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Press release

Stockholm, February 12, 2013

Nordic Outlook: Monetary tailwind meets political headwind Global growth has bottomed out –deleveraging slows recovery

The needle of the world economic compass is pointing in the right direction. Our forecast scenario from the autumn of 2012 remains in place. Global growth will increase both in 2013 and 2014, but at a subdued pace and at divergent speeds in different countries and regions. A number of positive forces are in motion: global **monetary policy** is becoming more growth-focused; the recovery in the **United States** and **China** is on increasingly firm ground; **Japan** has launched a new economic stimulus programme; greater **political flexibility** permeates governments' fiscal tightening efforts and the introduction of banking regulations and standards; **the imbalances in the euro zone** are diminishing.

But it is too early to breathe a sigh of relief and lean back. Growth is being effectively held back because households, governments and banks in the Western world have not yet achieved their **debt consolidation** targets. There is still heightened **economic and political uncertainty** in the US, Europe and China due to American budget uncertainty, deep euro zone problems and China's change of leadership. This destabilises the optimism of industrial firms, which may easily be transformed into a self-amplifying downward spiral of postponed capital spending and hiring decisions. **Gross Domestic Product (GDP) in the 34 countries of the Organisation for Economic Cooperation and Development (OECD)** will grow by **1.5 per cent in 2013** (up from 1.3 per cent in 2012) and **2.1 per cent in 2014**. Global resource utilisation will be low during this forecast period. Continued high unemployment will push down the rate of pay increases. **OECD inflation will remain stable at 1-2 per cent**, even though the balance sheets of central banks will continue to grow during 2013.

The spotlight will fall on monetary policy and its targets, techniques and independence. This is because of low growth expectations and high unemployment in the OECD countries, while fiscal policy is constrained. **A monetary policy evolution or revolution** is unfolding. This means, for example, that an inflation targeting policy is being expanded into nominal GDP growth and nominal credit growth targets and a "fiscalisation" of monetary policy, in which the decisions of central banks move closer to governments and parliaments. The pattern that is emerging, in public discourse and with the US and Japan as practical examples, implies that central banks are being pressured to accept higher inflation and increased inflation risks in order to achieve lower unemployment and more job creation. In the short term, this is positive for global economic growth, but it pushes inflation expectations and long-term yields upward, increases the need for macroprudential supervisory tools and generates capital flows and appreciation pressure for Nordic and Asian currencies, among others. Our conclusion is that the **US Federal Reserve will leave its key interest rate at 0-0.25 per cent** during our forecast period, since US unemployment will end up at 6.8 per cent in 2014 – above the Fed's 6.5 per cent benchmark. **The Bank of England and the European Central Bank (ECB) will not touch their key rates during 2013-2014 either**.

The economic outlook in the US 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. US households are now close to debt levels that are sustainable in the long term. Meanwhile we expect home prices to climb by at least 10 per cent in 2013-2014. In addition, industrial firms have been under-investing for years. There will be no major growth surge, however, due to a dose of fiscal tightening totalling 1.2-1.5 per cent of GDP per year, and because of continued high unemployment. **American GDP will grow by 2.1 per cent this year and 2.7 per cent in 2014**. US federal budget policy is an obvious source of concern and growth risk, but we expect that given his politically stronger position, President Obama will reach agreements with Congress this spring. As a result, public sector debt will peak at 115 per cent of GDP in 2015 and then decline very slowly. **The Fed will hike its key interest rate only after our forecast**

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period, in the spring of 2015, while its bond purchases (quantitative easing) will end early in 2014. This exit policy will be end immediately if it leads to undesired increases in long-term yields.

In China, government economic policy is expected to become clearer this spring after the change of leadership, which will support higher capital spending and consumption. What is happening in China is a historic economic, financial and political experiment with an uncertain outcome. Social discontent, home price and goods inflation, border disputes as well as questions about – and the impact of – China's new growth model are significant risks to growth, but the likelihood that they will materialise during our forecast period is small. **We expect China's GDP to grow by 8.1 per cent in 2013 and by 7.7 per cent in 2014**. This is above the political target of 7.5 per cent and well above the 6 per cent GDP growth that is regarded as a critical level to enable the country to avoid rising unemployment. The central bank will begin a cautious key interest rate hiking cycle late in 2013 from a rate of 6.00. We expect the yuan to become about 5 per cent stronger against the US dollar during 2013-2014.

The euro zone's acute crisis has faded but its problems are far from solved. Euro zone countries have made both economic and political progress. Without the presence of the ECB's crisis mitigation mechanisms, however, borrowing costs for governments and banks would not have fallen and financial stress decreased. Corrections are under way in euro zone competitiveness and imbalances, but further structural reforms are necessary to create lasting current account surpluses that will reduce large external debts and refinancing risks. **We expect the euro zone to show near-zero growth in 2013-2014, while unemployment will rise to a new record level of 12.4 per cent**. According to the OECD, the euro zone's banking system is EUR 400 billion undercapitalised, which hampers credit supply and economic growth.

Our euro zone scenario still contains large elements of political uncertainty. European cooperation and crisis resolution capacity will be tested at both national and supranational levels by social pressures and coming parliamentary elections (for example in Italy and Germany in 2013 and at the EU level in 2014) and growing calls for referendums related to the emergence of a new European political union. There is still a disturbingly high probability that at least one country, for example Greece, will choose to withdraw from the euro zone, although the immediate risk has diminished. As we have indicated earlier, we believe that Spain will need an emergency loan to deal with that instability that permeates the Spanish economy and banking system. During the next two years, an escalating debate on the future of both the euro and the EU will add uncertainty to economic policy, thus hampering growth. As a result of this, we predict that **the euro will lose value against the dollar**, especially **during 2014**; the **EUR/USD exchange rate in December 2014 will stand at 1.20**.

Sweden's economic slowdown will persist in 2013-2014, but growth has already bottomed out despite a surprisingly weak year-end 2012. We are thus sticking to the forecast we presented last autumn. The recovery will occur with support both from underlying capital spending and consumption potential and from the government and the Riksbank (Sweden's central bank), which will take new steps to stimulate the economy. The dose of government fiscal stimulus in 2014 will be as large as in 2013 (about SEK 25 billion or 0.7 per cent of GDP), focusing primarily on households for tactical political reasons: next year's parliamentary elections at the EU and national levels. The net lending deficit will be about 1.5 per cent of GDP in both forecast years, and central government debt will climb by 3 percentage points to more than 36 per cent of GDP (including the latest loan to the Riksbank). Yet these developments will pose no threats to confidence that would raise Sweden's interest rate margins. Sweden's zero inflation environment, the fiscal stimulus and this spring's new collective agreements in the labour market – which are expected to result in total pay increases of less than 3 per cent – will generate strong real purchasing power for households, whose overall savings ratio will be above 10 per cent. **Sweden's GDP will grow by 1.2 per cent in 2013** (up from 0.8 per cent in 2012) **and will reach 2.5 per cent in 2014**.

The Riksbank will cut its key interest rate to 0.75 per cent and then leave it unchanged for the rest of our forecast period. There are a number of reasons for this. Resource utilisation will remain low and unemployment will be at a high 8.2 per cent in 2014, or 1.5 percentage points higher than on the day of the 2006 parliamentary election. Cost pressures are being pulled down, and inflation – both CPI and CPIF inflation (CPI without interest rate changes) – will stay below 2 per cent during our forecast period. Meanwehile global monetary policy is moving towards greater flexibility in interpreting the scope for inflation, and this will result in expansionary monetary conditions for extended periods. **The Riksbank will find it difficult to "stand out from the crowd" without pushing up the value of the Swedish krona**. Our forecast is that in

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effective exchange rate terms (TCW), the krona will appreciate by **4 per cent. This is equivalent to an interest rate hike of around 1 percentage point**. In December 2013, the **EUR/SEK and USD/SEK exchange rates will be 8.30 and 6.50, respectively; in December 2014 they will stand at 8.10 and 6.75**.

As earlier, the joker in the pack when setting the key interest rate is household debt. Our forecast is that household debts will increase by 4-5 per cent a year in 2013-2014. We believe this is consistent with the Riksbank's tolerance level. According to our calculations, stable home prices combined with low residential investments indicate that lending growth will decelerate rather than accelerate. **Too much focus on debt may also turn into a growth risk for Sweden.** Looking ahead, we expect housing construction in Sweden to be low in relation to population growth. This is due to such factors as building legislation and rent controls, which affect profitability. Since the Swedish political landscape does not allow room for decisions that will stimulate construction, understandably restrictive lending practices may also worsen the construction situation even more, adversely affecting long-term growth. The need for macroprudential supervisory tools is increasing, but due to disunity among the Riksbank, government and Financial Supervisory Authority about these tools and the allocation of responsibility – as well as the need for international coordination – it may take time before such tools are in place. **This is a major dilemma for the Riksbank**.

A subdued global recovery will mean that the other Nordic countries and the Baltic countries must rely on stronger domestic demand – consumption and capital spending – for increased economic activity during the next two years. The potential is good, thanks to generally strong fundamentals. **Norway** will continue to stand out, sustained by both its domestic economy and demand for oil. **GDP growth will end up at 2.4 per cent in 2013 and 2.3 per cent in 2014**. Norges Bank will begin its interest rate hiking cycle this autumn; the bank's key rate (now 1.50 per cent) will be 1.75 per cent at the end of this year and at 2.50 per cent at the end of 2014. If appreciation pressure against the Norwegian krone becomes too great, key rate hikes will be postponed. Meanwhile the situation is troublingly weak in **Denmark** and **Finland**, and **GDP growth will barely exceed 1.5 per cent in 2014**. Danish households are being squeezed by high debt and a continued weak real estate market. Finland's export sector is clearly feeling the impact of problems elsewhere in Europe, but is expected to benefit from the higher Swedish krona. In **Estonia** and **Lithuania**, growth will end up **just above 3 per cent in 2013** while **Latvia** will achieve **nearly 4 per cent**. During 2014, growth in the three Baltic countries will reach **around 4 per cent**. A continued favourable economic trend in the Baltics may be jeopradised by accelerating pay increases, in the absence of corresponding productivity gains. Latvia will switch to the euro on January 1, 2014.

Key figures: International and Swedish economy

International economy. GDP, year-on-year changes, %	2011	2012	2013	2014
United States	1.8	2.2	2.1	2.7
Euro zone	1.4	-0.5	-0.3	0.9
Japan	-0.5	2.0	1.3	1.5
OECD	1.8	1.3	1.5	2.1
China	9.3	7.8	8.1	7.7
Nordic countries	2.3	1.0	1.3	2.2
Baltic countries	6.4	4.0	3.4	3.9
The world (purchasing power parities, PPP)	3.8	3.3	3.7	4.1
Swedish economy. Year-on-year changes, %				
GDP, actual	3.7	0.8	1.2	2.5
GDP, working day corrected	3.7	1.1	1.2	2.7
Unemployment, % (EU definition)	7.5	7.7	8.2	8.2
Consumer Price Index (CPI) inflation	3.0	0.9	0.1	1.3
Government net lending (% of GDP)	0.2	-0.7	-1.3	-1.3
Repo rate (December)	1.75	1.00	0.75	0.75
Exchange rate, EUR/SEK (December)	8.91	8.58	8.30	8.10

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