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Nordic Outlook: A divergent world economy in great need of support and political resolve

The global economic crisis refuses to go away. The slowdown in Europe has gained strength since summer, with increased risks of global contagion. The desired "recovery dynamic" is being delayed because of continued private and public sector **debt consolidation** in the Western world. In addition, there are various **sources of political uncertainty** connected to the euro zone crisis, fiscal policy issues in the United States, China's leadership change and the Middle East situation. The situation may deteriorate further unless optimism increases in the corporate sector.

We are now seeing **divergent growth rates in the world economy.** On the one hand, for example, the US economy is on firmer ground, and we believe that growth in emerging economies including China has bottomed out. **The US**, with a growth rate of **2.4 per cent in 2013** and **2.7 per cent in 2014**, will **help drive** the global economy and financial markets. We also expect China to be a stabilising global force, once its growth rebounds to **about 8 per cent** and the reform policies of the new Xi administration become clearer. On the other hand, a negative economic policy dynamic is dominant in the euro zone. Growth is depressed in spite of support from the European Central Bank (ECB) and some improvement in imbalances related to competitiveness, current account and government finances. **Gross Domestic Product (GDP) in the 34 countries of the Organisation for Economic Cooperation and Development (OECD)** will grow by **1.3 per cent in 2012, 1.6 per cent in 2013** and **2.1 per cent in 2014. Overall, downside risks will predominate due to the euro zone crisis.** Low resource utilisation will push down the rate of pay increases in the OECD countries. Because of this, **OECD inflation will remain stable at a low 1-2 per cent**, despite "money printing" by central banks.

The central banks in the US, Japan, the United Kingdom and the euro zone are stepping up their efforts and setting new historical records in monetary stimulus, among other things by purchasing government securities. The world's biggest economic experiment is thus continuing. During the past five crisis years, central bank balance sheets have expanded by more than USD 11 trillion, or 20 times the GDP of Sweden. The purpose of these quantitative easing measures is to soften the impact of public and private sector debt consolidation in order to prevent deflationary spirals from spinning dangerously out of control, while ensuring the supply of liquidity in the financial system. Monetary stimulus policies **are unlikely to threaten price and financial stability.** The risk of these measures is instead that they may disrupt pricing mechanisms in financial markets, making effective resource allocation in the economy more difficult. Another possible risk is that the impact of central bank policies may ease pressure on the political system to implement the necessary budget measures and restructuring policies. The differences in monetary stimulus between countries may also contribute to undesired exchange rate shifts that will lay the groundwork for protectionist tendencies. Overall, we expect that due to continued weak growth, low resource utilisation and ultra-loose monetary policies, the **historically low interest rate environment will persist.** Despite problems on both sides of the Atlantic, we anticipate that because of stronger US growth, **the euro will weaken against the dollar, trading at USD 1.22 one year from now and at USD 1.15 in two years.**

Economic performance remains weak in the euro zone: GDP growth will be -0.2 per cent in 2013 and 0.8 per cent in 2014. Unemployment will thus continue climbing, reaching a historically high 12.4 per cent. Growth will be weak in Germany, too, despite fiscal stimulus measures totalling more than 0.5 per cent of GDP in 2013. Meanwhile the economic policies of France are increasingly being questioned. The broader economic slowdown is an impediment to the forces now trying to stabilise and restore the euro system. However, the differences between labour costs in the various euro zone countries have begun to narrow, which will help shrink current account deficits and diminish imbalances. The ECB's new Outright Monetary Transactions (OMT) bond purchasing programme is necessary to prevent new government liquidity crises. We predict that Spain will apply for a financial bail-out within a few months, after which we expect the ECB to begin buying its sovereign bonds. The outlook for Greece is uncertain; the country needs a debt write-down, while due to the weak parliamentary majority in favour of fiscal belt-tightening, there is still a very large risk of a new election and a Greek withdrawal from the euro zone.

The EU summit on December 13-14 is an imporetant crossroads for the euro project, since a final roadmap and timetable for a euro zone political union (EPU) will be unveiled there. Such a union inherently involves controversial issues, including constitutional ones. The stability and future of the euro will depend on increasing broad-based support for more federalism and centralisation. Given the current economic crisis environment, it is likely to be difficult to generate enthusiasm for this strategy, contributing to **persistent scepticism about the future of the euro, which in turn will continue to dampen economic activity.**

Sweden's export dependence can be both an asset and a liability. Exports are squeezed today by weak international demand, a stronger krona and heavy dependence on cyclically sensitive investment and intermediate goods. Overall Swedish exports are now falling, but we still expect some recovery in the next couple of years. GDP growth in 2013 and 2014 will depend on higher domestic consumption. Purchasing power will be stimulated by rising real wages and a more active fiscal policy, which especially in 2014 will focus on households. Continued historically low mortgage rates will also provide support. **We expect GDP to grow by 0.7 per cent in 2012, 1.3 per cent in 2013 and 2.5 per cent in 2014.** But the resilience of the economy is now also being severely tested by unemployment – which is climbing faster than expected and will reach at least 8.3 per cent in 2014 – as well as by a continued risk of home price declines; we are sticking to our forecast of a 10 per cent price drop from the 2011 peak.

Inflation pressure in the Swedish economy remains low and the Consumer Price Index will stay below zero during the first half of 2013. The krona will appreciate by 3 per cent during 2013 to SEK 8.30 per euro, but weaken somewhat against the US dollar a bit further ahead. The negative effect of the krona on exports may be partly offset by rising labour costs in countries like Germany as part of the re-balancing efforts of euro zone countries. Because of low resource utilisation and inflation prospects, the **Riksbank will lower its key interest rate in December and February to 0.75 per cent.** The effect on economic growth will be modest, but pressure on the krona will ease since the differences in monetary policy compared to other countries will be less prominent. Our forecast is that household debts as a percentage of disposable income will stabilise at around 175 per cent. This is probably an acceptable development for a majority of the central bank's Executive Board, opening the way for key rate cuts.

The Swedish government faces an uphill battle in terms of credibility. The Finance Ministry's GDP forecasts for 2013-14 (in September's autumn budget) are in great need of downward revisions, which will have adverse follow-up effects on the labour market and public finances. We expect a budget deficit of nearly SEK 50 billion in 2014 (1.3 per cent of GDP). This is a full SEK 80 billion weaker than the government's latest forecast in the autumn budget. Our forecast assumes that, in addition to about SEK 25 billion worth of stimulus measures to be implemented in 2013, the government will allocate an additional SEK 25 billion in 2014. An expansionary fiscal policy is entirely consistent with established stabilisation policy principles, and in the prevailing situation a passive fiscal policy is indefensible, even if the cyclically adjusted balance (which determines the room for reforms) will show negative figures in the next couple of years. Despite a poorer economic outlook, we do not expect central government debt to increase, but instead to remain at a stable level of around 33 per cent of GDP, which is low in historical and international terms.

The other Nordic countries are now clearly being affected by the international slump, especially by the German slowdown. Aside from Sweden, the Finnish and Danish economies are now stagnating. Norway is also feeling the effects of international trends, but its economy has maintained a good pace of expansion. Its recovery will be modest and in line with other countries. The **Danish economy** will grow by 1.4 per cent in 2013 and 1.7 per cent in 2014, a subdued performance affected by the negative aftermath of falling home prices and high debt. The national bank will stick to its near-zero key interest rate (0.20 per cent) throughout our forecast period. In Norway, however, we expect **Norges Bank** to begin its rate hikes before the summer of 2013, thus standing out while other central banks move in the opposite direction. Monetary tightening will be necessary because of the strained resource situation and financial risks connected to rising home prices and increased debt. The Norwegian krone will thus appreciate to NOK 7.00 per euro during 2013. A larger appreciation than this may mean that Norges Bank will not deliver key rate hikes according to our forecast of 75 basis points during 2013 and 75 bps in 2014 to 3.00 per cent. In export-dependent **Finland**, GDP growth will reach only 0.8 per cent in 2013 and 2.0 per cent in 2014, aided by consumption and capital spending, but exports and fiscal tightening will have the opposite effect, even though we expect the euro to weaken and the Swedish krona to strengthen. Finland's unemployment rate will climb to the same level as in Sweden: 8.3 per cent.

In Estonia, Latvia and Lithuania, GDP will grow by 3.5 to 4.5 per cent (close to potential levels) in 2013 and 2014, sustained by relatively good domestic demand that will soften the adverse impact of exports. Real income is improving due to gradually falling unemployment and low inflation, but Estonia is grappling with inflation of around 4 per cent. There are more and more signs that Latvia will join the euro zone in 2014. This implies continued tight fiscal policies in 2013. In Lithuania, the euro zone question has become a lower priority following the recent change of government.

Key figures: International and Swedish economy

International economy. GDP, year-on-year changes, %	2011	2012	2013	2014
United States	1.8	2.2	2.4	2.7
Euro zone	1.4	-0.4	-0.2	0.8
Japan	-0.7	1.7	0.8	1.3
OECD	1.8	1.3	1.6	2.1
China	9.2	7.7	8.1	7.7
Nordic countries	2.3	1.4	1.6	2.2
Baltic countries	6.4	3.9	3.8	4.2
The world (purchasing power parities, PPP)	3.8	3.3	3.8	4.1
Swedish economy. Year-on-year changes, %				
GDP, actual	3.9	0.7	1.3	2.5
GDP, working day corrected	3.9	1.0	1.3	2.6
Unemployment, % (EU definition)	7.5	7.6	8.2	8.2
Consumer Price Index (CPI) inflation	3.0	0.9	0.1	1.4
Government net lending (% of GDP)	0.1	-0.4	-0.8	-0.9
Repo rate (December)	1.75	1.00	0.75	0.75
Exchange rate, EUR/SEK (December)	8.91	8.75	8.30	8.30

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