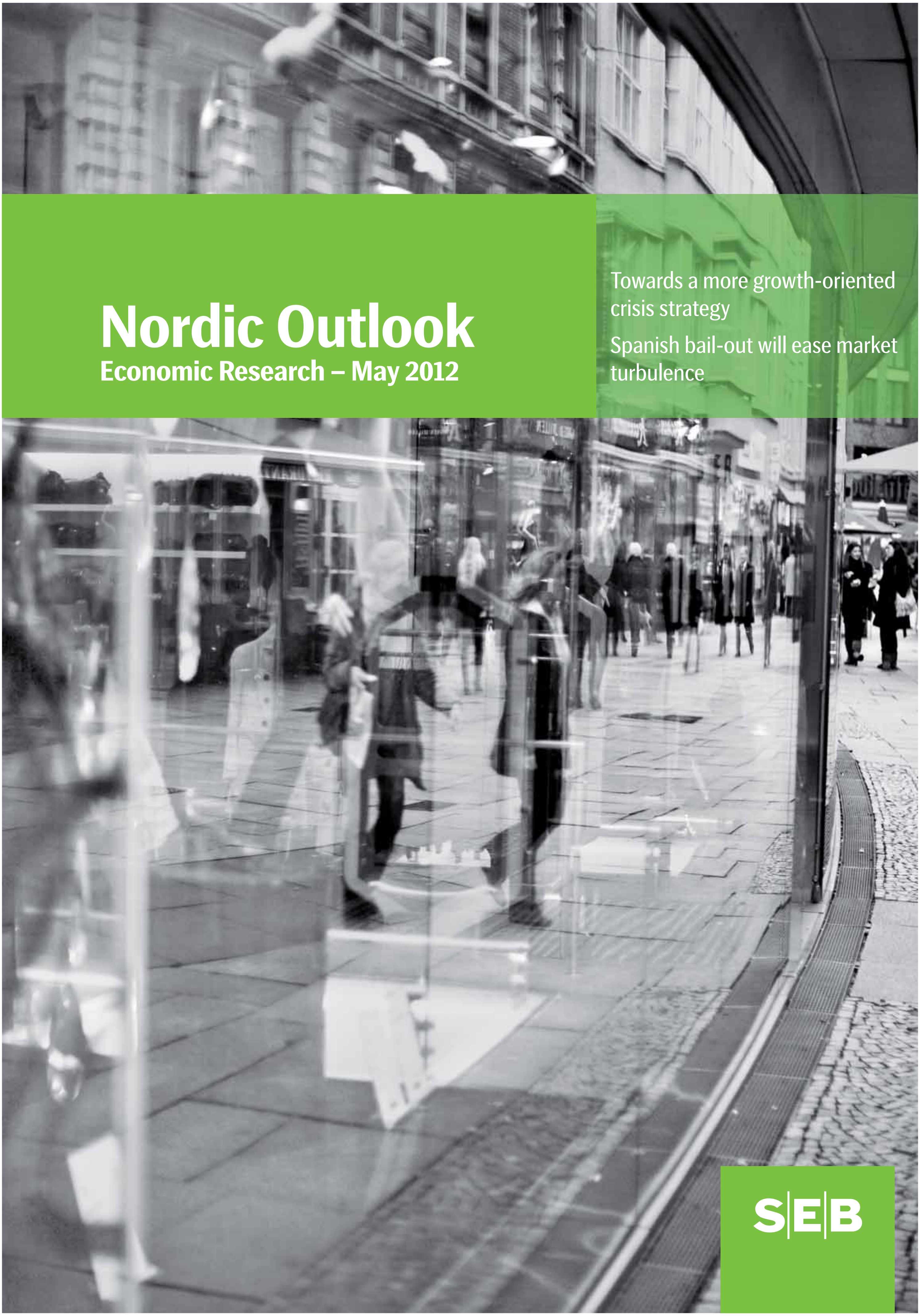

Nordic Outlook

Economic Research – May 2012

Towards a more growth-oriented crisis strategy

Spanish bail-out will ease market turbulence

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This report was published on May 8, 2012.

Cut-off date for calculations and forecasts was May 3, 2012.

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New bail-out efforts to help maintain modest growth

- **Spanish rescue package on the way**
- **US economy will maintain cruising speed**
- **Faster pace again in Asia during second half**
- **Austerity policies have reached their limits**
- **Low inflation, but ECB target under pressure**
- **Growth gaps will squeeze EUR/USD to 1.20**

The world economy has recently lacked a clear direction. The European Central Bank (ECB) offered three year Long-Term Refinancing Operation (LTRO) loans to the banking sector late in 2011, which marked the beginning of a wave of policy loosening. After that, rising risk appetite and improved household and business optimism dominated the first quarter of 2012, but recent months have been characterised by renewed concerns. The deepening crisis in Spain has again underscored the serious risks and challenges that the euro zone must deal with. Economic signals from the United States have also become more mixed, with a preponderance of negative news. Meanwhile worries about a hard landing in China have recently subsided a bit. Emerging economies are now implementing a soft landing, while preserving fairly rapid growth. This will help sustain the global economy but is not enough to lift it.

In several important respects, economic events are following our latest forecasts. For a long time, our main scenario has been that the recovery will be anaemic; growth is not self-perpetuating but instead needs continued support. In many countries, the economy is constrained by the need for further debt consolidation. A sustainable solution to the deep euro zone crisis remains elusive. The LTRO loans in December and February provided breathing space and helped avoid a credit market freeze, but the underlying problems remain. The gaps in competitiveness are still very wide, and the challenge of implementing the necessary austerity in crisis-hit countries without strangling economic activity remains to be met.

For a long time, one part of our scenario has been that sooner or later, Spain would need an international bail-out. **The next step in the euro zone crisis is that Spain will soon receive such a bail-out**, aimed at easing pressure on its banking sector. We believe that this rescue package will come from euro zone bail-out funds and the International Monetary Fund (IMF) and total EUR 150 billion. It will focus on the banking sector, unlike the general bail-outs received by Greece and Portugal to cope with their large government debts. In addition, we believe that Portugal's loan conditions will be softened.

Meanwhile the policy shift we discussed in February's *Nordic Outlook* is being confirmed. There is a limit to how much belt-tightening countries can withstand. We believe that the focus will move increasingly from belt-tightening to structural reforms that strengthen long-term growth. In this context, the ECB will be pressured in various ways to be more active. For example, we are now seeing the IMF recommending that the ECB raise its inflation target in order to facilitate rebalancing in the euro zone economies. We also expect the European Investment Bank (EIB), among others, to expand its ending capacity in order to make the recovery easier and avoid an excessive downturn in capital spending. It is uncertain how Germany's Bundesbank and the ECB will ultimately respond to this type of policy realignment, but our scenario is that effective structural reforms in individual countries will make concessions from the ECB and the Bundesbank possible.

Global GDP growth
Year-on-year percentage change

	2010	2011	2012	2013
United States	3.0	1.7	2.5	2.7
Japan	4.5	-0.7	2.2	1.7
Germany	3.7	3.0	0.8	1.6
China	10.4	9.3	8.5	8.7
United Kingdom	2.1	0.7	0.5	1.7
Euro zone	1.9	1.5	-0.6	0.8
Nordic countries	2.7	2.5	1.1	2.0
Baltic countries	1.1	6.2	2.5	3.4
OECD	**3.1**	**1.7**	**1.6**	**2.1**
Emerging markets	7.3	6.2	5.6	5.9
World, PPP*	**5.3**	**3.9**	**3.6**	**4.1**
World, nominal	4.6	3.2	2.9	3.4

Source: OECD, SEB * Purchasing power parities

Despite the drama that often characterises the world economy, our scenario is largely unchanged, compared to the February issue of *Nordic Outlook*. At that time, we upgraded our global growth outlook. In the US, we expect growth to be around the trend rate: 2.5 per cent in 2012 and 2.7 per cent in 2013. Debt adjustment (deleveraging) will prevent a historically more normal recovery during the next couple of years, but the underlying growth dynamic is sufficient to ward off a new recession. Emerging economies have lost momentum, but their resilience has been confirmed, and we foresee some acceleration in their growth during the second half of 2012.

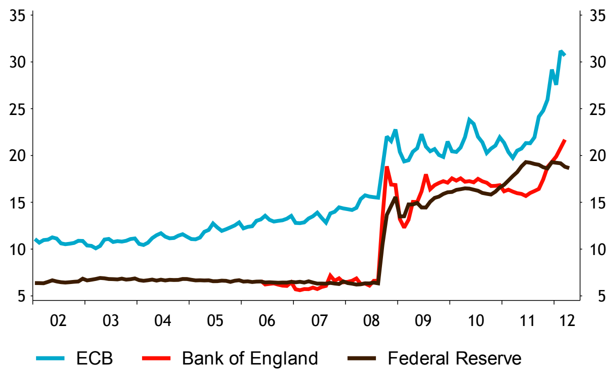
The euro zone moved into a recession in the fourth quarter of 2011. We expect negative growth during the first half of 2012. Full-year GDP will shrink by 0.6 per cent. The German economy will resist this trend better than expected, but the recession in southern Europe will be deep. We have seen positive signals in the UK and the Nordic countries in recent months, reinforcing the assumption that the recession can be isolated to crisis-plagued euro zone countries. Growth in Eastern (including Central) Europe is slowing, although the big Russian and Polish economies are showing resilience. Overall, we expect **global GDP growth**, adjusted for purchasing power parities (PPP), to end up at **3.6 per cent in 2012 and 4.1 per cent in 2013**.

Policy shifts generate fluctuations

To a great extent, the shift in economic outlook and risk appetite in recent years has been determined by the reactions of economic actors to changes in official policy. The background is the **dual ambitions that have dominated economic policy** since 2008. On the one hand, policymakers wish to remedy the causes of the excesses that triggered the crisis. This includes restructuring the financial system, for example, making the banking system more resilient by increasing capital adequacy requirements (Basel III etc). Another key ambition is to bring down public sector debt in order to improve the credibility of long-term public sector commitments and reduce vulnerability to economic fluctuations.

Central bank balance sheets

Per cent of GDP



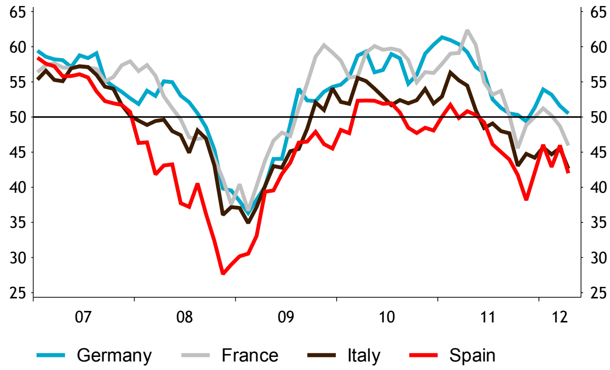
Source: ECB, Fed, Bank of England

Concurrently with this **"pedagogical policy"**, there has been a great need for **stimulus policies** aimed at easing the adjustment in various ways. This includes central bank measures such as exceptionally low interest rates and non-conventional programmes to prevent debt reduction from occurring too fast. When economic conditions have become somewhat stronger, central banks have made an effort to discuss exit strategies. In other words, they have begun announcing a phase-out of their extraordinary stimulus measures. This, in turn, has generated financial market turbulence and declining optimism in the real economy on various occasions. This reaction has then led to new central bank programmes, aimed at restoring confidence in order to keep the economy on an even keel and manage all the imbalances without causing a deep recession.

Complicating the picture in the euro zone is that so many actors with different tasks and interests are involved in crisis management. The ECB and Germany wish to maintain pressure on the governments of debt-plagued countries to implement belt-tightening programmes that will ensure their promised budget improvements (see the Theme article, page 12). Meanwhile these governments are struggling with declining democratic legitimacy and increased domestic protests.

Purchasing managers' indices turning down again

Composite PMI, index



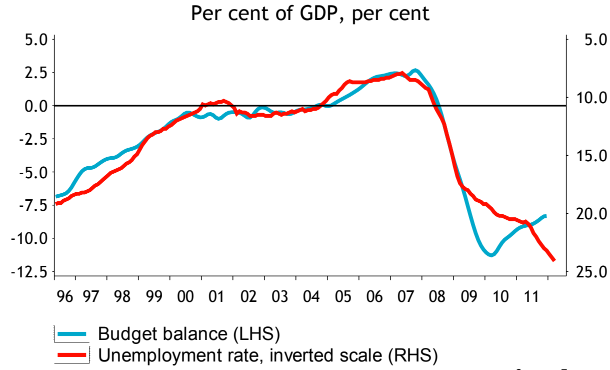
Source: Markit Economics

Spanish crisis may have contagious effects

At present we are in the midst of a new phase of cautious trench warfare in the euro zone. After delivering its LTRO loans, the ECB has left the next initiative up to political leaders and has adopted more of a wait-and-see attitude. But the economies of southern Europe are now losing momentum again as the positive confidence-building effects of LTRO fade away. **Within a short time Spain's problems have worsened**, due to upward revisions in budget deficits, a new phase of rapidly rising unemployment and further home price declines. In this situation, the Spanish banking system is quickly entering a crisis that cannot be managed at the national level, without support from EMU and IMF. The chart below shows the **close correlation between the budget balance and unemployment** (inverted scale). During a period when unemployment was trending towards levelling out, it was possible to reduce the deficit by 2-3 percentage points. Given a renewed acceleration in the jobless rate, it is difficult to believe that further belt-tightening will be the solution.

Spain: Strong correlation between unemployment and public balance

Per cent of GDP, per cent



Source: Eurostat

There will also be increased calls, from both within the euro zone and elsewhere, for the ECB to do more (by means of key interest rates and its balance sheet). We expect the ECB to move in this direction, but at the same time to be cautious about expanding its Securities Markets Programme (SMP) or extending LTRO. Its view of national fiscal policy is also shifting towards a greater emphasis on growth. This will gradually lead to belt-tightening programmes with longer timetables and greater focus on long-term supply-side structural measures.

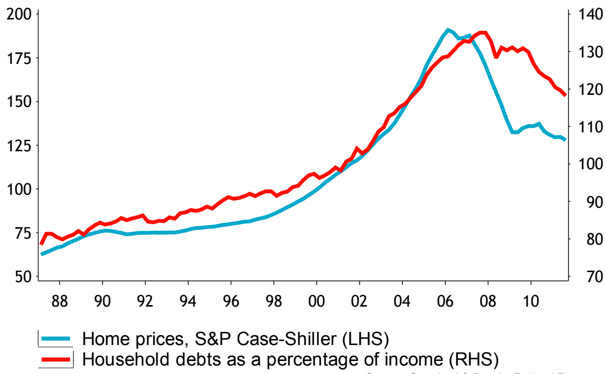
One important question is how the EU will react to the shift towards a more growth-oriented policy that is now evolving. With several important elections in France, Germany, Greece and Ireland, it is not difficult to foresee a tendency towards watering down efforts to enforce the EU's new fiscal discipline pact. How the ECB, Germany and the Bundesbank will act in this situation is difficult to determine.

US economy will move sideways

The US economy has continued moving up to a little more solid ground. The contagious effects of the euro zone crisis on the US banking system have been rather minor, which has helped speed economic healing processes. We expect **GDP growth of 2.5 per cent in 2012 and 2.7 per cent in 2013**: close to trend growth. The labour market situation has slowly improved, but we foresee some disappointments during the next six months, given modest GDP growth. Because of renewed signs of weakness in the labour market, **we expect the Federal Reserve to expand its quantitative easing (QE) programme** once Operation Twist expires this summer. This forecast is a close call, especially in light of the upcoming presidential election in November. One way of neutralising criticism of QE is to sterilise the Fed's bond purchases, since long-term inflation risks will thus be perceived as smaller. We also expect the Fed to focus its purchases on mortgage-backed securities, given the renewed trend towards falling home prices.

US: Home prices and debt

Index, per cent of disposable income



Source: Standard & Poor's, Federal Reserve

Although US growth is nowhere near a new recession, there are still impediments that are preventing a normal recovery process. The above chart shows the association between the level of home prices and debts as a share of disposable income. After the dramatic home price slide of 2007-09, debt deleveraging seems to have progressed about halfway towards restoring the wealth position of households. Continued deleveraging needs will hold back consumption over the next couple of years, especially in light of renewed home price declines. If the process continues at its current pace, however, a substantial surge in American consumption would be conceivable some time in mid-decade.

Capital spending will also determine when a viable recovery will begin in earnest. At present there are several underlying positive factors, both in the US and in other industrialised countries. Many companies have very strong balance sheets; a combination of large cash reserves and low capital spending at the outset means there is potential for a rapid upswing in fixed investments. Relatively low capacity utilisation remains a restriction, but uncertainty about economic policy stability in the short and long term is probably at least an equally important constraint. Continued restrictive credit conditions and a ravaged banking system are other obstacles, especially in Europe. Although many large companies have the financial ability to self-finance their capital spending, there is lingering uncertainty at the customer and sub-contractor levels, which is hampering future-oriented investments. As long as these uncertainty factors remain prevalent in the 34 countries of the Organisation for Economic Cooperation and Development (OECD), companies will tend to concentrate many of their new investments in the emerging economies.

US: Continued low capital spending level

Corporate fixed investments, per cent of GDP

Source: US Department of Commerce

New upturn soon in emerging markets

Emerging markets are continuing to provide important support to the world economy in a situation of very weak growth in the OECD countries. Strong central government finances and good employment growth have helped sustain domestic demand in a situation of flagging international demand. Especially **in Asia a soft landing has thus been possible** while maintaining a high level of growth.

The slowdown in **China** is continuing, and we expect GDP growth there to stabilise just above 8 per cent during the second quarter. After that we foresee potential for a rebound in the pace of growth. Falling inflation has helped economic policy-makers shift their focus back to growth-promoting measures. We expect average annual **GDP increases in China of 8.5 per cent in 2012 and 8.7 per cent in 2013**.

In most other Asian economies, we believe that GDP growth has already begun to accelerate. For example in India, leading indicators have risen. This includes purchasing managers' indices, which have recovered from their lows of last autumn. Here too, falling inflation has helped shift monetary policy in an expansionary direction. We predict GDP growth of 7.0 per cent this year in India and 7.3 per cent next year, but the lack of structural reforms in India will make it difficult for the economy to resume the high growth rates achieved a few years ago.

Nordic slowdown

Weaker international demand is pushing down growth in the small, export-dependent Nordic economies. This year, GDP growth will end up around ½ per cent in Denmark, Finland and Sweden. Their direct exposure to southern Europe is small, but since growth is also declining sharply in Germany, exports will be affected on a broad front. **Norway diverges from this pat-**

tern, and because of strong domestic demand its GDP growth will be even stronger than in 2011. As international demand improves late in 2012, the Nordic countries will recover, but their growth will remain below trend in 2013 at around 2 per cent.

Relatively good central government finances and current account surpluses have given the Nordic countries manoeuvring room during the crisis. Despite their weak GDP growth in 2012, financial developments have been more stable than during earlier international crises. The Nordic countries thus appear to have strengthened their position as **attractive investment alternatives** to major market. **Long-term bond yields in Sweden and Denmark** are close to German yields, and Finland is the euro zone country that has been able to maintain the lowest yield spread to Germany.

GDP growth, Nordic and Baltic countries
Year-on-year percentage change

	2010	2011	2012	2013
Sweden	5.0	4.0	0.7	1.9
Norway	0.7	1.6	2.3	2.6
Denmark	1.3	1.0	0.5	1.4
Finland	3.6	2.9	0.7	1.7
Nordics	**2.7**	**2.5**	**1.1**	**2.0**
Estonia	2.3	7.6	1.5	2.5
Latvia	-0.3	5.5	2.5	4.0
Lithuania	1.4	5.9	3.0	3.5
Baltics	**1.1**	**6.2**	**2.5**	**3.4**

Source: OECD, SEB

Because of increased stability, the central banks in Sweden and Norway face new challenges when their currencies no longer support export companies as they did during earlier international slowdowns. Meanwhile high residential market valuations represent an extra complication for monetary policy in both countries. In Sweden, we expect low inflation and high unemployment to help persuade the **Riksbank to cut its key interest rate** once in September to 1.25 per cent. In Norway, good growth and high resource utilisation will contribute to **Norges Bank's decision to begin a rate hiking cycle in 2013**. We expect the bank to raise its key interest rate from today's 1.50 per cent to 2.50 per cent at the end of 2013.

Consumption will sustain Baltic growth

During 2011 the Baltic countries were the fastest-growing in the EU, with Estonia at the top with 7.6 per cent. Recently the international slowdown has caused a sharp export-led deceleration in GDP growth in highly export-dependent Estonia, while the slowdown in Latvia and Lithuania has been milder. During the coming year, exports will remain weak as capital spending declines, but consumption growth will be sustained by stronger real wages and other factors. Generally speaking, there are also pent-up purchasing needs after the earlier crisis and harsh austerity policies, which squeezed the level of consumption. In 2012 we expect **weak GDP increases in the Baltics, in the 1.5-3.0 per cent range** (highest in Lithuania), followed by some acceleration in 2013, when growth will remain somewhat below its potential pace of 4.0-4.5 per cent. We have revised our Lithuanian forecast upward after unexpectedly strong growth in the first quarter. Given **surprisingly strong consumption increases**, we foresee **certain upside risks** for our GDP forecasts in **Estonia and Latvia**.

The underlying balance in the Baltic economies has improved, now that their exceptional current account deficits and deteriorating competitiveness have been corrected. Estonia still has inflation problems, however, and all three countries are characterised by worsening labour market structural problems. In particular, emigration is a long-term problem.

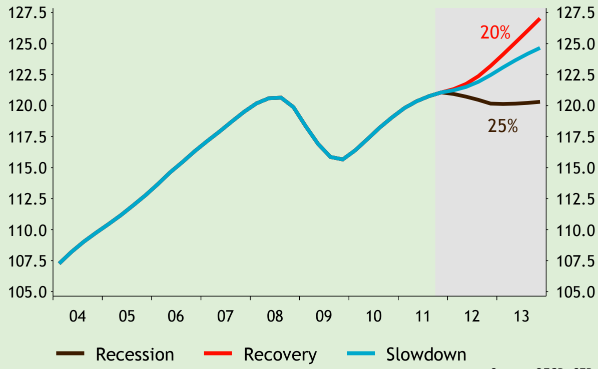
Despite the prevailing crisis in the euro zone, our forecast is that **Latvia will introduce the euro as planned in 2014**, while Lithuania's euro zone accession will be delayed one more year due to a slightly excessive budget deficit this year.

Downside risks dominant again

To some extent, the risk situation has shifted in a negative direction since the February issue of *Nordic Outlook*. Our main scenario is still that the euro zone will be in recession during the first half of 2012, but that the OECD countries as a whole will demonstrate low but positive GDP growth. Because of the Spanish crisis and the major dilemma faced by the euro zone in terms of finding a credible economic policy strategy, we now foresee somewhat higher risks of declining GDP in 2012.

As earlier, a deeper euro zone crisis is the most important likely driving force behind a recession in the OECD countries as a whole. The risks of an escalating Middle East crisis and a consequent rise in oil prices have also increased. The main upside potential is that the American economy will enter a more normal recovery dynamic, with contagious effects on the whole world economy. Overall, however, the upside risks are limited. 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. Recent months have reinforced the image of the OECD countries being stuck in a period of lacklustre growth as long as the healing process after the financial crisis and earlier debt build-up is under way.

GDP in the OECD countries
Index 100 = 2000



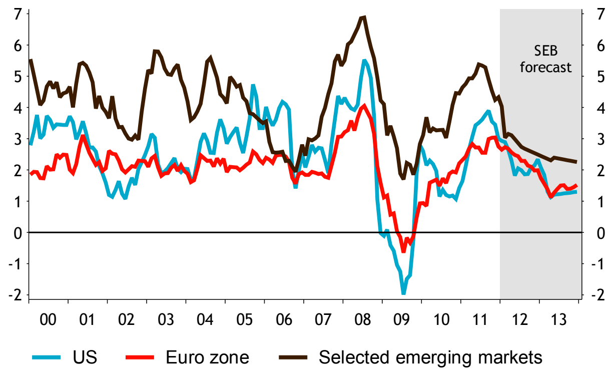
Source: OECD, SEB

Mixed inflation signals

The inflation rate in the world economy is now on its way down, as earlier upturns in commodity prices disappear from the 12-month figures. The recent downturn in emerging economies has been sharper than we had anticipated. In the OECD countries, however, inflation is stuck at higher levels than we had predicted, partly due to recent high crude oil prices. **Core inflation also has provided upside surprises**, however. As previously, our main forecast is for continued decline in CPI to around 1½ per cent in the OECD countries next year. Such an inflation slowdown will provide welcome support to the economy by allowing greater household purchasing power and more manoeuvring room for central banks.

CPI inflation is falling

Consumer Price Index, year-on-year percentage change

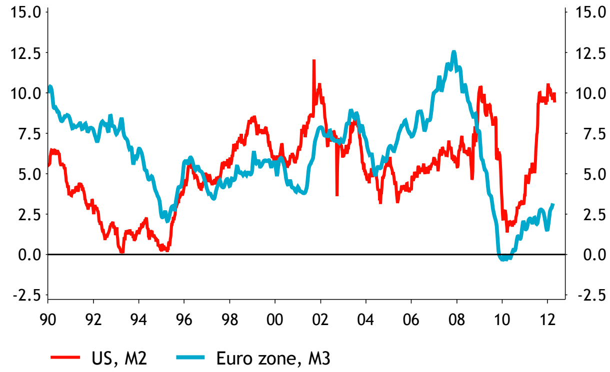


Source: Eurostat, BLS, SEB

So far, the impact of weak growth on inflation has been less than expected. This is a source of concern. It complicates the inflation dynamic, especially in the euro zone. In countries like Greece and Spain, we can now see signs that competitiveness is beginning to be restored to some extent by means of declining real wages. On the other hand, inflation is being sustained by higher indirect taxes, which are an element of the austerity programmes in various countries. The overall inflation rate in southern Europe is at about the same level as in the euro zone as a whole. The **signs of accelerating wage and salary increases that are now discernible in Germany are welcome**, both from an internal competitive perspective and from a growth perspective. But the path towards easing the imbalances in the euro zone by means of a slightly higher German inflation rate is problematic as long as the ECB clings to its dogmatic interpretation of the inflation target. This dilemma is now becoming more acute and controversial. The IMF, for example, again seems to be recommending that the ECB raise its inflation target to 4 per cent in order to facilitate the necessary adjustment processes.

Money supply

Year-on-year percentage change



Source: Federal Reserve

We see no major risks that exceptionally loose monetary policies will create inflation in the short and medium term. This is especially true in the euro zone, where the money supply is still increasing at a very slow pace. Problems in the financial system as well as a lack of demand for credit among households and

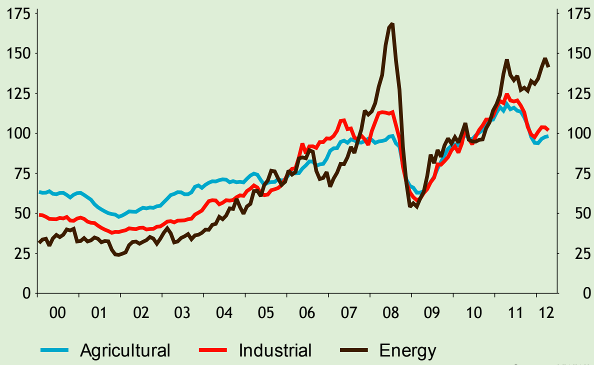
Cheaper commodities, but oil a risk factor

Commodity prices stabilised early in 2012 after their downturn last autumn. This stabilisation largely reflects the pattern of global economic indicators. In addition, oil prices have climbed due to geopolitical worries, mainly related to Iran's nuclear programme.

Oil prices (Brent crude) have traded in the USD 115-120/barrel interval during the past month, after a temporary peak of USD 130 in early March. Among the factors keeping prices down are seasonally weak demand and a high production level among members of the Organisation of Petroleum Exporting Countries (OPEC). Led by Saudi Arabia, production was raised during the first quarter in an effort to push down prices towards OPEC's long-term target of USD 100/barrel. Looking ahead, we predict that oil prices will continue to be squeezed by a high production level in **Saudi Arabia**, while certain OECD countries are expected to tap some of their strategic reserves. On the other hand, uncertainty about the Iran issue will persist, while global demand will eventually strengthen somewhat. We are thus forecasting that **oil prices will remain at USD 115-120/barrel**. If oil prices should climb towards USD 140-150/barrel, for example driven by further geopolitical worries, the fragile recovery in the world economy would be threatened.

Commodity prices

Index, USD



Source: HWWI

Industrial metals have largely bottomed out this time around, and we expect prices to **climb weakly** during the coming year. Looking at **agricultural commodities**, we generally anticipate falling prices in the coming year. The reasons are expectations of more normal harvests and growing incentives to increase production.

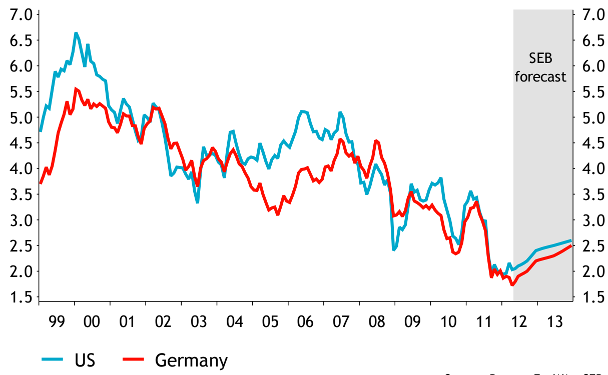
businesses are contributing to this. In the US, money supply growth is around 10 per cent, reflecting a better-functioning financial system. This may eventually lead to inflation pressure, but due to low resource utilisation in the economy, the Fed has plenty of time to act before this occurs.

Long-term yields remain sharply depressed

Whereas stock markets recovered early in 2012, government bond yields in major economies have been stuck at historically low levels. Since September 2011, US and German 10-year yields have remained in a fairly narrow interval, 1.75-2.25 per cent. After a rebound early in March, the trend has again been almost continuously downward. US 10-year Treasuries are being quoted at just above 1.90 per cent and their German equivalents at 1.60 per cent – the latter is a record low.

Several factors explain these persistently low yields. Inflation has been fairly stable. Inflation expectations have remained at low or modest levels that have been comfortable for central banks. The market's conviction that monetary policy will remain ultra-loose has been confirmed. In addition, fragile risk appetite has caused many investors to seek safe havens such as American, German and Nordic government securities in a world of ongoing debt crises in many countries.

10-year government bond yields
Per cent



Source: Reuters EcoWin, SEB

We are also forecasting that the factors which have constrained yields will mainly continue. The ECB will of course leave its repo rate untouched, but it is prepared to undertake other stimulus measures as needed. The Fed will also keep its federal funds rate unchanged, and after this summer it will probably launch a QE3 programme focusing on mortgage securities, which will primarily help to keep American mortgage rates low. An expected stabilisation and weak recovery in the world economy will therefore only result in a **modest upturn in yields**: in the US, 10-year yields will climb to 2.60 per cent by the end of 2013, while German 10-year bonds will move up to 2.50 per cent during the same period.

Since last spring, the long-term yield spread between the US and Germany has been very narrow and stable, often close to zero. In recent months, however, a significant yield gap of 20-30 basis points has arisen. The downward movement of German yields is largely related to the worsening euro zone crisis, which is mainly connected to Spain; German bonds have been viewed as a safe investment. Our forecast is that the **US-German differential on long-term yields will again shrink somewhat** in the near future and then remain at about 20 basis points for a year. By the end of 2013 this spread will narrow to 10 points.

Because of the downward trend this spring, Swedish 10-year sovereign yields are now close to their record low of 1.59 per cent in January. Looking ahead, Sweden's low supply of government securities and heavy foreign interest in a stable AAA-rated country indicate that **the long-term yield spread to Germany will narrow**. The Riksbank's key interest rate cut last autumn has also has a similar effect. The spread will move from today's slightly positive level to zero this autumn and to -5 points at the end of 2013. This implies that yields will gradually rise to 2.45 per cent in December 2013.

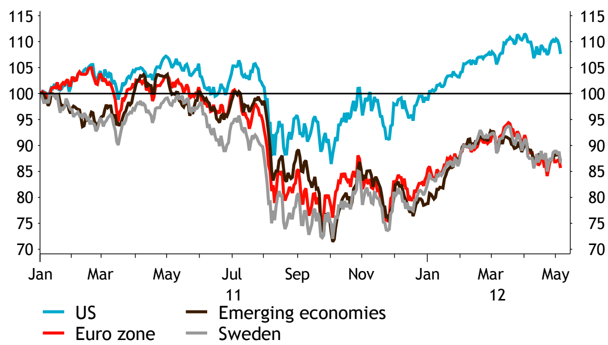
Norwegian government securities remain attractive to international asset managers. The 10-year yield spread to Germany will be squeezed somewhat to 35-40 basis points in the next few months and remain there for the rest of 2012. During 2013 the spread will gradually turn upward as Norges Bank begins its rate hiking cycle early in the year. By the end of 2013 the yield differential against German 10-year government securities will be 70 basis points, and the 10-year yield will be 3.20 per cent.

Stock market recovery has faded

The strong stock market recovery that began late in November has faded in recent months. Profit-taking has contributed to this trend; from late November to early March, many stock markets gained 20-25 per cent. A correction of this sharp upturn was therefore not unexpected.

However, there are also fundamental reasons why the stock market climate has turned harsher. Euro zone financial turbulence has returned with renewed strength, focusing on the difficult situation of the Spanish economy. The election campaigns in France and Greece have helped fuel market worries. Concerns about a hard landing in China have persisted in financial markets and were exacerbated by weak GDP figures for the first quarter. During the spring, rumours of an imminent American/Israeli attack on Iran have also been a warning flag.

US stock markets outperforming their peers elsewhere
Index 100 = Jan 2011



Source: Reuters EcoWin, SEB

In recent months, US stock markets have resisted the downturns experienced by the rest of the world, thus performing far better than stock markets in other countries. Relatively better growth expectations compared to other mature markets have contributed to this favourable trend. There are also many indications that mergers and acquisitions may experience an upswing, and that the trend towards rising corporate dividends and share repurchases will be a lasting one. During the spring the Nasdaq OMX Stockholm performed weakly, as did stock exchanges in emerging markets and the rest of Europe.

At present, **stock markets are largely priced to reflect existing risks and uncertainties**; we regard a euro zone recession as already priced in. Looking ahead, our assessment remains that Nordic stock markets have the potential to perform more strongly than the rest of Europe. Large GDP declines can be avoided, and when the economy stabilises, the cyclical exposure of the Stockholm and Helsinki exchanges will become an advantage. Assuming that an escalation of the euro crisis can be avoided and that the recession in the euro zone will be modest, and given relatively low valuations and continued extremely loose monetary policies, there is **potential for a stock market upturn in the 10 per cent range by year-end**, compared to the current level.

Weaker euro ahead

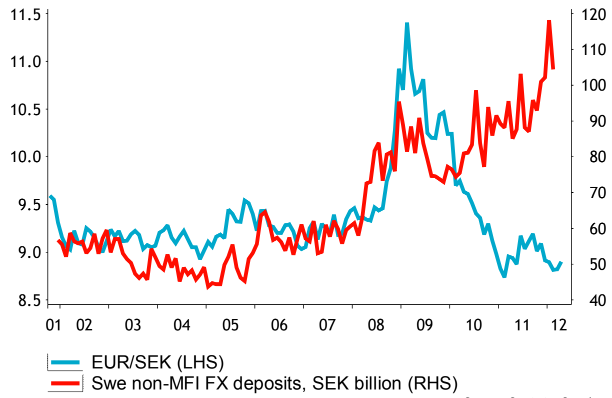
The long-term theme in the foreign exchange (FX) market is the continued weakening of large, established reserve currencies to the benefit of smaller, peripheral ones. Above all, Asian asset managers will reduce the share of G3 currencies in their portfolios. The euro and the US dollar still account for nearly 90 per cent of global FX reserves. The financial crisis has led to new rules for hedge funds and other investors that have limited the role of speculatively oriented market players. This strengthens the view that more long-term reserve managers and central banks will play a larger part in currency movements. Since last autumn, the EUR/USD – by far the world's most heavily traded currency pair – has remained within an increasingly narrow interval between 1.26 and 1.35. Among the G10 currencies, these two together with the Japanese yen have also shown the weakest performance since the stock market bottomed out last autumn.

Looking ahead, we believe there will be a **downward trend in the EUR/USD exchange rate**. The risks of a serious crisis are considerably larger in the euro zone. In the coming months, events surrounding the bail-out programme for Spain are likely to weigh down the euro. In the long term we also foresee prospects of a stronger USD, driven by US-euro zone growth gaps and continued sluggishness in the euro zone reform process. **We thus expect the EUR/USD rate to be 1.28 at the end of 2012 and 1.20 at the end of 2013.** If anything, the risk is that the euro will weaken even faster in the near future.

Large deficits in the American economy, combined with uncertainty surrounding the fiscal policymaking process during the coming year will mean problems for the US as well, but the role of the USD as a global reserve currency is still not threatened. The country should thus be able to continue pursuing expansionary fiscal and monetary policies without dramatic consequences for its currency. But we expect that global reserve managers will gradually reduce the USD's share of their portfolios from today's 62 per cent to 50 or even 40 per cent within 10 years. This will make the US more sensitive to domestic imbalances.

Looking ahead, Japan's economic problems are likely to affect the FX market. International credit rating agencies will probably increase their focus on Japan's weak central government finances. High domestic savings have rescued the country so far, but Japan's savings surplus will shrink over time as the population ages. Investors are thus likely to become more sceptical of an economy with a debt of more than 200 per cent of GDP and interest rates of around 1 per cent. Japan's central bank is also determined to prevent further yen appreciation. Overall, we believe that the **JPY has peaked** and **will gradually**, though slowly, **weaken**. According to our equilibrium models, the JPY is one of the most overvalued G10 currencies. This has started to be more apparent in Japan's trade balance figures. At the end of 2013, the **USD/JPY exchange rate will stand at 94**.

Swedish non-MFI foreign exchange deposits



Source: Statistics Sweden

Scandinavian currencies will continue to strengthen compared to most established currencies. We are sticking to our forecast that the **EUR/SEK exchange rate will cautiously slide down towards 8.70/50** during the next 12 months. Swedish export companies have reduced their currency hedging activity and also continue to hold large reserves of foreign currencies. We believe that both of these factors will eventually help increase flows into the SEK. By the end of 2013, we expect the EUR/SEK rate to stand at 8.40, but a sharp downturn in the housing market and the accompanying strains on the financial system would pose a risk of a weaker SEK.

The Norwegian krone has strengthened during the early months of 2012, despite a very dovish monetary policy from Norges Bank. During the second half of 2012, we expect Norges Bank to carry out a relatively dramatic increase in its currency purchases on behalf of the Government Pension Fund Global. This will help weaken the NOK, pushing the EUR/NOK rate towards 7.60/70 in the autumn. After that, we believe that the NOK will strengthen as Norges Bank implements rather vigorous key interest rate hikes. By late 2012 or early 2013, the EUR/NOK rate will again test new record levels. **In a longer-term perspective, the arguments for an appreciation of the NOK are strong.** By the end of 2013, we expect the EUR/NOK exchange rate to stand at 7.35.

The euro zone crisis – a part of the global power game

- **Spain will get a EUR 150 billion bail-out loan**
- **Breathing room, but euro questions persist**
- **International cooperation an uphill battle**
- **Power struggle in the IMF and G20**

The euro zone crisis is now entering a critical new stage, due to the increasingly acute situation in Spain. We expect Spain to receive a financial bail-out in the near future, with the euro zone countries and the International Monetary Fund (IMF) sharing the burden according to their customary 2/3 to 1/3 principle. Portugal will also probably receive expanded financial aid shortly. **Concurrently with the crisis in the common currency area, a struggle is now under way over the future economic and political balance of power in the IMF and the Group of 20 countries** (G20). This will make the process more complex, with more issues being drawn into the negotiations – thereby creating risks in a situation where expanded international cooperation is especially urgent.

There are a number of reasons for the deepening crisis in Spain. The country's net international investment position at the end of 2011 was a shortfall of nearly EUR 1 trillion, or 100 per cent of the year's GDP. This is among the highest such levels in the Western world and is the result of large current account deficits over a 50-year period, but these deficits have accelerated since 1990 as a consequence of progressively weaker competitiveness.

Spain: Net international investment position
EUR billion

Direct investment	16.3
Portfolio investment	-616.0
Other investment	-314.4
Financial derivatives	6.0
Banco de España	-81.0
Total	**-989.1**

The situation in the Spanish banking system is now rapidly deteriorating. Although the IMF recently determined that the largest Spanish banks had enough capital and earning capacity to withstand heavy strains, other banks are so highly vulnerable that the entire banking sector is at risk of facing long-term funding problems. The share of problem loans is climbing rapidly and totals about 10 per cent (EUR 150 billion) of the overall lending portfolio. The central bank, Banco de España, owes the ECB system EUR 170 billion. In addition, the situation of the banks is becoming increasingly vulnerable in an environment with a shrinking economy, rising unemployment and falling home and share prices.

Our forecast is that in the near future, Spain will receive a financial bail-out loan from other euro zone countries and the IMF totalling around EUR 150 billion. During the spring of 2012, the IMF is carrying out its Article IV consultation with Spain. Logically, a decision on a bail-out loan should be made in conjunction with this evaluation. We expect a large proportion of the loan to be targeted directly to the banking sector. Meanwhile reforms are being implemented that will separate good, viable banks from weak government-dependent banks.

Principles surrounding an IMF loan

The IMF's Executive Board, consisting of 24 directors who represent all 188 member countries, approves loans by a simple majority, although consensus is often reached. The IMF Executive Board performs follow-up evaluations and makes quarterly payments to the borrowing country on a quarterly basis. The member countries make funds ("credit lines") available to the IMF. These are mobilised only when a need arises. The IMF makes quarterly forecasts to determine the degree of utilisation of credit lines, usually in US dollar terms. Normally the currency reserves of central banks are used in order to lend money to the IMF; if these reserves are too small, a government may first take out a loan in a foreign currency that is then managed by the central bank. A member country's credit line is determined on the basis of an established IMF formula than takes into account the size of its economy. If a country has more than 15 per cent of voting power on the Executive Board (as the US does today), this gives it major influence on the IMF and the G20. The IMF bears the credit risk from the borrowing country. An IMF loan enjoys "preferred creditor" status. Lender countries receive a return equivalent to 3-month Treasury bill rates.

Long-term challenges in saving the euro

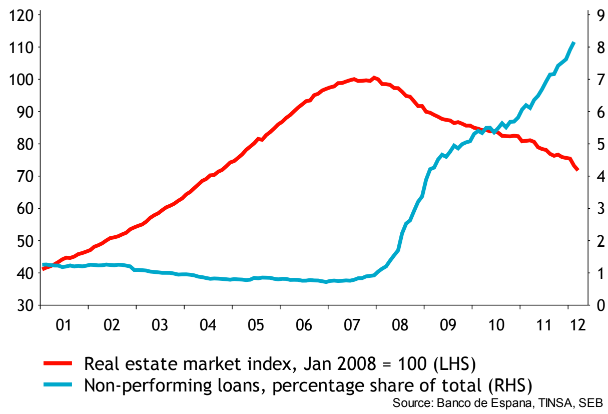
A rescue action on behalf of Spain is far from providing a definitive solution to the euro zone crisis. In several countries, sovereign bond yields are unsustainably high in an environment where shrinking economies make credible and lasting debt restructuring more difficult. The political picture is also very unclear, judging from the tone of election campaigns for the French presidency, the Greek parliament and German state parliaments and the run-up to the Irish referendum on the new EU fiscal pact.

The ECB's actions reflect scepticism, as well as fears that the political system will slow the pace of economic reforms. Mistrust among the various actors is increasing the credibility problems of the euro project, as is also illustrated by the IMF being forced to develop a scenario based on a collapse of the common currency. The euro zone countries have many issues to resolve in order to persuade the international community:

- Major G20 countries (including the US, the UK and China) are tying the hands of the IMF and demanding that the euro zone countries (especially Germany) show greater effectiveness and decisiveness in their crisis management.
- The euro zone's existing framework is raising questions: Do the ECB's inflation target and the new EU fiscal pact represent a straitjacket that will make a solution to the euro zone crisis more difficult? What concessions are Germany Bundesbank prepared to make in order to save the euro?
- There is great uncertainty as to whether the centralisation of economic and political power required by a common currency is actually possible to carry out within a reasonable time frame.

The ECB's recent two three year loans under its Long Term Refinancing Operations (LTRO), totalling around EUR 1 trillion, have fulfilled an important function by reducing the severe refinancing problems that the euro zone banking system faced in late 2011. But LTRO is a two-edged weapon (see *Nordic Outlook*, February 2012). The LTRO loans do not take away the need for the banking system to trim its balance sheets further. According to the IMF, this need totals SEK 2 trillion. The most important potential problem with the ECB's "balance sheet policy" is that it undermines the role of the market in setting correct financial prices. It also helps increase the concentration of national sovereign bond risk in the national banking system.

Spain: Housing market and NPLs



Increased tensions in the IMF and G20

In the international economic policy cooperation system, a rather complicated power game is now under way. The IMF and the Group of 20 countries are pressuring the ECB to do more to avoid an economic and financial crisis. As a condition for allowing the ECB's balance sheet to grow further, however, the ECB and Germany are demanding further fiscal austerity from the crisis-hit countries in the euro zone. Another possibility for the ECB is to resume its Securities Markets Programme (SMP) on a large scale in order to reduce the credit risks of individual governments. This is also controversial, however. The ECB's monetary policy securities portfolio totals EUR 215 billion today, and an expansion of SMP may, paradoxically, lead to higher bond yields. The explanation is that the ECB's sovereign bond holdings are apparently protected from debt write-downs, judging from the Greek example. Any future debt write-downs may thus be concentrated in the private sector, driving up risk compensation and thus yields.

The euro zone crisis has also become a pawn in a broader political game. Fundamentally it is about tensions connected to the need for shifts in the global balance of power, following a period of sharply increasing globalisation. Global imbalances are helping to intensify the polarisation between the OECD countries and the emerging economies. This is reflected in increasing difficulties among G20 heads of state and government in reaching consensus on solutions to global problems. It is also a question of how the new economic and financial world will be governed at both the national and international level.

According to an agreement reached in 2010, the IMF's quota system will be reformed in such a way that the emerging economies will gain increased voting power in the IMF at the expense of developed economies. The US Congress has not yet taken this step (the US has 17 per cent of IMF voting power; enough to block such change). Although the G20 meeting in Mexico this June may take a step forward on this power-allocation issue, it is more likely to occur in Tokyo next October in conjunction with the IMF/World Bank annual meetings, or early in 2013 after the US presidential and congressional elections.

The divisions within the G20 are also expressed in other ways, where the dividing line is not between the OECD countries and the emerging economies. The vulnerability that still plagues the global economic and financial system requires international firewalls that will generally reduce risks of contagion during international crises. This spring, the G20 approved a strengthening of the lending capacity of the IMF by "at least USD 430 billion". This is actually a rather simple accounting transaction, in which central banks earmark capital that is then utilised by the IMF only as needed. It should be uncontroversial for the world's major economies to strengthen the global firewall and calm creditors in this way. In the prevailing cooperation climate, this decision nevertheless ended up being a time-consuming and difficult process.

The global "firewall"

- EFSF/ESM: total lending capacity EUR 700 billion
- EFSM: EUR 49 billion (already utilised)
- The IMF's current lending capacity: USD 360 billion
- Extra funds for the IMF ("Washington Moment") USD 430 billion
- Swap lines (liquidity) between central banks: unlimited
- Liquidity support from central banks (like LTRO): unlimited
- Monetary policy portfolios (like SMP): unlimited

It is possible to identify various reasons for the sceptical attitude towards providing indirect support to the euro zone countries. At present, Congress is generally averse towards expanding US international commitments. In addition, the focus of American policy is clearly shifting towards Asia. In the UK, public opinion has become increasingly sceptical of the EU, and it hardly possible for the government to accept a trend in which the EU will move towards greater supranational authority. Meanwhile the BRIC countries are having a hard time finding a suitable role in the international cooperation system. What we see is thus a world in transition, with actors in new and untested roles.

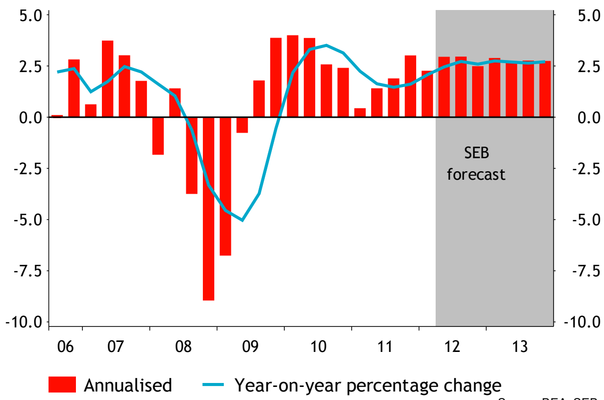
Slowly moving up to a little more solid ground

- **Growth close to trend in 2012 and 2013**
- **Stabilisation of home prices within reach**
- **With inflation falling, Fed will stimulate**

In recent months, the performance of the American economy has been roughly in line with our forecast in the February issue of *Nordic Outlook*. Job growth accelerated early in 2012, but unusually warm weather probably pushed up the figures. Nor was this improvement reflected in stronger demand; GDP growth slowed to 2.2 per cent in the first quarter compared to 3 per cent in the fourth quarter of 2011. Recent statistics also raise some questions; around 70 per cent of macroeconomic data have come in lower than expected during the spring.

Overall, we are sticking to our forecast of GDP growth close to trend. **The US economy will grow by 2.5 per cent this year and 2.7 per cent in 2013**, or somewhat above consensus. High oil and petrol prices will dominate the risk scenario in the short term, and any turmoil related to 2013 fiscal policy may lower expectations a little later this year. Financial conditions will have a neutral impact, and the euro zone recession will not cause the US economy to stumble. The labour market will lose momentum over the next six months but will continue to improve in 2013. **Unemployment will level out in 2012 but keep falling in 2013**. At the end of our forecast period, the US jobless rate will stand at 7.5 per cent.

US economy will muddle through



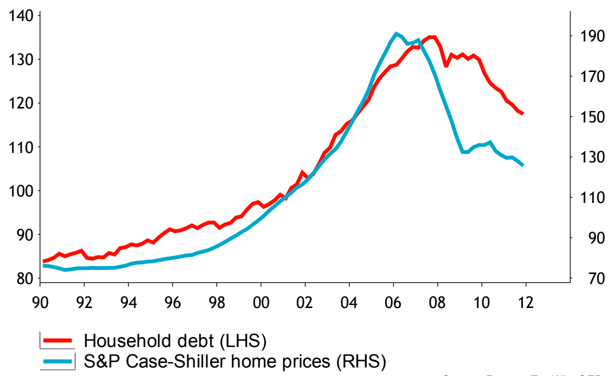
Source: BEA, SEB

Weak income growth combined with debt deleveraging in the household sector will prevent a normal recovery process. Household debt as a percentage of disposable income has fallen considerably from its peak, but **current home price levels justify further debt adjustment**. Despite enormous stimulus measures – with the Federal Reserve tripling its balance sheet and maintaining zero interest rates since late 2008, and with three straight years of annual budget deficits exceeding USD 1 trillion – the recovery has been the weakest on record. Last year the economy grew by a measly 1.7 per cent, compared to an average of 5 per cent during the corresponding cyclical phase in the post-war period.

Inflation, which was 3.1 per cent last year, will exceed 2 per cent again this year but drop significantly in 2013. Thanks to **tame core inflation and restrained inflation expectations**, the door is ajar for further Fed bond purchasing programmes. Although it is a close call, we believe that the **Fed's new quantitative easing programme will be launched after the summer**.

Ongoing deleveraging is holding growth back

Per cent of disposable income, index



Source: Reuters EcoWin, SEB

Plenty of labour market slack

Job creation has averaged 200,000 per month so far this year, compared to 150,000 last year. Few employees are being laid off, but businesses are meanwhile keeping a low profile in terms of hiring.

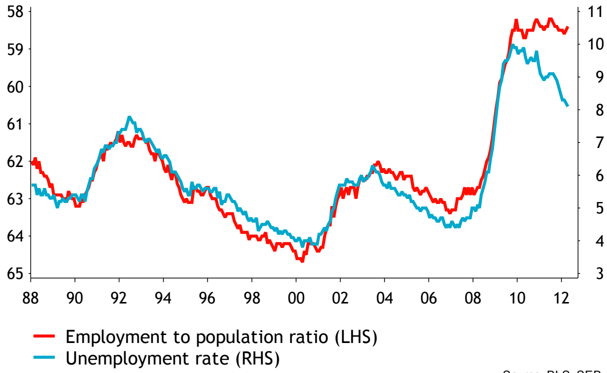
Productivity fell during the first quarter. During cyclical upturns, it is unusual for productivity to fall several quarters in a row, since companies usually defend their profit margins aggressively. This, in turn, usually causes hiring to lose momentum for a while. This year's unusually warm US winter – the fourth warmest since measurements began in 1896 – probably contributed to a temporary surge in hiring. This also indicates that **job growth will shift to lower gear in the next few months**, thereby repeating last year's pattern.

According to historical associations between GDP growth and unemployment, the jobless rate should have risen in 2011, but instead it fell dramatically. In 2008-2009, however, unemployment increased faster than these associations justified. Looking at the period as a whole, current unemployment levels can be justified from the perspective of economic models. But now that the gap between GDP growth and unemployment has closed, it is an indication that faster GDP growth will be needed in order to push down unemployment further. **According to**

our forecast, unemployment will level out during the next six months, then gradually continue to fall. By the end of 2013, the jobless rate will stand at 7.5 per cent.

Labor market slack remains significant

Per cent



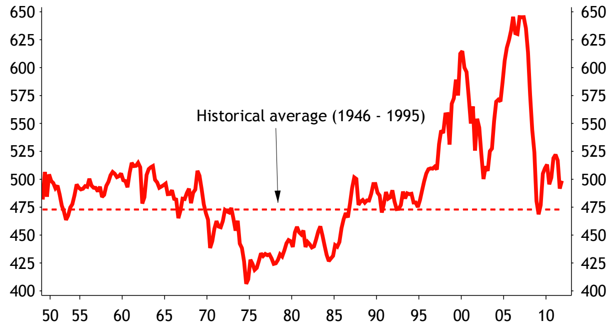
Source: BLS, SEB

12.5 million people are unemployed, but this figure still tends to underestimate the quantity of idle resources. According to Fed Chairman Ben Bernanke, the employment to population ratio is a better measure of resource utilisation. **This ratio has not increased significantly since 2009**. Meanwhile the employment level remains 5 million below its previous peak. Concealed in the total figure, however, is the fact that the oldest employees (aged 55 and over) gained 4 million jobs while other age groups lost 9 million.

The trend towards falling wage and salary growth confirms large surplus in labour market supply. **The rate of increase for average hourly wages is close to record-low levels** and is below inflation. Adjusted for inflation, median household income is at its lowest level since 1996. One consequence of falling purchasing power is that many households are applying for economic subsidies; the number of food stamp recipients increases by 400,000 a month. Some 47 million people or 15 per cent of the US population are now part of this subsidy programme.

Current net worth should be putting upward pressure on the savings ratio

Per cent of yearly disposable income



Source: Federal Reserve, SEB

More consumption and less saving

Household confidence indicators have recovered since last autumn but remain far below historical averages. Somewhat happier consumers reflect positive labour market signals, but also the 20 per cent stock market upturn of the past six months, which has increased their net worth by around USD 2.3 trillion. According to classic rules of thumb, **a one dollar long-term increase in stock market wealth corresponds to a consumption increase of 3-4 cents** during a three-year period. This is equivalent to a consumption increase of up to USD 90 billion (0.8 percentage points) spread out over the next few years. Also freeing up room for consumption is the fact that the household debt service ratio has fallen to record lows.

However, we still believe that consumption growth will be restrained; **household consumption growth will average just above 2 per cent in 2012-2013**. The stock market upturn is being offset by persistent home price declines, and only a fraction of the wealth lost during the crisis years has been recovered. Meanwhile more vigorous job growth has not led to an upswing in real disposable income, which of course is the driving force in most consumption models. On the contrary, real disposable income is showing a downward trend. Instead,

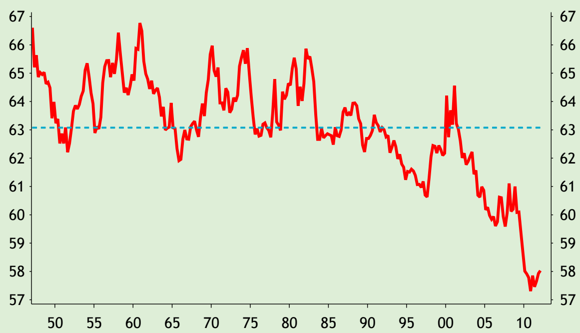
Skewed income allocation

For many years, percentages of gross domestic product paid to labour and owners of capital, respectively, were approximately constant over time (Kaldor's stylised facts). But in the past two decades, the share of income going to wages and other forms of compensation (the labour share) has fallen sharply, not only in the United States but also in the rest of the world. In 1990 the labour share totalled 63 per cent in the US, which is also equivalent to the historical average. Last year the labour share was below 58 per cent. Recalculated into dollars, these sums are enormous: a 5 percentage point lower share is equivalent to an annual income loss of more than USD 500 billion.

Globalisation and technological advances are common explanations. As China has been integrated into the world market, the labour supply has increased sharply, resulting in a global pay squeeze. In addition, increasingly automated production systems lead to lower demand for labour in manufacturing. Instead the service sector, with its generally lower pay level, is becoming more and more important.

Labor's share of income is shrinking

Per cent of income



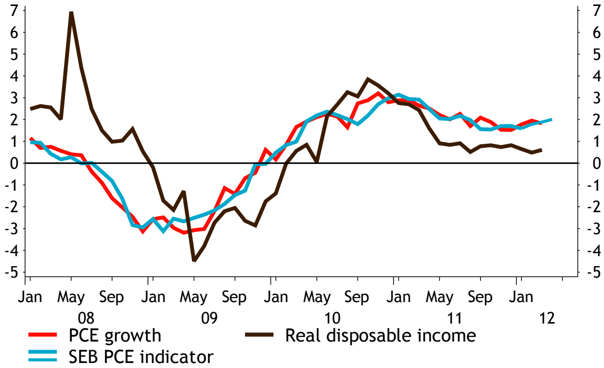
Source: BLS, SEB

Income gaps are also growing. Of the total increase in US income during 2012, 93 per cent or USD 288 billion went to the 1 per cent of the population with the highest incomes. **The remaining 99 per cent thus had to share 7 per cent of the income increase, or the equivalent of USD 80 per person**.

the **household savings ratio has fallen to its lowest level since 2008**, thereby sustaining consumption nicely. Further declines in saving are difficult to justify from a wealth perspective. But as employment continues to climb, income should give consumption a helping hand.

Income growth not yet supporting consumption

Year-on-year percentage change



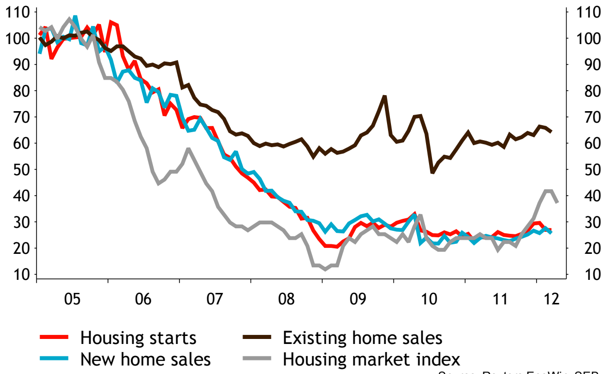
Source: BEA, SEB

Increased housing market confidence

After steadily declining over the past several years, housing market confidence has risen significantly and housing investments have increased four quarters in a row. But housing supply still exceeds demand which forebodes a **shaky recovery in construction activity**. Sales are continuing to climb, but levels remain depressed from a historical standpoint. For the first time since 2005 construction investments will grow in 2012-2013. Since construction investments represent a low 2 per cent of GDP, their contribution to GDP growth will be comparatively small.

Housing indicators bottoming out

Rebase 2005 = 100



Source: Reuters EcoWin, SEB

Home prices are still falling on a broad front and are back at 2002 levels, according to Case-Shiller. **Home prices will bottom out this year before stabilizing in 2013**.

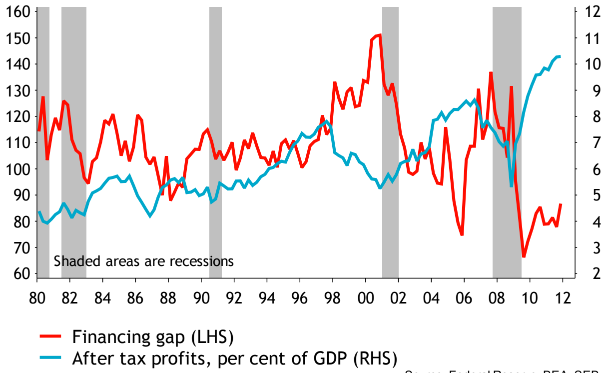
Strong balance sheets provide resilience

Capital spending by companies has slowed sharply in recent quarters. One explanation may be that investment decisions were accelerated last year for tax reasons, which in turn would lead to an upswing later this year. On the other hand, small businesses are planning little capital spending and weak order bookings do not indicate any short-term change in scenario. However, surveys of larger companies by the Institute of Supply Management (ISM) point towards continued expansion. Our forecast is that **corporate capital spending will grow by 6 per cent this year and 8 per cent in 2013**.

The euro zone recession and the appreciation of the US dollar in trade-weighted terms since it bottomed out last year indicate that **net exports will contribute negatively to growth this year**. We predict that the US trade deficit with other countries will again widen in 2013. **Industrial production will grow by 3-4 per cent annually during the next couple of years**: a slowdown compared to 2010-2011.

Corporate sector in a strong position

Ratio of capital outlays to internal funds, after tax profits



Source: Federal Reserve, BEA, SEB

The corporate sector has very strong finances. On an aggregate level, companies are sitting on more than USD 2 trillion in liquid assets, and the ratio of capital expenditures to internally generated funds (the "financing gap") is at a low 87 per cent. Just before the 2008 recession, the ratio was 130 per cent, and before the 2001 recession it exceeded 150 per cent. Since the ratio has never been less than 100 per cent at the start of a US recession, companies are resilient. In addition, a historically high 77 per cent of corporate sector debts has long maturities, making refinancing risk low. **Corporate profits are at record levels as a percentage of GDP**.

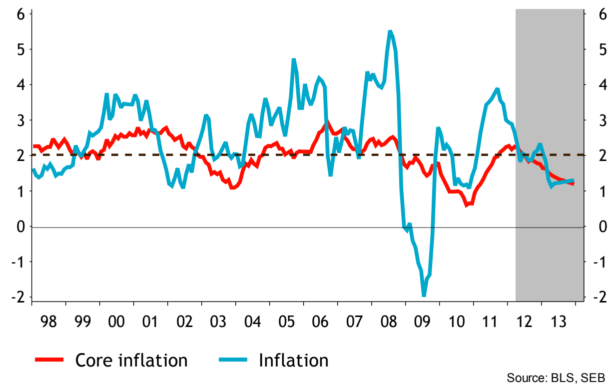
There are thus many indications that mergers and acquisitions may experience an upswing and that the trend towards rising corporate dividends and share repurchases will persist. Last year, dividends increased more than 10 per cent among large companies in the S&P 500, and in 2010 by nearly 20 per cent. Share repurchases are a way to keep corporate valuations high.

Inflation will fall below 2 per cent

After peaking last autumn at just below 4 per cent, inflation has fallen substantially. In March, inflation was 2.6 per cent. According to our forecasts, it will continue downward. The US is more sensitive to oil prices than the euro zone, for example, and the oil price upturn since last autumn is softening the decline in inflation. We are thus revising our forecast for 2012 upward compared to the last *Nordic Outlook*. **Inflation will end up at 2.2 per cent this year and 1.4 per cent in 2013.**

The large output gap is the main reason why we are predicting low inflation pressure in the next couple of years. The gap is currently 5.5 per cent of GDP, equivalent to USD 850 billion. The amount of slack in the economy will help keep pay increases at record lows. Looking at core inflation, which excludes food and energy prices, favourable base effects will also contribute to our prediction of low wage and salary increases, especially in 2013. Measured as annual averages, **core inflation will be 2.0 per cent this year and 1.4 per cent next year**.

Inflation is waning
Year-on-year percentage change

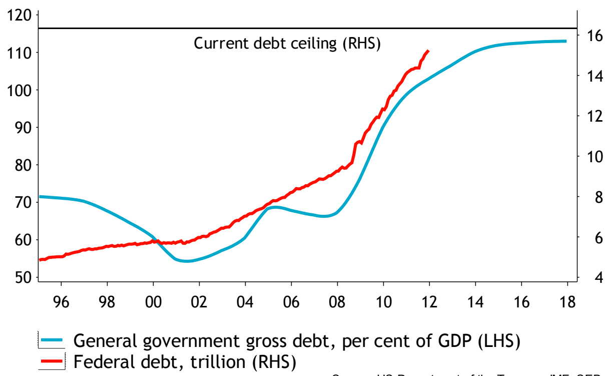


Source: BLS, SEB

Mounting fiscal policy worries

In the absence of new political decisions, the US will face an unprecedented fiscal shock in 2013. The Bush administration's tax cuts will expire, as will the tax cuts pushed through by the Obama administration a couple of years ago. In addition, automatic spending cutbacks equivalent to USD 1.2 trillion over ten years will go into effect in January 2013. The overall tightening effect would be USD 600 billion (4 per cent of GDP). Such a fiscal policy would be disastrous for economic activity and is unrealistic in political terms. In our main scenario, we assume that the Bush tax cuts will be extended and that the automatic spending cuts will be postponed for one year. **Fiscal tightening will thus total 1.5 per cent of GDP in 2013, which the recovery can cope with**. But the pieces of the puzzle will not fall into place until after the November presidential election. As a result, there is a danger that fiscal policy will be a focus of attention and pose a risk to **financial markets, households and businesses during the autumn**.

Debt ceiling will soon be reached
Per cent of GDP, USD trillion



Source: US Department of the Treasury, IMF, SEB

Negotiations on the **debt ceiling**, a major source of concern last year, **will be back in the spotlight after the summer**. Given the rapid growth rate in federal debt, it will hit the USD 16.34 trillion ceiling before the election, according to our calculations.

According to public opinion polls, Barack Obama has a comfortable lead over Mitt Romney, his presumed Republican opponent in the presidential election, and is thus favoured to be re-elected. **This Congress is already being viewed as the most polarised in US history**, with an almost totally empty political mid-field making it extremely difficult to reach agreements across the partisan divide. Considering the sizeable long-term challenges facing the country, this is an unfortunate situation.

Our overall forecast implies that the deficit will shrink slowly and gradually. The federal budget deficit peaked at 10.1 per cent of GDP in 2009 and is **expected to have fallen to 6 per cent by 2013**. This means that the national debt will continue to grow. According to the IMF's latest forecast, it will level out at 113 per cent of GDP in 2017.

Tricky monetary policy deliberations

Market expectations concerning a new round of quantitative easing (QE) from the Federal Reserve have fluctuated in recent months. The minutes of the Federal Open Market Committee meeting in March again lowered the likelihood of such new stimulus programmes, at least in the near term. Only a few FOMC members thought new stimuli might be needed if the economy loses momentum or if inflation remains below 2 per cent. This implies a shift since the January FOMC meeting, when a number of members said they foresaw further Fed bond purchases in the not-too-distant future. The **probability of further monetary policy easing has thus decreased**.

At the same time a weaker labour market trend, alongside continued low inflation expectations, may cause the QE issue to be raised again. Add high long-term unemployment, which worries the Fed. According to the central bank, most long-term unemployment is explained by cyclical factors. Official measures aimed at stimulating demand, such as expansionary monetary policy, may thus improve the situation. New easing may also be needed because of the threatened blast of fiscal winter in early 2013. Although it is a close call, **we are sticking to our forecast that more QE will materialise this autumn**.

Such a programme would probably focus on mortgage-backed securities and sterilised purchases. This is a compromise between doing nothing at all and launching a new, full-fledged QE programme. This may neutralise the implicit tightening that will occur when the Fed's current Operation Twist ends this summer. Sterilised bond purchases may also be easier to accept because the inflation risks are smaller.

The Fed lowered its most important key interest rate to the current 0-0.25 per cent level late in 2008. According to the Fed's forecasts, which put GDP growth at a few notches above consensus, the fed funds rate will remain unchanged until late 2014. Ben Bernanke has pointed out on innumerable occasions that prematurely rapid rate hikes were a crucial policy mistake in the 1930s and that this will not be repeated. Several other FOMC members have also joined the chorus, saying that the zero interest rate policy will remain in place for the next couple of years. **According to out forecasts, the Fed will not raise its key rate until 2015**.

Recovery on the right track

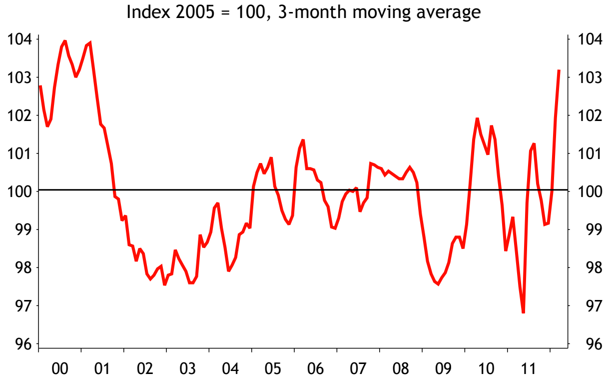
- **Above-trend growth, falling unemployment**
- **Due to deflation, BoJ will continue stimulus**
- **Overvalued yen will decline further**

Recent statistics confirm that Japan's economic recovery is continuing. Reconstruction following the March 2011 natural disasters and expansionary fiscal policy are sustaining demand. Our forecast is thus that **GDP will grow by 2.2 per cent in 2012 and 1.7 per cent in 2013**: somewhat above consensus in both years. Energy supply disruptions, questions about Chinese economic performance and high oil prices are downside risks in this forecast. Prices appear likely to continue falling in 2012, which means that Japan will have experienced four straight years of deflation. We thus expect the Bank of Japan (BoJ) to continue expanding its bond purchasing programme.

Household confidence indicators have recently climbed, although their level remains lower than before the natural disasters. The recovery is beginning to gain a foothold at the consumer level, as reflected in rebounding retail sales. The government's subsidies for low-energy cars have also boosted auto sales, and in March the strongest figures since 2007 were recorded. Unemployment fell in February and is expected to continue downward towards 4 per cent at the end of our forecast period, which will also sustain consumption. We predict that **private consumption will grow by 1.5 per cent in 2012 and by 0.8 per cent in 2013**. Especially this year, fiscal stimulus measures will help sustain incomes.

Bounce in retail sales fuels recovery hopes

Index 2005 = 100, 3-month moving average



Source: Reuters EcoWin, SEB

Company surveys such as Economic Watcher Sentiment and indicators like machinery order bookings provide an **optimistic picture of the capital spending market**, including parts of Japan outside the earthquake-stricken Tokohu region. The purchasing managers' index in the service sector rose in March to a new record level (53.7) in its five-year history, but it fell back in April. Manufacturing sector PMI has also trended upward since last year. Meanwhile a warning sign is that companies indicate continued spare capacity, according to the BoJ's latest Tankan survey. Our overall assessment is that **corporate capital spending will grow by 8 per cent this year and 4 per cent in 2013**. Residential investments, which fell every year from 2007 to 2010, grew by 5 per cent last year. Reconstruction work will ensure continued decent growth figures, and **we predict that residential investments will increase by an average of 3.8 per cent yearly in 2012-2013**.

The energy supply from Japan's many nuclear power plants has been shelved. We believe that this situation will ease slightly, in time for peak summer demand. But the outcome is uncertain; energy supply is a downside risk in our GDP forecast. Energy shortages would push up inflation. Apart from their 2009 peak, energy price increases are now the highest since the early 1980s. Japan's core inflation measure includes energy, which has helped core inflation climb above zero. But underlying inflation pressure is still non-existent. Deflation has a firm grip when both food and energy prices are excluded. Given the amount of slack in the economy, we foresee continued very low inflation in the next few years. **Inflation will be -0.1 per cent in 2012 and 0.2 per cent in 2013**.

The authorities have increased their focus on price stability. The BoJ introduced a 1 per cent inflation target last winter. This is one reason why the central bank further expanded its bond purchase programme in April, despite signs that the economy is on the mend. Due to excessively low inflation over the next couple of years, the **BoJ will probably launch new bond purchase programmes**. We expect a key interest rate of 0.1 per cent throughout our forecast period. The BoJ must navigate wisely, since there is talk of amending the Bank of Japan Law, and its independence is at stake.

Fiscal policy will be expansionary this year and neutral in 2013. As in 2011, the budget deficit will be 10 per cent of GDP this year. In 2013 it will be 8.5 per cent of GDP. Government debt will climb to a huge 242 per cent of GDP in 2013. This debt indicates the enormous long-term problems Japan faces, especially in light of its unfavourable population trend.

The yen has weakened sharply against both the euro and the dollar compared to last winter's peaks, although it has regained some ground in recent weeks. According to our equilibrium ratios, the yen remains sharply overvalued, and our forecast is that the weakening will recommence. **In December 2013 the USD/JPY exchange rate will stand at 94**.

Global growth engine despite below-trend GDP rise

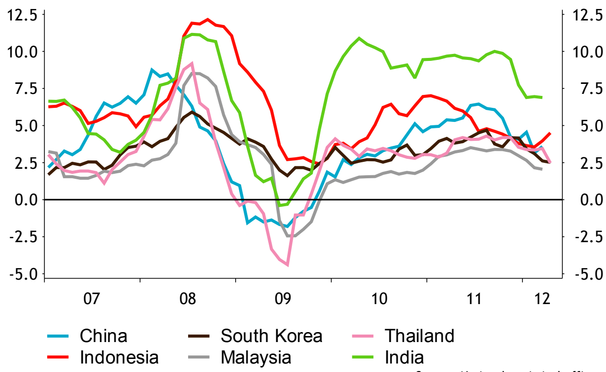
- **China: weak start in 2012 but no hard landing**
- **India: Key rate cuts are aimed at sustaining growth**
- **Inflation will continue to fall somewhat**

Asia will be the world's fastest-growing region in 2012, even though its GDP increase will end up below trend. **The region will thus continue to provide vital support to the global economy at a time of very weak expansion in the OECD countries**. China's GDP growth slowed further in the first quarter, but most other Asian economies showed somewhat higher growth. In the second half, we expect some acceleration in the region's GDP growth. **Strong government finances and good domestic demand, driven by rising employment, will create greater resilience to weak external demand**.

Inflation has declined, largely due to falling growth rates and lower commodity prices. We expect inflation to stabilise in 2012 and continue downward in many countries. A renewed oil price upturn would not pose a major inflationary threat to the region, since strong fundamentals make these economies resilient to price increases, but in countries with official fuel subsidies such as India and Thailand, government finances risk being adversely impacted by high energy prices.

Inflation pressure easing in Asia

Per cent



Source: National statistical offices

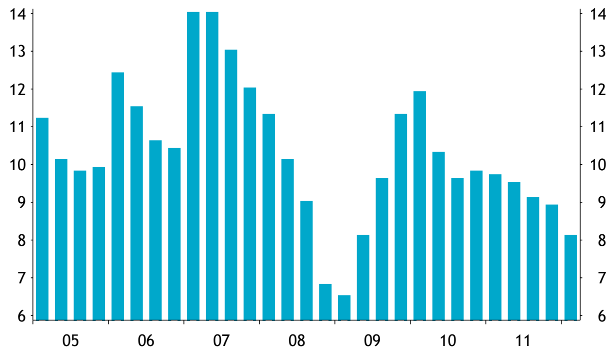
Partly due to slower inflation, India cut its key interest rate in April, but most other central banks have left their key rates unchanged. Many central banks have room to cut key rates in case global economic conditions worsen.

China: Growth is set to rebound

Current economic developments in China are characterised by **uncertainty**, and financial markets remain worried about a hard landing. The timing of the Chinese New Year makes it more difficult to interpret the final statistics for January and February, thereby contributing to the uncertainty, but it is clear that economic activity is now slowing. Year-on-year **GDP growth ended up at 8.1 per cent during the first quarter**, a noticeable deceleration from 8.9 per cent in the preceding quarter. The growth rate thus fell for the fifth straight quarter. Quarter-on-quarter growth also slowed to an annualised 7.4 per cent, the smallest increase since China began publishing quarter-on-quarter GDP change figures.

China's GDP growth has decelerated

Year-on-year percentage change

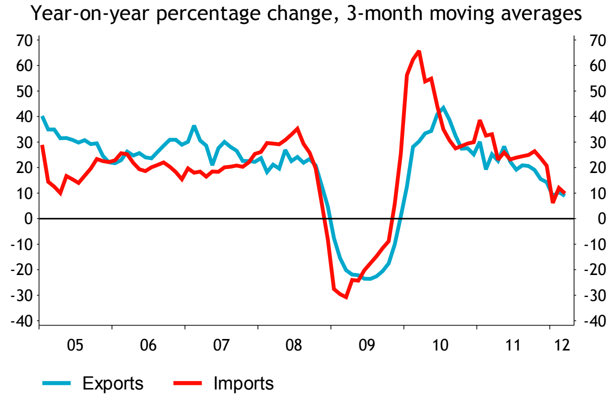


Source: National Bureau of Statistics of China

There are nevertheless signs that growth bottomed out in the first quarter. Purchasing managers' indices provide conflicting data (see box below), but the official PMI indicates stabilisation. The OECD's leading indicator for China rebounded in February. Industrial production and retail sales both accelerated in March after a period of slowdown. Meanwhile there are also signs of stabilisation in exports. Overall GDP growth is expected to end up just above 8 per cent in the second quarter, then speed up somewhat in the second half of 2012. Measured year-on-year, we expect that **GDP will climb by 8.5 per cent in 2012 and by 8.7 per cent in 2013**.

Clear slowdown in export and import growth

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



Source: National Bureau of Statistics

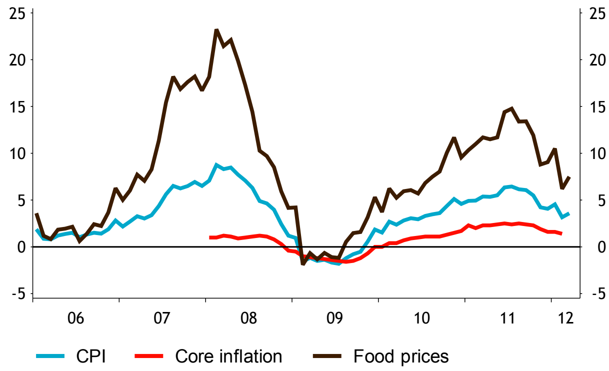
Early in March, the official growth target for 2012 was lowered to 7.5 per cent, which led to negative reactions in financial markets. In practice, this is of limited importance. The target should instead be regarded as a floor, below which economic growth should not fall.

In the first quarter, capital spending increased by 21 per cent year-on-year: a modest deceleration compared to the 24 per cent upturn in the same quarter of 2011. In spite of disruptions related to the New Year, it is **clear that the growth in both exports and imports has continued to slow**.

In March, exports rose 8.9 per cent year-on-year: a historically weak increase. Exports to the EU were actually lower than a year earlier, while exports to the US are performing strongly. Overall, we believe that **export growth will end up around 10 per cent in 2012**. Import growth has also slowed because of subdued domestic demand and falling commodity prices.

The inflation rate has fallen

Year-on-year percentage change



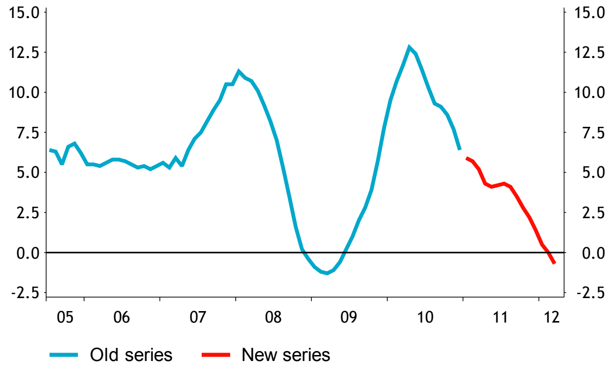
Source: National Bureau of Statistics

China's inflation rate has cooled considerably since peaking in July 2011. In March, inflation took off again and reached 3.6 per cent, but this upturn is regarded as temporary. Core inflation remains low. Food price inflation has subsided again, after peaking in connection with the Chinese New Year, and producer prices are at the same level as a year ago. In March, the authorities raised petrol and diesel prices more than expected. This decision can be interpreted as yet another sign of diminishing inflation worries and a confirmation that the focus of economic policy will now shift to sustaining growth. The central bank's quarterly survey also indicates that inflation expectations fell during the first quarter. **Our forecast is that annual average inflation will end up at 3.5 per cent in 2012 and 3.8 per cent in 2013**.

We expect no major changes in monetary policy, as long as growth does not decelerate too sharply. Reserve requirements were lowered in February by 50 basis points to 20.5 per cent for large banks. Further cuts of 150 points are expected this year, and cuts will continue in 2013. The reserve requirement will be 17.5 per cent at year-end 2013. T**he key interest rate is expected to be cut by 25 basis points during the third quarter.**

Home prices are falling

Year-on-year percentage change



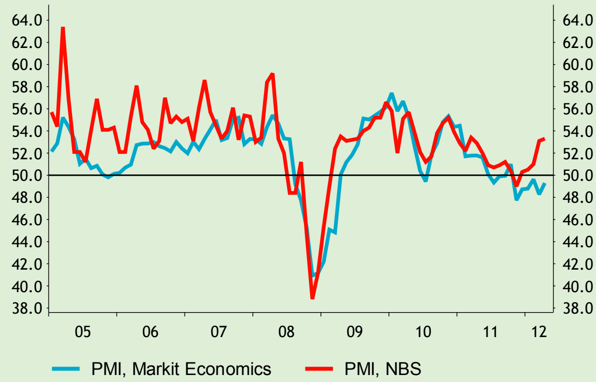
Source: National Bureau of Statistics of China

The housing market continues to slow. **Home prices, measured month-to-month in 70 major cities, fell in February for the fifth straight month**. Prices are now somewhat below

Divergent PMIs contributing to uncertainty

One reason for uncertainty about China's economy is that different purchasing managers' indices have given different signals. This divergence applies to the official PMI and the one compiled by Markit Economics and HSBC. **In March, China's official PMI rose sharply to 53.1** and had thus climbed four months in a row. **Markit's index, however, fell to 48.3**.

Divergent trend for purchasing managers' indices



Source: Markit Economics, National Bureau of Statistics of China (NBS)

Difficulties with seasonal adjustments may explain part of the difference; official PMI usually climbs sharply in March. A more important explanation is probably differences in the sizes of the companies surveyed. Markit includes a larger share of small and medium-sized companies. Small firms have recently had a significantly tougher time than large ones, among other things in terms of access to lending. This is confirmed by a quarterly survey from China's National Bureau of Statistics that shows weaker growth for small private companies compared to large state-owned companies. The slowdown in GDP growth during the first quarter means that Markit's PMI has been a better indicator of the recent overall economic trend. **In a longer perspective, however, both PMIs have shown a limited ability to explain GDP growth**. In light of this, the financial market reaction to these PMI figures seems exaggerated.

their year-ago level. The slowdown is happening slowly; in March, prices fell 0.1 per cent from the previous month. The number of properties sold is lower than a year ago.

Despite this deceleration, the authorities have clearly signalled that they consider the price level too high. They are concerned that high prices will make it difficult for low- and average-income households to buy a home. Current housing market regulations will thus probably not be eased in the near future. Meanwhile we are seeing an ongoing improvement in the underlying housing market balance. Chinese wages are continuing to rise at a healthy pace, which means that the capacity of households to pay for housing purchases will strengthen in an environment of stable or slightly falling prices. **Our assessment is that home prices will continue to fall at a slow pace and that the total price downturn during 2012 will not exceed 5 per cent**. If tendencies towards sharper declines should arise, this can be countered by loosening housing market regulations. Looking ahead, the subdued activity in the construction sector will help keep GDP growth down, although there are signs of stabilisation.

The appreciation of the yuan against the US dollar has halted during 2012; at present, the exchange rate is close to its year-end 2011 level. In mid-April the central bank doubled the permitted daily trading range for the yuan exchange rate against the dollar to 1 per cent, but this measure is expected to have little impact. It should mainly be viewed as a step towards long-term liberalisation of the currency. In recent months, Chinese authorities have argued that the yuan is now close to its equilibrium level. There is thus reason to assume that its appreciation against the dollar will be slower than in 2011, when it ended up at a bit below 5 per cent. China's currency reserve increased again in the first quarter, however, indicating a continued need for currency adjustment. **In our assessment, the USD/CNY exchange rate will stand at 6.15 at the end of 2012 and 6.00 at the end of 2013**.

During the spring, political tensions have increased in China in the run-up to next autumn, when a large portion of the Communist Party leadership will be replaced. The focus has been on **Bo Xilai**. Bo appeared to be a candidate for the Politburo Standing Committee, China's nine-member highest decision-making body, but after various scandals and accusations. Bo was ousted from his posts. These events are remarkable and illustrate the power struggle that is under way prior to the shift in leadership. It is becoming more and more difficult for the Communist Party to conceal what is happening behind the scenes, in an environment where digital media are becoming more widespread. Many uncertainties remain in the run-up to the leadership change this autumn, but **Xi Jinping and Li Keqiang are expected to take over the most powerful positions, as president and general secretary of the Communist Party and as prime minister respectively**. The coming leadership reshuffle decreases China's willingness to launch new reforms. We thus expect no major changes in the direction of economic policy in the short term.

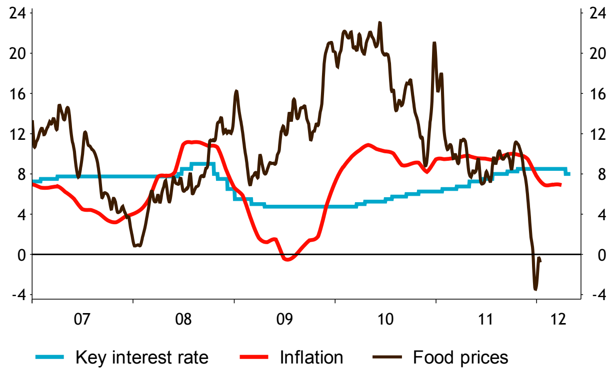
India: Growth has bottomed out

During the final quarter of 2011, year-on-year GDP growth ended up at 6.1 per cent, the lowest since spring 2009. **We believe that growth has now bottomed out**. Leading indicators have turned upward and the purchasing managers' index has recovered from last autumn's lows. Industrial production has slowed in recent months but accelerated in February. Exports appear to have stabilised, though at slow growth rates. **We expect GDP to increase by 7.0 per cent in 2012 and by 7.3 per cent in 2013**.

In March, the central government unveiled its fiscal 2012/2013 **budget**. It may be regarded as **a first step towards bringing India's large fiscal deficit under control**. However, the budget does not make any great progress towards tackling the country's large subsidy expenditures. The inflation rate fell slightly in March to 6.9 per cent. Food price inflation slowed significantly. **We expect inflation to end up at 7.0 per cent in 2012 and 7.5 per cent in 2013**. In mid-April, falling inflation pressure combined with weak growth and a tighter government budget persuaded the Reserve Bank of India to cut its key interest rate by 50 basis points to 8.0 per cent. Early in March, it had lowered the required reserves ratio (RRR) to 4.75 per cent. Yet these cuts should not be interpreted as the beginning of an extensive loosening of monetary policy; the central bank is still worried about inflation. **Our assessment, however, is that there will be a 25 basis point rate cut in the second quarter and another in the third quarter**.

Lower inflation pressure made key rate cut possible

Per cent, year-on-year percentage change



Source: Ministry of Commerce and Industry, Reserve Bank of India

One weakness of the new budget is its absence of structural reforms that can boost growth. **Without such reforms, the Indian economy cannot resume its 9-10 per cent growth rate** of a few years ago. It is difficult to foresee any significant economic policy shift in the next couple of years. The Congress Party, which leads the current coalition government, did poorly in local elections in February and March and was thus unable to improve its weak position at national level. **No improvement in the reform climate can be expected until after the May 2014 parliamentary election**. The closer India moves to the election, the worse the conditions for reform will be, since the Congress Party's parliamentary allies are strongly against proposals to promote economic growth. For example, these parties have managed to indefinitely postpone the deregulation of foreign investments in the retail sector.

India's current account deficit is expected to reach a ten-year high during 2012 and to continue weighing down the rupee. **We foresee a USD/INR rate of 50.0 at the end of 2012 and 48.0 at the end of 2013**.

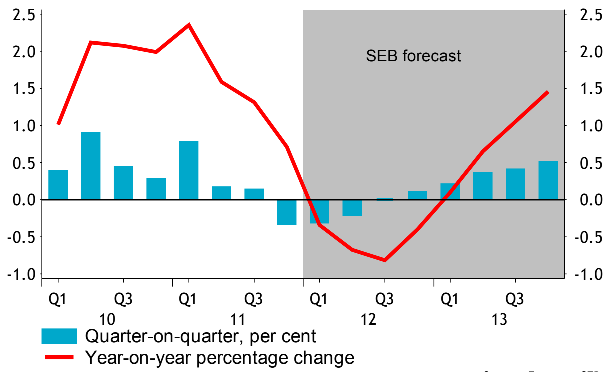
Deepening north-south divergence

- **Bail-out package for Spain on the way**
- **Germany sustaining euro zone growth**
- **Further labour market weakening**
- **ECB will be forced into the spotlight again**

Euro zone GDP fell during the fourth quarter of 2011, and the downturn probably continued in the first quarter of 2012. Measured as an annual average, **we expect GDP to decline by 0.6 per cent in 2012**, an upward revision by 0.2 percentage points compared to February's *Nordic Outlook*. **In 2013 we expect a weak recovery, with GDP rising by 0.8 per cent.**

GDP growth

Per cent



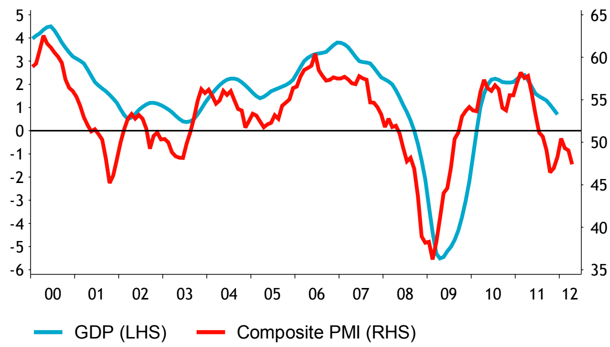
Source: Eurostat, SEB

After a stabilisation early in 2012, market worries about the government financial crisis in the euro zone took off again during the spring. Greece's debt write-down and the European Central Bank's three-year loans have not been enough to solve the problems. **The current focus is on weak government finances and the difficult macro situation in Spain, but worries have also spread to Italy**. These countries' borrowing costs have again climbed to levels that are hardly sustainable in the long term. There is a growing likelihood that Spain – like Greece, Ireland and Portugal – will be forced to seek a bail-out package. However, the relatively new governments of both Spain and Italy are clearly focused on reforms and on getting their finances under control. **Our main scenario is that Spain will receive a bail-out, but that the euro zone will stay together**. Yet it cannot be ruled out that Greece and Portugal will leave the common currency.

The latest wave of financial worries has caused **several economic indicators to fall, after signs of stabilisation earlier this year**. Although the euro zone composite purchasing managers' index has fallen and stood at 46.7 in April, its level does not indicate a powerful recession, but rather a limited GDP decline consistent with our forecast. Most signs thus point to continued labour market deterioration.

Purchasing managers' index (PMI) indicates GDP decline

Year-on-year percentage change and index

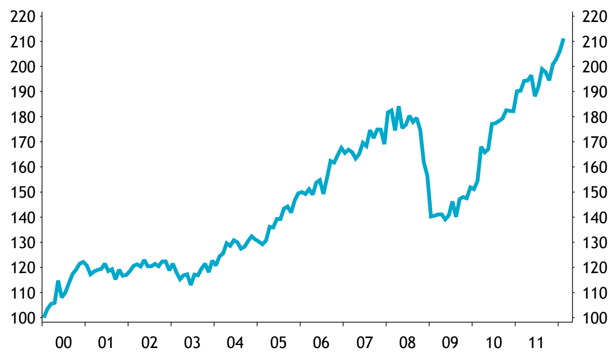


Source: Eurostat, Markit Economics

The plight of the euro zone is being eased by relatively good international demand. The US recovery is continuing, albeit at a modest pace, and growth in Asia looks set to bottom out during the first half. Euro zone industrial production has begun creeping upward, and exports have increased by around 10 per cent year-on-year in recent months.

Exports have taken off

Index 100 = 2000



Source: Eurostat

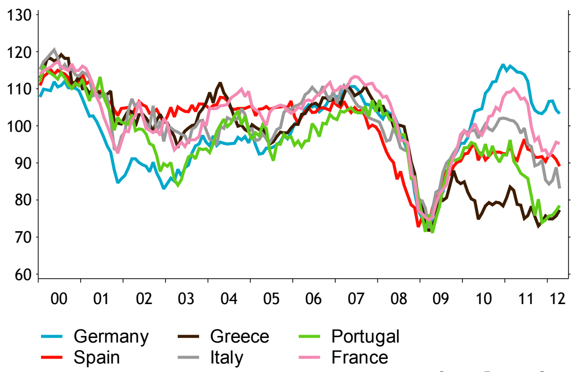
Germany sustaining growth

There is still a wide divergence between euro zone countries. All of the crisis-hit countries in southern Europe will suffer sizeable GDP declines in 2012. In Italy and Spain, we expect GDP to fall by nearly 2 per cent, while the downturn in Greece and Portugal will be around 5 and 4 per cent, respectively. France will end up with near-zero growth this year.

Germany, with its relatively well-ordered government finances, good competitiveness and large current account surpluses, has the potential **to boost average GDP growth in the euro zone**. A number of forces will also help stimulate German domestic demand. Pay increases are showing signs of accelerating, and sluggish German home prices have begun to climb in the past year. During the spring, final statistics in a number of areas have provided upside surprises. The IFO business sentiment index has continued to improve, and unemployment has fallen further. Yet a clear decline in the PMI and weak industrial production in March underscore that the German economy, too, is slowing after last year's 3 per cent GDP growth. Our overall assessment is that **Germany will continue to avoid recession, easing the risk of a deeper downturn for the euro zone as a whole. We expect German GDP to grow by 0.8 per cent this year and by 1.6 per cent in 2013**.

Divergence in the euro zone

Economic Sentiment Indicator (ESI), index



Source: European Commission

GDP, selected countries

Year-on-year percentage change

	2010	2011	2012	2013
Germany	3.7	3.0	0.8	1.6
France	1.4	1.7	-0.1	0.8
Italy	1.8	0.5	-1.9	0.2
Spain	-0.1	0.7	-1.9	0.3
Greece	-3.5	-6.8	-5.5	-1.3
Portugal	1.4	-1.6	-3.8	-0.9
Ireland	-0.4	0.7	-0.4	1.3
GIPS	**-0.5**	**-0.7**	**-2.5**	**0.0**
Euro zone	**1.9**	**1.5**	**-0.6**	**0.8**

Source: Eurostat, SEB

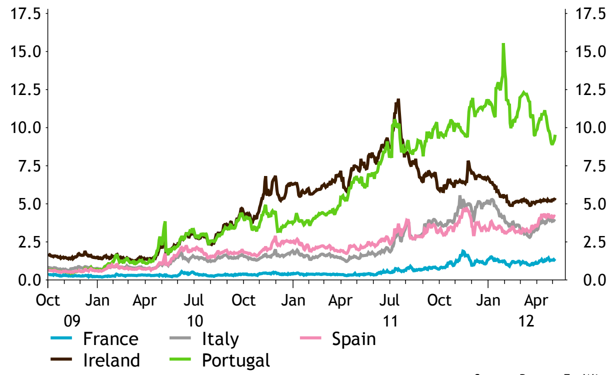
Spain in a tight spot

Market worries about government finances have gained new momentum during the spring, and bond yields in Spain and Italy have climbed the most. The main focus is on Spain. These **worries were triggered when it became clear that Spain's budget deficit for 2011 was significantly larger than expected**. Spain's 2011 budget deficit reached 8.5 per cent of GDP, compared to an earlier forecast of 6 per cent. The reduction in the deficit last year thus ended up at a modest 0.8 per cent of GDP. This poorer outcome is largely explained by sizeable deficits in Spain's regions. The 2012 deficit target has been raised from 4.4 per cent of GDP to 5.8 per cent, but the 3 per cent target for 2013 remains in place.

Very weak macroeconomic performance is making Spain's difficult situation worse. Unemployment continues to climb rapidly. Meanwhile, consumer confidence has deteriorated sharply during 2012 and is approaching the levels that prevailed in 2008-2009. The housing market is continuing to weaken. The price decline has accelerated, and home prices are now some 20 per cent below their spring 2008 peak. Home prices are expected to keep falling this year, squeezed both hard-pressed households and the fragile banking sector. The central bank has tried to stabilise the banking sector through bail-out measures and forced mergers of private banks, but many problems remain. Most indications are that Spanish banks do not have enough capital, despite these measures.

Spread against Germany

Percentage points

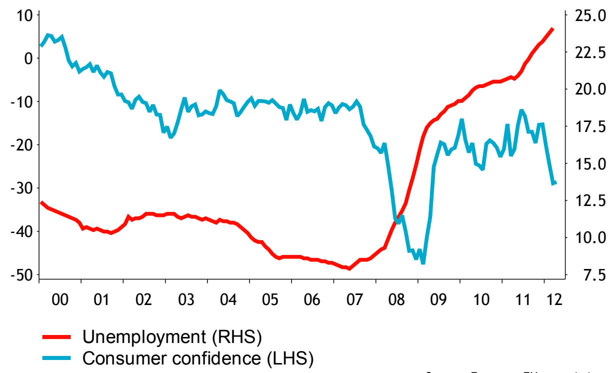


Source: Reuters EcoWin

Mariano Rajoy's new government is focusing on both structural reforms and fiscal belt-tightening. A poorer financial starting position, combined with far weaker economic performance than expected, have forced the Spanish government to lower its fiscal ambition level; t00his year's deficit will thus be more than expected. The government's current dilemma is extremely difficult to handle. **Expanded austerity measures would make the recession even deeper**.

Spanish economy heading in the wrong direction

Per cent, index



Source: Eurostat, EU commission

Italy has also been pulled into financial market worries, and its sovereign bond yields have recently climbed. As in Spain, the macroeconomic situation is very weak. GDP again fell during the fourth quarter of 2011, while unemployment continues to rise rapidly. Due to a more powerful recession than expected, the **government has been forced to postpone budget-balancing by one year to 2014**. The targeted budget deficit in 2013 has been raised from 0.1 per cent of GDP to 0.5 per cent. As in Spain, it is questionable whether the government of Mario Monti will be able to push through its ambitious reforms in practice. **Despite their scaled-down ambition levels, we believe that both Spain and Italy will have difficulty**

achieving their targets, since our forecasts for their economic growth are gloomier than these governments' own forecasts.

Market worries about events in **Greece** have become less acute since that country's debt write-down in late February, although its economic problems are far from resolved. Now that the second international bail-out package is in place, Greece **essentially has the financing it needs until the end of 2014**. But continued bail-out payments are contingent on Greece carrying out its commitments, which cannot be taken for granted, considering how sluggishly it carried out much of the previous reform task. The May 6 parliamentary election does not seem to result in a stable government. Therefore the risk that austerity measures will not be fully implemented has increased.

Portugal managed to achieve its 2011 budget targets (albeit with the help of one-off effects). Evaluations of the country's efforts related to its bail-out package have largely been positive. But 2012 looks set to be a tough year, with a sharp GDP decline that will make it very difficult for the government to meet the deficit target: 4.5 per cent of GDP.

Other countries will also have a tough time; **France** will probably be forced to enact further belt-tightening during 2012. As expected, François Hollande won the French presidential election. Hollande has caused concerns in financial markets, since he seems less eager to restore order to French government finances than his predecessor Nicolas Sarkozy. In practice, however, the differences between the two presidents are limited and Hollande will probably be forced to water down or completely scrap some of his proposals.

Germany has a continued bright budget outlook, with deficits expected to be less than 1 per cent of GDP in both 2012 and 2013. The federal budget will be balanced in 2014, two years earlier than planned. In the euro zone as a whole, we foresee budget deficits somewhat lower than according to our assessment in February's *Nordic Outlook*. **In 2012 we expect euro zone budget deficits to end up at 3.6 per cent of GDP; in 2013 they will shrink to 3.1 per cent. We believe that euro zone government debt will climb from 87.2 per cent in 2011 to 93.5 per cent in 2013.**

Public budget balance, selected countries
Per cent of GDP

	2010	2011	2012	2013
Germany	-4.3	-1.0	-0.9	-0.6
France	-7.1	-5.2	-5.1	-4.4
Italy	-4.6	-3.9	-2.7	-2.3
Spain	-9.3	-8.5	-7.0	-6.3
Greece	-10.3	-9.1	-6.6	-5.8
Portugal	-9.8	-4.2	-4.8	-3.3
Ireland	-31.2	-13.1	-9.0	-7.1
Euro zone	**-6.2**	**-4.1**	**-3.6**	**-3.1**

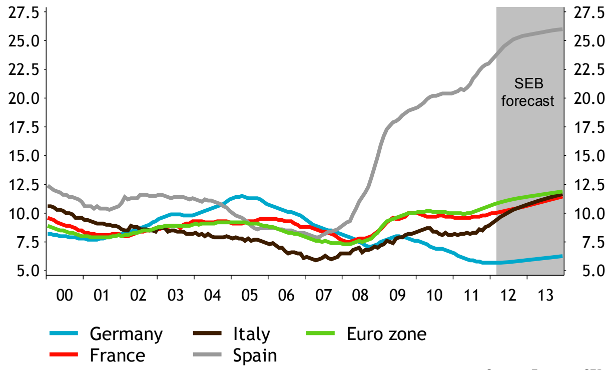
Source: European Commission, SEB

Continued labour market deterioration

Unemployment continued to climb, reaching 10.9 per cent in March: the highest level **since the euro zone was established**. Youth unemployment also increased, totalling 21.6 per cent in March. The number of unemployed rose to more than 17 million, an increase of some 1.7 million in one year. Meanwhile the divergence between trends in individual countries is widening. In crisis-hit countries, the jobless rate is continuing to rise rapidly. Labour market deterioration has occurred especially rapidly in Greece during recent months. Eurostat's harmonised unemployment measure climbed by two percentage points in three months to 21 per cent in January. Unemployment is also rising in Italy, Spain and Portugal, while there are signs of stabilisation in France and Ireland.

The German labour market remains resilient, however, and unemployment fell in March according to the national measure. **Yet a strong German labour market is not enough to keep unemployment down in the euro zone as a whole**. We have thus revised our unemployment rate forecast upward compared to February's *Nordic Outlook*. **Measured as annual averages, we expect euro zone unemployment to end up at 11.1 per cent this year and 11.7 per cent in 2013**.

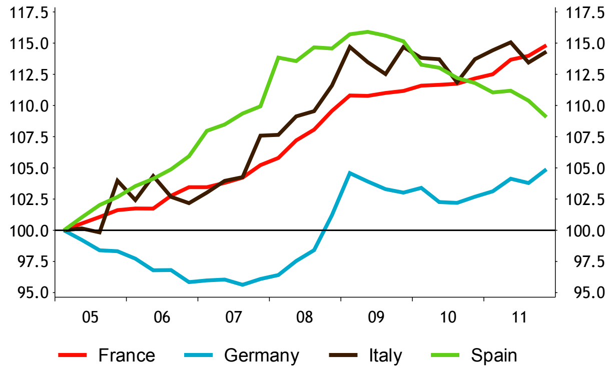
Unemployment will continue climbing
Per cent



Source: Eurostat, SEB

The weak labour market has affected the pay situation in varying degrees in crisis-plagued countries. Wages and salaries in Greece are now falling very sharply. In Spain, too, an adjustment of unit labour costs seems to have occurred, although different sources of statistics provide divergent signals. In Italy and France, however, no improvement is visible in terms of the competitiveness situation compared to countries like Germany.

Unit labour costs
Index 100 = 2005



Source: ECB

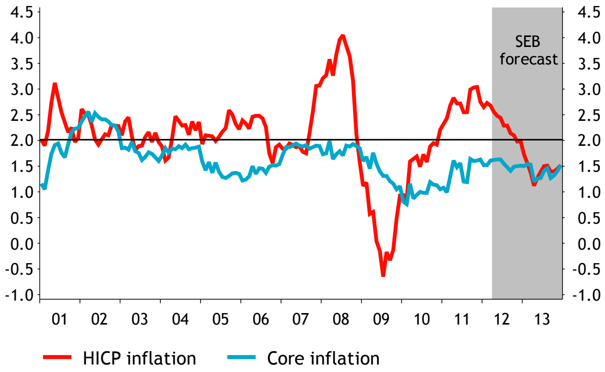
One long-term effect of weak labour markets and falling wages and salaries in crisis-hit countries is increased **emigration**. For example in Ireland and Greece, we have already seen clear signs that young people are inclined to move to other countries when their home country's labour market weakens. Examples from Eastern Europe show that emigration may become extensive. Latvia's population has declined by more than one tenth in the past decade, and migration from Estonia and Lithuania has also been sizeable.

Persistent inflation

Euro zone inflation has been relatively high so far during 2012, despite the downturn in economic activity. This is largely due to the lingering effects of earlier energy price upturns. Together with high unemployment and fiscal austerity measures, stubbornly high inflation is helping keep down household purchasing power. In March, inflation stayed at 2.7 per cent for the fourth straight month; the slowdown since its previous 3.0 per cent peak in November is modest. As before, however, our forecast is that inflation will slow in 2012, though we have revised our forecast somewhat higher compared to February's *Nordic Outlook*: **in 2012, we expect inflation to end up at 2.4 per cent and then fall further to 1.4 per cent in 2013**. Core inflation will fall further, driven by low capacity utilisation, and will stand at 1.5 per cent at the end of our forecast period.

Inflation will exceed the ECB target

Year-on-year percentage change



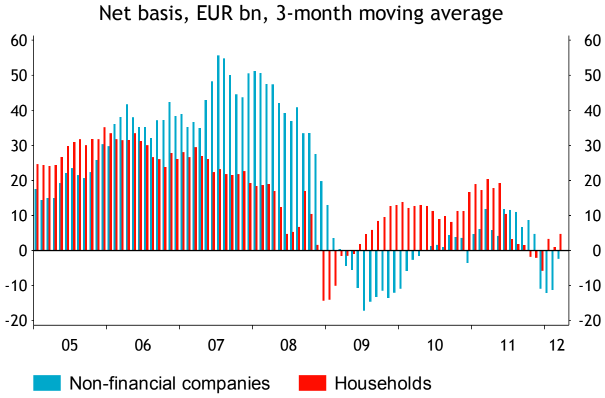
Source: Eurostat, SEB

Weak bank lending is hampering growth

Tight credit conditions are one main cause of the euro zone recession. Although the ECB's three year loans have enabled the euro zone to avoid a severe credit contraction, bank lending remains very restrictive. In March, total lending in the euro zone increased by a low 0.6 per cent year-on-year.

Continued weak bank lending

Net basis, EUR bn, 3-month moving average



Source: ECB

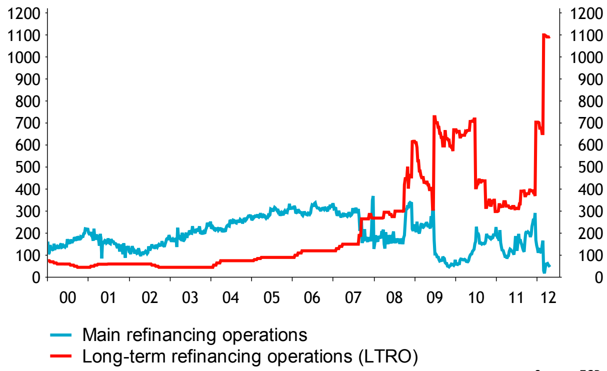
The ECB's *Bank Lending Survey* for the first quarter shows that euro zone banks tightened credit conditions to a lesser extent than in the fourth quarter of 2011. The levelling out trend is expected to continue during the second quarter. Net corporate demand for loans fell sharply, and household demand for home mortgage loans and consumer credit also decreased, but this decline in demand is expected to slow in the second quarter. The study indicates that **lending to both companies and households will remain weak during 2012**. The situation remains problematic for banks in many countries, especially Spain, but the study showed that access to funding improved during the first quarter thanks to the ECB's three year loans.

How long can the ECB wait and see?

This spring the ECB has been in wait-and-see mode, and its March, April, and May meetings led to no changes. **The recent increase in market worries about Spain's government finances do not yet seem to have made the ECB more willing to loosen monetary policy**. The second three year loan to euro zone banks, which was offered on February 29, has not been repeated and this looks unlikely to occur in the near term. The liquidity situation has improved since the turn of the year, and the ECB has announced that it needs time to study the longer-term effects of its three year loans. Nor does the ECB seem likely to re-start sovereign bond purchases under its Securities Markets Programme (SMP) soon. ECB President Mario Draghi has clearly stated that it is now up to crisis-plagued countries to solve their government financial problems. The refi rate has remained at 1 per cent since last being lowered in December 2011. **We believe that the ECB will continue allowing 1 per cent to be the floor for the refi rate**, as it did during its previous monetary policy low during 2009/2010.

ECB lending to banks

EUR billion



Source: ECB

But the question is how long the ECB can continue to maintain its wait-and-see attitude. Its strategy of waiting for the political system to enact fiscal tightening measures and structural reforms does not appear likely to last very much longer. The positive impact of last winter's three year loans is beginning to fade, and there is a risk that euro zone bank lending will start to weaken again. The problems of Spain, but also of Italy, risk becoming unmanageable unless the ECB takes new actions. One possibility is that the ECB will still be forced to restart bond purchases (SMP) on a larger scale. That tool is politically controversial, however, and could lead to higher bond yields. (See Theme article, page 12).

Growth will be weak in spite of bright spots

- **Inflation will continue to fall**
- **Bank of England will take it easy**
- **Summer Olympics set to stimulate economy**

Contrary to previous economic signals, British GDP again fell during the first quarter of 2012. The recession will be brief, according to our forecasts. Austerity programmes and a weak labour market point towards persistently slow growth, but leading indicators like the purchasing managers' index have climbed significantly since last autumn. **We predict GDP growth of 0.5 per cent this year and 1.7 per cent in 2013.** Unemployment will peak at 8.8 per cent this year and level out in 2013. **Inflation will be above target this year but continue downward in 2013.** Right now inflation is above Bank of England forecasts, and according to both our assessment and the latest monetary policy meeting minutes, **further quantitative easing plans have been shelved**. The BoE's most important key interest rate will stay at 0.50 per cent throughout our forecast period.

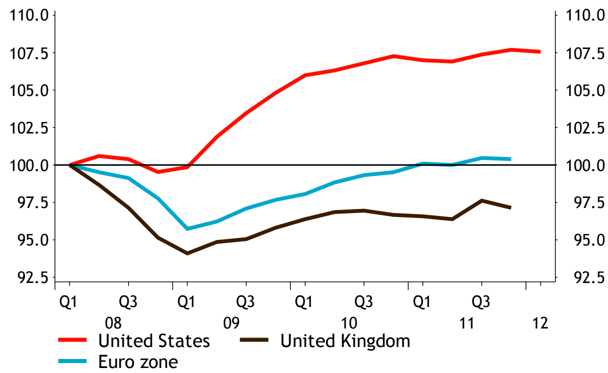
After shrinking by 1.2 per cent last year, **consumption will stabilise** in 2012. Consumer confidence has regained part of last year's slide but hardly exudes any budding optimism. Next year, when pay growth again exceeds inflation, consumption will climb by a decent 1.8 per cent. Manufacturing indicators are pointing upward, but this is not yet reflected in hard data; since December the purchasing managers' index has climbed 7 points, while actual output has fallen slightly. Having lost 1.2 per cent last year, industrial production will grow by 0.5 per cent this year and 2.5 per cent in 2013. This summer's Olympic Games in London will stimulate growth in various sectors.

Labour market statistics have recently led to upside surprises after a period of negative developments. For the first time in a year, unemployment fell slightly to 8.3 per cent in March. Given weak GDP growth, this improvement is temporary. **The jobless rate will average 8.6 per cent in 2012-13**. Low wage growth indicates that unemployment is well above its equilibrium level (6.8 per cent, according to the OECD).

Despite similar crises in their banking systems and housing markets, the recovery in the UK has been slower and inflation higher than in the US. Last year, UK inflation peaked at 5.2 per cent. This development raises questions about the amount of slack in the economy. According to the Office for Budget Responsibility (OBR), the **output gap is a low 2.5 per cent** even though the GDP level is a full 14 per cent below its long-term trend. The equivalent US figures are 5.5 and 12 per cent, respectively, according to the IMF's calculations. The **years of economic crisis may thus have led to a major permanent output shortfall in the UK**. The large role of the banking system in GDP and tougher austerity measures are conceivable explanations. Add weak productivity growth – well below that of other comparable economies.

Weak productivity growth in the UK

Index 100 = Jan 2008



Source: BLS, Eurostat, SEB

The UK is changing how it calculates the Consumer Price Index. Owner-occupiers' housing costs will probably be included in CPI from early 2013. Since home prices affect these costs, the connection between home prices and inflation will become clearer, probably contributing to slightly higher average inflation over time. Since the inflation target is unlikely to be adjusted, the effect may be somewhat tighter monetary policy. In the short term, we expect little impact from the reform: **home prices will move sideways**, according to our forecasts.

Over the next couple of years, **inflation** will fall according to both our forecasts and the Bank of England's. It **will average 2.7 per cent this year and 1.6 per cent in 2013**. The pound is one factor driving this development. The effect of the dramatic weakening in the currency during 2007-2009 has faded, and recently the **pound has appreciated significantly** against the euro. This reflects worsening debt problems in Spain and elsewhere, while the UK is viewed as a safer haven. In the near term, relatively better growth prospects indicate that this trend will continue. At the end of 2013 we expect the **EUR/GBP exchange rate to be 0.77**, i.e. its strongest level since 2008.

The UK government's austerity policies remain firmly in place. The **budget deficit**, which totalled 8 per cent of GDP last year, **will shrink to 7.3 per cent this year and 6 per cent in 2013**. Tight fiscal policy will benefit the UK's sovereign credit rating. In a recent report, Standard & Poor's confirmed that the country will retain the highest credit status. It also enjoys top ratings with Moody's and Fitch, but with a negative outlook.

Russia and Poland weathering euro zone crisis well

- **Indicators show somewhat brighter picture**
- **Less risk of a serious credit crunch**
- **Shaky currencies, but appreciation ahead**

Eastern (including Central) European economies are stabilising after a minor slowdown this past year in Russia and Poland and sharper growth declines in smaller countries like the Czech Republic, Estonia and Lithuania. In recent months, **forward-looking industrial indicators have levelled out** after deep declines in the end of 2011. But in several countries, for example in Poland, the Czech Republic and Hungary, the industrial purchasing managers' index is slightly below the expansion threshold of 50. Russia's PMI has strengthened and is close to 53. Meanwhile **household optimism** in Eastern Europe **has recovered**, especially in Poland.

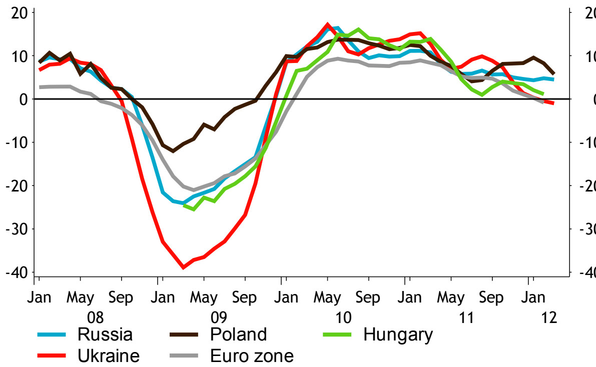
This does not change our previous view that the economic **recovery late in 2012 and during 2013 will be sluggish**. Weak demand in Western Europe and relatively tight credit conditions are holding back exports and capital spending. The ECB's LTRO loans to euro zone banks have thawed interbank markets in both Western and Eastern Europe and thereby clearly reduced risks of a severe credit shortage (read more in SEB's *Eastern European Outlook*, March 2012). In late 2011 a credit tightening began also in many Eastern European countries, but in the first quarter of 2012 there was a clear easing of the tightening, according to the latest Institute of International Finance (IIF) loan survey among banks in emerging economies. The credit conditions will probably only gradually revert to a more normal stance.

On the plus side, there is **relatively good real wage growth** and **labour markets are resilient** in the face of slower growth, although Poland's unemployment will increase somewhat further. Inflation will fall this year in most countries, but core inflation will stay relatively high in Estonia and Poland. In Russia, fiscal policy will also shift to an expansionary direction this year, while tightening will remain moderate elsewhere. On the whole, there are good prospects for continued decent private consumption growth.

We still anticipate a **mild slowdown in Russia and Poland in 2012**, since their exports are smaller in relation to GDP than elsewhere in the region, while they have little or moderate dependence on financing via euro zone banks and little or moderate public debt. Poland's growth will slow from 4.3 per cent last year to 3.3 per cent in 2012 and 3.6 per cent in 2013. Capital spending will be a key driving force. Russia's GDP also grew by 4.3 per cent last year and will expand by 3.8 per cent in 2012 and 4.1 per cent in 2013. The economy will continue to be sustained by high oil prices, this year expected to be in line with the goverment´s USD 115/barrels (Urals) assumption that will balance the budget, but **long-term questions about Russian growth persist**, due to heavy commodity-dependence and the sluggish reform pace. Political uncertainty has also increased, manifested by large protests at the recent parliamentary and presidential elections. Russia's imminent WTO membership may eventually strengthen growth somewhat via foreign trade, investments and structual changes.

Manufacturing output

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



Source: Reuters EcoWin

Economic developments in Eastern Europe will remain polarised, due to varying degrees of financial and trade ties with the euro zone and the varying overall role of exports. The northern parts of the region including Russia and Poland will cope with the euro crisis relatively well, while some central and especially southern parts will be harder hit. The Baltics and the Czech Republic will be among the "medium hard hit", while Bulgaria, Croatia, Romania, Hungary and Ukraine will be the "hardest hit" due to relatively strong euro zone banking ties. Ukraine will muddle through with decent growth, partly sustained by favourable steel prices.

Many Eastern European currencies have weakened in the past two months. Last winter's sharp recovery, following the autumn slide, has now ended. There is **room for appreciation further ahead**; growth advantages compared to the West indicate this. But **in the near term, global uncertainty will hurt these currencies**. The choppy performance of the zloty is also due to monetary policy uncertainty. In recent months, Poland's central bank has made hawkish statements, since inflation has been stubbornly high, well above its target of 2.5 ± 1 per cent, and growth has been robust. Our forecast is uncertain, but we believe that the central bank will soften its stance as inflation fades and enters the target zone by year-end. We predict one key rate cut, to 4.25 per cent, in the fourth quarter of 2012.

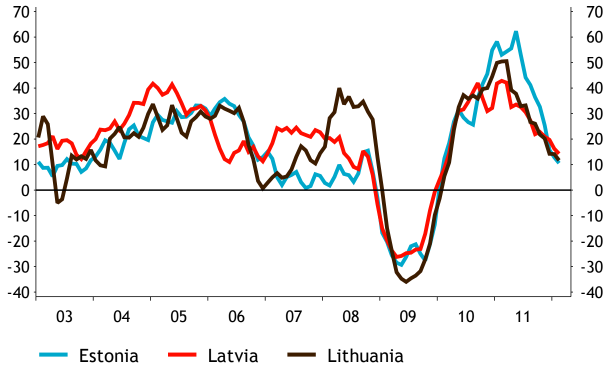
Weak growth – but support from domestic demand

- **Export slump will persist during 2012**
- **Imbalances have been shrinking**
- **Latvia will achieve 2014 euro zone target**

The economies of the three Baltic countries have recovered nicely after their depression-like downturn in 2009. This is very much the result of dynamic, competitive exports and tough budget-tightening. **The Baltics showed the highest full-year 2011 growth in the EU**: Estonia, 7.6 per cent; Lithuania, 5.9 per cent; and Latvia, 5.5 per cent. But late in the year, these economies began a deceleration that is completely tied to the international cyclical downturn, especially in Western Europe. In the case of Estonia, the weakening trend in Sweden and Finland, which together buy around 30 per cent of its exports, has been especially important. **A rapidly fading export boom has led to a sharp decline** in growth in very highly export-dependent Estonia, while the **slowdown has been more gentle in Lithuania and Latvia**. Private consumption and capital spending have continued to strengthen, albeit from low levels. Meanwhile sentiment indicators have stabilised, in line with the international pattern.

Exports in current prices

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

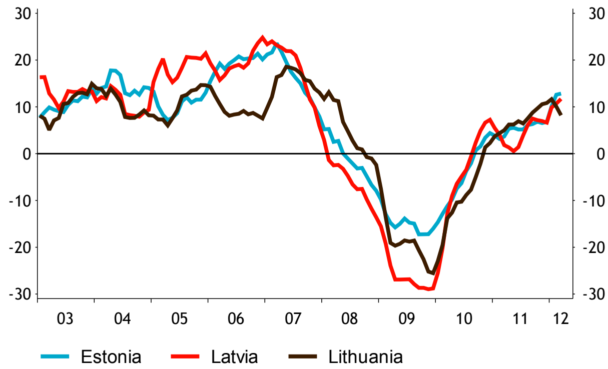


Source: National statistical offices

Over the coming twelve months we expect exports to remain relatively weak. At the same time, capital spending is expected to fade while consumption will grow at a decent, if somewhat decelerating pace. **Several factors indicate that domestic demand will not weaken**: The cyclically sensitive construction and housing markets as well as capital spending are already sharply depressed and have begun weak recoveries during the past year. Harsh austerity policies are past, though Latvia and Lithuania will continue public budget-tightening this year. Wages and salaries are increasing at a modest pace after sharp cuts during 2009-2010. There is also pent-up consumer demand after the deep crisis.

Retail sales in fixed prices

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



Source: National statistical offices

Overall, we still expect **weak GDP increases of 1.5-3.0 per cent this year, followed by some acceleration in 2013**. Growth will remain below its potential pace, estimated at 4.0-4.5 per cent. The Lithuanian forecast has been revised upward due to unexpectedly good Q1 growth led by domestic demand and we see **certain upside risks** in our GDP forecasts for Estonia and Latvia due to potential for faster increases in domestic demand also in these countries.

Fundamentals have improved noticeably in the past few years. The Baltics have overcome their earlier imbalances, mainly in the form of high wage-driven inflation and extreme current account deficits. The relatively large lingering budget deficits in Latvia and Lithuania will shrink further this year, reaching more sustainable levels. One exception to this picture is that **Estonia will show continued inflation problems**. Another is that all three countries are characterised by increasingly serious **labour market structural problems**, caused among other things by a renewed wave of emigration in recent years, which has amplified the negative demographic trend in the region.

Estonia: Continued stagflation tendencies

Estonia's economy has rapidly lost momentum. During the first three quarters of 2011 there was stable GDP growth, averaging 8.8 per cent year-on-year. In the fourth quarter, this rate was halved to 4.5 per cent. Measured quarter-on-quarter, the deceleration began as early as spring 2011, and during the last quarter GDP fell by 0.2 per cent. The deterioration in exports is having an impact, leading to very weak industrial production in early 2012 as well. The bright spots are continued positive consumption and tourism trends; for example, February's 30 per cent year-on-year increase in new car sales was the highest in the EU, and tourism set a record that same month.

Private sector deleveraging has progressed quite far; net debt is now back at the same level as before the 2006-2008 overheating crisis. However, in gross terms the decline is more modest. Deleveraging will continue this year in all three Baltic countries, which will have some restraining effect on economic growth.

GDP will increase by 1.5 per cent in 2012 and 2.5 per cent in 2013. This, in turn, will bump unemployment a bit higher. Estonia's relatively broad-based inflation will average 4.0 per cent this year. Next year, it will climb to 5.0 per cent, partly driven by faster growth in the money supply. In Estonia's small economy, inflation has historically proved to have a significant connection to changes in the money supply.

Latvia: Mild slowdown before adopting euro

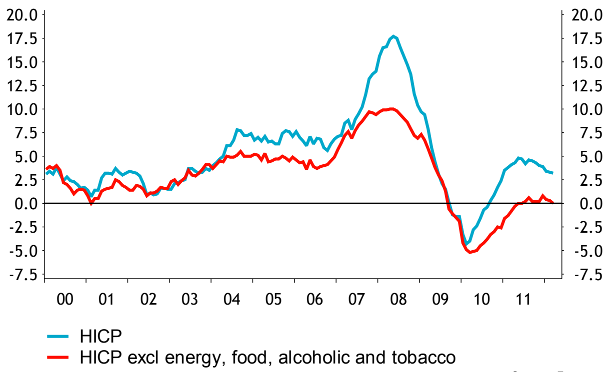
With exports equivalent to a moderate 45 per cent of GDP, the deceleration in Latvia will be less dramatic than in Estonia and Lithuania, where exports weigh in at 70 and 60 per cent respectively. In Latvia, too, retail sales are chugging along at a good pace, with year-on-year increases in constant prices of 15 per cent in January and 10 per cent in February this year. More subdued growth is expected this spring, however, since hefty heating costs will undermine consumer spending power.

GDP growth will be 2.5 per cent this year and 4.0 per cent in 2013. The rebound will be partly due to an upswing in capital spending based on expectations of coming euro zone membership. Unemployment will continue falling gradually, but at a more sluggish pace than in recent years to an average of 12 per cent in 2013. Inflation will slow from more than 4 per cent last year to 2.5 per cent in 2012 and 2.1 per cent in 2013.

Our assessment for some time has been that **Latvia will convert to the euro in 2014 as the government has planned**. In the spring of 2013, the EU and ECB are expected to evaluate whether Latvia meets the six Maastricht criteria, of which the key criteria are low inflation and a budget deficit ceiling. According to the inflation criterion, the latest available 12-month inflation average must not exceed 1.5 percentage points above than the three EU countries that have the lowest inflation. The budget deficit limit is 3 per cent of GDP.

Latvia: Inflation

Year-on-year percentage change



Source: Eurostat

Of the two, the inflation criterion may be the more difficult to achieve. But given underlying inflation of zero, stable and moderate pay increases in the past year and slowing economic activity, no broad price upturn seems likely in the coming year. One threat might be an extremely low qualifying limit due to internal devaluations and very low inflation in crisis-ridden southern European countries. But due to tax hikes, which are part of Latvia's austerity policy, the downturn in inflation will not be so deep despite a sharp pay squeeze. Looking at the budget criterion, for some time the government has been stubbornly pursuing an austerity policy to bring down the deficit. This was also one of the main requirements of the EU/IMF-led bail-out loan programme that ran from December 2008 until early 2012. We believe that the budget deficit will shrink from 3.5 per cent of GDP last year to 2.4 per cent in 2012 and 1.6 per cent in 2013, thus ending up below the ceiling by a sizeable margin.

Lithuania: Plunging growth, political unrest

Falling international demand has resulted in a gradual economic slowdown, although domestic demand has held up nicely. During the winter, the EU's broad-based household and business sentiment indicator stabilised but was somewhat more downbeat in Lithuania than elsewhere in the Baltics and in the euro zone. Weak exports will continue to keep growth down this year, while the slowdown in consumption and capital spending will be modest. This year's GDP growth will also be hampered somewhat by the effects of the Bankas Snoras bankruptcy late in 2011; the central bank foresees an impact of as much as 0.5 percentage points.

GDP will grow by 3.0 per cent in 2012 and 3.5 per cent in 2013. The forecast is revised up by 1.0 and 0.5 percentage points, respectively, after the unexpectedly strong first quarter GDP growth (3.9 per cent compared to the same period in 2011). Unemployment will shrink somewhat further, reaching 12 per cent in average next year. Inflation, which has mainly been commodity-driven, will cool to 2.5 and 3.0 per cent, respectively. Underlying inflation will remain calm and low.

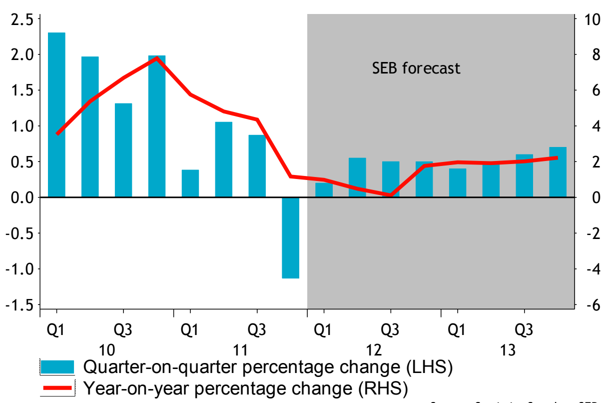
Politics will be dominated by uncertainty as the autumn parliamentary election approaches. The ruling tripartite centre-right coalition has lost popularity. Several opposition parties are now challenging the government and its biggest party, the Homeland Union. The Social Democrats are leading, according to opinion polls. Our assessment is that there will be a change in the governing coalition after the election. This makes future policies uncertain. Late last year, the incumbent government managed to reach agreement on an unexpectedly tight budget for 2012, after the growth outlook had been lowered. Its aim is to keep the budget deficit below 3 per cent of GDP this year (compared to 5.5 per cent last year) and thus also achieve euro zone membership by 2014. However, we believe that the deficit will end up at 3.5 per cent this year and fall below 3 per cent only in 2013. **Our main scenario is that Lithuania will join the euro zone in 2015, but there is great uncertainty about future political strategy and economic policy priorities**, which may become clearer only after the October parliamentary election.

Restrictive economic policy will hold down growth

- **Rising consumption set to sustain GDP**
- **Increased likelihood of a soft landing in the housing market**
- **Labour market will gradually weaken**
- **Low inflation will make a rate cut possible**
- **Krona becoming more like a hard currency**

The Swedish economy is resisting the euro zone crisis, roughly in line with our forecasts earlier this year. We expect **GDP to grow by 0.7 per cent this year and by 1.9 per cent in 2013**. Although the GDP figure for the fourth quarter of 2011 signals even weaker growth, incoming data have indicated a rather clear stabilisation early this year. Growth during 2012 will primarily be driven by household consumption, while weak international demand will cause exports and capital spending to level out. During 2013, capital spending and exports will climb again in step with the modest international recovery.

Clear economic slowdown in 2012



Source: Statistics Sweden, SEB

As expected, the Riksbank chose to keep the key interest rate unchanged at its April policy meeting, even though both the inflation and labour market trends would allow some room for further stimulus, in our view. The continued rise in household debt (albeit at a lower pace than earlier) and signals of stabilisation and recovery in the housing market probably helped persuade a majority of the central bank's Executive Board to abstain from a further rate cut. We also expect the **Riksbank** to hold off from a rate cut at its July meeting, but we believe that it **will lower the repo rate to 1.25 per cent in September** in an environment of rising unemployment and lingering trouble spots in the euro zone. After that, we expect the Riksbank to leave the key rate untouched until the end of 2013.

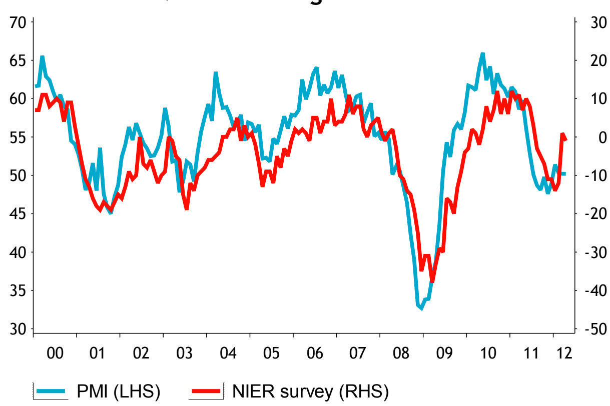
The government is continuing its cautious fiscal strategy. The spring fiscal policy bill was scanty and included no new stimulus measures. As earlier, we expect this autumn's budget bill for 2013 to include further stimulus totalling SEK 15 billion. This means that overall fiscal policy will provide a weak expansionary effect, equivalent to 0.3 per cent of GDP.

These cautious strategies by both the government and the Riksbank pose an obvious risk that official economic policy will be unnecessarily restrictive. One consequence is that the government's "work principle" initiatives, aimed at encouraging labour market participation, will not have a chance to operate in a more normal demand environment. Right now, the jobless rate in Sweden appears likely to be higher at the end of 2013 than when the government took office in 2006. Not being able to show larger results from all its efforts will probably create difficulties for the government in the 2014 parliamentary election.

Mixed export signals

Merchandise exports fell sharply during the fourth quarter of 2011, contributing to weak GDP growth. Since then, the signals from exporters have been mixed. Merchandise exports rose in early 2012, while order bookings and production fell sharply in February. But confusingly, the decline in production was mainly attributable to non-durable consumer goods, which are normally very insensitive to cyclical fluctuations.

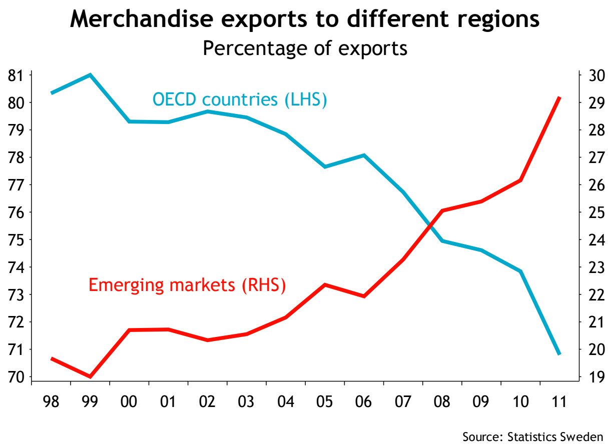
Manufacturing confidence



Source: Swedbank, NIER

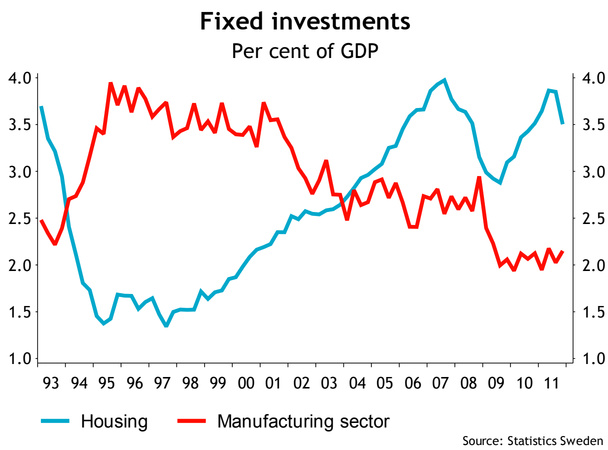
Sentiment indicators have also showed mixed trends. The National Institute of Economic Research (NIER) confidence indicator has climbed rapidly. This upturn has mainly been driven by companies' expectations, but their assessment of current conditions has also risen. On the other hand, the purchasing managers' index (PMI) is at a relatively low level and has also fallen in recent months. Such large differences between the NIER Business Tendency Survey and the PMI are unusual, but a similar pattern is also evident in other European countries. In Germany, for example, the IFO business sentiment survey indicates a significantly strong trend than the PMI. One partial explanation is that the NIER and IFO surveys cover about five times as many companies as the respective PMIs and thus include more small businesses, which are mainly active in the domestic market. The divergence between these measures might reflect an unusually large difference between domestic and international demand. Historically, the PMI has tended to lead the NIER survey, although it has also been more volatile and thus provided misleading signals to a greater extent. It is possible that some of the companies in the NIER survey have not yet felt the impact of the deceleration, which indicates a risk of reversals in the next few months. Yet our main impression is still that on the whole, Swedish companies have weathered the recent slump relatively well and they are now in the process of ramping up their expectations for the second half of 2012.

Overall, we believe that **exports will stagnate this year, then increase by 3 per cent in 2013**. The high percentage of input and intermediate goods, which often fluctuate more during an economic cycle, is a risk factor. Exports to other European countries are largely concentrated in northern Europe, which is a favourable factor, along with the rising share of exports destined for emerging markets.



Industrial capital spending will level out

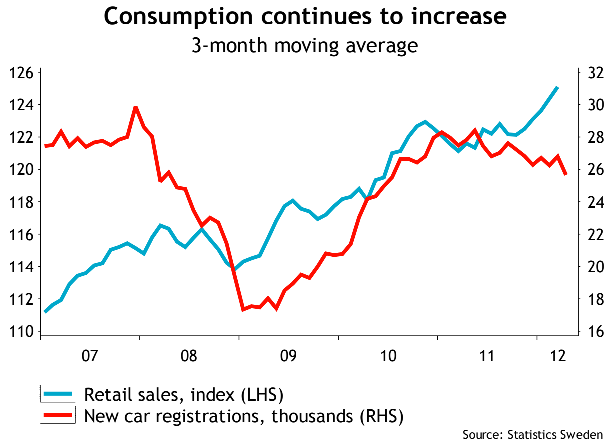
According to Statistics Sweden's February survey, industrial firms cut back their capital spending plans for 2012, although they still expect a slight upturn. In an environment dominated by shrinking demand and growing uncertainty, addition downward adjustments are likely to occur this year. But capital spending remains depressed after its sharp decline in 2009, making a renewed downturn unlikely. We thus expect industrial investments to level out this year.



We expect residential investments, which have climbed dramatically in recent years, to fall by 15 per cent this year. The number of housing starts has decreased significantly, and the previous abnormally high level of renovation investments will help intensify the decline, but after a very long period of low housing construction the downturn will be modest. Overall, this means that **fixed investments will be unchanged in 2012 and will increase by 3 per cent in 2013**.

Consumption holding up

Indicators are pointing towards a recovery in household consumption after a weak fourth quarter. Retail sentiment has recovered from very low levels, while household optimism has improved. Cyclically sensitive new car registrations have shown a stable trend in recent months, which is another indication that a downturn in consumption can be avoided.



Overall, **we expect consumption to increase by 1.5 per cent this year and 2.3 per cent in 2013**. Consumption is being sustained by rising incomes, mainly driven by real wages, but the Riksbank's interest rate cuts are also contributing. Household debt as a percentage of disposable income has climbed by more than 50 percentage points during the past decade, causing such international organisations as the IMF and the OECD to warn about this trend in increasingly sharp terms. However, lending to households has gradually decelerated in recent years. The rate of increase is now close to the level that is compatible with a constant ratio between debts and income.

Household income and consumption

Year-on-year percentage change

	2010	2011	2012	2013
Consumption	3.7	2.1	1.5	2.3
Income	1.2	3.3	2.3	2.4
Savings ratio, % of disp. income	8.5	9.7	10.2	10.3

Source: Statistics Sweden, SEB

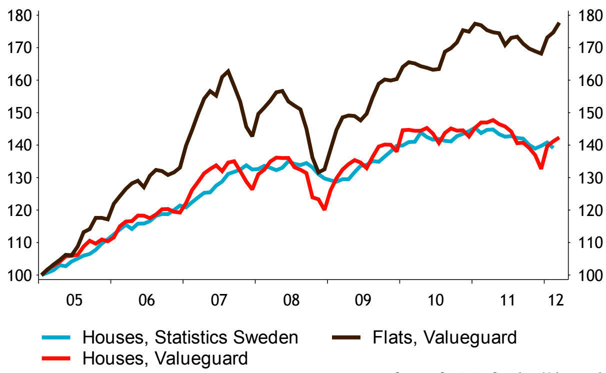
Stabilisation in the housing market

After a weak closing late last year, the housing market stabilised early in 2012, mainly due to lower interest rates and the stock market recovery. According to some measures, home prices have begun to climb again. Short-term indicators, among them SEB's home price indicator, show that prices may continue upward in the immediate future.

However, underlying factors point towards a weak trend a little further ahead. Changes in the rule system, aimed at eventually creating a more stable system, will moderate price increases in the next couple of years. This applies, for example, to requirements related to the structure of bank refinancing and the introduction of ceilings on the loan-to-value ratio. In addition, the supply of homes in the secondary market is clearly larger than normal, which will help push down prices in the medium term. We believe that prices will again decline as unemployment rises after this summer. We are thus sticking to our forecast of a **price downturn of 10-15 per cent compared to peak levels early in 2011**. Yet the rebound of recent months indicates that the risk of a deeper downturn, with serious negative contagious effects on the economy, has decreased.

Home prices

Index 100 = 2005



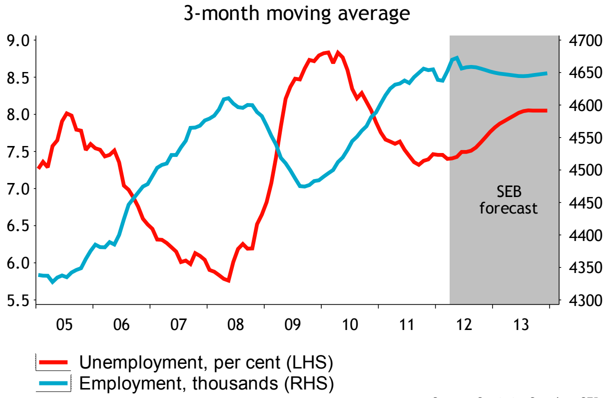
Source: Statistics Sweden, Valueguard

Jobless rate will start climbing after summer

So far, the labour market has shown resilience to the economic downturn. Employment seems to be continuing its slight upward trend, although unusually large fluctuations make it difficult to interpret. Short-term indicators, such as the number of newly registered job vacancies, the number of lay-off notices and company hiring plans according to the NIER survey, are at levels that point towards continued weak job growth. We thus believe that it will take another several months before weak GDP growth has an impact in the form of declining employment. We expect the **jobless rate to begin climbing after the summer, reaching just above 8 per cent in early 2013**.

Unemployment will gradually rise

3-month moving average



Source: Statistics Sweden, SEB

Labour market

Year-on-year percentage change

	2010	2011	2012	2013
Employment	1.0	2.1	0.3	-0.2
Labour supply	1.1	1.2	0.3	0.3
Unemployment, %	8.4	7.5	7.5	7.9
Average hours worked	1.5	0.2	0.2	0.0
Productivity, GDP	3.2	1.6	0.5	2.0

Source: Statistics Sweden, SEB

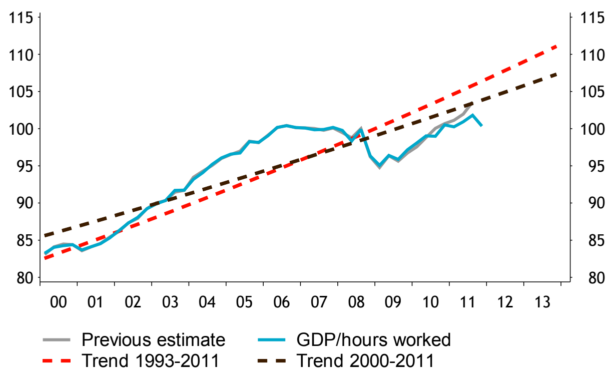
Falling trend growth in productivity

Productivity growth has been unexpectedly weak during the recovery of the past few years, especially considering its large downturn during the financial crisis. In the most recently published national accounts, employment measured in number of hours worked was revised upward by a further 1.5 per cent for the period 2010-2011, emphasising the picture of a weak productivity trend.

The new figures imply that trend growth in productivity since 2000 has been clearly lower than in the 1990s. Trend growth in productivity during 1993-2011 amounted to on average 2.2 per cent, but if we look only at the period 2000-2011 the figure is only 1.7 percent. One reason for the deceleration may be the structure of output. During a long period, exports and production increased in economic sectors with very rapid productivity growth, but also characterised by falling prices. In recent years, expansion has occurred to a greater extent in sectors with low productivity growth but with faster price increases in the world market. This situation is reflected, for example, in the fact that the trend towards deteriorating terms-of-trade in Swedish foreign trade has ceased.

Lower productivity growth last decade

Index 100 = 2007



Source: Statistics Sweden, SEB

Collective pay agreements falling into place

The industrial collective labour agreement reached last autumn pointed towards average pay increases of 2.5-3.0 per cent. During the past month, pay agreements in other sectors have begun falling into place, despite a bit more sabre-rattling than usual. Like the industrial pact, the agreements in retail and wholesale as well as in the construction sector ended up with average annualised wage and salary increases equivalent to 2.6 per cent. For many retail and wholesale sector employees, the pay increase will be higher than 2.6 per cent, but a lower increase in starting pay and more flexible working hours will nevertheless bring the estimated total cost of the agreement to the same level as the industrial agreement. Local government employees got an agreement of 3.0 per cent after a threat to go on strike, which was never executed. At present, negotiations are contentious in certain areas, but there are many indications that the current wage round can be completed without large-scale labour disputes. **Our forecast of pay increases averaging 3.5 per cent during 2012 still seems reasonable**, but the agreements that have now been reached will run for shorter periods than has been customary in the past two decades. Since the labour market will be weaker when the next wage round takes place, the total rate of pay increases is likely to fall somewhat in 2013.

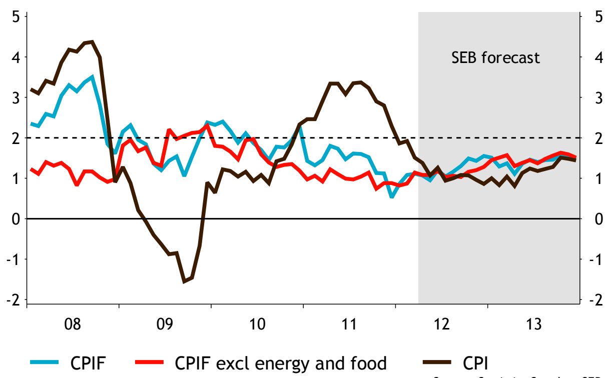
Dissatisfaction with the standard-setting role of the industrial agreement has nevertheless been manifested more clearly than usual elsewhere in the labour market. For example, unions representing retail and wholesale employees and construction workers – with support from the Swedish Trade Union Confederation (LO) at national level – have become more vocal in calling for changes in the system. This applies especially to their reactions to the National Mediation Office's strategy of adhering rather strictly to the levels that industrial unions and employer organisations had negotiated. Next year's wage round may thus be relatively difficult, despite a weaker labour market and although it will occur in an environment where the political blocks will probably be trying to position themselves on labour market issues in the run-up to the 2014 election.

Inflation below Riksbank target

Consumer Price Index (CPI) inflation has continued to fall rapidly. It amounted to 1.5 per cent in March. CPIF (excluding interest rate expenses) nevertheless climbed to 1.1 per cent in recent months, after having dipped to 0.5 per cent in December. The upturn in CPIF of recent months has mainly been driven by energy prices, but core inflation – which excludes such volatile components as energy and food – has also risen somewhat. The main factor behind the turnaround in core inflation is the reduction in the price squeeze from the earlier appreciation of the krona. This will probably push up inflation somewhat further in the next few months. Higher pay increases will also contribute some upward pressure. The reduction in restaurant value-added tax in January had a marginal impact: prices of restaurant services fell only one per cent, compared to a theoretical contribution of more than 10 per cent.

Inflation below 2 per cent

Year-on-year percentage change



Source: Statistics Sweden, SEB

Overall, **we expect CPIF inflation to climb to about 1.5 per cent and stay at this level during 2013**. In 2012 the Riksbank's interest rate cuts will cause the mortgage rate component to help bring CPI inflation below 1 per cent by mid-year.

Riksbank will resume rate cuts after all

The Riksbank left its key interest rate and its rate path completely unchanged in April. It is thus continuing to signal that lowering the refi rate to 1.5 per cent in February was the final step in its current rate-cutting cycle.

Even though our growth and inflation forecasts do not differ very much from those of the Riksbank, we believe that the key interest rate will be cut one more time. High unemployment and low inflation mean there is room for further loosening. An economic policy in which neither the Riksbank nor the government wishes to take advantage of this room will undoubtedly generate an intensive debate that will put great pressure on an already divided Executive Board. New waves of European market instability will probably appear during the next six months, adding to the reasons for the Riksbank to consider additional stimulus. The timing of further rate cuts will depend on incoming data. We believe that decent sentiment indicators and continued housing market resilience over the next several months will cause the Riksbank to hold back at its July meeting as well. Instead, **we view September as the most likely time for a rate cut to 1.25 per cent**. After that, we expect an unchanged repo rate until the end of 2013.

Continued low bond yields

Swedish 10-year sovereign bond yields are currently about 10 basis points above equivalent German yields. The Riksbank is maintaining a higher key interest rate than the ECB. This creates some upward pressure even for long-term Swedish bonds. Small supply and continued heavy international interest in bond investments with a safe AAA status nevertheless point towards continued downward pressure on long-term yields. We therefore expect Swedish 10-year bond yields to again fall below German ones in 2012, with a spread of –10 basis points towards year-end. During 2013, too, we believe that Swedish long-term yields will remain lower than German ones. The modest upturn in international yields that we predict will, however, mean that long-term Swedish yields will climb somewhat from today's record lows. At the end of 2013, the yield on 10-year Swedish sovereign bonds will be 2.45 per cent.

Narrow spread against Germany

Source: Reuters EcoWin

Continued krona appreciation

In the past quarter, the krona remained strong despite the gloomy economic picture and renewed international market worries. Because of Sweden's AAA credit rating, global currency reserve managers continue to seek krona-denominated investments as an alternative to more established reserve currencies. Yet the krona still tends to weaken somewhat in the most acute phases of financial instability. It thus still has quite a way to go before behaving like a pure "safe haven" currency that appreciates sharply at times of mounting international market turmoil. The shift in the krona's behaviour is clear, however, and we believe that the currency may continue to strengthen during the next six months, even in a situation of weak risk appetite and shaky economic conditions. Overall, **we expect the krona to appreciate to an EUR/SEK exchange rate of 8.70 in mid-2012 and further to 8.40 during 2013**. A stronger US dollar will initially cause the krona to weaken to a USD/SEK exchange rate of 6.81. At the end of 2013 USD/SEK is 7.00 according to our forecasts.

An even stronger krona in the future?

In the February issue of *Nordic Outlook*, we discussed the potential for Sweden to eventually be affected by the same type of problems that hard currency countries like Japan and Switzerland struggle with. Such a development would be driven by the long period of large current account surpluses, which would eventually begin to generate capital income sufficiently large to create a lasting trend towards a stronger krona. For example, if the EUR/SEK rate should move a bit below 8.00, this would create deflationary pressure that the Riksbank would have difficulty dealing with using conventional monetary policy. A stronger exchange rate also puts pressure on company profits, which in turn leads to lower pay increases. The central banks in Japan and Switzerland have repeatedly been forced to intervene to weaken their currencies and prevent export companies from suffering unreasonable pressure. The result in both Japan and Switzerland has been very low interest rates, with 10-year bond yields below 1 per cent. Such a development in Sweden would put insurance companies under heavy strain.

Small public sector deficits ahead

During 2010 and 2011, Sweden's general government finances have been largely in balance despite low resource utilisation in the economy. This reflects a surplus around 1 per cent of GDP in the structural balance. The economic slowdown is causing some weakening of public finances. We expect a **public deficit of 0.5 per cent of GDP in 2012 and 0.1 per cent in 2013**.

The central government borrowing requirement has shown large fluctuations during the crisis, both due to economic developments and cash transactions such as loans to the Riksbank and other countries. Due to the uncertain financial environment, we assume that the government will hold off on further divestments of state-owned shares in companies until after 2013. **The government's surplus will fall from SEK 68 billion in 2011 to balance in 2012. In 2013 there will be a small surplus of SEK 9 billion.**

Public finances
Per cent of GDP

	2010	2011	2012	2013
Net lending	-0.1	0.1	-0.5	-0.1
Gen. gov't gross debt	38.7	38.4	37.3	35.9
Central gov't debt (unconsol.)	35.7	33.1	32.4	31.2
Borrowing req., SEK bn	1	-68	0	-9

Source: Statistics Sweden, SEB

Given a marginal deficit combined with growth that will approach trend level in 2013, both central and general government debt will fall as a percentage of GDP, though at a slow pace. **Gross general government debt will reach 35.9 per cent of GDP and central government debt 31.2 per cent of GDP at the end of 2013**. This is low, both in a historical and global perspective.

We expect no major changes in fiscal policy strategy in the autumn's budget bill for 2013, but the finance minister will open his wallet a bit and provide SEK 15 billion worth of new stimulus measures. This means that **fiscal policy will become more expansionary, increasing from 0.1 per cent of GDP in 2012 to 0.3 per cent in 2013**. The reforms will be evenly divided between expenditure and revenue increases. The consequences of such a cautious policy are discussed in the Theme box on the next page.

High unemployment will mean policy tensions

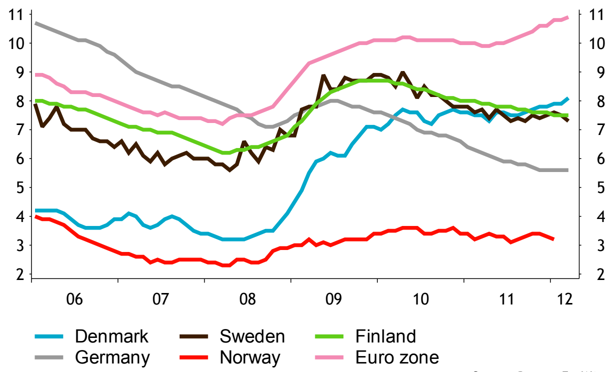
- **Higher unemployment in 2013 than in 2006**
- **Supply-side measures not tested due to low demand**

The Riksbank's decision to leave its key interest rate unchanged, combined with the cautious strategy of the spring fiscal policy bill, has raised the temperature of the economic policy debate. So far, the government's economic policy has been successful in many ways. Despite an international debt crisis and increased mistrust of sovereign borrowing, low Swedish debt has ensured low government bond yields. Still, labour market developments in the next couple of years will likely determine the outcome of the 2014 parliamentary election. The "work principle", with its efforts to boost incentives to work, has been at the core of the Alliance government's economic policy since 2006. If the government cannot demonstrate clear results from this policy, the political price will probably be high. In particular, comparisons with other countries with different economic policy strategies may be important.

To date, unemployment in Sweden has fallen about halfway compared to its upturn during the 2008-2009 crisis, but our forecast implies that by the end of 2013, it will climb to a level somewhat higher than when the government took power in autumn 2006. The jobless rate today is similar to that of Finland and Denmark, but far above that of Norway. In a wider European perspective, Sweden has done far better than the euro zone average but cannot match Germany's performance.

Unemployment

Per cent



Source: Reuters EcoWin

The comparison in the chart is based on Eurostat's harmonised definitions, yet it is hard to directly compare levels in different countries, since labour market structures are different. For example, one important reason why Sweden's unemployment level is higher than Germany's is differences in the labour market situation of young people. For years, registered unemployment among people under age 25 has exceeded 20 per cent in Sweden, while in Germany the figure has fallen from 14 per cent in 2006 to 8 per cent today. However, nearly half of Swedish youth unemployment consists of full-time students, usually applying for short-term, evening or weekend jobs. Relatively large number of students in Sweden thus exaggerates the unemployment figure compared to other countries. If we measure unemployment in the 25-74 age category, unemployment is somewhat lower in Sweden than in Germany.

It is also important to expand this analysis to employment as a whole. In many cases, government reforms have aimed at increasing labour supply, which in the short term may contribute to higher unemployment. The employment trend has been relatively favourable in recent years and labour market participation in Sweden is 2-3 percentage points higher (ages 16-64) than in neighbouring countries, except in Norway. But even taking in account these positive circumstances, Swedish unemployment seems high, given the efforts undertaken. Only a year ago, there was an intensive debate about the equilibrium unemployment level. The Finance Ministry presented studies pointing at 5 per cent, and its view was supported by Riksbank Executive Board member Lars E O Svensson, for example. Other observers, such as the National Institute of Economic Research, SEB and probably a majority of the Riksbank's Executive Board, made more cautious estimates in the 6.5 per cent range.

In the current situation, with unemployment moving up towards 8 per cent, it is clear that both structural and cyclical measures are needed. The government has already taken major steps to make it easier for the foreign-born to enter the labour market. It could undoubtedly do more in this area, but also to make it easier for young people to get established in the labour market. Yet the lack of demand-side programme seems to be the most obvious reason why unemployment remains high.

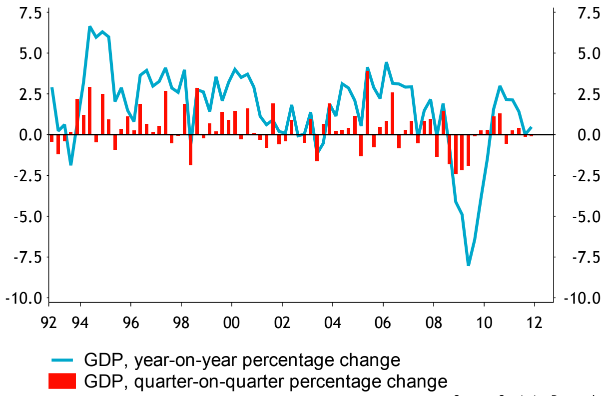
The Riksbank normally bears the main responsibility for keeping general demand at a suitable level. In the current situation, with a low key interest rate and a risk that further rate cuts might inflate a housing bubble, the responsibility nevertheless falls rather heavily on the government. Given good conditions provided by the public sector financial situation, there should be room for fiscal measures that boost demand in the economy in the short term while strengthening Sweden's competitiveness in the longer term. Unless more powerful demand-stimulating measures are implemented, we are likely to end up in the paradoxical situation that the government will have carried out a variety of sometimes painful, controversial supply-side measures whose effectiveness will not even get a chance to be thoroughly tested. To some extent, this resembles the situation in 1991-94, when the non-socialist government's structural changes were unable to make a difference in an environment of free-falling demand. If there is anything we think the government wants to avoid, it is a repetition of that experience.

Low but positive growth in 2012

- **Fiscal stimulus main economic driver**
- **Housing market under renewed pressure as private deleveraging continues**
- **Public deficits smaller than projected earlier**

The Danish economy muddled through 2011 with tepid growth, mainly driven by exports. Following last summer's bout of uncertainty, the **last two quarters showed marginally negative GDP growth**, with public consumption being the largest negative factor.

Public consumption drag on GDP growth



Source: Statistics Denmark

Manufacturing indicators and actual activity picked up towards the turn of the year. However, the latest observations show waning momentum in line with the global tendency. The medium-term outlook is still characterised by great uncertainty. We expect **growth to be 0.5 per cent in 2012 as fiscal stimulus takes over as the main growth driver – and a sluggish recovery to 1.4 per cent in 2013.** These estimates have not changed since *Nordic Outlook* in February.

Weakening momentum in manufacturing production

Percentage change, 3-month moving average

Source: Statistics Denmark

Hiring and investments stalling

After proving resilient for most of last year, the unemployment rate started to rise towards the end of 2011 and reached 4.3 per cent in March. The near term growth outlook suggests that unemployment is likely to inch up further.

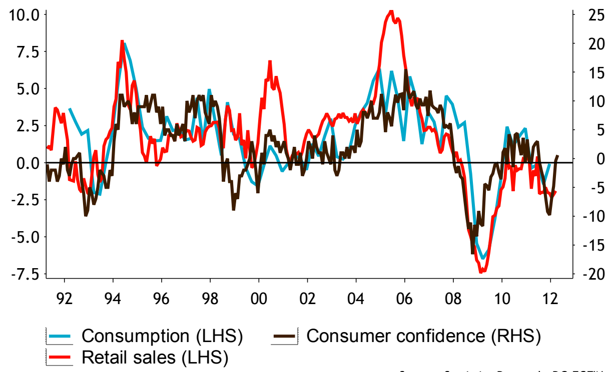
Companies scaled back capital spending in the final quarter of 2011 and are likely to be in a wait-and-see stance until the visibility improves. As the turnover in housing is low, residential investments have also stalled after a brief (but powerful) revival during 2011. Capacity utilisation suggests that capital spending will pick up if growth prospects improve. Public investments will create a cushion in 2012.

Consumers less pessimistic

The fourth quarter saw a **jump in private consumption**, possibly due to pent-up demand. Early in 2012 there has been a significant recovery in consumer confidence from a depressed level, and retail sales have also improved somewhat.

Improved but still low consumer confidence

Year-on-year percentage change, net balance



Source: Statistics Denmark, DG ECFIN

However, consumers still face headwinds preventing a major recovery. Unemployment is likely to rise and centralised wage talks entrench negative real pay growth. The **housing market is under renewed pressure**, weighed by uncertainty about future taxation while mortgage institutions are raising fees and phasing in more restrictions on variable mortgages without principal payments. The resumed slide in home prices and low turnover coincide with a pick-up in forced sales of property.

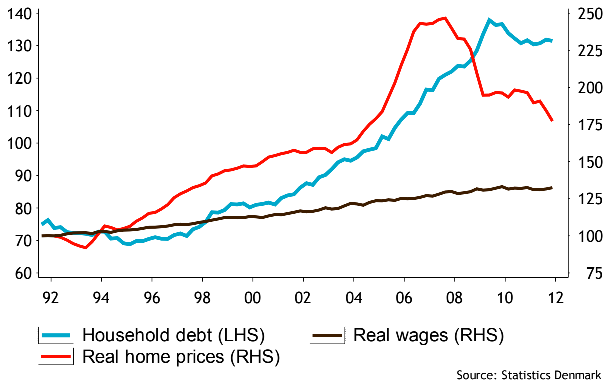
However, rock bottom mortgage rates and a one-off transfer from a pension reform offer counterbalancing factors and we expect positive, but small, consumption growth in 2012.

Private deleveraging continues

High **household debt levels and falling home prices continue to provide significant growth headwinds** as consumers pay back loans and the banking sector continues to be challenged by losses related to the bursting of the housing and farmland bubbles. The private debt to GDP level is elevated; deleveraging has significantly further to run, particularly as home prices continue to correct.

Continued deleveraging

Per cent of GDP, index 1992 = 100



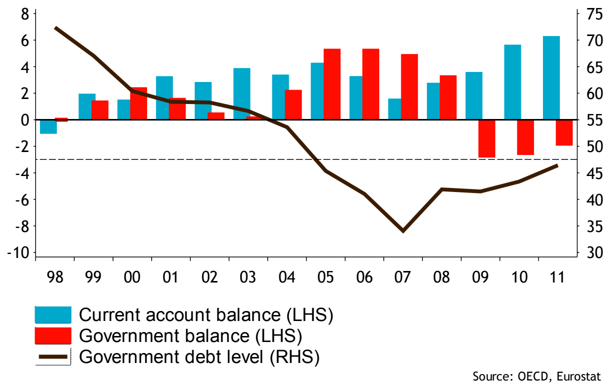
Policymakers launched a fifth bank package that lifted bad loans off the balance sheet of large corporate lender FIH and intends to extend credit to financially viable farmers and companies. There has been **further consolidation in the banking sector** and incentives offered in bank package 4 have merged bad banks before damaging failures materialised. Further consolidation in banking can be expected as the housing market remains under pressure, deleveraging continues and the financial regulators introduce accounting practices likely to force write-downs on property at some banks.

Major downward revisions in public deficit

The government has announced that the **public sector deficit for 2011 was half the December projection** due to higher than expected revenue from taxes on pension capital gains. At 1.9 per cent of GDP, the deficit is now comfortably within the EU threshold of 3 per cent.

High CA surplus and lower than expected deficit

Per cent of GDP

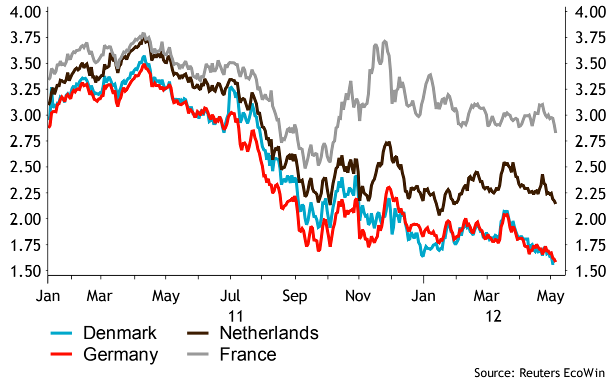


The deficit is forecast to rise to 4.1 per cent of GDP in 2012 due to expansionary policies. We expect a lower deficit as it has become **a recurrent theme that deficits end up significantly lower than forecast**. In 2010 the deficit was also revised lower and in retrospect the EU review should not have been initiated calling into question the need for public austerity in 2011. The revisions also remove the main argument for the relative muted fiscal expansion that the new government enacted when taking office.

The government has pre-funded most of next year's financing needs. Its liquidity totals 12 per cent of GDP or a quarter of official gross debt of 47 per cent of GDP. The official reason is to remain liquid in light of the uncertain debt markets. For the same reason, debt duration averages a fairly high 10 years. This high liquidity also means there is a sizeable war chest to handle fall-out that might appear in the banking sector. Danish government debt has fared well in the past year of turbulence with yields tracking Germany, significantly below other euro zone members. The Danish central bank has maintained a negative repo rate spread of 30 basis points to ECB.

10-year government yields in line with Germany

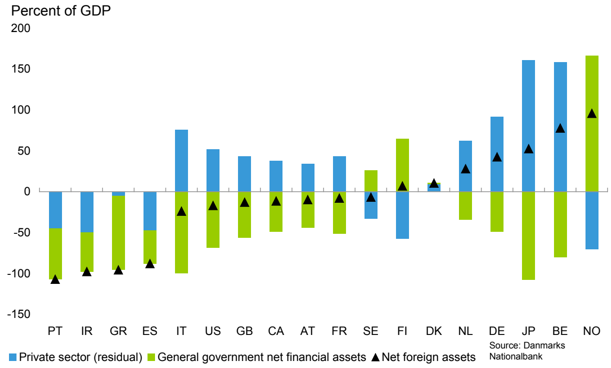
Per cent



Strong external balances

Net foreign wealth continues to rise due to large current account surplus. The private sector's net financial wealth is positive due to pension savings, and the public sector has financial assets that more or less match its liabilities; the latter phenomenon sets the Nordic countries apart from peers. Hence, Denmark is well positioned to deal with deleveraging as **the debt problem is mainly one of internal re-distribution.**

Private and public net wealth, 2010



Large, chronic current account imbalances are incompatible 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. Given the moderate expansionary fiscal policy currently planned, growth will remain positive but below trend in 2012.

Solid fundamentals are paying off

- **Growth to be stronger in 2012**
- **Wage growth will fail to moderate**
- **Norges Bank will stay on course**

The Norwegian economy has so far been largely unaffected by the global slowdown. Sequential growth did slow in late 2011 but seemingly reaccelerated in early 2012 as solid domestic demand more than made up for the chilly headwinds from abroad. With strong labour markets and income growth, private consumption was very solid at the start of the year. In addition, surging petroleum-related investment is stimulating parts of the manufacturing sector, while others are struggling with weaker export demand.

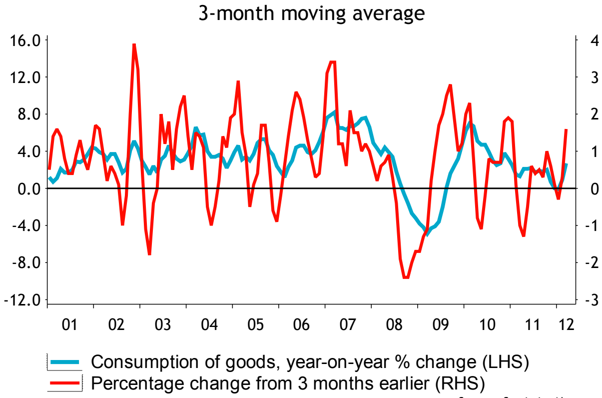
Relative to February's *Nordic Outlook*, we **are raising our forecast for overall GDP growth in 2012 to 2.3 per cent** (from 2.1 per cent) and foresee further acceleration to 2.6 per cent in 2013. Excluding oil/gas and shipping, **mainland GDP will climb by 2.7 per cent in the current yea**r (revised from 2.3 per cent) and by an even stronger **3.1 per cent in 2013**.

Consumption started 2012 with a bang

Private consumption growth in 2011 lagged well behind what accelerating employment growth and solid gains in real wages suggested. For the third time in four years, consumption thus trailed real disposable income by a wide margin, lifting the household savings ratio above 9 per cent at year-end, far above the long-term norm.

Consumption reflects strong fundamentals

3-month moving average



Source: Statistics Norway

In early 2012, however, consumption again started reflecting the upturn in consumer confidence and the firmness suggested by fundamentals. Private consumption of goods – almost half the total – rebounded sharply in the first quarter, rising a very solid 1.6 per cent from the final quarter of 2011, while non-auto retail sales showed the sharpest quarterly gain in five years. Although a moderation is looming, there is no mistaking the more solid underlying trend. We have lifted the forecast for **growth in overall private consumption to 3.1 per cent in 2012** and to **3.4 per cent in 2013**.

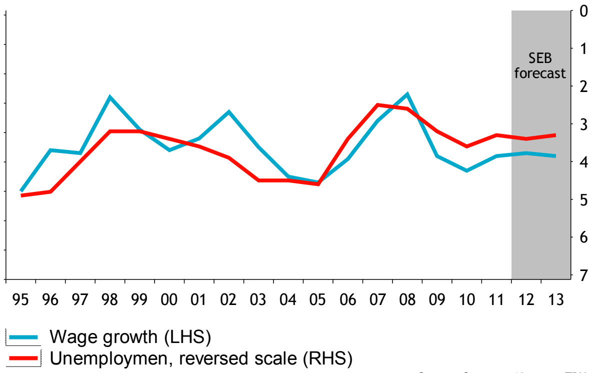
Risks to the forecast still seem tilted to the upside, since growth in real household disposable income in 2012 should match last year's 4.0 per cent gain. Employment growth is bound to slow from its hectic 2.3 per cent pace in the year to the first quarter, but wage and salary growth is holding up and overall inflation should be only slightly higher on average in 2012.

Wage growth will stay high

The wage round recently concluded in the private sector throws into doubt whether overall wage growth will moderate in 2012 as previously expected, if at all.

Tight labour markets support wage growth

Year-on-year pecentage change, per cent



Source: Statistics Norway, TBU

In April the trend-setting negotiations for blue-collar workers in manufacturing settled for an agreement lifting wages and salaries by an average of 2.15 per cent in 2012, including the carry-over effect from 2011. On top comes wage drift (local pay) which added 2.2 percentage points on average in 2007-11 but might moderate this year. This is because some export-related companies are struggling, although suppliers to the offshore oil and gas sector in particular are enjoying boom-like conditions. Wage growth for blue-collar workers in manufacturing should thus end up at some 4 per cent in 2012, slowing from 4.4 per cent in 2011 (when the central agreement assumed pay increases of 3.6-3.7 per cent), but pay hikes for white-collar employees in manufacturing (40 per cent of the sector's workforce) should remain stronger.

Wage inflation for other blue-collar workers in the private sector should be somewhat slower than in manufacturing, but most likely not in the dominant public sector. Here, wage growth has lagged the manufacturing sector, where actual pay increases have been higher than agreed in the central negotiations and assumed by public sector negotiators. Public sector unions are thus eager to close the gap (more so since their members have lagged even further behind white-collar employees in manufacturing).

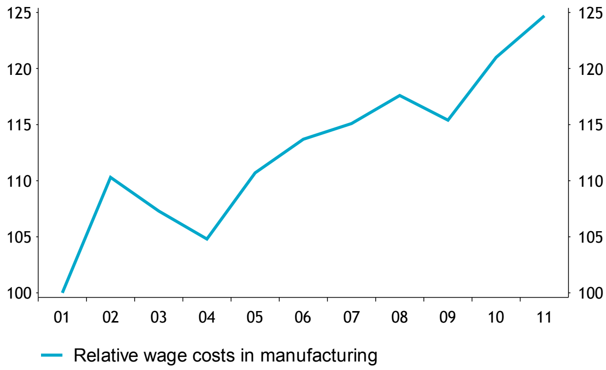
We expect overall **wage growth in 2012 to be similar to the 4.2 per cent increase in 2011** and thus well above Norges Bank's forecast.

Manufacturing is regaining strength

Conflicting forces are creating a mixed outlook for manufacturing. Exporters face weakness at major export markets and a further loss of competitiveness due to excessive wage growth Meanwhile solid domestic demand, especially the petroleum sector investment boom, is stimulating other parts of the manufacturing sector.

Competitiveness continues to deteriorate

Index 2001 = 100

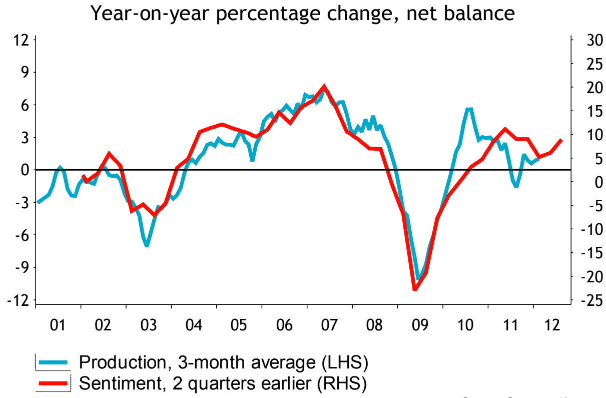


Source: TBU, SEB

According to Statistics Norway's most recent survey, oil companies operating on the Norwegian continental shelf are planning to invest 27.2 per cent more in oil and gas extraction and pipeline transportation this year than their reported figure for 2011, which showed a strong 16.6 per cent increase. Rising cost inflation will blunt this gain in volume terms, but it will be very strong nonetheless. Capacity constraints are building, making it unlikely that all planned capital spending will be realised in 2012, thus suggesting solid growth in 2013 as well.

Manufacturers foresee firmer activity

Year-on-year percentage change, net balance



Source: Statistics Norway

Strong demand from the offshore sector is one important reason for the improving manufacturing sector surveys. Following an exaggerated spurt in early 2012 to a 53-month (!) high in March, the purchasing managers' index (PMI) corrected markedly downward in April, although its level of 53.7 is still consistent with firmer activity. The Business Tendency Survey for the first quarter sends the same message, with an increase in the manufacturing sentiment indicator from 6.1 to 8.9, comfortably above the long-term average and consistent with accelerating production growth, measured year-on-year.

Overall manufacturing orders continued rising in early 2012, and manufacturers in general have become more optimistic about the near-term outlook. This overall optimism masks divergences, however. Export orders apparently continued contracting in the first quarter, impacting intermediate goods manufacturers that are export-oriented, in particular producers of basic chemicals, metals and paper products (three sub-sectors where actual production in early 2012 was well below the year-earlier level).

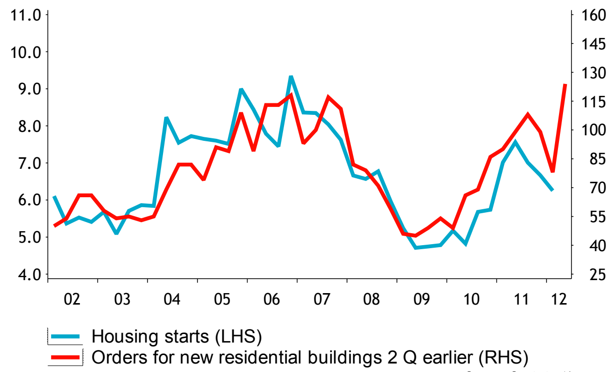
Consumer goods producers are faring better, while the capital goods sector remains the strongest. Here, production is on the rise in response to orders from the domestic market, in part reflecting booming petroleum investment. In addition, manufacturers of capital goods foresee rising investments ahead, as activity continues to rise so fast that shortages of available skilled workers are again putting a lid on activity.

Housing market will remain strong

Surging residential investment added a full percentage point to GDP growth in 2011. However, housing starts tapered off in the second half and in early 2012, which was surprising since starts remain well below what demographics suggest. Population growth was record-strong in 2011 and should accelerate in 2012 and the next few years, partly because net immigration remains high.

Surging orders suggest a sharp rebound

Thousands, index



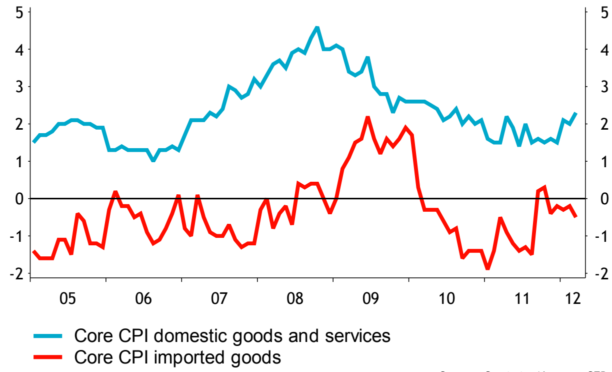
Source: Statistics Norway

Housing starts should thus reaccelerate strongly, as suggested by sharply higher orders in late 2011. In addition, while we are still wary about excessive home prices in the longer term, the persistent imbalance between supply and demand as housing completions continue to lag household formation should continue putting a floor under prices in the medium term.

Domestic inflation pressure is building

Overall CPI inflation remained low in the first quarter, reflecting sharply lower electricity prices than a year earlier. However, core inflation as measured by the CPI-ATE index – excluding taxes and energy – has trended higher, though still remaining well below Norges Bank's 2.5 per cent medium term target. (Note that a very strong base effect from surging airfares a year earlier likely dented core inflation quite markedly in April).

Domestic inflation has slowed
Year-on-year percentage change



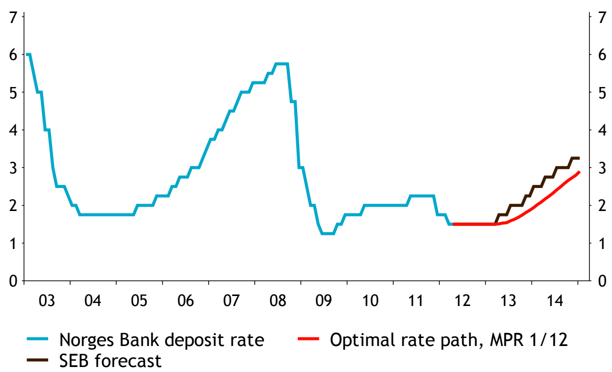
Source: Statistics Norway, SEB

Earlier appreciation in the NOK exchange rate should continue to blunt import prices and core inflation (since imported goods make up 28 per cent of the core CPI basket). However, in addition to the upward turn in food prices already seen, the very tight housing market suggests higher rents. More generally, an output gap-based analysis strongly hints of rising inflationary pressure. While the uptrend should be moderate, core inflation should lift by about ½ percentage point to 1.5 per cent in 2012, then to 1.9 per cent in 2013.

Norges Bank will stay on course

Firm domestic-led growth, tight labour markets, unexpectedly high wage growth and elevated home prices indicate that Norges Bank should start lifting its foot from the accelerator. Instead, the bank again surprised observers by cutting its key deposit rate 25 basis points to 1.50 per cent in March after its deeper-than-expected 50 bp cut last December, noting “weak growth prospects abroad” and excessively low inflation due to the stronger NOK. In addition, the optimal rate path was slashed 127 bps on average for next two years in the March *Monetary Policy Report*, implying unchanged key interest rates until late next summer and a deposit rate of 2.00 per cent by end-2013 and 2.75-3.00 per cent by end-2014.

Norges Bank to start hiking in early 2013
Per cent



Source: Norges Bank, SEB

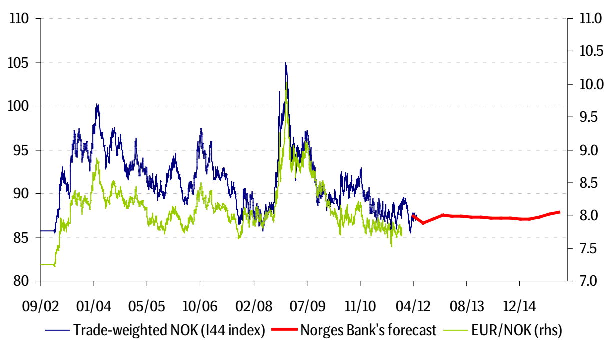
Norges Bank is certainly giving the impression that it is focusing almost solely on keeping a lid on the exchange rate. As such, the bank’s recent actions have been unsuccessful. The NOK is stronger against the EUR and a trade-weighted index than before the December rate cut, which is really not surprising. Considering that Norway is further along in the economic cycle than its peers, with healthy growth and a closed output gap, the expectation has been and still is that Norges Bank will start rate hiking well ahead of others. To the extent that key rates are seen as too low relative to what domestic fundamentals suggest, rate cuts might only fuel expectations that the bank will start hiking sooner than later.

The May 10 monetary policy meeting is probably too soon for Norges Bank to signal any change. Its concern for the NOK is likely to remain foremost until there are stronger signs of global recovery. However, the bank should rethink its strategy in the next *MPR* due on June 20. We do not expect the bank to make a full U-turn at that time by signalling higher policy rates soon. However, **absent a marked change to the outlook, a hike should come early next spring at the latest**. We expect the deposit rate to end 2013 at 2.50 per cent, or 50 bps higher than the current rate path suggests, and rise to 3.25 per cent by end-2014.

Norwegian assets still attractive

Superior fundamentals and relative interest rate expectations continue to push up the NOK. Speculations of foreign exchange (FX) interventions from Norges Bank are exaggerated, since the trade-weighted index is in line with the bank’s forecast. In addition, markedly higher FX purchases in the second half of 2012 on behalf of the Government Pension Fund Global will weigh on the currency. The flow outlook should improve in 2013. Combined with higher key rates, the trade-weighted NOK should resume appreciating: we forecast a EUR/NOK exchange rate of 7.35 and a USD/NOK rate of 6.13 by end-2013.

Norges Bank forecasts trade-weighted NOK to remain strong



Norwegian government bonds are still attractive from a capital preservation perspective. With almost half of estimated 2012 supply behind us, we see potential for tighter spreads vs. Germany from close to year highs. Further ahead, a wider key rate spread to the ECB should put some upside pressure on Norwegian yields. Although global reserve managers will likely continue to diversify into Norwegian assets, a substantial yield pick-up is to be found in other triple-A rated bonds, which could add upside pressure on Norwegian yields. We forecast the 10y spread vs. Germany will tighten to 40 bps by year-end before widening to 70 bps by end-2013, resulting in a 10y yield of 2.60 per cent at end-2012 and 3.20 per cent at end-2013.

Slowdown despite domestic resilience

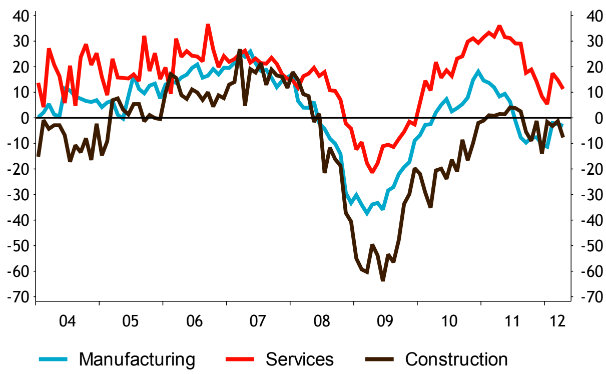
- **Big slump for cyclically sensitive exports**
- **Consumption will sustain GDP growth**
- **Low government debt will keep yield spread to Germany narrow**

During the past few quarters, Finnish economic performance has remained shaky. The international deceleration has hampered the country's cyclically sensitive economy. Exports weakened late in 2011, and GDP growth measured quarter-on-quarter was weak virtually throughout the year. So far this year, corporate surveys have signalled persistent weakness in manufacturing, although the labour market has continued its favourable trend. Meanwhile relatively high inflation has held back real wage increases. Yet consumption is holding up, and altogether we believe that **GDP will grow by 0.7 per cent in 2012 and by 1.7 per cent in 2013.** This implies a slight upward revision compared to *Nordic Outlook* in February.

The poorer global outlook has affected the mood at companies since last autumn, although the outlook has stabilised in recent months according to the European Commission's sentiment survey and other indicators. Finland's export-heavy manufacturing sector remains more pessimistic than the service sector. According to one Statistics Finland survey, there is increased pessimism both with regard to capital spending and the order situation; here, too, the downturn is clearest in manufacturing.

Indicators have stabilised

European Commission survey, net balances



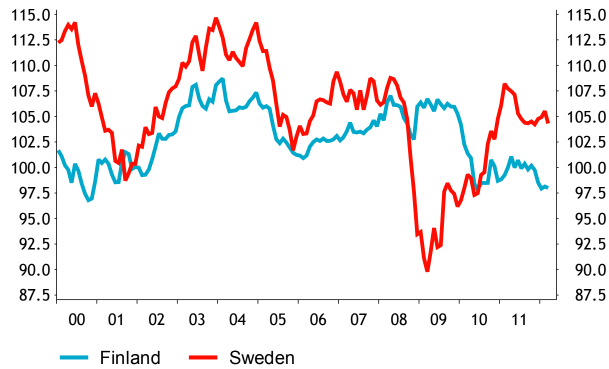
Source: DG ECFIN

Compared to countries like Sweden, Denmark and Germany, Finnish exports are less differentiated, with a clear focus on intermediate goods. This is one reason why Finland is extra hard hit by international cyclical fluctuations. This pattern was clear in 2009 and it has been repeated to some extent in recent quarters. The export slump of recent months has been especially apparent in such product categories as paper, machinery and electronics. The performance of the information and communications technology (ICT) sector has had a major impact on Finnish GDP growth. According to OECD estimates, this sector provided a positive GDP contribution of 1.3 percentage points annually between 2000 and early 2008; since then its contribution has average -1.0 points. Although the sector has recovered somewhat, not much of its nearly 50 per cent decline in value added has been regained. The negative trend for Nokia has continued. The company has repeatedly cut jobs in recent years, affecting Finnish units especially hard; the share of employees in Finland has fallen from over a third in 2005 to fewer than 15 per cent in 2011.

The cost situation compared to Sweden is of great importance, since the two countries compete in the world market in several key areas. Currency movements play an extra large role for forest products. The real effective exchange rate indicates that Sweden's competitiveness improved right after the Lehman Brothers crash, which partly explains Finland's sharp export decline. Since then Finnish industry has again improved its competitiveness, among other things because the euro zone crisis has contributed to a weakening trend for the euro against the Swedish krona. In exchange rate terms, Finland now has a better competitive situation than before the crisis.

Improved competetiveness

Real effective exchange rate, index 100 = 2005



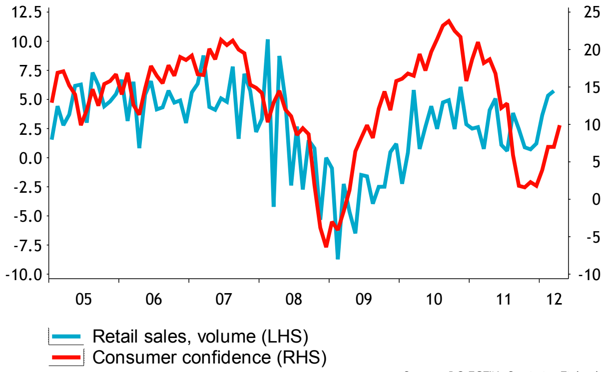
Source: BIS

Increased residential construction contributed to an upturn in capital spending last year. Fixed investment activity is now about to slow, according to forward-looking surveys, especially in the corporate sector. Capacity utilisation has risen in manufacturing but remains a bit below its pre-crisis level, reducing the need for capital spending in the near future. Overall, **we expect capital spending to remain unchanged in volume this year and then increase by 4 per cent in 2013**.

So far, the economic slowdown has not affected household confidence. Labour market expectations instead gradually improved during the first quarter of 2012. Meanwhile consumer confidence has recovered after a sharp decline during 2011, probably bolstered by receding worries about a deep recession like that of 2008-2009. These stable expectations are also reflected in actual consumer behaviour. Retail sales volume rose by about 5 per cent year-on-year, while new car sales increased sharply. Because of relatively high savings at the outset, combined with various real income increases in the near future, we expect household consumption to help stabilise the economy when international demand is weak. Overall, we predict that **household consumption expenditures will increase by 2 per cent annually in 2012 and 2013.**

Improved consumer confidence and higher retail sales

Year-on-year percentage change, net balance

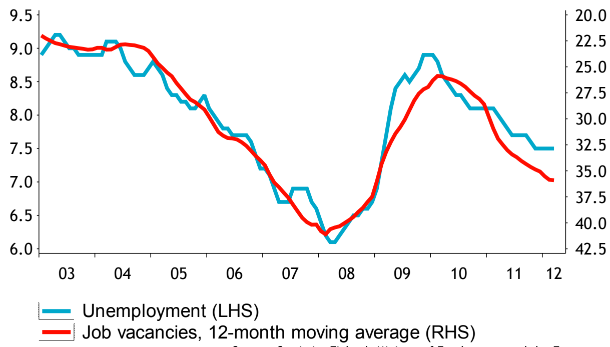


Source: DG ECFIN, Statistics Finland

Finland's weak economic growth has not yet affected the labour market. In February unemployment fell marginally to 7.4 per cent, after have stood still for three straight months. Employment has also shown resilience, and the rising number of job vacancies promises a stable trend in the immediate future. Job growth in manufacturing has shown a shaky trend, however. Looking ahead, we expect the slowdown to have a greater impact on the labour market. We expect the jobless rate to start climbing only after the summer, but **measured as an annual average, unemployment will fall marginally to 7.7 per cent in 2012**.

More job vacancies - unemployment will not increase until after the summer

Per cent, thousands

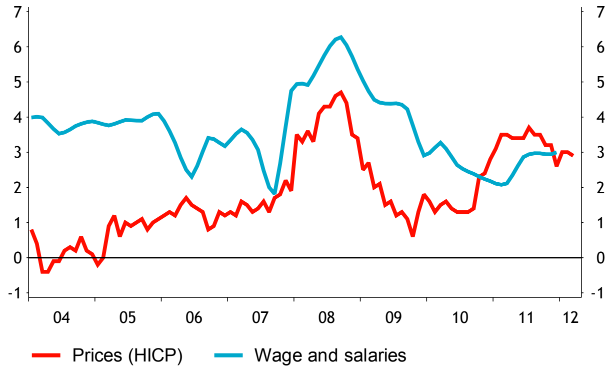


Source: Statistics Finland, Ministry of Employment and the Economy

After peaking in July 2011, employment fell during the second half. In January, HICP inflation rebounded somewhat to 3 per cent and has remained unchanged in recent months. Excise tax and VAT hikes will push up inflation this year, while lower commodity prices will have the opposite effect. **HICP inflation will fall from an annual average of 3.3 per cent in 2011 to 2.3 per cent in 2012 and 1.9 per cent in 2013.** Pay increases have accelerated somewhat, after a sharp decline in 2008-2010. Given the labour market trend, with falling resource utilisation, we expect pay hikes to stabilise at around 3 per cent.

Weak real pay increases

Year-on-year percentage change

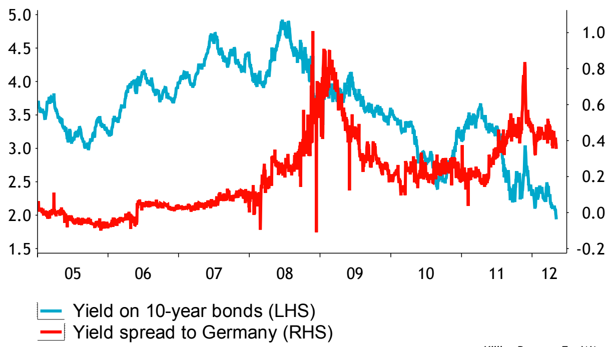


Source: Eurostat

A cyclically sensitive economy combined with a high tax ratio makes public sector finances vulnerable, but budget reform policies during previous crises have helped Finland avoid major austerity programmes in recent years. In spite of this, the general government budget deficit shrank from 2.5 per cent of GDP in 2010 to 0.5 per cent in 2011. Weak growth this year will put renewed pressure on public finances, and we expect the deficit to rise to 1 per cent of GDP. General government debt will level out at 50 per cent of GDP after having gradually climbed from about 35 per cent of GDP in 2008.

Low yields on sovereign debt but wider spread to Germany

Per cent, percentage points



Källa: Reuters EcoWin

Finland's relatively low government debt has been instrumental in avoiding contagion from the euro zone crisis, but yield spread to German 10-year bonds – which was negligible before the crisis – has widened. During 2010 the spread fluctuated between 15 and 30 basis points but in 2011 it rose to 40-50 points. Looking ahead, we expect the yield spread to remain at the same level and, if anything, to fall marginally.

DENMARK

Yearly change in per cent

	2011 level, DKK bn	2010	2011	2012	2013
Gross domestic product	1,786	1.3	1.0	0.5	1.4
Private consumption	868	1.9	-0.5	0.5	1.5
Public consumption	511	0.3	-1.0	0.5	0.0
Gross fixed investment	310	-3.7	0.4	2.0	3.0
Stockbuilding (change as % of GDP)		0.8	0.4	0.0	0.0
Exports	957	3.2	6.8	0.5	3.0
Imports	863	3.5	5.2	1.0	3.0
Unemployment (%)		4.2	4.1	4.5	4.2
Consumer prices, harmonised		2.2	2.5	2.1	1.5
Hourly wage increases		2.3	1.7	1.5	1.5
Current account, % of GDP		5.5	6.5	7.0	7.0
Public sector financial balance, % of GDP		-2.7	-1.9	-3.0	-1.5
Public sector debt, % of GDP		43.6	47.0	48.0	47.0

FINANCIAL FORECASTS	May 3rd	Sep 12	Dec 12	Jun 13	Dec 13
Lending rate	0.70	0.60	0.60	0.60	0.60
10-year bond yield	1.70	2.05	2.20	2.30	2.50
10-year spread to Germany, bp	9	5	0	0	0
USD/DKK	5.65	5.72	5.80	6.00	6.20
EUR/DKK	7.44	7.43	7.43	7.44	7.44

NORWAY

Yearly change in per cent

	2011 level, NOK bn	2010	2011	2012	2013
Gross domestic product	2,410	0.7	1.6	2.3	2.6
Gross domestic product (Mainland Norway)	1,960	1.9	2.6	2.7	3.1
Private consumption	1,089	3.7	2.2	3.1	3.4
Public consumption	548	1.7	1.5	2.3	2.4
Gross fixed investment	523	-5.2	6.9	6.7	5.7
Stockbuilding (change as % of GDP)		1.9	0.0	-0.9	-0.1
Exports	935	1.8	-1.1	0.5	1.8
Imports	744	9.9	2.5	1.4	4.7
Unemployment (%)		3.6	3.3	3.4	3.3
Consumer prices		2.5	1.2	1.4	2.0
CPI-ATE		1.4	0.9	1.5	1.9
Annual wage increases		3.7	4.2	4.3	4.2

FINANCIAL FORECASTS	May 3rd	Sep 12	Dec 12	Jun 13	Dec 13
Deposit rate	1.50	1.50	1.50	2.00	2.50
10-year bond yield	2.09	2.35	2.60	2.90	3.20
10-year spread to Germany, bp	48	35	40	60	70
USD/NOK	5.74	5.88	5.82	5.93	6.13
EUR/NOK	7.56	7.65	7.45	7.35	7.35

SWEDEN

Yearly change in per cent

	2011 level, SEK bn	2010	2011	2012	2013
Gross domestic product	3,495	6.1	3.9	0.7	1.9
Gross domestic product, working day adjusted		5.9	4.0	1.0	1.9
Private consumption	1,666	3.7	2.1	1.5	2.3
Public consumption	928	1.9	1.8	0.9	0.8
Gross fixed investment	640	7.7	5.8	0.0	3.0
Stockbuilding (change as % of GDP)	44	2.1	0.7	-0.7	0.0
Exports	1,748	11.7	6.8	0.2	3.3
Imports	1,530	12.7	6.1	-0.7	3.7
Unemployment (%)		8.4	7.5	7.5	7.9
Employment		1.0	2.1	0.3	-0.2
Industrial production		9.6	6.8	-0.5	2.5
Consumer prices		1.2	3.0	1.2	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 (%)		8.5	9.7	10.2	10.3
Real disposable income		1.2	3.3	2.3	2.4
Trade balance, % of GDP		2.5	2.6	2.7	2.9
Current account, % of GDP		6.8	7.2	6.8	6.3
Central government borrowing, SEK bn		1	-68	0	-9
Public sector financial balance, % of GDP		-0.1	0.1	-0.5	-0.1
Public sector debt, % of GDP		38.7	38.4	37.3	35.9

FINANCIAL FORECASTS	May 3rd	Sep 12	Dec 12	Jun 13	Dec 13
Repo rate	1.50	1.25	1.25	1.25	1.25
3-month interest rate, STIBOR	2.16	2.05	1.90	1.85	1.85
10-year bond yield	1.71	2.00	2.20	2.30	2.45
10-year spread to Germany, bp	10	0	0	0	-5
USD/SEK	6.75	6.65	6.64	6.81	7.00
EUR/SEK	8.88	8.65	8.50	8.45	8.40
TCW	122.7	119.7	118.0	118.1	118.0

FINLAND

Yearly change in per cent

	2011 level, EUR bn	2010	2011	2012	2013
Gross domestic product	188	3.7	2.9	0.7	1.7
Private consumption	105	3.0	3.3	2.0	2.0
Public consumption	46	0.2	0.8	0.3	0.3
Gross fixed investment	37	2.6	4.6	0.0	4.0
Stockbuilding (change as % of GDP)		1.1	0.4	0.1	0.0
Exports	75	7.8	-0.8	2.0	5.1
Imports	76	7.7	0.1	3.5	6.2
Unemployment (%)		8.4	7.8	7.7	8.0
Consumer prices, harmonised		1.7	3.3	2.3	1.9
Hourly wage increases		2.6	2.4	2.9	3.0
Current account, % of GDP		1.4	-0.7	2.0	2.0
Public sector financial balance, % of GDP		-2.5	-0.5	-1.0	-0.5
Public sector debt, % of GDP		48.4	48.6	49.0	49.0

EURO ZONE

Yearly change in per cent

	2011 level, EUR bn	2010	2011	2012	2013
Gross domestic product	9,414	1.9	1.5	-0.6	0.8
Private consumption	5,403	0.9	0.2	-1.1	-0.1
Public consumption	2,031	0.5	0.0	-0.6	0.0
Gross fixed investment	1,807	-0.7	1.5	-1.3	1.7
Stockbuilding (change as % of GDP)		0.6	0.1	-0.2	0.0
Exports	4,121	11.1	6.3	2.7	3.9
Imports	3,989	9.4	3.9	1.4	3.1
Unemployment (%)		10.1	10.1	11.1	11.7
Consumer prices		1.6	2.7	2.4	1.4
Household savings ratio (%)		9.6	9.3	9.1	9.2

US

Yearly change in per cent

	2011 level, USD bn	2010	2011	2012	2013
Gross domestic product	15,319	3.0	1.7	2.5	2.7
Private consumption	10,872	2.0	2.2	2.2	2.3
Public consumption	3,022	0.7	-2.1	-1.7	-0.8
Gross fixed investment	2,010	2.6	6.8	7.4	8.6
Stockbuilding (change as % of GDP)		1.6	-0.2	0.3	0.1
Exports	2,113	11.3	6.7	4.4	5.4
Imports	2,697	12.5	4.9	3.6	5.0
Unemployment (%)		9.6	9.0	8.2	7.9
Consumer prices		1.6	3.1	2.2	1.4
Household savings ratio (%)		5.3	4.7	4.2	5.1

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2010	2011	2012	2013
GDP				
United Kingdom	2,1	0,7	0,5	1,7
Japan	4.5	-0.7	2.2	1.7
Germany	3.7	3.0	0.8	1.6
France	1.4	1.7	-0.1	0.8
Italy	1.8	0.5	-1.9	0.2
Inflation				
United Kingdom	3.3	4.5	2.7	1.6
Japan	-0.6	-0.2	-0.1	0.2
Germany	1.2	2.5	2.0	1.8
France	1.7	2.3	2.0	1.7
Italy	1.6	2.9	2.8	2.2
Unemployment (%)				
United Kingdom	7.9	8.0	8.5	8.6
Japan	5.1	4.5	4.4	4.1
Germany	7.7	7.1	5.8	6.1
France	9.8	9.7	10.3	11.1
Italy	8.4	9.4	10.0	11.2

EASTERN EUROPE

	2010	2011	2012	2013
GDP, yearly change in per cent				
Estonia	2.3	7.6	1.5	2.5
Latvia	-0.3	5.5	2.5	4.0
Lithuania	1.4	5.9	3.0	3.5
Poland	3.9	4.3	3.3	3.6
Russia	4.0	4.3	3.8	4.1
Ukraine	4.2	5.2	3.2	4.2
Inflation, yearly change in per cent				
Estonia	2.7	5.1	4.0	5.0
Latvia	-1.2	4.2	2.5	2.1
Lithuania	1.2	4.1	2.5	3.0
Poland	2.7	3.9	3.8	2.8
Russia	6.9	8.5	5.0	6.0
Ukraine	9.4	8.0	7.0	8.0

FINANCIAL FORECASTS

		May 3 rd	Sep 12	Dec 12	Jun 13	Dec 13
Official interest rates						
US	Fed funds	0.25	0.25	0.25	0.25	0.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	1.00	1.00	1.00	1.00	1.00
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50
Bond yields						
US	10 years	1.93	2.20	2.40	2.50	2.60
Japan	10 years	0.90	1.00	1.10	1.20	1.20
Germany	10 years	1.61	2.00	2.20	2.30	2.50
United Kingdom	10 years	2.04	2.40	2.60	2.70	2.90
Exchange rates						
USD/JPY		80	83	85	90	94
EUR/USD		1.32	1.30	1.28	1.24	1.20
EUR/JPY		105	108	109	112	113
GBP/USD		1.62	1.63	1.60	1.59	1.56
EUR/GBP		0.81	0.80	0.80	0.78	0.77

GLOBAL KEY INDICATORS

Yearly percentage change

	2010	2011	2012	2013
GDP OECD	3.1	1.7	1.6	2.1
GDP world	5.3	3.9	3.6	4.1
CPI OECD	1.5	2.5	2.1	1.3
Export market OECD	12.0	5.8	4.6	6.3
Oil price, Brent (USD/barrel)	79.9	112.3	119.0	120.0

Economic Research available on Internet.

Nordic Outlook published by SEB Economic Research is available on the Internet at: www.seb.se. This page is open to all.

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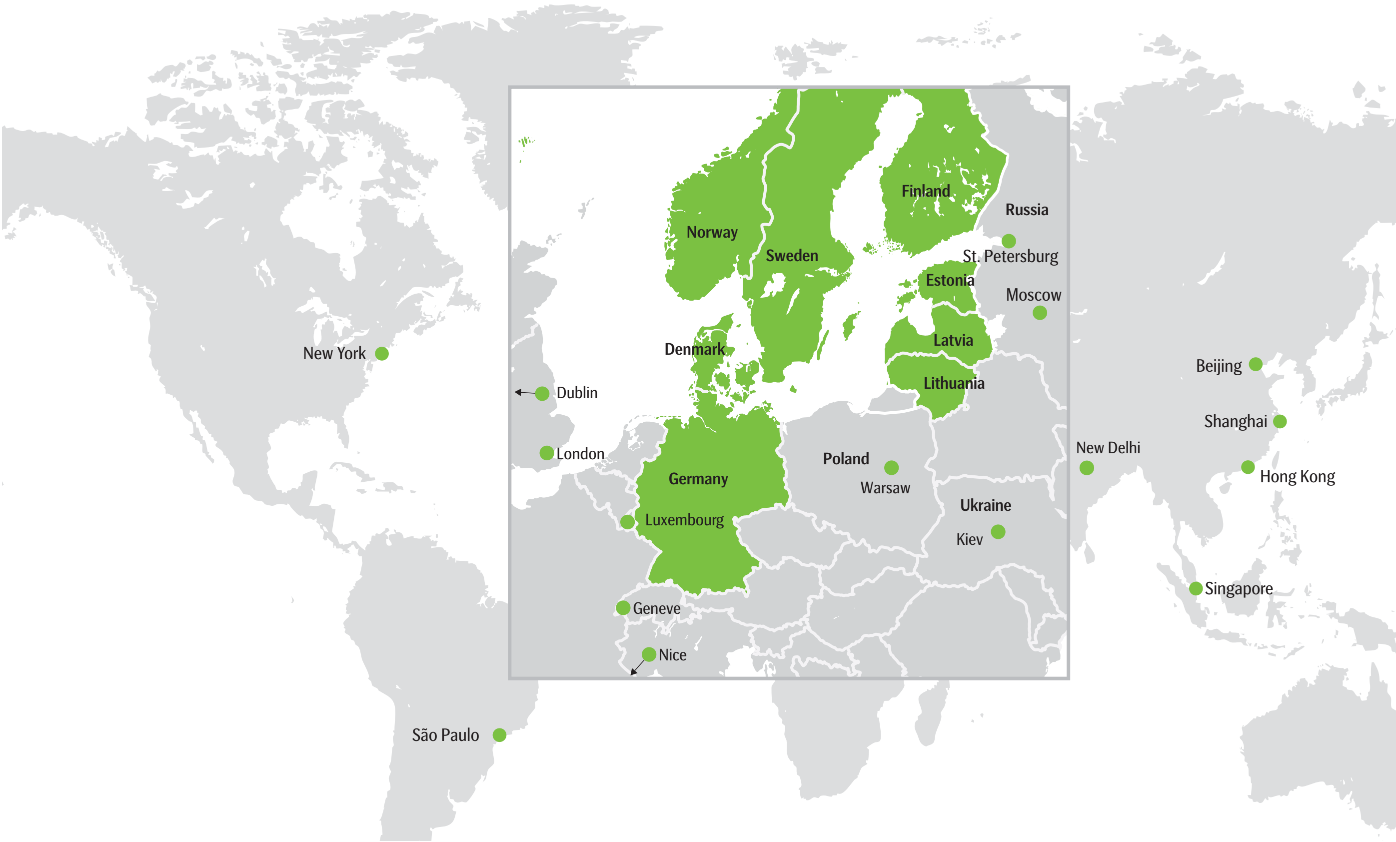

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SEMB0090 2012.05