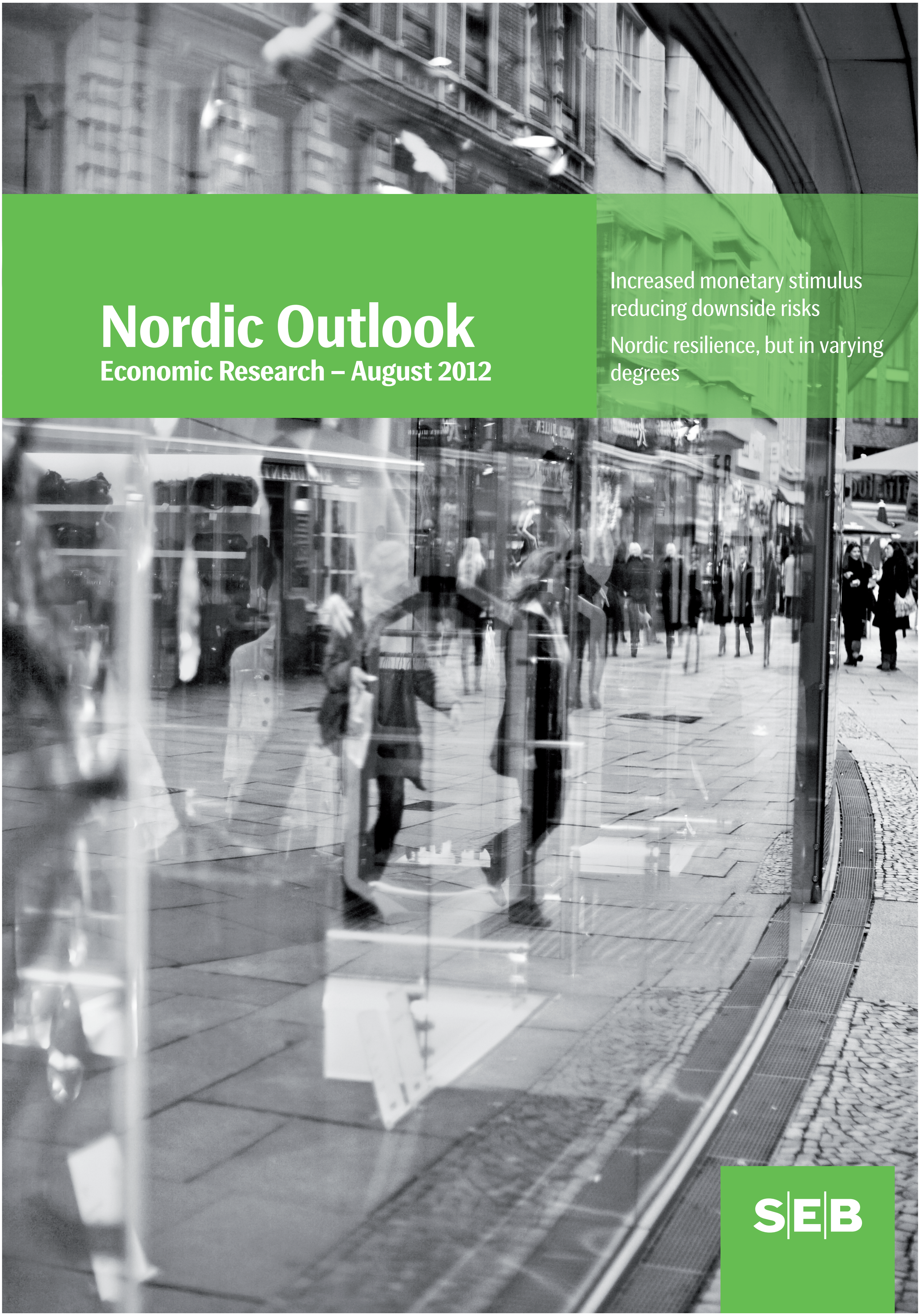

Nordic Outlook

Economic Research – August 2012

Increased monetary stimulus reducing downside risks

Nordic resilience, but in varying degrees

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This report was published on August 28, 2012.

Cut-off date for calculations and forecasts was August 23, 2012.

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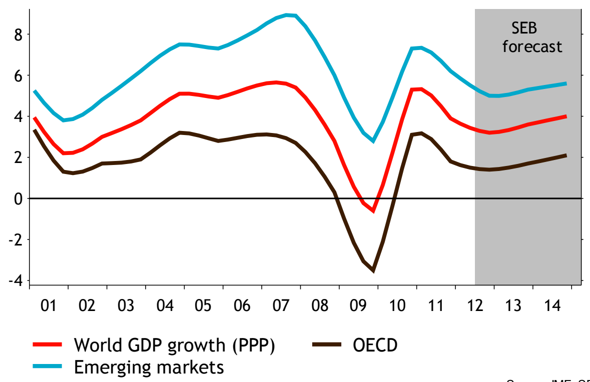
Increased monetary stimulus reducing downside risks

- **US economy slowly ticking upward**
- **Euro zone: Extreme challenges with small bright spots**
- **Faster pace again in Asia during second half**
- **Global risks more symmetrical**
- **Low interest rates, with negative elements**
- **EUR/USD rate will continue down to 1.15**

The world economy continued to lose momentum in the second quarter of 2012. The slowing trend has been more synchronised than before. GDP growth in the United States was a mere 1.5 per cent during the second quarter, although subsequent signals have been more promising. After three straight quarters of negative growth, the British economy is now in recession. The deep downturn in southern Europe has worsened even more, while its contagious effects on the German economy have become clearer. Emerging economies have also decelerated on a broad front in Asia, South America and Eastern Europe, but the Nordic countries have remained resilient, with strong GDP figures in Norway and Sweden.

Growth is bottoming out

Year-on-year percentage change



Source: IMF, SEB

Financial markets showed negative trends last spring, with falling equity prices and rising bond yields in crisis-hit European countries, but stock markets bounced back in early June and have performed strongly, especially since late July. Signals from the US Federal Reserve and especially from the European Central Bank (ECB) helped improve the market mood. In a number of important respects, the trend is consistent with our long-standing main scenario. **Growth is not self-perpetuating**; instead, because of ongoing balance sheet adjustments, **economies are in constant need of support from central banks**. This also means that small shifts in central bank signals cause fluctuations in both the real economy and financial markets.

Overall, the latest slowdown is one reason why **we have adjusted our global growth forecast** for 2013. We now believe that the euro zone economy will continue to shrink this autumn and that GDP growth next year will end up close to zero. The healing forces in the American economy are continuing, but due to debt deleveraging and fiscal tightening the US recovery will not take off next year either. We expect total GDP in the 34 countries of the Organisation for Economic Cooperation and Development (OECD) to climb 1.7 per cent in 2013, a downward adjustment from 2.1 per cent in the May issue of *Nordic Outlook*. Emerging economies are also entering a calmer phase, with growth somewhat below the average for the past decade. Falling inflation is making room for economic policy stimulus that will help growth again accelerate somewhat in 2013.

Global GDP growth

Year-on-year percentage change

	2011	2012	2013	2014
United States	1.8	2.2	2.2	2.6
Japan	-0.7	2.7	1.5	1.3
Germany	3.1	0.8	1.0	1.5
Euro zone	1.5	-0.4	0.2	0.9
China	9.3	7.8	8.0	8.2
United Kingdom	0.8	-0.4	1.4	1.6
Nordic countries	2.4	1.7	1.9	2.2
Baltic countries	6.2	3.1	3.8	4.4
OECD	**1.8**	**1.4**	**1.7**	**2.1**
Emerging markets	6.2	5.0	5.3	5.8
World, PPP*	**3.9**	**3.3**	**3.6**	**4.1**
World, nominal.	3.2	2.5	2.9	3.3

Source: OECD, SEB * Purchasing power parities

The exceptionally difficult economy policy choices facing the world economy, and especially Europe, will determine development in a slightly longer perspective. The following sections (for example, the box entitled “The roadmap to a euro zone political union” and the theme article “The central bank toolkit”) discuss these issues in more detail. One conclusion is that important common steps are being taken to try to respond to serious threats of a deepening recession accompanied by political unrest and disunity in Europe. These steps will probably stabilise conditions in the medium term. But the situation is still fragile, and major long-term questions remain unanswered. Meanwhile the risks of a new recession in the US have diminished. The Fed is prepared to carry out further stimulus measures, while housing and other cyclically sensitive sectors are rebounding from exceptionally depressed levels. Our conclusion is thus that GDP growth will speed up in 2014 and that **the risk picture is more symmetrical than previously**.

Policy challenges in several dimensions

The main economy policy task at the global level consists of remedying the causes of the excesses that triggered the crisis, while **ensuring that the adjustment process does not completely strangle economic growth**. Pushing down public sector deficits in an effort to strengthen the credibility of government commitments is a central element of **"pedagogical policy"**. Another key element is to strengthen the resilience of the financial system, for example by tightening capital adequacy requirements for banks. The task of central banks, however, is to ease the impact of private and public sector debt reduction with the aid of exceptionally low interest rates and to a growing extent ahead, employ non-conventional measures.

This crisis resolution strategy thus means that **expansionary monetary policies and contractive fiscal policies are largely pulling in opposite directions**. This is an unavoidable price in order to create a more balanced world economic situation. To minimise this tug-of-war the OECD and the International Monetary Fund (IMF), for example, have recommended that countries with a degree of financial freedom postpone belt-tightening or, if possible, pursue expansionary policies. At the global level, we believe that this balancing act will turn out decently in the next few years. **Fiscal policy in OECD countries will slow GDP growth by about 1 percentage point**, leading to a gradual decline in budget deficits. Stabilisation of government debt will occur in most countries, but Japan – with its continued soaring central government debt – is an exception.

How the euro zone crisis unfolds will be crucial to world economic growth and risk appetite in the next couple of years. For a long time, constructive ways of managing the crisis have been blocked by basic mistrust among actors with different ways of describing the problems and different interests. The change in approach that we began to discern in last spring's issues of *Nordic Outlook* has been confirmed. Greater consensus has emerged that there is a limit to how much belt-tightening southern European countries can handle. Further austerity requirements as a consequence of a deepening downturn are unlikely. Instead, countries may be granted more time to implement the austerity measures already imposed.

However, it will be essential for southern European countries to demonstrate a genuine desire to deal with public financial imbalances and serious structural problems, in order for other elements of crisis management to function. The roadmap entitled **"Towards a genuine economic and monetary union"** – launched in June by the European Council – reflects ambitions to strengthen economic, financial and political cooperation. Although this plan will probably be subjected to divisive discussions within and between countries, it represents a framework for debate. This, in turn, will make it easier for the ECB to act in a more decisive way to stabilise the situation.

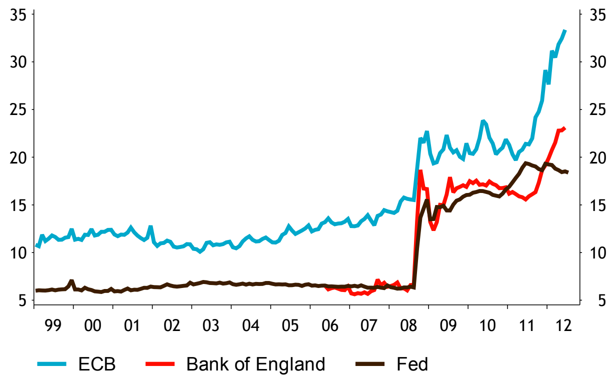
Despite a trend towards more constructive, coordinated management of the euro zone crisis, the situation remains fragile. Continued deep recession in southern Europe will mean increases in unemployment, along with risks of ever-broader popular and parliamentary expressions of discontent. In northern Europe, support for deeper cooperation will also be put to the test. In the near future, there will be a focus on the rulings of Germany's constitutional court and on the Dutch parliamentary election. Further ahead, popular support for deeper economic, financial and political cooperation will be crucial. As earlier, our conclusion is that **the future of the euro in its existing form is surrounded by uncertainty**.

Increased unconventional monetary policy

Conventional monetary policy has reached the end of the road in many countries. Most indications are that lowering the key interest rate below 0.50 per cent is ineffective. The consensus among central banks is that at present, setting deposit rates for banks below zero per cent involves unnecessary risks (systemic problems and uncertainty).

Central bank balance sheets

Per cent of GDP



Source: ECB, Bank of England, Fed

However, unconventional monetary policy is continuing to set new historical records. In the past five years, the balance sheets of the major central banks have more than doubled. In principle, such policy measures have no limits in terms of volume (see also the theme article on page xx). The effects that central banks are trying to achieve are to:

- Ensure good access to liquidity at low funding cost for banks, which can thereby assist households and businesses
- Counteract falling asset prices
- Establish a kind of lender-of-last-resort function for governments facing unreasonably high bond yield costs.

The medium-term risk of new financial imbalances or uncontrolled inflation is rather small, in our assessment. The danger is instead connected to the fact that enormous central bank liquidity injections, including purchases of securities, undermine pricing mechanisms in the financial market. This may lead to ineffective allocation of financial resources, which in turn will hamper long-term economic growth.

Although there is disagreement within and between central banks about the effects of new unconventional measures, leading central banks are prepared for more stimulus.

We expect the ECB to soon formally approve **an expansion of its Securities Markets Programme (SMP)**. We anticipate that Spain, as well as Italy, will formally apply for aid from the Euro Group, which will give the ECB a green light to begin purchasing these countries' government securities as early as September. We also believe that Spain will try to obtain a more traditional bail-out loan, in addition to its EUR 100 billion bank bail-out.

In addition, we expect that **the ECB will carry out another key interest rate cut** in October to a refi rate of 0.5 per cent. Another **Long-Term Refinancing Operation (LTRO) is not a high priority at present** but may be considered at a later stage. We are sceptical, however, that the European Stability Mechanism (ESM) will receive a full-scale banking licence, which would expand its lending capacity. At present, the introduction of a maximum yield on sovereign bonds of crisis-hit countries (or a maximum spread against German sovereign bonds) seems too big a step for the ECB to take. It is too far removed from the bank's monetary policy mandate. Another piece of the euro zone crisis management puzzle is that we foresee a further **debt write-down ("haircut") of 30 per cent for Greece** and that Portugal will probably need another bail-out from EU emergency funds.

We also believe that the **Federal Reserve will launch a third round of quantitative easing (QE3)**, probably as early as September. The Fed's "promise" to keep its key interest rate unchanged at current levels will be extended until mid-2015. The **Bank of Japan will carry out at least one more QE programme this autumn**, in which purchases of corporate shares and bonds may be considered. **This summer, the Bank of England expanded its unconventional policy**, and we anticipate an expansion of asset purchases equivalent to GBP 50 billion in November.

The central banks of Norway and Sweden diverge from the pattern, since traditional interest rate policy is their main weapon. Our forecast is that Sweden's Riksbank will cut its repo rate in September as a consequence of low inflation and weak growth prospects. A strong Swedish krona will then trigger a further rate cut to a repo rate level of 1.0 per cent early in 2013. Norges Bank, however, will begin hiking its deposit rate early in 2013 in response to rising inflation and resource utilisation. The bank will then gradually raise the key rate to 3.25 by the end of 2014.

Diminishing dose of fiscal austerity

The shift in fiscal policy mind-set that we predicted in the last issue of *Nordic Outlook* has been confirmed in recent months. Demands for more belt-tightening in southern Europe because the deepening recession weakens the budget situation seem more and more counterproductive. Last spring, Spain was granted another year to bring its deficit down to 3 per cent of GDP. Greece will also encounter a more understanding attitude concerning its recently publicised wishes to be granted another two years to achieve the targets in its bail-out programme. The contractive effect on GDP in crisis-hit countries (Greece, Ireland, Italy, Portugal and Spain = GIIPS) peaked in 2011 and 2012 and will gradually ease in 2013 and 2014, we believe.

The dose of fiscal austerity in OECD countries will be close to 1 per cent of GDP in 2011-2013 and then fall somewhat in 2014. This forecast assumes that the US Congress will reach agreements late in 2012 extending current tax cuts from the turn of the year. In Japan, stimulus packages after the 2011 earthquake mean that fiscal tightening will begin only in 2013, despite soaring government debt levels. In the next couple of years, fiscal tightening in the US, Japan and the UK will be significantly more powerful than in the euro zone.

Fiscal austerity effect

Change in structural balance, as a percentage of GDP

	2011	2012	2013	2014
United States	0.6	1.3	1.2	1.0
Japan	-0.3	-0.5	0.7	0.5
United Kingdom	1.5	1.2	1.4	1.1
Euro zone	1.0	0.4	0.2	0.2
Of which GIIPS	2.2	2.5	1.2	0.0
Nordic countries	-0.1	-0.4	-0.1	-0.2
OECD	1.0	1.0	1.1	0.7

Source: IMF, OECD, SEB

Partly due to austerity measures, budget deficits will shrink during the next couple of years. In 2013 the deficit in the euro zone as a whole will again drop below 3 per cent of GDP. The improvement is occurring fastest in the US and the UK. In 2014 we expect deficits in both countries amounting to 5 per cent of GDP. This represents a halving compared to 2009, when the deficits were at their largest. We expect government debt to peak in 2014 or 2015. In Japan, the downturn will occur significantly more slowly, and no levelling out of the country's enormous government debt is discernible yet.

Public budget balance, selected countries

Per cent of GDP

	2012	2013	2014	Debt*
United States	-8.1	-6.3	-4.9	114.0
Japan	-10.0	-8.7	-7.9	245.6
United Kingdom	-8.0	-6.6	-5.0	92.8
Euro zone	-3.2	-2.7	-2.2	90.8
OECD	-5.3	-4.2	-3.4	110.0

* Gross debt, 2014

Source: IMF, OECD, SEB

Overall, deficits and government debts in developed countries will still be disturbingly high at the end of our forecast period. The austerity process will continue for quite a long time into the future, which will also hamper growth in the medium term.

US: still sluggish in 2013 but then brighter

The pattern in the American economy from 2010 and 2011, with slowdown tendencies in mid-year, has been repeated this year. GDP grew by only 1.5 per cent during the second quarter, on an annualised basis. Such weak growth means that the improvement in the labour market has faded, in line with our forecast of last spring. We have adjusted 2013 growth downward for various reasons. The economic is not ripe for a clear recovery, while weaker international conditions combined with a stronger dollar will create headwinds for exporters. Meanwhile consumption will be hampered by continued household financial consolidation needs. Fiscal policy will also be clearly contractive even if the US Congress can reach agreement in important areas this autumn.

Despite this downward adjustment, the American economy has moved up to firmer ground and recession risks are shrinking. Cyclically sensitive portions of the economy such as durable

The roadmap to a euro zone political union

Measures to save the euro project are being launched in quick succession. The ECB's ability to act will depend on achieving institutional advances in euro zone cooperation. Member countries will face many controversial issues over the next couple of years concerning economic, financial and political structures. Looking ahead, the survival of the euro will be highly dependent on the capacity of the political system to win popular support for such deepened cooperation.

These political decisions will be based on the roadmap entitled "Towards a genuine economic and monetary union" that the euro zone countries agreed on at their June 28-29 summit. The roadmap is also called "the report of the four presidents" since European Council President Herman Van Rompuy, European Commission President José Manuel Barroso, Euro Group President Jean-Claude Juncker and ECB President Mario Draghi are in charge of its work. An interim report is scheduled to be completed in mid-October. Documentation for decision-makers will be available by the EU summit on December 13-14. The plan consists of four building blocks, together aimed at building a solid economic and monetary union (EMU):

- **A financial (=banking) union** is expected to include a common supervisory and deposit guarantee mechanism as well as a system for restructuring and winding up banks.
- **A fiscal union** will rely on expanded collective decision-making, a central budget with shared fiscal resources (a revenue sharing/solidarity union) and taxation and debt issuing authorities (including common debt instruments).
- **An economic policy union** will provide an integrated policy framework and foster greater harmonisation of (income/capital/corporate) tax tables, pension systems and labour market policies.
- **A democratic union** is intended to include mechanisms that safeguard democratic values and systems, ensure the legitimacy of decision-making and create a clear allocation of responsibility for implementing decisions.

These plans point towards greater supranationalism and less national sovereignty. The strategy implies that various revenue sharing/buffer systems will collectively allocate risks and financial resources among euro zone countries. Discussions are expected to begin as early as this autumn, but such changes will require amendments in EU treaties. They will probably also require constitutional review processes in a large number of euro zone countries, with accompanying referendums and/or constitution-ratifying parliamentary elections.

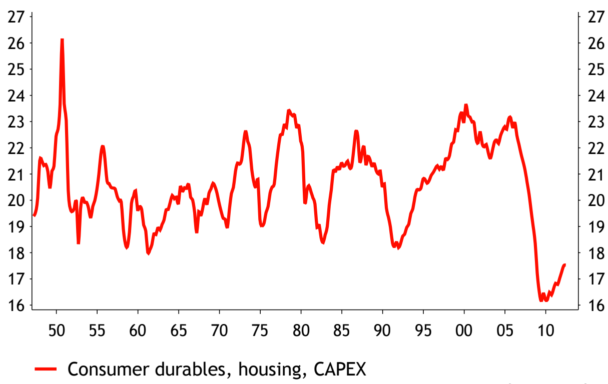
Gaining popular support for political integration will not be easy in an environment where the economy is shrinking and unemployment is climbing. This risks setting the stage for political and social unrest. One sensitive issue concerns the roles of EU institutions in relation to national parliaments and governments. The shift towards greater power for EU institutions that many of the proposals represent is contrary to the trend of recent years, in which national parliaments have sought to limit the powers of supranational bodies. The economic crisis has also led to national measures that affect competition-neutrality within the EU. The French approach to the problems of the car industry is one example.

The roadmap will also change future relations and cooperation mechanisms between euro zone countries and other EU countries, not least the UK, Sweden and Denmark. To date, EU strategy has been held together by a "multi-speed Europe" strategy. But if the euro zone countries actually take major new steps towards integration, there is a risk that the rest of the European project will be of peripheral importance and that other countries will be shut out of key decisions in a way that will be unsustainable in the long term. In the UK, Prime Minister David Cameron has already opened the door to a referendum on the "relationship" with the EU. Sweden and Denmark, too, will face difficult choices over the next couple of years about their relationship with the euro zone.

goods consumption, residential construction and capital expenditures have begun to rebound. Moreover, their depressed level implies large potential for further recovery. The time for a clear upturn in consumption is also drawing closer. After dramatic home price declines in 2007-09, debt deleveraging has progressed quite far. The healing process in household balance sheets may be accelerated by a degree of recovery in home prices. Mortgage interest rates have continued to be squeezed downward. Yardsticks of value such as home prices divided by cost of rent also indicate that homes are undervalued. A combination of modest growth, low inflation and persistently depressed resource utilisation will give the Fed manoeuvring room for actions to support the economy. We foresee overall GDP growth of between 2½ and 3 per cent in 2014.

Most cyclical sectors are still depressed

Per cent of GDP



Source: BEA, SEB

Euro zone: Recession settling in this autumn

The trend towards somewhat more constructive management of the euro crisis has not yet had an impact on the real economy. The overall euro zone economy shrank in the second quarter by 0.2 per cent compared to the first quarter. Leading indicators point to a continued downturn in the third quarter. We have thus delayed the date when we believe the euro zone economy will stop shrinking. This mainly affects our full-year forecast for 2013. **Next year GDP will rise by 0.2 per cent**. This is a downward revision of 0.6 percentage points from the May *Nordic Outlook*. **In 2014, growth will increase to 0.9 per cent** but will remain below long-term trend growth.

The divergent performance of northern and southern Europe is a clear feature of the euro zone situation. The economies in southern Europe will shrink more than 2 per cent this year, and for the second year in a row Greece will note a GDP decline of more than 6 per cent. Next year the decline in output will be halved, and in 2014 GDP will stabilise in southern Europe.

Germany is propping up euro zone growth, but here too there are signs of deceleration after the export-led upturn of 2011. Because of a clearer impact from the international crisis, we have revised our GDP forecast for 2013 downward by 0.6 percentage point, but good competitiveness, strong government finances and somewhat more expansionary fiscal policy in the run-up to the autumn 2013 Bundestag election will enable Germany to avoid recession. **German GDP will grow by 0.8 per cent this year and by 1.0 per cent in 2013. In 2014, growth will speed up to 1.5 per cent**.

GDP, selected euro zone countries

Year-on-year percentage change

	2011	2012	2013	2014
Germany	3.1	0.8	1.0	1.5
France	1.7	0.3	0.3	0.5
Italy	0.5	-2.0	-0.6	0.3
Spain	0.7	-1.7	-0.8	0.1
Greece	-6.9	-6.4	-2.9	-1.1
Portugal	-1.6	-2.8	-2.4	-0.5
Ireland	0.7	0.1	1.1	1.6
Euro zone	**1.5**	**-0.4**	0.2	**0.9**

Source: Eurostat, SEB

EM countries: Stimulus after slowdown

Asian emerging market (EM) countries are being squeezed by weak international demand and by past economic austerity measures. Purchasing managers' indices have recently fallen in many countries, and GDP growth decelerated further during the second quarter. In heavily export-dependent economies like Singapore and Taiwan, the slowdown is the most apparent. Yet we still believe that strong domestic demand – driven by more accommodative economic policies, low household debt and good wage growth – will help **sustain decent growth in Asia over the next couple of years**. Although GDP increases will end up below trend during our forecast period, the region will remain resilient to weakness in Europe and the US, thereby providing **support to the rest of the world economy**.

More symmetrical risks

Given the downward adjustment in our basic growth forecast, combined with somewhat brighter prospects for economic policy, **we believe that the risk picture is more symmetrical than in the May issue of** *Nordic Outlook*, when downside risks were dominant.

Alternative scenarios

Year-on-year GDP change

	2012	2013	2014
Recession scenario (20%)			
United States	2.0	-0.5	-0.5
Euro zone	-0.6	-2.0	-2.0
OECD	**1.1**	**-1.5**	**-1.5**
EM economies	4.7	3.3	3.5
Recovery scenario (20%)			
United States	2.4	3.5	4.0
Euro zone	-0.2	1.0	1.5
OECD	**1.7**	**2.5**	**2.5**
EM economies	5.3	6.3	6,5

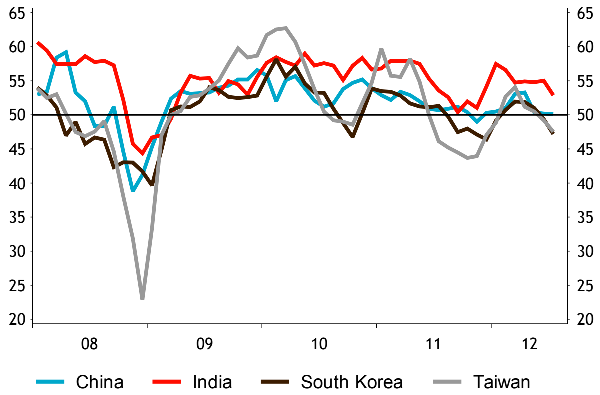
Source: OECD, SEB

As earlier, a more serious euro zone crisis is the most important risk factor in the world economy. Deepening tensions between countries and EU institutions, with stronger tendencies towards a break-up of the euro project, may lead to sharp declines in GDP. Our recession scenario implies an overall decline in GDP of about 5 per cent in the euro zone during the period 2012-14. In such a scenario, the American economy would also slide into a recession, albeit a considerably milder one. The effects on other parts of the world economy would be noticeable, although the largest of the emerging economies would show resilience, in the same way as they did in 2008-2009.

Other downside risks in the world economy besides those that form the basis for our recession scenario can also be singled out. An escalating Middle East crisis with rising oil prices, or weaker growth in important emerging economies because of rising food prices, cannot be ruled out. A deadlock in the US Congress that triggered a powerful fiscal tightening (the "fiscal cliff" risk) may also generate weaker global growth.

The upside potential in our forecast is if the US economy enters a recovery dynamic with contagious effects throughout the world economy. The conditions for this will improve with time as household debt deleveraging progresses and as the housing market provides positive contributions to GDP growth. Once the situation of households improves, there are prospects of rapid expansion in capital spending, given depressed corporate investment levels and strong balance sheets. A vigorous US upturn would have major contagious effects at global level, especially via financial channels. Although the problems in Europe are of a long-term nature, a US-driven upturn would make crisis management easier.

Purchasing managers' index turning down



Source: Markit, National Bureau of Statistics of China

In **Latin America**, too, the general picture indicates that **growth is shifting to lower gear**, but for most economies the slowdown has been limited so far and there are no signs that the euro zone crisis has had any major impact. Looking ahead, domestic demand is expected to sustain growth in many countries. GDP expansion will slow in 2012 but accelerate to about 4 per cent during 2013. There are clear differences in the region, however. In Brazil, the slowdown is being driven by weakness in manufacturing, which is being held back by competitiveness problems despite exchange rate depreciation in the past year. In Mexico, growth is being sustained by good exports to the US. Meanwhile strong domestic demand is providing support in Chile and Peru. The main risk is higher food prices, which weigh heavily in the Consumer Price Index (CPI). Falling commodity prices threaten to hurt countries like Argentina and Venezuela, where export income is vital in order to maintain growth.

Mixed Nordic resilience

The export-dependent Nordic economies are being squeezed by weak international economic performance, but a relatively stable labour market is sustaining domestic demand. Despite support from a weaker euro, the slowdown is clearest in Finland and Denmark, where GDP growth will reach only about 0.5 per cent in 2012. Thanks to an unexpectedly strong first half, Swedish GDP will grow by 1.2 per cent this year. The strong currency will contribute to growth in 2013. **Norway will continue to diverge from this pattern**. High oil prices and strong domestic demand will more than offset the international slowdown and the strong krone. Norwegian GDP will grow by 3.7 per cent in 2012 and by 2.7 per cent in 2013. Not until 2014 will all Nordic countries reach their trend growth rates.

GDP growth, Nordic and Baltic countries

Year-on-year percentage change

	2011	2012	2013	2014
Sweden	3.9	1.3	1.5	2.5
Norway	1.4	3.7	2.7	2.3
Denmark	1.0	0.5	1.4	1.7
Finland	2.7	0.6	1.6	2.0
Nordics	**2.4**	**1.7**	**1.9**	**2.2**
Estonia	7.6	2.0	3.0	4.9
Latvia	5.5	3.5	4.0	4.5
Lithuania	5.9	3.5	4.0	4.0
Baltics	**6.2**	**3.1**	**3.8**	**4.4**

Source: OECD, SEB

Domestic demand stabilising the Baltics

Growth in the Baltic countries will improve successively in 2013-2014 following the export-driven deceleration of the past year. **Gradually rising domestic demand** will cushion the three economies as the export engine sputters in 2013. So far this year, consumption and capital spending have turned out to be somewhat stronger than expected. We are generally raising our GDP forecasts for 2012, and in Estonia and in Lithuania also for 2013. Weighed together, **GDP in the region will increase by 3.1 per cent this year and 3.6 per cent in 2013. Only in 2014 will growth reach its potential pace of 4.0-4.5 per cent**. High unemployment will continue to decline slowly in Latvia and Lithuania. Estonia's faster slowdown will abruptly decelerate. The Baltic countries will continue to struggle with significant structural problems in the labour market, partly caused by the new emigration wave of recent years.

We expect Latvia to meet the Maastricht criteria, paving the way to euro zone accession in 2014. The EU institutions may, however, throw obstacles in the way during next year's evaluation by questioning the sustainability of Latvia's decline in inflation and budget deficit. Lithuania also aims at euro zone membership in 2014 but is in somewhat poorer shape in terms of meeting the criteria. We continue to believe that **Lithuania's euro zone accession will be delayed until 2015**.

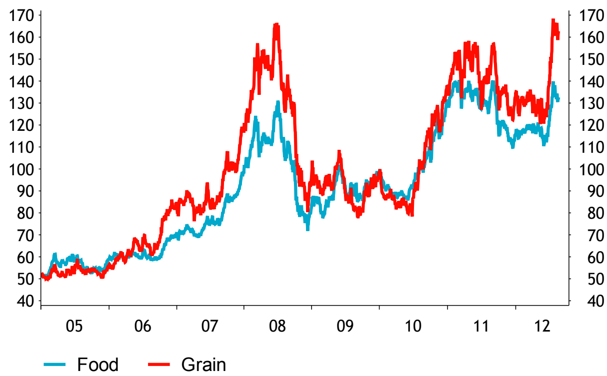
Supply-side factors push up commodities

Commodity prices have shown mixed performance in recent months. **Supply-side factors have been instrumental in keeping prices up** and are expected to continue doing so as demand remains weak in the world economy during 2013.

Oil prices have bounced back to about USD 115/barrel (Brent crude) after a sharp drop from nearly USD 130 in March 2012 to about USD 90 in June, when a large supply and weaker economic data squeezed prices. In the near future, we expect prices to drop marginally due to the completion of work in the North Sea and the beginning of exports from South Sudan. **Looking ahead, we predict stable oil prices**: we expect this year's average to be USD 112/barrel. We predict USD 110/barrel in 2013 and USD 115/barrel in 2014.

Sharp upturn in grain prices

Index, measured in USD

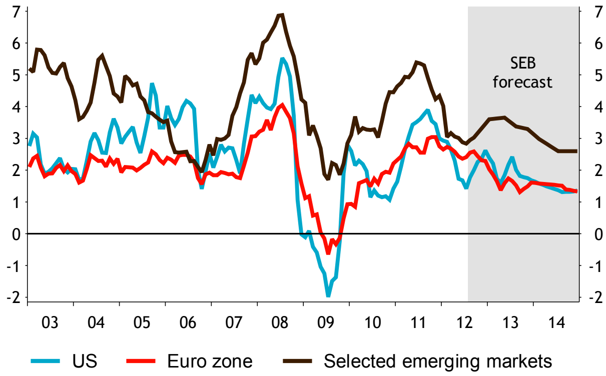


Source: HWWI

Grain prices have soared in a way reminiscent of their movements in 2008 and 2010, but prices of other agricultural commodities such as coffee, rice and sugar have been more subdued. This has limited the overall upturn in food prices. To a very large extent, the grain price hikes of about 30 per cent during June and July were caused by extreme heat in the US and to some extent also in Eastern Europe. These prices are now so overblown that they are far from reflecting underlying supply and demand conditions. **Provided that more normal weather conditions resume, grain prices will fall in the coming year**. This happened, for example, in 2011 after the El Niño weather phenomenon had driven up prices.

CPI inflation is falling

CPI, year-on-year percentage change



Source: BLS, Eurostat, SEB

Lasting low inflation

The inflation rate in the world economy has fallen recently, as earlier upturns in commodity prices have disappeared from the 12-month figures. This trend is quite consistent with earlier forecasts, although the downturn has been a bit faster than expected in emerging economies. Core inflation in the OECD countries (excluding volatile food and energy prices) has nevertheless provided upside surprises, especially in the US.

Our forecast implies continued slowing in the inflation rate. Low resource utilisation is holding back pay increases, leading to weak underlying inflation pressure. Rising world market prices for food will push up inflation somewhat in the near term. In the OECD countries, the effect will nevertheless be rather small, while emerging economies will be more heavily affected. Certain tax increases within the framework of austerity policies in southern Europe will also help fuel higher inflation rates. Overall, we expect inflation of around 1½ per cent in the next couple of years. Lower inflation will provide a welcome addition to household purchasing power. Meanwhile central banks will gain greater flexibility to expand stimulus measures.

Credible inflation targets for better or worse

Even viewed over a long period, inflation has been remarkably stable. During the period of financial excesses at the global level in 2004-07 which preceded the crisis, underlying inflation was low and stable. Since the financial crisis broke out, diametrically opposite inflation scenarios have been discussed: deflation risks driven by a lack of optimism and low resource utilisation, as well as soaring inflation driven by monetary expansion. Yet these extremes have not come true at all; instead, core inflation has continued to show a stable pattern.

There is also widespread confidence in stable inflation ahead. In both surveys and pricing in the inflation-indexed bond market, medium-term inflation expectations are around 2 per cent. Today's **exceptionally low nominal interest rates** in many countries thus **do not reflect concerns about deflation, but instead a belief in long-lasting economic stagnation**. We should of course be careful in our interpretation, since interest rates are extremely depressed as investors search for "safe havens" amid the prevailing economic instability.

Underlying price and wage behaviour has been relatively insensitive to changes in the level of economic activity, which has both positive and negative aspects. Partly because of this unresponsiveness, it has been possible to avoid a general deflation process despite low resource utilisation and falling asset prices. Pay increases have admittedly slowed, but they have still help maintain decent household purchasing power. This

Negative interest rates in practice

A Japanese-style low interest rate environment has become a reality in many countries this year. Both short-term interest rates and long-term yields have hit record lows. Due to the world economic situation, negative nominal key rates (as in Denmark today) and negative short-term bond yields (Switzerland, Denmark and Germany) may become more and more common. Today investors are accepting negative returns on sovereign debt securities with maturities of up to two years. In other words, they are prepared to pay a "fee" to debt management authorities in a number of countries to "store" their money in a safe place, even though the value of their investment is simultaneously being undermined by inflation.

Brief periods of negative nominal interest rates and yields will hardly have any lasting negative effects on either the functioning of the financial system or the real economy. But they pose a technical challenge to various institutions in a given country to create systems that can handle negative interest rates. To an even greater extent, they imply a mental readjustment for various market players, especially for savers who must accept the idea that investing in short-term fixed income securities or putting money in a bank will not pay any interest, but instead "cost money".

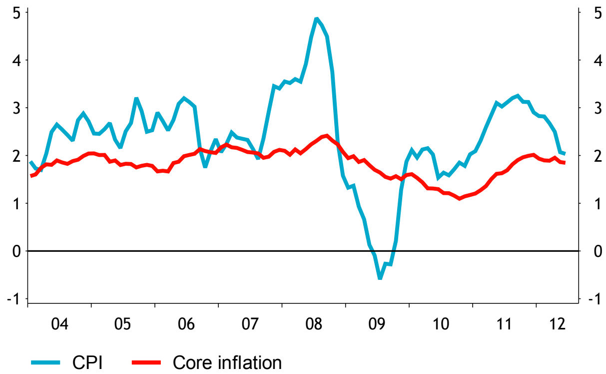
One effect is increased demand for physical bank notes. After all, a wad of bank notes is free, as opposed to having money invested in a short-term fixed income fund or in a bank account. This is one of the main reasons why many economic models assume that interest rates cannot be negative. But bank notes and bank accounts are not perfect substitutes. Handling large amounts of bank notes for long periods represents both security risks and practical space problems. There is thus a willingness to pay someone to store money.

Another conceivable effect of negative interest rates is that the short-term interest market will struggle with poorer liquidity and large interest rate fluctuations. The impact of central bank monetary policy measures may thus diminish. The analysis carried out by the Riksbank and others concerning the bank's experience of negative deposit rates in 2009-2010 shows only small systemic effects. Yet one caution is justified: we are dealing with unknown territory, even for central banks.

has softened both the slowdown in general demand and price declines in the housing market. Stable inflation also means that long-term future projections can still fairly reliably assume that GDP in current prices will grow, albeit slowly. This is of great importance to stock market valuations, for example.

Stable core inflation in OECD

Year-on-year percentage change



Source: OECD

Sluggish responses to inflation trends also contribute to delays in adjustment processes. When real wages in various sectors and regions remain steady, this contributes to more lasting high unemployment. Despite deep recession in southern Europe, for example, inflation in the crisis-plagued countries is at about the same as in the overall euro zone. Reducing competitiveness gaps between southern Europe and Germany by means of internal devaluations or revaluations will take a long time, although mental attitudes are changing on both sides.

Except for certain short periods, inflation expectations have been stable. This has been instrumental in enabling central banks to implement exceptional stimulus measures without major credibility problems. Meanwhile credibility has a flip side. If underlying inflation is so stable, this means that it functions poorly as the signalling system that an inflation target policy needs. During the financial bubble, central banks were lulled into a false sense of security by low inflation. They hiked interest rates at a late stage as a reaction to rising commodity prices, which had also already caused a major deceleration. Today, too, some central banks seem to have difficulty interpreting the situation. When the rate of inflation and pay increases is relatively close to long-term trend levels, some models also signal that resource utilisation is close to equilibrium. **When economic actors are confident in inflation targets, this may paradoxically fool central banks into making monetary policy mistakes**.

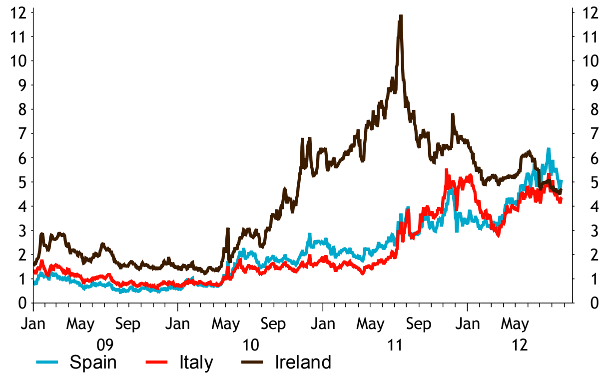
Persistently low bond yields

After last spring's downturn, bond yields in the world's leading economies are now historically very low. Late **in July, new record lows were set** for 10-year US Treasuries (1.39 per cent) and for 10-year German bonds (1.16 per cent). For short maturities, yields have even been negative in countries like Germany, Denmark and Finland. A synchronised economic slowdown and signals indicating that various central banks would loosen their monetary policies contributed to the downward pressure. This was reinforced by mounting worries about Spain and Italy, leading to an intensified search for safer investments.

In the past month, however, the fixed income market has been characterised by a **slight relief rally** related to the euro zone crisis. **After ECB President Mario Draghi's statement** that the ECB will do whatever it takes to save the euro, both Spanish and Italian 10-year yields have dropped rather sharply. The downward trend in Irish and Portuguese bond yields has also continued. The upcoming ECB purchases of government securities and new bail-out loans to Spain that we have forecasted should lead to additional downward pressure on yields, but uncertainty about the future of the euro zone will persist. Spreads will consequently remain wide throughout our forecast period.

Narrowing yield spreads in recent months

10-year sovereign bond spreads to Germany, per cent



Source: Reuters EcoWin

Both German and US 10-year yields have gradually crept up by 30-40 basis points since their lows. We expect **yields to move sideways once central bank stimulus measures are launched. Then** we predict **a slow upturn** in the wake of somewhat stronger global growth. At the end of our forecast period, German 10-year yields will stand at 2.30 per cent and American ones 2.60 per cent.

Yields on Nordic government securities will also remain low in an environment where fewer and fewer countries retain an AAA rating. We expect **Swedish 10-year yields to follow German ones this coming year**. Further ahead, strong economic conditions should lead to expectations that the Riksbank will begin raising its key rate before the ECB does. At the end of 2014, Swedish yields will thus be 20 basis points above their German equivalents. In Norway, Norges Bank's gradual key rate hikes starting in the spring of 2013 will also cause a slightly larger yield gap against Germany. The spread for 10-year government bonds will widen to 80 bp by the end of 2014.

Our forecast thus implies that **yields will remain exceptionally low for a long period**. Key interest rates remaining close to zero in the foreseeable future, combined with unconventional actions, will reinforce the exceptionally low-yield environment. However, our view that inflation expectations will remain stable and stay close to central bank targets represents an important difference compared to the deflationary environment in Japan over the past couple of decades. This is one important reason behind our forecast that long-term yields will still move upward and that the yield curve will gradually become somewhat steeper once global growth turns a little stronger.

Improved stock market outlook

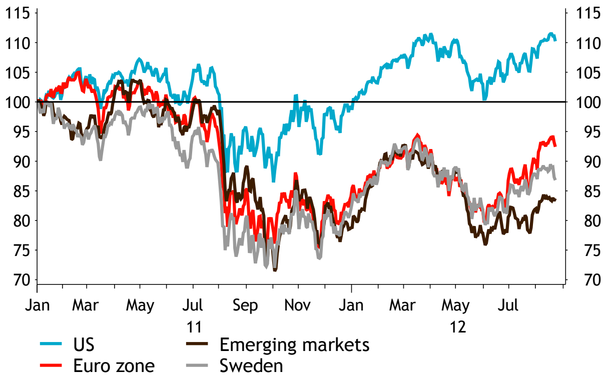
Stock markets were also dominated by a relief rally after the

ECB president's reassurances. Spanish and Italian share indices, for example, have gained more than 20 per cent in the past month. A new expected dose of stimulus from the Fed, combined with signals of further economic policy loosening in China, also contributed to the market upturns. The latter development was reflected especially in recoveries for commodity-related share prices. Certain positive economic signals in recent weeks, after constant disappointments during the second quarter, have also been important to the shift in stock market climate. In light of our economic scenario, with global GDP growth bottoming out this autumn, extremely loose monetary policies and relatively cautious initial valuations, it is likely that **the stock market recovery will continue during the coming year**.

Meanwhile there are plenty of warning flags. Volatility as measured by the VIX index is at deeply depressed levels, which hardly reflect the risk situation in the world economy. Over the past few months, oil prices have climbed by nearly 30 per cent and rising grain prices may also cause some problems. If Middle East tensions between Israel and Iran should escalate, this will probably cause oil prices to continue climbing and seriously hamper the recovery. The latest quarterly corporate report period was the weakest for a long time, which also means that after the recent share price recovery, valuations are not as depressed as earlier.

US stock markets holding on to their lead

Index 100 = Jan 2011



Source: Reuters EcoWin, SEB

The Nasdaq OMX Stockholm has lost some ground in relation to leading global stock markets in recent months. The strong krona has contributed to this, although many large Swedish corporations have become less dependent on exchange rates. Looking ahead, we believe that Nordic stock markets can keep up with the global recovery. Based purely on economic conditions, the Nordic stock markets should have the potential to perform more strongly than those of Western Europe in general. But continued strong currencies will weigh down the stock markets in Sweden and Norway.

Currencies driven by search for safe havens

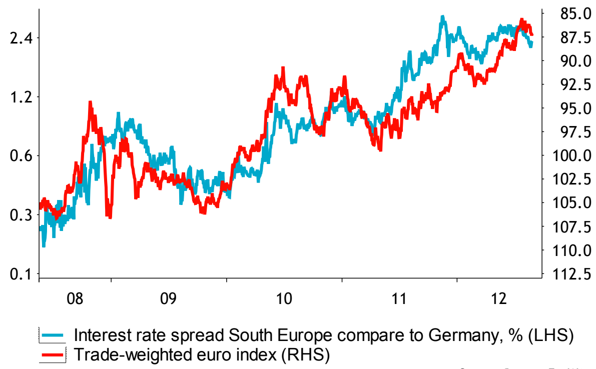
Imbalance problems in major Western economies continue to dominate the foreign exchange (FX) market as international asset managers seek alternatives to the established reserve currencies, the euro (EUR), US dollar (USD) and British pound (GBP). The search for safer, but less liquid, alternatives has led to continuous appreciation pressure on the currencies of Australia and Canada, for instance. Recently the currencies of Sweden and Norway have also become more attractive to currency reserve managers.

These smaller, but fundamentally strong **"alternative reserve currencies"** have reached historically strong levels, but we believe they **can appreciate a bit more** in the near future, given somewhat better risk appetite. The **EUR/SEK** exchange rate will drop below the 8.00 barrier this autumn before the Riksbank's key rate cuts lead to a slight rebound towards about 8.10. The **Norwegian krone** will stabilise during the autumn as the central bank increases its purchases of foreign currencies for Norway's Government Pension Fund. But then the bank will hike its key rate, driving the EUR/NOK exchange rate below its previous historical low of 7.22 and down towards 7.00.

Problems on both sides of the Atlantic affect the analysis of the EUR/USD exchange rate. **The euro will probably enjoy short-term support** because of the actions that the ECB and ESM/ESFS will launch jointly. A degree of concern about US budget policies and the "fiscal cliff" may also weigh down the dollar in the near future. In a longer perspective we believe that the **EUR/USD rate will gradually fall to 1.15**. The deep economic and political crisis in the euro zone will push down the euro for a long time to come. The US has progressed significantly further in terms of household debt deleveraging, and differences in GDP growth will remain large in the next few years. The most important argument against an even stronger USD is that the euro zone has a better external balance than the US.

Market worries have pushed down the euro

Interst rates spreads and euro index



Source: Reuters EcoWin

The euro crisis has driven the EUR/GBP exchange rate to levels that British exporters have difficulty handling. We believe that the euro may regain a little ground this autumn in conjunction with quantitative easing by the Bank of England. After that, the weakness of the euro will probably take the upper hand but the BoE is likely to take steps to soften this movement. The pound will thus gradually weaken against the USD, and the pound will generally be a loser in the FX market.

FX market interventions are becoming increasingly common and more widely accepted tools for dampening exchange rate movements. The Swiss central bank is continuing to intervene in the FX market to stabilise the EUR/CHF exchange rate above 1.20. The Bank of Japan is threatening further interventions unless the yen weakens, but we believe that the JPY will eventually weaken towards more fundamentally reasonable levels without central bank interventions. The USD/JPY exchange rate will climb towards 94 at the end of 2014.

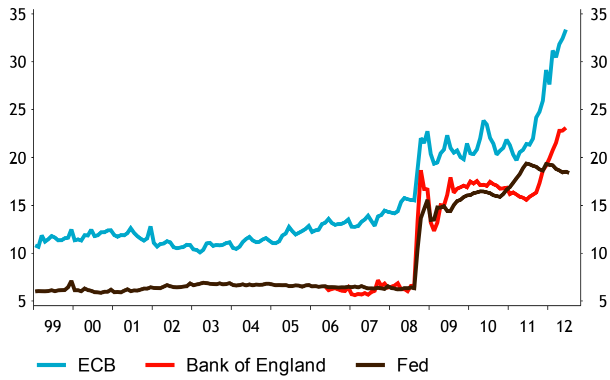
Lots of power left despite already heavy burden

- **Major potential for central banks to increase their dose of stimulus measures**
- **Price of more stimulus is lower credibility and greater risk of future imbalances**
- **Printing new money is effective but controversial**

In recent years, the world's central banks have made enormous efforts to sustain economic growth and ensure financial stability. Interest rates have been cut to the bone, while balance sheets have exploded. As such actions have grown in scale, there has been mounting concern that central banks are running out of ammunition, but as the table on the next page shows, they have a number of tools left to use. In most cases they can also increase the scale of methods already being utilised. In principle, a central bank in full control of its own money printing press always has the ability to try to stimulate economic activity and combat deflation tendencies. The dilemma is that the more extreme actions it undertakes, the greater the risks of lower credibility and future imbalances. Below is a brief description of the most important tools in a central bank's kit.

Central bank balance sheets

Per cent of GDP



Source: ECB, Bank of England, Fed

Cutting interest rates. At some time during recent crisis years, most central banks have cut key interest rates to nearly zero. To intensify the impact and influence interest rates further out on the yield curve, a central bank (like the US Federal Reserve) can promise that its key rate will remain near zero for a long period. A more extreme method is to raise the bank's inflation target to signal that monetary policy will be expansionary long-term as well. In the short term, the most extreme action is to lower the deposit rate below zero, so banks must pay the central bank to keep money there. If this "fee" is passed on to ordinary bank accounts, households too must pay to save and their desire to spend money instead will increase. Negative interest rates are still a relatively little-researched field, though they have been practiced for some time by the Danish National Bank (though not yet resulting in negative interest rates for Danish savers).

Liquidity injections. One classic way of supporting financial stability is to flood the market with "short money". Since this is done via repos, where a central bank lends money and accepts collateral, inflation risks are limited even in case of very large injections. To boost volume, many central banks have also chosen to ease the requirements for collateral they will accept for these loans. They may also choose to extend the maturity of the repos to influence longer market rates. Two examples of this are when the Riksbank offered Swedish banks a total of SEK 300 billion in three one-year repos in 2009 and when the European Central Bank (ECB) offered euro zone banks unlimited access to 3-year money in its two Long-Term Refinancing Operations (LTROs) in 2011/12.

Asset purchases. One way for a central bank to seriously begin attacking long-term yields is to buy bonds. These purchases push up bond prices (=lower yields) to levels that make prices of other assets (mortgage bonds, real estate or equities) look more attractive. In extreme cases, a central bank can even expand these actions to include direct purchases of equities or properties. The Bank of Japan (BoJ) has begun to do this on a small scale. One way for a central bank to try to influence asset prices without direct purchases is to announce a target price for the asset. Assuming that the bank is viewed as credible, the asset price will adjust relatively spontaneously to this target without the bank having to buy so much itself. The risk is that the central bank may not be viewed as credible, for example because the market sees the target price as unreasonably high. The market will then keep selling and the central bank may be forced to make enormous purchases to maintain its target price. The Fed has considered setting a ceiling on long-term yields.

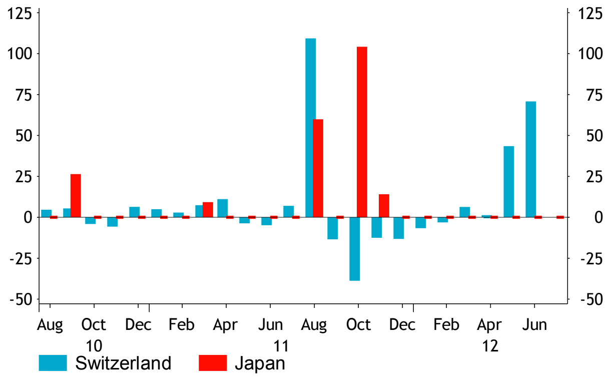
Unsterilised asset purchases. Sterilising asset purchases means that a central bank withdraws as much money (by selling certificates or via reverse repos) as it has supplied to the market as payment for assets it has bought. In this way, the money supply does not increase and inflation risks are limited. In the case of unsterilised purchases, however, the central bank does not withdraw liquidity. The assets are bought using newly printed money, increasing the monetary base and – assuming banks are willing to lend – also broader money supply measures. This has a stronger impact on the real economy and thus on inflation. In recent years, the Fed and Bank of England (BoE) have made unsterilised bond purchases, while the ECB has chosen to sterilise its (to date) modest bond purchases.

Targeted credits. A central bank can supply favourable loans to banks, which in turn lend the money to businesses and households. The BoE's "Funding for Lending" programme is one example. The BoJ has also used this method to provide targeted assistance after the 2011 tsunami.

Selling the domestic currency. One way to stimulate growth and increase inflation expectations is to sell one's own currency to weaken its exchange rate. What makes this so controversial is that a country is thus "stealing" growth from trade partners, whose currencies rise and competitiveness worsens. Because of the risk that such behaviour can start "currency wars", it is used only in exceptional cases when the exchange rate has risen sharply in a short period or shown excessive volatility. The only major central banks (without formal exchange rate targets) that practise this today are Switzerland and Japan.

Exchange interventions

USD billion



Source: Reuters EcoWin

"The helicopter drop". Perhaps the most extreme method that a central bank can use is to print new money and send it directly to households, which can then spend it. Milton Friedman called this the "helicopter drop of money", and Ben Bernanke mentioned this method in a famous 2002 speech.

The sensitive money printing press

Summarising the above discussion, one sensitive issue is to what extent a central bank "prints new money". Traditional monetary policy in the form of interest rate changes affects neither the size of the balance sheet nor the money supply. Although liquidity injections via repos and sterilised asset purchases enlarge the balance sheet, they have no direct impact on money supply. But unsterilised asset purchases and currency interventions expand the monetary base; how big an effect this has on total money supply in the economy (decisive in boosting inflation) depends on how willing the banks are to lend this money onward to businesses and households. If they do not wish to lend, the central bank can only put money into the economy by starting to buy real assets such as equities or properties or by sending cheques directly to households: the "helicopter drop".

Below we have summarised the most important tools a central bank can use to pursue more expansionary monetary policy and to what extent they have been used by various central banks. These tools are ranked (according to our own subjective assessment) from conventional to unconventional.

Direct effect of different stimulus methods on	Size of balance sheet	Money growth "printing money"	
		Monetary base	Whole economy
Rate cuts	–	–	–
"Operation Twist"	–	–	–
Liquidity injections (repos)	↑	–	–
Sterilised bond purchases	↑	–	–
Unsterilised bond purchases	↑	↑	↑?
Target for monetary base	↑	↑	↑?
Currency interventions (unster.)	↑	↑	↑?
Real asset purchases (unster.)	↑	↑	↑
"Helicopter drop" (unster.)	↑	↑	↑

Stimulus method (ranking from conventional to unconventional)	**ECB**	**Fed**	**BoE**	**BoJ**	**SNB**	**RB**	**NB**
Cut interest rates	●	●	●	●	●	●	●
Cut interest rates to close to zero per cent	●	●	●	●	●	●	○
Increase liquidity through short term repos	●	●	●	●	●	●	●
Promise to keep rates low for extended period	○	●	○	●	○	◖	○
Offer long term repos	●	●	●	●	●	●	●
Offer long term repos of unlimited size	●	○	○	○	○	○	●
Lower collateral requirements for repos	●	○	●	●	○	●	●
Lower reserve requirements	●	○	○	○	○	○	○
Extending portfolio duration (Operation Twist)	○	●	○	○	○	○	○
Sterilised bond purchases	◖	○	○	○	○	○	○
Unsterilised bond purchases (printing money or QE)	○	●	●	●	○	○	○
Set a target for monetary base (printing money or QE)	○	○	○	●	○	○	○
Buy mortgage backed securities	◖	●	◖	●	○	○	○
Buy senior unsecured bank debt	○	○	○	●	○	○	○
Raise the inflation target	○	◖	○	●	○	○	○
Negative deposit rates	○	○	○	○	○	◖	○
Offer cheap lending to targeted sectors	○	○	●	●	○	○	○
Introduce a cap on long-term government bond yields	○	○	○	○	○	○	○
Sell the domestic currency to weaken the exchange rate	○	○	○	●	●	○	○
Buy corporate bonds	○	○	○	●	○	○	○
Buy real assets such as equities or real estate	○	○	○	◖	○	○	○
Send checks to households (helicopter drop)	○	○	○	○	○	○	○

● used extensively, ◖ partly used, ○ not used (since the start of the financial crisis in 2008)

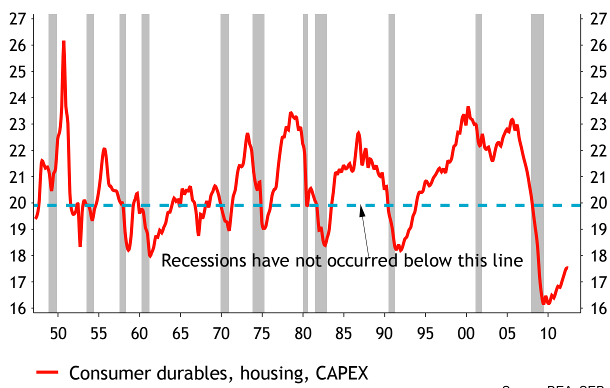
Fiscal uncertainty infecting households and businesses

- **Lower recession risk than last year**
- **The housing market has turned around**
- **Exports are losing momentum**
- **The Fed will launch Q3 in September**

The performance of the American economy has been slightly weaker than we predicted last spring. The pattern from 2010 and 2011, with slowdown tendencies in mid-year, is thus being repeated. GDP grew by only 1.5 per cent during the second quarter, on an annualised basis. Such weak growth means that **the economy has stagnated in per capita terms** and its resilience has been reduced. But despite the problems in Europe and the fiscal policy turmoil that is hampering households and businesses, we believe that **the risk of recession is lower than last year**. One key difference is that the housing market has now moved up to more solid ground. As a whole, the most cyclical sectors are close to bottoming out, limiting downside risks. In recent weeks, statistics have also generally stabilised in relation to market expectations. On the other hand, the retail sector and certain regional business indices have raised warning flags. A cyclical downturn later this autumn would also fall within the historical framework, viewed in a very long time perspective; since the 1850s, US recessions have occurred at average intervals of 3.5 years.

Most cyclical sectors are still depressed

Per cent of GDP



Source: BEA, SEB

The latest crisis wiped out 20 years of wealth accumulation. Combined with debt retirement, lower international demand, a weak labour market and fiscal tightening, this will hamper growth, especially in 2012-13. **GDP will rise by 2.2 per cent both this year and next, and by 2.6 per cent in 2014.** Not until 2014 will unemployment fall, reaching 7.5 per cent at the end of our forecast period. A tame inflation trend will give the Federal Reserve manoeuvring room and it will launch new stimulus measures in September, according to our forecasts.

Households muddling through

American households are fighting an uphill battle. Household confidence indicators remain far below historical averages. The Conference Board survey in particular has lost ground, since the labour market weighs more heavily there than in the Michigan survey, for example. Unemployment has turned upward again; in the second quarter, hours worked rose at their slowest rate in 2½ years. Meanwhile various wages and salary measures continue to weaken. Partly because oil prices have fallen since their spring peaks, however, growth in real income has been decent during the past few months. But instead of increasing their consumption, households topped up their savings in the second quarter. Consumption growth slowed to 1.5 per cent on an annualised basis. In the short term, we also expect **uncertainty about fiscal policy** to hold back consumption. Meanwhile oil prices have rebounded. We predict that **private consumption will grow by an annual average of 1.9 per cent during our forecast period**. Household income will grow slightly faster. **Households will increase their saving modestly** over the next couple of years. In 2014 we expect a savings ratio of 5.6 per cent.

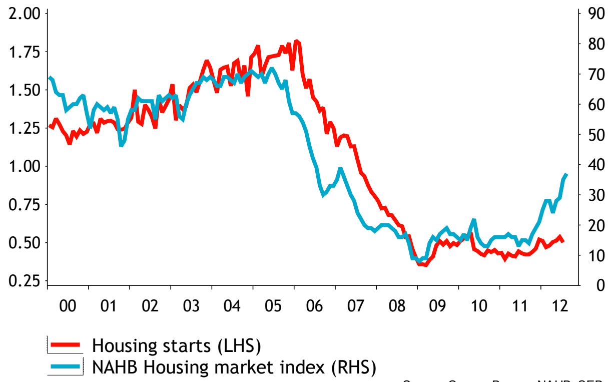
If the labour market heals faster, consumption may prove stronger than in our main scenario. Meanwhile it seems likely that earlier declines in wealth and income will hold back consumption for a while. According to a recent Federal Reserve study, median household income fell by 8 per cent from 2007 to 2010. Net wealth fell by 30 per cent, wiping out 20 years of wealth creation. Nor does the stock market upturn since 2009 benefit the average household; nearly 90 per cent of equities and more than 80 per cent of all financial holdings belong to the richest 10 per cent. Home price changes also tend to have a biggest wealth effect than stock market fluctuations, since homes are often highly leveraged. Recent positive signals from the housing market are thus a bright spot worthy of attention.

Housing market healing

After a continuous decline in 2006-2010, housing investments have contributed positively to GDP for five straight quarters. This turnaround is a step towards sustainable recovery. According to indicators, this healing process will continue; the number of building permits is 15 per cent higher and housing starts 24 per cent higher than a year ago. Meanwhile the National Association of Home Builders index is at its highest level since 2007. **Housing investments will grow by 11 per cent this year and just above 8 per cent on average in 2013 and 2014**. There is also an upside risk here, but since such investments now account for only about 2 per cent of GDP, forecasting errors have little impact on the overall economy.

Housing rebound

Millions, index

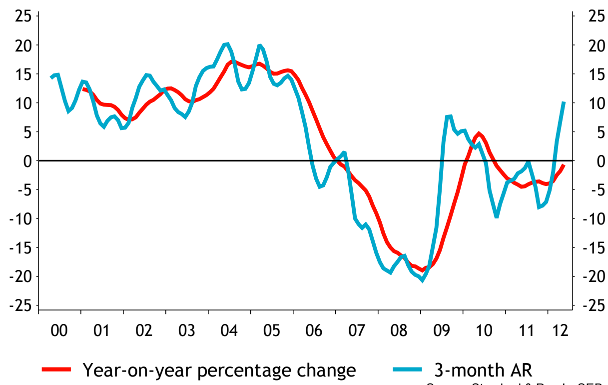


Source: Census Bureau, NAHB, SEB

Home prices have also started climbing, by most measures. The month-on-month **Case-Shiller Index has rebounded** and is close to zero year-on-year. However, several factors indicate that major home price increases are unlikely during our forecast period. Despite record-low interest rates, new mortgage applications are at near-bottom levels. Loans are cheap but not easy to get for those who are young, first-time buyers or low-income. There is still a large surplus of homes if the "shadow" inventory of future foreclosure sales is included. Yet there are reasons for optimism ahead. The number of households is increasing at the fastest pace since 2008. New home construction is growing significantly more slowly, so surplus inventory will shrink fairly rapidly. Yardsticks of value such as home prices divided by cost of rent also indicate that homes are undervalued. **More than 80 million Americans are younger than age 20**, which means that the next long-term upturn phase in the housing market is not too distant.

Home prices are increasing again

Case-Shiller Composite-20



Source: Standard & Poor's, SEB

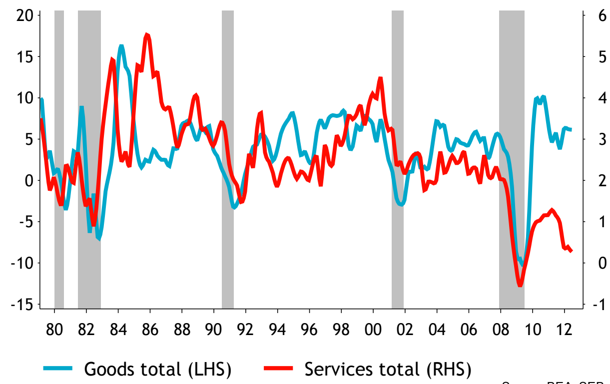
Companies are resting on their laurels

The manufacturing sector, which has shown strength and resilience during the recovery, will slow down according to our forecasts. The ISM purchasing managers' index in manufacturing, perhaps the single most important indicator of economic cycles, has dropped below the neutral 50 mark for the first time since 2009. The ISM service index has also fallen. Current ISM index levels do not signal recession, but some regional surveys do. A three-month average of the Philadelphia Fed's business outlook index stands at -12. Such a low level has historically been a reliable recession signal. The NFIB small business index remains at recession levels and has also lost ground since last spring.

Dividing the economy into goods and services, it is clear that contrary to the pattern of recent decades, goods have dominated growth so far during the recovery. The energy boom has contributed, and production of natural gas in particular has soared. In addition, the long-term trend towards falling domestic oil output has ended. Given all the large energy projects, the upturn in this sector will probably continue.

Exceptionally weak recovery in the service sector

Year-on-year percentage change

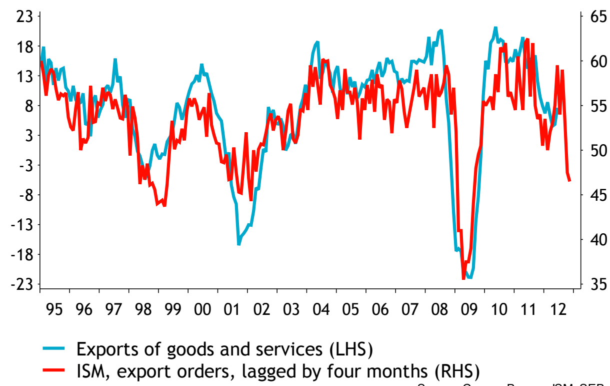


Source: BEA, SEB

However, services have lost ground and their share of GDP has fallen in recent years. If the recovery is to gain real traction, the service sector must shift into higher gear since there are many indications that manufacturing – with its links to the export sector – will face mounting obstacles. The ISM export index has plunged this summer and Europe has obviously infected American industry. Compared to one year ago, export growth to Europe has decelerated from nearly 20 per cent to 2 per cent year-on-year. Having grown by 9 per cent annually in 2010-2011 and served as an engine of recovery, exports are slowing dramatically. Our forecast is that export growth will average 5 per cent in 2012-2014, but the risk is on the downside. The current account deficit, which has been stable in recent years, will gradually widen during our forecast period.

Is a trade shock coming?

Year-on-year percentage change, index

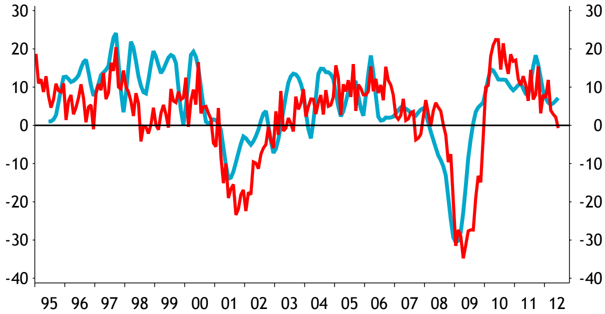


Source: Census Bureau, ISM, SEB

The appreciation of the US dollar since August 2011 – in trade-weighted terms the currency has gained 12 per cent – is also holding back exports but will probably have little impact on GDP. We estimate the GDP effect of this trend at about 0.3 percentage points over a two-year period.

Orders point to Capex slowdown

Annualised, year-on-year percentage change



Source: BEA, Census Bureau, SEB

Corporate capital expenditures ("capex") for machinery and software, one of the most cyclical elements of GDP, have grown rapidly in recent years. Very low borrowing costs and strong balance sheets provide reasons for continued optimism, but according to surveys many companies believe that demand does not justify expansion at present. According to the Fed's Beige Book, uncertainty about the fiscal policy playing field has also contributed to the postponement of investment and hiring decisions. Furthermore, such short-term indicators as order bookings show that a deceleration in corporate capital spending is on the way. Overall, however, weaker corporate investments are being offset by robust residential investments. Our forecast is that capital expenditures by businesses will grow by an average of 8.5 per cent in 2013-2014.

Unemployment is stable

Job creation has slowed since early in 2012 and unemployment has climbed a bit, but since the end of 2009 the jobless rate has fallen substantially. This is largely explained by a 5 percentage point decline in employment from its peak, equivalent to 12 million jobs. According to our forecast, unemployment will level out in the coming year and then fall gradually. **At the end of 2014, it will stand at 7.5 per cent**. As a consequence of idle labour market resources, wage and salary growth will continue to decelerate. Viewed over the past year, hourly wages have increased 1.3 per cent or USD 0.25.

Weak wage growth

Year-on-year percentage change

Source: BEA, SEB

Our forecast is that **job growth will be just above 100,000 per month during the second half of 2012**, which indicates a stable unemployment trend. But this assessment is tentative. Uncertainty about fiscal policy may cause many companies to postpone hiring. Roughly 4.4 million people are hired each month in the US, while 4.3 million leave their jobs. In the short term, a small percentage downturn in hiring may thus have significant consequences for employment.

Inflation is decelerating

Compared to one year ago, inflation has more than halved from nearly 4 per cent to 1.4 per cent in July. It appears likely that inflation will rise somewhat but stay low overall, although **rising food prices have popped up like a joker in the pack**. Food

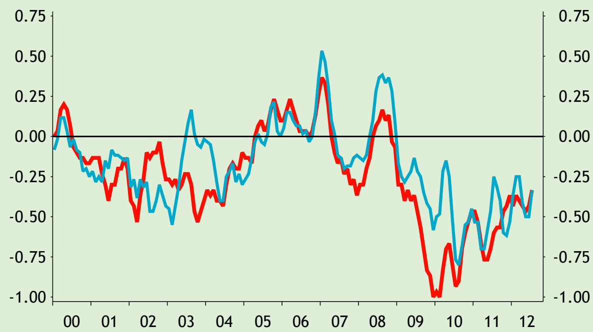
Participation rate important to the Fed

The most important reason why US unemployment has fallen in recent years is that many people have left the labour market. If labour force participation had remained at the same level as when the recovery began three years ago, the jobless rate would be around 11 per cent today. Structural factors such as retirements and the growing number of students are often mentioned as conceivable explanations. A large proportion of the downturn is also due to the numerous people who have given up their job search. Labour force participation for men is at its lowest since measurements started in 1948. In addition, the downturn in labour force participation among people in the 35-54 age category, where retirements and other structural explanations play a minor role, is also significant.

The driving forces behind lower labour force participation are of vital importance to monetary policymakers. If the downturn is mainly due to structural factors, this means that unemployment is a good measure of the amount of slack in the labour market. In that case, there is limited room for further monetary policy stimulus. But if the reason for lower labour force participation is instead that many people have temporarily given up looking for jobs, they will return when the outlook improves. The more time they spend outside the labour market, however, the harder it becomes for them to find their way back, since their knowledge and skills become rusty. In that case, there is **reason to speed up the recovery by means of additional monetary policy easing**.

Broad based decline in labour force participation

Year-on-year percentage point change



Source: BLS, SEB

and beverages account for 14 per cent of the Consumer Price Index basket and thus require significant household resources. Since declining last spring, oil prices have also rebounded. Meanwhile underlying inflation is on its way down and inflation expectations are stable. The overall picture is thus that inflation will remain under firm control in the coming year. **As annual averages, inflation will end up at 2.2 per cent this year and 2.0 per cent in 2013**. This represents a slight upward adjustment compared to our May forecast.

Fiscal policy headwind is worsening

The threatened fiscal policy tightening at the turn of this year is the single biggest threat to the US economic recovery. The combination of expenditure cuts and tax hikes would total USD 600 billion in 2013, or around 4 per cent of GDP. Active Congressional decisions will be required to ease this blow. According to current laws, the tightening effect will be greatest at the beginning of 2013 and then fade during the course of the year. The situation is uncertain, but our forecast assumes that Congress will extend most of the Bush administration's tax cuts and postpone some of the automatic expenditure cuts. Like the IMF, we expect the **fiscal headwind to total just above 1 per cent of GDP in 2013**. The federal budget deficit, which peaked at 13 per cent of GDP in 2009, will gradually continue to shrink. In 2014 the deficit will total a bit above 5 per cent of GDP. Such a trend implies that **the national debt will level out, peaking at 114 per cent of GDP in 2015**.

How large the budget tightening will be and what areas will be affected will depend on partisan political deliberations and negotiating gambits. Navigating away from the "fiscal cliff" will require that both Democrats and Republicans make concessions, but this will be tough because **this Congress is viewed as the most polarised in US history**. The structure of the system also makes it easier to prevent than to enact new legislation, unless either the Republicans or the Democrats win solid majorities in the houses of Congress after the election.

The presidential election campaign appears likely to be unusually harsh and combative. President Barack Obama has shelved bipartisanship and is pursuing a campaign against the wealthiest. His rhetoric is hard for Republicans, headed by presumptive presidential candidate Mitt Romney, to stomach. Having moved far right in order to secure the Republican nomination, Romney is finding it difficult to shift back towards the middle of the road. The president also leads in opinion polls and is the favourite among betting companies. Despite the weak economy, **Obama thus has a good chance of being re-elected**. It would be the first time since Franklin D. Roosevelt's victory in 1936 that an incumbent president wins a renewed mandate when unemployment is above 7.2 per cent.

If this forecast proves incorrect and Romney wins the election, fiscal tightening may be larger than anticipated. Vice presidential candidate Paul Ryan once unveiled an alternative budget that would slash the deficit at a significantly faster rate. Temporary cuts in Social Security pension charges expire at the end of 2012 in both Ryan's and Obama's budget proposals. But in Ryan's proposal, expenditures would be reduced dramatically in 2013-2014 and the budget effect would exceed that of Obama's proposed tax hikes. In any event, most indications are that **fiscal policy issues will play a key role in the presidential election campaign**.

Further monetary policy easing likely

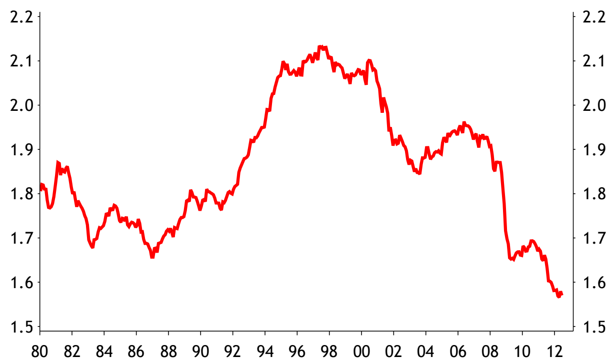
At its August Federal Open Market Committee meeting, the Fed was already leaning towards further quantitative easing but decided to postpone its decision for a while. The Fed wants to see a continuing improvement in the labour market and falling unemployment. Instead, the jobless rate has climbed in recent months, which is the clearest argument for monetary easing. Inflation has fallen rapidly this year, but this does not necessarily mean much because it was already part of the Fed's forecasts. Rising food prices may also lead to a temporary uptick. But in our assessment, tame inflation will give the central bank manoeuvring room and **new monetary policy easing will come after the September FOMC meeting**. Although interest rates are already record-low, we believe that the Fed will approve a new quantitative easing (QE) programme that will also include mortgage bonds. It also seems reasonable for the Fed to extend its "promise" to keep the key rate at the current level for an additional six months, until mid-2015.

Fed Chairman Ben Bernanke is a political appointee. His mandate expires in January 2014. Although this is not set in stone, our forecast is that Bernanke's appointment will be renewed. To some extent, uncertainty on this matter will nevertheless undermine the Fed's "promise" to keep its most important interest rate unchanged in the foreseeable future.

One problem with more QE is that its impact fades over time. According to the Fed's own analyses, QE1 helped lower the corporate cost of capital by nearly 100 basis points. The corresponding effect of QE2 totalled 13 points. One reason may be that QE1 genuinely helped the mortgage-backed securities market to find its footing again, while QE2 seems like more of a panic measure aimed at reducing fears of a cyclical "double dip". The ratio of nominal GDP to M2 money supply can be viewed as one measure of how well monetary policy has succeeded in getting the economy moving. This ratio is continuing downward towards new lows, which may be seen as evidence that monetary policy has been rather ineffective. The Fed has also declared that fiscal policymakers must also do their part in order to help bring about an economic recovery.

Velocity of money still declining

Ratio of nominal GDP to M2 money supply



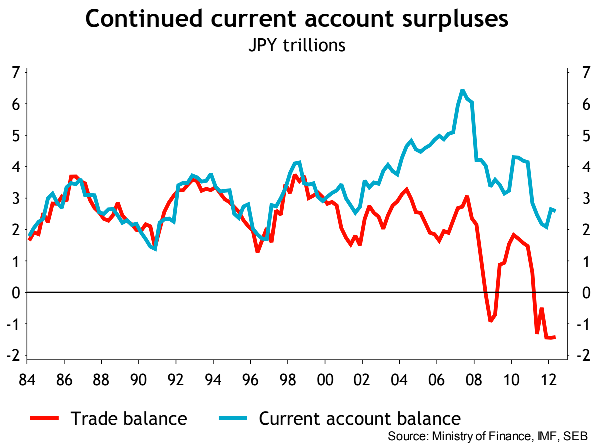
Source: Federal Reserve, BEA, SEB

A continued struggle against deflation

- **Japan's 2012 GDP growth fastest in the G7**
- **Hurt by China's slowdown and strong yen**
- **New stimulus from Bank of Japan**

The Japanese economy is continuing its uneven performance. Reconstruction after the 2011 natural disasters and stimulus measures aimed at households helped GDP increase by an annualised 5.5 per cent in the first quarter. Although GDP grew by less in the second quarter and the slowdown is likely to continue this autumn, 2012 will be a good year for growth. **The economy will expand by 2.6 per cent this year, by far the fastest in the G7 countries**. Partly due to lower Asian demand and a shift from fiscal expansion to tightening, GDP growth will decelerate to 1.5 per cent in 2013 and 2014. Meanwhile the struggle to achieve price stability will continue. **We expect the Bank of Japan (BoJ) to expand its quantitative easing programme** at least once more this year.

Household confidence indicators have stopped rising but remain at decent levels. We predict sharp fluctuations in consumption, both short-term and slightly longer-term. Since the beginning of 2012, subsidies for low-energy cars have had a clear impact, but the disappearance of this subsidy will now hamper consumption. It is also apparent that sales tax will rise from 5 to 8 per cent in April 2014 and then 10 per cent in April 2015. Similar reforms have historically had a major impact on consumption patterns. Consumers decide on their purchases earlier, with consumption rising in the quarter before the law changes and then dropping sharply when the change goes into effect. Our overall assessment is that **consumption will grow by 2.6 per cent this year and by 0.6 per cent in 2013**.



Outside the construction sector, which is benefiting from reconstruction work, companies are fighting an uphill battle. Both lower Chinese demand and euro zone problems are holding back industry, which is also struggling with a very strong currency. Purchasing managers' indices for manufacturing and services have fallen gradually since spring to well below 50, but the METI production plan survey indicates a **stabilisation in industrial output**, which fell for three months in a row during April-June. Machinery order bookings, an indicator of capital spending by businesses, fell steeply in May but regained some ground in June. Overall, we predict that **corporate capital spending will grow by around 4 per cent in both 2013 and 2014**, with a downside risk. So far in 2012, exports to China have fallen by 7 per cent year-on-year and exports to the EU are down more than 20 per cent. Partly offsetting this, exports to the US rose by a robust 15 per cent. **Exports will climb 4 per cent this year and 3.5 per cent in 2013**.

Between 2012 and 2013, a fiscal policy shift is in the cards. We also expect a **somewhat tightening direction** in 2014, but this will not suffice to achieve primary balance (excluding interest payments). Contrary to the trend in most countries, Japan's deficits as a share of GDP have increased in recent years. The deficit will be 8 per cent of GDP in 2013 and 7.5 per cent in 2014: well above other leading economies. Government debt will thus grow to **a huge 245 per cent of GDP in 2014**.

Japan showed a trade deficit in 2011 as well as so far this year. This raises important questions about the prevailing economic structure, with net savings and large current account surpluses. Since other components lead to such big surpluses, current account deficits seems improbable in the next couple of years. But if this assessment is wrong, the consequences are likely to be dramatic since Japan will be forced to import capital to fund its government debt.

Tighter fiscal policy will be offset in part by new monetary easing. Regardless of whether Yoshihiko Noda's administration gets a renewed mandate or a new government takes power, **price stability will be high on the agenda**. As long as inflation falls below target, the BoJ is likely to be under continuous pressure. **Inflation**, which has fluctuated around zero so far this year, **will end up a bit below the BoJ's 1 per cent target next year as well**. The bank is thus likely to gradually expand its quantitative easing programme, which already encompasses USD 875 billion (JPY 70 trillion), mostly in Japanese government bonds. Besides sovereign bonds, purchases of corporate bonds and equities may be considered.

The yen has fluctuated sharply this year. Having weakened sharply early this year, it has appreciated again to **near record-strong levels against both the US dollar and the euro**. This has led the IMF to support possible foreign exchange market interventions. Our forecast is thus that the yen has peaked for now and will weaken. **The USD/JPY rate will be 80 in December 2012 and 85 in December 2013**.

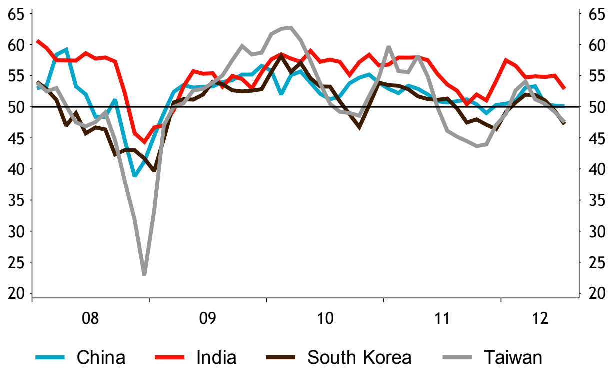
Showing resilience to new pressures

- **Domestic demand will help offset export deceleration**
- **No hard landing in China**
- **Clear growth slowdown and major reform needs in India**

Asia's emerging economies are now being squeezed by weak international demand and past economic austerity measures. Purchasing managers' indices have recently fallen noticeably in many countries. GDP growth decelerated somewhat further during the second quarter of 2012. This slowdown is the most apparent in highly export-dependent economies such as Singapore and Taiwan. Yet we still believe that strong domestic demand – driven by more accommodative economic policies, low household debt and good wage growth – will help **sustain decent growth in Asia over the next couple of years**. Although GDP increases will end up below trend during our forecast period, the region will remain resilient to weakness in Europe and the United States, thereby providing important **support to the rest of the world economy**.

Purchasing managers' indices have fallen

Manufacturing sector



Source: Markit, National Bureau of Statistics of China

Compared to 2011, inflation pressure in Asia has eased. A cautious recovery in energy prices during the past few months, as well as the recent price upturn for agricultural commodities, nevertheless mean that **inflation is expected to climb temporarily in many countries**. Underlying inflation will remain low, however, and the higher inflation rate is not expected to have any major effects on monetary policy.

Because inflation has cooled greatly since 2011, most central banks in the region have a chance to lower key interest rates in order to stimulate growth. This has already occurred in South Korea and Vietnam, for instance. Strong finances will also enable governments **to use fiscal policy as a response to weaker external demand**. Hong Kong and Singapore have the best potential to pursue expansionary fiscal policies, while large budget deficits in India and Vietnam are blocking this opportunity in practice.

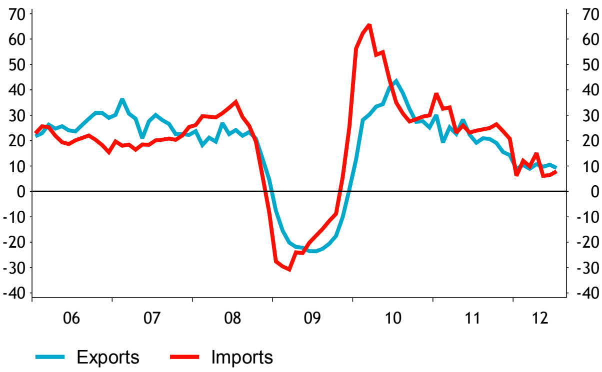
China: Signs of stabilisation

Statistics for the past two months have supported our assessment that **China can avoid a hard landing**, as long as the economy is not subjected to a powerful external shock. Growth cooled further, from a year-on-year rate of 8.1 per cent in the first quarter to 7.6 per cent in the second quarter. The growth rate thus fell for the sixth consecutive quarter.

These statistics point to a **stabilisation of the economy late in the second and early in the third quarter**. Purchasing managers' indices and leading indicators have levelled out. The labour market has coped well with the downshift in growth, and continued good pay increases are helping to sustain the retail sector. Car sales have rebounded in recent months. Meanwhile the important housing market is showing signs of recovery and exports are beginning to stabilise, but industrial production remains weak. **In 2012 as a whole, we expect GDP growth to end up at 7.8 per cent. In 2013, GDP will increase by 8.0 per cent and in 2014 by 8.2 per cent**. We have revised our forecasts for both 2012 and 2013 downward by 7/10 of a percentage point since the May issue of *Nordic Outlook*. This GDP forecast assumes that continued monetary easing along with more expansionary fiscal policy will help sustain growth during the second half of 2012 and in 2013.

Export and import growth is levelling out

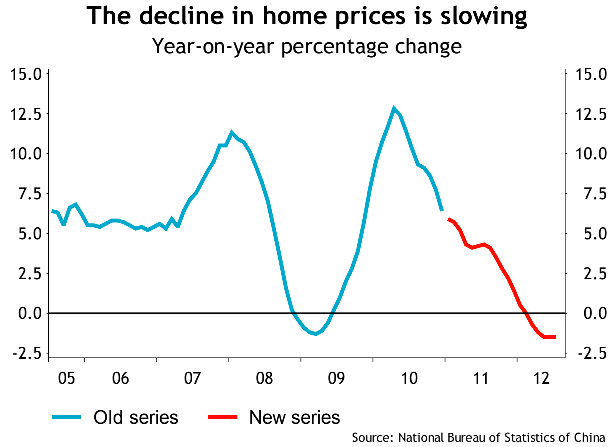
Year-on-year percentage change, 3-month moving average



Source: National Bureau of Statistics of China

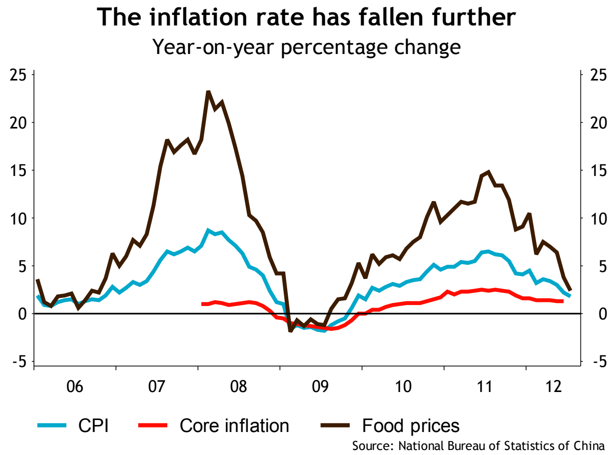
Exports have shown signs of levelling out in recent months, although July figures were unexpectedly weak, with a year-on-year increase of only 1 per cent. It might be difficult to reach the target of a 10 per cent increase for exports in 2012. However, during 2013 and 2014 we expect China's exports to revert to a growth rate of between 10 and 15 per cent.

Signs of stabilisation in the housing market are growing stronger. The number of home sales has risen in recent months, although prices continue to fall somewhat year-on-year. There has been no significant easing of the government's regulations, which indicates that the recovery is being driven by stabilisation in underlying demand. Since prices have fallen as wage levels have continued to rise, this means the ability of households to buy homes has improved. We thus believe that the **risk of a hard landing in the housing market has receded further in recent months**.



Efforts to boost bank lending by lowering reserve requirements and urging banks to expand their loan portfolios are now beginning to bear fruit. New lending rose at a healthy pace during the spring but fell to CNY 540 billion in July. Looking ahead, lending is expected to continue upward; both banks and state-owned enterprises have received clear signals to lay the groundwork for expanded infrastructure investments.

The inflation rate has cooled greatly in recent months; in July, inflation was 1.8 per cent. Core inflation is at low, stable levels and the rate of food price increases is only 2.4 per cent year-on-year. However, temporary base effects explain a large proportion of the CPI inflation slowdown in recent months. This is one reason why we expect the inflation rate to climb a bit in the near term, though we believe it will remain below the official 4 per cent target during our forecast period. China has thus successfully achieved control of inflation and there is now good potential for economic stimulus measures. **As annual averages, we expect inflation to end up at 3.1 per cent in 2012, 3.5 per cent in 2013 and 3.8 per cent in 2014**. Rising food prices in the world market pose an upside risk.



Partly due to slower inflation, the People's Bank of China has cut its key interest rate faster than we had anticipated. Since May, it has lowered the rate from 6.56 to 6.00 per cent. Furthermore, flexibility in rate-setting has increased. In our assessment there will be **further key rate cuts in the third and fourth quarters**, after which the key rate will remain at 5.50 per cent during our forecast period. Bank reserve requirements have been lowered three times since November but remain historically high. We expect further cuts from the current 20 per cent to 18.5 per cent by the end of 2012.

This October or November, a large portion of the Communist Party leadership will be replaced. This change of leadership is curbing the desire to introduce new reforms; we thus expect

China boosting tensions in vicinity

China's emergence as a major economic and military power is increasing the risk of conflicts with other countries in South-east Asia but also with the US, which has a central security policy role in the region. Control of the South China Sea is an important source of tension, since this "inland" sea has extensive gas and oil resources and is meanwhile one of the world's most heavily trafficked maritime transport lanes, accounting for more than half of global volume. Disputes on territorial boundaries between China and such countries as the Philippines and Vietnam have occurred regularly over the past decade and have recently become even more frequent.

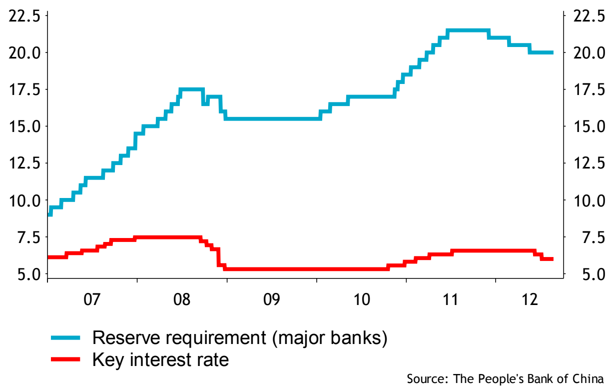
China's challenge to the US as the leading power in the region has already caused the US to begin shifting a large proportion of its military forces from the Middle East to Asia. In addition, sizeable rearmament is also under way in other countries in South-east Asia; these countries are also being forced into a rapprochement with the US in order to counter-balance China's increasing strength.

The risk of serious confrontation between China and the US is small at present. China's defence expenditures are still limited compared to the US; estimates for 2012 are around USD 160 billion, but the US spends more than four times as much. Yet the long-term trend favours China, which can also focus its resources in Asia while the US has global obligations. So far, China's strategy apparently prioritises economic development over military ambitions, but its tone has become more strident in recent years. The rising number of recent incidents, combined with China's growing strength, indicates a major risk of limited conflict with Vietnam or the Philippines. Such a conflict seems unlikely to have any major impact on the big Chinese economy but may strike a harder blow against Vietnam, for example, where 10 per cent of exports go to China and revenue from Chinese tourists is also important.

only a careful adjustment of economic policies. Fiscal policy is starting to be more expansionary, however. Given the lack of automatic stabilisers such as unemployment benefits, active fiscal measures are especially important when growth slackens. With the 2012 public sector budget deficit expected to be 1.5 per cent of GDP, there is potential to pursue an expansionary fiscal policy, but China is unlikely to see a stimulus programme of the same magnitude as it launched in 2008-2009 (some 7 per cent of GDP), which led to imbalances and debt for local authorities. Instead it is a matter of **reversing the sharp deceleration of the past two years in central government infrastructure investments**. For example, railway investments will double in the second half of 2012 and it will be easier for private companies to participate in infrastructure investments.

Monetary policy is being eased

Per cent



Throughout 2012, the appreciation of the yuan against the US dollar has halted. The Chinese currency has even lost some value. Although it has weakened by only around 1 per cent, this is the first extended period of depreciation since the currency peg ended in 2005. There are several reasons for this. China's long-term objective is an exchange rate that can move in both directions. The central bank thus has an interest in eliminating the common assumption that the yuan cannot depreciate against the USD. A strengthening of the dollar against currencies like the euro has also pushed up the value of the yuan in trade-weighted terms. This strengthening in trade-weighted terms has contributed to China's weak export trend and low inflation, which in turn has reinforced the motives for the new currency strategy. However, the People's Bank of China has intervened at the CNY 6.38 per dollar level to avoid further depreciation. We thus expect changes in the CNY's rate against the dollar to be small during the rest of 2012. In 2013 and 2014, we foresee a resumption of the appreciation trend against the dollar. **In our assessment, the USD/CNY exchange rate will stand at 6.30 at the end of 2012 and 6.20 at the end of 2013. In 2014 it will end up at 6.00.**

India: Weak response to sharp deceleration

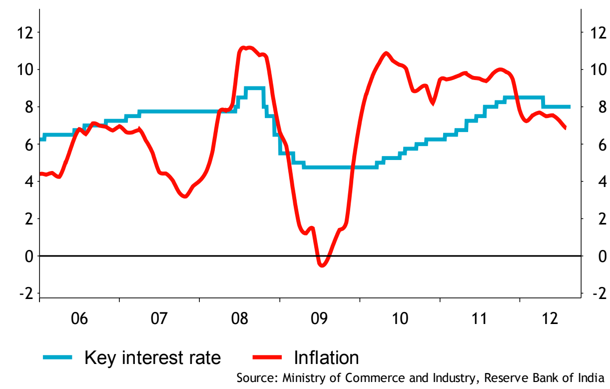
GDP growth continued to slow in the first quarter to 5.3 per cent year-on-year, substantially worse than expected and the weakest increase since 2004. The purchasing managers' index has stabilised but is below the average for the past six years. Meanwhile leading indicators have fallen. **Weak capital spending is the main explanation for sagging domestic demand**. Both industrial production and exports have dropped significantly during 2012. The export level is now lower than on the corresponding date in 2011, despite a major rupee depreciation. A weak monsoon rain season is expected to hurt agricultural production. Overall **we expect GDP to grow by 5.8 per cent in 2012 and 6.0 per cent in 2013, with growth of 6.5 per cent in 2014**. We have revised our forecast sharply downward compared to *Nordic Outlook* in May.

It is increasingly evident that **economic growth is being held back by weak structural policies**. This includes the need to reform the system of costly energy subsidies. This summer's widespread electricity outages are an obvious example of the result of many years of neglected infrastructure investments. Various sectors, such as retailing, need to be opened up to foreign competition. However, no major decisions are expected to be made before the May 2014 parliamentary election. Looking further ahead, the prospects of a better reform climate are not especially good, since the largest opposition party is also cool towards economic reforms.

Meanwhile a large budget deficit, along with stubbornly high inflation, will mean that both **fiscal and monetary policies have little room to stimulate the economy in the short term**. Inflation admittedly slowed to 6.9 per cent in July but remains well above the central bank's comfort zone. Nor is inflation expected to decline much in the future. The rupee has weakened by around 20 per cent against the US dollar in the past 12 months, pushing import prices upward. **We believe that inflation as a full-year average will end up at 7.2 per cent in 2012 and at 7.0 per cent in 2013 and 2014**.

Inflation is stuck close to 7 per cent

Per cent



The Reserve Bank of India is in a difficult position, having to weigh high inflation against a sharp deceleration in growth. After cutting its key interest rate by 50 basis points in April, the central bank has left this rate at 8.0 per cent. During 2012, communication from the Reserve Bank has been a poor guide to its interest rate decisions. However, the central bank apparently believes that rate cuts only have a limited impact on growth and that they instead risk fuelling inflation. Our assessment is that the **key interest rate will be cut by 25 points in the third quarter and another 50 points during the fourth quarter and then remain at 7.25 per cent**.

The central bank's attempts to stabilise the currency have been unsuccessful; the rupee has continued to weaken in recent months. **We expect the USD/INR rate to be 55.0 at the end of 2012 and 52.5 at the end of 2013**.

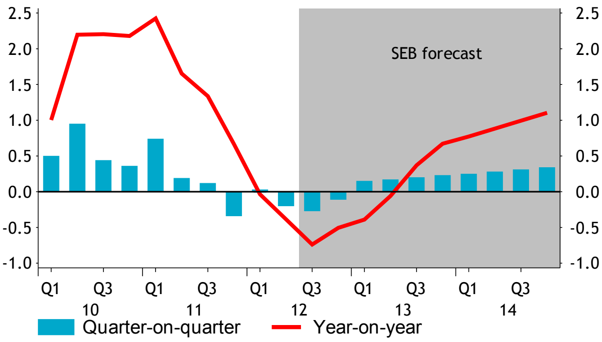
Near-zero growth in 2013 due to crisis-hit countries

- **Signs of German economic deceleration**
- **Weakening euro providing some support**
- **Bundesbank opposes ECB bond purchases**

The euro zone economy is continuing its slump. In the second quarter of 2012, GDP fell by 0.2 per cent from the first quarter. Leading indicators point towards a further downturn in the third quarter. Meanwhile there are worrisome signs that German growth is also decelerating. We have thus delayed the date when we believe the euro zone economy will stop shrinking. This mainly affects our full-year forecast for 2013. As annual averages, we foresee that **euro zone GDP will fall by 0.4 per cent in 2012. Next year GDP will rise by 0.2 per cent**: a downward revision of 0.6 percentage points from the May *Nordic Outlook*. **In 2014, growth will accelerate to 0.9 per cent** but remain well below long-term trend growth.

GDP growth is expected to bottom out in the third quarter

Per cent



Source: Eurostat, SEB

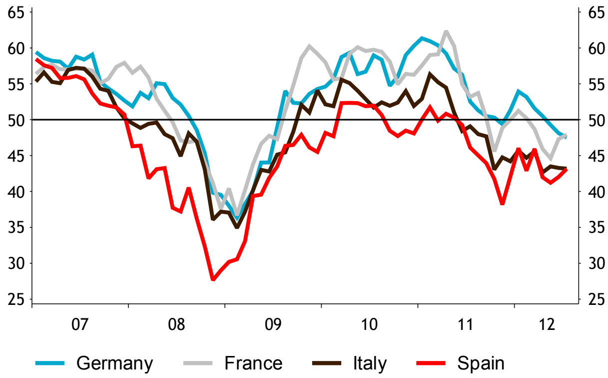
Deepening economic problems meanwhile imply that new steps will be taken to resolve the crisis. Despite resistance by Germany's Bundesbank, the European Central Bank (ECB) is now moving towards assuming greater responsibility for stabilising the euro and helping crisis-plagued countries by purchasing their sovereign bonds. **The ECB's arsenal of weapons is extensive and should not be underestimated**. ECB actions will also create more political manoeuvring room. Yet there is a risk that disunity about the mandate, objectives and tools of the European Stability Mechanism (ESM) or disputes about the European Council's recent roadmap *"Towards a genuine economic and monetary union"* will again increase uncertainty about managing the euro zone crisis. The ability of political systems to gain popular support for deeper economic, fiscal and political cooperation will be crucial in the long term. As earlier, our conclusion is that **the future of the euro in its existing form is surrounded by uncertainty**.

Signs of German economic slowdown

Most euro zone indicators have fallen since the May issue of *Nordic Outlook*. The composite purchasing managers' index (PMI) in Germany has fallen four months in a row. The indices have ended up below the neutral 50 mark in all four of the largest euro zone countries, but their levels are showing signs of stabilisation and are well above their 2008-2009 lows. **PMI figures thus indicate a relatively limited GDP decline**, consistent with our current forecast, rather than a sharp slide.

Purchasing managers' indices have weakened

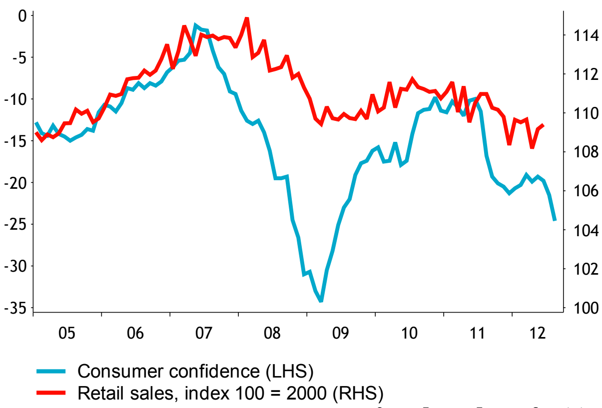
Composite PMI, index figure



Source: Markit Economics

Consumer confidence is still squeezed by high unemployment and austerity measures. In Italy, confidence has even fallen below the depths reached during the 2008-2009 crisis. Depressed retail sales and private consumption will contribute to lower euro zone growth during our forecast period.

Plunging consumer confidence, stagnant retail sales



Source: Eurostat, European Commission

Germany plays a vital role in sustaining euro zone growth. After an export-led upturn during 2011 and a strong first quarter, the German economy decelerated in the second quarter of 2012, with growth of only 0.3 per cent. The IFO business sentiment index fell in July for the third consecutive month. Although it remains well above its long-term average level, the decline has contributed to increasing concern about the resilience of the German economy to the ongoing euro zone crisis. The ZEW index, which measures the German financial sector's view of economic prospects, has also fallen significantly in recent months. Exports, industrial production and retail sales have held up decently so far, but **order bookings are now beginning to show signs of weakness**. German order bookings fell by nearly 8 per cent year-on-year in June and are well below their latest peak in mid-2011.

Because of a clearer impact from the international crisis, we are revising our GDP forecast downward by 0.6 percentage points, but good competitiveness and strong government finances and somewhat more expansionary fiscal policy in the run-up to the autumn 2013 Bundestag election will avoid recession. **German GDP will grow by 0.8 per cent this year and by 1.0 per cent in 2013. In 2014, growth will accelerate to 1.5 per cent**.

GDP, selected countries

Year-on-year percentage change

	2011	2012	2013	2014
Germany	3.1	0.8	1.0	1.5
France	1.7	0.3	0.3	0.5
Italy	0.5	-2.0	-0.6	0.3
Spain	0.7	-1.7	-0.8	0.1
Greece	-6.9	-6.4	-2.9	-1.1
Portugal	-1.6	-2.8	-2.4	-0.5
Ireland	1.4	0.1	1.1	1.6
Euro zone	**1.5**	**-0.4**	**0.2**	**0.9**

Source: Eurostat, SEB

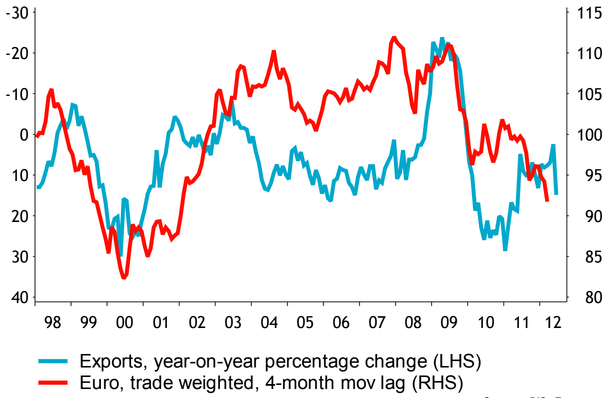
Weakening euro providing some support

In recent months, the euro zone crisis has led to a noticeable currency depreciation. In real trade-weighted terms, the euro reached its lowest level since 2002 this July. It has weakened by around 3 per cent against the US dollar since 2012 began. **To some extent, the weakening of the euro is cushioning the economy**. Shifts in exchange rates tend to affect exports with a 4-5 month lag, and this past year's weakening of the euro is sufficiently large to help exports grow in the future.

However, a weaker euro is of limited importance to crisis-hit countries, since it does not help their competitiveness against the euro zone core countries that are their most important export markets. Euro depreciation is also being offset by falling external demand. Export order indicators have remained weak in recent months, and the example of the 2008-2009 crisis shows that euro zone exports fell sharply despite a major slide in the value of the common currency.

We estimate that a 10 per cent weakening in the euro will have an overall GDP effect of about 0.5 percentage points. The effects vary between countries, depending on both size of exports compared to GDP and how much of these exports will go to countries outside the euro zone. A sizeable proportion of exports from countries like Germany and Ireland, around 60 per cent, is destined for countries outside the euro zone. Their exports thus benefit more from currency depreciation. In Spain around 40 per cent of exports go to countries outside the euro zone, and in Greece as little as 30 per cent, which means that the growth stimulus is especially weak for these economies.

Can euro depreciation help stimulate exports?



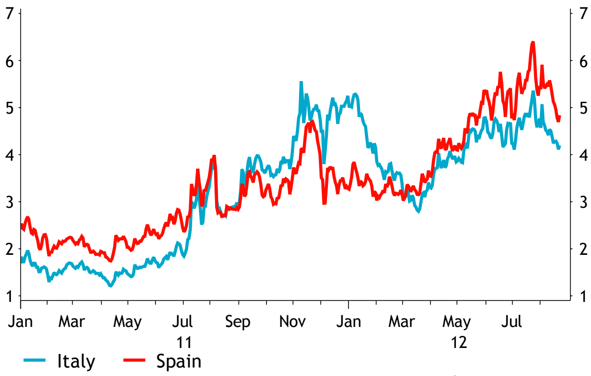
Source: BIS, Eurostat

Continued challenges in crisis-hit countries

The situation in Greece has stabilised somewhat, at least temporarily. The three-party government – New Democracy, Pasok (Social Democrats) and the Democratic Left – seems determined to implement the measures that Athens and the "troika" of international lenders agreed on as prerequisites for new loan payments (next round: September or October). Major difficulties remain, however, since a shrinking economy combined with widespread tax-dodging and faulty collection systems are counteracting the effects of the austerity measures. The conclusion remains that the tax situation is untenable and that the public debt target of 120 per cent of GDP is not credible. **The assessment is that a new debt restructuring will take place, with a 30 per cent haircut on the nominal value of Greek sovereign bonds**. The public sector will take the hit this time instead of the private sector. The political and socioeconomic challenges remain so large that **there is still a risk that Greece will abandon the euro**.

Sovereign bond yield spread against Germany

10 y government bonds, percentage points



Source: Reuters EcoWin

In **Spain**, macroeconomic growth remains very weak. The government continues to carry out its crisis policies but is under pressure from political protests. Unemployment, now nearly 25 per cent, is expected to rise further. Home prices have fallen 30 per cent since their 2007 peak. We anticipate a further decline of at least 10 per cent. Together with the risk of poorer economic performance in South America, this will lead to strains for the Spanish banking system. The bail-out loan to the banking system of up to EUR 100 billion will initially increase public sector debt to around 90 per cent of GDP by the end of 2012. Spain's debt thus remains lower than the euro zone average. **Spain is**

expected to apply for a traditional bail-out loan within one year. Sources within the European Commission have indicated that an amount as large as EUR 300 billion may be needed in order to stabilise Spain's government finances.

Our assessment is that **the European Union's bail-out funds have enough resources available to finance a Spanish rescue package**. Instead, the problem is that in practice, a rescue package would use up the resources of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Given the current size of these funds, it would thus become impossible to finance any rescue loans to Italy and give additional aid to Ireland and Portugal. Expanding the resources of the bail-out funds has proved politically difficult, which implies greater pressure for action by the ECB.

In **Ireland** and **Portugal**, the situation has brightened somewhat. Both countries have implemented the reforms connected to their bail-out packages. Macroeconomic conditions are showing signs of stabilisation. Ireland's export-driven economy can also take advantage of the weaker euro.

Italy appears capable of greatly reducing its budget deficit over the next couple of years. The main risk seems to be of a political nature: the confidence in the incumbent technocratic government will be undermined, triggering a new election. As in Spain, macroeconomic growth is very weak. GDP fell during the second quarter, for the fourth quarter in a row. Unemployment is starting to approach 11 per cent.

France also has weak central government finances, but at present its **deficit problems** are not so acute. Instead, the economy is being hampered by weak competitiveness and **nonexistent growth**. President François Hollande has proposed measures that actually risk making the economy function more poorly, for example tax hikes and a partial reversal of the increased retirement age. The government has occasionally adopted a strident tone towards the auto industry, which is being forced to dismiss large numbers of employees due to excess capacity. This indicates an insufficient grasp of the problems.

Fiscal tightening, selected countries

Change in cyclically adjusted saving, per cent of GDP

	2011	2012	2013	2014
Germany	1.2	0.4	0.1	0.2
France	1.1	0.9	0.6	0.3
Italy	0.4	2.5	1.0	-0.3
Spain	0.8	3.1	0.3	-0.1
Greece	3.3	2.2	1.8	1.6
Portugal	2.6	3.3	1.6	-0.2
Ireland	1.9	1.9	0.8	1.7
Euro zone	**1.0**	**0.4**	**0.2**	**0.2**

Source: IMF, SEB

Budget austerity measures have peaked

In the euro zone as a whole, fiscal policy was at its tightest as early as 2010, with an effect equivalent to 1.0 per cent of GDP. This was due to austerity measures in the crisis economies but also because fiscal policy shifted after the stimulus measures of 2008-2009. **Compared to coming austerity measures in the US and the UK, the 0.5 per cent effect in the euro zone is relatively small**. The most dramatic belt-tightening is occurring in relatively small countries and thus does not have such a major impact in the region as a whole. Austerity policies will

Growing mutual dependence in the euro zone

Since the creation of the common currency, there has been a strengthening of the mutual dependence situation in the euro zone. Economic imbalances within the region and the ongoing liquidity crisis have been instrumental in driving this trend.

Compared to other parts of the world economy, the euro zone as a whole has a relatively good balance with other countries, reflected in relatively small current account surpluses and deficits. However, this conceals large internal imbalances. In 2011, Germany was the world's largest exporter of international investment capital while Italy, France and Spain were the world's 3rd, 4th and 5th largest importers of capital. Germany's international wealth position has grown by EUR 821 billion in the past decade. During the same period, Italy, France and Spain increased their debt by EUR 1,208 billion (see table).

As long as the gaps in competitiveness between euro zone countries persist, current account deficits must be financed. Debtor-lender relationships are overwhelmingly internal within the euro zone. When a borrower's payment capacity is in question, this means that there is a lender – such as a pension fund, bank, industrial company or central bank – that is not sure it will achieve a return on its investment (or that risks a debt write-down). It is difficult to see how these imbalances can be reversed through repayments generated by changes in trade flows. Instead it is likely that large capital transfers from "North" to "South" will need to take place. Debts and assets need to be written down, and a system of mutual responsibility for payments will have to expand in order to save the euro.

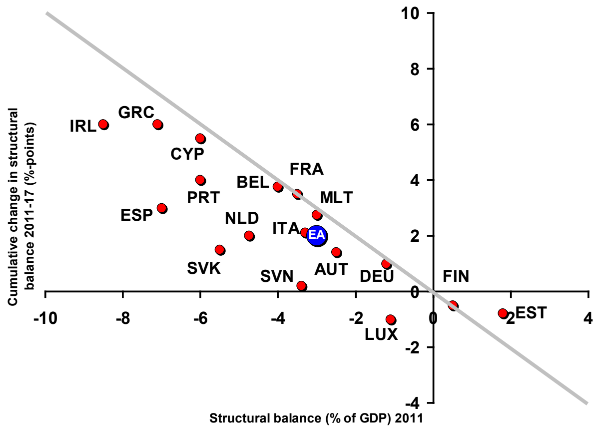
EUR billion Selected euro zone countries	External position 2002	External position, 2011	Change, 2002-2011
Germany	108	929	+821
Netherlands	-112	249	+361
Belgium	98	213	+115
Luxembourg	24	36	+12
Finland	-53	31	+84
Slovakia	-6	-45	-39
Ireland	-23	-153	-129
Greece	-83	-171	-88
Portugal	-77	-176	-99
France	47	-317	-364
Italy	-161	-325	-164
Spain	-303	-983	-680

Source: Eurostat

continue, although our assessment is that the countries providing bail-out funds will ease their conditions a bit. This year, belt-tightening in crisis-plagued countries is equivalent to 2-3 per cent of GDP. It will decline to 1-2 per cent in 2013. Further large-scale austerity measures appear unlikely. Spain, Italy and France believe they can narrow their budget deficits without further actions, but this will depend on macroeconomic growth not deteriorating further.

Although crisis-hit countries are making progress and actual cyclically adjusted deficits are improving, most euro zone countries are still expected to show budget deficits in 2014. The overall euro zone deficit is expected to fall from 4.1 per cent of GDP in 2011 to 3.3 per cent in 2012. **In 2014 the deficit is expected to have shrunk to 2.2 per cent. Central government debt will stand at 93.0 per cent of GDP.**

Euro area: Planned fiscal consolidationIs it enough?



Germany's strong government finances lowers the budget deficit for the region as a whole. The country's deficit will stabilise at 0.5 per cent of GDP in the next couple of years despite weak growth. Germany has pursued a weakly contractive fiscal policy, which has held back recovery. In discussions about reducing global imbalances, Germany's current account surpluses are often cited, but looking at the public sector, no wealth has been built up in the past decade. On the contrary, government debt has risen from around 60 per cent of GDP in 2001 to more than 80 per cent in 2011.

Public budget balance, selected countries

Per cent of GDP

	2011	**2012**	**2013**	**2014**
Germany	-1.0	-0.6	-0.5	-0.5
France	-5.2	-5.0	-4.0	-2.9
Italy	-3.9	-2.0	-1.6	-1.4
Spain	-8.5	-6.6	-5.0	-4.2
Greece	-9.1	-6.5	-4.8	-3.2
Portugal	-4.2	-4.5	-3.1	-2.8
Ireland	-13.1	-8.5	-7.2	-4.8
Euro zone	**-4.1**	**-3.3**	**-2.7**	**-2.2**

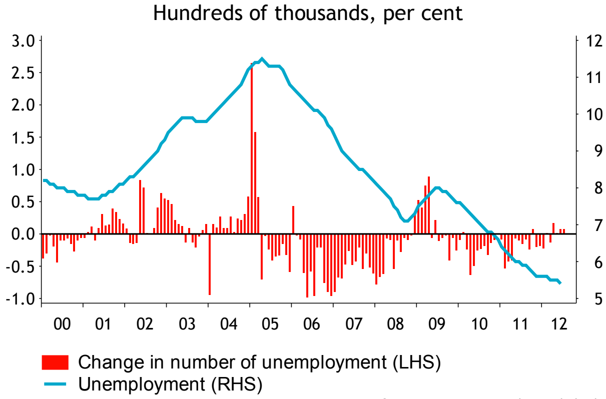
Source: EU commission, SEB

Unemployment sets new records

Unemployment continues to set new records; in June it reached 11.2 per cent. The number of unemployed in the euro zone is now close to 18 million, up more than 2 million in one year. This increase is still being driven by crisis-hit countries. Unemployment continues to climb rapidly in Greece and Spain. The labour markets in France, Italy and Portugal are also continuing to weaken, though more slowly. But in Ireland, signs of stabilisation are apparent. Until last spring, the weakening of crisis-hit countries' labour markets was partly offset by falling joblessness in Germany. **German unemployment now seems to have bottomed out**. The number of people without jobs has risen in recent months, albeit marginally. Because of weaker economic signals, we foresee a slight upturn in the jobless rate, though from low levels,

German labour market no longer gaining strength

Hundreds of thousands, per cent

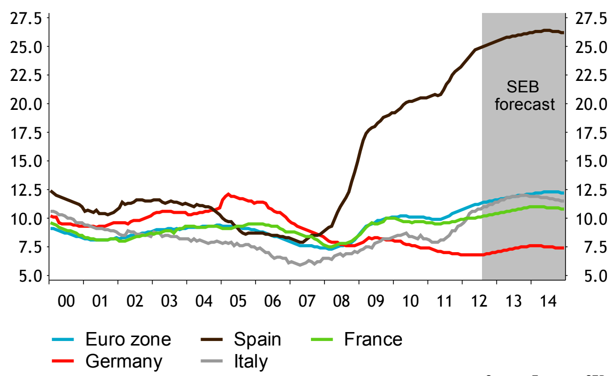


Source: Eurostat, Deutsche Bundesbank

Generally weak economic growth in the euro zone, combined with public sector job cuts in crisis-hit countries, will mean a continued overall increase in the jobless rate. Measured as annual averages, **we expect euro zone unemployment to end up at 11.2 per cent this year and 11.9 per cent in 2013. We then expect the jobless rate to level out in the course of 2014, but the annual average will still rise to 12.3 per cent**. We have revised our unemployment forecast slightly upward since the May *Nordic Outlook*. The weak labour market will hold back consumer demand and thus economic growth. A more serious aspect is that mass unemployment threatens to undermine popular support for austerity policies, thereby weakening the legitimacy of the political forces that back them.

Unemployment already at a record level

Per cent



Source: Eurostat, SEB

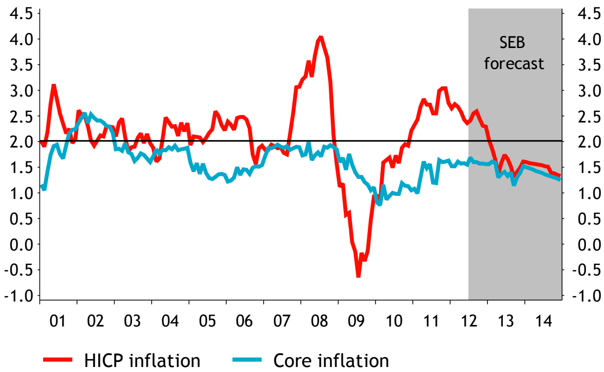
Inflation still above ECB target

In July, HICP inflation remained at 2.4 per cent for the third consecutive month, well above the ECB ceiling of just under 2 per cent, but the rate has fallen from 2.7 per cent at the beginning of this year. The price upturn will continue to slowly decelerate during the rest of 2012, among other things because energy price increases in 2011 will disappear from the 12-month figures. Meanwhile inflation is being pushed down by weaker economic activity and reduced capacity utilisation, but due to rising energy and food prices the deceleration will occur more slowly than in our previous forecast. Inflation expectations remain stable at close to the ECB target.

Measured as annual averages, the inflation rate will end up at 2.5 per cent in 2012. In 2013 it will fall further to 1.6 per cent and to 1.5 per cent in 2014. Core inflation has remained around 1.6 per cent since autumn 2011 and will fall further to 1.4 per cent at the end of our forecast period, driven by low capacity utilisation.

Inflation is above the ECB target

Year-on-year percentage change



Source: Eurostat, SEB

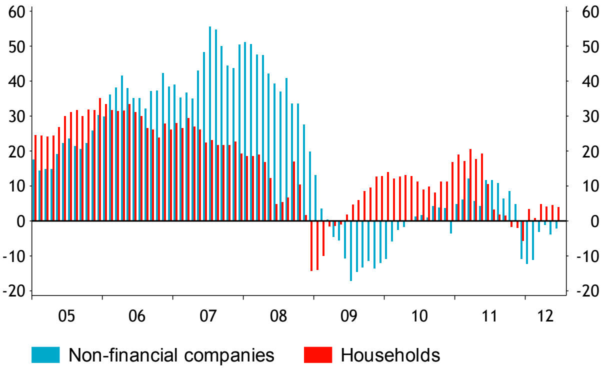
Expanded actions by the ECB

At its July monetary policy meeting, the ECB lowered its refi rate by 25 basis points to 0.75 per cent – below its 1.0 per cent floor during the 2008-2009 crisis – after having waited since last spring for the right moment. We expect this rate cut to have rather limited stimulus effects. Further rate cuts are two-edged, since they also weaken incentives for banks to lend money. As part of efforts to promote more efficient markets, the ECB also seems unwilling to lower its deposit rate below today's 0 per cent. **Our assessment is that the ECB will cut the refi rate one more time in October but then leave it at 0.5 per cent for the rest of our forecast period.** The ECB is apparently not considering new three-year (LTRO) loans of the type that it has offered earlier. One reason is that the ECB's latest *Bank lending survey* singles out low demand from companies, not tight credit conditions, as the main reason for low lending, but we believe that the ECB will be prepared to imple ent new LTRO stimulus rounds at a later stage.

Early in September, the ECB will unveil details of its new bond purchasing programmes. The point of departure will be that the bank should not replace the ESM bail-out fund but instead serve as a "lender of last resort" for governments that cannot obtain short-term funding (up to one year) at reasonable bond yields. This decision implies ignoring the wishes of Germany's Bundesbank, but this will probably occur with the implicit acceptance of the German federal government. The ECB may argue that this action will help lubricate the traditional monetary policy transmission mechanism; this may also help soften the Bundesbank's opposition.

Continued weak bank lending

Net basis, EUR bn, 3-month moving average



Source: ECB

The ESM bail-out fund is expected to start its operations immediately after the German constitutional court has given its approval on September 12. Although its is desirable for all 17 euro zone finance ministers to vote in favour of letting the ECB begin its purchases, 85 per cent approval is probably sufficient to start buying government securities. Countries like Finland and the Netherlands thus cannot stop the decision. When it announced its refi rate decision **in August, the ECB emphasised that countries must apply for aid from the EFSF/ESM before purchases of their government securities by the ECB will be considered**. Applying to the Euro Group for ECB bond purchases will imply certain restrictions on national sovereignty and thus have a political price. This is why the governments of Italy and Spain have so far been unwilling to follow this route. But in our assessment, the deadlock will be removed and Italy and Spain will apply to the Euro Group for support and this will give the ECB a go ahead for purchasing government securities. However, this time international lenders will be more cautious about intervening in the budget and reform policies of countries receiving support, compared to the way Greece, Ireland and Portugal have been handled.

To summarise, recent developments have underscored that in principle the ECB possesses unlimited potential to let its balance sheet grow in order to aid crisis-hit countries. At present, the financial risks of such a policy are minor. The ECB may, however, face credibility problems if it is perceived to be slavishly following the wishes of political leaders by indirectly granting governments a credit line to the bank's balance sheet. But we do not believe that the ESM will receive a banking licence in the near future, as countries like Italy are advocating; this would require EU treaty changes and is something that not only the Bundesbank but also the German government will clearly rule out, at least for the time being. The ECB is also expected to help by adopting a more flexible interpretation of the inflation target and accepting somewhat higher inflation, especially if there is upward pressure on average inflation in the euro zone due to a high rate of inflation in Germany.

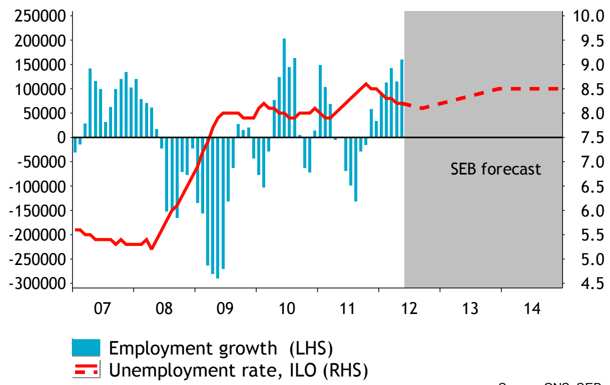
Weak growth creating doubts about austerity policy

- **Sharp GDP drop despite Olympics stimulus**
- **Resilient labour market**
- **Tame inflation trend opens way for more QE**

The British economy is fighting an uphill battle and GDP has declined for three straight quarters. The level of GDP is 4.5 per cent below its pre-crisis peak and the economy is losing ground to comparable countries. One explanation is that the UK has implemented larger austerity measures than Germany, France and the United States, for example. **GDP will decline by 0.4 per cent this year and then grow by 1.4 per cent in 2013 and 1.6 per cent in 2014**. Inflation has fallen steeply since peaking last autumn and will drop below the Bank of England's target at the turn of the year. Looking ahead, we predict that tame inflation will open the way for further quantitative easing (QE) when the current programme has expired. **The BoE will expand its asset purchases by GBP 50 billion in November** but abstain from further key interest rate cuts.

The labor market has been surprisingly firm

3-month change, per cent



Source: ONS, SEB

This forecast includes a consumer-driven recovery during the second half of 2012, with the Olympic Games providing a consumption boost. Further ahead, tame inflation will help give households a breather and real incomes will increase decently, while demand in the euro zone stabilises. Meanwhile the labour market has shown surprisingly strong performance so far this year. The number of jobs rose by more than 180,000 from March to May and unemployment unexpectedly fell. This is the equivalent to US non-farm payrolls of around 300 000 per month for 3 months in a row. This is propbably becaouse the Olympics had a larger temporary effect than anticipated. Staff cutbacks are continuing in the public sector, and the overall growth picture is compatible with a slightly rising jobless rate. **Unemployment will reach 8.5 per cent in 2013** and remain at that level in 2014

Manufacturing remains weak. Industrial production has stagnated throughout 2012 and indicators are pointing in the wrong direction; the purchasing managers' index (PMI) in the sector plunged in July, for example. The construction and service sectors are also showing weakness, and PMI indices have dropped below a neutral level of 50 for the first time since 2009. The euro zone crisis has spread to British industry, and exports have fallen for the past six months, but the exceptionally weak trade figures in June were primarily due to weak exports outside the European Union. Our overall assessment is that **exports will stagnate this year and grow by 3.5 per cent in 2013**.

Austerity measures helped create confidence in financial markets when they were launched a few years ago. According to George Osborne, Chancellor of the Exchequer, the government will stick to its austerity policy; the aim is to achieve structural balance in the budget within five years, and the government plans to accelerate cost-cutting in 2013-2014. **The budget deficit**, which is estimated at 8 per cent this year, **will fall to 5 per cent of GDP in 2014** according to our forecasts. Now that the UK has entered a new recession, this belt-tightening policy is increasingly being questioned. IMF, for example, argues that budget tightening should occur at a slower pace. Such criticism is likely to become louder as the recession causes warning bells to ring again about the creditworthiness of the UK.

The experience of the US last year meanwhile shows that a lower credit rating need not result in higher government bond yields. An independent central bank that is also sitting on 25 per cent of bond issues provides stability. As earlier, our assessment is also that **the UK will keep its AAA rating**. Although the pound has strengthened greatly against the euro in the past year, it remains somewhat undervalued according to our calculations. A weak growth picture and further QE make it likely that currency appreciation pressure will fade. Our forecast is an **EUR/GBP rate of 0.78 at the end of 2013**, i.e. close to its current level. But if the euro zone crisis flares up, flows to "safe harbours" would mean continued upward pressure.

A rising pound has helped curb inflation. Next spring, inflation will reach 1.5 per cent. It will remain low during the next couple of years, averaging **1.8 per cent in 2013 and 1.5 per cent in 2014**. This opens the way for more QE, and we expect the BoE to expand it by GBP 50 billion in November to GDP 425 billion. Shrinking loan portfolios in recent years have also persuaded the BoE to enact special programmes to boost bank lending (the Funding for Lending Scheme). If such measures do not have an effect, some major banks may be entirely nationalised.

Continued divergence within the region

- **Domestic demand helps Poland and Russia**
- **Euro crisis hurting south-eastern countries**
- **More stable credit conditions**

In many parts of Eastern (including Central) Europe, **leading indicators have stabilised since spring** after relatively sharp declines. Purchasing managers' indices in manufacturing, for example, have levelled out just above or below the expansion threshold of 50. We are sticking to our view that overall growth in the region will slow this year and only climb a bit in 2013, due to weak demand and banking system woes in Western Europe. Exports and capital spending will slow. Meanwhile the **increasingly apparent polarisation trend in the region** will continue. The big Russian and Polish economies will cope well with the euro zone crisis, with relatively stable growth of 3.8 per cent on average in 2012 and 3.2 per cent in 2013 – a bit below potential, but some central and especially southern parts of the region will be relatively hard hit. Hungary, the Czech Republic, Croatia and Slovenia will report weak recessions this year and marginal growth in 2013. Bulgaria, Romania, Slovakia and Ukraine will report slight GDP increases. Lower steel prices and political uncertainty are important factors behind Ukraine's abrupt slowdown this year. We have generally lowered our 2013 forecasts somewhat, due to downward adjustment in the international forecast. In 2014, when the world economy rebounds, we foresee slight upturns in growth for most Eastern European countries.

Russia and Poland will perform better largely because these **economies are less dependent on exports and less vulnerable to debt retirement and tighter credit in the West**. Russia is not so dependent on bank financing via the euro zone. Although Poland is highly dependent on the West since most of its banks are owned by euro zone banks, they are solidly capitalised. Signals from Western parent banks are that funding for Poland in particular will not be greatly tightened. Relatively rapid credit growth, especially in Russia but also in Poland, will slow gently in the coming year. A third positive factor for the two countries is that they have **room for stimulus measures**. In Russia, favourable oil prices open the way for a more expansionary fiscal policy, but the recent fast upturn in inflation, driven by administrative price hikes and a poor harvest, will lead to two interest rate hikes in Q4 2012. At the end of this year, Polish inflation will drop below the central bank's upper limit (the target is 2.5 per cent ± 1 per cent). This will open up for three interest rate cuts, the first one in Q4 2012. However, the government must continue with its moderate budget tightening next year in order to keep government debt below its ceiling, 55 per cent of GDP.

As earlier, our conclusion is that domestic demand will chug along faster in Russia and Poland than in many other Eastern European countries, though capital spending will cool this year. In Russia, private consumption is driven by strong real pay growth, while Polish wages are rising modestly. But in the short term, consumption will slow because of worries about the euro zone crisis, and in Russia due to higher inflation. In countries like the Czech Republic and Hungary, consumption will remain weak due to austerity policies, weak credit growth and uncertainty about government finances (Hungary).

Russia's recent World Trade Organisation accession may have **rather positive effects** on its economy via growing trade and investments. But these effects will materialise **only after a few years**. Their strength will also depend partly on the pace of reform. Lengthy transition periods for lowering tariffs and liberalising services, as well as the subdued world economy, mean that WTO effects are small in a 1-2 year perspective.

Better risk appetite has strengthened many Eastern European currencies after last spring's large depreciations. **Over the next six months, exchange rate movements will be more stable** as the euro zone crisis occasionally lowers risk willingness. Looking ahead, there is room for further appreciation based on growth advantages against the West, interest rate differentials and long-term valuations. Ukraine, showing a large current account deficit, is expected to take a step toward a more flexible exchange rate (read devaluate the hryvnia) in the fourth quarter of 2012.

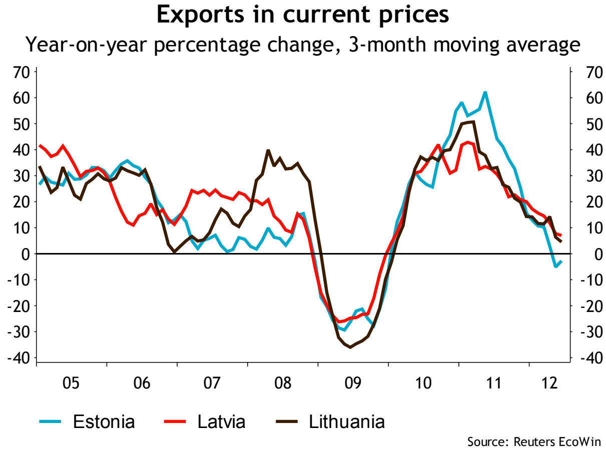
Credit situation slowly thawing

Looking at Eastern Europe as a whole, credit conditions have eased somewhat and stabilised in the past two quarters, after signs of dramatic tightening in the second half of 2011. Eastern Europe no longer diverges negatively from other emerging markets. In the second quarter, demand for consumer loans also rose for the first time in a year. These conclusions can be drawn from Institute of International Finance loan surveys and reports from the Vienna Initiative in July. The ECB's low-interest loans to euro zone banks undoubtedly helped stabilise the credit situation in Eastern Europe as well, but tensions remain; for example the percentage of bad loans rose steeply in the second quarter. The credit environment is still abnormally tight and will probably thaw only slowly in the coming year, especially sluggishly in the south. Meanwhile, it is worth noting that the National Bank of Poland's second quarter survey already showed an initial easing of bank lending policies for corporate and home loans. The NBP also expects increased demand in the third quarter.

Domestic demand a shock absorber in export slump

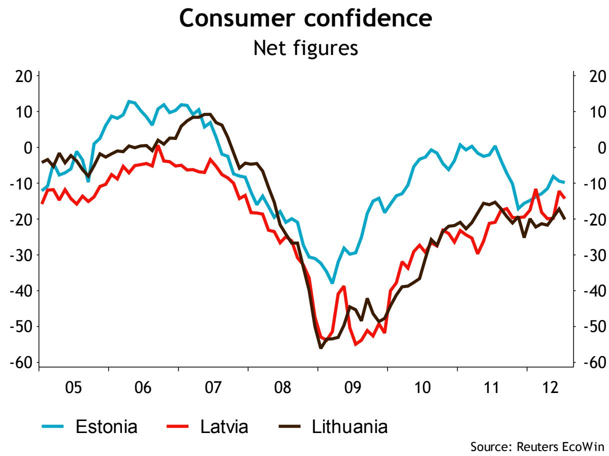
- **Exports weak but competitive**
- **Slow decline in high unemployment**
- **Latvia will meet criteria to enter euro zone**

The export-driven slowdown in the Baltic countries is being softened by continued decent domestic demand. **GDP growth – which has fallen sharply, especially in Estonia but also in Lithuania – will gradually recover in 2013**, sustained by growing private consumption and capital spending. Our GDP forecasts for 2012 (Estonia's and Lithuania's also for 2013) are somewhat higher than in May's *Nordic Outlook*, where we foresaw upside risks because of domestic demand. But **not until 2014 will GDP growth reach its potential pace** of 4.0-4.5 per cent. This means that high unemployment will shrink slowly. **Inflation will remain low in Latvia and Lithuania but relatively high in Estonia**, where the impact of wages and later also money supply will be larger.



The 2010-2011 export boom helped the Baltics to get back on their feet after their depression. Exports were further stimulated by pay cuts totalling 12 per cent in Estonia and Lithuania and 19 per cent in Latvia. This repaired Baltic competitiveness, which had been undermined by previous overheating. In the past year, however, export growth – which had peaked at 50-70 per cent in current prices – rapidly faded. Last spring, highly export-dependent Estonia and Lithuania reported negative export growth, though partly as a result of base effects and in Lithuania's case also a planned production hiatus at the country's export-heavy oil refinery. We predict **continued weak Baltic export growth** next year, **followed by a rebound in 2014 as external demand normalises**.

In the past 2-3 years, all three countries have regained lost export market shares; Lithuania and Estonia have reported large additional net market share gains. We believe that **the competitiveness of Baltic exports remains good, but with certain warning signs in Estonia**. In the past two years, real effective exchange rates (measured by CPI) have appreciated by a mere 1-2 per cent after depreciation during 2009-2010 of about 5-10 per cent (largest in Latvia). This is partly due to the falling euro and because wages and salaries have increased at a modest pace and have not led to any major cost surge. But Estonia diverges, with relatively high pay growth (Q1: +6.9 per cent year-on-year) despite still significant slack in the overall economy. If this pay growth accelerates further, Estonia risks higher cost pressure and renewed competitiveness problems.

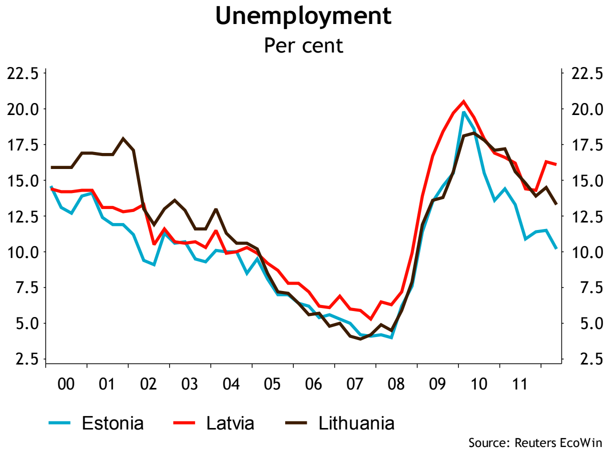


Domestic demand is resilient to the export slump. Household confidence has improved this year despite weaker exports, for example. **Private consumption and capital spending have driven GDP growth** since 2011 and will do so in the coming year as well, but levels remain depressed after the crisis. Capital spending will benefit from increasing construction activity and later also recovery in still-cool housing markets. The Baltics will also use more EU funds for infrastructure projects. Consumption will be fuelled by rising household income and gradual labour market improvement, although this will slow a bit in the coming year. But it will take another 1-2 years before credit expansion becomes a positive growth driver. Although demand for loans has increased somewhat, private sector deleveraging is expected to continue for a while.

Exceptionally large current account deficits during the years of overheating were quickly replaced by surpluses in 2009-2010 as well as part of 2011. The reasons were improved trade balance and initially also changes in the earnings of foreign-owned banks. This year, weakened exports have pushed the Baltic economies back into current account deficits. In the wake of gradual increasing domestic demand, we expect **increasing current account deficits** over the next couple of years,

but the levels will be modest and will thus pose no threat to financing or economic stability.

Unemployment is shrinking from high levels, but only sluggishly in Latvia and Lithuania. Estonia's faster job downturn is now decelerating abruptly due to the decline in growth. The downturn in unemployment is also **partly an effect of large-scale emigration**. When the Baltics joined the EU in 2004, there was a wave of emigration, since many people sought jobs abroad. The latest deep crisis started a second wave. The negative demographic trend will pose a serious threat to economic growth capacity ahead. The three countries are also struggling with other significant **structural challenges**, including a combination of high youth and chronic unemployment while some sectors have bottleneck problems.



Estonia: Big export sector having an impact

Estonia is showing a dramatic downshift in growth. During the first three quarters of 2011 there was stable GDP growth, averaging about 8.5 per cent year-on-year – the fastest of all EU countries. In the subsequent fourth quarter, growth was halved. After that, the deceleration continued to 2.0 per cent in the second quarter of 2012. Estonia's large export sector (equivalent to about 75 per cent of GDP) turned from an advantage to a disadvantage as demand mainly in Western Europe, with Sweden and Finland as the biggest markets, lost momentum. The decline in growth essentially follows our earlier forecasts. Domestic demand is somewhat better than expected. Among other things, public sector construction is strengthening more than anticipated, since the government has used its revenue from the sale of emission allowances. This effect will essentially end in 2013, however. **We expect GDP to increase by 2.0 per cent this year, by 3.0 per cent in 2013 and 4.9 per cent in 2014.**

Inflation has eased marginally since spring and was 4.1 per cent year-on-year in July. Inflation will remain at this relatively high level this year and next, partly due to comparatively high pay growth. Not until 2014 will inflation slow to 3.3 per cent.

Latvia: Mild slowdown before adopting euro

Latvia's lower relative exports than Estonia and Lithuania have helped make its economic slowdown gentler. Growth fell from 6.9 per cent year-on-year in the first quarter to 5.1 per cent in the second quarter. Economic deceleration will continue in the second half, when Latvia's so far fairly resilient exports are expected to drop and the euro zone crisis may generate uncertainty among consumers and investors. Meanwhile trade with Russia will provide some support and in the short term there is capital spending momentum, including some partly EU-financed investments. We believe that **GDP growth in 2012 will reach 3.5 per cent, a bigger upward adjustment** of our forecast (by 1 percentage point) than in Estonia and Lithuania. There is also a certain upside risk. Then growth will strengthen gradually to **4.0 per cent in 2013 and 4.5 per cent in 2014**. This scenario assumes that capital spending will receive an extra push in the run-up to euro zone accession.

Inflation has fallen continuously in the past year from about 4.5 per cent to 1.9 per cent in July. Weak pay growth and calmer energy prices partly explain this downturn, and in July the VAT cut from 22 to 21 per cent also contributed. Weak underlying price pressure and large idle resources point towards continued low price increases, Higher food prices, due to commodity effects, pose an upside risk in the short term. Inflation will average 2.1 per cent in 2013 and 3.0 per cent in 2014.

We still believe that **Latvia will meet the Maastricht criteria** in the evaluation of its euro zone application that the EU and ECB is expected to carry out next spring. Inflation will be low enough (no more than 1.5 per cent above the three EU countries with lowest inflation, based on averages for the 12 months before the evaluation), while unexpectedly good growth and continued fiscal austerity this year will push the budget deficit below the 3 per cent of GDP threshold, probably approaching 2 per cent. Latvia can thus **probably convert to the euro in 2014 as the government has planned**. But this assumes that the EU side does not throw any obstacles in the way; Latvia must also receive EU certification that the downshift in inflation and the deficit can be viewed as lasting.

Lithuania: Falling growth, uncertain election

Lithuania has seen a continuous decline from 6.7 per cent year-on-year growth in the third quarter of 2011 to only 2.1 per cent in the second quarter. The latest quarterly figure was extra depressed by an oil refinery shutdown. Other industrial activity maintained a relatively healthy pace. Consumption growth slowed a bit, while capital spending was sluggish. Yet GDP growth has been somewhat higher than expected. The second half of 2012 will be partly sustained by rebounding oil output. **GDP will rise by 3.5 per cent in 2012. In 2013 and 2014** we expect broad-based growth of **4.0 per cent annually**. Inflation will climb marginally to 3.0 per cent annually in 2013-2014.

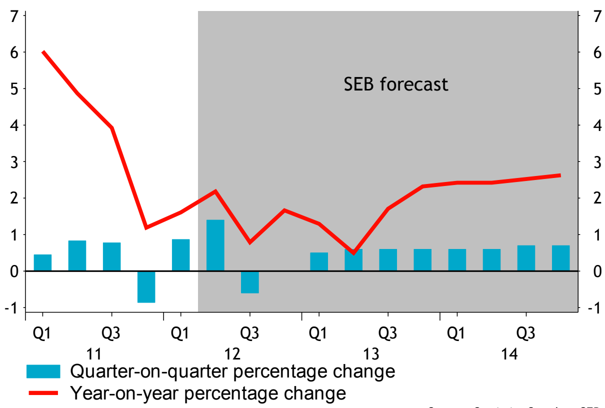
As in Latvia, the government is aiming at euro zone accession in 2014. The inflation criterion may be within reach, though Latvia is in far better shape – looking only at the past year's performance. Despite fiscal tightening, it may be tricky to achieve a budget deficit of 3 per cent of GDP in 2012. A **change of government is also probable** after the October parliamentary election. At present it is difficult to predict the political direction and economic policy priorities of the government. In other words, the euro zone issue involves both economic and political uncertainties. As previously, we believe that **Lithuania will join the euro zone in 2015**.

Good resilience, but economic slowdown in 2013 too

- **Correction likely after strong 2nd quarter**
- **Inflation will remain below Riksbank target**
- **EUR/SEK rate below 8.00 this autumn**
- **Riksbanken will cut key interest rate twice**
- **Fiscal stimulus in run-up to 2014 election**

The Swedish economy is resisting the euro zone crisis relatively well. Due to the very strong preliminary GDP figure for the second quarter, we have revised our full year 2012 growth forecast upward to 1.3 per cent (1.6 per cent corrected for the number of working days). Since other indicators do not fully support the Q2 figure, our forecast takes into account a partial reversal during the second half (for a discussion, see the box). Partly due to the ever-widening economic downturn in Europe and the deceleration in emerging market countries, we have adjusted our **2013 forecast downward to 1.5 per cent** (1.9 per cent in May's *Nordic Outlook*). During 2014 growth will be somewhat faster and we expect GDP to grow by 2.5 per cent.

Growth below trend also in 2013



Source: Statistics Sweden, SEB

The government has recently signalled that it sees room in the budget for fiscal stimulus. We already assumed earlier that the government would be forced to change direction, but have still **adjusted the stimulus dose upward to SEK 25 billion**. Expansionary policy will continue during the election year 2014, and we then expect additional measures equivalent to a further SEK 25 billion.

Low inflation, a weak labour market and slowing household lending growth point to a rate cut by the Riksbank in a near future. The timing is very uncertain but **our forecast of a cut in September stands**, despite the strong Q3 GDP-figure. The appreciation of the krona is a further justification and is one reason why we **expect another cut, bringing the repo rate down to 1.0 per cent at the end of 2012.**

It is logical to shift both fiscal and monetary policy into a higher gear, in light of low resource utilisation. Economic stimulus together with a stronger currency will also help push down the current account surplus. This brings Sweden more in line with the recommendations of the IMF and other bodies on what economic policies countries with surpluses should pursue.

Manufacturers have lowered production

Despite rising GDP, **manufacturing activity decelerated noticeably during the first half of 2012**. Both merchandise exports and industrial production fell compared to the second half of 2011. Although short-term sentiment indicators have recovered somewhat, the continued fragility of the world economy makes a lasting upturn unlikely.

Merchandise exports to different regions

Percentage of total merchandise exports, 2011

	Germany	Sweden
European Union	59	56
GIIPS countries	11	5
France	10	5
Germany	-	10
Nordic countries	5	22
Outside the EU	41	44
United States	7	6
China	6	4
Japan	1	1

Source: Eurostat, SEB

Our main scenario – that Swedish exports will benefit from relatively robust demand in major northern European export markets – has gained support in recent months. As the table shows, Germany has a relatively large exposure to southern Europe and France. This probably explains the more noticeable downturn now discernible in German industrial indicators.

Looking ahead, however, the **ever-stronger krona will lead to a further slowdown in Swedish exports**. According to historical estimates, a 10 per cent krona appreciation leads to 2.5-3 per cent lower exports, with a lag of about one year, but such sensitivity appears to have diminished in recent months. Krona appreciation will slow export growth by 1-2 percentage points during 2012 and 2013. Service exports have performed more strongly than expected, but it is unusual for merchandise and service exports to move in completely different directions. Service exports usually follow the movements of merchandise exports, but with smaller amplitude, which indicates that service exports will slow during the second half. However, we have adjusted our 2012 service export forecast upward. **Overall exports will increase by 1 per cent thus year**, followed by a modest recovery to 3 per cent in 2013 and 4 per cent in 2014.

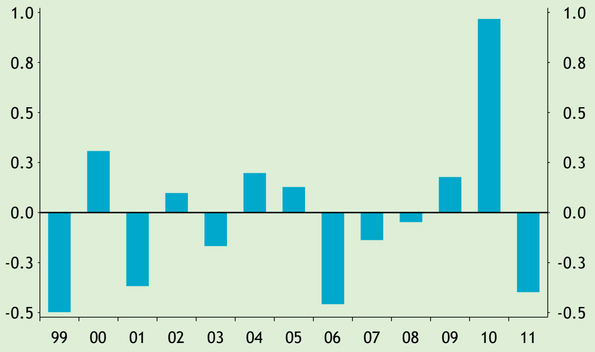
GDP overestimated in the second quarter

Our overall assessment is that the **GDP estimate for the second quarter** – a 5.5 per cent year-on-year upturn – **will be adjusted downward**. A reasonable assumption is that Statistics Sweden's flash estimate is genuinely the best possible. Meanwhile a natural element of the forecasting process is a reconciliation between the often volatile quarterly GDP figures and other measures of economic activity such as NIER Business Tendency Surveys, labour market figures and estimates of resource utilisation. This reconciliation often provides a rather good picture of the probability allocation of later revisions, which in this case points to a downward revision.

Such an examination is especially important at this time of year. The GDP figure unveiled late in July is a flash estimate that is only published for the second quarter in order to provide documentation for the government's budget preparations. The first correction of the flash estimate typically represents a substantially larger revision than for normal quarterly figures. Since the flash estimate was launched in 1999, on four occasions the correction was 0.3-0.5 percentage points and on one occasion as much as one percentage point.

First correction of flash GDP estimate for Q2

Year-on-year percentage change



Source: Statistics Sweden

If we study the details of the estimate, an unchanged stockbuilding contribution compared to the preceding year was the biggest surprise. Both the Business Tendency Survey and the historical pattern of economic cycles point to negative stockbuilding during 2012. Falling merchandise imports also support this. We have thus only made a slight upward revision in the inventory forecast for the full year based on the second quarter figure. Another argument indicating that the second quarter figure is overstated is that the rebound in productivity that was generated is unusual in the prevailing cyclical situation.

Mixed capital spending signals

Due to weaker economic conditions, **industrial companies continue to cut back on their capital spending plans**. According to the latest survey in May, capital spending is expected to be unchanged this year. Our forecast is that industrial investments will be in line with the plans in the May survey, but there is a downside risk; weak demand may contribute to further cutbacks in spending plans. Given the low initial level of spending, however, major declines can probably be avoided.

Overall **capital expenditures are being sustained by important domestic sectors**. For example the energy sector has very expansive spending plans in 2012. Housing investments, which have risen strongly in recent years, are nevertheless expected to decline by 15 per cent this year. Housing starts have fallen significantly, and expectations among construction companies have declined. Yet a long period of low housing construction indicates that the downturn will be limited. Overall, this means that **capital spending will increase by 2 per cent** this year and then accelerate slightly during 2013 and 2014.

Households are continuing to consume

Households have **maintained their consumption relatively well during the slowdown**. There are many indications that consumption will continue to climb. After a slump late in 2011, both consumption expenditures and household confidence have recovered. Rising real wages, partly due to low inflation, will provide **relatively good income growth**. We also assume that fiscal stimulus will contribute to somewhat higher income both in 2013 and 2014. Uncertain economic conditions and eventually rising unemployment point to slower consumption growth ahead, however. Our forecast is thus that **consumption will grow more slowly than income both in 2012 and 2013**.

Household income and consumption

Year-on-year percentage change

	2011	2012	2013	2014
Consumption	2.0	1.5	2.0	2.3
Income	3.0	2.8	2.3	2.8
Savings ratio, % of disp. income	9.7	10.9	11.3	11.7

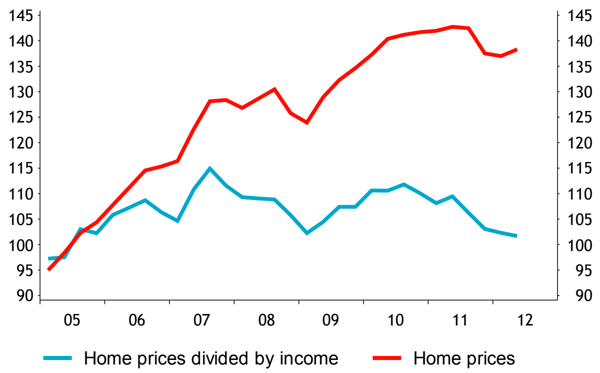
Source: Statistics Sweden, SEB

Fewer risks in the housing market

In recent months, home prices have shown signs of recovery after a cautious downturn late in 2011. We are **sticking to our forecast that in the medium term, prices may fall somewhat further**. We predict that the total downturn in home prices since the 2011 peak will end up around 10 per cent. The market in southern Sweden is being squeezed by the strong krona, which has contributed to a drastic decline in interest from Danish home buyers.

Soft landing for home prices

Index 100 = 2005



Source: Statistics Sweden

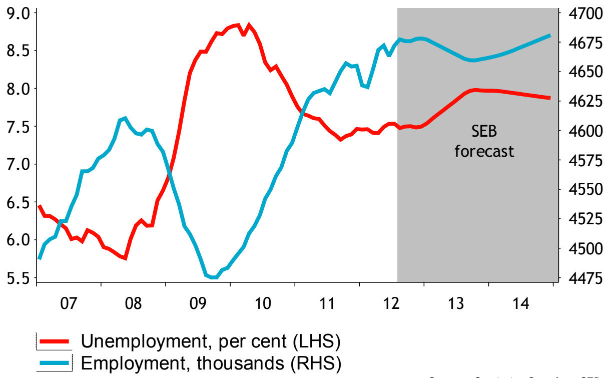
Yet the **risks of a large downturn**, with clear macroeconomic effects, **have decreased in recent months**. Housing market indicators are pointing recently towards stable or slightly rising prices, and the forecasted interest rate cuts by the Riksbank will provide further support. In a longer-term perspective, the rate of increase in home prices has slowed since 2007. Prices divided by income have already fallen by about 10 percentage points, increasing the probability of a soft landing.

Gradual weakening in the labour market

Like growth, **the labour market has provided upside surprises lately**. The jobless rate has been around 7.5 per cent since mid-2011. Short-term indicators such as newly registered vacancies and lay-off notices have gradually continued to weaken, but their levels signal continued job growth for the next 3-4 months. Assuming that growth slows, however, there are many indications that unemployment will eventually climb slightly and that job creation will fall a bit. Our forecast that **unemployment will climb to about 8 per cent** is intact, though we now expect the upturn to begin late in 2012.

Unemployment will rise gradually

3-month moving average



Source: Statistics Sweden, SEB

Labour market

Year-on-year percentage change

	2011	2012	2013	2014
Employment	2.1	0.5	0.0	0.2
Labour supply	1.2	0.6	0.3	0.2
Unemployment, %	7.5	7.5	7.8	7.9
Average hours worked	0.2	0.0	0.0	0.1
Productivity, GDP	1.6	1.1	1.6	2.4

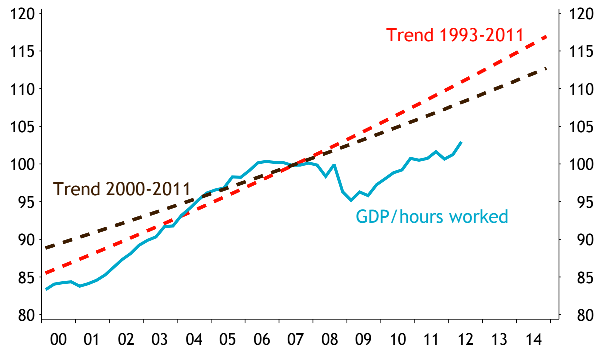
Source: Statistics Sweden, SEB

Falling trend growth in productivity

Productivity growth will be modest during 2012 and 2013, which is natural when demand slows. Meanwhile only a small fraction of the productivity lost during the financial crisis has been recovered. Annual trend growth in productivity during 1993-2011 amounted to 2.1 per cent, but if we look only at the period 2000-2011 the figure is only 1.7 per cent. **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 lower 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. Productivity changes driven by structural effects are often not any problem for the economy, since lower productivity is offset by the ability of companies to charge higher prices. Because the profit level in the corporate sector is relatively good, given the cyclical situation, this indicates that structural effects are an important element of the explanation.

Lower productivity growth in recent years

Index 100 = 2007



Source: Statistics Sweden, SEB

New wage round early in 2013

A large proportion of this year's wage round is over and more than 2 million employees are covered by new collective labour agreements concluded since the first one in the manufacturing sector was signed in December 2011. The various industrial agreements provided pay increases averaging 2.5-3 per cent. Since then, most other sectors have reached agreements in that interval. In cases where agreements have been concluded at a lower level, other contractual cost increases contribute to a total amount that ends up consistent with the industrial agreements. We are maintaining our forecast of **pay increasing totalling 3.5 per cent in 2012**, including wage drift. Partly due to the uncertain economic situation, the agreements were for short periods, and the kick-off for the next round of negotiations will occur as early as this autumn. **Late in March 2013, a number of industrial agreements will expire,** which implies that the negotiations will enter their most intensive phase early in 2013. In all, a large number of collective agreements covering at least 2.2 million employees will expire during 2013.

During the latest wage round, a number of parties showed dissatisfaction with the prevailing system in which industry has a standard-setting role. However, this had little impact; the number of disputes and employees affected by industrial actions and lost working days remain at historically low levels. At present, all indications are that the 2013 wage round will also take place in an uncertain economic environment, which may trigger tensions between the trade unions' ambitions to boost real wages and the desire of employers – squeezed by the demand situation – to keep cost increases down. **We expect pay increases will slow somewhat to just above 3 per cent both in 2013 and 2014.**

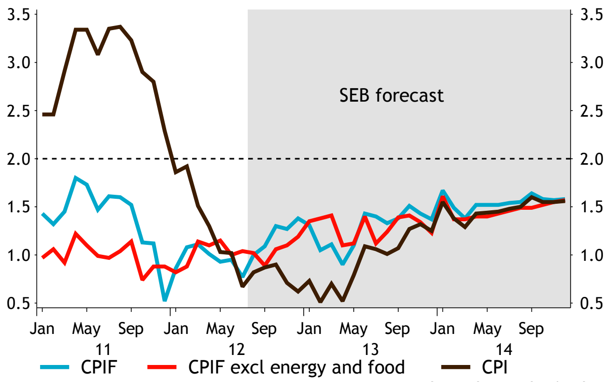
Slowly rising inflation

In the past two years, **inflation has been pushed to low levels by small wage and salary increases and the recovery of the krona** after the financial crisis. This summer, CPIF inflation (excluding interest rate expenses) has even fallen below 1 per cent, among other things due to falling electricity prices.

Inflation is now about to bottom out, once the downward pressure from earlier krona appreciation has eased and pay increases rise somewhat. Electricity prices are also expected to normalise this autumn in line with the forward contracts in the electricity market. **CPIF inflation will rise gradually from below one per cent today to 1.5 per cent at the end of 2014.** Because of the recent krona appreciation, however, we have adjusted our forecast for 2013 downward. Rising food prices will push up inflation, but because of the krona appreciation its impact on Sweden will be smaller than on most other countries. Consumer Price Index (CPI) inflation fell to 0.7 per cent in July and is expected to fall somewhat further in the second half, when the Riksbank's interest rate cut pushes down the costs of home ownership. When the effect on interest costs gradually disappears from the 12-month figures during 2013, CPI will climb at the same pace as CPIF.

Inflation well below 2 per cent

Year-on-year percentage change



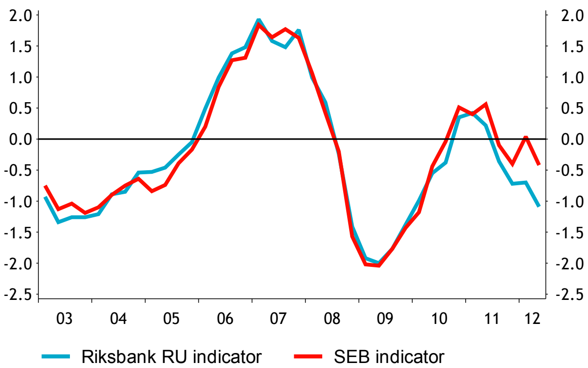
Source: Statistics Sweden, SEB

Riksbank will cut key interest rate twice

We are sticking to our forecast that the **repo rate will be lowered already in September**, but the strong second quarter GDP figure has reduced the probability. After that, the **Riksbank will cut the repo rate one more time in december 2012 to 1.0 per cent**.

Low resource utilisation

Percentage points



Source: Riksbank, SEB

Although the Riksbank is very likely to adjust its 2012 growth forecast upward, the **arguments in favour of rate cuts have thus actually become stronger in recent months**. Low inflation pressure, a shaky labour market and continued financial market turbulence are reasons supporting further rate cuts. Because lending to households is also continuing to slow, it is more difficult to argue that rate cuts will risk jeopardising long-term financial stability, although signs of a home price rebound support the opposite view.

Increasingly expansionary monetary policies in other countries, including new expected stimulus measures from the Fed and ECB, are also helping make Swedish monetary policy appear more restrictive. This, in turn, is instrumental in reinforcing appreciation pressure on the krona, which will tend to further push down inflation and growth. Although the krona's movement in trade-weighted TCW terms is modest so far in a historical perspective, it is a force that will influence the interest rate outlook over the next couple of years.

Low key interest rates internationally, including zero rates at all the major central banks until the end of 2014, are an argument for low Riksbank key interest rates as well. The Swedish economy is well prepared to join an upturn when the world economy takes off, which indicates that the Riksbank will be among the first central banks to raise its key rate. According to our forecast, however, inflation will be low and unemployment high even at the end of 2014, while Sweden's key interest rate is high in an international perspective. **The repo rate will remain at 1.00 per cent during 2014 as well.**

The exchange rate and inflation

Rapid krona appreciation this summer will slow inflation by an estimated 0.2-0.3 percentage points in 2013. To determine inflation sensitivity, we have analysed the correlation between the exchange rate and the sub-components in the CPI basket. Prices of energy, food and imported goods are the items affected most by exchange rates. **Petrol prices have a very rapid impact**, while **effects via food and other goods occur with a lag** of 6-12 months. According to our calculations, a 10 per cent appreciation will cause inflation to decline by 0.5-1.0 per cent, with a lag of up to 12 months. Variations within this interval may depend on what caused the krona's movement and on the general demand situation.

The effect of exchange rate movements in our analysis is lower than, for example, the Riksbank usually concludes. It is also likely that the long-term effect of a permanent shift in exchange rate is underestimated by the 0.5-1.0 per cent interval. For example, if all cost changes in case of a 10 per cent exchange rate movement were passed onward, it would lower CPI by 2.5 percentage points. Such large changes in price levels have little support in factual data, however.

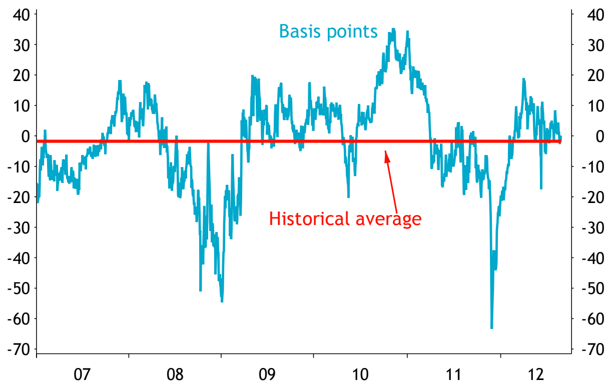
Currency interventions a possible tool if krona continues to strengthen

The large continued potential for capital inflows will **probably force the Riksbank to consider foreign exchange market intervention** (selling kronor, buying foreign currencies). This tool is beginning to gain more widespread acceptance and is being used by an increasing number of countries to manage the side effects of the euro zone crisis and global imbalances. Because of ever-diminishing sensitivity to interest rates and yields in large portions of capital flows, such intervention is reasonably a more effective instrument for influencing exchange rates than key interest rate cuts. In the prevailing situation, it is also unlikely that market intervention would affect the credibility of the Riksbank's inflation target. Yet our assessment is that the bank will not consider such intervention **until undiminished currency inflows push up the krona by an additional 5-10 per cent**, equivalent to a trade-weighted TCW index level of around 110.

Continued low bond yields

Swedish 10-year sovereign bond yields are now close to equivalent German yields, after having been somewhat higher during most of 2012. The Riksbank is maintaining a higher key interest rate than the ECB, which 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**. This argument is also highly applicable to Germany, where two-year sovereign bonds are now showing negative interest rates. We expect Swedish 10-year bond yields to climb roughly in line with German ones and thus believe that the spread will remain close to zero. Looking further ahead, expectations that the Riksbank will raise its key rate before the ECB will probably become increasingly clear. We thus expect Swedish bond yields to end up somewhat higher than German yields late in our forecast period.

Narrow bond yield spread against Germany



Source: Reuters EcoWin

Krona breaking new ground

The recent strength of the krona **confirms its reclassification into a less cyclically sensitive currency**. There are a number of arguments for this, including such fundamentals as low government debt and large current account surpluses. In an international environment where most of the formerly AAA-ranked countries have lost their status, these factors now have greater real importance. Since returns also matter less, Sweden's attractiveness to international portfolio managers is increasing. At present, foreign investors own nearly half of Swedish sovereign and mortgage bonds.

The actions of the Riksbank have also played a major role. For a long time, the bank has described the krona as undervalued – part of a relaxed attitude towards krona appreciation that increasingly stands out in a world where many central banks are actively combating appreciation pressure. For example, the central banks of Switzerland and Denmark have introduced powerful measures against large capital inflows, thereby helping divert these flows to the Swedish krona. When the Riksbank left its key interest rate unchanged in July while several other central banks moved towards further monetary policy stimulus, this added to appreciation pressure.

Our assessment (see the box) is that the krona is now being traded close to its equilibrium level. So far, the Riksbank also seems to view the level of the krona as reasonable but that future signals of distress among exporters may persuade the bank to become more sceptical. We thus believe that **the krona will strengthen further in the near term** and that EUR/SEK exchange rate will drop below 8.00 during the fall. When the Riksbank then delivers its rate cuts EUR/SEK will move towards the 8.10-level. Also the USD/SEK rate will also drop in the near future. Given our forecast of gradual dollar appreciation against the euro, this movement will be small. The USD/SEK rate will bottom out around 6.50 this autumn and then slowly move to a level somewhat above 7.00. In trade-weighted terms, the krona will continue downward to a TCW index low around 112 this autumn before gradually weakening up to 115.

Fiscal policy will be more expansionary

Recent signals from the government indicate that it is now about to back away from its previously very cautious fiscal policy. Statements by Finance Minister Anders Borg and Prime Minister Fredrik Reinfeldt earlier this summer and signals from the latest government deliberations at the Harpsund summer estate indicate a greater willingness to spend money in the autumn budget negotiations. This confirms our analysis in a theme article in the last *Nordic Outlook* that both domestic factors and reasonable international allocation of responsibility were arguments in favour of a more expansionary policy. We are now expecting **SEK 25 billion worth of reforms in 2013 and an additional SEK 25 billion in 2014**; significantely more than our interpretation of the outcome of the recent government Harpsund meeting. Without new reforms, fiscal policy will be slightly contractive in the coming years. Together with the assumed additional reforms, **fiscal policy will be expansionary, corresponding to just over 0.5 per cent of GDP per year 2013 and 2014**.

Public finances

Per cent of GDP

	2011	2012	2013	2014
Net lending	0.1	-0.2	-0.3	-0.1
Gen. gov't gross debt	38.4	37.3	36.8	35.2
Central gov't debt (unconsolidated)	33.2	32.8	32.4	30.9
Borrowing req., SEK bn	-68	20	22	-10

Source: Statistics Sweden, SEB

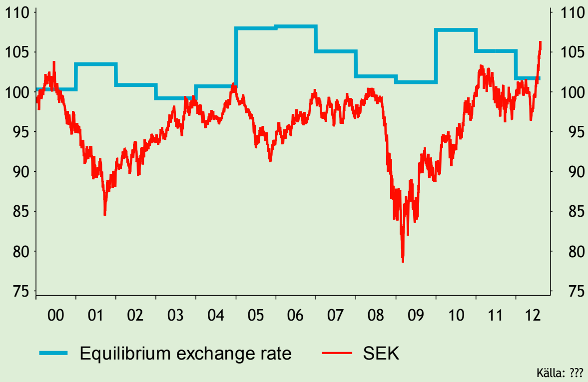
The three small parties in the Alliance government (the Centre, Liberals and Christian Democrats) are struggling with low support in public opinion polls. This means that the budget negotiations are likely to be tough. Statement by the coalition parties in the run-up to the budget negotiations and after their deliberations at Harpsund indicate that research, infrastructure and corporate taxation have been identified as issues where there is major consensus. In these fields, opposition party resistance is also smaller than on issues such as expanding earned-income deductions. The new Social Democratic leadership also appears to have been lured into a political trap. It is hardly politically possible to stick to their previous position, which involved whole-hearted support for the finance minister's former cautious fiscal policy. Considering that the 2014 fiscal policy bill will be an election-year budget, we expect that by then the government's policies will have shifted towards measures that are more targeted to individuals, such as **tax cuts and increased government grants**.

Krona still reasonably valued

Since late May, the krona has appreciated noticeably. It has strengthened by more than 8 per cent against its trade-weighted TCW index and is at its highest level since 1996. Obviously it is difficult to calculate exactly what is a reasonable long-term level for the krona, and different indicators provide a mixed picture. Our internal model for long-term equilibrium exchange rates (SEBEER) **indicates that the krona**, after being undervalued since the mid-2000s, **is now somewhat above our estimate of a long-term trade-weighted equilibrium exchange rate**.

SEK somewhat overvalued according to SEBEER

Index



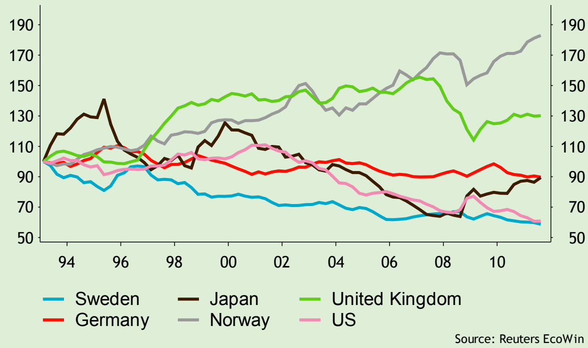
An alternative approach is to base such calculations on deviations from the long-term average value of a trade-weighted real exchange rate index. At present, this indicates that the krona is clearly undervalued in relation to historical levels.

It is also possible to assess the strength of a currency based on the structural (non-cyclically dependent) current account balance. Persistent current account surpluses in relation to other countries beyond what is required to stabilise the country's net external position at a sustainable long-term level might be signs of an undervalued currency. Such calculations by the IMF in the spring of 2012 indicated that the krona was still undervalued by about 5-10 per cent at that time. The appreciation that has occurred since then would thus indicate that at present, the krona is being traded at close to its long-term equilibrium exchange rate.

Meanwhile there are many indications that at least large Swedish export companies are becoming less and less sensitive to variations in the value of the krona. This seems to be due to such factors as increased globalisation. At the same time, Swedish productivity growth among manufacturers exposed to competition has been very strong this past decade, and Swedish companies should be able to continue holding their own amid international competition despite a strong krona.

Sharply diverging development of real effective exchange rate

Based on unit labour cost, index 100 =1993



Most indications are that the krona is not overvalued at present, but is instead rather reasonably valued from a longer-term perspective. This does not prevent the recent krona appreciation from causing strains for individual companies and economic sectors. A slow, cautious restructuring of the Swedish economy that squeezes the export sector and favours domestic portions of the economy has probably already begun.

This implies that **central government debt will continue to fall as a share of GDP** from 33.2 per cent in 2011 to 31 per cent in 2014. General government gross debt is 4-5 points higher. If financial assets are also taken into account, the public sector's financial assets are at a stable level of just below 20 per cent of GDP. This year and next, the government borrowing requirement will be around SEK 20 billion.

Sweden's cyclically sensitive public finances have shown marginal surpluses during the past two years. Measured in cyclical adjusted terms these surpluses are higher, around 1 per cent of GDP, and consistent with the official surplus target. Due to weak economic conditions and fiscal stimulus measures, **public sector net lending will fall from 0.1 per cent of GDP to -0.2 per cent in 2012 and -0.3 per cent in 2013**. In 2014 net lending will improve to just below balance.

Forecasts, government borrowing requirement

SEK bn

	2012	2013	2014
SEB	20	22	-10
National Debt Office (June)	32	15	-
National Inst. of Econ. Research (June)	10	13	-
National Fin. Management Auth. (June)	8	20	-37
The government (April)	-12	-35	-90

Source: NDO, NIER, ESV, the Finance Ministry, SEB

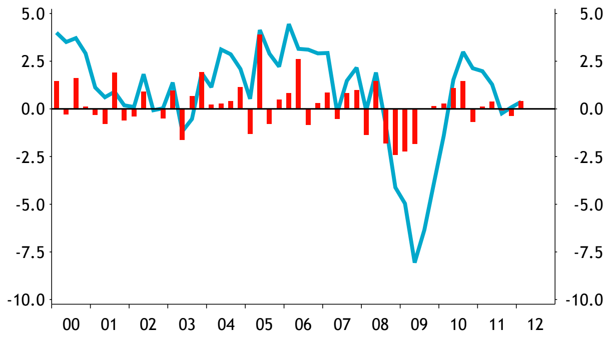
Current account surges as krone weakens with euro

- **Low but positive growth ahead**
- **Fiscal stimulus main near term driver**
- **Current account lifted by trade and income**
- **Negative central bank deposit rate**

The Danish economy continues to muddle through. The first quarter saw 0.4 per cent growth, driven by domestic demand, while trade data suggest exports have lifted growth in the second quarter. At the same time consumers face structural headwinds and the global backdrop is characterised by uncertainty. Growth is expected to reach **0.5 per cent 2012, followed by 1.4 per cent in 2013 and 1.7 per cent in 2014.** These estimates are unchanged from the May issue of *Nordic Outlook*.

GDP rose in the first quarter

Percentage change



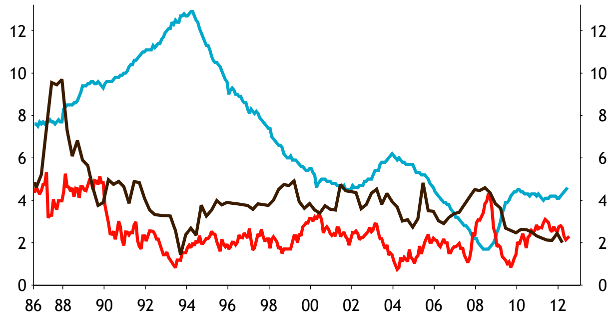
Source: Statistics Denmark

Consumers under pressure

After consumers had released pent-up demand towards the end of 2011 and in the first quarter of 2012, consumption indicators have been subdued in the second quarter. The improvement in consumer confidence stalled around a level consistent with flat consumption, while retail sales and particularly new car registrations also point to largely unchanged consumption. Recent indicators thus suggest that the positive effect of one-off transfer due to a reform of the early retirement scheme has been rather muted.

The tendency to save is natural, given the large gross debt households accumulated in the housing bubble, which needs to be reduced after the drop in home prices. Consumers are also burdened by a negative real wage trend, which recent wage negotiations seem to have entrenched. **Unemployment has also risen noticeably** in recent months and uncertainty about the outlook for the housing market is also a problem. While the latter has shown some signs of stabilisation and a recent tax reform promises to keep real estate taxes stable until 2022, prices are still likely to decline further.

Unemployment has started rising



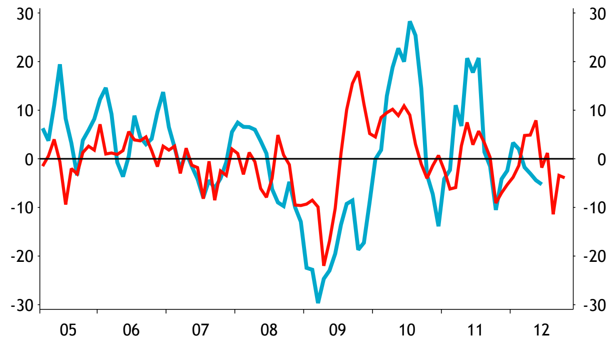
Source: Statistics Denmark

As global growth bottoms out and real wages improve, we expect consumption to recover over the next couple of years – but it will be gradual given the context of deleveraging.

Capital spending to level off

Corporate capital spending saw a powerful start to the year, but capacity utilisation has improved more moderately and business surveys suggest that investment plans are on hold. This signals that **capital spending will be less vigorous for the remainder of the year**. This is collaborated by the resumption of a decline in manufacturing output and negative business sentiment, suggesting that the more cyclical parts of the economy are currently weighing on activity.

Manufacturing softening



Source: Statistics Denmark, DG ECFIN

Housing investments have softened following recent house price weakness, a trend that is likely to continue. However, plans to speed up public investments are still expected to offer some support later in 2012.

Public consumption near term growth driver

Public consumption increased in the first quarter, but following the very subdued trend of last year, it is still quite far behind budget. We thus expect **fiscal policy to provide a boost to growth during the second half of this year**.

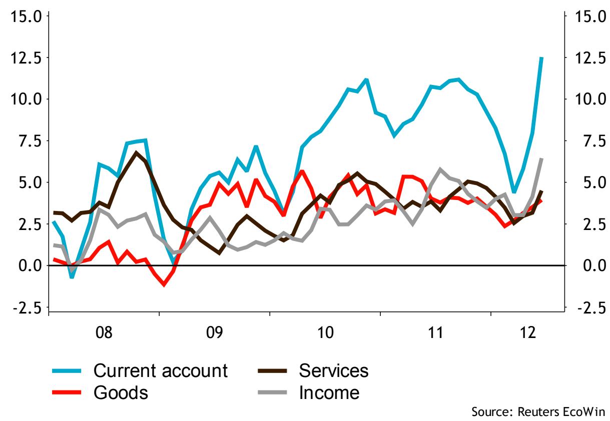
The government discussed a labour market reform with labour and employer organisations as well as a tax reform with political parties. The aim is to increase the labour supply to deal with future demographic challenges. The labour market negotiations broke down, while the government and elements of the opposition have agreed to **a new fiscal reform that lowers income taxes**. This will have a moderate positive impact on private consumption in 2013, with the full reform being implemented by 2022.

It is still an open question what the full content of next year's budget will be and which parliamentary parties will vote for it. The outlook for fiscal policy is therefore uncertain, but the growth impact from public consumption and public investments is likely to decrease in 2013 compared to 2012.

Current account surplus reaches new record

The current account surplus staged a major rebound in the second quarter and set a new record in June. It has been surprisingly resilient in light of waning global growth. Net exports of goods and services as well as income all contributed to the recent improvement.

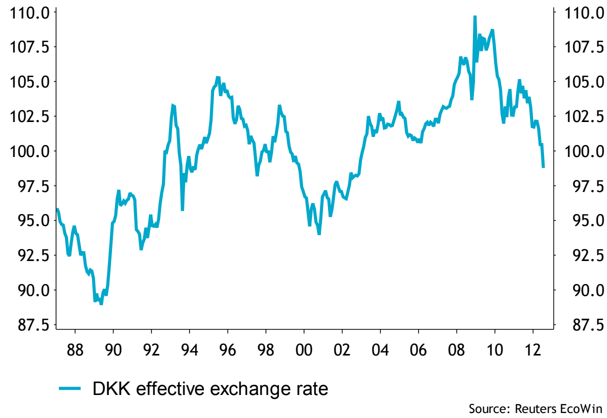
Breakdown of current account



Rising merchandise exports to other Nordic countries and the US offset the drop in exports to the euro zone and BRICs, while the rise in service exports was fairly broad based. A likely factor is the **improvement in terms of trade** caused by the drop in the effective Danish krone rate, due to its peg to the euro.

Export orders for the manufacturing sector softened in the second quarter, and growth by Denmark's trading partners is also expected to slow in the near future. Hence, the second half of 2012 could see a more subdued trend before the global trough in activity and continuous improvement in terms of trade from a weaker krone turns export growth more positive next year.

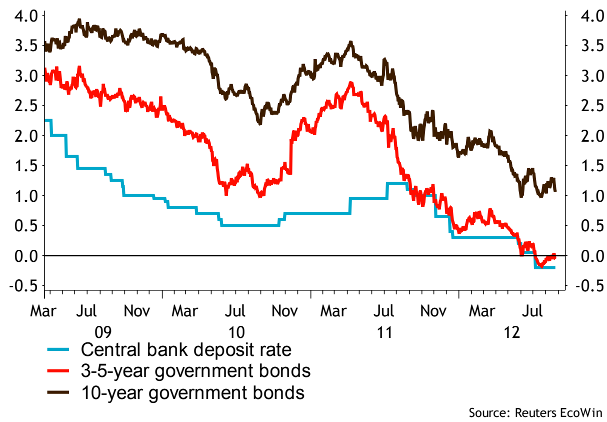
Effective DKK has dropped



Negative Danish yields

The demand for Danish assets has continued. A significant portion of the government bond yield curve is currently in negative territory, although some of this trend has been reversed by the recent more positive euro sentiment.

Danish interest rates and yields



The demand for Danish assets is well founded as the country has a significant external surplus and is a net creditor versus the world. Hence **dealing with the fallout from private deleveraging is mainly an internal distribution issue.**

The combination of a large current account surplus and increasing investor demand for Danish assets has resulted in positive pressure on the krone. **The central bank has conducted significant intervention in currency markets and subsequently lowered key interest rates below those of the ECB**. When the ECB cut its deposit rate for banks to zero in July, the Danish central bank maintained the spread (as is normal) resulting in a deposit rate of -0.2 per cent. .

The intent to do so was well flagged, but it still seems to have had a significant impact on the krone, which has since weakened markedly versus the euro. However, the easing of perceived euro zone risk has also been a contributing factor, and trade flows probably turned less positive in this period as well. While short-term trends are mainly driven by euro zone politics, medium-term prospects suggest that the positive pressure could linger. This is because the current account surplus is expected to continue while Denmark's moderate fiscal deficit is reduced, underpinning the country's sound public finances.

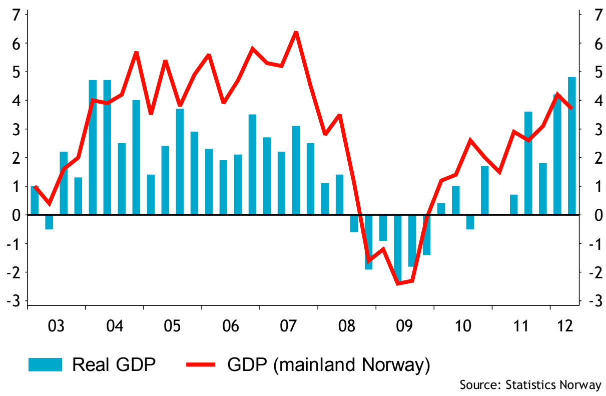
Going on its own

- **Growth forecasts revised higher**
- **Fundamentals support housing markets at least for now**
- **Norges Bank to stand pat until 2013**

The Norwegian economy continued to power on in spring, setting it further apart from peers. Overall GDP expanded a solid 1.2 per cent from the first to the second quarter and mainland GDP – excluding oil/gas and shipping – was up 1.0 per cent and a well above-trend 3.7 per cent year-on-year. Growth was broad-based among domestic demand components with an added lift from net exports.

Growth continued to run above trend

Year-on-year percentage change



The expansion in the past two quarters marked the strongest back-to-back gains in mainland GDP since 2007. While growth should take a breather in summer, the **forecast has been revised upward to 3.4 per cent for 2012** from 2.7 per cent in May's *Nordic Outlook*, and to **3.1 per cent for 2013. Overall GDP should be up 3.7 per cent and 2.7 percent in 2012 and 2013**.

Strong income growth powers consumption

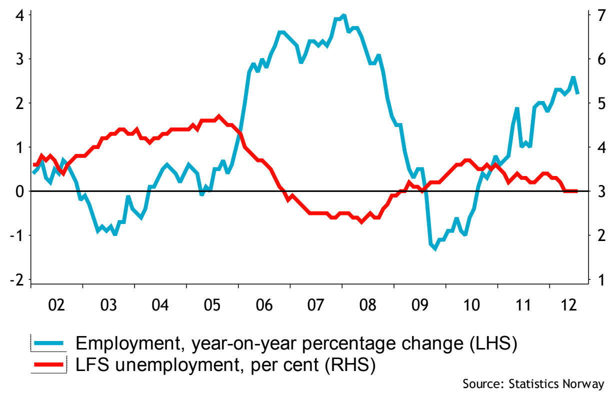
Private consumption remains robust, fuelled by very solid real income growth. In the second quarter, consumption thus gained 1.0 per cent from the previous quarter and was up 3.5 per cent year-on-year. Consumption this past spring got an extra lift from a spurt in spending on electricity and is in for a "payback" in the near term. However, the underlying trend remains firm and our forecast for **consumption growth in 2012 has been raised to 3.6 per cent**, marking a notable acceleration from 2.4 per cent in 2011, when consumption trailed income by a margin of almost 2 percentage points.

Hence, relative to earlier expectations, employment growth has been surprisingly strong so far this year while overall inflation has been lower. Considering that nominal wage growth will be little changed from last year's 4.2 per cent rate, households' real disposable income growth should accelerate from a very solid 4.3 per cent in 2011 to near 5 per cent in the current year, lifting the saving rate further from already elevated levels.

Various unemployment measures have diverged somewhat in recent months. In seasonally adjusted terms, the number of registered unemployed individuals has crept higher since March, though holding steady at a low 2.5 per cent of the labour force. Meanwhile, the Labour Force Survey (LFS) unemployment rate averaged 3.0 per cent in May-July, 0.4 percentage point less than at the end of 2011 and at its lowest in three years.

Labour market remains in very good shape

3-month moving average



More importantly, continued robust employment growth portends still-healthy momentum in the economy. The gain in employment has moderated from a very strong 0.9 per cent in the first quarter of the year to 0.3 per cent on average in May-July from the previous three-month period, hinting that the rate of acceleration has peaked. However, the level was still up by an above-trend 2.2 per cent year-on-year and full-year growth in 2012 should be only slightly slower.

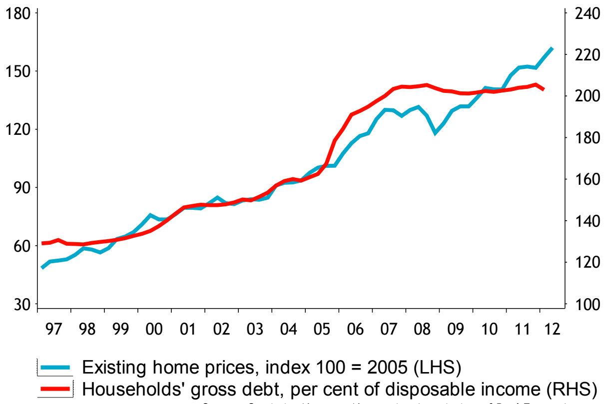
In 2013, nominal wage growth should continue to top 4 per cent, but slowing momentum in job creation and somewhat higher inflation (and interest rates) should dent the increase in real disposable income to about 4 per cent. Such a rate would still imply solid consumption growth but we leave the 2013 forecast at 3.4 per cent.

Fundamentals support home prices for now

Norwegian households seem excessively leveraged. In the ten years to 2007, gross debt thus jumped from 130 per cent to slightly more than 200 per cent of disposable income. While the increase has since levelled out (204 per cent in early 2012), the high debt burden poses a risk in the longer term.

The sharp debt build-up largely mirrors the relentless rise in home prices, only briefly interrupted by a 10 per cent correction from June 2007 to November 2008. Since then, existing home prices have surged 39 per cent as of July 2012 – when they were up 7.8 per cent on the year – and are twice as high as in mid-2003. Prices have thus increased far more than general inflation or rents, but they are up only slightly more than households' disposable income since early 2005.

Rising debt mirrors higher home prices

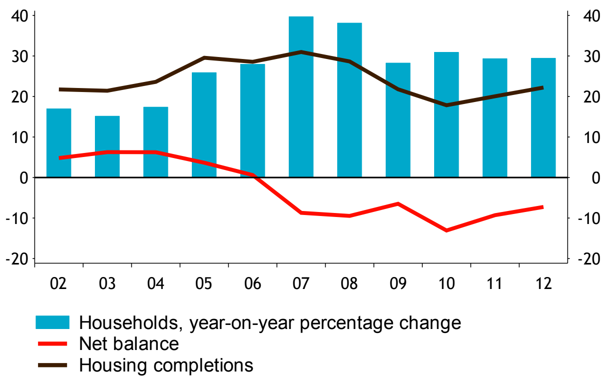


Source: Statistics Norway, Norwegian Association of Real Estate Agents

Norwegian home prices are uncomfortably high, setting a very high bar for first-time home-buyers. However, the key to establishing whether there is a bubble about to burst is to what extent prices have surpassed any equilibrium, inducing excessive risk-taking and/or excessive expectations of further price gains. However, based on income growth, housing stock relative to population and the level of real after-tax interest rates, Statistics Norway has calculated that home prices as of 2011 were actually lagging the model: excluding the effect of interest rates, prices were only marginally "inflated".

Housing completions continue to lag demand

Thousands



Source: Statistics Norway, TBU

Persistent supply-demand imbalances are *the* key reason for higher home prices, as housing completions have lagged demographics: e.g. while some 20,000 homes were completed in 2011, the number of households increased by almost 30,000. Moreover, the record-strong population growth, fuelled by labour immigration, looks set to continue. Assuming a constant number of persons per households, population projections by Statistics Norway imply that the number of households will rise by almost 30,000 per year through the decade. Meanwhile, housing starts have accelerated to an annual rate of 29,000 units in the first half of 2012, but they need to rise further merely to catch up with the under-supply of recent years.

Moreover, households have enjoyed very strong income growth for years (reflecting an income "shock" for Norway due to very strong terms of trade gains). Households' aggregate disposable income is thus up more than 50 per cent since 2003 and it increased by a solid 6.2 pee cent year-on-year in the second quarter of 2012. Finally, interest rates are historically low, well below what Norges Bank considers "normal" and, in our view, what domestic fundamentals would suggest.

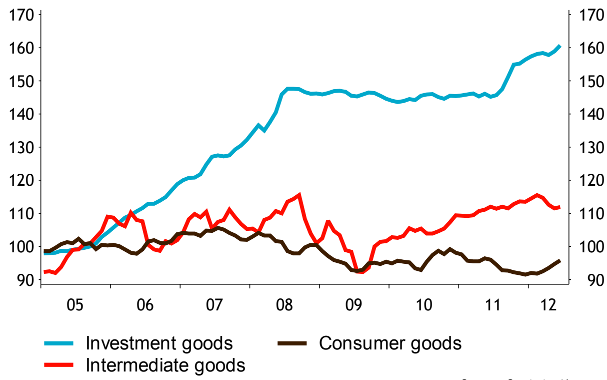
Home prices might correct in the medium term. However, absent any exogenous shock, still-solid fundamentals should put a floor under the housing market and, at a minimum, prevent a slump – at least until a larger number of housing starts fixes the key problem by aligning supply better with demand.

Sharp split in manufacturing

Momentum in manufacturing – excluding the energy sector – is slow but is not contracting as elsewhere in Europe. Looking through the monthly volatility, production has been growing in every quarter since late summer 2011 and was up 2.7 per cent in the year to the second quarter. Energy production (oil and gas extraction, electricity), which makes up three quarters of overall industrial production, surged an exaggerated 11.1 per cent over the same period and is in for a correction.

Sharply divergent trends in production

3-month moving average, index 100 = 2005

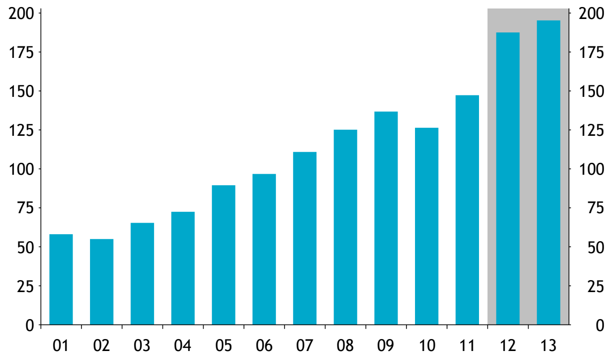


Source: Statistics Norway

Developments within manufacturing are sharply split between production for the domestic market and export industries. In particular, production of investment goods is in the lead, rising fully 10.6 per cent in the year to the second quarter fuelled by the very strong investment cycle in the offshore oil and gas sector.

Strong investment cycle in oil and gas activity

Bn NOK



Source: Statistics Norway

According to Statistics Norway's survey in June, oil companies operating on the Norwegian continental shelf expected nominal capital expenditures to increase almost 28 per cent in 2012 while the first estimate for 2013 implied a more modest 4 per cent gain. Capacity constrains might blunt the increase in the current year, with more to come in 2013 when investments will probably climb further as new projects are included.

Meanwhile, manufacturers in the export-oriented intermediate goods sector are feeling chilly economic winds from abroad. Within this sector, developments are particularly depressed for production of paper and paper products, which has been in a secular and steep downtrend for years, while sharply declining production of basic chemicals is being heavily affected by structural problems in the solar cell industry (including plant shutdowns). Aggregate output in these two sub-sectors dropped more than 20 per cent year-on-year in the second quarter.

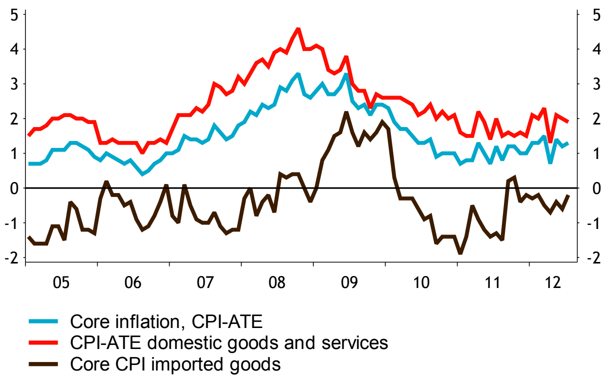
Statistics Norway's manufacturing survey for the second quarter saw the sentiment index easing from a net balance of 8.9 in the first quarter to 7.1, which still is above the long-term average. Production expectations remained firmly in positive territory, as the stock of orders reportedly continued increasing and overall demand was seen holding up in the third quarter. While overall export orders continued sliding in the spring, the survey noted that the decline seemed to be coming to a halt.

Inflation trending only slowly higher

Overall CPI inflation has been softer than expected on balance so far in 2012. Fuelled by a 30 per cent plunge in electricity prices since February, headline inflation was only 0.2 per cent in July while the core CPI-ATE inflation measure – excluding taxes and energy – was up a moderate 1.3 per cent. Disregarding monthly volatility due to excessive movement in a few items (such as airfares), core inflation has thus remained in a rather narrow range over the past year without showing signs of any definite trend change. As such, underlying inflation has yet to show any impact from continued above-trend growth in the economy.

Core inflation has been range-bound

Year-on-year percentage change



Source: Statistics Norway, SEB

Going forward, we still expect the tide to turn. Until year-end, headline CPI will get an extra lift from a "normalisation" of electricity prices. However, core inflation is seen trending only slowly higher from 1.3 per cent on average in 2012 to 1.7 per cent in 2013 and 2.0 per cent in 2014. The forecasts match Norges Bank's projections in the June *Monetary Policy Report*.

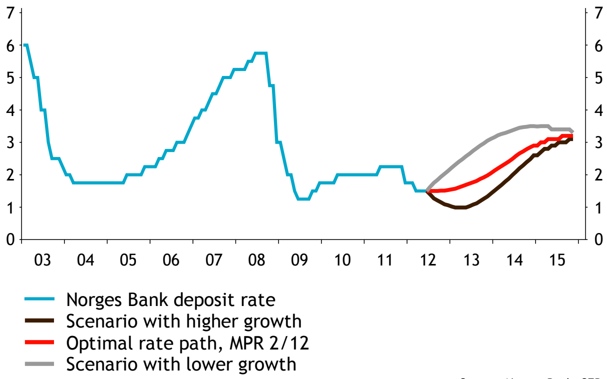
Norges Bank shifting focus to domestics

Norges Bank has been in no rush to hike its key interest rate, as inflation has shown few signs of accelerating, global uncertainty remains high and a wider key rate gap vs. peer central banks risks fuelling NOK appreciation: the latter consideration was instrumental in the bank's most recent two cuts in the deposit rate to 1.50 per cent. However, the June *Monetary Policy Report* saw a subtle shift of focus. Despite continued downside risks from abroad (especially in the euro zone), the resilience of the Norwegian economy and mounting imbalances seemingly gained the upper hand as the optimal rate path moved the first rate hike closer in time to around year-end (and May 2013 at the latest).

Hence, markedly weaker domestic activity or a substantial appreciation of the import-weighted NOK (I44) is needed for Norges Bank to consider cutting its key rate again. Weak global growth and benign inflation at home will keep the bank sidelined for now. We expect the rate hike cycle to restart next spring, lifting the key rate to 2.25 per cent by the end of 2013 and to 3.25 per cent at the end of 2014.

Norges Bank more focused on growth

Per cent



Source: Norges Bank, SEB

Norges Bank's expectation that its key rate will be hiked ahead of its peers is reflected in the bank's currency forecast; the import-weighted NOK is expected to strengthen by 2 per cent in the coming two years. As such, the current strong krone should not trigger any interventions from the central bank. With positive peer-relative Norwegian rate developments, a rock solid growth outlook and a strong fiscal position, demand for the Norwegian krone is expected to remain high. Higher foreign exchange purchases (i.e. NOK selling) by the central bank to recycle oil revenues abroad will temporary stop further import-weighted NOK appreciation during this autumn. Beyond that, there are few arguments for a trend change as the NOK is still undervalued against most G10 currencies. We expect the EUR/NOK exchange rate to fall below its estimated equilibrium value of 7.22 (SEBEER) to a new all-time low by year-end. By end 2013 we forecast EUR/NOK at 7.00 and USD/NOK at 5.93.

Norwegian government bond yields have remained depressed. Considering the ongoing euro zone turmoil, no imminent upside pressure on yields globally and continued diversification to fundamentally strong countries there will be continued demand for Norwegian government bonds in the near term. Eventually, rate hikes will push the 10-year yield and the spread vs. Germany higher. We expect the 10y spread vs. Germany to widen to 65 basis points by the end of 2013 and 80 bps by the end of 2014.

Weak exports holding back the economy

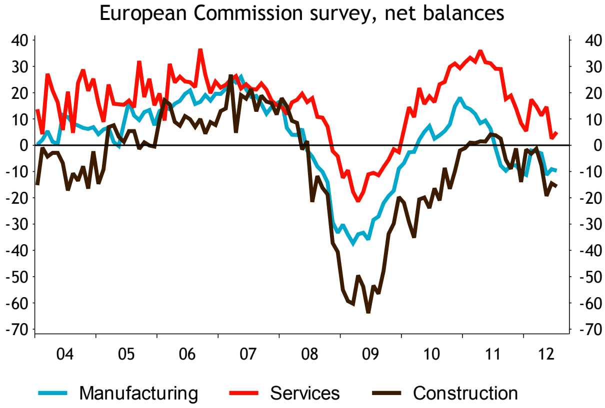
- **Slower growth in the second half of 2012**
- **Yield spread to Germany at pre-crisis level**
- **Persistent current account deficit**

Finnish growth has been jumpy during the last year. First quarter 2012 GDP growth was unexpectedly high (0.8 per cent quarter-on-quarter) and preliminary data for the second quarter point to a decline of 1.0 per cent. At the same time unemployment has continued to fall slightly. Exports and industrial production are down so far this year, while domestic sectors have performed rather favourably. The near-term outlook appears gloomier. GDP growth will be very weak during the rest of 2012, yet this implies that Finland can avoid a new recession thanks to the strong first quarter. **As annual averages, GDP will grow by 0.6 per cent in 2012**, almost entirely driven by the first-quarter upturn. Next year the will be a slight recovery to 1.6 per cent, before the economy reverts to trend growth in 2014.

Forward-looking indicators point towards weaker near-term growth, although the level has stabilised in recent months. The European Commission sentiment survey for Finland's export-dominated manufacturing sector is in negative territory, while the service sector index has levelled out just above zero. The weakening of the euro is providing some support for exporters. This past spring, companies stated that their competitive situation had improved, especially in markets outside the European Union but also compared to Sweden. Export order bookings are still falling, but expectations have recovered during the spring and summer. Hopes of increased order bookings from markets outside the EU are contributing to this.

Indicators have stabilised after last spring's decline

European Commission survey, net balances



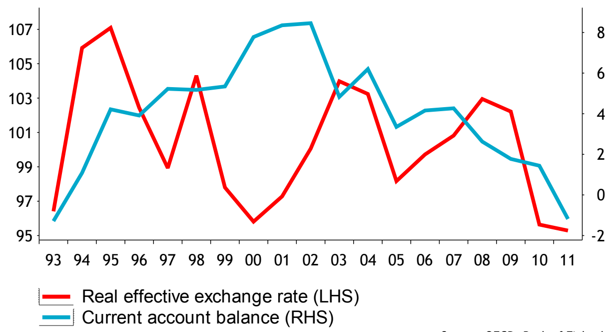
Source: DG ECFIN

As a share of the economy, exports have declined by 10 percentage points since 2008 and are now below 40 per cent of GDP. The downturn is mainly due to merchandise exports. Only part of the information and communications technology (ICT) sector's 50 per cent value-added decline in 2008 has been recovered; this is partly due to Nokia's problems; Finland's share of its employees fell from about 35 to 15 per cent in 2005-2011. Low capital spending in other countries is hampering exports, despite little direct exposure to southern Europe and decent growth in the three most important export markets – Sweden, Germany and Russia. In the past year, Finnish exporters have performed weakly compared to Sweden and Germany. Exports are not expected to climb rapidly in the next few years, though a weaker euro has improved competitive conditions; the real effective exchange rate fell some 7 per cent in 2009-2011; this trend has continued in 2012. If it continues or stabilises, Finland may benefit from a more favourable cost situation and see exports rise, as Sweden did in 2008-2009 when the krona fell in value. This trend may also benefit such exports as wood products, in competition with other Nordic countries. Exports will increase by 1,2 per cent in 2012 and 4,4 per cent in 2013.

Partly due to shaky export performance and deteriorating terms of trade, **in 2011 Finland showed its first current account deficit since 1993**. Weak price trends for exports of electronics and wood products, combined with a relatively rapid rise in import prices, including oil, were behind this shift. The deficit is expected to persist in the next few years, but unlike the situation in southern Europe we foresee no major risks that it will cause short- or medium-term credibility problems for the economy. During its surplus years, Finland built up international buffer (in net terms) of about EUR 30 billion.

Deficit in the current account

Index, per cent of GDP



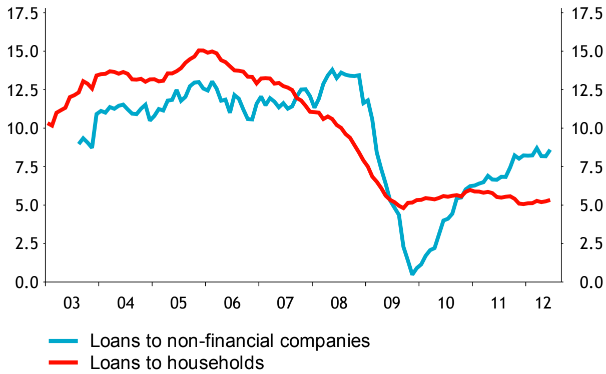
Source: OECD, Bank of Finland

Capital spending rose more than 4 per cent in 2011 and thus contributed decently to GDP growth. Capacity utilisation in manufacturing has recovered significantly since the dramatic slide of 2008-2009 but remains a bit below historical averages. We anticipate a slight continued upturn in fixed investment activity, despite the uncertain international outlook. The number of construction starts was weak early in 2012, especially for commercial properties. Overall construction investments will fall this year. Lending to the corporate sector has increased somewhat in the past two years; according to survey responses the funding situation is not perceived as any major problem.

The rate of increase is nevertheless well below the pre-crisis level. **Overall capital spending will increase weakly, at 1.5 per cent 2012, 3.0 per cent 2013 and 3.5 per cent 2014.**

Increased lending, especially to businesses

Year-on-year percentage change

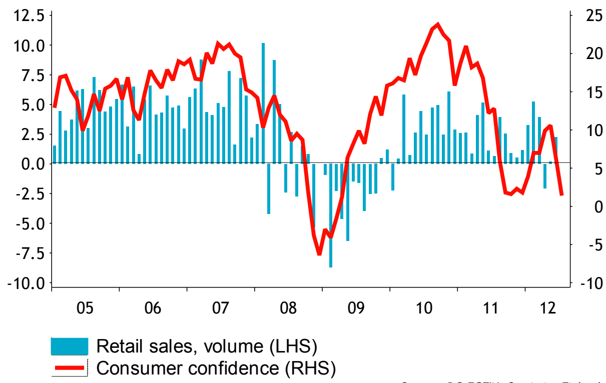


Source: Reuters EcoWin

Despite falling consumer confidence and high inflation, consumption rose sharply in the first quarter of 2012. The latest statistics provide somewhat mixed signals; retail sales climbed in June and was unchanged in July while consumer confidence fell. So far this year, consumption has benefited from falling unemployment and low interest rates. Yet high inflation, pushed up by such factors as indirect tax hikes, has undermined purchasing power and the euro zone crisis has curbed optimism. We expect a relatively stable labour market and falling inflation to have a positive impact. **Consumption will grow by 2 per cent annually 2012-2014.**

Falling consumer confidence

Year-on-year percentage change, net balance



Source: DG ECFIN, Statistics Finland

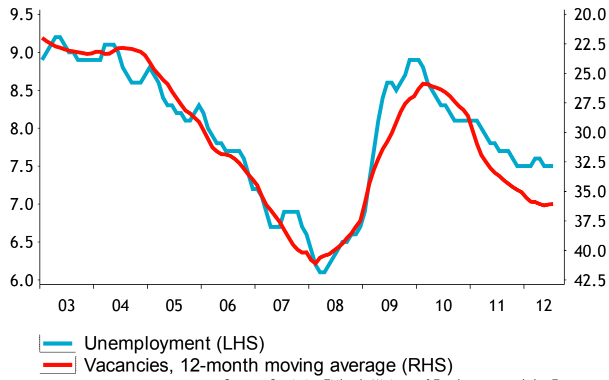
The labour market situation looks stable, despite weak growth. In 2011 unemployment fell by 0.5 percentage points. After an upturn in the spring, the downturn continued to 7.4 per cent in June 2012. The number of job vacancies indicates a continued near-term decline before the economic slowdown has some effect. Late this year unemployment reaches 8 per cent and after that rising only marginally until 2014.

HICP inflation peaked in mid-2011 at 3.7 per cent and subsequently fell to 2.9 per cent in June 2012. Price increases are being sustained by higher VAT and indirect taxes and will not fall below 2.5 per cent during the rest of this year. **Measured as annual averages, inflation will end up at 2.7 per cent in 2012 and then fall 2 per cent in 2013 and 2014**.

Because of its good starting position, Finland's government financial situation has been relatively stable in recent years. The country is among the few that have not exceeded the deficit or debt criteria of the EU stability pact, despite a cyclically sensitive economy. The budget deficit shrank from 2.5 per cent of GDP in 2010 to 0.5 per cent in 2011. Although the budget is largely in balance, the government has taken further steps to strengthen public finances in the next few years. This includes expenditure curbs, VAT and excise tax hikes and higher pension charges, improving the public sector balance by more than 2 per cent of GDP by the end of 2016. The programme is relatively front-loaded. Weak economic growth will still make the deficit rise to 0.8 per cent of GDP this year, then gradually improve to balance in 2014. Because of this limited deficit, general government debt will peak at 51 per cent of GDP in 2012 and then fall slowly by the end of 2014. Government debt will be affected by such items as a payment to the ESM bail-out fund equivalent to 0.8 per cent of GDP.

Unemployment levelling off

Per cent, thousands

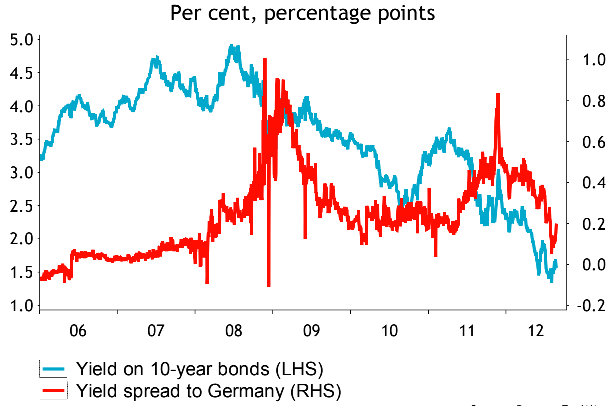


Source: Statistics Finland, Ministry of Employment and the Economy

During the crisis, Finland has strongly advocated stricter rules and has opposed very large-scale support to joint bail-out mechanisms. We believe that the country will continue to pursue this policy and demand tighter monitoring and stronger institutions to prevent future financial crises and bail-outs. Meanwhile Prime Minister Jyrki Katainen is among those who have said that the euro has been good for Finland. In our assessment, despite demanding collateral for bail-out loans and requiring majority approval for ESM actions, **Finland does not wish to be the actor that triggers the collapse of the euro**. Interest rates on sovereign debt are historically low, and the yield spread to Germany has fallen to the same level as before the 2008 financial crisis. Despite euro zone worries, Finland is viewed as a safe investment and the country is still AAA-rated.

Yield spread to Germany fall to pre-crisis level

Per cent, percentage points



Source: Reuters EcoWin

Economic data

DENMARK

Yearly change in per cent

	2011 level, DKK bn	2011	2012	2013	2014
Gross domestic product	1,783	0.8	0.5	1.4	1,7
Private consumption	865	-0.8	0.5	1.0	1,5
Public consumption	510	-1.3	0.5	0.3	0,3
Gross fixed investment	308	0.2	2.0	2.0	4,0
Stockbuilding (change as % of GDP)		0.3	0.0	0.0	0,0
Exports	959	7.0	0.5	3.0	3,5
Imports	863	5.2	1.0	2.5	3,5
Unemployment (%)		4.1	4.8	4.8	4,6
Consumer prices, harmonised		2.7	2.5	1.8	1,6
Hourly wage increases		1.7	1.5	1.5	2,0
Current account, % of GDP		6.7	7.0	7.0	7,5
Public sector financial balance, % of GDP		-1.8	-3.0	-1.5	-0,5
Public sector debt, % of GDP		46.5	48.0	48.0	47,0

FINANCIAL FORECASTS	Aug 23rd	Dec 12	Jun 13	Dec 13	Jun 14	Dec 14
Lending rate	0.20	0.05	0.05	0.05	0.05	0.05
10-year bond yield	1.23	1.45	1.70	1.80	2.05	2.25
10-year spread to Germany, bp	-15	-15	-10	-10	-5	-5
USD/DKK	5.93	6.10	6.20	6.31	6.47	6.47
EUR/DKK	7.45	7.44	7.44	7.44	7.44	7.44

NORWAY

Yearly change in per cent

	2011 level, NOK bn	2011	2012	2013	2014
Gross domestic product	2,407	1.4	3.7	2.7	2.3
Gross domestic product (Mainland Norway)	1,957	2.4	3.4	3.1	3.0
Private consumption	1,091	2.4	3.6	3.4	3.2
Public consumption	548	1.5	1.8	2.5	2.2
Gross fixed investment	520	6.4	6.9	5.5	4.4
Stockbuilding (change as % of GDP)		0.3	-0.3	0.0	0.0
Exports	932	-1.4	2.6	2.0	1.6
Imports	751	3.5	1.6	4.3	4.3
Unemployment (%)		3.3	3.1	3.2	3.1
Consumer prices		1.2	1.0	1.9	1.9
CPI-ATE		0.9	1.3	1.7	2.0
Annual wage increases		4.2	4.3	4.2	4.4

FINANCIAL FORECASTS	Aug 23rd	Dec 12	Jun 13	Dec 13	Jun 14	Dec 14
Deposit rate	1.50	1.50	1.75	2.25	2.75	3.25
10-year bond yield	1.91	2.10	2.45	2.55	2.85	3.10
10-year spread to Germany, bp	53	50	65	65	75	80
USD/NOK	5.83	5.90	5.83	5.93	6.17	6.17
EUR/NOK	7.32	7.20	7.00	7.00	7.10	7.10

SWEDEN

Yearly change in per cent

	2011 level, SEK bn	2011	2012	2013	2014
Gross domestic product	3,492	3.9	1.3	1.5	2.5
Gross domestic product, working day adjusted		3.9	1.6	1.5	2.6
Private consumption	1,664	2.0	1.5	2.0	2.3
Public consumption	928	1.8	0.9	0.8	0.8
Gross fixed investment	642	6.2	2.5	3.0	3.0
Stockbuilding (change as % of GDP)	40	0.7	-0.7	-0.2	0.1
Exports	1,751	6.9	1.1	2.7	4.3
Imports	1,533	6.3	-0.3	3.0	3.7
Unemployment (%)		7.5	7.5	7.8	7.9
Employment		2.1	0.5	0.0	0.2
Industrial production		6.8	-0.5	2.5	3.5
Consumer prices		3.0	1.1	0.8	1.4
CPIF		1.4	1.1	1.3	1.5
Hourly wage increases		2.6	3.5	3.1	3.1
Household savings ratio (%)		9.7	10.9	11.3	11.7
Real disposable income		3.0	2.8	2.3	2.8
Trade balance, % of GDP		2.6	2.7	2.9	2.9
Current account, % of GDP		7.2	6.8	6.3	6.3
Central government borrowing, SEK bn		-68	20	22	-10.0
Public sector financial balance, % of GDP		0.1	-0.2	-0.3	-0.1
Public sector debt, % of GDP		38.4	37.3	36.8	35.2

FINANCIAL FORECASTS	Aug 23rd	Dec 12	Jun 13	Dec 13	Jun 14	Dec 14
Repo rate	1.50	1.00	1.00	1.00	1.00	1.00
3-month interest rate, STIBOR	1.97	1.75	1.50	1.50	1.50	1.50
10-year bond yield	1.41	1.60	1.80	1.90	2.20	2.50
10-year spread to Germany, bp	3	0	0	0	10	20
USD/SEK	6.59	6.56	6.67	6.86	7.04	7.04
EUR/SEK	8.28	8.00	8.00	8.10	8.10	8.10
TCW	116.4	113.0	114.8	115.1	115.3	115.1

FINLAND

Yearly change in per cent

	2011 level, EUR bn	2011	2012	2013	2014
Gross domestic product	187	2.7	0.6	1.6	2.0
Private consumption	105	2.5	2.0	2.0	2.0
Public consumption	46	0.4	0.3	0.0	0.2
Gross fixed investment	37	6.8	1.5	3.0	3.5
Stockbuilding (change as % of GDP)		1.2	0.1	0.0	0.0
Exports	77	2.6	1.2	4.4	6.0
Imports	78	5.7	3.5	5.0	6.0
Unemployment (%)		7.8	7.6	8.0	8.0
Consumer prices, harmonised		3.3	2.7	2.1	1.9
Hourly wage increases		2.4	2.9	3.0	3.0
Current account, % of GDP		-1.2	-1.0	-1.0	-0.5
Public sector financial balance, % of GDP		-0.5	-0.8	-0.3	0.0
Public sector debt, % of GDP		48.6	47.6	45.0	44.0

EURO ZONE

Yearly change in per cent

	2011 level, EUR bn	2011	2012	2013	2014
Gross domestic product	9,189	1.5	-0.4	0.2	0.9
Private consumption	5,301	0.2	-0.8	-0.3	0.1
Public consumption	2,014	-0.3	0.0	-0.2	0.0
Gross fixed investment	1,764	1.6	-2.4	0.5	2.0
Stockbuilding (change as % of GDP)		0.1	-0.5	0.1	0.0
Exports	3,734	6.3	2.7	3.5	4.2
Imports	3,613	4.1	0.1	3.2	3.5
Unemployment (%)		10.1	11.2	11.9	12.3
Consumer prices		2.7	2.5	1.6	1.5
Household savings ratio (%)		9.3	9.1	9.2	9.1

US

Yearly change in per cent

	2011 level, USD bn	2011	2012	2013	2014
Gross domestic product	15,321	1.8	2.2	2.2	2.6
Private consumption	10,874	2.5	1.9	1.9	2.0
Public consumption	3,051	-3.1	-2.1	-1.1	-1.0
Gross fixed investment	1,991	6.6	9.3	7.6	9.7
Stockbuilding (change as % of GDP)		-0.2	0.3	0.0	0.0
Exports	2,120	6.7	4.3	5.2	6.0
Imports	2,715	4.8	4.2	4.8	5.0
Unemployment (%)		9.0	8.3	8.3	7.8
Consumer prices		3.1	2.2	2.0	1.4
Household savings ratio (%)		4.2	4.0	5.1	5.6

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2011	2012	2013	2014
GDP				
United Kingdom	0.8	-0.4	1.4	1.6
Japan	-0.7	2.6	1.5	1.5
Germany	3.1	0.8	1.0	1.5
France	1.7	0.3	0.3	0.5
Italy	0.5	-2.0	-0.6	0.3
Inflation				
United Kingdom	4.5	2.7	1.8	1.5
Japan	-0.3	0.2	0.3	0.5
Germany	2.5	2.1	1.8	1.7
France	2.3	2.0	1.7	1.4
Italy	2.9	3.6	2.2	2.0
Unemployment (%)				
United Kingdom	8.2	8.3	8.4	8.5
Japan	4.6	4.4	4.2	4.2
Germany	7.1	5.6	6.4	6.3
France	9.7	10.2	10.8	11.0
Italy	9.4	10.7	11.8	11.8

EASTERN EUROPE

	2011	2012	2013	2014
GDP, yearly change in per cent				
Estonia	7.6	2.0	3.0	4.9
Latvia	5.5	3.5	4.0	4.5
Lithuania	5.9	3.5	4.0	4.0
Poland	4.3	3.1	3.2	3.8
Russia	4.3	3.8	3.8	4.2
Ukraine	5.2	2.5	3.2	4.0
Inflation, yearly change in per cent				
Estonia	5.1	4.0	4.3	3.3
Latvia	4.2	2.5	2.1	3.0
Lithuania	4.1	2.5	3.0	3.0
Poland	3.9	3.8	2.8	2.6
Russia	8.5	5.0	5.8	6.0
Ukraine	8.0	2.5	6.0	7.5

FINANCIAL FORECASTS

		Aug 23rd	Dec 12	Jun 13	Dec 13	Jun 14	Dec 14
Official interest rates							
US	Fed funds	0.25	0.25	0.25	0.25	0.25	0.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.75	0.50	0.50	0.50	0.50	0.50
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	0.50
Bond yields							
US	10 years	1.67	1.85	2.05	2.25	2.55	2.55
Japan	10 years	0.83	0.95	1.00	1.10	1.20	1.20
Germany	10 years	1.38	1.60	1.80	1.90	2.10	2.30
United Kingdom	10 years	1.56	1.80	2.00	2.10	2.50	2.70
Exchange rates							
USD/JPY		78	80	83	85	90	94
EUR/USD		1.26	1.22	1.20	1.18	1.15	1.15
EUR/JPY		99	98	100	100	104	108
GBP/USD		1.59	1.54	1.54	1.51	1.49	1.49
EUR/GBP		0.79	0.79	0.78	0.78	0.77	0.77

GLOBAL KEY INDICATORS

Yearly percentage change

	2011	2012	2013	2014
GDP OECD	1.8	1.4	1.7	2.2
GDP world	3.9	3.3	3.6	4.1
CPI OECD	2.5	2.1	1.6	1.5
Export market OECD	5.7	3.3	5.2	6.6
Oil price, Brent (USD/barrel)	112.3	112.0	110.0	115.0

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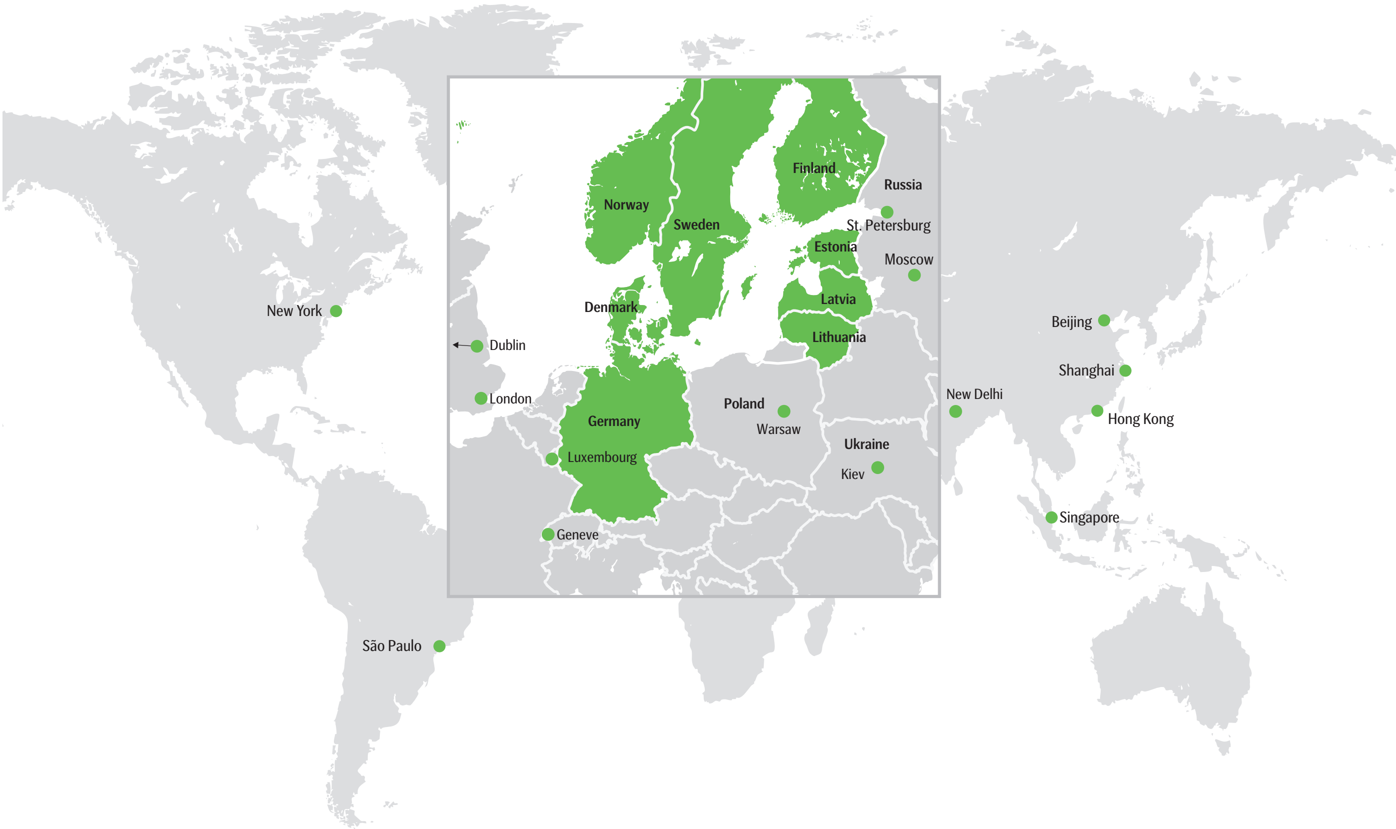

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SEMB0096 2012.08