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Press release

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Nordic Outlook: Fight against economic slowdown escalates
Sweden under pressure to re-assess its economic policy framework

The growth rate in the world economy is accelerating, but activity is still divergent and anaemic. **Gross domestic product (GDP) in the 34 countries of the Organisation for Economic Cooperation and Development (OECD)** will grow by **1.3 per cent in 2013** and **2.3 per cent in 2014**. Our scenario of low international price pressures remains in place; if anything, **inflation has provided downside surprises** because of low resource utilisation and downward pressure on wages and salaries as well as on commodity prices. Meanwhile both fiscal austerity policies and the targets, techniques and independence of central banks are under re-assessment. Although official economic policies enjoy market confidence – as reflected, among other things, by low bond yields and rising stock markets – changes in fiscal and monetary policy are also creating uncertainty.

Factors **on the plus side** for global growth are **cyclical forces and monetary policy**. Capital spending and inventory levels are depressed. In the United States, which is playing a key role in the economic recovery, household consumption is buoyed by rising home prices and share prices as well as by the near-completion of the debt deleveraging process. Emerging economies will accelerate cautiously, although several of these countries have suffered recent setbacks. Various central bank actions are ensuring low interest rates and an unlimited supply of liquidity, while fiscal austerity policies are being softened. On the **minus side** is the euro zone, which – despite its progress in correcting imbalances – is still struggling with a dangerous combination of weak growth, undercapitalised banking systems and inadequate credit supply, high government debt and political instability.

Central banks are continuing to postpone their exit policies. They are able to do so because of low inflation, weak growth and the development of alternative (macroprudential) tools. The main risks associated with unconventional monetary policies have to do with the failure of political leaders to make necessary reform decisions and with malfunctions in financial market pricing. **We expect the US Federal Reserve to continue its monthly securities purchases during 2013** and to begin a phase-out only in early 2014. The federal funds rate will remain at **0-0.25 per cent** throughout our forecast period. The European Central Bank (**ECB**), like Sweden's **Riksbank, will lower its key interest rate this summer by 0.25 percentage points** – to 0.25 and 0.75 per cent, respectively. These rates will remain in place until the end of 2014. We do not expect the ECB to introduce negative interest rates, due to the risk of undesired effects in the functioning of the interbank market and systemic technical problems. **The upturn in long-term yields until the end of 2014 will not exceed 40-60 basis points**. If the easing of fiscal austerity policy is not supplemented by restructuring measures and long-term plans to bring down government debt – while monetary policy is increasingly subjected to political control – there is a risk of significantly driving up both inflation expectations and interest rates.

In terms of global economic and financial policies, Japan is a joker in the pack. The international community and the Japanese themselves have given the green light to "Abenomics", a set of economic policies named for Prime Minister Shinzo Abe. During our 2013-2014 forecast period, Japan's expansionary fiscal policies and radical monetary policies will signify a positive injection in the world economy via faster growth and downward pressure on global interest rates. In the long term, Japan is instead a risk factor. Unless Abenomics leads to higher pay and increased labour market participation, especially for women, Japan will have a destabilising effect on the world economy. **Our risk analysis** implies that an upturn in Japanese long-term yields of 150-200 basis points (to 2.5-3 per cent) is manageable both to Japan and the world.

The **euro zone** is struggling with **serious challenges** that are **keeping the future of the euro project uncertain. We expect GDP in the currency area to fall by 0.7 per cent in 2013 and grow by 0.7 per cent in 2014**. The **German economy** is also feeling the effects of euro zone recession, and we expect GDP growth of only **0.3 per cent this year** and **1.3 per cent in 2014**. Chancelor Angela Merkel will not deliver an expansionary fiscal policy, despite the September 2013 election and international calls for more active German budget stimulus. The economic performance of France will be even worse, with President François Hollande under pressure to turn around an unfavourable trend. ECB monetary policies and the European Stability Mechanism (ESM) bail-out fund have nevertheless sharply reduced the liquidity risks facing euro zone governments and banks. Ongoing competitiveness adjustments and belt-tightening policies are pushing down current account and budget deficits in various crisis-hit countries of the euro zone. The easing of austerity measures will give countries more time to achieve fiscal targets and to stabilise their political and economic situation.

But other fundamental problems remain. The credit supply in southern Europe is inadequate, due to weak banks, over-indebted households and businesses as well as falling home prices. Current account improvements are mainly attributable to weak domestic economies. **Unemployment will continue to climb, reaching a new record level of 12.4 per cent in 2014**. Efforts to create a political union – an important stabilising factor – are taking ever-shorter and slower steps forward. The euro is being pushed down by the economic trend. The fact that austerity policies are being re-assessed may also lead to uncertainty about the sustainability of international bail-out loan agreements. **The EUR/USD exchange rate will stand at 1.26 by the end of this year and 1.20 at the end of 2014**.

The US economy will continue its rebound after a temporary slowdown in activity during the next few quarters, due among other things to the automatic "sequester" cutbacks in the public sector. We expect **GDP** to grow by **2.0 per cent in 2013** and by **3.2 per cent in 2014** without signs of rising inflation pressure. The labour market will improve slowly, but since the ongoing decline in labour market participation will level out, unemployment will not drop to 6.5 per cent – the level at which the Fed is supposed to re-assess its near-zero key interest rate – before the end of 2014. Budget policy remains a source of political turbulence, but federal budget deficits are shrinking faster than expected. We forecast that federal debt will peak at 105-110 per cent of GDP. Meanwhile the housing market will continue to recover, with home prices rising 7-10 per cent both in 2013 and 2014.

The slowdown in China during the past few months does not change our overall picture of continued solid **GDP growth of 7.9 per cent in 2013 and 7.7 per cent in 2014**, well above China's critical growth level of 6 per cent. The leadership change has now been formally completed, but it is too early to say how willing the Xi administration is to implement reforms. Generally speaking, inflation pressure is low, with core inflation below 2 per cent and producer prices still falling year-on-year. Home prices have begun to accelerate, increasing the pressure for measures to slow credit expansion. During the fourth quarter of 2013, the central bank will hike its key interest rate by 0.25 percentage points to 6.25 per cent. By the end of 2014, the key rate will be at 6.75 per cent. The yuan will continue to appreciate, but at a somewhat slower pace. At the end of 2014, the USD/CNY exchange rate will be 6.00.

In Sweden the recovery is continuing, but at a troublingly slow pace. The euro zone is weighing down exports and capital spending growth, while strong households will keep consuming despite rising unemployment. An increasing labour supply during the next couple of years, following a more long-term trend that has included a sharp reduction in the number of people taking sick leaves and early retirement as well as an increase in those working past their 65^{th} birthday, will lead to a continued rise in unemployment during 2013 to 8.2 per cent, followed by a cautious decline in 2014. **GDP will grow by 1.3 per cent in 2013 and 2.5 per cent in 2014. We expect the Consumer Price Index (CPI) to show weak deflation in 2013, and price increases in 2014 will be a modest 0.8 per cent**. Household consumption will be sustained by strong income growth, a high savings ratio (11.4 per cent) and rising stock market prices. We expect home prices to rise by 5 per cent this year and level out in 2014 when the government, Riksbank and Financial Supervisory Authority take action, by means of recommendations and possible new changes in risk weights for home mortgage loans, aimed at slowing the upward price trend. Falling resource utilisation and continued low inflation – Sweden's new collective pay agreements, for example, are among the lowest three-year contracts concluded in the past two decades – will persuade the **Riksbank to lower its repo rate in July to 0.75 per cent**. This level will remain in force for the rest of our forecast period. The government will raise its dose of fiscal stimulus by SEK 10 billion for the election year 2014 (to SEK 35 billion, or 0.9 per cent of GDP) compared to the 2013 budget. **The net lending deficit will be 2 per cent of GDP in 2014**.

Sweden's 20-year-old economic policy framework is facing an intensified debate. Over the past decade, underlying inflation (CPIF) has been below target more than 80 per cent of the time. The Riksbank's sizeable revision of its inflation outlook earlier this year is probably one step towards admitting that long-term inflation will be lower. The bank's policy dilemma is further accentuated by a continued rise in home prices and household debt. Meanwhile the government finds it increasingly difficult to explain that a budget surplus target of 1 per cent of GDP still applies. This runs a risk of undermining the credibility of the policy framework. The surplus target has actually assumed a greater tightening effect on the central government budget. Net lending in the old age pension system is now around zero, instead of the earlier surplus of 1 per cent of GDP. This means that it used to be sufficient for the budget to be in balance – now it must show a surplus to meet the target. **Our conclusion is that Sweden is ripe for a far-reaching review of the economic policy framework; a first step would be to decide that public finances must be in balance** (not show a 1 per cent surplus).

From **a Nordic perspective** – like at the global level – the economic picture is showing more and more divergent trends. Even though the euro has weakened, the Danish and Finnish economies are characterised by stagnation. In both countries, slumping exports are combined with sagging domestic demand. In **Denmark, GDP will increase by 0.2 per cent this year and 1.6 per cent in 2014**; corresponding **figures for Finland are a decline of 0.2 per cent and an increase of 1.6 per cent**. At present there is no indication that the governments of the two countries are prepared to follow the international trend and use fiscal policy more actively to stimulate growth. In Norway, the domestic economy is more resilient. We expect **GDP growth in Norway of 1.7 per cent this year and 2.4 per cent in 2014**. Because of low inflation pressure and the risks of an excessively strong krone if Norges Bank diverges from the global central bank pattern, the expected key interest rate hike will be postponed and will not occur until the spring of 2014. **The Norwegian krone will trade at 7.45 per euro by the end of 2013 and 7.35 by year-end 2014. Our corresponding EUR/SEK exchange rate forecasts are 8.35 and 8.10, respectively**.

The three Baltic countries have been the fastest-growing economies in the EU for three years. Expansion is now slowing in Latvia and Lithuania, while **Estonia's growth in 2013** will largely be unchanged compared to 2012, at **3.3 per cent**; next year, activity will increase by **3.7 per cent**. In **Latvia**, we expect growth of **3.5 per cent this year** and **4.8 per cent** in 2014; the corresponding **figures for Lithuania are 3.2 per cent and 3.5 per cent**. Growth in these three countries is mainly being driven by private consumption, although exports will also grow decently thanks to good competitiveness after earlier internal devaluations. In Estonia, however, cost pressures have begun to emerge in the wake of high pay increases. We are sticking to our assessment that Latvia will get the green light to introduce the euro at the beginning of 2014. There is a 50 per cent chance that Lithuania will achieve its target of euro zone accession in 2015, since the country will find it difficult to bring inflation below the maximum qualifying level.

Key figures: International and Swedish economy

International economy. GDP, year-on-year changes, %	**2011**	**2012**	**2013**	**2014**
United States	1.8	2.2	2.0	3.2
Euro zone	1.6	-0.6	-0.7	0.7
Japan	-0.6	2.0	1.7	1.4
OECD	1.8	1.3	1.3	2.3
China	9.3	7.8	7.9	7.7
Nordic countries	2.3	1.0	1.0	2.2
Baltic countries	6.4	4.1	3.3	3.9
The world (purchasing power parities, PPP)	3.8	3.3	3.6	4.2
Swedish economy. Year-on-year changes, %				
GDP, actual	3.7	0.8	1.3	2.5
GDP, working day corrected	3.7	1.2	1.3	2.7
Unemployment, % (EU definition)	7.8	8.0	8.2	8.1
Consumer Price Index (CPI) inflation	3.0	0.9	-0.1	0.8
Government net lending (% of GDP)	0.0	-0.7	-1.5	-2.0
Repo rate (December)	1.75	1.00	0.75	0.75
Exchange rate, EUR/SEK (December)	8.91	8.58	8.35	8.10

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