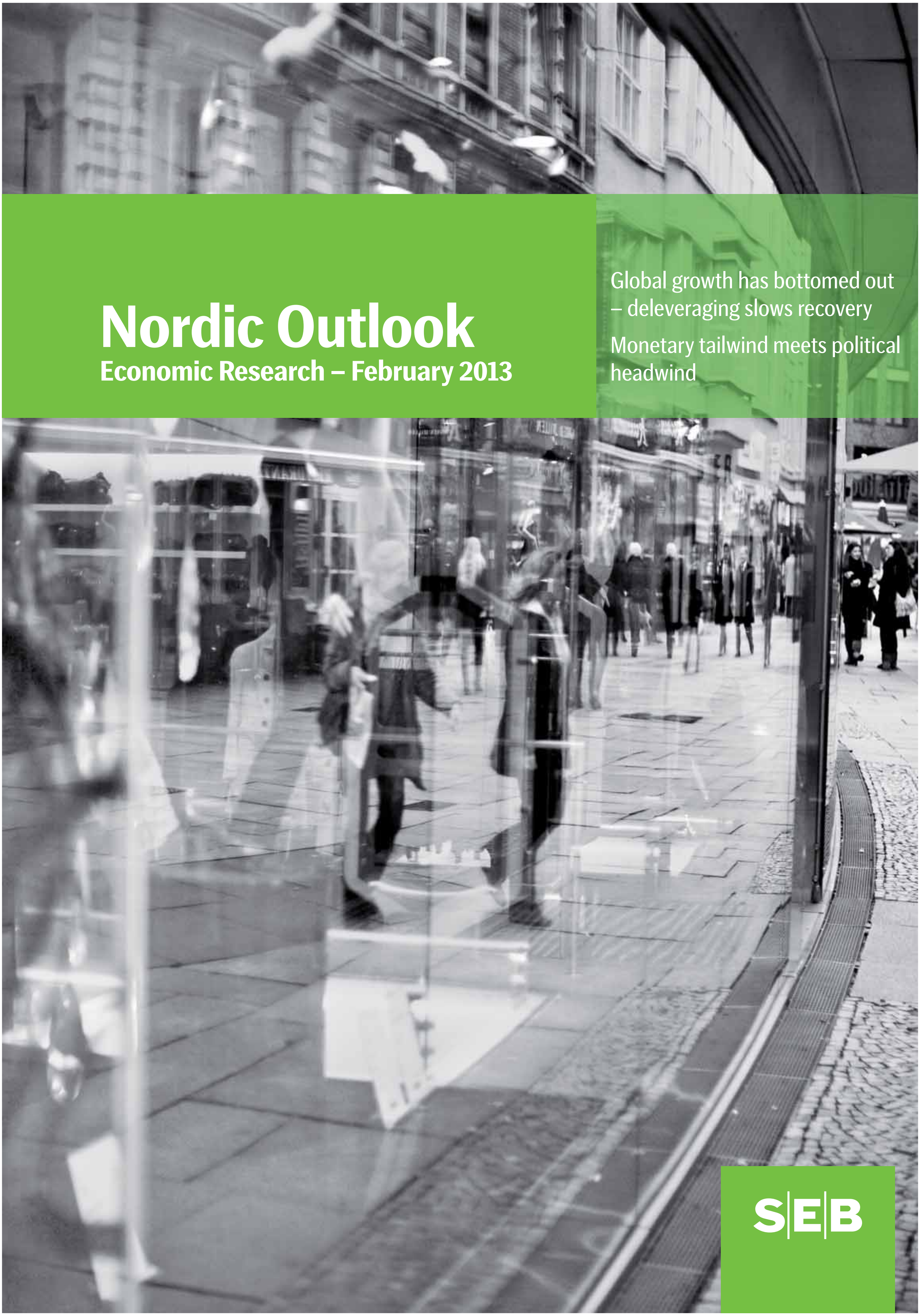

Nordic Outlook

Economic Research – February 2013

Global growth has bottomed out – deleveraging slows recovery

Monetary tailwind meets political headwind

SEB

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Subdued performance, but positive forces in motion

- **Sluggish OECD growth during first half, but China and US are stable economic engines**
- **Euro zone stuck in long tunnel of problems – complex political issues causing worries**
- **Central banks assuming more responsibility for growth – loose policies through 2014**
- **Long-term yields and equities climbing cautiously – stronger USD in 2014**
- **Nordics/Baltics: Domestic dynamism will offset weak external demand**

The world economy continues to move in the **right direction**, but at a **subdued pace** and at **divergent speeds** in different countries/regions. Global GDP growth is being held back by heightened **economic policy uncertainty** and, in the Western world, because households, governments and banks **have not yet achieved their debt consolidation targets**. There are many large, experimental issues related to China's economic and financial stability, Europe's stumbling progress towards political union and the "new" monetary policy, for example. Unemployment will keep rising this year, especially in Europe.

Economic policy uncertainty

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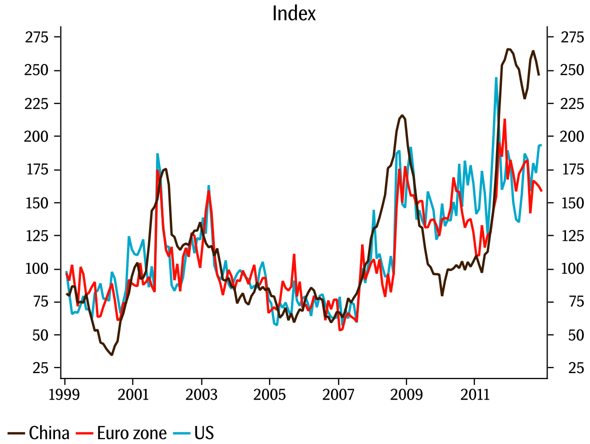


Source: www.economicpolicyuncertainty.com

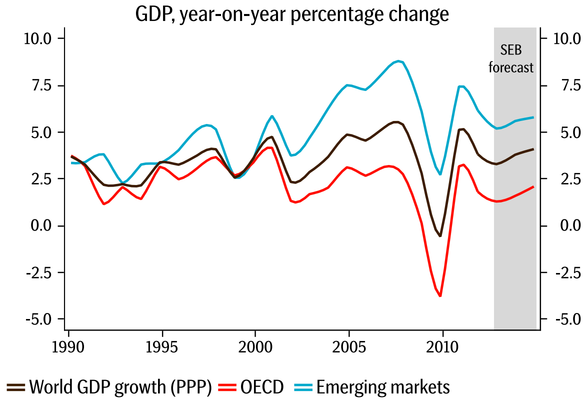
Frustratingly high political uncertainty

Difficult issues must be handled by political systems that are not yet **architecturally adapted**, at either the national or global level, to demonstrate the necessary resolve in a world of new challenges. This **destabilises the optimism of industrial firms** and may easily trigger a self-amplifying downward spiral of postponed capital spending and hiring decisions. Political leaders need strong, clear mandates from voters that enable them to make tough decisions. Meanwhile, **central banks are being forced to play a leading role** in the economic recovery.

Despite headwinds, global growth will accelerate both in 2013 and 2014. A number of positive forces are in motion. Central banks will set new records for **monetary stimulus** in 2013. This will ease financial stress in the system and help sustain asset prices. Meanwhile changes under way in the monetary policy framework will increase the likelihood of low key interest rates for an extended period. **The recovery in the US and China** is on increasingly firm ground, benefiting global risk appetite. **Japan's new focus** on stimulus-driven growth is also expected to help lift the global economy, at least in the short term. **Greater flexibility** in both fiscal consolidation efforts and in implementing the new Basel III regulatory framework for banks will reduce their negative impact on growth. **In Europe, imbalances are large but shrinking**, and an improvement in competitiveness is under way via wages and productivity; borrowing costs of crisis-hit countries are falling, while the likelihood of a euro zone collapse is diminishing. All these forces together, combined with the risk picture, contribute to a **global GDP growth rate that will be close to trend by the end of our forecast period**.

Growth has bottomed out

GDP, year-on-year percentage change



Source: IMF, OECD, SEB

Our scenario intact – growth has bottomed

Overall, our forecast adjustments compared to *Nordic Outlook* in November 2012 are small. **Our main scenario is intact**: global economic growth has bottomed out. In the 34 countries of the Organisation for Economic Cooperation and Development (OECD), growth will total **1.5 per cent in 2013** (up from 1.3 per cent in 2012) and **2.1 per cent in 2014**, still below trend. **Global growth** (in purchasing power parities, PPP) will climb from 3.3 per cent in 2012 to **3.7 per cent in 2013** and then to **4.1 per cent in 2014**. Given this outcome, divergences and tensions between countries will increase, due to different economic conditions. Some countries will be forced to pursue constrained, defensive crisis policies while others can act in an aggressive, forward-looking and long-term way. This environment will generate more pressure for global cooperation to prevent protectionism and currency wars.

Global GDP growth
Year-on-year percentage change

	2011	2012	2013	2014
United States	1.8	2.2	2.1	2.7
Japan	-0.5	2.0	1.3	1.5
Germany	3.2	0.7	0.6	1.6
China	9.3	7.8	8.1	7.7
United Kingdom	0.9	0.0	1.3	1.5
Euro zone	1.4	-0.5	-0.3	0.9
Nordic countries	2.3	1.0	1.3	2.2
Baltic countries	6.4	4.0	3.4	3.9
OECD	**1.8**	**1.3**	**1.5**	**2.1**
Emerging markets	6.3	5.1	5.5	5.7
World, PPP	**3.8**	**3.3**	**3.7**	**4.1**
World, nominal	3.1	2.6	3.0	3.4

Source:OECD, SEB

A subdued global recovery will mean that **the Nordic and Baltic countries** must rely on stronger domestic demand – consumption and capital spending – for increased economic activity in the next two years. The potential is good, thanks to generally strong fundamentals. **Norway** will continue to stand out, sustained by both the domestic economy and demand for oil; Norges Bank will hike its key interest rate this autumn. The **Swedish economy** will also gradually accelerate to GDP growth of 2.5 per cent in 2014, with the help of good disposable income increases that will be sustained by more expansionary fiscal policy and low inflation. In **Denmark** and **Finland**, however, the situation is troublingly weak and growth will barely exceed 1.5 per cent in 2014; Danish households are squeezed by high debt and a weak real estate market, while Finland is feeling the impact of a sluggish global economy. In **Estonia** and **Lithuania**, growth will end up just above 3 per cent in 2013; **Latvia** will reach nearly 4 per cent. In 2014, growth in the three Baltic countries will be around 4 per cent, i.e. near trend. Latvia will adopt the euro on January 1, 2014.

Nordics and Baltics, GDP growth
Year-on-year percentage change

	2011	2012	2013	2014
Sweden	3.7	0.8	1.2	2.5
Norway	1.2	3.0	2.4	2.3
Denmark	1.1	-0.5	0.7	1.7
Finland	2.8	-0.1	0.4	1.7
Estonia	8.4	3.1	3.3	4.0
Latvia	5.5	5.3	3.8	4.5
Lithuania	5.9	3.6	3.2	3.5

Source: OECD, SEB

Symmetric upside-downside risk picture

Several factors may force growth curves downward. Companies may abstain from investing and hiring due to uncertainty about economic policies and a lack of stability and predictability. This includes the US as well as China and Europe. Because of central bank actions, political systems may abstain from making necessary decisions, while public confidence in political leaders erodes as unemployment climbs. This may lead to poorer international relations, the emergence of protectionism and widespread currency wars. **We estimate the probability of this negative scenario at 20 per cent**.

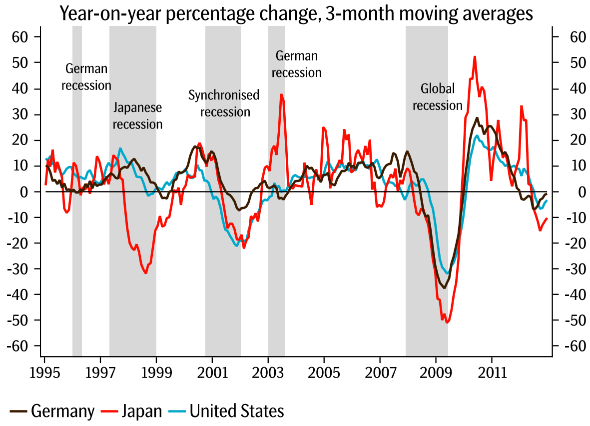
The global recovery may also occur faster than expected. When the Chinese National People's Congress ends in March and the US Congress has reached certain budget agreements, uncertainty may diminish and confidence may improve. Capital spending that was postponed earlier may materialise. This would be reinforced by expansionary monetary conditions and a credit market thaw, sustaining asset prices by means of greater risk appetite. **We estimate the probability of this positive scenario at 20 per cent. Our overall conclusion is that the risks in our growth forecast are symmetric**.

Alternative scenarios
Year-on-year GDP change

	2013	2014
A. Deeper political/euro zone crisis (20%)		
United States	1.5	1.7
Euro zone	-1.5	-1.0
OECD	**0.0**	**0.0**
EM economies	4.5	4.5
B. US/China-led recovery (20%)		
United States	3.5	4.0
Euro zone	1.5	2.0
OECD	**2.6**	**2.7**
EM economies	6.3	6.5

Source: OECD, SEB

G3 order bookings send warning signals
Year-on-year percentage change, 3-month moving averages



Source: Macrobond, SEB

Over the past couple of months, the global financial market has been undergoing a **rapid rebalancing towards riskier assets** such as equities and debt instruments. This is positive for economic growth and balance sheet repairs. Meanwhile volatility in financial asset prices is unusually low, very much thanks to central banks that are intervening and influencing financial market prices. This is creating a **mismatch** between financial asset prices and short/long-term economic, financial and political challenges. Excessively high and static return requirements increase the risk that financial imbalances will now be built up and may need to be corrected later. This would create instability, since global economic and political conditions may change very rapidly.

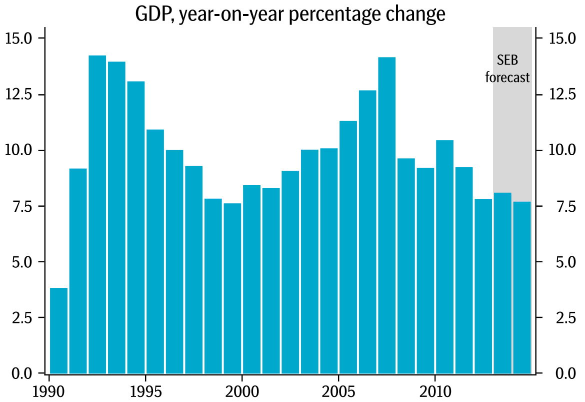
US and China will show steady recovery

The economic outlook in the United States and China will steadily continue improving. This will add stability, risk appetite and dynamism to the world economy despite continued problems in Europe. **In the US, the underlying growth trend will gain strength**. American households have now come fairly close to debt levels that are sustainable and reasonable in the long term. Meanwhile we expect home prices to climb by 10 per cent in 2013-2014. Companies have also been under-investing for many years. This means that a capital spending rebound is waiting around the corner. There will be no major growth surge, however, partly due to fiscal tightening that will total about 1.5 per cent of GDP in 2013 and 1.3 per cent in 2014. Another reason is that although unemployment will fall, it will remain high for at least another 2-3 years.

US political leaders are playing a high-stakes game. New congressional deadlocks are an obvious risk to growth, especially in a short-term perspective. But our main forecast is that fiscal agreements will be reached, under the threat of downgraded credit ratings. President Barack Obama's position among voters has strengthened and the Republicans risk being blamed if budget negotiations break down. Because of rising nominal GDP and some cost-cutting, public sector debt is expected to peak at 115 per cent of GDP around 2015 and then slowly move downward. Due to falling inflation pressure, and since unemployment is expected to remain above the Federal Reserve's new monetary policy benchmark of 6.5 per cent, the central bank will hold off until **the summer of 2014 before ending its bond purchases (quantitative easing) and until the spring of 2015 before hiking its key interest rate**.

China: No more double-digit annual growth figures

GDP, year-on-year percentage change



Source: IMF, SEB

During 2012 China struggled with heightened economic policy uncertainty, but this will ease during the spring when the change of leadership is completed, providing support for both capital spending and consumption. **China also has room for manoeuvre in economic policy**, enabling it to prop up the economy and deliver annual **growth of around or just below 8 per cent in the next two years**. **But reversals are likely**.

China's development is a large economic, financial and political "experiment" with an uncertain outcome. Inflation, overblown home prices and a deeper euro zone crisis are risks, but we do not believe they are sufficiently probable to affect our growth forecasts for 2013-2014. In a longer-term perspective, the major risks are connected to political developments, border disputes in Asia and the worsening of Japan's underlying growth problems and large government debt.

Euro zone crisis is multi-dimensional

The euro zone has left its acute crisis behind. Crisis-hit countries now enjoy lower borrowing costs, share prices have climbed and financial stress has decreased. These are very important steps in the right direction. The reason is that the ECB's tools have worked and governments have delivered policies that may pay off. Differences in competitiveness and thus imbalances between euro zone countries are narrowing and positive economic signals from the US and China are improving external demand. We expect the euro zone as a whole to show **near-zero growth during 2013-14**. Meanwhile this implies that **unemployment will reach a new record level of 12.4 per cent**.

The euro zone crisis is not one crisis but several: **a sovereign debt crisis, financial crisis, competitiveness crisis, growth crisis, job/social crisis, political crisis and crisis of confidence**. For understandable reasons, there is thus no simple solution. Minor missteps can quickly lead to major confidence problems and economic as well as financial effects. Multi-year fiscal consolidation programmes must be implemented in an environment of weak growth and high unemployment. Today political leaders need strong, clear mandates from their citizens to carry out policies that can address imbalance problems while building a new institutional framework around a political union.

Our euro zone scenario still contains **large elements of political uncertainty**. European cooperation and cohesion will be tested by **social pressures** as well as by the process of moving towards a **political union** with greater federalism and centralisation, **referendums on independence** and signals from the **United Kingdom** of a desire to re-examine the country's EU membership. Germany will be forced to play a stabilising main role; the Bundestag election this coming autumn and the election to the European Parliament in June 2014 could play a decisive role in Europe's future and its ability and power to implement the necessary restructuring.

Challenges remain for crisis-hit countries

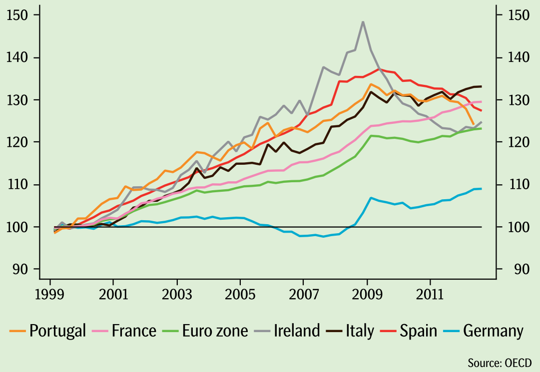
There is still a high probability that at least one country will withdraw from the euro zone. The most likely country is **Greece**, due to the risk of political instability and the weak parliamentary support for the country's crisis policies. Because of **Spain's** economic and financial situation, it will receive an emergency loan during 2013; Cyprus will also obtain an emergency loan of EUR 15-20 billion. The February 2013 election in **Italy** is expected to result in a government with broad parliamentary support; in the short term, political risk will thus diminish. **Portugal** and **Ireland** have managed to gain credibility and are seeing results from their policies, but major strains will continue over the next couple of years. The joker in the pack

Euro zone's crisis-hit countries on the right path

Competitiveness gaps within the euro zone are now being corrected from two directions. According to the OECD, unit labour cost is **falling in countries like Greece, Portugal, Spain and Ireland** while it is **rising in Germany**, narrowing the differences in competitiveness. This is helping push down the current account deficits that crisis-hit countries have been running for many years. Another result is that imbalances will decrease in the Target2 central bank payment system. Imbalances will also narrow as a result of greater confidence in the financial system and shrinking conversion risk (i.e. risk of reversion to 17 national currencies).

Euro zone: ULC shows smaller imbalances

Index 100 = 1999



Most of this adjustment is attributable to weak domestic demand and rapidly rising unemployment, i.e. there is a significant cyclical component. Unfortunately, most indications are still that some countries must implement further structural reforms to improve their competitiveness, while holding back pay increases. Italy and France must also bring an end to their ominously escalating labour cost trends. Our conclusion is that euro zone countries must 1) complete/extend their multi-year fiscal consolidation and restructuring programmes in order to shrink budget deficits and government debts and 2) generate sustainable current account surpluses that push down the large external debts of crisis countries and reduce refinancing risks..

is **France**: weak growth/competitiveness will force the administration of President François Hollande into budget-cutting to retain its credibility and ability to borrow in the financial market.

Fiscal tightening will ease somewhat

Many countries are still struggling with a combination of excessive private debt (above 160 per cent of GDP) and overly high public sector debt (above 80 per cent of GDP), but trimming both private and public debt simultaneously has too powerful a negative impact on economic growth.

Permanently weak government finances are among the larger medium- and long-term risks to the world economy. Budget deficits and growing government debts create uncertainty about future taxes and public expenditures, hampering consumption, capital spending and long-term growth. In addition, governments need room to deal with the challenges connected to an ageing population and the climate issue.

The UK opens Pandora's box

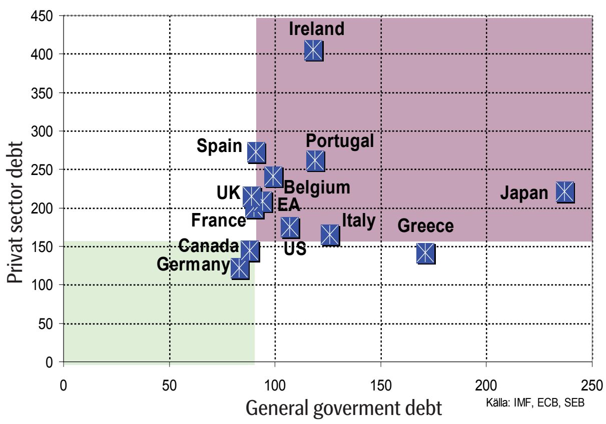
Despite warnings, British Prime Minister David Cameron has deliberately chosen to raise the controversial issue of **British withdrawal from the EU**. This implies that the UK will renegotiate the terms of its agreement with the EU and then the British people will let their voices be heard, indirectly in a parliamentary election on May 7, 2015 and directly in a **referendum**.

The exact motives behind this proposal are unclear, but it is obvious that the Tories may pick up important EU-sceptic votes both in the election to the European Parliament in June 2014 and in their own parliamentary election less than a year later. **Looking ahead, there is a high probability that the gap between the UK and the EU will widen**. The reason is that the 17 euro zone countries – which do not include the UK – will be making serious efforts to develop a political union with large elements of federalism, centralised political decision making, circumscribed national sovereignty and collective debt/risk spreading. In our assessment, this is a development that will be difficult for the British to accept.

Cameron's initiative is negative for both the UK and the EU. The prime minister is fuelling further economic policy **uncertainty** in his own country, which risks having an adverse impact on investments, growth and London's role as a financial centre. His initiative also creates a **hothouse atmosphere for anti-EU sentiments** and extremist parties in other countries, amid a situation of low growth and high unemployment. This will make EU cooperation more difficult, at a time when such cooperation is perhaps most important and critical. **Other countries, not just the UK, also need to organise referendums** connected to the constitutional amendments that will be necessary as a result of the development of a European political union.

It is difficult to believe that the UK can bring about a renegotiation of existing EU treaties. Although there is plenty of time left before a British referendum, Europe must bear in mind the prospect of a European Union without the UK. This would give the **EU an entirely new internal political balance**, with the Franco-German axis as the driving force and no UK to act as a counterforce. It would also give the **EU a weaker voice in the world**. The most important factor that may change this scenario is a deepened economic crisis in the UK that would make the country more dependent on the EU and the world.

High private debt and public sector debt



Fiscal austerity effect, selected countries
Change in structural balance, as a percentage of GDP

	2011	2012	2013	2014
United States	0.8	1.1	1.5	1.3
Japan	-0.4	-0.8	-1.0	-1.0
United Kingdom	1.9	1.2	1.4	1.2
Euro zone	1.0	0.4	0.4	0.4
Of which GIPS*	0.9	2.3	1.9	1.0
Nordic countries	0.3	0.0	0.2	0.2
OECD	0.8	0.8	0.7	0.7

Source: IMF, OECD, SEB *Greece, Ireland, Portugal and Spain

But the shift towards a more flexible approach to fiscal consolidation is continuing. New studies from the International Monetary Fund (IMF) have shown that excessively severe fiscal tightening at the beginning of the financial crisis probably made the situation worse. The message about the importance of public belt-tightening formally remains in place. In practice, however, there is a growing risk that necessary austerity and restructuring will be postponed, especially when central banks are being pressured to do more and the financial market situation is improving. **The dose of austerity in the OECD countries will be 0.7 per cent of GDP in both 2013 and 2014. US fiscal tightening is consistent with our expectations, while Japan is stimulating more**.

Public budget balance, selected countries
Per cent of GDP

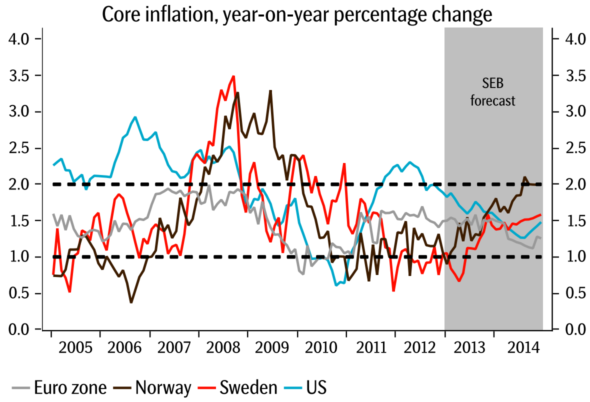
	2012	2013	2014	Debt*
United States	-8.7	-6.1	-5.4	113.0
Japan	-10.0	-10.5	-9.0	250.0
United Kingdom	-8.2	-7.3	-5.8	96.0
Euro zone	-3.3	-2.7	-2.0	93.7
OECD	-5.3	-4.2	-3.4	112.0

* Gross debt, 2014

Source: IMF, OECD, SEB

Monetary flexibility, thanks to low inflation
Inflation pressure will remain weak in 2013 and 2014, despite increased economic activity and enormous monetary stimulus programmes in the US, Europe and Japan. The picture is the same for emerging economies. One important explanation for low inflation is that the world economy still has a large amount of slack – high unemployment and low capacity utilisation – which pushes down wages, salaries and prices. There is concern that companies, after a long period of postponed capital spending, will try to increase prices when economic activity expands. Because of global competition, however, this inflation risk is limited. Individual countries may periodically report higher Consumer Price Index (CPI) inflation, for example due to changes in indirect taxes and/or climate-related effects that influence energy and food prices but have no major impact on long-term underlying inflation pressure. Our forecast is that **during the next two years, commodity prices will not threaten a favourable inflation scenario**, due to a good supply of commodity production capacity and subdued economic performance.

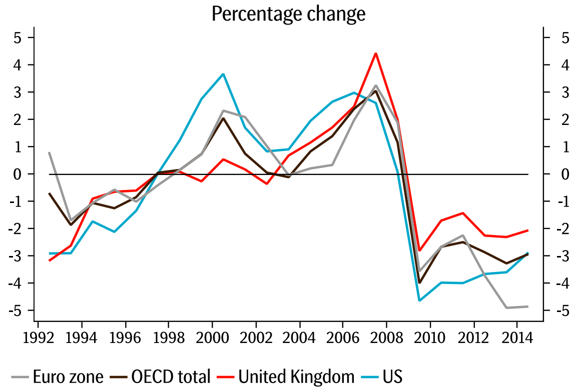
Inflation pressure will remain low
Core inflation, year-on-year percentage change



Source: BLS, Eurostat, Statistics Norway, Statistics Sweden, SEB

Money supply growth in the OECD countries also remains at levels that will hardly cause concern. As long as the financial system continues to adjust and shrink its balance sheets in response to a new risk environment and regulations or requirements, we expect the flow of liquidity in the global system to remain sluggish. However, we believe that the risk of monetary inflation is greater in the US than in Europe, since American banks have progressed further in their adjustments. In contrast, according to the OECD, European banks need to raise around EUR 400 billion in capital to fulfil the necessary capital adequacy requirements.

Output gap as percentage of total economy
Percentage change



Source: OECD

Growth-friendlier monetary policy coming?
Public discourse about the targets and techniques of monetary policy and the independence of central banks is deepening and intensifying (see the Theme article, "Monetary policy – evolution and revolution" on page 12). There are obvious weaknesses in the monetary policy framework. Over the past 20 years, there has been too much focus on a central bank's task of dealing with exogenous forces. This has concealed the emergence of endogenous forces in the economic and financial systems – challenges that are now being addressed. These are related to target formulation, the effectiveness of interest rate management, the choice of tools, the relationship to financial stability, clarity of communication, the need for global cooperation and political independence.

Ever since the start of the crisis in 2008, monetary policy has moved towards becoming **"politicised and fiscalised"**. There are clear signs that various central banks – such as the Bank of Japan, the European Central Bank and the US Federal Reserve – have been pressured and are now prepared to accept **higher inflation and greater inflation risks** in order to achieve **lower unemployment** and more job creation.

Public discourse about the "new" monetary policy strengthens our conclusion that the Fed, ECB, Bank of England and Bank of Japan will not touch their key interest rates during our forecast period. New monetary records will be set, however, since the Fed and BoJ in particular will let their balance sheets continue to grow by purchasing bonds and other securities. Overall, we believe that the risks of unconventional monetary policy will remain small even in a longer perspective. As described earlier, the problems are instead related to:

1. Reduced pressure on political leaders,
2. Distortion of financial asset prices,
3. Destabilising capital flows arising at the global level.

Macroprudential tools urgently needed

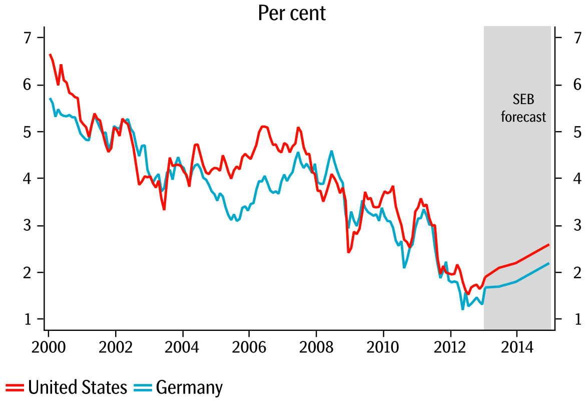
The low interest rate environment and rising economic activity are increasing the need to rapidly develop effective **macroprudential supervision tools** (instruments to regulate credit volume). By most indications, however, the process is moving slowly. There are many unresolved questions, for example about the effectiveness of various tools, international coordination, the allocation of responsibility among public agencies and how the tools should be introduced. As a result, central banks find themselves in a political, pedagogical and intellectual dilemma when it comes to weighing and explaining risks and the balance between price stability and fiscal stability. Looking a bit further ahead, there is also a risk that the expanded role of central banks will lead to doubts about their independence, and that attempts will be made to move the **monetary policy decision making process closer to governments and parliaments.**

What has happened, and is happening, in monetary policy is **positive for economic growth**, especially because of its signalling value and the reduced risk of economic reversals during our 2013-2014 forecast period. But this also implies that **inflation expectations must be adjusted upward**, increasing the upward pressure on long-term yields while short-term interest rates can remain at historically low levels. This is an experiment, and we are not really sure how it will turn out. The uncertainty that may occur could adversely affect growth in a long-term perspective if central banks lose their credibility and their control of the economy and cannot demonstrate that they have a toolbox for implementing an exit policy when this is eventually needed.

We expect American and German long-term sovereign bond yields to climb by 60 basis points during our forecast period, reaching 2.60 and 2.20, respectively, by the end of 2014. This rise in yields will be driven by reduced macroeconomic risks. Due to the large quantity of idle resources, globalisation and stable inflation expectations, the upturn in yields will be moderate. The central banks' exit from unconventional monetary policy will also be very lengthy and cautious, and we expect new actions by central banks if movements in yields are too large in relation to a fragile recovery. This supports a continued low interest rate scenario.

10-year sovereign bond yields

Per cent



Source: Macrobond, SEB

With currencies as a growth weapon

There is growing concern that US, European and Japanese monetary policy mean that **emerging economies will now have to pay the price** of activist monetary policy through **stronger currencies, export losses and financial imbalances**. The question of competitive devaluations is on the 2013 agendas of both the Group of 20 (G20) and the IMF. But we do

Japanese monetary policy

The Bank of Japan's formal independence has become a focus of attention since the appointment of a new prime minister. Shinzo Abe has declared that the central bank and the government should now join forces to end deflation and foster economic growth, while keeping the yen competitive. The outcome so far: The BoJ has **adopted a new formal inflation target** of 2 per cent instead of its previous 1 per cent ambition and has **pledged, in principle, to make unlimited securities purchases** until this target is reached (starting in 2014).

Over the past two decades, Japan has failed to increase its inflation rate. There is **nothing new in the monetary policy package** that provides a fundamental reason to believe that Japan will be able to leave deflation behind. **In the past 20 years, Japan has almost always had a negative output gap** (economic slack), which has been the result of both cyclical and structural factors. To achieve higher inflation, **this gap must be closed and expectations of faster economic growth must increase**, thereby **pushing up inflation expectations**. Japan also needs **stable income and pay increases** for households that will not worsen the competitiveness of Japanese industry. Fiscal policy is a more powerful tool than monetary policy. The government's new stimulus package, totalling 2.8 per cent of GDP, will hopefully have some impact but meanwhile there is growing concern about Japan's unsustainable government finances.

not expect any concrete results from such coordination/cooperation. **The verbal currency war will thus continue, adding uncertainty to real economy and the financial market.**

Positive changes in global risk appetite and central bank policies have generated large currency movements in recent months – for example in the Japanese yen (JPY), euro (EUR) and British pound (GBP) – and will determine the basic conditions in the foreign exchange market during 2013. **The appetite for the euro as a global funding currency has decreased** as expectations about the ECB's low interest rate policy have fallen – the focus on negative interest rates has disappeared while LTRO liquidity is being withdrawn – and as conversion risk has decreased. Repayment of short-term euro loans and reversed capital flows will help support the euro during the first half of this year.

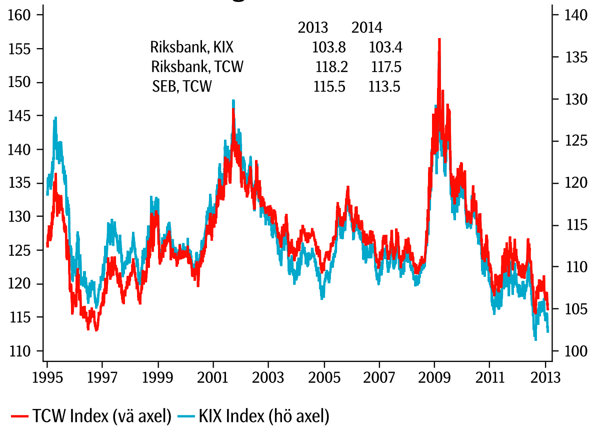
Meanwhile there is **greater appetite for Japanese yen as a funding currency**, since Japan's government and central bank are explicitly aiming at a weak currency and low interest rates. The outlook for the yen is thus still negative, and despite its recent depreciation it remains overvalued in the long term. But Japan has multiple problems: a gigantic public debt of 250 per cent of GDP, slow growth and a deteriorating external balance. Due to both short- and long-term factors, **the USD/JPY exchange rate will stand at 95 at the end of 2013 and 107 at the end of 2014**.

For the classic reserve currencies – dollars, euros and pounds – there is still great economic and political uncertainty, but it has diminished. The attractiveness of alternative reserve currencies like the Swedish krona, Norwegian krone and Swiss franc is thus also decreasing. During 2014 we expect the dollar to regain strength; the key to this is that the Fed will be approaching the end of its bond-buying programme, markets will gradually begin pricing in a Fed interest rate hike and political uncertainty will continue to surround the euro. **Our forecast is that the EUR/USD rate will stand at 1.28 at the end of 2013 and 1.20 at the end of 2014**.

Scandinavian currencies will remain strong

We expect both the Swedish krona and the Norwegian krone to become stronger during our forecast period. The cyclical component as a driving force in the foreign exchange market will increase during 2013-2014, while the appetite for alternative reserve currencies – in a world of great risks and a high probability of political reversals – will persist. In **Norway**, the krone will benefit from good growth prospects compared to other European countries and from the beginning of Norges Bank's rate hiking cycle this coming autumn. In **Sweden**, an improved economic outlook and continued strong fundamentals will attract capital. **We expect the EUR/NOK and EUR/SEK rates to stand at 7.25 and 8.30, respectively, at the end of 2013 and at 7.25 and 8.10 at the end of 2014**.

Sweden: Exchange rate indices and forecasts



Source: Riksbank, SEB

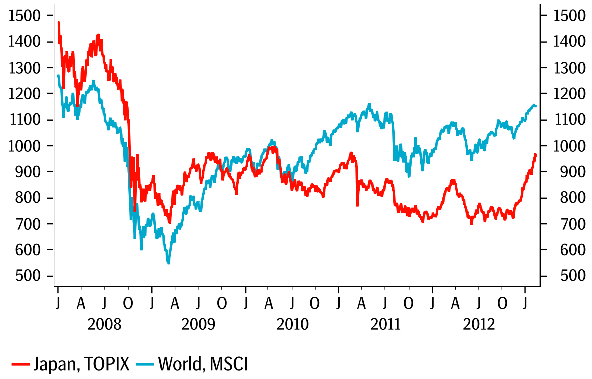
The likelihood of even stronger Swedish and Norwegian currencies is connected to two factors: the development of **macroprudential supervisory tools** as alternatives or complements to interest rates and **global monetary policies**. If we are correct in concluding that it will take time to put macroprudential supervisory tools in place – for practical and political reasons – and that the world's major central banks will continue their unconventional monetary policies, accept higher future inflation and keep their key interest rates low for a long time, there is a risk that the SEK and NOK will appreciate too fast, adversely impacting the export sector.

Optimistic stock markets – higher yields

The outlook for equities will remain the same as in the November issue of *Nordic Outlook*: **cautiously positive**. In recent months, the global stock market index has risen by about 12 per cent. The economic outlook for the US and China continues to improve, which will strengthen risk appetite. The world economic situation is far from good, but on the other hand we do not expect it to deteriorate in the short term in a way that deviates from the consensus picture. Meanwhile global monetary policies are edging towards becoming even more growth-friendly. The attractiveness of alternative asset classes such as corporate bonds and debt instruments will also decrease, due to narrower credit spreads and historically low interest rates.

Global stock market approaching all-time high

Stock market index



Source: Macrobond

- **Central banks are more and more accepting of higher inflation and greater inflation risks**
- **Effects: Positive for growth – continued low short-term interest – rising long-term yields**

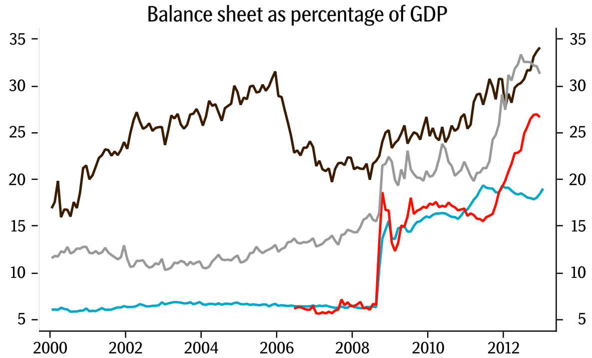
The monetary policy debate is intensifying. A global recession and the Western world's debt crisis have revealed weaknesses in the monetary policy framework in a number of key areas. This applies to choice of **targets**, effectiveness of **interest rate management**, choice of **tools**, relationship to **financial stability**, clarity of **communication**, need for global **cooperation** and ultimately also the political independence of central banks. *Is monetary policy undergoing an evolution or a revolution? What will be the economic and financial impact?*

Stable inflation – unstable markets

Inflation targeting policy has relied on the general view that price stability – defined by many countries as annual consumer price increases of about 2 per cent – will automatically lead to good growth, low unemployment and financial stability. Today there are unfortunately many indications that low, stable inflation has lulled many people into a false sense of security about stability, while dangerous imbalances have built up in the background. **There has been excessive focus on managing exogenous forces** (such as demand- and inflation-influencing factors) **and too little focus on the emergence of endogenous economic and financial systemic forces and their negative effects** (such as globalisation of financial systems and reinforcement effects due to the interplay between/within financial systems and the real economy).

Central banks are expanding more

Balance sheet as percentage of GDP



— Euro zone — Japan — United Kingdom — US

Source: Macrobond

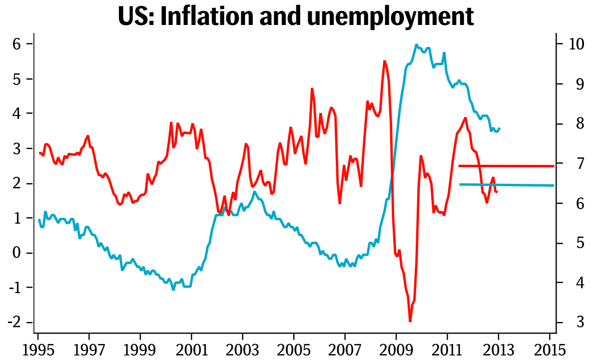
Central bank policies act as stabilisers

The deep financial crisis has forced the world's central banks to shift from using interest rates as their sole policy instrument to aggressively using their balance sheets to sustain/stabilise the financial system. At times, their aim has been far broader, with both the US Federal Reserve (Fed) and European Central Bank (ECB) lending huge sums in order to **keep banks, and in the ECB's case also individual governments, from collapsing**. Monetary policy has probably been necessary, as well as successful, in halting acute crisis situations. Global and regional financial stress has been reduced, while yields and credit spreads have been squeezed. These measures have created more time for political decision making. But central banks are moving **ever deeper into areas and issues that are fundamentally political** and cannot be interpreted in a straightforward way based on their mandate to preserve price stability. Central banks have acted in lieu of – or indirectly on behalf of – governments. Boundaries have moved and monetary policy mandates have been re-interpreted, while an emerging debate on central bank independence is discernible.

"Fiscalisation"...

Ever since the start of the crisis in 2007-2008, monetary policy has become more **"politicised" and "fiscalised"**. There are clear signs that central banks have been pressured – and are now prepared – to accept both **higher inflation and greater inflation risks** to achieve **lower unemployment** and more job creation. Examples of this trend are the ECB's Outright Monetary Transactions (OMT) programme, which has few connections to price stability – instead, it is an important tool in fiscal pacts. And in Japan, the Shinzo Abe regime is creating a "policy pact" with the central bank to boost growth, while pushing to raise the inflation target from one to two per cent.

US: Inflation and unemployment

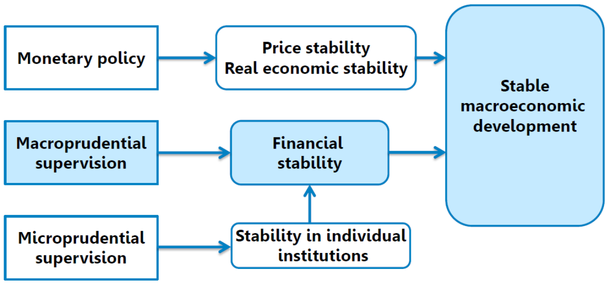


— CPI, year-on-year percentage change (LHS)
— Unemployment, per cent (RHS)

Source: BLS

Are inflation targets too restrictive?

Another clear trend is the questioning of monetary policy's very strong focus on inflation and the view that an inflation level of around 2 per cent has been set too narrowly. Representatives of the International Monetary Fund (IMF) and individuals with links to monetary policy decision making or the academic world have declared that inflation targets must be increased to allow greater room for **more negative real interest rates** and **faster corrections of nominal imbalances**. A small hike in the inflation target is also expected to make labour market adjustments easier. The debate seems to be moving towards **developing or even replacing the inflation target with a nominal GDP target**.



Source: The Riksbank

Greater focus on financial stability

Another area in which the role and methods of central banks are being re-assessed is financial stability, which has always been part of their sphere of responsibility. The main thesis here seems to be that banking **regulation**, among other things via capital requirements and other rules, is one way forward. However, the disunity within the Executive Board of Sweden's Riksbank and in relation to the Ministry of Finance, for example, shows that **the solutions are far from obvious** when rising household debt is being weighed against low inflation and higher unemployment. Although none of the major central banks has faced this dilemma so far, it is easy to imagine that in the future, the US and UK, for instance, might encounter a situation where lending is again rising rapidly while inflation is too low and unemployment is too high. Developing macroprudential tools is crucial in enabling the continuation of a low interest rate policy aimed at sustaining growth and jobs.

The Fed shows the way

The Federal Reserve is the central bank that has taken the most revolutionary steps so far. The Fed will link its future decisions on adopting less expansionary monetary policy, among other things, to the date when US unemployment is expected to fall below 6.5 per cent. This is a clear **change of approach**. Only a year ago, the Fed declared in its annual policy document, in keeping with the opinion of most central banks, that *"it would not be appropriate to specify a fixed goal for employment"* since employment is largely determined by non-monetary factors that affect labour market structure and dynamics.

The Fed's policy shift underscores some important things. *First*, the bank is clearly increasing its **focus on the labour market** without extensive discussion about whether unemployment is cyclical or structural. If it is structural, for example due to lack of mobility or job skills, monetary policy will not work; instead there is an increased risk of negative side effects from monetary stimulus. *Second*, the shift confirms greater acceptance of inflation/inflation risks. *Third*, the Fed hopes that its changed approach will result in a smoother transition, easier communication and greater transparency during its future exit policy and that it will exude more optimism than by more defensively specifying a date for reversing its policies.

Major implications for interest rates

There are many indications that Western monetary policy is undergoing changes in its targets and techniques. Because of the weak recovery and high unemployment levels, the **pressure on central banks to speed up the recovery will increase rather than decrease**. It is not unlikely that within a few years, more central banks will have **raised their inflation targets** or switched to basing their policy on a **nominal GDP target**. The result of such a policy shift would be higher nominal interest rates, but also presumably that real interest rates will fall from already low levels. Meanwhile asset purchases would presumably expand, and the already long period of near-zero key interest rates would be extended.

A nominal GDP target for Western economies would probably end up in the **4-5 per cent** range. This is based on a 1.5-2 per cent rate of price increases and trend growth of 2-3 per cent. In reality, though, the allocation between inflation and real growth would not matter – as long as the 4-5 per cent target is achieved. Monetary policy would thus remain expansionary as long as forecasts indicated nominal growth of less than 4-5 per cent for the next few years. If a country has also undergone a severe recession, this policy can also be designed in ways that attempt to offset the lost output of prior years.

A GDP target or a higher inflation target does not address the risk of financial imbalances. A **credit growth target of 4-5 per cent** would ensure that the credit market grows in line with the underlying economy. The introduction of counter-cyclical capital buffers, one among many tools developed to enable the authorities to pursue macroprudential supervision in practice, is intended to prevent the risk of financial imbalances. Slow credit expansion lowers capital requirements, while rapid expansion raises capital buffer requirements. Clear regulations can serve as automatic stabilisers that ensure financial stability.

Less independence – more collaboration

Looking a bit further ahead, it is also likely that the expanded role of central banks will cause their independence to be questioned and that attempts will be made to bring the **monetary policy decision making process closer to governments and parliaments**. But changing the independent status of central banks will require difficult political decision making processes. A more likely development is that, as in Japan, more governments will try to indirectly influence the targets and techniques of monetary policy.

Another trend is an increasing need for cooperation and coordination of monetary policies in different countries, especially the G20. Today there is significant concern among emerging economies that they will be forced to pay the price of Western activist monetary policy through stronger currencies and rising asset prices. **Global monetary policy cooperation will nevertheless be easier, because in many respects today's inflationary forces have also been globalised.**

Stronger growth as fiscal policy becomes clearer

- **Temporary dip in consumption this spring**
- **Potential surge in capital spending**
- **Unemployment will fall slowly**
- **Fed will continue to expand balance sheet**

The American recovery will continue at the same pace compared to last year. In practice this means a **stronger underlying growth trend**, since the dose of austerity is higher: the fiscal headwind will be 1.5 per cent this year, compared to 1.1 per cent in 2012. **GDP will grow by 2.1 per cent in 2013 and 2.7 per cent in 2014**. Viewed from a historical perspective, the recovery is the weakest recorded to date. Yet **unemployment has fallen steadily** from double-digit percentages and will **continue to decline slowly**, reaching 6.8 per cent at the end of 2014. The Federal Reserve's ultra-loose monetary policy will thus remain in place, and the **Fed will not raise its key interest rate until the first half of 2015.** Its bond purchases will continue until unemployment reaches 7 per cent, which will occur in mid-2014 according to our forecast.

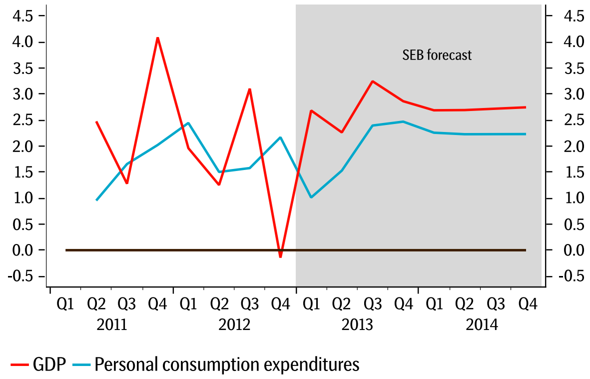
Private consumption will dip in the immediate future because of the federal tax hike on January 1 but will gradually strengthen after that. As the fiscal fog dissipates, there is also good potential for a rebound in corporate capital spending. Meanwhile the **housing market will contribute more and more to growth**. Construction will also impact employment in the next couple of years, while rising home prices will stimulate consumption via wealth effects and optimism. **New fiscal trouble spots and political stalemates are the biggest risk to our relatively positive economic scenario.**

Consumption will stumble in the short term

The **social security tax hike totalling about USD 1,000 for an average household** that arose as a result of the year-end federal budget agreement will have a powerful, but temporary, effect on disposable income. Consumption will thus dip early in 2013. Economic indicators also point to weak consumption; consumer confidence has also dropped steeply in recent months as a result of greater fiscal uncertainty. In January low-income earners, for whom the payroll tax hike is most noticeable, drove this downward trend. Consumption growth will decelerate from an annualised quarter-on-quarter rate of more than 2 per cent in late 2012 to 1 per cent in the first quarter of 2013 and 1.5 per cent in the second. Even larger effects cannot be ruled out, and private consumption is the biggest downside risk to our GDP forecast. Measured as annual averages, **private consumption will grow by 1.7 per cent this year and 2.3 per cent in 2014**. Income growth will show a similar profile, and the household savings ratio will only increase marginally from its current level of 4.7 per cent on a quarterly basis.

Weak consumption growth in the first half of 2013

Annualised



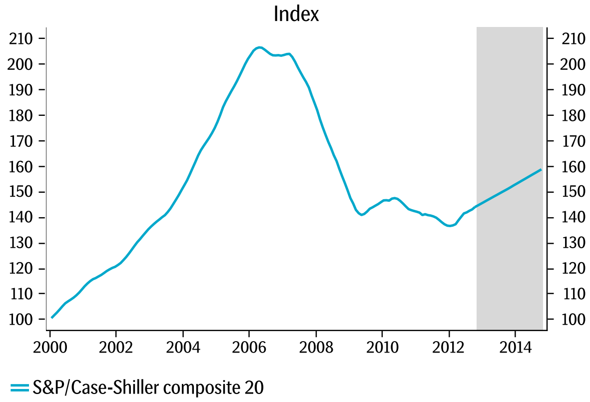
Source: BEA, SEB

Housing market a source of optimism

The housing market is on increasingly firm ground. Construction volume will continue to climb, since the market has caught up with the earlier over-supply and current levels are below demographic demand. Reconstruction following Hurricane Sandy in the autumn of 2012 will also provide a short-term boost. This work will be partially financed by USD 50 billion in government funds. Housing starts are expected to surpass an annual rate of one million in 2013. Measured as annual averages, housing starts will total 960,000 this year, compared to more than 2 million during the peak year 2005. **Housing investments**, which grew by 12 per cent last year, **will average 14 per cent growth in 2013-2014**. Their contribution to GDP will total 0.3-0.4 percentage points in the next couple of years, twice their 2012 level.

Home prices will continue up

Index



Source: Macrobond, SEB

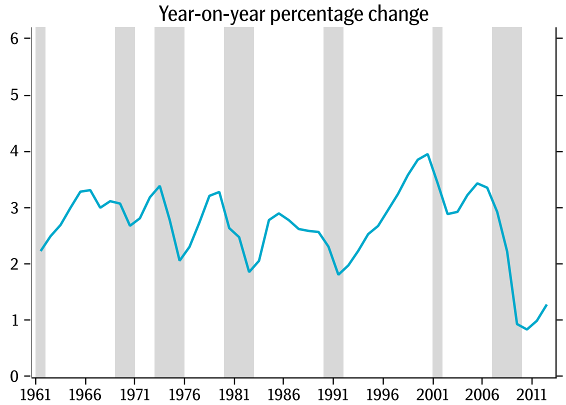
The recovery in home prices is now well established, while there is plenty of room for a continued upturn. As measured by the Case-Shiller Index, prices fell by 34 per cent from their 2006 peak but climbed more than 6 per cent last year. As earlier, our forecast is that **home prices will continue to climb by an average of 5 per cent annually in 2013-2014**. Given that home prices showed good increases late in 2012, the inventory of homes for sale is low and the credit supply is improving (due to new policy initiatives), there is a growing probability of a price increase in excess of 10 per cent.

Capital spending will rebound

Due to the uncertain fiscal playing field, corporate capital expenditures plummeted during the second half of 2012. Meanwhile the big picture is that **companies have under-invested for a number of years**. The normal pattern is that during an economic recovery phase, companies usually bump up their capital stock to meet higher demand, which has not happened this time. Capital stock is increasing at its slowest rate since the Second World War. But later this spring, when the fiscal policy fog has dissipated, a **capital spending surge is in the cards**, especially considering the good trend of corporate earnings and strong balance sheets. Short-term indicators such as order bookings have rebounded following last autumn's stagnation, which supports this scenario. Confidence indicators such as the ISM purchasing managers' index are also decently optimistic, especially in the service sector, but since the November 2012 presidential election, small business confidence has fallen dramatically. **Capital expenditures by businesses will increase by 8 per cent this year and 10 per cent in 2014**. A combination of stronger housing and business investments will thus offset the gloomier consumption outlook.

Capital stock growth has rarely been lower

Year-on-year percentage change



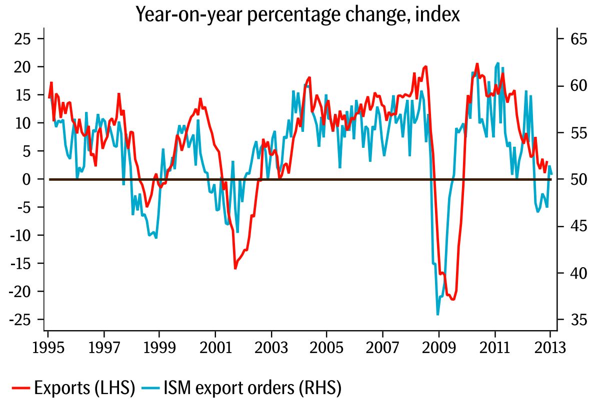
Source: European Commission, BEA, SEB

Neutral contribution from foreign trade

This winter, the US trade deficit reached a four-year high. Foreign trade contributed to weak GDP growth in the fourth quarter of 2012. Exports to the euro zone show an unfavourable trend, although they account for a modest 14 per cent of total US exports. Meanwhile such indicators as the ISM export order index are pointing to an **export upturn later this spring**. After earlier appreciation, the US dollar also recently weakened in trade-weighted terms. According to our forecast, **foreign trade will make a neutral contribution to growth in the next couple of years**. Current account deficits will remain just above 3 per cent of GDP during the same period.

Indicators suggesting a rebound in exports

Year-on-year percentage change, index



Source: Census Bureau, ISM, SEB

Labour market will gradually heal

According to classic rules of thumb, unemployment falls by half a percentage point for each percentage point that growth exceeds its trend rate. But even though the economy has grown by a modest 2 per cent on average in recent years, unemployment has fallen. The **potential growth rate must therefore have been far lower** than the 2.5 per cent that most forecasters regarded as their pre-crisis benchmark. This downshift in the trend rate of growth may have several causes. High chronic unemployment undermines the knowledge and skills of the labour force, making a return to employment more difficult. Corporate capital spending fell sharply during the recession years, reducing production capacity. The economic downturn may also have shaken companies and investors to the core, decreasing their risk appetite and potential to devise powerful new solutions.

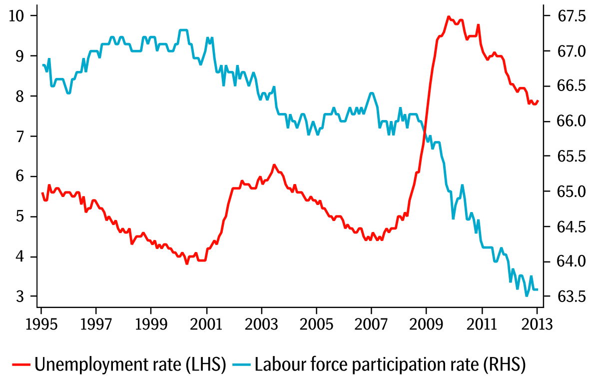
As the economy heals, **we believe that the trend rate of growth will also recover**. This occurred, for example, after the Great Depression of the 1930s, which forced innovations in products and manufacturing as well as the transport sector that benefited the economy for many years afterward. According to the consensus among economists, as well as the Fed's own forecasts, unemployment will not revert to its long-term equilibrium level (5.5 per cent) until 2016.

Another reason why unemployment has fallen is that fewer people are working. Between 1960 and 2000, the labour force participation rate trended upward as more women began to work. But since then, two thirds of this upturn has been wiped out, which is worrisome because it harms the long-term growth potential of the economy. Since the recovery began in 2009, the participation rate has fallen by 1.5 percentage points, which has "trimmed" unemployment figures substantially. If the participation rate had instead remained at its 2010 level, unemployment would be 9.5 per cent today. But as the recovery moves ahead, our forecast is that **more people will re-enter the labour market**. The downturn in unemployment will thus become slower, and the improvement will instead be reflected by a reversal in the negative participate rate trend. **At the end**

of 2014 unemployment will stand at 6.8 per cent, according to our forecasts.

Both unemployment and participation are down

Per cent of labour force

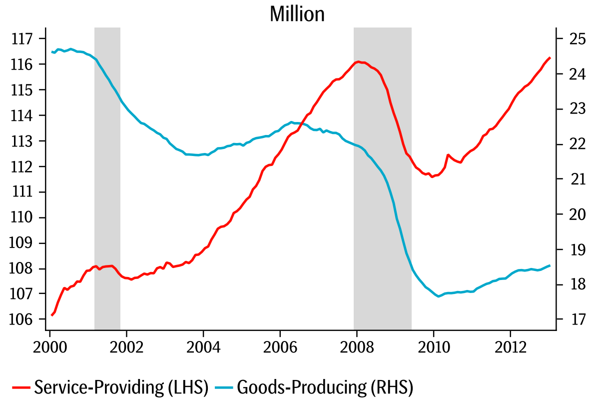


Source: BLS

As for the number of jobs, both the latest surveys and the Fed's Beige Book indicate an **unchanged labour market in the short term**. There are nevertheless reasons for optimism. On the plus side, fewer people are being laid off; early in 2013, new unemployment benefit claims were at their lowest level in five years. Yet continued fiscal policy uncertainty, especially in the defence industry, are holding back hiring. **Job creation will stall in the immediate future.** Looking a bit further ahead, however, the **construction sector will provide cause for optimism about employment**. In the construction industry, job creation is lagging. During the crisis years, 2.2 million construction jobs disappeared, but since the housing market recovery began, the sector has hardly been hiring at all. Instead, the existing workforce has increased its hours, which are now at high levels. The recovery in the construction sector will thus soon require large-scale hiring. Meanwhile the big picture is that employment is around 4 million people below its 2007 peak. **The service sector has recovered its decline, while industrial jobs lag behind.**

Services vs goods-producing jobs

Million



Source: BLS, SEB

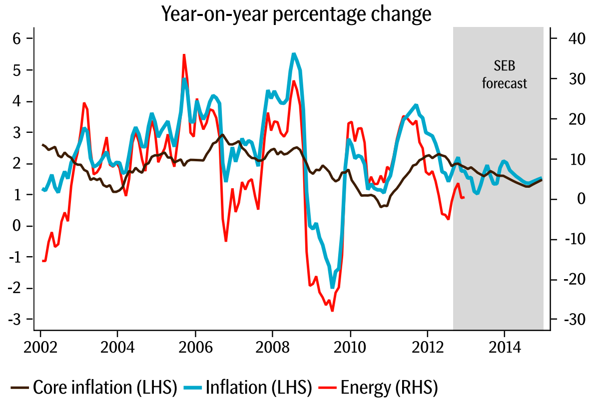
In 2012, non-farm job creation has averaged around **180,000** a month. We foresee similar increases this year. **In 2014, job creation will average 200,000 a month.**

Continued low inflation in 2013-2014

Headline inflation, which was 2.9 per cent a year ago, is 1.5 per cent today while core inflation stands at 1.8 per cent. An output gap of -6 per cent means there are large quantities of idle resources in the economy, while various yardsticks of wages and salaries indicate weak wage pressure. Our inflation estimate is thus unchanged: **low inflation will persist during the next couple of years**. Measured as annual averages, Consumer Price Index inflation will be 1.5 per cent in 2013-2014, thus posing no obstacles to continued ultra-loose monetary policy.

No inflation threat in sight

Year-on-year percentage change



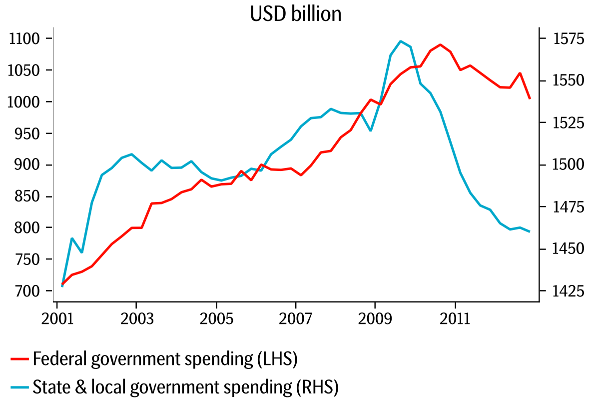
Source: BLS, SEB

Three sources of fiscal concern this spring

As mentioned earlier, the budget agreement early in 2013 resulted in **tax increases equivalent to 1.3 per cent of GDP**. This shifts the focus to the expenditure side. Under existing federal law, spending cuts equivalent to USD 110 billion in 2013 will automatically go into effect on March 1, 2013. According to our forecast, **expenditure cuts will be only USD 20 billion this year**; the rest will be postponed until 2014 and 2015. The **fiscal headwind will thus total around 1.5 per cent of GDP this year**, which is consistent with our earlier estimates. We estimate the probability that all expenditure cutbacks will go into effect at 25 per cent. In that case, it would result in nearly 1 percentage point lower GDP growth during the second and third quarters of 2013, compared to our main scenario.

Adjustment in federal government spending ahead

USD billion



Source: BEA, SEB

Congress raised the federal debt ceiling in January, and funding is assured until mid-May. In exchange for a more lasting increase, however, as in 2011 the Republicans are calling for matching expenditure cuts over a ten-year period. So far, President Obama has been cool towards these Republican demands. Given the public opinion situation – with Obama enjoying strong support while the Republicans will be saddled with the blame if the debt ceiling is not raised and the budget must be balanced immediately – **the president may well emerge victorious from the budget battle**. Overall, the debt ceiling issue is less of a risk than in our earlier assessments.

Another uncertainty factor is that Congress has not approved a budget for the fiscal year 2013 (which began last October) but is instead continuing to apply the 2012 budget until March 27. Unless a solution is reached in time, **federal government operations may thus be partly shut down** until a new budget has been passed. The economic effects will naturally depend on how long the political deadlock lasts. This budget scenario is a downside risk, especially for second quarter growth. We foresee a 20 per cent risk of such a development.

In recent years, public sector consumption has contributed negatively to growth. This trend reflects adjustments at state and local levels. Looking ahead, **federal expenditures will instead be trimmed**. Spending cuts of USD 80 billion have already been passed. In addition, stimulus spending is expiring and we expect further federal belt-tightening as a result of this spring's agreements. Our overall assessment is that **public sector investments will decrease by 1.5 per cent in 2013 and by 1 per cent in 2014**, measured as annual averages.

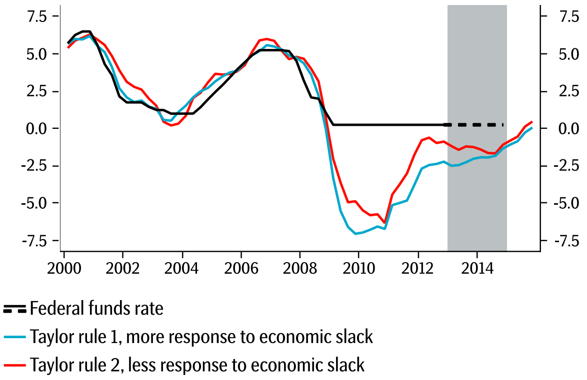
Loose monetary policy will continue

At its December meeting, the Fed decided to introduce thresholds for unemployment and inflation that should be reached before key interest rate hikes may be considered. According to our forecasts, the unemployment threshold of 6.5 per cent will not be reached until early 2015. Since inflation will not pose any obstacles either, **the Fed will not hike its key rate until the spring of 2015**. This forecast is also compatible with our estimated Taylor rules, which underscore the need for continued ultra-loose monetary policy.

The next step towards greater monetary policy transparency and understanding of the central bank's reaction function is **for the Fed to also introduce thresholds for its bond purchases (quantitative easing)**. This issue was discussed last year, but a decision was postponed. We believe that such a decision may be approved later this spring and that bond purchases will continue as long as unemployment exceeds 7 per cent, provided that inflation is under control. This implies a continued **expansion in the Fed's balance sheet into early 2014**. After publication of the December 2012 meeting minutes, which discussed ending bond purchases as early as 2013, market expectations swung in a more hawkish direction. Recently, however, Fed monetary policy committee members, including Chairman Ben Bernanke, have underscored the importance of continued monetary stimulus measures.

Taylor Rule: Still suggesting more easing

Per cent



Source: BLS, Fed, SEB

Another reason why the Fed's bond purchases may become larger and continue longer than the consensus forecast is chronic unemployment. **Nearly 40 per cent of job seekers, some 4.8 million people, are still chronically unemployed**. The Fed's view is that unemployment is overwhelmingly cyclical, but the longer people are outside the labour market, the greater the risk that unemployment will become structural. The Fed would like to avoid such a development at any price.

When will American unemployment reach the threshold?

At its monetary policy meeting in December 2012, the Federal Reserve introduced thresholds for unemployment (6.5 per cent) and inflation (2.5 per cent looking ahead one year) to determine when it will hike its key interest rate again. Unemployment has fallen from 10 per cent in October 2009 to 7.8 per cent. Reaching the Fed's 6.5 per cent threshold may take a long time, however. Looking at earlier economic cycles, the corresponding improvement has taken an average of more than two years, but meanwhile GDP growth has exceeded 3.5 per cent year-on-year. Growth has not been that strong since 2004.

One example can illustrate the challenge. Assuming that the working-age population keeps increasing at the same pace as in recent years and that the labour market participation rate remains unchanged, 270,000 jobs must be generated each month for unemployment to reach 6.5 per cent by the end of 2013. In order for unemployment to reach the threshold by the end of 2014, an average of 200,000 jobs will be required. In order to reach the threshold by the end of 2015, an average of 175,000 jobs a month will be needed. If job creation average 150,000 per month during the next few years, the threshold level will not be reached until the end of 2018. If such a trend coincides with Federal Reserve bond purchases at an unchanged rate, the Fed's balance sheet will grow to nearly USD 9 trillion from today's USD 3 trillion. Such an expansion in the balance sheet is not our forecast, however, but should instead be viewed as a hypothetical projection.

Economic policy measures will boost growth

- **Weaker currency benefiting exports**
- **An escalating battle against deflation**
- **Sovereign debt continuing to increase**

The Japanese economy went into recession in the second half of 2012. Looking ahead, prospects appear brighter; the new government made a flying start with a large-scale fiscal stimulus programme, a higher inflation target and Fed-inspired monetary policy initiatives. The yen has thus weakened sharply, pushing up imported inflation and improving the export outlook. Overall, we predict that **GDP will grow by 1.3 per cent in 2013 and 1.5 per cent in 2014**: this is above consensus for both years. Average annual unemployment will fall towards 4 per cent in 2014.

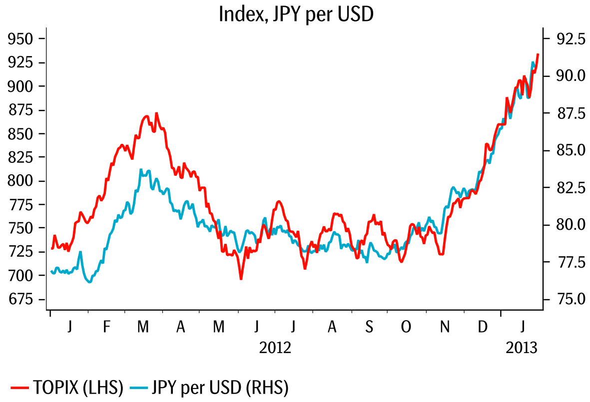
After last year's downward trend, both household and business confidence indicators have rebounded dramatically. **The stock market has gained about 30 per cent** since autumn, helping to sustain consumption, but a consumption tax hike will slow the upturn in 2014. After last year's decline, **industrial output will grow 2-3 per cent annually in the next couple of years**. The purchasing managers' index (PMI) came in at a feeble 47.7 in January but will recover as the currency decline impacts exporters' order books. In the domestically oriented service sector, PMI reached a decent 50.5 in January. Stimulus measures and post-earthquake reconstruction will boost public sector and housing investments over the next couple of years.

The government's **new stimulus programme** (JPY 10.3 trillion, USD 116 billion), **2.8 per cent of GDP**, is one major reason why we are revising our growth forecast upward. Infrastructure investments and reconstruction work are key elements of the package, but defence agencies will also enjoy increased appropriations. This reflects tense foreign relations, especially with China, after Japan nationalised three disputed islands in the East China Sea. The conflict with China contributed to a **tripling of Japan's foreign trade deficit last year**. Continued problems with nuclear reactors – only a few of the country's 50 or so plants are operating – also contributed. So far this year, Japan's foreign policy signals are mixed: **a defence build-up combined with diplomacy and a conciliatory tone**. Vital economic ties make a peaceful solution likely. **Foreign trade will contribute positively** to GDP **over the next couple of years**, and the country will show a current account surplus. In the short term, there will thus be less concern that Japan may be forced to import capital to finance its sovereign debt.

Monetary policy will also provide support. The Bank of Japan decided to introduce a new **formal inflation target of 2 per cent**. It also announced a Fed-inspired programme of monthly government bond and short-term debt purchases with no time limit, in line with the new government's wishes. Compared to the size of the economy, however, **the programme is more cautious than its American counterpart**. Further measures, such as expanded government bond-buying and purchases of riskier assets like mortgage bonds may come after the current BoJ leadership is replaced in March. Closer ties with the government mean that the BoJ's independence is being undermined. But in the best case, these aggressive steps will **end the deflationary spiral** and help resolve a core problem in the economy (see the box on page 10). Only then can we hope for stabilisation of **sovereign debt, which will soar past 250 per cent of GDP in 2014**. Although we expect some fiscal tightening in 2014, **Japan's credit rating is in jeopardy**.

High correlation between yen and stock market

Index, JPY per USD



Source: Macrobond, SEB

The BoJ's new monetary policy initiatives have led to sharp currency depreciation. Since November 2012, the yen has lost 17 per cent against the dollar. Brighter economic prospects, especially for large exporters such as Toyota and Panasonic, are reflected in Japanese equity indices which are trading at four-year highs. Since last autumn, the correlation between the yen and the stock market has been nearly faultless. **The JPY** is being traded at a three-year low against the USD and **will continue to weaken**, according to our forecasts. In December 2014, a dollar will cost 107 yen. Especially in Europe, there is **muttering about currency manipulation for competitive purposes**. Viewed in a slightly longer perspective, the yen remains strong. As a way of overcoming stubborn deflation, yen depreciation is providing a helping hand. Both headline and core inflation figures are around zero year-on-year but are expected to climb gradually. **Inflation will be 0.3 per cent in 2013 and 1.7 per cent in 2014**, measured as annual averages. Planned tax hikes in 2014 will impact inflation figures. Annual inflation expectations average 1 per cent for the next five years: a promising sign for the central bank and the government.

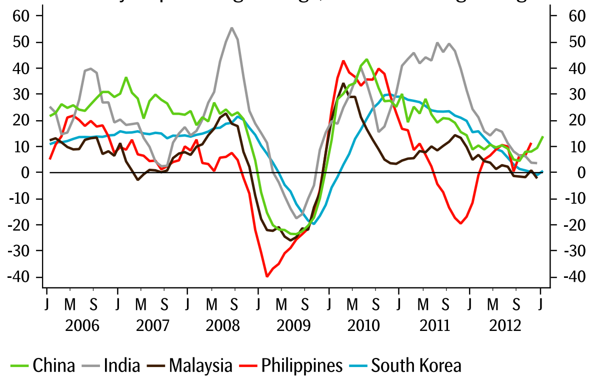
Domestic demand offsetting international weakness

- **Deceleration ended in the fourth quarter**
- **China: Recovery under way**
- **India: Continued weak growth**

Despite below-trend GDP growth, Asian emerging economies are still ahead of European and US growth by a wide margin. **The economic deceleration of recent quarters appears to have stopped during the fourth quarter of 2012**, although growth will remain below trend and will thus be substantially slower than a few years ago.

Asia: Exports

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



Source: National statistical offices

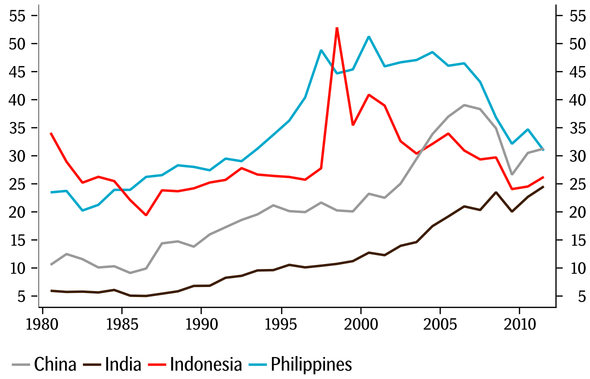
Purchasing managers' indices (PMIs) are showing an improvement in manufacturing in recent months, but activity is still low in historical terms. **Exports from the region have begun to accelerate**. We expect this increase to continue in 2013 but to be modest; it is unlikely to exceed 10 per cent. We believe US and especially European export demand will remain weak, but subdued demand for the region's export goods will be offset by good domestic demand, largely driven by continued strong private consumption.

Further ahead, however, exports to Europe and the US will play a diminishing role in economic growth. Intra-regional trade is increasingly important, while the ratio of exports to GDP has begun to level out and even fall in some economies. We expect this trend to continue. Given the increasing role of domestic demand, **in the long run growth in the region will be less and less dependent on developments in the West**.

Inflation is subdued in the region. Due to continued low inflation during 2013 **we expect monetary policy to remain accommodative in most economies**. A cautious normalisation of key interest rates is nevertheless expected to begin during the last quarter of 2013, continuing in 2014.

Asia: Export shares

Per cent of GDP



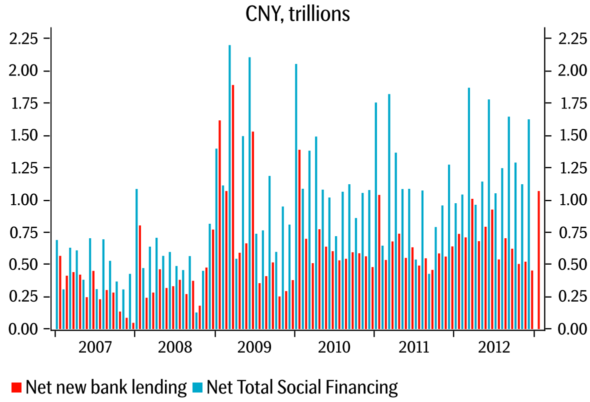
Source: World Bank

China: Modest recovery

After seven straight quarters of slowdown in the Chinese economy, **GDP growth accelerated as expected during the fourth quarter**. Growth was 7.9 per cent compared to the year-earlier quarter, and GDP thus increased by 7.8 per cent during 2012 as a whole. Compared to the preceding quarter, GDP rose by 2.0 per cent.

Bank lending and total social financing

CNY, trillions



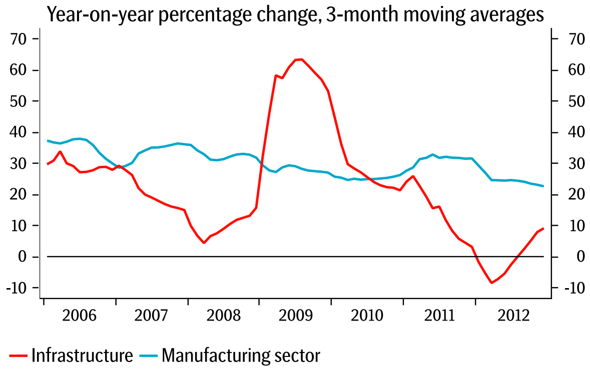
Source: The People's Bank of China

PMIs have improved and are now above the threshold level of 50. **Most hard data also indicate improvements in the fourth quarter**; retail sales, industrial output and exports have all shown stable growth in recent months. Bank lending came in far below expectations in December but recovered in January. Total social financing (a broader measure of financing including for example corporate bonds and trust loans) showed a strong increase of CNY 1.6 trillion in December. However, in year-on-year terms credit growth is levelling off.

The recovery will be modest, however. During 2013, exports will continue to be hampered by weak demand from the US and especially from Europe. There are still weaknesses in the housing market. This will impede growth, even though home prices will continue their cautious month-to-month rise. **The recovery has also benefited greatly from government infrastructure spending**, which accelerated in the autumn. This included higher railway investments. The government's desire for further stimulus by means of capital spending seems limited, however. After modest acceleration during the first half of 2013, we thus expect economic growth to decelerate again late this year and in early 2014. **We expect China's GDP to increase by 8.1 per cent in 2013 and by 7.7 per cent in 2014**.

Government infrastructure investments are driving the recovery

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



Source: National Bureau of Statitics of China

There are numerous long-term **risks** to China's economic growth. Not least, **social discontent** is increasing while **conflicts with neighbouring countries** persist. The necessary **transition to a new growth model** based on private consumption has barely begun and risks triggering a sharp deceleration in growth. Although there are high expectations of the new Chinese leadership, how these issues will be handled remains very uncertain. Yet it is unlikely that any of these risks will have an impact during our forecast period.

Inflation was higher than expected in December but decelerated to 2.0 per cent in January. **We expect inflation to spike temporarily in February** due to the timing of the Chinese New Year celebrations. Price pressures are nevertheless generally low, with core inflation below 2 per cent and producer prices still falling year-on-year. **During 2013 we expect inflation to end up at around 3.5 per cent**.

The key interest rate has remained at 6.0 per cent since it was cut in July, and we expect no imminent change in monetary policy. The People's Bank of China will continue to rely on repo transactions instead of adjusting the key rate or bank reserve requirements. **Our assessment is that the key interest rate will remain at 6.0 per cent until the fourth quarter of 2013, when we expect a 25 basis point hike**.

The yuan has resumed its appreciation against the US dollar. Our assessment is that it will end up rising around 3 per cent in 2013 and 2 per cent in 2014. **We expect the USD/CNY exchange rate to be 6.10 at the end of 2013 and 6.00 at the end of 2014**. During 2013, we expect the highest permitted daily trading interval for the yuan/dollar rate to be increased to 1.5 per cent. This change is not expected to have any major impact but should be regarded as a step along the way towards a liberalisation of the currency.

India: Monetary policy easing under way

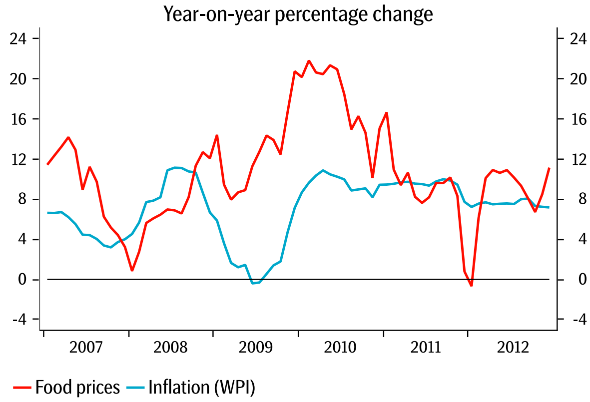
There are **signs that India's economic growth bottomed out during the third quarter**, when GDP increased by 5.3 per cent year-on-year. Fourth quarter growth is expected to have accelerated somewhat. PMIs for the manufacturing industry and the service sector have rebounded although their current levels are well below those of recent years. There are also some signs that industrial production and exports are stabilising. However, **we expect growth to remain lower than in previous years**. Because of continued high inflation and a large government budget deficit, monetary and fiscal policy have little chance of stimulating growth. **We estimate that GDP will have increased by 5.4 per cent in 2012. In 2013, GDP will climb by 5.7 per cent and in 2014 by 6.0 per cent**.

Extensive regulations continue to hamper growth although the economic reform proposals unveiled in September were a step in the right direction and some measures have been implemented. For example, fuel price subsidies have been reduced to try to cut the budget deficit and regulations limiting foreign participation in some sectors have been relaxed. However, **more reforms are needed** if growth is to recover substantially and opposition to changes remains strong, both among political parties and various interest groups.

Since last spring, the Reserve Bank of India (RBI) has been under great pressure from both business and political leaders **to lower its key interest rate** in response to the very weak investment trend. For some time the central bank resisted and kept its key rate at 8.0 per cent, citing high inflation and overly expansionary fiscal policy. However, inflation has cooled off somewhat and the RBI's measure of core inflation has also fallen, opening the way for an easing of monetary policy. Consequently, the key interest rate was cut to 7.75 per cent at the January meeting. We expect further cuts leaving the **key interest rate at 7.0 per cent by the end of 2013**.

India: Inflation

Year-on-year percentage change



Source: Ministry of Commerce and Industry

The rupee strengthened in September last year as the reform proposals were presented but weakened again toward the end of 2013. However, in 2013 the strengthening has resumed and **we expect the rupee (INR) to be trading at 51.0 per USD and 48.0 at the end of 2014.**

Reduced stress, but continued weak economic growth

- **Many euro zone problems still unresolved...**
- **...but downturn is bottoming out – ECB is helping by keeping key rate at 0.75 per cent**
- **Germany's growth will speed up the pace**
- **Continued divergent trends for inflation and the labour market**

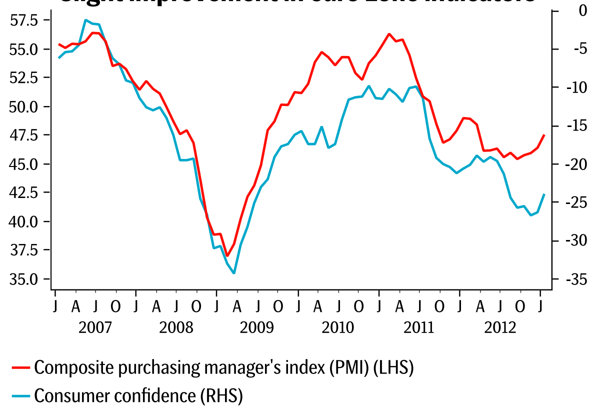
The euro zone crisis is far from over. In a number of areas the economy is moving in the right direction, but with a major risk of reversals remaining. On the one hand, there is great political uncertainty, the banking system is not finished healing and fiscal consolidation is still under way. This will result in rising unemployment, poorer credit supply and continued recession in southern Europe. On the other hand, tough political decisions have been made and fiscal consolidation in various crisis-hit countries has progressed; their large budget and current account deficits are shrinking. There are also hopes that economic recovery in Germany, the United States and China will help crisis countries overcome their problems.

We believe that last autumn's euro zone economic slump bottomed out in the fourth quarter. With its Outright Monetary Transactions (OMT) programme, the European Central Bank meanwhile continues to show it is prepared to act vigorously if necessary. Overall, this means that the **euro zone economy will improve during our forecast period**. Yet there is a great risk that the ECB's actions, which have bought time for political leaders and improved the situation in financial markets, will ease pressure on these leaders to make difficult but necessary decisions, causing political uncertainty to remain at a high level.

Many complex and constitutional issues concerning the euro project and the long path towards political union and a federalist Europe **remain unanswered**. Despite signs of greater stability, individual crisis countries such as Greece and Spain have many problems.

Euro zone economic performance was very weak in the fourth quarter of 2012. GDP fell by an estimated 0.5 per cent compared to the preceding quarter. Industrial production and retail sales were squeezed, while unemployment continues to rise. Reduced financial stress during the autumn has not yet had an impact on real economic growth. **One bright spot is that this economic weakness has appeared temporary**, especially in Germany. **We believe that overall euro zone growth bottomed out during the fourth quarter of 2012**. Several euro zone indicators have improved in recent months; the composite purchasing managers' index has climbed for four months in a row. Consumer confidence has also improved, but remains well below its long-term average.

Slight improvement in euro zone indicators

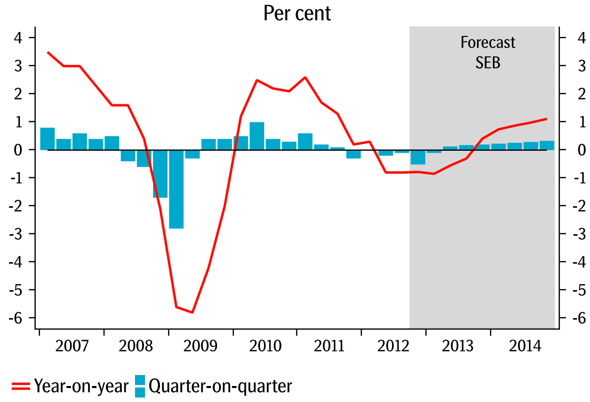


Source: European Commission, Markit

However, we expect euro zone economic activity to remain weak in 2013 and 2014. Exports have performed decently and are gaining some momentum from the recovery in the US and China, but growth will still be very fragile. We estimate that as an annual average, **euro zone GDP fell by 0.5 per cent in 2012**. Because of the weak fourth quarter, we have **lowered our 2013 GDP growth forecast from -0.2 to -0.3 per cent**, but due to a somewhat improved growth outlook later in 2013, fourth quarter 2012 weakness will not have a full impact. **We foresee 2014 GDP growth of 0.9 per cent**.

GDP growth in the euro zone

Per cent



Source: Eurostat, SEB

Financial stress in the euro zone has eased substantially in the past six months. Borrowing costs in crisis-hit countries continued to fall early in 2013. Meanwhile stock market performance has been positive. One important contributing factor is the ECB's OMT programme, even though it has not yet been used. **The risk that countries will withdraw from the euro zone has also greatly diminished**.

Sharp but temporary slump in German growth

German economic activity weakened significantly in the fourth quarter. GDP declined by an estimated 0.5 per cent compared to the preceding quarter. Industrial output has fallen sharply in the past six months and capital spending growth has been weak, but we expect reduced uncertainty about the survival of the euro zone to improve investment appetite and foresee a recovery in the first half of 2013. Retail sales, in contrast, have shown better resilience, bolstered by decent labour market conditions, which will continue. The IFO business sentiment index has improved during the past three months. The manufacturing purchasing managers' index (PMI) climbed significantly in January, though it still has some way to go to the neutral 50 mark. Domestic and foreign order bookings have both begun to rebound. **Germany's GDP rose by 0.7 per cent in 2012. We expect it to increase by 0.6 per cent in 2013, followed by 1.6 per cent growth in 2014**.

The campaign for the federal **parliamentary election in September 2013** has started. Chancellor Angela Merkel's CDU party enjoys strong public support, while its liberal coalition partner FDP risks dropping below the five per cent threshold and losing all its Bundestag seats. This would force Merkel to seek cooperation with the Social Democrats (SPD), but **our main scenario is that the current CDU/FDP coalition will remain in office even after the election**. We see only small economic policy differences between the FDP and the SPD as a coalition partner to the CDU. In either case, Germany can be expected to continue pursuing a cautious economic policy aimed at maintaining its strong finances. Nor do we expect Germany's policies towards the European Union and the euro zone to undergo major shifts in case of a CDU/SPD coalition, although the government's attitude towards crisis-hit peripheral countries might soften a bit.

GDP, selected countries

Year-on-year percentage change

	2011	2012	2013	2014
Germany	3.2	0.7	0.6	1.6
France	1.7	0.1	0.2	0.5
Italy	0.6	-2.0	-0.9	0.4
Spain	0.4	-1.3	-1,5	0.2
Greece	-7.1	-6.3	-4.4	-0.6
Portugal	-1.7	-3.0	-1.9	-0.3
Ireland	1.4	0.7	0.9	1.9
GIPS countries	-0.9	-2.0	-1.7	0.3
Euro zone	**1.4**	**-0.5**	**-0.3**	**0.9**

Source: Eurostat, SEB

In **France**, the economy is continuing to stagnate. In the third quarter of 2012, GDP actually rose for the first time in four quarters, but the increase ended up at a feeble 0.1 per cent quarter-on-quarter. As in many other euro zone countries, French households continue to be squeezed by high unemployment. Meanwhile capital spending is hampered by overcapacity in manufacturing and weak competitiveness. Nor is public sector consumption expected to provide any support to growth; further austerity measures will probably be required if the target of reducing the budget deficit to 3.0 per cent of GDP is to be realised, due to the government's excessively optimistic growth forecasts. As for economic policy, there are certain bright spots. President François Hollande's government has begun to back away from its proposed 75 per cent marginal tax on high income earners. Employers and unions have also reached agreement on certain labour market reforms. But there is **a great need for more extensive reforms**, and overall growth prospects look poor. **We expect GDP growth to end up slightly above zero both in 2013 and 2014.**

Continued fiscal tightening

The budget deficits that a number of euro zone countries are grappling with are moving in the right direction, but much work remains. As in many other fields, there are wide divergences in performance. The overall public budget balance in the euro zone is not alarmingly high, at somewhat above 3 per cent of GDP. In Germany, the 2012 public budget balance is expected to end up just below zero, while the GIPS countries continue to struggle with deficits of 5-10 per cent of GDP. Germany's situation allows a neutral or mildly expansionary fiscal policy, although the country is expected to pursue a cautious policy in order to ensure strong confidence. Since a number of countries are continuing to carry out necessary belt-tightening, euro zone fiscal policy will remain contractive, but somewhat less so than in prior years.

One lesson of recent years is that in an environment of low demand and already low key interest rates, public sector austerity measures have a more negative impact on demand than earlier rules of thumb have indicated. Because the ECB promised last autumn to do everything it can to keep the euro zone together – contributing to a sharp decline in yields on borrowing by crisis-hit countries – there is less pressure on political leaders at national and EU/euro zone levels to pursue reform efforts.

We believe that reform efforts will proceed somewhat more slowly in the near future and that **austerity packages will be watered down and more back-loaded**. Focusing on structural reforms that will have an impact only after several years is consistent with the recommendations of the IMF and other organisations and also softens some of the negative growth effects. In light of upcoming elections in Germany (September) and for the European Parliament (June 2014), and given the controversial nature of many issues related to deeper euro zone cooperation, political leaders are very likely to want to maintain a low profile on EU/euro zone-related issues.

GDP forecasts – comparing SEB and the IMF

Year-on-year percentage change

	SEB		**IMF**	
	2013	**2014**	**2013**	**2014**
Germany	0.6	1.6	0.6	1.4
Italy	-0.9	0.4	-1.0	0.5
Spain	-1.5	0.2	-1.3	1.0
Greece	-4.4	-0.6	-4.0	0.0
Portugal	-1.9	0.3	-1.0	1.2
Ireland	0.9	1.9	1.4	2.5

Source: IMF, SEB

We predict that overall **euro zone budget deficits will shrink from -3.3 per cent of GDP in 2012 to 2.5 per cent in 2013**

The situation in crisis-hit euro zone countries

Spain is stuck in a long-lasting economic slump and recession. GDP fell by 0.7 per cent in the fourth quarter of 2012 compared to the preceding quarter: its sixth straight quarter of decline. Combined with fiscal tightening and debt deleveraging in the private sector, this is leading to a downward spiral of increased unemployment and falling demand. Meanwhile, credit losses in the banking sector due to declining home prices are creating problems for government finances and confidence. Our main scenario is still that **Spain will be forced to seek further support** from the euro zone countries, and that the ECB will begin buying its sovereign bonds. Losses in the banking sector and further home price declines may possibly trigger further support, due to a downgrading of credit ratings and a resumption of rising bond yields. The probability that the country can manage with the help of the ECB's current indirect support has increased.

Italy shares France's problems of poor competitiveness and a long period of weak growth; in January, consumer confidence was at its lowest level in 15 years. Government finances are weak, and although there is no acute threat, we expect that Italy will need to implement **further austerity measures in 2013** in order to compensate for weak macroeconomic performance and achieve the budget targets the government has set. **Italy has taken some new steps towards reform**. For example late in November, employers and trade unions reached agreement on new rules related to collective contracts that will improve competitiveness. **The February 24-25 parliamentary election is not expected to pose any major risks**. The most likely outcome is a compromise between a leftist/centrist coalition and a centrist coalition led by Mario Monti, the current technocratic prime minister. In this scenario, budget consolidation is expected to continue, and this applies to most of the conceivable government constellations. The greatest risk is that no clear majority can be formed. A weak government might slow down the pace of reform and increase political instability.

In December 2012, it became clear that **Greece** would receive the next tranche of its international bail-out loan, which eased worries about the government's finances, creating a little more breathing room. Some reforms have been pushed through Parliament in recent months. **Greece's fundamental problems remain, however**. The IMF's regular reviews of the country's reform programme and austerity measures will continue, and **there is still a risk that Greece will not achieve its targets**. Official growth forecasts appear optimistic, and further belt-tightening may be required. Meanwhile **the political situation is unstable**, with a fragile governing coalition and a lingering risk of snap elections. **GDP is expected to fall sharply again this year**, but recent statistics also show certain **signs of incipient stabilisation**. There is still a high probability that the country may leave the euro zone, but it has decreased.

Portugal has been praised by the IMF for its reform programme. Given its solid parliamentary majority, **the governing coalition is expected to continue along the path of reforms and austerity measures** despite increasing political tensions and popular protests. The government's reform policies have been rewarded with **a large decline in borrowing costs**. The country's aim is to **re-enter the bond market during 2013**. This is most likely to occur in the autumn. However, there are still challenges. Official growth forecasts for 2013 have been revised downward. Achieving the government's target of reducing the deficit to 4.5 per cent of GDP will require **budget tightening of more than 3 per cent of GDP in 2013**, mainly in the form of tax hikes.

Ireland has made significant progress in reforming its economy, and its **competitiveness has improved substantially** in recent years. The government is sticking to its plans to exit the EU/IMF bail-out programmes during 2013. Because of its export-driven economy, **Ireland's GDP growth has surpassed that of other crisis-hit countries**. Given the key role of the pharmaceutical industry, however, Irish growth is at risk of being affected by a "**patent cliff**". Patents on a number of important drugs will expire in the next few years, with the risk that their production will be moved to low-wage countries. **Unlike Spain, Ireland has shown an interest in applying for support from the European Stability Mechanism (ESM)** and thus being allowed to take advantage of the OMT programme. Ireland and Portugal are expected to pressure the euro zone to further ease their borrowing conditions, for example by cutting interest rates and extending maturities, which will probably also eventually be granted.

Cyprus has been hard hit by the economic crisis in Greece, mainly because the exposure of Cypriot banks to Greece has resulted in large losses. **As early as June 2012, Cyprus requested a bail-out loan** and the country began negotiations with the EU/ECB/IMF troika in November. The bail-out loan has been estimated at EUR 17 billion, of which EUR 10 billion would be used for recapitalisation of banks. Although this bail-out loan is only equivalent to 0.1 per cent of euro zone GDP, the loan must still be tied to austerity measures in order to be consistent with the management of loans to other bail-out countries. The negotiations reached an impasse due to different perceptions of the need for austerity measures as well as privatisation of companies. Another factor making the talks more difficult is the image of Cyprus as a tax haven with large-scale money laundering. The negotiations are, however, expected to resume after the **February 17 election**, and **our assessment is that an agreement on a bail-out loan will be reached this spring**.

In **Slovenia**, weak macro performance including a **GDP decline in 2012 and poor economic prospects** is further complicated by a **very fragile banking sector** that depends on loans from the ECB. Although bank recapitalisation has already been implemented, there is still a great need for additional capital. The government's plans to create a "bad bank" have been delayed, and **it cannot be ruled out that Slovenia will be forced to apply for an emergency loan**.

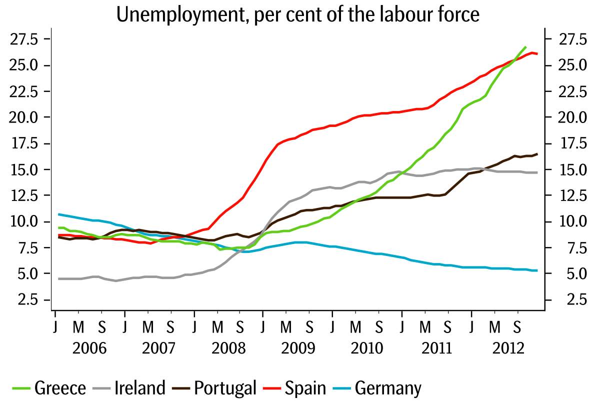
and then continue to fall by another 0.5 per cent of GDP in 2014. The dose of austerity will be less than 0.5 per cent of GDP both in 2013 and 2014. This is half as much as in 2011, and somewhat less than in 2012. **Public sector debt will continue to climb, reaching 94 per cent of GDP in 2014**. There is a risk that official GDP forecasts will need to be revised downward; our view of economic performance is generally gloomier than the IMF predicts, for example. If our forecasts prove correct, this will also have a negative impact on the public finances of the affected countries. Although the need for belt-tightening will increase, our assessment is that this will be postponed and will occur only in the years following 2014.

Divergent unemployment and inflation trends

Households are still being squeezed. High and rising unemployment, combined with continued austerity programmes in crisis-hit countries – and generally tight budgets in many other EU countries as well – will mean low household income increases. In addition, inflation will only fall slowly. Meanwhile there are sharp differences between euro zone countries.

Sharp divergence in labour market performance

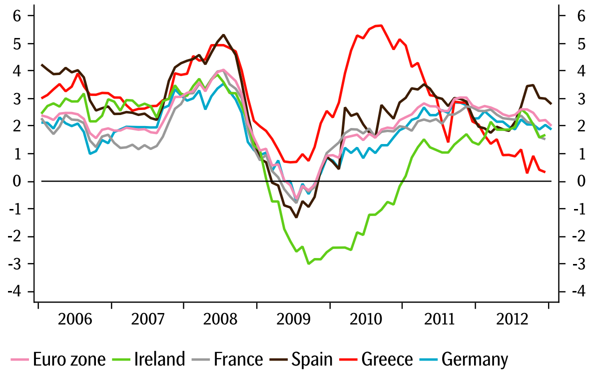
Unemployment, per cent of the labour force



Source: Eurostat, SEB

For the euro zone as a whole, unemployment increased from 10.8 per cent early in 2012 to 11.8 per cent in November. The divergence between countries is meanwhile continuing. During the same period, youth unemployment rose from 21.9 to 24.4 per cent; in Spain and Greece, it is more than 50 per cent for 15-24 year olds. Although unemployment in Germany is expected to increase somewhat in the near future, the gap between northern and southern Europe will widen (see the box on the German labour market), creating tensions at the national level and greater migration within the EU. Measured as annual averages, **unemployment in the euro zone will climb to 12.0 per cent this year and to 12.4 per cent in 2014**.

Inflation is expected to fall, but with divergent trends between countries



Source: Eurostat

The trend of inflation also diverges among euro zone countries. During 2012 the total rate of price increases in the euro zone, measured as annual average, remained above the ECB target. However, Harmonised Index of Consumer Prices (HICP) inflation fell during the end of the year and reached 2.0 per cent in January. Tax hikes have pushed up inflation in several crisis-hit countries. In Ireland previously and in Greece today, the upward

German labour market is functioning better

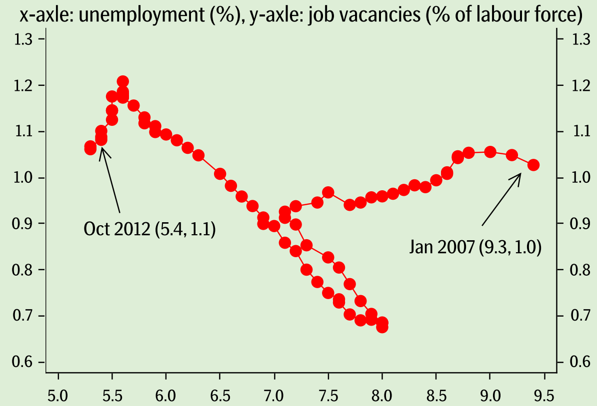
The German labour market has continued to deliver upside surprises. Unemployment is at a 20-year low and is lower than when the economic crisis began. There are many indications that the German labour market has become more efficient and that such reforms as Hartz I-IV and the "Kurzarbeit" system have had a clearly positive impact.

Two methods – the correlation between GDP growth and unemployment ("Okun's coefficient") and the relationship between the number of job vacancies in the labour market and unemployment (the "Beveridge curve") – **support this**. According to our estimates, 1 percentage point slower growth will lead to a 0.4 per cent rise in euro zone unemployment. Measured from 2000 until today, the figure for Germany is somewhat worse than average, but during the 2008-2009 recession period, Germany beat all other countries by showing a coefficient of zero; in other words, **lower GDP growth did not affect unemployment**.

The relationship between the number of job vacancies and unemployment also indicates that **the labour market** in Germany **is functioning more efficiently today than five years ago**. This is probably a result of better matching between labour supply and demand, as well as greater mobility.

Beveridge curve indicates better matching

x-axle: unemployment (%), y-axle: job vacancies (% of labour force)



Source: SEB, Deutsche Bundesbank, Eurostat, German Federal Statistical Office price trend is now weaker than the euro zone average. **Measured as annual averages, euro zone inflation will continue falling to 1.5 per cent in 2013 and 2014**. In the past two years, core inflation has largely remained in the 1.0-1.5 per cent range. Driven by idle resources in the labour market and low pay increases, **we expect core inflation to fall slowly from 1.5 per cent in December 2012 to 1.4 per cent in 2013 and remaining around that level in 2014**, measured as annual average.

ECB still in wait-and-see mode

Since it unveiled the OMT programme in September, the ECB has not taken any new policy initiatives. The refi rate has remained at 0.75 per cent since being lowered in July 2012. At the January and February policy meetings the decisions of an unchanged refi rate were unanimous. The sovereign financial crisis has become far less acute, and borrowing costs in crisis-hit countries have fallen dramatically. In our judgment, a key interest rate cut would have only a marginal stimulus effect. We are thus sticking to our assessment that **the refi rate will remain at 0.75 per cent during our forecast period** and that no new policy initiatives will be unveiled.

Meanwhile **ECB policies are being put under pressure** by developments in a number of areas. The repayment of the ECB's LTRO loans, recently rising short-term market rates – with the euro overnight index average (EONIA) rising from 10 to 30 basis points – a stronger euro and announcements of further expansionary policies from the Federal Reserve, the Bank of England and the Bank of Japan this winter **are putting pressure on ECB policy to become more expansionary, if anything**. To what extent these factors together will lead to tighter monetary policies is uncertain, however.

In addition, bank lending to euro zone companies remains very weak, as shown in the ECB's latest *Bank Lending* Survey and other research. But this is driven primarily by weak demand rather than lack of liquidity. The ECB's chances of influencing such lending are thus limited. The OECD has estimated that the European banking system needs another EUR 400 billion in capitalisation, contributing to the reluctance of banks to lend money. Especially in southern Europe, the economic situation is also making banks wary about new lending. In Europe, about 85 per cent of corporate financing occurs via the banking system. This means that a cautious banking sector has a larger impact on the real economy than in the US.

Although **cutting the refi rate by 25 basis points would have a marginal stimulus effect**, it is one of the tools the ECB may need to use if unchanged monetary policy has a contractive effect in practice, due to the above-mentioned factors. In such a situation, the ECB may be forced to use one or more tools, such as verbal interventions to **weaken the euro, lowering deposit rates** below zero and **promising additional liquidity facilities** if the situation should deteriorate.

British economy back on firm ground again

- **Unemployment falling slowly**
- **Above-target inflation in 2013**
- **Bank of England not rocking the boat**
- **Referendum on EU membership in 2017?**

The United Kingdom has been the weakest performer among major economies since 2009. More powerful fiscal headwinds are one explanation. High public sector debt, weak household balance sheets and nonexistent productivity growth are alternative or further explanations. After last year's stagnation, our assessment is that **GDP will grow by 1.3 per cent in 2013 and 1.5 per cent in 2014**, unchanged since our November forecast. Fiscal austerity policies remain in place, while weak exports are holding back growth. **Recently, inflation has been surprisingly high**. In 2013 it will exceed the Bank of England's 2 per cent target for the ninth straight year. The BoE will thus abstain from expanded asset purchases.

Household consumption rose by an average of 0.5 per cent in 2010-2012. One reason for this weak trend is shrinking wealth; net worth as a percentage of disposable income has fallen by one fourth in recent years, while the tax burden has increased. Retail sales showed weak consumption around year-end. Consumer confidence remains a couple of standard deviations below its historical average. On the plus side is the resilient UK labour market. Despite weak growth, the **jobless rate unexpectedly fell last year and will be flat over the next couple of years**, contrary to our previous forecast. In recent quarters, real disposable income has rebounded as well. According to mortgage statistics, the housing market has also started moving and **home prices will rise cautiously in 2013-2014** after several years of stagnation. Our overall forecast is that **private consumption will grow by an average of 1.3 per cent in 2013-2014**, compared to 1 per cent last year.

The recovery in business investments has been weak in historical terms. The euro zone crisis has infected British exporters, and demand has been weak at home. After Prime Minister David Cameron's recent policy speech, it is clear that the UK will hold a referendum on EU membership in 2017 if the Conservatives remain in power (see the box on page 8). For companies, this means **several years of uncertainty on this vital issue**. Meanwhile their fundamentals look rather favourable. Companies have strong balance sheets. Combined with easier access to credit and a gradually brighter global, this points to an **acceleration in capital spending during the next couple of years**. On the minus side is **continued spare capacity** since the crisis years, which may delay the rebound. The composite purchasing managers' index looks neutral. The weakening of the pound over the past six months, mainly against the euro, is not yet reflected in rising export indices.

The pattern from previous years has been repeated and consumer prices have recently increased faster than expected. Inflation will peak at nearly 3 per cent by mid-year 2013, then gradually fall. In annual averages, **inflation will be 2.4 per cent this year and 2.0 per cent in 2014**. Due to stubborn above-target inflation, further monetary stimulus measures are unlikely. Besides, many BoE officials have been openly sceptical about the impact of further bond purchases. Yet **incoming Governor Mark Carney may shake things up**. His speeches have been interpreted as meaning that far-reaching changes in BoE monetary policy, such as abolishing the inflation target in favour of a nominal GDP target, may be in the cards. The aim is to help the stagnating economy take off. But if GDP growth roughly follows our forecasts, we believe such changes are unlikely. Instead **the BoE will abstain from expanding asset purchases** from the current GBP 375 billion, while leaving its key rate unchanged at 0.50 per cent in 2013–2014.

GBP per EUR

Source: Macrobond, SEB

Fiscal tightening continues. Since 2010 the austerity dose has been far bigger in the UK than in the US, Germany and France. **Austerity policies** will remain in place, **equivalent to 1.3 per cent of GDP in 2013 and 2014**: about the same as in 2012. The budget deficit will fall from 8.2 per cent of GDP last year to 5.8 per cent in 2014. Since summer, the pound has weakened against the euro. This trend has accelerated in 2013. We see several reasons for this. Despite belt-tightening, the UK's **AAA credit status is in jeopardy**; according to rating agencies, its outlook is negative. The euro zone debt crisis also seems less acute, undermining the role of the pound as a "safe haven" in turbulent times. The currency has also weakened against the US dollar, but to a lesser extent. After continuing to weaken in the short term, it will appreciate. **The EUR/GDP rate will stand at 0.82 at the end of 2014**, compared to 0.86 today.

Stabilisation, but no immediate upturn

- **Continued divergence in the region**
- **Russia: Sustained by domestic demand**
- **Poland: Gradual recovery after domestic slump**

Eastern (including Central) Europe ended 2012 weakly. A consistent feature across the region has been depressed industrial output, especially due to weaker demand in Western Europe. Germany is a key market for several Central European countries. It buys 30 per cent of Polish and Czech exports, for example. Meanwhile there are **signs of stabilisation in indicators during the past few months**, in line with the trend in the West. Manufacturing purchasing managers' indices are at low levels, however: a few points below the expansion threshold of 50 in most countries and somewhat higher in Russia (52.0 in January), which has shown better domestic resilience. The pattern is the same for consumer confidence. There are signs of levelling out/slight upturns in countries like Poland, the Czech Republic, Slovakia and Hungary, but all of them are at historically low levels, especially Hungary. Russian household confidence has fallen, but the index is relatively high in a historical perspective.

We expect no immediate upturn in Eastern Europe but foresee a **gradual recovery later this year, continuing in 2014**. Slow exports and weak capital spending will hold back growth for a while. In many places, consumption also provides insufficient support because of weak labour markets and, in most countries, budget consolidation. In 2013, fiscal policy will remain contractive in countries like the Czech Republic, Slovakia, Poland and Hungary but will ease in the latter two: in Hungary due to extra spending before the April 2014 election.

The **regional divergence** typical of Eastern Europe in the past year or two **will continue in 2013**. Russia and Poland will show better growth than many others, but we have significantly lowered our Poland forecast for 2013 after the marked domestic led slowdown in GDP growth during the second half of 2012. We foresee Russian growth of 3.4 per cent in 2013 and 4.0 per cent in 2014. Poland's GDP will increase by 2.1 and 3.5 per cent, respectively. Russia and Poland benefit from relatively good economic fundamentals and less dependence on EU-based banks; Poland is very dependent on them but has well-capitalised banks. Continued high oil prices will also buoy Russia. In Poland, a broad decline in interest rates over the past six months will help – with the central bank continuing to cut its key rate twice to the level 3.25 per cent in spring – along with a sharp downturn in inflation, which will prop up consumption and capital spending over time. Some central and especially southern parts of the region are more depressed. For example, the Czech Republic and Hungary are climbing very slowly out of their 2012 recession. Both Slovenia and Croatia may show negative growth again, following about a 2 per cent GDP decline in 2012.

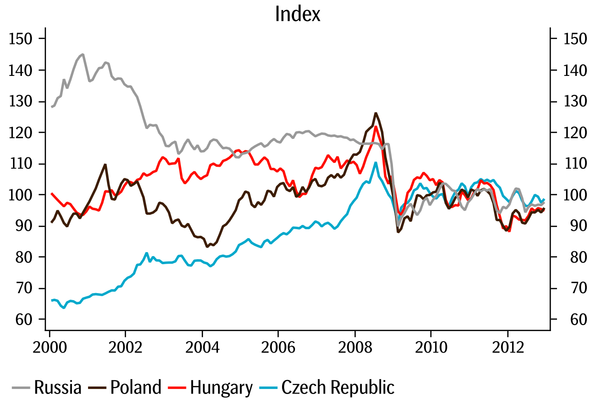
Inflation is trending somewhat downward in most countries. Weak labour markets, relatively stable commodity prices and appreciating currencies are holding back price increases. But in Russia, inflation will climb from about 5 per cent in 2012 to 6 per cent in 2013. The reason is upward pressure at the beginning of the year from higher taxes and fees on alcohol and tobacco, plus base effects from the depressed inflation curve in the first half of 2012. In Ukraine, inflation will rebound clearly in 2013 from extremely depressed levels in 2012, partly driven by higher energy prices and an expected devaluation of at least 10 per cent against the USD.

Credit conditions have again largely normalised in Eastern Europe, after the very tight situation prevailing in late 2011 and the first half of 2012. The ECB's low-interest LTRO loans to euro zone banks a year ago also had a positive impact on Eastern European banks, with their relatively large Western ownership. In the past six months, credit supply and funding costs of banks in Eastern Europe have greatly improved, as in the West. Yet credit conditions for customers are only thawing slowly; notably, there was new tightening in Poland late in 2012 after earlier easing. Meanwhile demand for credit is generally low. Credit growth in 2013 will thus be relatively weak, except in a few countries like Russia where growth remains strong.

Many currencies in the region have gained strength due to the global wave of higher risk appetite. With respect to the rouble and zloty we predict minor appreciation in 2013. Growth advantages and higher interest rates levels are two major reasons.

Nominal effective exchange rates

Index



Source: BIS

Slight dip this year but continued solid resilience

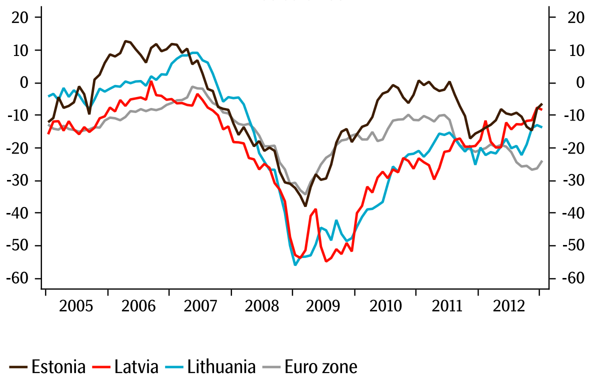
- **Good export growth despite weak demand**
- **Households will drive GDP growth**
- **Latvia expected to join euro zone in 2014**

We are sticking to our forecast of continued gradual recovery in the Baltic countries, though this year we expect a slight dip in Latvian and Lithuanian growth and only a marginal upswing in Estonia. Weak external demand and a low capital spending appetite, mainly in Lithuania and Latvia, continue to hamper growth early in 2013. Meanwhile private consumption is chugging along at a healthy pace. **Estonia's GDP will expand by 3.3 per cent in 2013, while Latvia's will grow by 3.8 per cent and Lithuania's by 3.2 per cent**. During 2014, once the world economy has rebounded, growth will be broad-based and climb somewhat to potential, which is around 4 per cent.

In 2011 the Baltics, led by Estonia, grew by 8.4 per cent: fastest in the EU. The troika remained on top last year, even after a sharp export-led deceleration in highly export-dependent Estonia to an estimated 3.1 per cent and a broader slowdown in Lithuania to 3.6 per cent. Latvia, earlier hardest hit, had a far more uniform growth profile: an estimated 5.2 per cent in 2012. In recent months, sentiment surveys have provided somewhat mixed signals. Manufacturing indicators in Latvia and Lithuania have been relatively stable, in Lithuania's case after an earlier slowdown. In Estonia, industry has continued to sag, partly due to weakening in Sweden and Finland, two major export markets, but in January the sentiment strengthened somewhat. **Household confidence has generally gained strength**: in December, Latvia and Lithuania saw their highest levels since 2007 and 2008, respectively. Notably, consumer confidence trended upward in 2012 and was not affected by sagging export sectors and the euro zone crisis.

Consumer confidence

Net balance



Source: European Commission

Export growth has revived a bit in the past six months – unexpectedly fast in Latvia and Lithuania, where the 12-month increase in current prices was about 25 per cent in November: historically good rates. An abrupt deceleration from year-on-year rates of 60-70 per cent had occurred in all three countries early in 2011, reaching negative levels in Lithuania and Estonia by spring 2012. Exports are thus performing decently despite weakness in Western Europe, indicating good competitiveness. Also sustaining Baltic exports is the fact that Russian demand is holding up nicely; Russia is Lithuania's biggest market by far and No. 3 for Estonia and Latvia. Overall, we believe exports will still only be a moderate force in GDP growth during 2013.

In 2013, **households will remain the engine** of growth in the Baltics. Faster wage growth, low interest rates and gradual labour market improvement will create more room and desire for consumption. In the past three years, unemployment has gradually fallen from some 20 per cent to below 10 per cent in Estonia and 12-13 per cent in Lithuania-Latvia in the third quarter of 2012, but we believe this trend will slow. Lingering uncertainty will prevent hiring.

Inflation will remain low in Latvia and relatively low in Lithuania, but will get stuck at a high 4 per cent in Estonia, where the impact of wages and over time from money supply will be larger. In Estonia we predict nominal pay increases of as much as 7-8 per cent this year; if such growth persists, it threatens to generate cost pressures and again undermine competitiveness. Higher electricity prices are a major inflation driver in Estonia and Lithuania early in 2013.

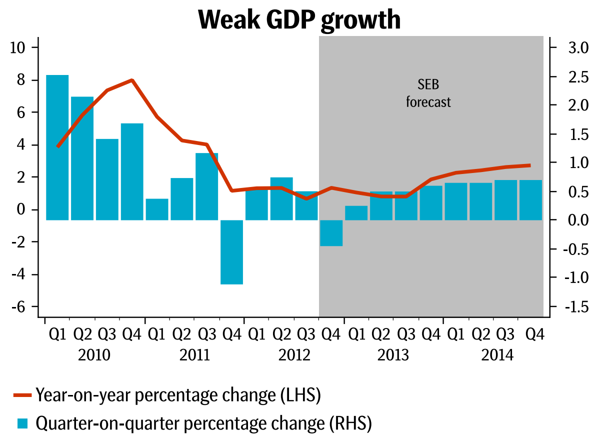
Public finances are solid. Estonia and Latvia will show small budget deficits while Lithuania is again expected to report a modest deficit, at or somewhat above 3 per cent of GDP in 2013. Fiscal policy is mildly contractive in Latvia and Lithuania, which aim to join the euro zone in 2014 and 2015, respectively.

Latvia, which is applying for euro zone membership, is expected to meet all the Maastricht criteria by wide margins in its ECB/EU evaluation this spring. **Latvia can thus convert to the euro on January 1, 2014**. We are uncertain, however, whether Lithuania will be able to show sufficiently and enduringly low inflation and budget deficits to achieve its 2015 membership target; its chances are 50-50. Qualifying for the euro zone in 2015 will require a clear slowdown in Lithuanian inflation this year and early in 2014, as well as a budget deficit below 3 per cent of GDP this year. If the inflation criterion had been applied this year, Lithuania with its 3.2 per cent inflation in 2012 would have ended up well above the requirement, which would have been 2.77 per cent: the most recently available 12-month average may not exceed 1.5 percentage points above the three EU countries with the lowest inflation.

Continued below-trend growth

- **Recovery after a weak year-end 2012**
- **Both monetary and fiscal policy support**
- **Unemployment will rise**
- **Riksbank will keep key rate low in 2014**
- **Slower wage and salary growth**

After a weak year-end 2012, with many indications of a relatively sharp drop in GDP during the fourth quarter compared to the preceding quarter, forward-looking indicators have recovered. We our sticking to our forecast that Sweden can avoid a recession. **GDP will grow by 1.2 per cent this year and by 2.5 per cent in 2014**, largely unchanged compared to *Nordic Outlook* in November. But because of below-trend growth in both 2012 and 2013, unemployment will rise during much of 2013 and remain high throughout our forecast period.



Source: Statistics Sweden

Given a weak labour market, falling resource utilisation and continued low inflation, the **Riksbank will cut its repo rate again in February to 0.75 per cent.** Continued expansionary policies by the world's major central banks also make it likely that the repo rate will remain at this level throughout next year.

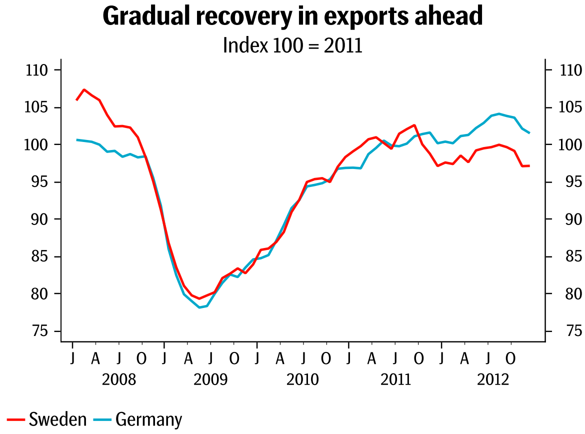
The government has signalled that its fiscal policy will remain expansionary in order to slow the economic deceleration, and we expect some additional stimulus to be unveiled in the spring budget this April. Total **fiscal stimulus will be about SEK 25 billion** or 0.7 per cent of GDP both this year and in 2014.

Collective agreements for more than two million employees – about half the labour force – will be renegotiated during 2013. The talks are now entering their most intensive phase. Given rising unemployment, the rate of pay increases is likely to be slower than in 2012. We predict that **the agreements will again run for only one year, and we have lowered our forecast of pay increases to less than 3 per cent**.

Exports will climb from a low level

Late in 2012 there were many signs of deceleration in the export sector, and monthly data indicate a sizeable decline in exports and industrial output during the fourth quarter. Yet at the same time, more forward-looking sentiment indicators confirm that the recovery in the US and emerging economies is now spreading to Sweden and elsewhere in Europe. The levels of most indicators are still low, and in merchandise exports the recovery is occurring gradually. Overall, we believe **exports will climb by 2.0 per cent in 2013 and 4.3 per cent in 2014**.

Gross fixed investments held up relatively well despite last year's downturn. Statistics Sweden's capital spending survey nevertheless shows that businesses have become more cautious. Industrial companies, for example, plan to trim their capital spending by 3 per cent in 2013. Plans for domestic sectors are more mixed but generally indicate a deceleration compared to 2012. Weak demand and uncertain economic prospects are holding back capital spending, but given the low initial level there are signs that such spending will rebound fairly rapidly once economic growth takes off. Residential investments fell by an estimated 10-15 per cent during 2012, but a stabilisation in the number of housing starts indicates that the decline will gradually decelerate this year (see the box on the housing market). Altogether, we predict that **capital spending will increase by 1-2 per cent this year and then accelerate to 4-5 per cent during 2014**.



Source: Statistics Sweden

Worried households but rising consumption

Households are now more clearly aware that the labour market is weakening. Consumer confidence fell late last year to its lowest level since 2009. Yet consumption is continuing to rise, and the confidence indicator recovered a bit in January. We still believe that given strong real income increases and falling mortgage interest rates, Swedish households will not reduce their consumption. The risk of a **significant decline in home prices has also eased**, although we still view a home price decline as the biggest domestic risk factor. Our assessment is that home prices will be unchanged or fall slightly during our forecast period.

Household income and consumption

Year-on-year percentage growth

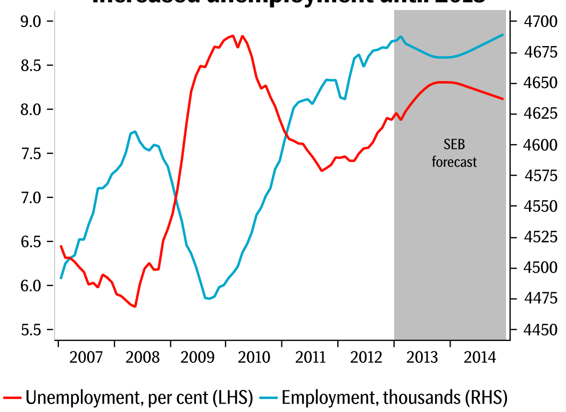
	2011	2012	2013	2014
Consumption	2.1	1.5	2.0	2.3
Income	3.5	2.6	2.1	2.5
Savings ratio, % of disp. income	10.1	10.3	10.2	10.5

Source: Statistics Sweden, SEB

Unemployment will rise

It is clear that unemployment has been in a rising trend for the past three or four months. So far, the upturn is being driven by an expanding labour supply while employment is still increasing and has actually been somewhat stronger than expected. Short-term indicators weakened late in 2012, however. Combined with weak GDP growth, this indicates that the number of jobs will level out. **Unemployment will climb to nearly 8.5 per cent in mid-2013** and the number of jobs will fall slightly. The labour market will stabilise in the second half, but we foresee no clear improvement during 2014.

Increased unemployment until 2013



Source: Statistics Sweden, SEB

Pay negotiations and more lay-off notices

As in 2012, this year's pay negotiations will take place during a period of relatively large concerns about the economic outlook. Industrial agreements expire late in March, which means that the negotiations will enter a decisive phase during the coming month. Some manufacturing firms have negotiated temporary pay cuts in exchange for shorter working hours, in the same way as occurred during the financial crisis in 2009. Although the number of pay-cutting companies is too small to influence overall pay outcomes, these agreements support a modest pay increase scenario in 2013. Initial pay demands by trade unions are at around 3 per cent, or lower than their demands in 2012.

We have adjusted our wage and salary forecast downward. We now expect pay increases, including wage drift, to total less than 3 per cent. Due to the uncertain economic situation, agreements are likely to run for only one year.

Dates when major agreements expire in 2013

Date	Number of employees	Sector
Feb 28	120,000	Transport, construction
Mar 31	1,750,000	Manufacturing, distributive trades, local government
Apr 30	142,000	Distributive trades (white collar)
May 31	210,000	Hotels, restaurants
Sep 30	145,000	Central government sector

Source: National Institute of Economic Research, SEB

Falling CPI – low CPIF

Inflation pressure in Sweden has been surprisingly low, and CPIF inflation has continued to fluctuate around 1 per cent. Because of the stronger krona and modest pay increases, this trend is likely to continue this year. We even expect the CPIF rate to average less than 1 per cent during the next six months due to falling energy prices. Fading downward pressure from the exchange rate – and to some extent a gradually diminishing impact from restaurant prices after the value-added tax cut in January 2012 – point towards a somewhat higher inflation rate this and next year. Yet CPIF inflation is expected to be well below the Riksbank's target throughout our forecast period. Consumer Price Index (CPI) inflation, which is being pulled down by declining home mortgage interest expenses, dropped below zero this winter. A further key interest rate cut in February is expected to increase downward pressure. We predict that CPI inflation will fall to -0.5 per cent in April and then gradually rebound as a consequence of base effects.

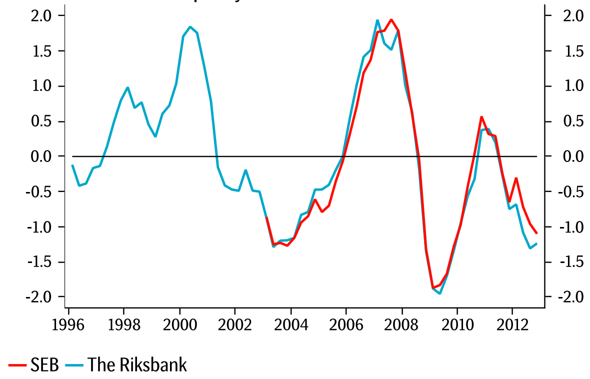
Riksbank will cut repo rate to 0.75 per cent

Forward-looking indicators have recovered, and international risk sentiment has improved. Yet we are sticking to our forecast that the **Riksbank will lower its repo rate one more time to 0.75 per cent**. Our main scenario is that this rate cut will come as early as **February**; April is our second-ranked alternative. The forces driving this rate cut are rising unemployment, falling resource utilisation and inflation that is well below target. Continued expansion in household borrowing is an upside risk, but household income is now increasing as fast as lending. This is consistent with the Riksbank's forecast; its latest Executive Board minutes hint that concerns about increased household borrowing and the housing market have faded somewhat among those Board members who support current monetary policy. According to our calculations, stable home prices combined with low residential investments also indicate that lending growth will decelerate rather than accelerate. Continued highly expansionary monetary policies by the world's major central banks imply that it will be some time before the Riksbank begins to hike its repo rate, although it will presumably be in the frontlines once the rate hiking cycle begins. We predict that the **repo rate will remain at 0.75 per cent until the end**

of our forecast period.

Capacity utilisation supports a further rate cut

Capacity utilisation indicators



Source: The Riksbank, SEB

Somewhat wider yield spread to Germany

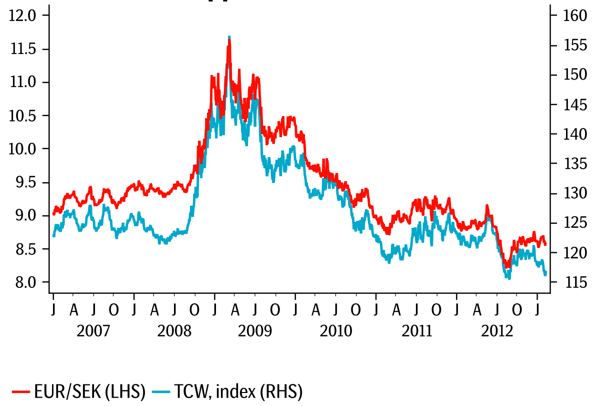
After having been mostly negative since the 2008 financial crisis, the spread between 10-year Swedish and German sovereign bonds has climbed to over 30 basis points. The main driving force behind this upturn is rising risk appetite, which has led to a downturn in foreign purchases of Swedish government bonds as a safe investment. Rising yields have also eased pressure on the financial solvency of insurance companies, helping to reduce domestic demand for long-term bonds. Changes in the regulatory framework, for example the Basel III agreement, also pushed down long-term yields earlier; in our assessment, this effect will now decrease, also reducing the demand for safe long-term fixed-income securities.

In addition, an increased supply of bonds with long maturities (more than 12 years), in line with the government's new sovereign debt management guidelines and the Riksbank's request that the National Debt Office should borrow SEK 100 billion for the currency reserve, has also helped push the yield spread against Germany higher. Although the loan raised for the Riksbank will be denominated in foreign currency, it may indirectly result in lower demand for bonds in Swedish kronor, since some investors who are attracted by Sweden's stable AAA credit rating can enjoy its benefits without subjecting themselves to exchange rate risks. Looking ahead, we expect a large proportion of the above-mentioned factors to continue pushing up Swedish yields, but according to our models the upturn has already been rather large. We thus believe there will be a certain downward correction of the yield spread against Germany in the coming months, mainly due to rising German yields. After that, we expect the yield spread to widen somewhat again. Altogether, we predict that **Swedish 10-year yields will climb to 2.10 per cent at the end of 2013 and further to 2.40 per cent by the end of next year**.

Gradually stronger krona

Although the krona has weakened against the euro from its peak in mid-2012, the EUR/SEK exchange rate is lower than it was at any time during 2006-2011. In addition, the upswing in the EUR/SEK rate in recent months is largely a result of the euro's appreciation against all currencies. In trade-weighted TCW terms, the krona is still less than 1-2 per cent away from its peak during 2012. Our description of **the krona having broken its historical pattern of weakening during economic downturns is thus still intact**.

SEK appreciation continues



Source: Macrobond

There are many indications that the "safe haven" flows that benefited the krona during the global financial turmoil of 2012 are over. Meanwhile developments in recent months indicate that the krona will revert to its historical pro-cyclical pattern and will appreciate as the economic outlook improves. Both the US and the euro zone are suffering from structural problems and have highly expansionary monetary policies, which we also expect to contribute to a stronger krona. On the other hand, the krona is now close to its highest level since 1996. We thus expect a cautious decline in the **EUR/SEK exchange rate to 8.30 at the end of 2013 and onward to 8.10 at the end of 2014**. Since we expect the dollar to appreciate against the euro, the USD/SEK rate is likely to rise somewhat. **In TCW terms, the krona will appreciate to 112.0 at the end of 2014**, or 4 per cent stronger than today.

Expansionary fiscal policy, weaker finances

Continued weak economic performance and rising unemployment are leaving their mark on public sector finances. Only a few months after the government had unveiled its 2013 budget, the autumn 2012 slowdown forced it to revise its growth and public finance forecasts downward. Meanwhile the government promised no further stimulus measures beyond those included in the budget bill.

The government's more expansionary policy will continue, following the shift in last autumn's budget bill, when reforms totalling SEK 23 billion in 2013 were unveiled. Initially, the government was criticised for no longer prioritising budget surplus targets. That criticism has largely died down, and there is a political consensus that fiscal stimulus is needed in the current economic situation, although there is disagreement on the details. Our view is still that budget policy will remain expansionary in **2014** – an election year (with both national and European parliamentary elections) – when we expect **a further SEK 25 billion** or 0.7 per cent of GDP in new stimulus measures. Aside from it being an election year, there are a number of reasons for a continued expansionary policy. Further stimulus is consistent with stabilisation policy principles; given the cyclical situation, the economy would benefit from such stimulus.

Because of Sweden's low sovereign debt, deficits pose no threat to confidence in government finances, especially if reform programmes focus on restructuring measures that will improve future growth potential.

This trend implies a deterioration in net lending from -0.5 per cent of GDP in 2012 to about -1.5 per cent of GDP per year in 2013 and 2014. The central government borrowing requirement will increase during our forecast period, but the borrowing requirement is ballooning because the National Debt Office will borrow SEK 100 billion to enable the Riksbank to strengthen the currency reserve. This will increase the borrowing requirement by the same amount, pushing up sovereign debt by 2.7 percentage points. **The central government borrowing requirement will be SEK 161 billion in 2013 and SEK 63 billion in 2014**. The National Debt Office borrowing for the Riksbank is a major reason why central and general government gross debt will rise during our forecast period. At the end of 2014, central government debt will reach 36 per cent of GDP. This is low in a Swedish historical and international perspective.

Public finances

Per cent of GDP

	2011	2012	2013	2014
Net lending	0.2	-0.5	-1.5	-1.3
Gen. gov't gross debt	38.3	37.0	40.4	40.5
Central gov't debt (unconsolidated)	33.1	33.2	35.8	36.2
Borrowing req., SEK bn	-68	25	161	63

Source: Statistics Sweden, SEB

Price boom without construction boom

It is surprising that the **long period of rising home prices since the mid-1990s has not been accompanied by any acceleration in residential construction**. Home prices have climbed by about as much as in other countries, but even during its strongest years housing construction has not matched what we have seen in other Western countries, measured either in terms of residential investments as a percentage of GDP or the number of new homes in relation to population.

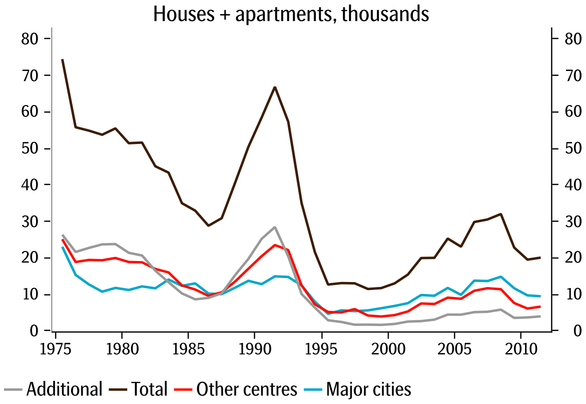
We have previously cited low construction as one factor that may partly enable Sweden to avoid a large home price decline similar to those that many other countries have experienced. There are many indications that this conclusion is relevant. **But the focus on debt may also turn into a growth risk**. In other words, given the combined ambition of the Riksbank and the Financial Supervisory Authority to curb lending to households, along with political disunity about housing policies, it may be difficult to accelerate residential construction in the future. Yet population growth points to a surge in housing demand during the next couple of years.

Factors behind the low construction level

A number of factors have apparently contributed to the shortfall in construction. If we divide up the number of completed homes between major cities, other population centres and additional categories, major cities are the only category that bounced back after the crash that followed the construction boom of the 1980s.

Newly constructed homes at historically low level

Houses + apartments, thousands



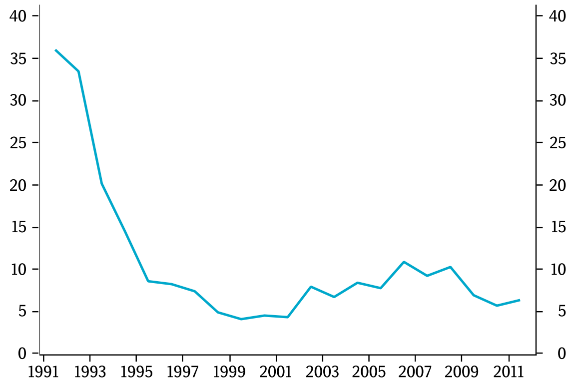
Source: Statistics Sweden, SEB

One often-mentioned reason why housing construction in major cities has not increased despite heavy demand is that Swedish building laws give neighbours and others extensive opportunities to appeal construction plans, delaying construction and making it more difficult.

Another reason why the number of rental housing starts did not climb following the 1990s crisis either, after a large surplus supply of housing created during the construction boom of the 1980s, is probably a combination of rent controls plus the abolition of mortgage interest deductions and other subsidies during the early 1990s.

Low construction level for new rental housing

Thousands

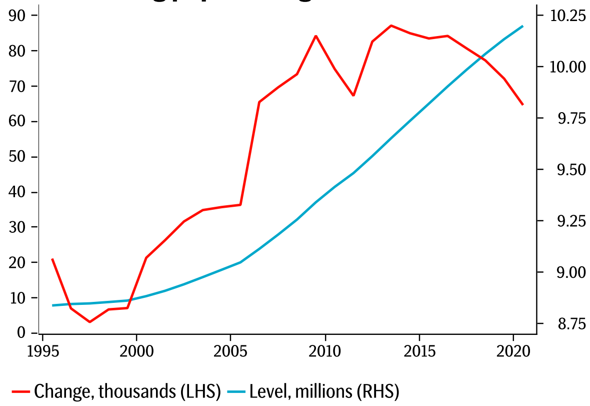


Source: Statistics Sweden, SEB

Accelerating population growth

Another contributing factor behind the low construction level after the mid-1990s may be that population growth was modest during the period 1995-2005. However, this trend came to a close during the past 5-10 years, when population growth has instead been strong.

Strong population growth since 2005



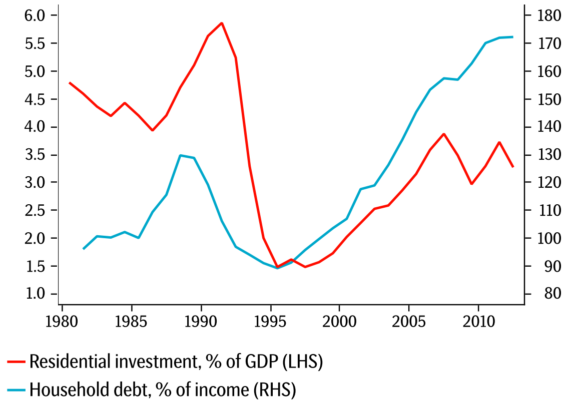
Source: Statistics Sweden, SEB

Analysis by the Swedish National Board of Housing, Building and Planning (Boverket) indicate that 30,000-60,000 homes per year would need to be built in the years ahead in order to keep up with population growth and to catch up from earlier low levels of construction. This is higher than construction has been in any individual year since 2005. Boverket's assumptions about population growth until 2020 also appear to have been greatly surpassed, according to the latest forecast from Statistics Sweden. Although Boverket's estimates were made nearly a decade ago, they still support our assessment that **underlying demand for housing will be heavy during the next ten years**.

Will housing construction increase?

The latest figures from Statistics Sweden indicate that the number of housing starts in 2012 will end up at 15,000 (which means that residential investments totalled an estimated 3.0 per cent of GDP). This implies that **construction and residential investments would need to double as a percentage of GDP** from current levels in order to meet demand, based on Boverket's estimates. However, there are reasons to be sceptical that construction will come close to these levels, in any event during the next couple of years.

Household debt and residential investment



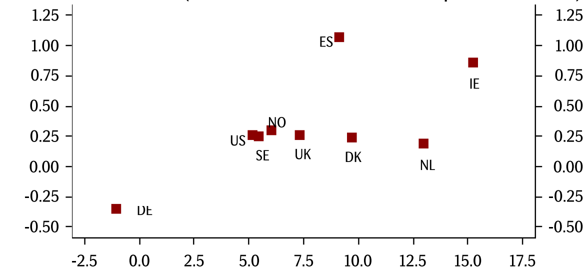
Source: Statistics Sweden, SEB

Household debt and residential investment

One question is whether an **upturn in construction can be combined with the ambition of the Riksbank and FSA** (and the government) **to keep household debt from increasing**. Although the correlation between household debt ratios and residential investments as a percentage of GDP is far from perfect, the **investment upturn of the late 1980s and during the 2000s went hand in hand with higher loan-to-value ratios**; the downturn in LTV ratios in the early 1990s coincided with a sharp decline in residential investments.

Average increase in household debt vs average increase in residential investment for different countries (2000-2007)

Y-axis: Housing investments, % of GDP; X-axis: Change in pp of household debt ratio (household debt as share of disposable income)



Source: Macrobond, SEB

Hardly surprisingly, an international comparison shows a similar pattern. Although the correlation between residential investments and household borrowing is far from perfect here as well, there is a connection between the increase in household borrowing and residential investments. Despite this somewhat weak connection, it is **difficult to find periods in any country when construction has increased rapidly without an increase in household debt**.

Obstacles to rental units as well

One way of boosting residential investments without higher household debt would be increased construction of rental housing. Today less than one fourth as many rental units are being built per year as in the early 1990s (see chart above). Taking into account conversions of rental units into cooperative tenant-owned units, the total number of rental units has actually decreased over the past decade.

However, there are strong reasons to expect a sharp increase in the number of rental units during the next couple of years. **Low construction of rental units**, despite heavy demand for housing, is largely explained by their lack of profitability due to a **political deadlock**. The government wants to stimulate construction by easing today's tough rental controls and simplifying the permitting process, but the opposition parties refuse to accept anything but minor changes in rent-setting. Instead they want to use subsidies to stimulate more construction. Neither of these policies is likely to attract a parliamentary majority even after the 2014 election, if current public opinion trends persist.

No strong recovery for construction

The conclusion of our analysis is that over the next couple of years, housing construction will probably only recover part of its decline in 2011 and 2012 and that housing construction will remain low compared to population growth. Another conclusion is that the Riksbank's perfectly understandable desire to limit the expansion of lending to households is not uncomplicated, and the situation is made more difficult by political conflicts related to the construction of rental units.

Weak growth momentum as consumption falters

- **Net exports up again on global recovery**
- **Housing market still faces headwinds**
- **Disinflationary pressure dominates**
- **Limited impact of negative rates outside FX**

The Danish economy continues to show weak growth. As a consequence of lacklustre momentum and stimulus, we have revised our growth estimate for 2013 downward compared to the last *Nordic Outlook*. **We expect growth to be 0.7 per cent this year, increasing to 1.7 per cent in 2014**. This estimate is contingent on a global improvement in growth.

Private consumption fell in the third quarter, while confidence and car registrations point to continued declines at the beginning of this year. Consumers are still deleveraging and experiencing negative real wage growth. However, a drop in inflation this year to 1.5 per cent should result in flat real wage growth.

Housing investments have turned downward again while home prices stabilised in the second half of 2012. The stabilisation in growth will help sustain home prices, but other factors will act as a counterbalance. Households are still pessimistic and the tailwind from declining mortgage yields will be less forceful going forward. Additionally, mortgage institutions are raising fees and becoming more restrictive with the cheap non-amortisation variable rate loans that fuelled the housing bubble. As a consequence, we expect home prices to be marginally down in 2013.

Net exports pulled down growth as the economic activity of key trading partners turned lower in the second half of 2012 and imports stayed surprisingly strong. Exports are expected to pick up, with the global recovery turning net exports supportive of growth in 2013. Corporate investments have stayed fairly resilient in light of the subdued trend of capacity utilisation and should pick up gradually as growth prospects improve.

Assessing trend growth and slack in Danish the economy

We have taken a deeper look at trend growth as well as slack in the Danish economy in order to assess the need and room for economic stimulus.

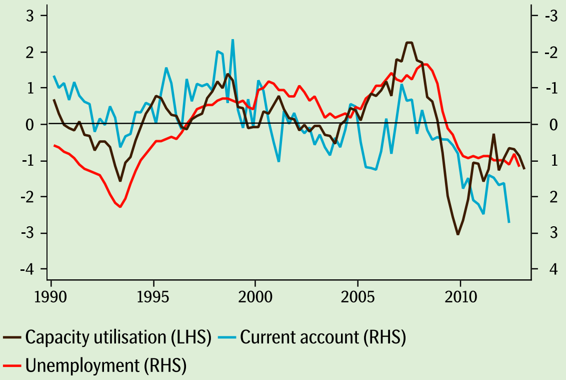
To judge trend growth, we have looked at changes in GDP and two different measures of unemployment rates with long histories. We prefer the survey-based measure for a couple of reasons: it is an international standard and includes unemployed people who are not registered for benefits or have dropped out of the benefits systems. It is also stationary, making it more useful for evaluating spare capacity. The typical domestic reference is the net figure (excluding people with job offers) based on benefit registrations. The two measures differ markedly, putting unemployment at 8.0 and 4.8 per cent, respectively.

The two measures lead to similar conclusions for trend growth: **Unemployment starts rising when growth drops below 1-1.5 percent** and vice versa. A similar exercise for capacity utilisation suggests a figure at the top of this range. Denmark's relatively low trend growth is related to an already high labour market participation rate and muted population growth. But productivity growth is also subdued, something that remains a bit of a puzzle but could be related to measurement problems.

Low unemployment and high capacity utilisation generally indicate that resources are stretched, causing inflation and limiting growth. A **current account deficit is also a constraint, given the krone's peg against the euro**. The peg was introduced as a straitjacket for economic policy, and many of the major reforms over the last decades have been a consequence of a deteriorating current account.

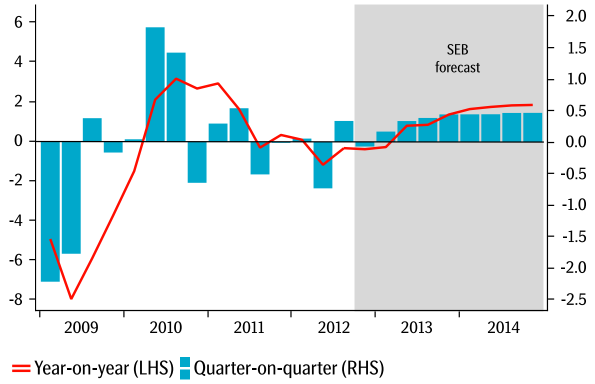
Significant slack in the Danish economy

Standardised series



Source: Macrobond

The recent surge in the current account means it is not a constraint. On the contrary, it suggests that domestic demand should be raised for the currency peg to be sustainable. Although capacity utilisation has risen from its trough, it is still below its average indicating higher than average spare capacity. Lastly, unemployment has levelled out above its long-term average, pointing to underutilised resources (there is a bit of divergence in different labour market signals, though). In other words, **the economy could most likely grow for several years at a pace well above 2 per cent before growth constraints kick in.**



Fiscal policy is still not significantly offsetting economic headwinds. While rising in 2012 after a bout of austerity in 2011, spending has lagged budgets considerably. At the same time, the headwind from private deleveraging is a risk that could send the economy into a downward spiral. Current government plans call for public consumption to rise by 0.8 per cent annually going forward, but recent evidence suggests actual spending will trail that. The low debt level means there is room to ease policy further. Meanwhile disinflationary pressure dominates (see below).

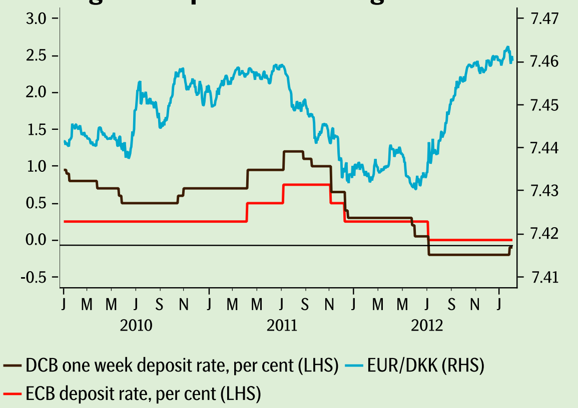
Central bank raising rates to support the krone

The combination of lower euro zone tensions and a negative Danish deposit rate has had a marked effect on the krone. The EUR/DKK exchange rate has risen close to parity within the peg, and since September the central bank has gradually stepped up its foreign exchange (FX) market intervention to support the krone. As the second line of defence it raised deposit rates late in January to minus 10 basis points. With continued healing in the euro zone affecting portfolio flows and money market rates rising marginally due to liquidity withdrawal in the euro system, we expect another 10 bp hike in the second quarter (bringing the deposit rate in line with the ECB).

Lars Rohde, former head of the ATP state pension fund ATP, took over as central bank governor early in February. This is not likely to lead to imminent changes in the monetary policy regime or operational framework. He might be more vocal about the inconsistency of a large current account surplus and a peg, thus leaning in a more growth-friendly direction in public discourse.

The effects of a negative interest rate in Denmark

The negative deposit rate is rooted in the Danish central bank's **target of maintaining the peg between the krone and the euro** in a situation with a large current account surplus, periodic euro zone uncertainty leading to net portfolio inflow and euro zone interest rates at zero. Nonetheless, the lessons of this "experiment" might have broader relevance.



The central bank had flagged the possibility of negative rates well in advance, and **the cut itself was not a surprise**. Money market rates declined marginally as the last uncertainty was removed and have generally stayed below zero since. In other words, the **negative deposit rate has been transmitted to the interbank market.** There has also been a **marked effect on the currency**, as described above.

However, the average corporate and household deposit rates at bank have stayed positive, although some isolated corporate deposit rates have been negative. Bank lending rates decreased in the second half of 2012, indicating some transmission, but remain above 2010 levels when policy rates were around one percent higher. The negative rates do not seem to have impacted the money multiplier. Broader measures of money supply have continued their moderate positive trend since the first half of 2012 and if anything the multiplier has come down a tad. **Hence bank recapitalisation and subdued loan demand due to deleveraging seem to dominate any effect there might be from negative rates in the credit channel.**

The money market has kept functioning normally. **There has not been a pick-up in the circulation of DKK notes** in general or high-denomination DKK notes in particular. The limited substitution indicates that the cost of cash is higher than 20 basis points. One side effect is a cost to banks that have significant deposits at the central bank as a consequence of the increase in FX reserves.

To sum up, the negative deposit rate has had limited impact outside FX markets, where the goal of easing the pressure on the DKK was accomplished. **The Danish experience suggests limited problems from introducing negative rates, but (without a peg) not any benefits either.**

Momentum has peaked, growth settling at trend

- **Sharp downshift in late 2012 exaggerated**
- **Trend-like mainland GDP growth in 2013**
- **Rate hikes to come somewhat later**

A number of real economic indicators suggest markedly slower momentum in the second half of 2012. On the demand side, private consumption of goods has stalled, exports have slowed and manufacturing production declined in the final quarter of the year. The extent of the downshift might raise warning flags that the recovery is about to falter.

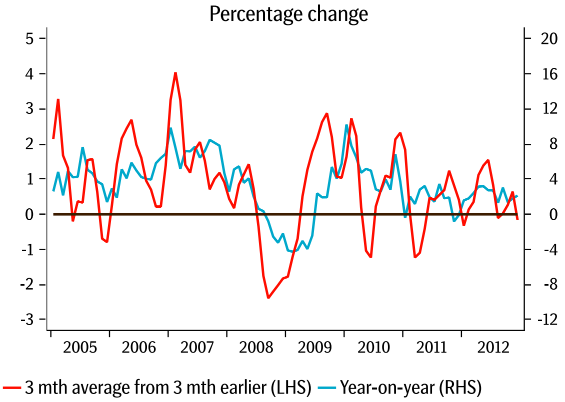
However, while the maximum rate of acceleration in overall growth seems to have passed, the slowdown should prove transitory. Growth in **mainland GDP** – i.e. excluding oil/gas and shipping – should settle at a more trend-like pace, **slowing from 3.3 per cent to 2.9 per cent in 2013-14**. Meanwhile, a "less hectic" pace of investment in the petroleum sector and a deceleration in oil and gas exports should produce a rather marked downshift in **overall GDP growth from 3.0 per cent in 2012** – the strongest in eight years – **to 2.4 per cent in 2013.** These forecasts are slightly lower than in the previous *Nordic Outlook*.

Consumption should recover in early 2013

The slowdown has been the most pronounced in private consumption of goods. Such spending gained a solid 3.0 per cent in the year to the second quarter of 2012, but stalled in the third quarter and showed a 0.2 per cent sequential decline in the fourth, the weakest quarterly outcome since the start of 2011. While combined spending on services and net consumption abroad, which accounts for almost half the total, should once again have lifted overall consumption in the fourth quarter, sequential growth was likely only modest.

Consumption of goods stalled in late 2012

Percentage change



Source: Statistics Norway

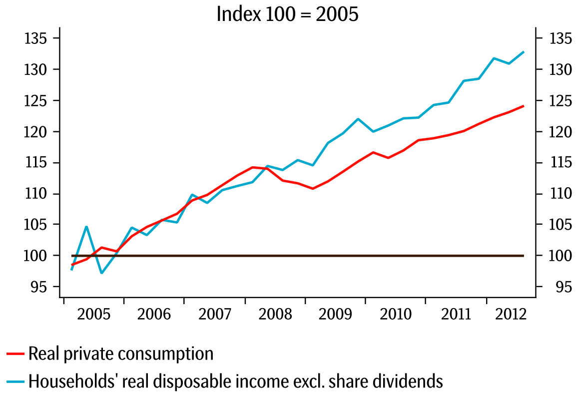
Full-year growth in private consumption should have been a healthy **3.2 per cent in 2012**, but there is no mistaking the sharp downshift in the second half of the year. However, we expect a recovery in the near term and similar growth in 2013.

For starters, the sharp slowing has not been signalled by any similar shift in sentiment. On the contrary, the quarterly survey of consumer confidence has trended higher to a slightly above-average level, which on the face of it should be consistent with slightly above-trend consumption growth.

On a more fundamental note, there are reasons to suspect that private consumption is being underestimated. The noticeable recent increase in the household savings rate to well above trend looks exaggerated. To put it differently, households' real disposable income has raced ahead of spending: while the gap in 2008-09 reflected heightened uncertainty, the further and marked widening during 2011 and 2012 is a conundrum.

Income is running well ahead of consumption

Index 100 = 2005



Source: Statistics Norway

Moreover, there is a very sharp split between household savings as measured in the national accounts and the financial accounts. On the former measure, very high savings should have flowed into real investments (like housing), financial assets and/or lower debt, but the financial accounts show persistent negative net financial investment. Even if the "truth" is somewhere between the two measures, consumption (and/or investment in real assets) is being underestimated.

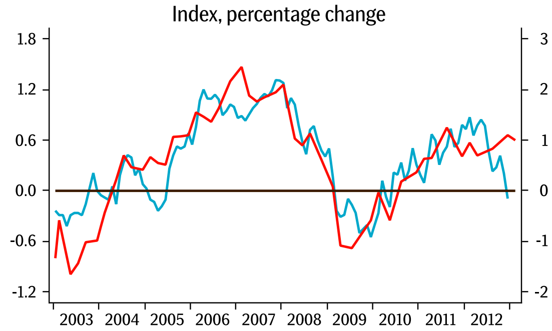
Labour market weakness exaggerated

Weaker consumption of goods apparently fits with what seems to have been an abrupt shift in the labour market. According to the Labour Force Survey, job creation showed a sturdy 2.6 per cent year-on-year rate in the second quarter of 2012, but then declined 0.2 per cent in the fourth quarter. Over the same period, the LFS unemployment rate jumped from 3.0 per cent to a two-year high of 3.5 per cent.

However, apart from the most recent episode, it is in fact hard to find a close correlation between employment and short-term momentum in consumption of goods. Over the longer term, overall income is the key determinant, and household real disposable income most likely continued to run ahead of consumption in late 2012. Going forward, healthy wage growth in 2013 as well suggests that the downshift in spending over the past two quarters will prove transitory.

Employment should recover

Index, percentage change



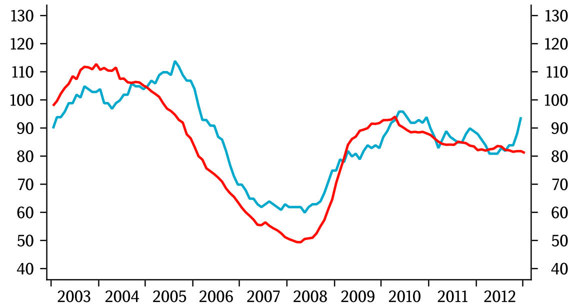
— Regional network employment indicator, 3 mth earlier (LHS)
— Employment, 6-month change (RHS)

Source: Statistics Norway, Norges Bank

Similarly, the jump in LFS unemployment in late 2012 looks exaggerated. In absolute terms, the number of unemployed persons increased by 10,000 between the third and fourth quarters, the sharpest increase over such a period in four years. Although this partly reflected a swelling labour force, while moderating momentum in the economy suggests some let-up in labour markets, the sheer size of the deterioration contrasts sharply with other indicators. In particular, the number of people registering as unemployed at the labour office actually slipped slightly between the third and fourth quarters of 2012 and inched lower in January. In the past, registered unemployment has generally been a leading indicator and is much less erratic than the Labour Force Survey.

Unemployment shows a split

No on 1.000



— Registered unemployment and employment schemes
— LFS unemployment, 3mth average

Source: Statistics Norway, NAV

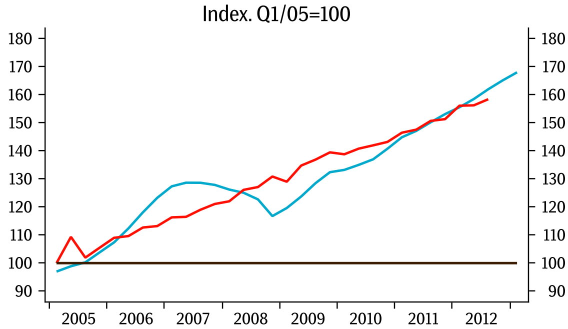
Employment is likely to recover and LFS unemployment correct downward going forward. However, full-year **job creation should slow from 1.9 per cent in 2012 to 1.0 per cent in 2013** while **LFS unemployment** should inch up from **3.2 per cent to 3.3 per cent** on average for the year.

Home prices supported by fundamentals

There is a heated debate about whether Norwegian home prices are forming a bubble. Prices look far too high relative to, among other things, general inflation or rents. Existing home prices have risen sharply since late 2008, including a 9.0 per cent average gain in 2011 and 7.7 per cent in 2012. Further gains were recorded in January with an 8.5 per cent year-on-year increase (slightly less than in December).

Demographics, income has lifted home prices

Index. Q1/05=100



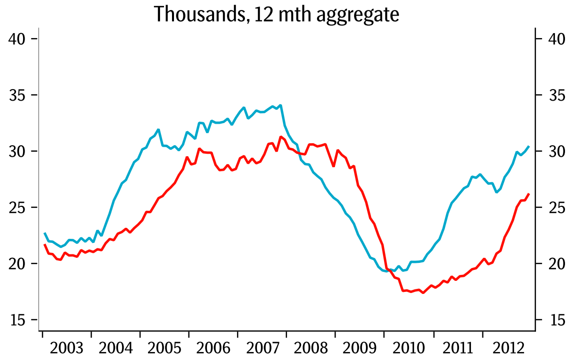
— Households' disposable income excl. share dividends
— Existing home prices

Source: Statistics Norway, Nef

Our long-held view has been more sanguine (see *Nordic Outlook*, February 2012). Hence, the better part of the continued home price inflation over the past few years can be explained by too low a level of new construction relative to very strong population growth, very strong real household income growth and historically low interest rates.

Housing starts have started to fill the gap

Thousands, 12 mth aggregate



— Housing completions — Approved housing starts

Soruce: Statistics Norway

The demand-supply imbalance is about to gradually shift in the not too distant future. Population growth should continue to run strong, boosted by labour immigration. However, housing completions increased by almost a third from 2011 to 2012 to above 26,000 units – the highest since 2008 – and was thus better, though not fully aligned with household formation (and the gap from previous years has yet to be filled). Completions will continue rising as seen in markedly higher approved housing starts, which in the fourth quarter of 2012 were running at an annualised rate of 39,000, although there is a noticeable time lag. Moreover, Norwegian authorities are considering requiring a much higher capital ratio at banks for mortgages, which is likely to diminish credit availability, while higher interest rates in coming years will affect affordability.

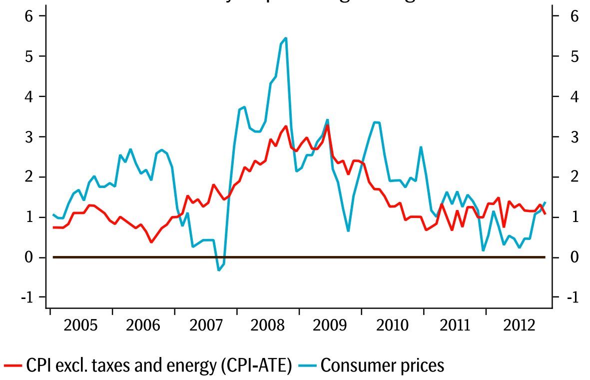
Existing home prices are expected to hold up in the short term, but a correction is likely within two or three years. Providing that the general economy is holding up, including still-healthy income growth, such a correction is likely to be somewhat stronger than the 10 per cent decline from peak to trough in 2007-08 but far short of a US-style 30-35 per cent price slump.

Core inflation to stay soft

Although the economy is operating at normal capacity – i.e. the output gap is closed – CPI inflation has continued to be surprisingly benign, rising 0.8 per cent on average in 2012, or slightly less than the 1.2 per cent rate in 2011. This moderation was due to plunging electricity prices (which have recovered recently). However, core CPI excluding taxes and energy (CPI-ATE) was soft as well. The annual average only picked up slightly from 0.9 per cent to 1.2 per cent in 2012.

Core inflation remains soft

Year-on-year percentage change



Source: Statistics Norway

Prices for imported goods should continue to decline due to the appreciation of the NOK in import-weighted term. The still-soft trend in prices for core domestic goods and services is more puzzling, although the average 2.0 per cent year-on-year rate in the final quarter of 2012 (by our calculation) was higher than a year earlier. Here, the somewhat firmer trend was driven by services. This included rents, which are still surprisingly benign considering what is going on in the housing market, while the year-on-year rate in services with wages as dominant factor accelerated slightly towards year-end.

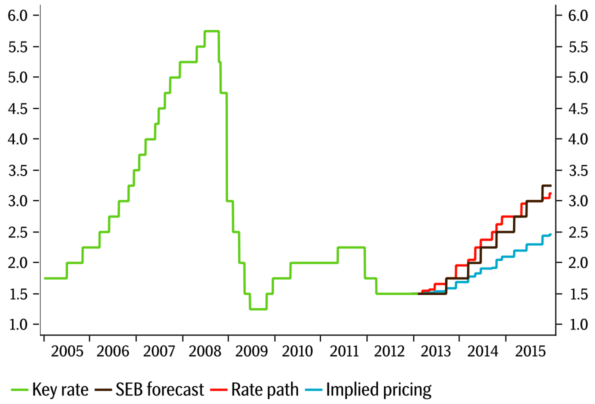
Core inflation is likely to remain muted going forward, rising only **1.3 per cent on average in 2013**, though some acceleration is likely as the year progresses, lifting the full-year average to **1.9 per cent in 2014**.

Key rate normalisation starting this autumn

Domestic fundamentals warrant higher rates. The economic momentum has slowed, but growth should stabilize at a trend-like pace. A closed output gap and acceleration in household credit growth suggest rates should be normalized although inflation remains below expectations. However, Norges Bank continues to be restrained by a strong NOK and very low interest rates abroad, and has been forced to lower its rate path when global rate expectations have declined to keep key rate differentials stable: wider spreads would have boosted the NOK beyond what's supported by strong fundamentals. At the same time, any rate cuts to weaken the currency wouldn't be credible given the domestic economy.

Norges Bank key rate and expectations

Per cent



Source: Norges Bank, SEB

SEB's central view is that the global economy is gradually recovering. Global interest expectations should thus have passed the trough. Although low rates abroad will limit the pace of normalization this will allow Norges Bank to emphasis on domestic fundamentals. The March *Monetary Policy Report* should sound dovish, but a shift of the cycle should be acknowledged by summer. We expect the bank to hike the deposit rate from 1.50 per cent to 1.75 per cent in September and lift the level to 2.50 per cent and 3.25 per cent in 2014 and 2015, respectively. Our view differs from current market pricing which implies only two 25bps hikes until end-2014.

There have been regulatory initiatives by the government aimed to curb lending to households. By March, the FSA will present proposals include both increasing risk weights on mortgages and limiting banks' possibility to fund mortgage lending by issuing covered bonds. This could ease the pressure on Norges Bank, but the final proposals, time schedule and total effect are still unknown. The bank thus still holds the most effective weapon to fight potentially financial imbalances.

Heavy demand for Norwegian financial assets

The stronger NOK over the past year has been supported by sound fundamentals attracting long term diversification flows, relative rate expectations and attractive valuation. These factors validate further NOK appreciation, but further gains in import-weighted terms should be modest as global risk appetite rather than "alternative safe haven" flows become a more important driver for currencies. **EUR/NOK will trade at 7.25 while USD/NOK will trade at 6.04 at the end of 2014.**

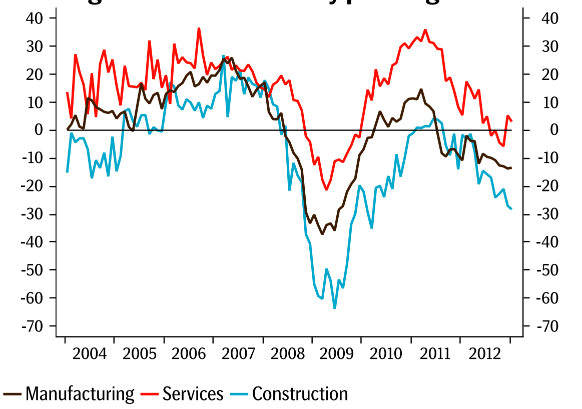
Despite Norges Bank rates hikes beginning this year, we expect Norwegian government bonds to perform well relative to Germany. A permanent boost in the supply of bonds due to export-related funding and low liquidity has widened spreads over the past year. However, supply-related underperformance is unjustified due to large upcoming redemptions and coupon payments as well as improved market conditions. We expect the 10-year spread vs. Germany to tighten to 60-65 bps this year before Norges Bank's rate hikes push it wider to 70 bps in 2014, equivalent to a 2.90 per cent yield.

Weak exports are pulling down growth

- **Resilient labour market and consumption**
- **High but falling inflation**
- **Stable government finances, but tight fiscal policy is contributing to weak growth**

After last autumn's recession, we expect weak yet positive growth ahead. The Finnish economy is being pulled down by exposure to cyclical export goods. Meanwhile the **labour market and consumption have shown resilience**. Forward-looking indicators have deteriorated since 2011, with a worse trend for export-oriented manufacturing than for services. Since late 2012, this divergence has been more clearly visible. We estimate that GDP fell by 0.1 per cent in 2012 after a weak ending. Growth will slowly gain momentum this year. **GDP will increase by 0.4 per cent in 2013 and 1.7 per cent in 2014.**

Leading indicators are mostly pointing downward



Source: European Commission

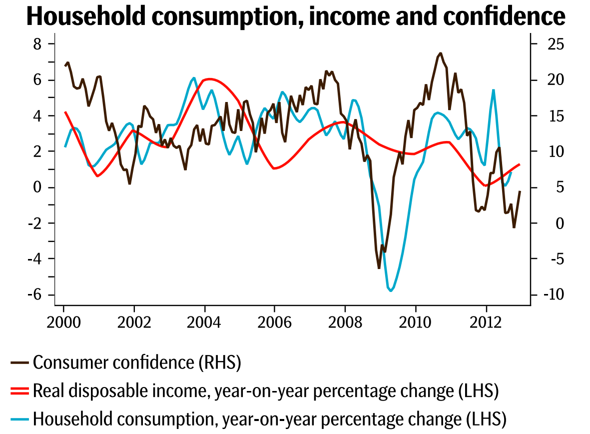
Weak growth in Finland's most important export markets has dragged down exports, although Russia – the third largest recipient – has resisted the downturn. We foresee a modest upturn in exports during 2013, but a weak first half. Measured as annual averages, **exports will grow by 2.8 per cent this year and 5.8 per cent in 2014**.

Since the pre-crisis period, structural problems in the information and communications technology (ICT) sector – where value-added has fallen sharply – have helped push down exports by 10 percentage points to 40 per cent of GDP. This drop in exports has also weakened the current account, which has slid into deficit after having been in surplus since the mid-1990s. The export volume trend meanwhile conceals some problems: deteriorating terms of trade are contributing to weakness in the current account as well as the ability of companies to cope with domestic cost and pay increases. Looking ahead, a weak increase in exports will be one factor behind a **continued current account deficit of more than 1 per cent of GDP** each year during our forecast period.

Low demand and declining capacity utilisation are hampering capital spending, which fell in 2012. Lending to households is increasing more slowly, now at a year-on-year rate of about 5 per cent. This rate of increase will continue to fall, holding back consumption and residential investments. Last autumn's feeble economic performance, which dampened business investments, is now also becoming visible in bank lending to companies. The rate of increase in such lending fell late in 2012 and is at a low level compared to the pre-crisis years.

Consumer confidence has improved in recent months, but from a low level. Household consumption rose in 2012, though the year ended on a weak note. We expect the rate of pay increases to decelerate and real wages to be squeezed by high inflation, driven up by tax hikes. **Household consumption will increase by 0.8 per cent in 2013 and 1.6 per cent in 2014**. The labour market produced an upside surprise, with unemployment falling in December to 7.7 per cent according to the Labour Market Survey. The number of vacancies remains at a relatively good level. The jobless rate will rise this spring, peaking at about 8.5 per cent in mid-2013. As annual averages, **unemployment will be 8.2 per cent in 2013 and 8.1 per cent in 2014**.

Household consumption, income and confidence



Source: Statistics Finland

Government finances are in deficit, and the economic slowdown is eroding some of the effects of the fiscal austerity programme. In spite of this, international confidence in Finland is good. The **public deficit will end up at about 1 per cent of GDP in 2013 and 2014**. Sovereign debt will level out at slightly above 50 per cent of GDP. Looking ahead, further belt-tightening will have to be implemented in order to ensure fiscal sustainability, although structural reforms such as higher retirement ages may ease austerity requirements.

DENMARK

Yearly change in per cent

	2011 level, DKK bn	2011	2012	2013	2014
Gross domestic product	1,792	1.1	-0.5	0.7	1.7
Private consumption	875	-0.5	0.5	0.0	1.5
Public consumption	508	-1.5	0.1	0.8	0.6
Gross fixed investment	312	0.2	0.7	0.8	3.4
Stockbuilding (change as % of GDP)		0.3	-0.3	0.1	0.0
Exports	957	6.5	1.8	1.9	3.3
Imports	863	5.6	2.9	1.8	3.3
Unemployment (%)		4.1	4.8	5.1	4.9
Consumer prices, harmonised		2.8	2.4	1.5	1.3
Hourly wage increases		1.7	1.5	1.5	1.5
Current account, % of GDP		5.6	6.0	6.0	6.0
Public sector financial balance, % of GDP		-1.8	-3.0	-2.0	-1.0
Public sector debt, % of GDP		46.4	45.4	43.4	42.8

FINANCIAL FORECASTS	Feb 7th	Jun 13	Sep 13	Dec 13	Jun 14	Dec 14
Lending rate	0.30	0.40	0.40	0.40	0.40	0.40
10-year bond yield	1.59	1.70	1.75	1.80	2.00	2.20
10-year spread to Germany, bp	-2	0	0	0	0	0
USD/DKK	5.57	5.49	5.65	5.83	6.02	6.22
EUR/DKK	7.46	7.46	7.46	7.46	7.46	7.46

NORWAY

Yearly change in per cent

	2011 level, NOK bn	2011	2012	2013	2014
Gross domestic product	2,575	1.2	3.0	2.4	2.3
Gross domestic product (Mainland Norway)	2,037	2.5	3.3	2.9	2.9
Private consumption	1,117	2.5	3.2	3.2	3.1
Public consumption	569	1.8	1.9	2.1	2.2
Gross fixed investment	518	7.6	6.6	6.3	4.5
Stockbuilding (change as % of GDP)		0.1	0.2	0.0	0.0
Exports	1,011	-1.8	2.0	1.6	2.1
Imports	754	3.8	3.6	4.7	4.3
Unemployment (%)		3.3	3.2	3.3	3.4
Consumer prices		1.2	0.8	1.7	1.8
CPI-ATE		0.9	1.2	1.3	1.9
Annual wage increases		4.2	4.3	4.0	4.2

FINANCIAL FORECASTS	Feb 7th	Jun 13	Sep 13	Dec 13	Jun 14	Dec 14
Deposit rate	1.50	1.50	1.75	1.75	2.25	2.50
10-year bond yield	2.56	2.25	2.35	2.40	2.65	2.90
10-year spread to Germany, bp	95	75	60	60	65	70
USD/NOK	5.53	5.33	5.45	5.66	5.85	6.04
EUR/NOK	7.41	7.25	7.20	7.25	7.25	7.25

SWEDEN

Yearly change in per cent

	2011 level, SEK bn	2011	2012	2013	2014
Gross domestic product	3,500	3.7	0.8	1.2	2.5
Gross domestic product, working day adjusted		3.7	1.1	1.2	2.7
Private consumption	1,673	2.1	1.5	2.0	2.3
Public consumption	924	1.1	0.9	0.8	0.8
Gross fixed investment	645	6.4	4.0	2.0	3.0
Stockbuilding (change as % of GDP)	42	0.5	-0.8	-0.2	0.1
Exports	1,749	7.1	-0.5	2.0	4.3
Imports	1,532	6.3	-0.2	2.6	3.7
Unemployment (%)		7.5	7.7	8.2	8.2
Employment		2.1	0.6	0.1	0.1
Industrial production		6.8	-2.9	1.5	3.5
Consumer prices		3.0	0.9	0.1	1.3
CPIF		1.4	1.0	1.1	1.5
Hourly wage increases		2.6	3.3	2.7	3.1
Household savings ratio (%)		10.1	10.3	10.2	10.5
Real disposable income		3.5	2.6	2.1	2.5
Trade balance, % of GDP		2.6	2.1	2.1	2.4
Current account, % of GDP		7.2	6.9	6.3	6.4
Central government borrowing, SEK bn		-68	25	161	63
Public sector financial balance. % of GDP		0.2	-0.7	-1.3	-1.3
Public sector debt, % of GDP		38.3	37.0	40.4	40.5

FINANCIAL FORECASTS	Feb 7th	Jun 13	Sep 13	Dec 13	Jun 14	Dec 14
Repo rate	1.00	0.75	0.75	0.75	0.75	0.75
3-month interest rate, STIBOR	1.17	1.10	1.10	1.10	1.10	1.10
10-year bond yield	1.95	2.00	2.05	2.10	2.20	2.40
10-year spread to Germany, bp	34	30	30	30	20	20
USD/SEK	6.43	6.25	6.36	6.48	6.61	6.75
EUR/SEK	8.61	8.50	8.40	8.30	8.20	8.10
TCW	116.9	115.3	114.4	113.4	112,8	112.0

FINLAND

Yearly change in per cent

	2011 level, EUR bn	2011	2012	2013	2014
Gross domestic product	189	2.8	-0.1	0.4	1.7
Private consumption	105	2.3	0.8	0.8	1.6
Public consumption	46	0.4	0.2	0.0	0.2
Gross fixed investment	37	7.1	0.7	1.8	3.5
Stockbuilding (change as % of GDP)		1.3	0.0	0.0	0.0
Exports	77	2.9	0.0	2.8	5.8
Imports	79	6.1	1.7	4.0	6.0
Unemployment (%)		7.8	7.7	8.2	8.1
Consumer prices, harmonised		3.3	3.2	2.3	2.1
Hourly wage increases		2.4	2.9	3.0	3.0
Current account, % of GDP		-1.6	-1.3	-1.2	-1.0
Public sector financial balance, % of GDP		-0.6	-1.0	-1.0	-0.8
Public sector debt, % of GDP		49.0	50.0	51.0	51.0

EURO ZONE

Yearly change in per cent

	2011 level, EUR bn	2011	2012	2013	2014
Gross domestic product	8,599	1.4	-0.5	-0.3	0.9
Private consumption	4,855	0.1	-1.2	-0.7	0.6
Public consumption	1,836	-0.1	-0.3	-0.4	0.2
Gross fixed investment	1,627	1.6	-3.4	-0.6	2.1
Stockbuilding (change as % of GDP)		0.1	-0.2	0.0	0.0
Exports	3,769	6.4	2.3	3.0	4.1
Imports	3,533	4.2	-0.3	2.5	3.6
Unemployment (%)		10.1	11.4	12.0	12.4
Consumer prices		2.7	2.5	1.5	1.5
Household savings ratio (%)		13.1	13.0	13.2	13.4

US

Yearly change in per cent

	2011 level, USD bn	2011	2012	2013	2014
Gross domestic product	15,321	1.8	2.2	2.1	2.7
Private consumption	10,874	2.5	1.9	1.7	2.3
Public consumption	3,051	-3.1	-1.7	-1.5	-1.0
Gross fixed investment	1,991	6.6	8.5	9.1	9.9
Stockbuilding (change as % of GDP)		-0.2	0.1	0.0	0.0
Exports	2,120	6.7	3.2	2.7	5.5
Imports	2,715	4.8	2.5	2.4	5.3
Unemployment (%)		8.9	8.1	7.5	6.9
Consumer prices		3.1	2.1	1.6	1.6
Household savings ratio (%)		4.2	3.9	4.3	4.5

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2011	2012	2013	2014
GDP				
United Kingdom	0.9	0.0	1.3	1.5
Japan	-0.5	2.0	1.3	1.5
Germany	3.2	0.7	0.6	1.6
France	1.7	0.1	0.2	0.5
Italy	0.6	-2.0	-0.9	0.4
Inflation				
United Kingdom	4.5	2.8	2.4	2.0
Japan	-0.3	-0.2	0.3	1.7
Germany	2.5	2.0	1.7	1.8
France	2.7	1.5	1.8	1.8
Italy	2.9	3.3	2.1	2.0
Unemployment (%)				
United Kingdom	8.2	8.1	7.9	7.9
Japan	4.6	4.3	4.2	4.0
Germany	5.6	5.5	5.7	5.7
France	9.9	10.6	11.5	11.4
Italy	8.4	10.7	11.8	11.6

EASTERN EUROPE

	2011	2012	2013	2014
GDP, yearly change in per cent				
Estonia	8.4	3.1	3.3	4.0
Latvia	5.5	5.3	3.8	4.5
Lithuania	5.9	3.6	3.2	3.5
Poland	4.4	2.0	2.1	3.5
Russia	4.3	3.4	3.4	4.0
Ukraine	5.2	0.2	1.8	3.5
Inflation, yearly change in per cent				
Estonia	5.1	4.2	4.3	4.4
Latvia	4.2	2.3	2.1	3.0
Lithuania	4.1	3.2	3.5	3.5
Poland	3.9	3.7	2.5	2.6
Russia	8.5	5.1	6.0	4.5
Ukraine	8.0	0.6	5.0	7.0

FINANCIAL FORECASTS

		Feb 07th	Jun 13	Sep 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	0.75	0.75	0.75	0.75	0.75
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	0.50
Bond yields							
US	10 years	1.99	2.10	2.15	2.20	2.40	2.60
Japan	10 years	0.76	0.90	1.00	1.10	1.20	1.20
Germany	10 years	1.61	1.70	1.75	1.80	2.00	2.20
United Kingdom	10 years	2.11	2.15	2.15	2.20	2.40	2.60
Exchange rates							
USD/JPY		93	92	93	95	100	107
EUR/USD		1.34	1.36	1.32	1.28	1.24	1.20
EUR/JPY		125	125	123	122	124	128
GBP/USD		1.57	1.60	1.53	1.47	1.48	1.46
EUR/GBP		0.85	0.85	0.86	0.87	0.84	0.82

GLOBAL KEY INDICATORS

Yearly percentage change

	2011	2012	2013	2014
GDP OECD	1.8	1.3	1.5	2.1
GDP world	3.8	3.3	3.7	4.1
CPI OECD	2.7	2.3	1.8	1.8
Export market OECD	5.8	2.4	4.7	6.2
Oil price, Brent (USD/barrel)	112.3	111.8	109.4	110.0

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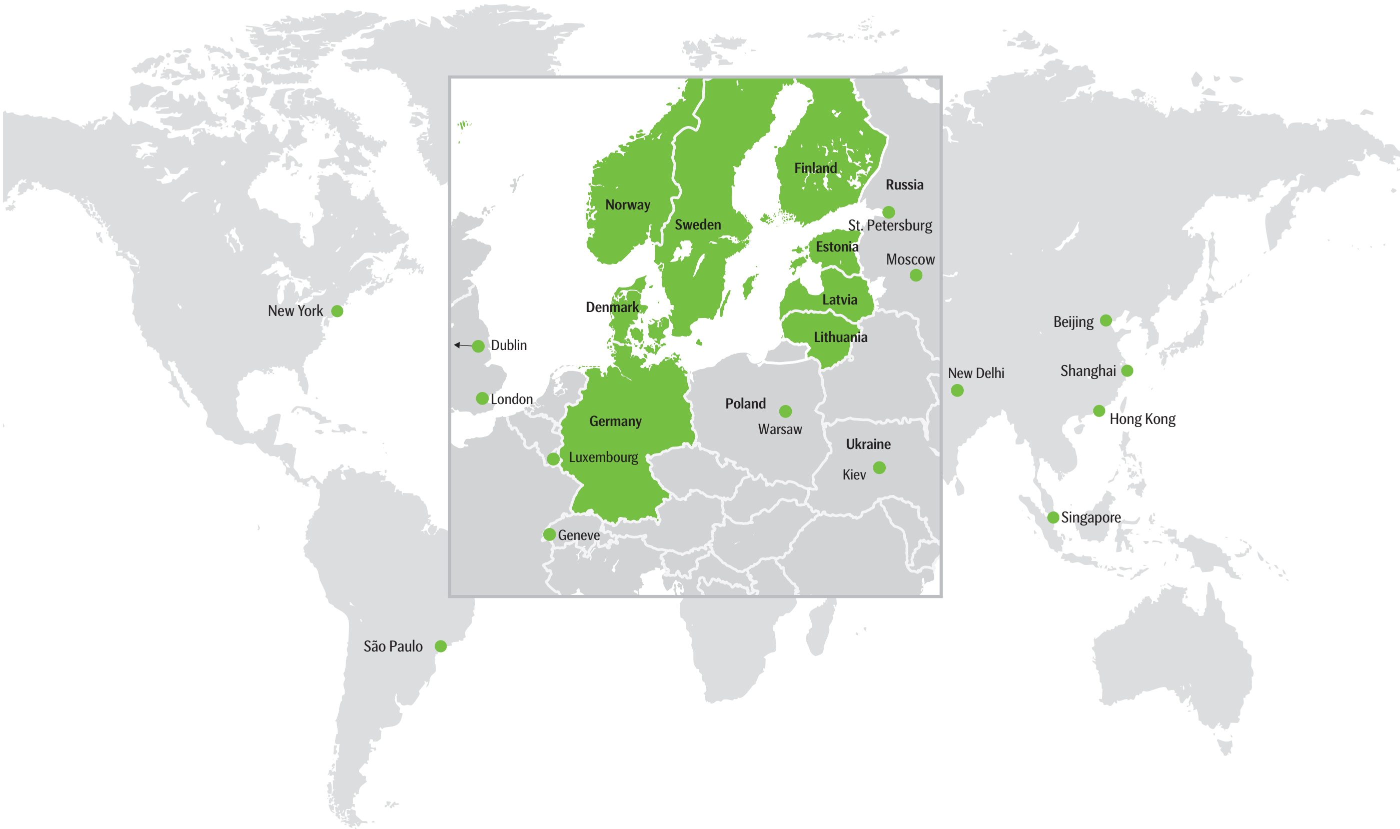

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