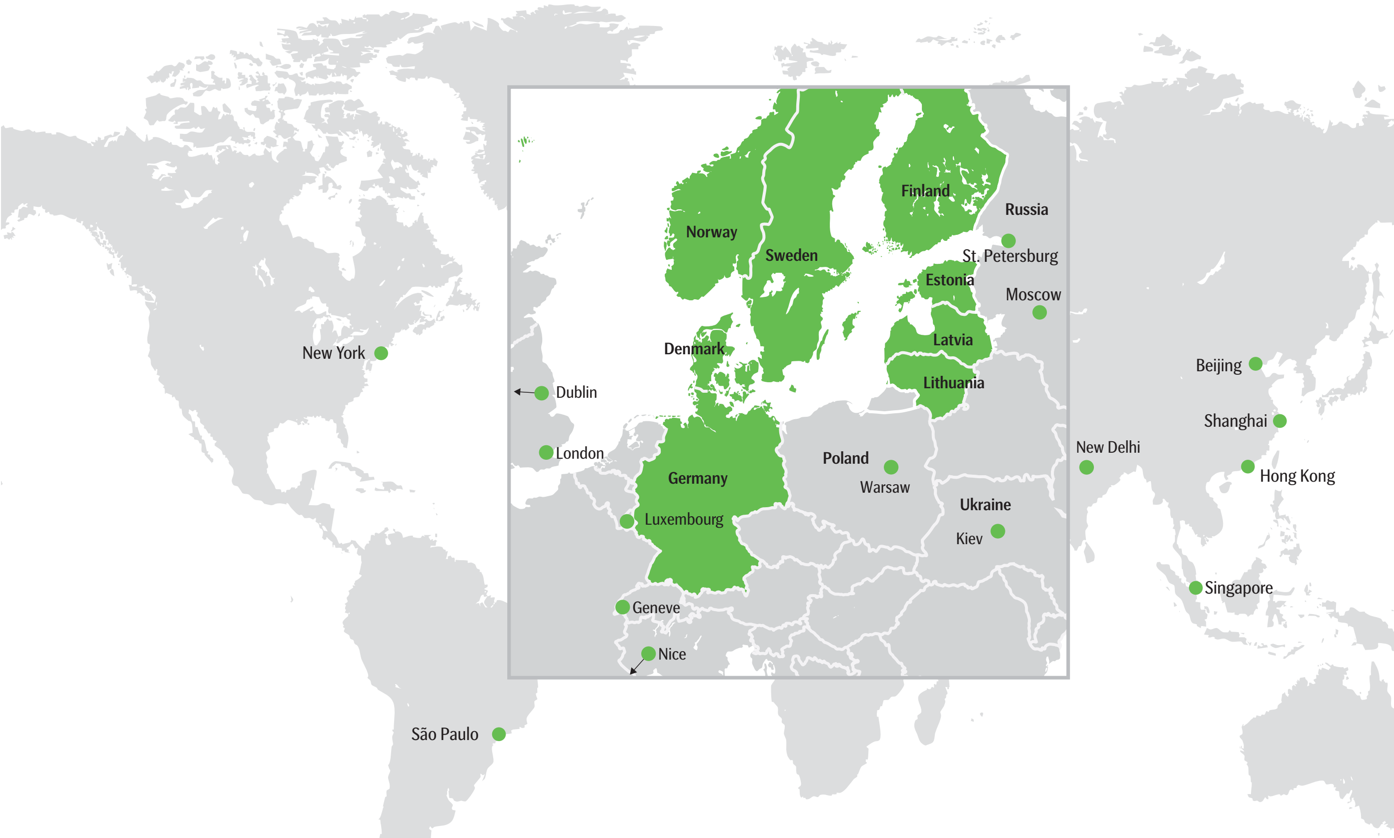

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