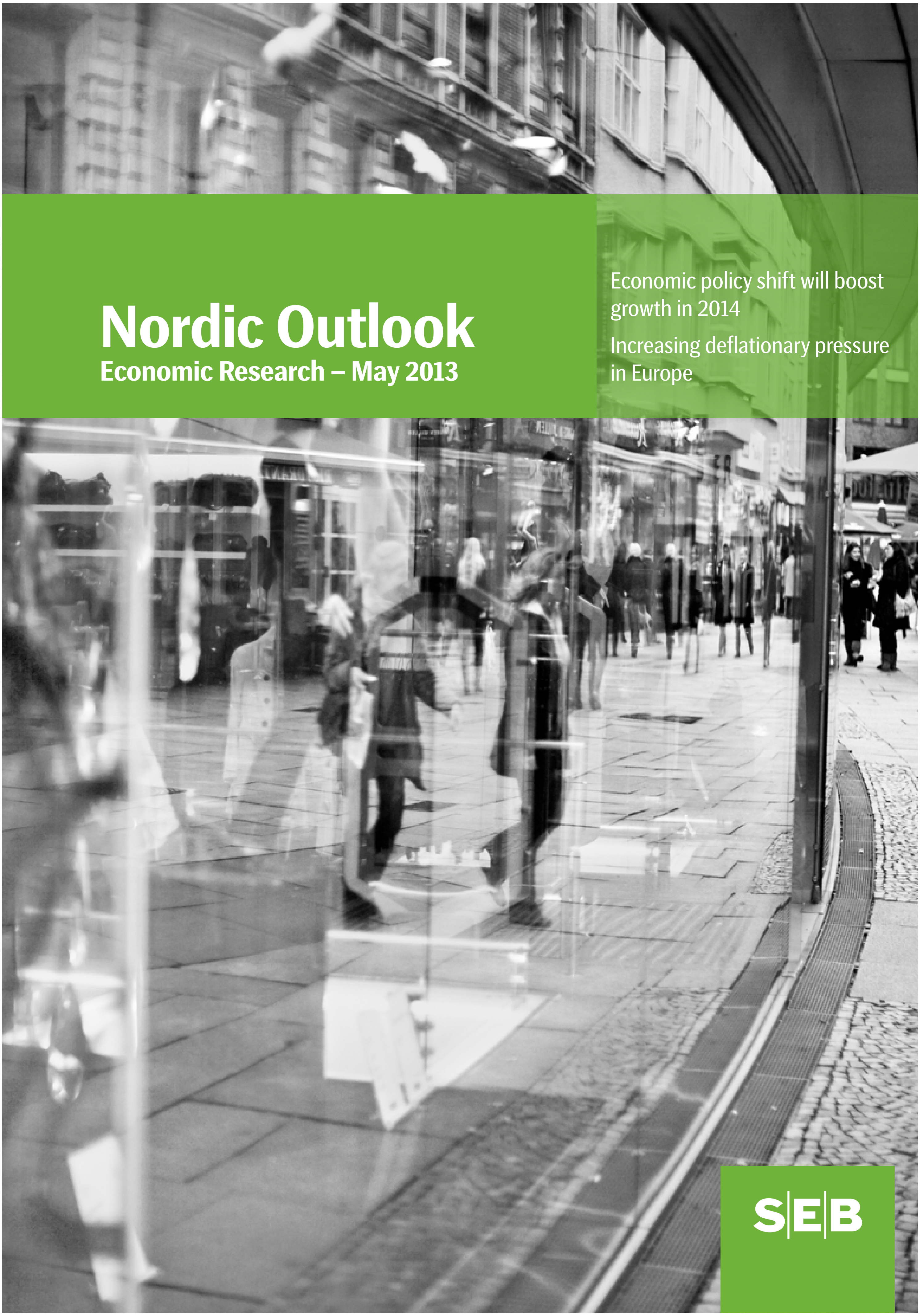
Nordic Outlook

Economic Research – May 2013

Economic policy shift will boost growth in 2014

Increasing deflationary pressure in Europe



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Recovery with increasingly clear divergences

- **Broad recovery will lift US economy in 2014**
- **Central banks testing limits**
- **Increased deflation risks in euro zone**
- **Fiscal austerity being eased**
- **Small upturn in bond yields**
- **USD appreciating against both EUR and JPY**

The world economy is on its way towards recovering. The growth rate will gradually rise in 2013 and 2014, but the recovery is **divergent and anaemic**. The main factors on the plus side are cyclical forces and economic policy. Global inventory levels are squeezed and corporate balance sheets are strong. **In the United States, the housing market and capital spending are rebounding** while household debt levels are now close to long-term equilibrium. Emerging economies will also accelerate cautiously, although several important countries have suffered reversals. **Central banks are setting new monetary records**. Their actions are ensuring historically low interest rates and an unlimited supply of liquidity. Stock markets have reacted positively, and rising household wealth is benefiting private consumption in many countries. A shift in attitudes towards austerity policy is also now under way. In the euro zone, crisis-hit countries are being granted longer respites to achieve their targets. This means that governments are abstaining from unveiling new belt-tightening measures.

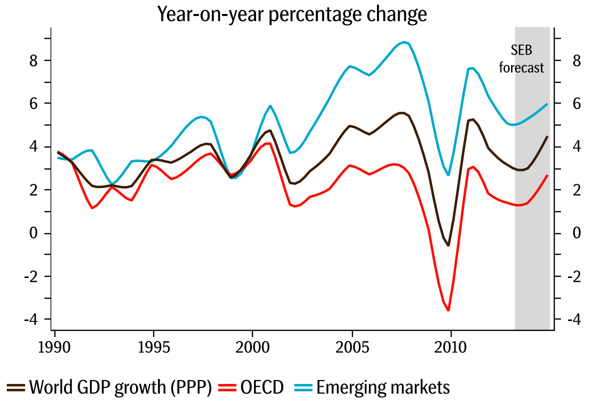
Despite many positive forces, the global recovery is surrounded by continued uncertainty. **The downside risks are mainly connected to the major problems of the euro zone**. Although a number of countries have made progress in terms of competitiveness and foreign trade imbalances, negative forces continue to predominate. Many economies are still in recession. Unemployment will continue to rise in the next few years, leading to persistent political uncertainty. The integration process is proceeding sluggishly and today there is still a risk that joint and national institutions will be incapable of making necessary decisions to ensure the survival of the euro. High private and public sector debt in the largest industrialised countries is also an impediment to long-term growth. **China's rapid growth is also associated with risks**, especially in the credit market. Its economic policies are being re-assessed and their contours remain unclear.

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 very expansionary set of fiscal and monetary policies named for Prime Minister Shinzo Abe. During our forecast period, 2013 and 2014, these policies will signify a positive injection in the world economy by means of higher growth and downward pressure on global interest rates. In the long term, Japan instead constitutes a risk factor. In order for "Abenomics" to succeed in a sustainable way, the weakening of the yen must result in higher pay increases, thereby ending Japan's deflation spiral. Restructuring policies that lead to higher labour force participation, especially for women, are another important element of this strategy.

Overall, we expect GDP growth in the 34 countries of the Organisation for Economic Cooperation and Development (OECD) to end up at 1.3 per cent in 2012 and in 2013 and to accelerate to 2.3 per cent in 2014. In emerging economies, there will be an acceleration to 5.3 per cent in 2013 and 5.6 per cent in 2014. For the overall **world economy** (in terms of purchasing power parities, PPP), **growth will rise from 3.3 per cent in 2012 to 3.6 per cent in 2013 and 4.2 per cent in 2014**. Compared to *Nordic Outlook* in February, this represents a downward adjustment in 2013 but a more rapid upturn in 2014.

Growth has bottomed out

Year-on-year percentage change



Source: IMF, OECD, SEB

Our scenario of low international price pressures remains in place: **if anything, inflation has provided downside surprises**. This gives central banks substantial room for manoeuvre. Looking ahead, low resource utilisation and downward pressure on wages and salaries indicate that the low-inflation environment will persist. Inflation expectations are stable and commodity prices have recently shown a falling trend. Especially in Europe, there is a mounting risk of excessively low inflation with elements of Japanese economic policy problems.

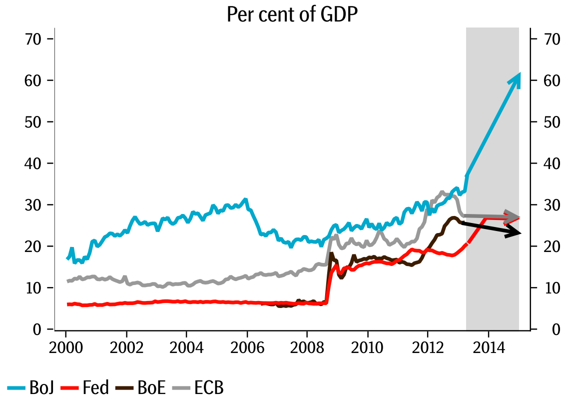
Central banks stretching their limits

Low interest rates, rising inflation expectations and higher share prices indicate that economic policies are inspiring confidence. **But this is a high-stakes game**; it is all happening in an environment of economic, financial and political regime changes in the aftermath of globalisation and global recession. Decision makers around the world are seeking new national and international consensus views about such matters as the causes and effects of inflation, financial infrastructures and the interplay among monetary, fiscal and regulatory policies.

Unconventional monetary policy is continuing in an expansionary direction. The US Federal Reserve is keeping its key interest rate at 0-0.25 per cent, while its monthly USD 85 billion in purchases of government and mortgage-backed securities will be **cautiously phased out only in early 2014**. The Bank of Japan and Bank of England are not expected to take further steps beyond the instruments/volumes already announced. **The European Central Bank (ECB), like Sweden's Riksbank, will lower its key interest rate** by another 25 basis points, but 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. In emerging economies, interest rates will remain relatively stable at significantly higher levels.

Central bank balance sheets continue to swell

Per cent of GDP



Source: BoJ, Fed, BoE, ECB

Central banks are grappling with three main questions that will shape monetary policy in a slightly longer perspective:

New inflation pattern? Central banks today are uncertain about the causes of inflation. The size of the output gap is difficult to determine after a relatively long period of low capital spending and high unemployment. Meanwhile the monetarisation of economies poses new risks. Low inflation and inflation expectations make it possible to continue pursuing a low interest rate policy with increased focus on growth and new jobs, but the risk of new financial bubbles may become a problem.

Distorted pricing? Long-lasting monetary stimulus increases the risk of incorrect pricing of credit and market risks. It is clear that riskier assets have risen in value with the help of liquidity and low interest rates and that financial market players are under pressure to fill their balance sheets with more risk.

Macroprudential tools? Instruments that can directly influence credit volume by means of regulations and requirements that govern the balance sheets of banking systems (size/composition) will play a bigger role in the future. But today there is disagreement at both the national and global level about the effectiveness and reliability of various instruments. The allocation of responsibility among governments, central banks and regulatory authorities is also unclear in most countries.

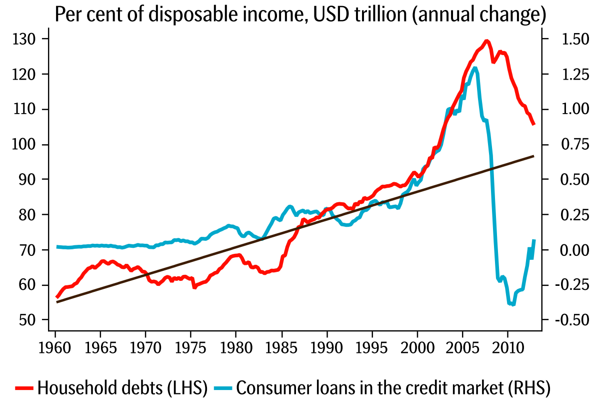
The effectiveness and impact of monetary policy depends on fiscal credibility. A theme article (page 11) in this issue discusses in greater detail the short- and medium-term fiscal policy shift in a more neutral direction that is now on its way to being implemented. It is important for this to be supplemented with restructuring measures and long-term plans to bring down government debt. We can also discern certain signs that monetary policy is being increasingly subjected to political control. If this trend continues, it may drive up future inflation expectations and interest rates.

Continued US upturn after temporary slump

The underlying conditions for a lasting US economic upturn are improving. **The housing market is in the process of recovering in earnest**, while by late 2013 household debt will decline to what we view as an equilibrium level. Debt will have fallen from a peak of 130 per cent of annual disposable income to about 100 per cent. Looking ahead, this will lay the groundwork for stronger private consumption. A renaissance for American industry, especially in the energy sector, is another reason **we have revised our GDP growth forecast upward to 3.2 per cent in 2014**. This is higher than both trend growth and the current consensus forecast.

Household deleveraging approaching its target

Per cent of disposable income, USD trillion (annual change)



Source: Federal Reserve, SEB

During the next few quarters, however, we foresee a certain slowdown. Several leading indicators have fallen in recent months, and the sharp 2013 US fiscal tightening is equivalent to about 2 per cent of GDP: a somewhat more severe headwind than we had previous expected. GDP growth this year will thus reach only 2.0 per cent.

The US labour market will continue to improve at a fairly slow pace. Although the April figure was better than expected, during the next few quarters the growth slump will affect employment. Companies are also trying to restore productivity growth and profit margins, thus hampering job growth. We expect employment to increase by an average of 140,000 jobs per month in 2013. The 2014 figure will be 220,000. Labour market participation will continue to fall. By the end of 2013 it will be at its lowest level in 30 years. This is one reason why unemployment will fall somewhat this year. It will then continue downward to 6.6 per cent in December 2014. **Unemployment**

will thus remain above the Fed's 6.5 per cent benchmark throughout our forecast period.

Global GDP growth

Year-on-year percentage change

	2011	2012	2013	2014
United States	1.8	2.2	2.0	3.2
Japan	-0.6	2.0	1.7	1.4
Germany	3.2	1.0	0.3	1.3
China	9.3	7.8	7.9	7.7
United Kingdom	1.0	0.3	1.1	1.6
Euro zone	1.6	-0.6	-0.7	0.7
Nordic countries	2.3	1.0	1.0	2.2
Baltic countries	6.4	4.1	3.3	3.9
OECD	**1.8**	**1.3**	**1.3**	**2.3**
Emerging markets	6.3	4.9	5.3	5.6
World, PPP	**3.8**	**3.3**	**3.6**	**4.2**
World, nominal	3.1	2.6	2.9	3.5

Source: OECD, SEB

Slowdown occurring as planned in China

After a recovery in Asian emerging economies, activity again slowed early in 2013. We expect growth to be somewhat below trend during the next couple of years, but still significantly higher than in the OECD countries.

GDP growth in China slowed to 7.7 per cent during the first quarter. This figure led to disappointment in financial markets but is in line with the official growth target of 7.5 per cent in 2013, a rate we believe is equivalent to trend growth. The contribution from consumption exceeded that from capital spending, another step in the right direction towards a growth model based to a greater extent on domestic consumption. Looking ahead, we expect growth to accelerate slightly, averaging **7.9 per cent in 2013 and 7.7 per cent in 2014**.

China's leadership change has now been formally completed, **but it is still too early to determine how willing the new leadership is to implement reforms**. In the near future, economic policy makers will face a dilemma because credit growth remains at a high level despite the economic slowdown. Credit expansion outside traditional bank lending is a particular source of concern. Since late 2012 the central bank has used repo transactions to withdraw liquidity. Our assessment is that the bank will hold off on raising its key interest rate until late 2013, when a 25 basis point hike to 6.25 per cent will occur.

Economic activity in India probably bottomed out in the fourth quarter of 2012, when it reached a weak 4.4 per cent year-on-year rate, but there are not yet any clear signs of recovery. Purchasing managers' indices, for example, are well below their historical average. Overall, though, we still believe **GDP will rise 5.5 per cent in 2013 and 6.0 per cent in 2014.**

A sizeable government budget deficit rules out fiscal expansion, but the slowdown in inflation over the past few months provides some support. In April, inflation (WPI) was 4.9 per cent, the lowest figure since late 2009. So far the central bank has lowered its key interest rate three times, and we expect more rate cuts during the second half of 2013.

Euro zone crisis rolls on

Developments in the euro zone crisis are characterised by both positive and negative trends. Crisis-hit countries have progressed quite far in improving their external balances, and several countries have also substantially adjusted their cost situation. Yet the peripheral euro zone countries – Cyprus, Greece, Ireland, Italy, Portugal and Spain, which together account for 40 per cent of the currency area – continue to show a dangerous combination of weak growth, high bond yields, continued large budget deficits, high government debt and political instability. **Because of these serious challenges, the future of the euro project remains uncertain.**

The euro zone **economic outlook** is weak due to continued adjustments in balance sheets, especially in southern Europe. Unlike the US, the household sector still faces most of the deleveraging process aimed at bringing its debts down to more reasonable levels. **Financially**, borrowing costs – and solvency risk – for governments and banks have been lowered sharply with the help of the ECB's Long-Term Refinancing Operation (LTRO) and Outright Monetary Transaction (OMT) programmes and the European Stability Mechanism (ESM), a bail-out fund. **Politically**, some restructuring policies have begun to bear fruit, but there are lingering questions about the ability of governments and parliaments to stick to the decisions they have made, while also making new decisions about growth and restructuring policies. In addition, steps towards a euro zone political union seem to be shorter and slower. **Socially**, the euro zone crisis is reflected by continued rising unemployment in several of the crisis-hit countries.

One fundamental problem in southern Europe is that the transmission mechanism is not working. There are various reasons why even solvent companies have difficulty getting loans. Banks are squeezed by undercapitalisation, low profit levels and a growing percentage of bad loans. Home prices are continuing to fall, for example in Spain, and additional downward adjustment remains in some countries. Borrowing costs for companies in euro zone crisis countries are also about 2 percentage points higher than in other euro zone countries, adversely affecting the competitiveness of these companies.

The task of creating a banking union aimed at decoupling debt-ridden governments from weak banks is stumbling a bit. Looking ahead, we also expect **Spain and Slovenia to receive support in order to recapitalise the banking sector**.

Overall, we predict that the euro zone economies will show zero growth in the third quarter after a downturn in the first half of 2013. Not until the fourth quarter will GDP increase. **Measured as annual averages, GDP will fall by 0.7 per cent in 2013 and then increase by 0.7 per cent in 2014**. Because the economy will again be growing at below trend in 2014, unemployment will continue upward. There are major differences among euro zone countries, but even the German export sector is now being affected by the crisis. GDP growth in Germany will end up at a low 0.3 per cent this year and then increase to 1.3 per cent in 2014. The French economy will largely be stagnant in both years.

Symmetric risk picture

As in the February *Nordic Outlook*, we view the risks to our main scenario as symmetric. **Despite an upward revision in our growth forecast for the US, upside potential still predominates.** Rising wealth due to both higher home and share prices may contribute to an even clearer consumer-led recovery in the US.

On the downside, **the main risks are that the economic and political crisis in the euro zone will be deeper than we expect in our main scenario.** We also see certain downside risks in our forecast for the Chinese economy. This perhaps mainly concerns the longer-term effects of demographic changes, but during our forecast period, credit market turbulence may also create difficulties for economic policy makers in keeping growth at the desired level.

Alternative scenarios

Year-on-year percentage change

	2013	2014
A. Deeper euro zone crisis/Chinese risks (15%)		
United States	1.5	1.7
Euro zone	-1.5	-1.0
OECD	**0.5**	**0.8**
Emerging market economies	4.3	4.4
B. US-led recovery (15%)		
United States	3.2	4.5
Euro zone	0.5	2.0
OECD	**2.5**	**3.5**
Emerging market economies	6.0	6.7

Overall, we estimate the probability of our main scenario at 70 per cent, **while assigning a 15 per cent probability to both alternative scenarios.** This implies a lower probability for the alternative scenarios than previously. The reason is that we have already raised our basic forecast of US growth. On the downside, the lower probability is due to the Japanese stimulus policy and increased credibility for ECB measures.

Divergent trends in the Nordic countries too

Recent economic signals indicate more divergent trends in the Nordic region as well. 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. GDP will grow this year by 0.2 per cent in Denmark, while a similar downturn will be recorded in Finland. One bright spot is that a rapidly falling inflation rate will strengthen real household income, which will help push up growth in both countries to 1.6 per cent next year.

Nordics and Baltics, GDP growth

Year-on-year percentage change

	2011	2012	2013	2014
Sweden	3.7	0.8	1.3	2.5
Norway	1.2	3.1	1.7	2.4
Denmark	1.1	-0.5	0.2	1.6
Finland	2.8	-0.2	-0.2	1.6
Estonia	8.3	3.2	3.3	3.7
Latvia	5.5	5.6	3.5	4.8
Lithuania	5.9	3.6	3.2	3.5

Source: OECD, SEB

In **Sweden**, and especially in **Norway**, the domestic economy is significantly more resilient. This helps maintain growth to a greater degree than in Western Europe generally, even though exports and investments are being hampered by weak international economic conditions and appreciating currencies. In 2013, GDP will increase by 1.3 per cent in Sweden and by 1.7 per cent in Norway. Then growth will accelerate in 2014 to around 2.5 per cent in both countries.

Baltic countries again topping EU growth

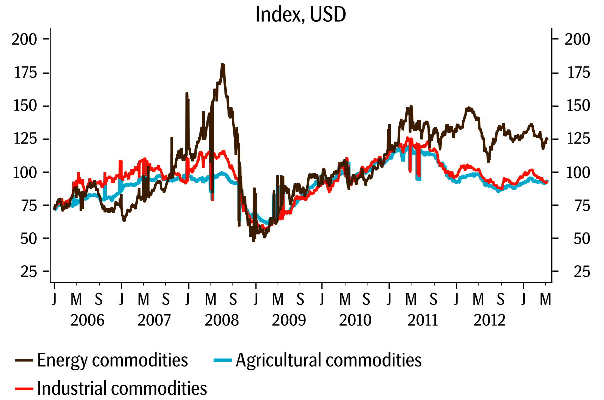
For the third straight year, in 2013 the Baltics will be the fastest-growing economies in the EU, though activity is expected to cool in Latvia and Lithuania. Meanwhile growth in Estonia will remain almost unchanged from 2012. Next year, Latvia will stay in the lead, with a growth rate at 4.8 per cent, while Estonia's growth rate will be 3.7 per cent and Lithuania's 3.5 per cent. In 2013-2014 growth will be driven mainly by private consumption, but exports will also increase at a decent pace thanks to good competitiveness after earlier internal devaluations. In Estonia, however, cost pressures are beginning to crop up in the wake of high wage and salary increases. Inflation will slow in all three countries but remain above 3 per cent in Estonia. We are sticking to our assessment that Latvia will receive the green light for euro zone accession in 2014, based on this spring's evaluation by the European Commission and the ECB. We believe Lithuania has a 50 per cent chance of achieving its target of euro zone accession in 2015, but it may be difficult to bring down inflation fast enough to stay below the maximum qualifying level one year from now.

Divergent commodity price trends

The outlook for commodity prices is mixed. In the past year, commodity prices have been sustained by increased risk appetite and investors' search for higher returns. In addition, various supply disruptions, for example weather-related disruptions in production, have pushed up prices.

Fall in commodity prices but still high levels

Index, USD



Source: HWWI

In February 2013 the upward price trend, which had been under way since the fourth quarter of 2011, came to an end. Yet even after a correction, commodity prices are generally at historically high levels. The price correction has been driven by renewed worries about global growth, especially in fast-growing economies such as China. In the background there are also positive supply effects following the large investments of recent years in production capacity. In addition, there are currently large inventories of some commodities, such as copper. The sharp price decline for gold during the spring – a gradual downturn began as early as the end of 2012 – is due to diminishing worries that central bank stimulus programmes will generate inflation down the road.

Our main forecast of a gradual recovery in the world economy **provides a platform for relatively stable commodity price performance in 2013 and 2014**. Gold and agricultural products are exceptions, with downward price pressures.

During the past two years, oil (Brent) has traded at a relatively stable average level of USD 105 per barrel. In 2012, global oil demand rose by 0.9 million barrels per day, while production increased by 2.5 million barrels. This led to a build-up of reserves. The Organisation of Petroleum Exporting Countries (OPEC) wants oil prices of close to USD 100/barrel and still has enough clout to control price levels. **Our oil price forecast is USD 110/barrel for both 2013 and 2014, as yearly average.**

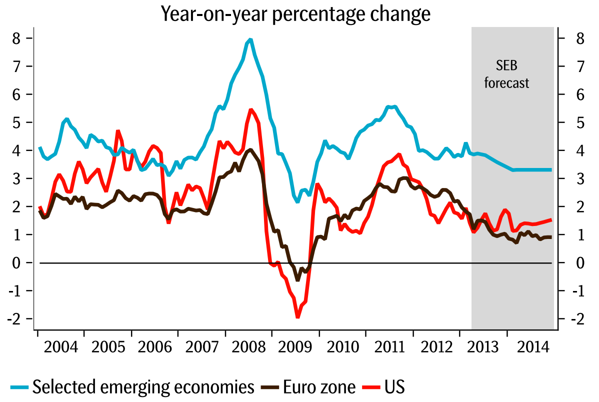
Mounting deflation risks

Inflation has mainly provided downside surprises early in 2013. Falling commodity prices have been an important factor behind this. In addition, various tax hikes in the euro zone have disappeared from the 12-month statistics. But a broader downturn in core inflation is discernible as well. Inflation expectations have also fallen in recent months and are now close to their lowest levels of recent years. In Japan, however, the government's new policy has succeeded in its ambition of raising inflation expectations. Actual prices are still falling.

Although commodity prices are now stabilising, **we expect continued downward pressure on inflation**. Pay increases in the US have admittedly risen somewhat, but in Western Europe we foresee a falling trend. Our forecast implies that the euro zone's Harmonised Index of Consumer Prices (HICP) **will drop below 1 per cent late in 2013**. German inflation is now also at around 1 per cent, which is making the rebalancing process in the euro zone more difficult.

CPI inflation is falling

Year-on-year percentage change



Source: Eurostat, BLS, SEB

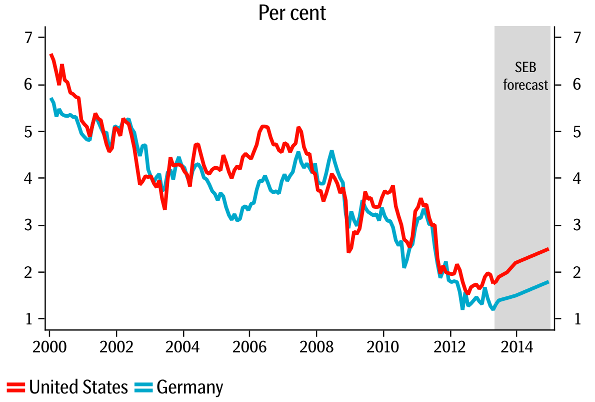
Downward pressure on inflation is illustrated by the fact that the Swedish, Norwegian and European central banks were recently forced to make significant downward revisions in their inflation forecasts. This implies greater room for sustaining growth and the labour market. But falling inflation also implies risks and policy dilemmas. **The euro zone is now beginning to enter a deflationary spiral with Japanese elements**, which may delay economic recovery and lead to a new wave of price declines in the housing market. In Norway and Sweden, the dilemma for central banks will be different. They have room for further interest rate cuts, but then risk pushing up home prices and household borrowing further. In this environment, there is an increasing need for effective macroprudential supervision tools (instruments to regulate credit volume) that can ease the burden on central banks.

Long-lasting low interest rate environment

The global low interest rate environment will continue for the next two years. During the spring of 2013, G7 interest rates have again been pushed downward towards historically low levels. German 10-year sovereign bond yields have even come close to setting a new record low of less than 1.20 per cent. This means that the bond market has defied the new stock market records and worries that extreme global monetary stimulus will lead to higher long-term inflation pressure.

10-year sovereign bond yields

Per cent



Source: Macrobond, SEB

As long as the market has confidence in economic policies and in a continued low-inflation environment, **interest rates will remain depressed along the entire yield curve**. Central banks have sufficient tools, including almost unlimited capacity for market intervention aimed at enforcing their promises of low interest rates. Continued conversion risk, albeit lower than earlier, is helping push down interest rates in core euro zone countries. The risk of rising interest rates and yields is mainly associated with possible negative reactions by credit rating agencies to more flexible attitudes towards austerity policies and the fact that the independence of central banks is being questioned to a greater extent.

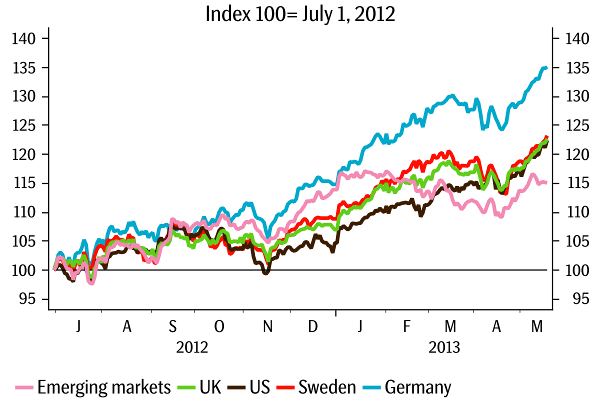
We expect long-term yields to rise cautiously by a total of 40 to 60 basis points between now and the end of 2014. German long-term (10-year) sovereign bond yields are thus expected to be 1.80 per cent at the end of 2014, and their US counterparts 2.50 per cent. Partly due to higher key interest rates, we foresee somewhat higher long-term yields in Norway and Sweden. The yield spread against Germany at the end of 2014 will be 75 basis points in Norway and 20 points in Sweden.

The stock market will continue rising

This spring, the stock markets in such developed economies as the US, Germany and the UK have reached record levels despite various economic disappointments in the US as well as Europe. In particular, the German stock market has performed strongly in the past six months, largely driven by a brighter outlook in the banking sector. Commodity-heavy stock markets in countries like Brazil and Russia, however, have moved in the opposite direction. The global stock market (MSCI) has gained 11 per cent so far in 2013 and 24 per cent in the past 12 months. **Positive driving forces mainly include new monetary easing by central banks and the absence of signals about exit policies.** In addition, quarterly company reports have mainly delivered upside surprises, ending up above or in line with expectations. They have often included cautiously optimistic future guidance.

Stock market indices

Index 100= July 1, 2012



Source: Macrobond, SEB

Our conclusion about the stock market trend in the coming year is generally the same as during the past six months: **cautiously positive**. Valuations are not too high, we would argue that the levels are normal considering the current state of the business cycle, our outlook and the alternatives. Although the growth picture is somewhat unclear in the short term, we expect the stability of the US recovery to sustain global risk appetite. Low inflation and stable inflation expectations also add predictability and cause no major changes in the expansionary policies of central banks. Milder austerity policies contribute to a favourable stock market climate as well. At the same time, the attractiveness of alternative asset classes such as corporate bonds and fixed income securities with narrow credit spreads and historically low yields is diminishing. Taken together, this provides continued support for stable and rising stock markets ahead.

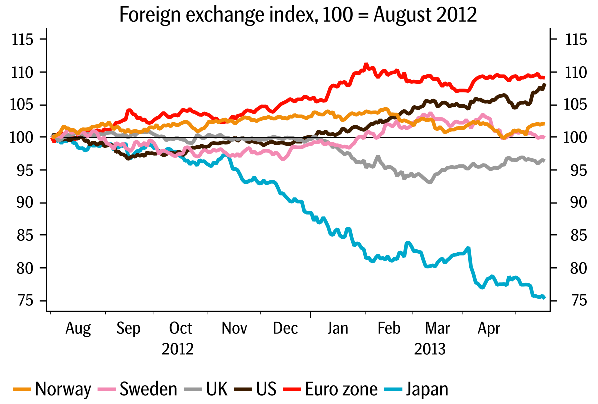
Central banks determine currency trends

Looking ahead, the various monetary policy strategies chosen by central banks will be the most important driving force for the foreign exchange (FX) market. We expect the US dollar to become stronger during our forecast period, reaching USD 1.20 per euro by the end of 2014. **The dollar will be sustained by an improved US economy** and by the Fed, which we expect to begin phasing out its monthly purchases of government and mortgage-backed securities starting early in 2014. In addition, the euro will be pushed down by the many-facetted problems of the euro zone. The US dollar has shown signs of moving in 7-8 year long-term trends. The situation today means that in effective terms, the dollar is already at weak levels. Trend analysis supports a forecast of a stable to stronger dollar ahead.

Meanwhile we expect the Bank of Japan's monetary policy to increase the pressure on Japanese pension companies to seek returns and exposure abroad, for example in European and US fixed income and stock markets. The flow effect is difficult to assess, but our scenario is that global portfolio managers normally currency hedge their fixed income portfolios. This means that the financial market should assume that BoJ policies will have their greatest impact on fixed income and to a significantly lesser extent in the FX market. Our forecast is that the USD/JPY rate will be 110 at the end of 2013 and 120 at the end of 2014, primarily based on the appetite for the yen as a financing currency. But unlike a decade or so ago, competition today for cheap financing currencies is considerably tougher, with many countries aiming at both zero interest rates and weak currencies.

Sharp yen depreciation and clear euro rebound

Foreign exchange index, 100 = August 2012



Source: Bank of England

We expect both the Swedish krona and the Norwegian krone to appreciate during our forecast period. Key interest rate differentials will buoy these two Nordic currencies, though not as much as a few months ago. **We expect the EUR/SEK rate to be 8.35 at the end of 2013 and 8.10 at the end of 2014. Our corresponding forecasts for the EUR/NOK rate are 7.45 and 7.35.** Risks associated with European economic performance and the expansionary trend in credit and housing markets will dampen international interest in Nordic market investments, despite continued strong internal and external balances.

From austerity to more neutral fiscal policy

- **Looser austerity measures recommended**
- **More neutral effects on growth in 2014**
- **Major long-term challenges**

During the 1980s and 1990s especially, fiscal policy led an obscure existence; a widespread consensus opinion was that monetary policy should assume predominant responsibility for stabilisation policy. In recent years, there has been **a greatly intensified focus on fiscal policy**. One important reason for this is that euro zone countries must resort to fiscal measures as national economic policy. Moreover, monetary policy has largely run out of ammunition, due to interest rates close to zero and the unclear effectiveness of unconventional policy.

Attitudes towards fiscal policy have been the subject of continuous lively debate. The risk that synchronised global austerity measures would push the world economy into a depressive spiral has been weighed against the need to stop the sovereign debt explosion and preserve the credibility of sustainable public finances. This dilemma is especially severe for euro zone countries, where the absence of a central bank of their own that can print money has created a genuine risk of defaults previously not associated with developed countries.

Fiscal policy direction

Change in structural balance, per cent of GDP

	2011	2012	2013	2014
United States	0.8	1.3	2.0	0.6
Japan	-0.6	-0.7	-0.5	0.0
United Kingdom	1.9	1.2	1.4	1.2
Euro zone	1.4	1.4	1.1	0.0
Of which GIPS*	0.9	2.3	2.0	1.0
Nordic countries	0.3	0.0	0.2	0.2
OECD	0.8	1.0	1.1	0.3

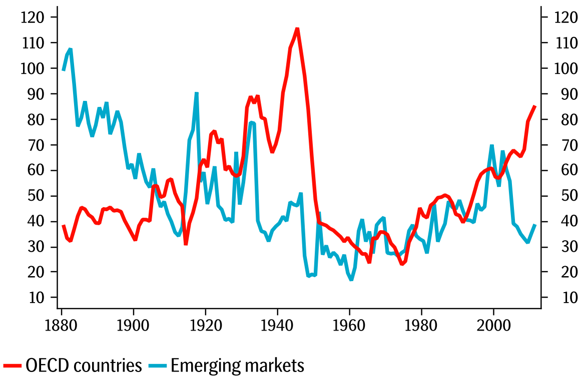
Source: IMF, OECD, SEB
*Greece, Ireland, Portugal and Spain

We can differentiate several distinct periods in the world economy during the course of the crisis:

- **During the 2004-2007 economic boom, fiscal policy was relatively expansionary.** During the most euphoric phase of globalisation, countries thus squandered the opportunity to improve their preparedness for future shocks.
- **During the acute phase of the financial crisis in 2008 and 2009, fiscal policy was clearly expansionary in most countries.** Both specially designed stimulus packages and the effects of automatic stabilisers contributed to this.
- **In recent years (2011-2013), rather powerful austerity policies have predominated.** After a pause in 2010, countries were forced into major belt-tightening in response to the euro zone crisis. In southern Europe, the tightening effect is equivalent to about 2 per cent of GDP in both 2012 and 2013. In the US, the effect is peaking at 2 per cent of GDP in 2013.
- **Looser fiscal policy in 2014-16.** We are now moving into a phase of more neutral fiscal policy. Growth remains modest and resource utilisation is low, while actual budget deficits have fallen to less alarming levels.
- **Longer-term austerity.** In the long term, high government debt combined with demographic strains will force many developed countries to cut costs. This fiscal policy phase is likely to begin when resource utilisation reaches normal levels in a medium-term perspective (3-5 years).

Government debt in OECD and emerging economies

Per cent of GDP



Source: IMF

Many reasons for a change in the debate climate

Our forecast, based on the IMF's table of current fiscal action programmes, means that the overall tightening effect in the OECD countries will decrease from 1.1 per cent of GDP in 2013 to 0.3 per cent in 2014. New austerity measures are unlikely to be launched. International organisations such as the OECD, IMF and European Commission are more and more clearly starting to advocate more expansionary policies. Crisis-hit euro zone countries will be given a longer respite to achieve the targeted budget deficit of 3 per cent of GDP, but countries like the US and the UK will also be advised to take it a bit easier with their austerity measures. A straightforward stimulus policy is still unusual. Japan is a major exception at the global level, while Norway and Sweden are examples of smaller economies that can take advantage of their underlying strong finances.

Public fiscal balance
Per cent of GDP

	2012	2013	2014	Debt*
United States	-8.5	-6.5	-5.4	109.2
Japan	-10.2	-9.8	-7.0	244.6
United Kingdom	-8.3	-7.0	-6.4	97.1
Euro zone	-3.7	-2.9	-2.6	95.3
Sweden	-0.7	-1.5	-2.0	40.8
OECD	-5.9	-4.7	-3.8	109.5
EM sphere	-2.4	-1.3	-1.3	23.0

* Gross debt, 2014
Source: IMF, OECD, SEB

Our approach to fiscal policy is changing, due to many factors.

- **Public budget deficits are shrinking significantly in many countries**. In the US, for example, the deficit has shrunk from over 10 per cent of GDP in 2009 to a forecast of just above 5 per cent in 2014. In the euro zone as a whole, deficits will drop below the 3 per cent threshold as early as this year.
- Austerity measures in southern Europe have had a **larger adverse impact on the economy than indicated by current rules of thumb**. Hopes that this impact would be softened by such counter-forces as lower lending rates or reduced household savings, in line with the "Ricardian equivalence" theorem, have been in vain.
- **Mounting deflation risks are paving the way for more expansionary policy**. All else being equal, our forecast of lower inflation rates means that real interest rates will be higher and monetary policy thus less effective (liquidity trap). This strengthens the motives for looser fiscal policy.
- **A continued rise in unemployment in southern Europe is increasing political risks**. Demanding new austerity measures as gloomier growth prospects weaken public finances would increase tensions in the euro zone and increasingly undermine the legitimacy of the incumbent governments. The risks of permanently high unemployment ("hysteresis") also grow the longer the jobless rate remains at record levels.
- In recent years, various decision makers have cited the **conclusions of American economists Carmen Reinhart and Kenneth Rogoff**. Their empirical study seemed to show that 90 per cent of GDP was a clear threshold at which high government debt began to hamper economic growth. This research turned out to include dubious data selection procedures and technical errors. Although there are still many reasons to avoid soaring government debt, the recent discreditation of this study has influenced public discourse.

Multi-dimensional competitiveness

Our euro zone section discusses the competitiveness of crisis-plagued countries. Measured in terms of unit labour costs, southern Europe's adjustments have made some progress. But competitiveness can also be viewed in a broader perspective. We are now seeing how the general business climate is increasingly being used as a means of competition, for example by lowering corporate income tax in various countries. Southern European countries thus face dual challenges. While they must improve the efficiency of their tax collection, they must also be able to offer competitive conditions in order to prevent the departure of companies and skilled labour.

Ambiguous German attitude

Germany occupies a key position in terms of approaches to fiscal policy and has been criticised for various reasons. One criticism is that the Germans themselves have done too little to help offset austerity measures in southern Europe. Another is that Germany has so stubbornly insisted on demanding full implementation of austerity policies in southern Europe.

Our forecast indicates that fiscal policy in Germany will largely be neutral in 2013 and 2014 and is thus continuing a relatively cautious strategy. As for approaches to the problems of southern Europe, we can see ambiguity among leading German politicians from Chancellor Angela Merkel on down. In reality, Germany is beginning to give in and to accept longer respites in meeting fiscal targets in southern Europe and France. Above all, Germany wishes to avoid open conflict with France, since disunity between the euro zone's two key countries might have a broad impact on market confidence. At the same time, a tougher line is clearly popular among voters. In the run-up to this autumn's parliamentary election, Chancellor Merkel is likely to continue making rather harsh statements about how the problems of southern Europe are a consequence of earlier neglect and have nothing at all to do with the necessary austerity and sacrifices now being made.

Unenthusiastic Swedish stimulus measures

Swedish fiscal policy will have an expansionary direction that is equivalent to 0.7 per cent of GDP in 2013 and 0.9 per cent 2014. Yet there are clear parallels between German and Swedish public debate. Although both Sweden's low government debt and resource utilisation indicate the need for more aggressive policy, the Alliance government and the Social Democratic opposition are competing to prove who is more faithful to the existing fiscal policy framework, whose target is a surplus of 1 per cent of GDP over an economic cycle. The main reason for this is probably historical. Previous non-socialist governments in the post-war period have failed to keep their finances under control. Finance Minister Anders Borg has established himself as the main guarantor of sound government finances, thereby changing the political landscape. Social Democratic leaders seem to view this as politically important and are thus prepared to pursue a policy rejected by most economists as well as their own trade union allies. In this environment, it is likely to take some time before changes in the fiscal policy framework are implemented, even though a number of economic reasons indicate that its surplus target is ripe for re-assessment.

Decent growth despite federal budget-tightening

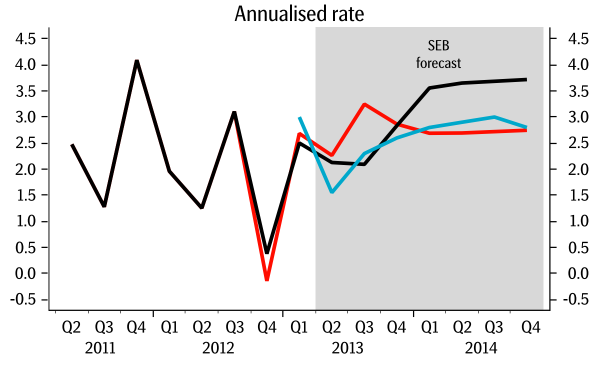
- **GDP growth will speed up in 2014**
- **Home prices up by 7-10 per cent annually**
- **Unemployment will fall below 7 per cent**
- **Fed will start unwinding QE in early 2014**

Decent GDP growth in the first quarter will help bring **this year's annual average growth** to around **2 per cent**. As in 2010-2012, however, the economy will decelerate during the second and third quarters – this time due to fiscal headwinds. The dose of federal austerity will increase from the equivalent of 1.3 per cent of GDP in 2012 to 2.0 per cent in 2013. In **2014** a less austere fiscal policy is one reason why we predict that GDP growth will accelerate to **3.2 per cent**: above consensus.

Slower GDP growth in the coming quarters will give the Federal Reserve grounds for continuing its monthly bond purchases (quantitative easing) at an undiminished pace. **Only in early 2014 will the Fed start applying the brakes.** In the second quarter of 2014, bond purchases will end once unemployment has fallen below 7.0 per cent. A key interest rate hike will happen only in early 2015. **Annual average unemployment will be 7.6 per cent this year and 6.9 per cent in 2014**, assuming that labour force participation levels out next year after a lengthy decline.

Decelerating growth this spring

Annualised rate



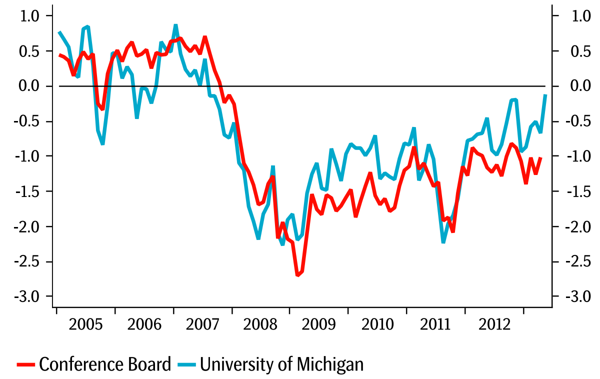
Source: BEA, SEB, Bloomberg

Rich households driving consumption

A combination of tax hikes and higher petrol (gasoline) prices has led to lower household confidence indicators, but **consumption was unexpectedly resilient in the first quarter of 2013**. The rate of increase climbed from 1.8 to 3.2 per cent. Rising wealth levels are probably one reason why households are generally comfortable with their current meagre level of savings – the **savings ratio is at a five-year low**. The top 20 per cent of income earners (who account for 40 per cent of consumption) benefit especially from rising share and home prices. Higher taxes and petrol prices are a bigger burden on low and medium income earners, as reflected in predicted weak sales at low-price retail chains like Wal-Mart. In the next few quarters, we expect budget-tightening and temporarily slower job growth to help decelerate consumption. Measured as annual averages, **private consumption will grow by 2.3 per cent this year and 2.8 per cent in 2014**.

Household confidence is low

Index



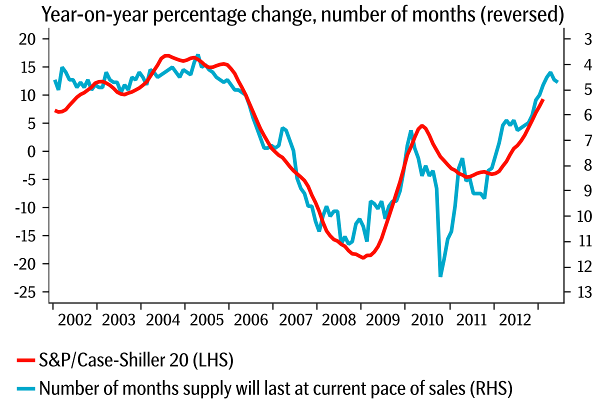
Source: Bloomberg, Conference Board, SEB

Faster home price increases

The housing market continues to gain strength. Both home prices and sales rose last year and will continue upward during the next couple of years. Using the Case-Shiller Index, **we expect home prices to rise by 7-10 per cent both this year and in 2014**. We have increased our price forecast compared to earlier assessments, partly due to tighter supply (measured as the number of months the inventory of homes for sale would last at the current rate of sales). Record-low mortgage interest rates and affordability indices point in the same direction.

Low supply is driving home prices up

Year-on-year percentage change, number of months (reversed)

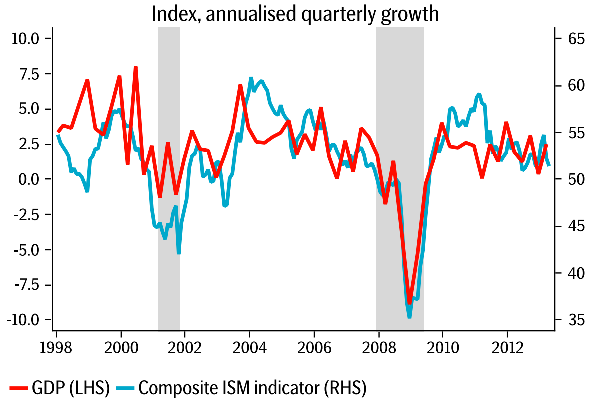


Source: S&P, NAR, SEB

Our picture of the housing market is not exclusively positive, however. Optimism in the construction sector has dimmed, according to the NAHB index. In addition, speculative purchases in cash are now contributing to higher home sales. This is because many companies, among them major institutional players like Blackstone, have bought bankruptcy assets for renovation and rental. A combination of low long-term interest rates and a search for returns is driving this trend and partly explains why new home sales are lagging behind existing home sales. There is thus a **speculative element in the housing market again**, though it is too early to warn of a new housing bubble. The growing number of rental units also means that rents are rising significantly more slowly than home prices. **Residential investments will grow by 15 per cent both this year and next**, compared to 12 per cent last year.

ISM indicator points towards 2 per cent GDP growth

Index, annualised quarterly growth



Source: ISM, Markit, SEB

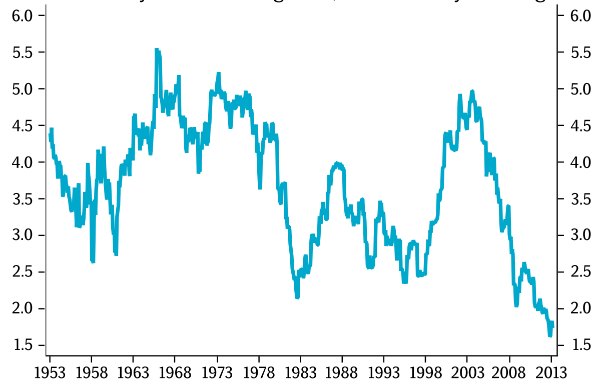
Capital spending surge in 2014

After a strong start to 2013, business confidence indicators have fallen. A composite index of the Institute for Supply Management surveys in the manufacturing and service sectors points towards GDP growth of around 2 per cent during the current quarter, which is in line with our forecasts. Confidence in the small business sector, which fell steeply around the turn of the year, has meanwhile regained some of this decline.

So far during the recovery, capital spending activity has been very low, leading to a decline in capital stock. **If this trend continues, it will hurt the supply side of the economy and lead to persistently weak productivity**. Developments in the past year indicate that potential economic growth has already fallen; despite modest 2 per cent real GDP growth, the jobless rate has fallen more than half a percentage point in the past year. In terms of Okun's Law, potential growth is thus around 1 per cent today. The supply side, measured as productivity plus labour force growth, points in the same direction.

Weak supply side growth

Productivity + labour force growth, annualised 5-year change



Source: BLS, SEB

Yet in our assessment, the **growth potential of the economy has not been permanently damaged**. The uncertain fiscal policy playing field of recent years has hampered capital spending. But as uncertainty eases, a **rebound in fixed investment is in the cards**, especially in light of technological advances in oil and gas extraction, which will mainly benefit the competitiveness of US manufacturers. Stronger corporate investments, combined with robust housing investments, will help lift GDP growth in 2014. **Capital expenditures by businesses will grow by 7.5 per cent this year and by more than 11 per cent in 2014.**

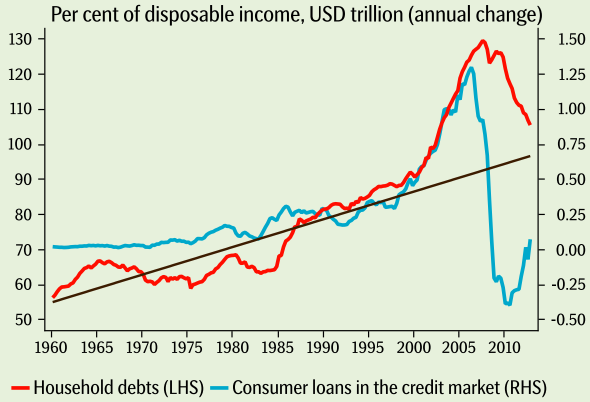
Net deleveraging will soon be over

From the end of 2007 until spring 2009, one fourth (or USD 16 trillion) of household wealth disappeared. Empirical studies indicate that this kind of wealth shock affects consumption for a three-year period. The impact of the downturn should thus have faded. In addition, 90 per cent of this lost wealth has been recovered since 2009, so **wealth will instead contribute positively to consumption during our forecast period**. In relation to income, however, there is some way to go until reaching earlier peaks; net household wealth is now 544 per cent of income, compared to 653 per cent at the end of 2007.

Despite the rising wealth of recent years, household debt deleveraging has continued. One key question for the economic recovery is how much longer this deleveraging will continue. At the end of 2012, household debts were equivalent to 105 per cent of disposable income, or 24 percentage points below their 2007 peak. A long-term trend line from 1960 to 2000 indicates that the equilibrium level is now somewhat below 100 per cent of income. Yet rising home prices reduce the need for deleveraging, while credit market statistics indicate rising **consumer loans**. These factors confirm our earlier assessment that **deleveraging will end in 2013**, setting the stage for a stronger consumption-led recovery in 2014.

Household deleveraging approaching its target

Per cent of disposable income, USD trillion (annual change)



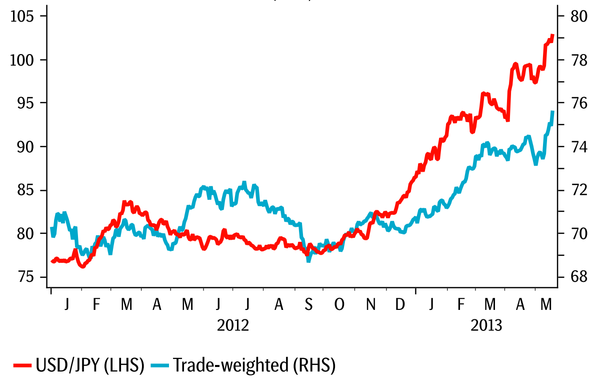
Source: Federal Reserve, SEB

Strong dollar will hamper exports

There is a clear connection between American exports, on the one hand, and global demand and changes in the value of the USD, on the other. Imports, however, are relatively insensitive to USD movements and are mainly affected by domestic demand. **In trade-weighted terms, the dollar has risen by 8 per cent since last autumn.** If USD appreciation continues, it will lower exports by 1.5 percentage points, according to our calculations. Given the size of exports (less than 14 per cent of the economy), the effect of the USD appreciation on GDP will be 0.2 percentage points. **Foreign trade will make a slightly negative contribution to growth in 2013-2014.** This downward revision in our export forecast since the last *Nordic Outlook* is offset, however, by such factors as stronger consumer growth.

Stronger dollar slowing export growth

USD/JPY, index



Source: Macrobond, SEB

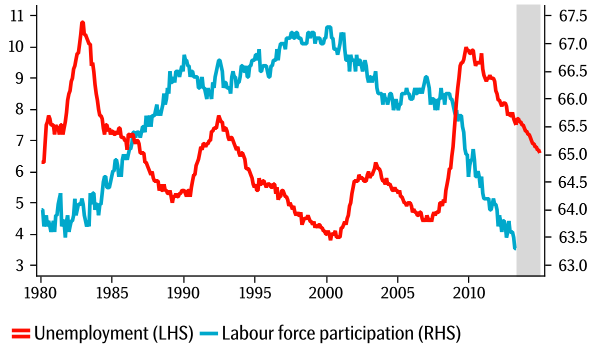
Unemployment will slowly fall

Employment has increased by an average of 196,000 per month so far during 2013, compared to 182,000 last year. As in the past few years, job growth will slow in the spring and summer: this time because fiscal policy is creating obstacles. The impact of **automatic federal budget cuts (the "sequester")** is more powerful than we foresaw in the February issue of *Nordic Outlook*. This will lead to the elimination of positions, especially at the federal level. According to the Congressional Budget Office (CBO), the outcome will be **750,000 fewer jobs by year-end**. Companies are also trying to restore productivity growth and profit margins, which hampers employment. Taken together, we are lowering our short-term forecast and predicting that employment will increase by an average of 140,000 people per month in 2013. **Our 2014 forecast is that job growth will average 220,000 per month.**

Our employment forecast for 2013 would normally be compatible with unchanged unemployment. However, labour force participation, which is affected by both structural (demographic) and cyclical factors, will continue to fall, reaching at its lowest level in 30 years by the end of 2013. This will help push down unemployment to an **annual average of 7.6 per cent this year**. The jobless rate will then continue falling to **6.6 per cent in December 2014**, with 6.9 per cent as the annual average. Our forecast for 2014 assumes that labour force participation will level out.

Lower labour force participation pushes down jobless rate

Per cent



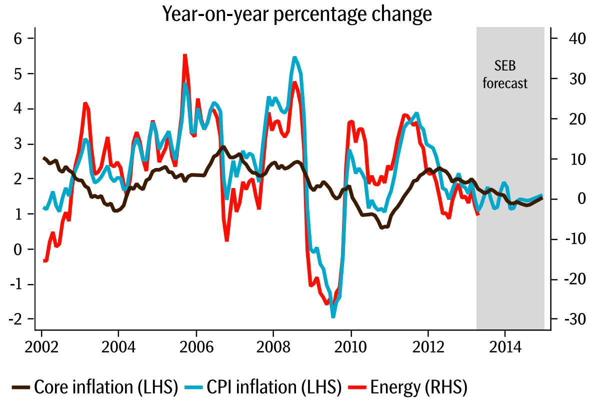
Source: BLS, SEB

Continued low inflation in 2013-2014

Despite monetary policy activism and falling unemployment, the low inflation environment will persist. We expect consumer prices to rise by only **1.6 per cent this year and in 2014**. This assessment assumes that there will still be plenty of idle resources in the economy, but various dark clouds have become visible in the inflation picture. Certain economic sectors are experiencing a shortage of qualified job candidates, according to the Fed's Beige Book. Average hourly wages, which had been trending downward until last autumn, have rebounded in the past six months.

Continued low inflation this year and next

Year-on-year percentage change



Source: BLS, SEB

Greater fiscal austerity this year

Partly due to the federal expenditure cuts that went into effect this spring, the **fiscal headwinds will be stronger** than we had previously anticipated. In 2013 as a whole, budget-tightening will be equivalent to **2 per cent of GDP**. Unexpectedly strong resilience in the economy, plus the fact that some expenditure cuts were already included in forecasts, explain why our GDP forecast for 2013 remains unchanged. Next year, fiscal austerity measures will shrink to 0.6 per cent of GDP. Current fiscal policies will help reduce the federal deficit from 8.5 per cent of GDP in 2012 to 5.4 per cent in 2014. The national debt will peak at 109 per cent of GDP next year.

The measures that have been approved will not solve the federal government's long-term fiscal problems, however. According to CBO projections, the budget deficit is expected to fall to 2.1

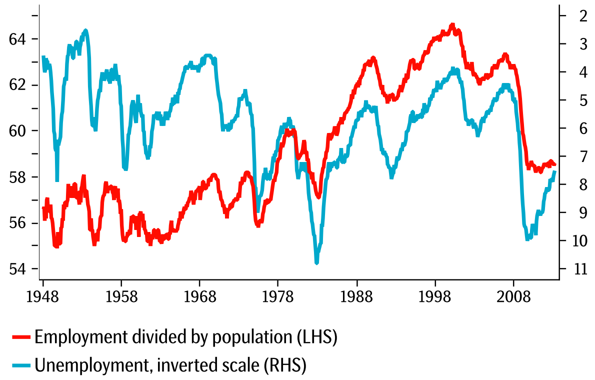
per cent of GDP by 2015 but to start increasing again in 2016. Sustainable long-term debt management will probably require a combination of spending cuts and tax hikes for the middle class as well. Since the 1960s, transfers to households have increased from 6 per cent to 18 per cent of their total income. In 1960, social service and entitlement programmes accounted for one third of federal spending, compared to two thirds today.

Continued loose monetary policy in 2013

Late in 2012 the Federal Reserve added the official unemployment rate to key variables guiding its monetary policy. The Fed's research shows that the jobless rate is the single best labour market indicator. Looking ahead, a given change in unemployment has strong explanatory value; since the 1980s, when unemployment has fallen by half a percentage point during a six-month period, the probability of a further decline during the following six months has been 75 per cent. But jobless figures also have limitations. In recent years, the decline in unemployment has largely been due to many people leaving the labour market. The quantity of idle resources in the economy is thus probably larger than official unemployment indicates. This is one reason why the Fed has declared that the 6.5 per cent unemployment threshold will not necessary signal the starting point for interest rate normalisation.

Different employment yardsticks, different messages

Per cent



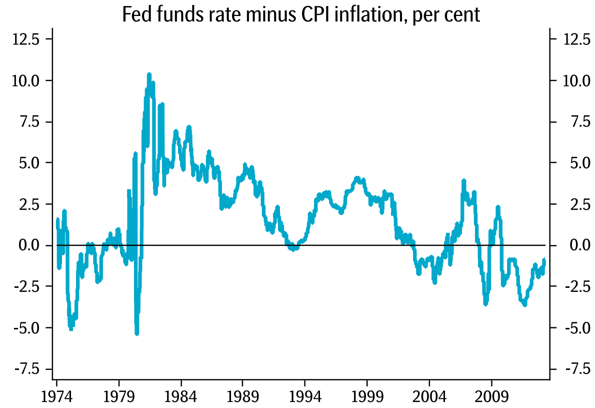
Source: BLS, SEB

The Fed's main interest rate (fed funds) has remained at 0-0.25 per cent since December 2008. According to our forecast, **it will not be raised until 2015**. In real terms, this key interest rate has been negative since 2009. Even if a new Fed chairman takes over in 2014, we believe that the direction of the bank's policies will remain the same. Our main scenario is that **Ben Bernanke will step down** when his term of office expires in January 2014. President Barack Obama will then have to nominate a successor. One frequently heard name is Janet Yellen, Vice Chair of the Fed's Board of Governors, who is regarded as dovish on interest rates.

As for quantitative easing, our forecast is that that the Fed will buy mortgage-backed and Treasury bonds at an undiminished rate (USD 85 billion per month) until December 2013. These purchases correspond to an estimated interest rate cut of 10 basis points per month. In 2014 they will be phased down to USD 60 billion per month during a three-month period. When the bond purchasing programme ends in March 2014, the Fed's **balance sheet will stand at nearly 30 per cent of GDP**, compared to 24 per cent today. Unemployment will meanwhile be 7 per cent, according to our forecasts, which may be compatible with the "substantial improvement in the labour market" that the Fed is aiming at before ending QE.

Real key interest rate negative since 2009

Fed funds rate minus CPI inflation, per cent



Source: Federal Reserve, BLS, SEB

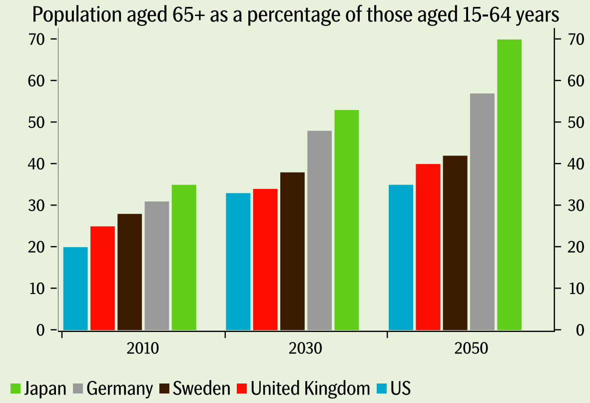
Ageing population will strain public finances

In both the US and other developed countries, an ageing population will strain public finances. In the OECD countries, the population aged 65 or over as a proportion of the working-age population will increase from 14 per cent today to 34 per cent in 2050. The situation is the most serious in Japan, but in Germany the demographic trend also looks gloomy. The situation is brighter in the US. Although many people born in the 40s and 50s are retiring, there will be a sizeable inflow into the labour force, with 88 million Americans aged 10-29.

Although the demographic challenge is gigantic in many places, there are bright spots. During their crisis years a number of countries, including Portugal, Italy and Greece, have implemented reforms that neutralise the budget impact of the ageing population. Forecasts so many years in advance are also marked by great uncertainty; minor changes in underlying assumptions may have a very large impact 40 years from now.

Ageing population a challenge

Population aged 65+ as a percentage of those aged 15-64 years



Source: UN, SEB

Weak light at the end of a long untested tunnel

- **Aggressive economic policies will boost growth and inflation in 2013-2014**
- **Pay increases and structural reforms vital in ending two decade-long deflation problem**
- **Abenomics may succeed – and fail**

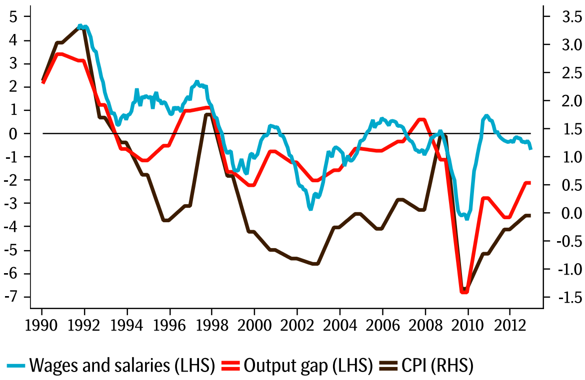
Japan is in a hurry to stop deflationary forces, stabilise its sovereign debt and manage the consequences of a rapidly ageing population. The expansionary economic policy ("Abenomics") initiated by the new prime minister, Shinzo Abe, has been accepted both internationally and by the Japanese. We expect it to boost **GDP growth to 1.7 per cent in 2013 and 1.4 per cent in 2014**, almost a percentage point above the annual average of the past two decades. But the economic outlook **beyond 2014 is unclear** and will depend on rising wages and salaries, increased labour supply, political perseverance and the confidence of financial investors.

Financial market reactions to these economic policies have been powerful. The **Tokyo Stock Exchange** (Nikkei index) has gained 55 per cent in the past six months, equivalent to almost USD 2 trillion. During the same period, the **yen** has weakened by nearly 25 per cent in effective terms, while **long-term yields** have risen by about 15 basis points to 0.85 per cent. In our view, the **yen is still about 10 per cent overvalued**. Our forecast is thus that the USD/JPY exchange rate will climb to 110 by the end of this year and 120 by the end of 2014.

We expect broad-based growth in 2013-2014, sustained by a depreciating currency, falling real interest rates and rising wealth. Both private and public sector consumption will increase, along with private investments. Both households and businesses have reacted positively to Abenomics, as reflected in rising confidence in various surveys. One reason why growth will be stronger in 2013 than in 2014 is that some consumption will be accelerated due to coming tax hikes; another reason is the fading effect of stimulus packages. Exports will benefit from a weak yen and robust Asian economic expansion. A full 25 per cent of Japan's exports go to China, for example. Given this growth picture, **unemployment will remain stable at about**, or even below, **4 per cent**. New regional conflicts that increase tensions in Asia pose a risk to the Japanese economy.

Deflationary impact of output gap and pay

Per cent



Source: IMF

Hopes of rising inflation will only be partly fulfilled. CPI inflation excluding food will reach 0.3 per cent in 2013 and 2.5 per cent 2014. The most important explanation is that the consumption tax hikes in 2014 and 2105 will boost CPI inflation by 2.0 and 0.7 percentage points, respectively. Rising import

Abenomics – what it will deliver

Mr Abe has given his name to an economic policy with three pillars: i. a big **fiscal stimulus package** (some 2 per cent of GDP) including higher public investments; ii. A nearly unlimited **expansionary monetary policy** that will double the monetary base by purchasing long-term (up to 40 years) government securities, a new 2 per cent inflation target and reduced central bank independence; iii. A **growth/structural policy** including increased labour supply, improved education and health care and greater efficiency in the agriculture and energy sectors.

Abenomics is aimed at achieving the following:

1. **A weaker yen.** A weak currency provides manoeuvring room to carry out necessary, tough, time-consuming reforms. A 10 per cent decline in the yen provides an export stimulus that boosts GDP growth by 0.2-0.3 percentage points. Meanwhile it raises the value of Japanese assets abroad. So far, this increase in value has been equivalent to USD 1.5 trillion. Larger capital buffers help safeguard the country's credit rating.

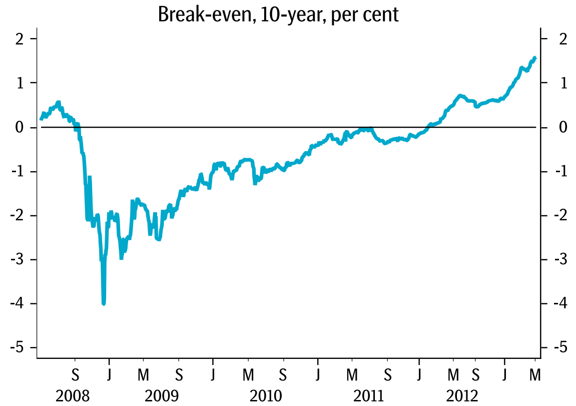
2. **Higher wages and salaries.** Political leaders want to reduce deflationary forces and increase optimism by boosting wages and salaries. Pay increases will ease the effect of consumption tax increases. Japan will thus experience combined external devaluation (weaker yen) and internal revaluation (higher pay), which may explain the lack of global criticism of Japan's monetary policy.

3. **Low interest rates.** If the policy is successful, nominal long-term yields may stabilise above today's 0.7 per cent or so, while real interest rates turn negative (higher inflation). Pensioners and others will thus see their fixed-income portfolios lose value, which may be partly offset by higher share prices.

prices and somewhat higher wages and salaries will also contribute to the inflation upturn. At present it is too early to write off deflationary forces, however. The Japanese economy still has plenty of idle resources and companies have been cautious about pay so far. The outcome of loose monetary policy in 2001-2007 also shows how stubborn deflation is.

Inflation expectations

Break-even, 10-year, per cent



Source: Bloomberg

Today **public debt** is 220 per cent of GDP and is expected to reach nearly **250 per cent by the end of 2014**, the highest level ever recorded in an OECD country. After a temporary fall to less than 0.5 per cent in late March/early April, **10-year government bond yields have increased to 0.9 per cent**. Meanwhile 10-year break-even inflation expectations have risen from 0.5 to more than 1.5 per cent in the past six months. Long-term real yields are thus now negative. **Our forecast is that nominal long-term yields will remain low in 2013-2014.**

Owners of Japan's sovereign bonds

Banks	41%
Insurance companies	22%
Pension funds	13%
Foreign market players	7%
Households	4%
Others	13%

Source: Financial Times

To stabilise the debt level, the government needs to both cut spending and raise taxes. **The budget deficit this year is nearly 10 per cent of GDP**, for the fifth straight year. The deficit is expected to shrink as earlier **stimulus packages are phased out**. The planned **consumption tax hike** will occur in stages: from 5 to 8 per cent in 2014 and to 10 per cent in 2015. Further such tax hikes are expected later. But steps must also be taken to ease the impact of the ageing population on public spending. Later this year, the government is expected to unveil a medium-term plan for how public finances can be put on a more sustainable, credible path.

The labour force has shrunk by 0.2 per cent a year in the past decade. Under current rules, the pace will accelerate to 0.6-0.8 per cent yearly in the coming decade or two. To manage the situation, the Abe administration is planning measures to raise labour market participation among young people and women. Expanded child care and changes in tax and benefit systems giving women incentives to return to the labour market after having children will probably be key elements of this policy. Also needed is deregulation and efficiency improvements in sectors such as health care, education, energy and the environment. Within a few months, the government will present more details of its "growth package".

Risks to financial market & world economy

If Abenomics fails, the main threat to global growth will be financial effects, not real economic ones (Japan accounts for 8 per cent of the world economy). Japan's main import countries are China (24 per cent of total imports), the US (9), Saudi Arabia (8), Australia (7) and South Korea (5). Rapidly rising Japanese yields, due to declining confidence in Japan's ability to service sovereign debt and rising inflation risk premiums, will create problems (loss of value) mainly for Japanese banks and pension companies, which hold most government securities. Japan has net claims on the rest of the world equivalent to 55 per cent of GDP or USD 3.25 trillion. This will help ease confidence problems.

In our **risk scenario**, Japanese yields rise **150-200 basis points** (= a weak positive real yield plus an inflation and credit risk premium of 2 per cent). This will give the **banking system** an unrealised **loss** of USD 150 billion. According to the Bank of Japan this is manageable, though small banks may have problems. The result will probably be a **stronger yen**, since repatriation of foreign assets will be needed to cover losses; **stock market declines** are thus probable. The **government budget deficit will increase** by about 1 per cent of GDP; the effect will be gradual since average sovereign debt maturity is about 6 years. **Sovereign debt will increase** about 10 percentage points in two years. The government is expected to react by **raising taxes** to narrow the budget deficit which, together with poorer export prospects, will send the economy into **recession**.

The **effects on the rest of the world of the above scenario are probably manageable**. The situation would be worse if the crisis were even deeper, with serious losses of confidence and secondary financial effects. In such a scenario, 1) yields would climb more, by nearly 400 basis points, 2) international yields would also react by rising, 3) the US and Europe would remain in a low growth pattern or even tip into recession.

What makes really severe risk scenarios less probable is that the Bank of Japan has instruments to prevent sharply rising yields. By lifting yield and credit risk into its balance sheet, it can ease upward pressure on yields. The BoJ has unlimited resources for such a policy. But the challenge is to be able to continue operating with undamaged confidence in the economy and government economic policy.

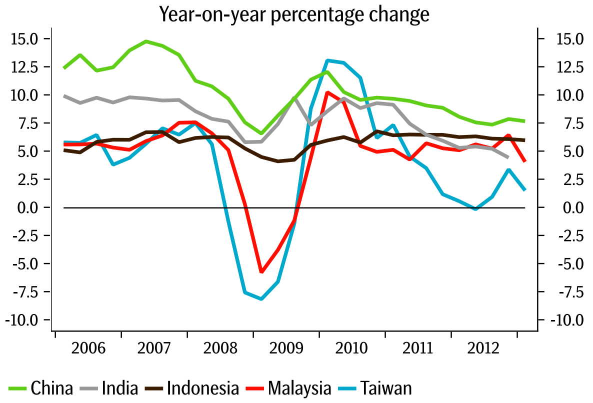
Weak external demand a factor in below-trend growth

- **Subdued inflation pressure and expansionary monetary policy**
- **China: Near-trend growth**
- **India: Production has bottomed out**

After a recovery in Asian emerging economies during the fourth quarter of 2012, activity again slowed early in 2013. **Growth** will remain **below trend**, but is far higher than in the OECD countries. Although purchasing managers' indices have climbed in several countries during the past few months, levels just above the expansion threshold of 50 indicate that manufacturers are still struggling. Yet exports have strengthened somewhat in recent months, driven primarily by demand from other developing countries. The improvement is modest, however, and export order bookings indicate that the recovery is beginning to fade. Total export demand will thus be weak compared to earlier years and will help hold back growth in the region both in 2013 and 2014.

Asia: Subdued start to 2013

Year-on-year percentage change



Source: National statistical offices

In recent years, the region has developed at different rates, with some countries benefiting from strong domestic demand (Indonesia, Thailand) while export-dependent economies (Malaysia, Singapore, Taiwan) have been hampered by weak external demand. This divergence is now starting to narrow.

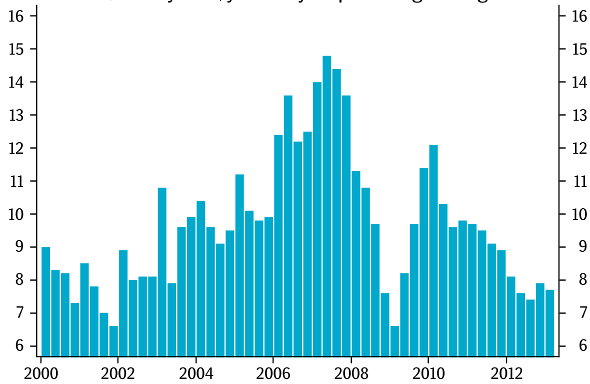
Headline inflation has fallen in most economies during the past year and is at a historically low level. Core inflation is also subdued and there are few signs that price pressures will soon intensify. A stable outlook for global commodity prices is benefiting the region, which is a net importer of both metals and energy. Meanwhile low producer price increases reinforce the impression of a **low-inflation environment**. The favourable inflation situation is creating **potential for continued expansionary monetary policy**. So far in 2013, key interest rates have been unchanged in most economies, but India is among those that have lowered rates. Late in 2013 and during 2014, we expect rate hikes to begin at a modest pace. One exception is India, where some further easing of monetary policy is expected as once-rapid inflation finally begins to slow.

China: Stable growth at a lower level

Year-on-year GDP growth fell to 7.7 per cent in the first quarter, compared to 7.9 per cent in the fourth quarter of 2012. Purchasing managers' indices usually show a clear seasonal improvement in March, but this year's upturn was significantly less than usual. In April, which is usually a strong month, the index fell. Final hard data for February are difficult to interpret, since Chinese New Year celebrations shift between January and February. March export and industrial output figures indicate a weak ending to the first quarter, while retail sales showed better resilience. The beginning of the second quarter has also been modest; a weak base of comparison in 2012 along with calendar effects imply that figures for retail sales and industrial production actually are weaker than they first appear. Overall, the picture of a modest recovery has emerged more strongly in recent weeks. **We expect China's GDP growth to end up at 7.9 per cent in 2013 and at 7.7 per cent in 2014**.

GDP growth slowed during the first quarter

Quarterly data, year-on-year percentage change



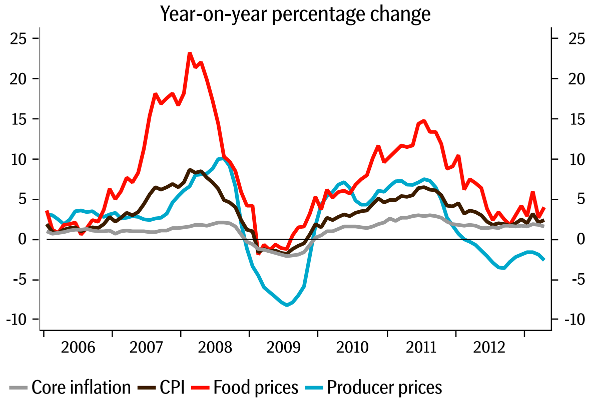
Source: National Bureau of Statistics of China

The weaker first quarter GDP figure was met with disappointment in financial markets, but the reaction of Chinese authorities seems relatively calm. Their growth target for 2013 is 7.5 per cent, which we estimate to be close to the trend rate of growth. Nor are there signs that the labour market has weakened. Viewed from a more long-term perspective, the GDP figure was beneficial, since the contribution from consumption surpassed the contribution from capital spending. This must continue to enable China to transition from a growth model based on capital spending and exports to one driven by domestic consumption. The national leadership change has now been formally completed, but it is still too early to determine how eager for reforms the new leaders are. One positive sign, however, is that the central bank governor, **Zhou** Xiaochuan, who has been a prominent advocate of reforms in the financial sector, has been appointed to another term.

It is worrisome that credit growth remains at a very high level despite the slowdown in the economy. Both the broadest measure of lending, "total social financing", and traditional bank lending accelerated greatly in March and surpassed expectations. Rapid credit growth contributed to a decision in April by the credit rating agency Fitch to downgrade China's credit rating one notch to A+. Chinese authorities are mainly worried about the credit growth being generated outside of traditional bank lending and have thus begun to tighten regulation of "wealth management products". Because of this tightening, credit growth is expected to level out during 2013.

Continued low inflation pressure

Year-on-year percentage change



Source: National Bureau of Statistics of China

After an expected temporary peak in February as a result of the Chinese New Year, inflation fell again. In April inflation was 2.4 per cent. The temporary increase in February was driven by food price increases. We expect inflation to accelerate somewhat during the rest of the year, driven to some extent by rising pork prices. Measured as annual averages, **inflation will end up at 3.3 per cent in 2013 and at 3.5 per cent in 2014**. Generally speaking, price pressure is low, with core inflation below 2 per cent and producer prices still falling year-on-year.

Home prices have begun to accelerate again; measured in 70 major cities, prices rose by more than 4 per cent in April. Although the number of home sales decreased in April sales are on an increasing trend since the beginning of the year. The authorities have announced that steps will be taken to slow the upturn, but these are expected to be relatively mild in order not to jeopardise already modest GDP growth.

The key interest rate has been unchanged since it was lowered in July 2012, and we expect no change during the next six months. 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**. **During 2014, we expect two more hikes pushing the key interest rate to 6.75 per cent**. Since the end of 2012, the People's Bank of China (PBoC) has focused its monetary policy on using repo transactions to try to withdraw liquidity from the financial system. Also, the focus of monetary policy has swung from the lending rate to the deposit rate. The deposit rate is expected to be hiked from the current 3 per cent to 3.25 per cent by the end of 2013 and to 3.5 per cent by the end of 2014.

During 2013 the appreciation of the yuan against the US dollar has regained momentum, setting new records. The PBoC has accepted more rapid strengthening of the yuan against the dollar, but market pressure indicates that appreciation should actually be occurring even faster. The yuan has also clearly

Plenty of long-term risks and challenges to growth

In the **short term**, the risk picture in the Chinese economy is dominated by **rapid domestic credit growth** and **weak external demand**. **Beyond our forecast horizon**, however, there are a number of challenges that may impact growth. **Geopolitical developments in South-east Asia** have attracted attention in the past year. China's border conflicts with its neighbours are fundamentally due to difficulties in managing its growing economic, political and military influence. A recent rise in the number of incidents indicates a greater risk of limited conflict between China and Vietnam or the Philippines, for example. Such a conflict would be geopolitically serious but would not necessarily have major economic effects. China's growing strength has also contributed to a partial shift in US security policy focus from the Middle East to East Asia.

Demographic changes pose another challenge to Chinese growth. According to the Asian Development Bank, favourable demographics have contributed some 0.7 per cent per year to China's GDP growth in the past two decades. China now faces a rapid demographic shift, with a shrinking labour force along with an ageing population instead pulling down growth. Its impact can be limited, however, by a continued transfer of the labour force from the agricultural sector to the manufacturing and service sectors, which will sustain productivity growth.

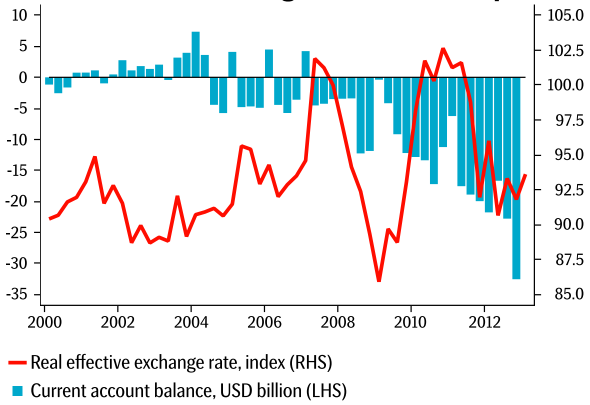
Meanwhile there is rising discontent among China's population with **inequality, environmental problems and corruption**. The demographic trend and social discontent are both intertwined with China's growth model. The current model, based on government capital spending and exports, has reached the end of the road. A transition to a model based on consumption-driven growth would be a way to manage both demographic change and popular discontent. Because of the ageing population, the need for both health care and elder care is increasing. These needs must be met through increased public sector consumption, which in turn stimulates private consumption by reducing the need for household savings. However, local governments have no revenue source to pay for social welfare. Introduction of a property tax would be the first step to provide revenues in order for local governments to increase social welfare payments. Generally speaking, the new leadership has not yet shown how it intends to deal with China's long-term growth challenges.

strengthened in trade-weighted terms during 2013. Our assessment is that yuan appreciation will continue but at a slower rate. **We expect the USD/CNY exchange rate to be 6.10 at the end of 2013 and 6.00 at the end of 2014**.

India: Growth has bottomed out

The growth of the Indian economy slowed further during the fourth quarter of 2012, ending up at a historically weak 4.5 per cent year-on-year. GDP growth for the full year 2012 thus reached only 5.1 per cent. **Economic activity probably bottomed out during the fourth quarter**, but there are no guarantees of a clear recovery. Purchasing managers' indices remain far below their historical averages, and in April the composite index fell to its lowest level since October 2011. Although industrial production has stabilised somewhat, in March it increased by a modest 2.5 per cent year-on-year. Exports have improved in recent months, and India's large trade deficit shrank in February and March but increased again in April. The already sizeable current account deficit grew further during the fourth quarter of 2012. The real effective exchange rate of the rupee has weakened again recently, but we now expect a slight appreciation against the USD ahead. **We expect the rupee to trade at 51.0 per USD by the end of 2013 and at 48.0 by the end of 2014**.

Current account deficit grew in the fourth quarter



Source: BIS, Reserve Bank of India

Domestic demand is also weak. Car sales, an important indicator of consumer demand in the absence of retail sales statistics, fell by more than 10 per cent year-on-year in April. Overall, **GDP will climb by 5.5 per cent in 2013 and by 6.0 per cent in 2014**. Because of India's sizeable budget deficit, combined with limited room for key interest rate cuts, there is little opportunity to stimulate the economy in the short term.

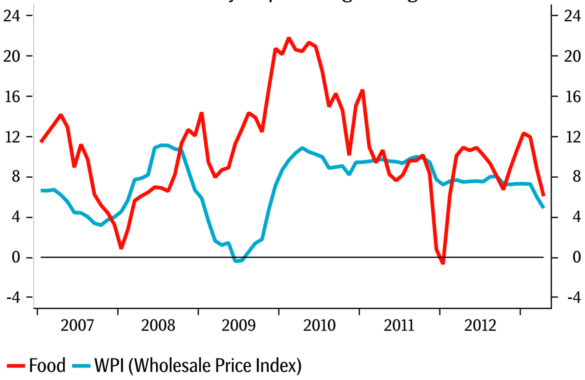
Despite government reform initiatives (such as reducing fuel subsidies and relaxing foreign investment rules), **continued reform efforts are in jeopardy**. The chances that the government can push through more reforms to strengthen economic growth and reduce the budget deficit will diminish further as the May 2014 parliamentary election approaches. Unless reform efforts regain momentum, the explicit target of returning to 7-8 per cent growth will remain distant.

The budget deficit has fallen somewhat in the past year but remains above 5 per cent of GDP. According to the budget unveiled in late February, deficit reduction efforts will continue, but the government faces a difficult task. Next year's election will increase pressure on the government to increase expenditures, while its own GDP forecasts look too optimistic.

The slowdown in inflation during the past few months will provide some support to the economy. In April, wholesale price index (WPI) inflation was 4.9 per cent, the lowest figure since late 2009. **Inflation is expected to end up at 5.9 per cent in 2013 and at 6.5 per cent in 2014.** The inflation slowdown has largely been driven by a significant drop in food price inflation and has, in turn, made it possible to loosen monetary policy. The central bank's key interest rate cut in late January was followed by further 0.25 percentage point cuts in March and May to 7.25 per cent. **Slowing inflation, combined with very weak growth, will enable the central bank to ease monetary policy a bit further.** Our assessment is that **the key rate will be cut by another 0.75 percentage points** during the second half and will thus be 6.5 per cent at the end of 2013. We expect the key rate to remain at this level during 2014.

Inflation has decelerated

Year-on-year percentage change



Source: Ministry of Commerce and Industry

The crisis is not over, despite massive ECB support

- **Leading indicators again point downward**
- **GDP will stabilise in the third quarter**
- **Inflation below 1 per cent**
- **ECB will be forced to take further action**

Since last summer, **euro zone financial developments have been positive in many respects**. The actions of the European Central Bank (ECB) have clearly reduced risk premiums, for example as reflected in narrower bond yield spreads between Germany and southern Europe. Meanwhile adjustments in the cost situation and foreign trade have made some progress. Periods of market instability, such as during the Cyprus crisis or when Portugal's constitutional court invalidated portions of that country's fiscal consolidation programme, have been relatively brief, with little spill-over to other crisis-hit euro zone countries.

Yet major challenges remain. The process of deepening euro zone integration is slowly moving ahead, amid various disappointments. Some steps have been taken towards a banking union, which might de-couple the financial problems of individual governments and the banking sector. Some countries, especially Germany, are hesitant due to fear of being forced to pay the costs of crisis-plagued banks in other countries. The region as a whole remains in recession as well. One important cause of this recession is a poorly functioning credit market transmission mechanism that is holding back economic activity in southern Europe, especially capital spending. The banking system, mainly in southern Europe, also remains weighed down by a growing share of bad loans.

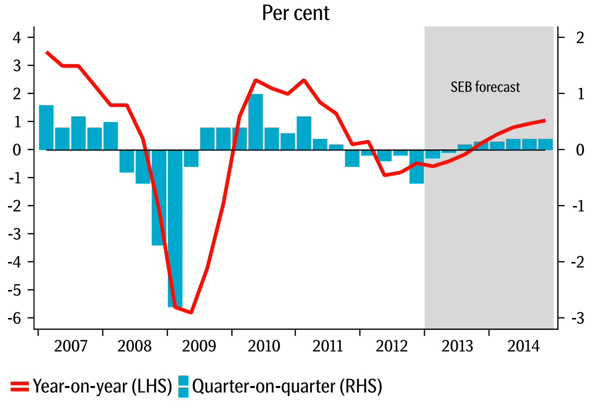
In this environment, **various players face difficult dilemmas**. The ECB is being forced to expand its role as a crisis manager and test the limits of its manoeuvring room under EU treaties. Individual governments are being pressed hard, as continued recession pushes up unemployment in a way that is generating social tensions and political uncertainty. As earlier, the future of the euro project thus remains uncertain.

Shrinking GDP, then below-trend growth

Indicators improved late in 2012, but this spring both purchasing managers' indices (PMIs) and the European Commission's Economic Sentiment Indicator (ESI) have again turned downward. The levels vary between countries, but even in Germany the manufacturing sector PMI has dropped below the expansion threshold of 50. Germany's IFO business sentiment index, however, remains above its historical average. Industrial production has shown a slowing trend in the past year, while exports have remained at an unchanged level in recent months, measured year-on-year.

Continued recession in the first half of 2013

Per cent



Source: Eurostat, SEB

Euro zone GDP continued to shrink in the first quarter of 2013, but the quarter-on-quarter downturn decelerated to 0.2 per cent, compared to 0.6 per cent in the fourth quarter of 2012. Short-term indicators point to continued very weak economic performance. We thus expect GDP to fall in the second quarter as well and then reach zero growth in the third quarter. Starting in the fourth quarter of 2013, GDP will climb slowly. **Measured as annual averages, GDP will fall by 0.7 per cent in 2013, while achieving 0.7 per cent growth in 2014.** Our forecast is below consensus for both years. Throughout our forecast period, growth will remain well below trend.

GDP, selected countries

Year-on-year percentage change

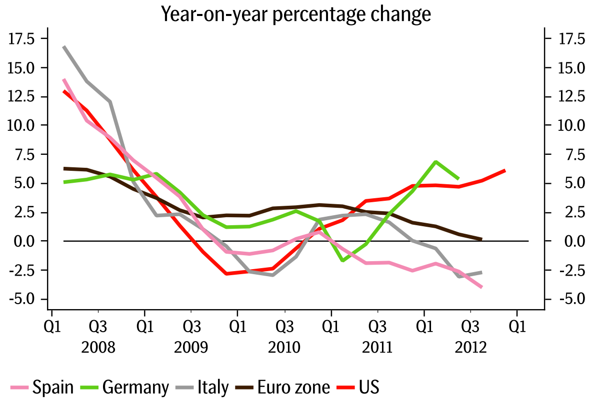
	2011	2012	2013	2014
Germany	3.0	0.7	0.3	1.3
France	2.0	0.0	-0.2	0.6
Italy	-0.5	-2.8	-1.7	0.3
Spain	-0.4	-1.9	-1.9	0.0
Greece	-7.1	-6.4	-5.0	-1.0
Portugal	-1.6	-3.2	-2,2	0.3
Ireland	1.4	0.9	0.9	1.5
GIPS countries	-1.2	-2.3	-2.0	0.1
Euro zone	**1.6**	**-0.6**	**-0.7**	**0.7**

Source: Eurostat, SEB

Behind this fragile economic performance are forces pulling in different directions. **Exports are showing a decent growth rate** and will be helped in the coming months by stronger global demand, especially from the US. A weaker euro will also help drive the export upturn. Domestic demand is being hampered by various factors. **Household optimism is squeezed by political uncertainty, austerity measures and rising unemployment.** So far, relatively high inflation has also played a part in undermining real income, but inflation is now rapidly on its way down. The dose of fiscal austerity in the euro zone will also decrease in 2014, leading to diminished headwinds for domestic demand.

Debt in non-financial companies

Year-on-year percentage change

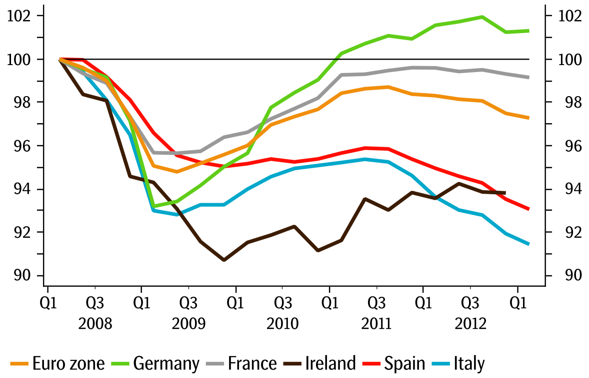


Source: Macrobond

Credit market problems are a major impediment to southern European economic growth. Despite a record-low ECB key interest rate, lending volume to households and non-financial companies continues to fall. For example, the IMF has estimated that non-financial companies in southern Europe need to reduce their loans by 20 per cent; Spain and Portugal are two countries singled out as especially hard pressed. Even solvent companies find it hard to get loans in an environment where banks are generally shrinking their balance sheets. There is an obvious need for **alternative tools besides interest rates to remedy the shortcomings of the transmission mechanism**. A recapitalisation of the banking sector and clearer progress in euro zone cooperation on bank supervisory and guarantee issues will be important pieces of the puzzle in resolving this problem.

Few countries have regained lost GDP since 2008

Index 100=2008 Q1



Source: Macrobond

Looking back at GDP growth since the economic crisis broke out, only Germany now has a higher GDP level than in early 2008. France has also recovered, but its GDP remains about 1 per cent below its 2008 level. Ireland, whose recovery is cited as a successful example among crisis-hit countries, has a GDP that is still 5 per cent below 2008. In the hardest-hit countries, the decline from 2008 levels is continuing. In Greece, GDP was about 20 per cent lower in 2012 than in 2008.

Germany's export engine is sputtering

Despite the relative strength of the German economy, a clear slowdown is now apparent there. The global recovery is not enough to compensate German exporters for weaknesses close at hand. After recovering in 2010, exports have decelerated. In current prices, they are now at a lower level than a year ago. Industrial production has fallen since the summer of 2012 but companies are expecting an improvement, according to the IFO business sentiment survey. Construction sector activity has also weakened, though partly because of cold winter and spring weather. Household confidence and retail sales are providing different signals at present; retail sales fell in March while consumer confidence improved. Wage and salary agreements in the labour market point to pay increases of 2.5-3.0 per cent, which in a low-inflation environment will lead to good increases in real purchasing power. We expect Germany's GDP growth to recover gradually, reaching annual averages of **0.3 per cent in 2013 and 1.3 per cent in 2014**. This means that in both years, German growth will be about 1 percentage point above the average for the rest of the euro zone.

German fiscal policy will be relatively neutral in 2013 and 2014 after belt-tightening equivalent to 1 per cent of GDP in 2012. This implies that the budget balance will be close to 0 per cent of GDP during the period 2012-2014. Germany will thus not yield to international pressure to pursue a more expansionary policy as a counterweight to fiscal cutbacks in southern Europe.

In September 2013, Germany will hold its federal parliamentary election. Chancellor Angela Merkel's European policy enjoys broad support, and the Christian Democrats (CDU/CSU) have a clear lead in opinion polls, but Merkel's Liberal coalition partner (FDP) is teetering close to the 5 per cent threshold and may lose all seats in the Bundestag. The EU-sceptic Alternative for Germany has gained ground but, according to opinion polls, will not make it into the Bundestag. There are thus many indications that the governing coalition will lose its parliamentary majority. Since the Greens have resisted working with the CDU, there is a high probability that Merkel will be forced into a grand coalition between Christian Democrats and Social Democrats. If so, it will be for the third time in the post-war period. Regardless of governing constellation, we expect Germany's current policies towards Europe to remain in place.

France in recession

The French domestic economy showed clear resilience during the sharp international economic downturn of 2008-2009, but in 2011 and 2012 its weak growth lost momentum. During the fourth quarter of 2012, GDP fell 0.3 per cent compared to the preceding quarter. Given a GDP decline of 0.2 per cent in the first quarter of this year, **France is now in a recession**. The composite purchasing managers' index also signals a significant risk of continued GDP decline.

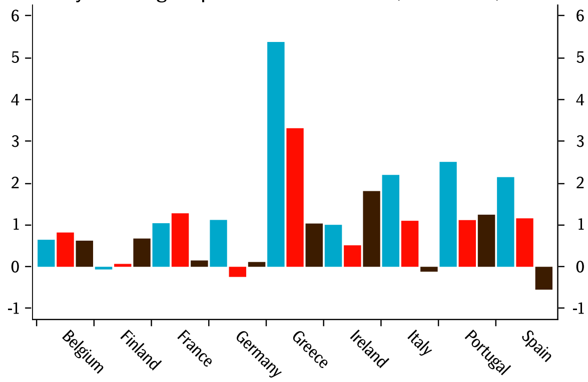
The French economy is weakening mainly because **private consumption, which was previously resilient**, is now being squeezed by rising unemployment and austerity measures. The weak export trend is not providing support to growth, either. Since the central government's fragile finances rule out fiscal stimulus, this spring the government has revised its GDP forecasts sharply downward. Our GDP forecast is more pessimistic than that of the government. In our assessment, France will experience a **falling GDP, -0.2 per cent, in 2013**, followed by a **weak GDP increase of 0.6 per cent in 2014**. The deteriorating growth picture has forced the government to postpone its target of achieving a budget deficit of 3 per cent of GDP by one year until the end of 2014.

Milder austerity policies in crisis countries

There are increasingly clear signs of a policy shift **from front-loaded cost-cutting to allowing more time**. Meanwhile there will be an **even greater focus on structural reforms**. Germany will have to abandon some of its earlier positions in order to avoid a continued downward spiral in the euro zone, with rising unemployment and deepening political uncertainty. On the other hand, crisis-hit countries will have to accept that the Troika (the IMF, ECB and European Commission) will continue to monitor their finances for a long period.

The diminishing effect of fiscal austerity

Year-on-year change in publ. structural balance, 2012-2014, % of GDP



Source: IMF

Portugal has been given more time to meet its targets, and France will not achieve its 2013 or 2014 budget targets. Spain also needs more time to meet the budget targets it has established. The failure to achieve these targets is largely a consequence of the more negative growth outlook. This, in turn, is because the austerity measures that have been imposed have had a bigger adverse impact on demand than traditional rules of thumb would indicate. **The overall dose of austerity** (measured as structural savings) **will decrease** from the equivalent of 1.4 per cent of GDP in 2012 to 1.1 per cent in 2013 and neutral in 2014. The actual public sector deficit in 2012 was 3.7 per cent of GDP: a clear decline from the peak of 6.4 per cent in 2009. This deficit will continue shrinking to 2.5 per cent in 2014.

Unemployment will continue to rise

Because of weak economic growth, the labour market turnaround will be delayed. In the euro zone as a whole, **unemployment rose to 12.1 per cent in March 2013**: 1.1 percentage points higher than a year ago. Divergences are very large; in Greece and Spain, the jobless rate is approaching 30 per cent, while Germany reports its lowest unemployment since reunification, 5.4 per cent. We expect joblessness to continue climbing and believe that Germany will also experience a weaker labour market ahead. Euro zone unemployment will rise to about 12.5 per cent by late 2013. The social and political problems associated with high unemployment pose one of the biggest threats to the continued reform process. Large divergences in jobless rates increase pressures and incentives to relocate from high-unemployment to low-unemployment countries. A more mobile labour force in the euro zone and EU is positive, but during this economic slump it may also generate populist political currents and national labour market protectionism.

One year with Hollande in the Élysée Palace

It has now been one year since François Hollande of the Socialist Party won the French presidential election. **Hollande's popular support rapidly fell to record lows**: from 60 per cent right after the election to 25 per cent today. This spring, a tax evasion scandal in the government contributed to the decline, but the main explanation is Hollande's weak management of France's economic problems combined with broken election promises. Promises to stop company lay-offs do not go together with an unemployment rate that has risen by 0.8 percentage points since the presidential election, reaching 11 per cent. With four years to go until the next presidential election and strong parliamentary support for Hollande, at present he faces no obvious domestic political threat.

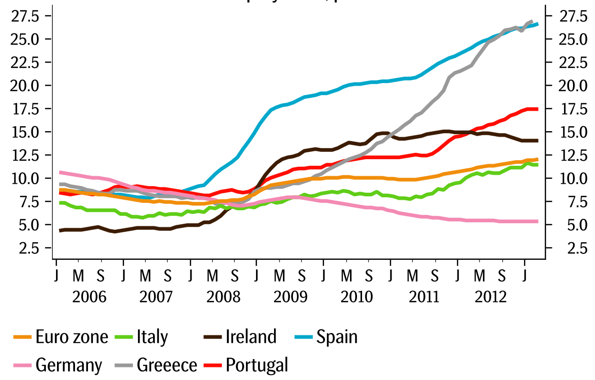
Hollande's explicit strategy is to **implement reforms at a leisurely pace**. The purely counterproductive measures enacted soon after the government took office in May 2012 (partial reversal of raised retirement ages and higher taxes) have recently been followed by a shift towards more growth-friendly reforms. A minor loosening of labour market laws has been enacted, but a highly regulated labour market continues to hamper France's fundamentally strong industrial sector, with its many leading international exporters.

Countries like Spain, Portugal and Ireland have progressed much further in their adjustment processes. This has made them more competitive compared to France, which is still running large trade deficits. **Relative economic decline has also weakened France's relations with Germany.** In practice, France has always been the weaker partner in their cooperation, but in recent years the gaps have become increasingly apparent. Meanwhile France's large, internationally exposed banking sector (more than 400 per cent of GDP) is a risk factor for financial stability.

Despite its weak economic performance, financial market confidence in France has risen. The yield spread to Germany on ten-year government bonds has fallen from a peak of nearly 200 basis points late 2011 to 40-50 bps. The ECB's increasingly forceful actions have thus increased market confidence in continued cooperation between the core euro zone countries. Although France and Germany have different strategies and motives for the future euro project, political developments in recent decades indicate that they can reach agreement in the end.

Weak labour markets in southern Europe

Unemployment, per cent



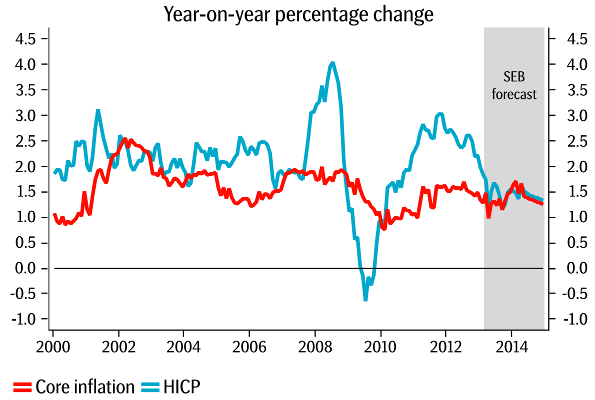
Source: Macrobond

Inflation heading below 1 per cent

The inflation rate has fallen in recent months and was 1.2 per cent in April. Lower energy prices and the fading effects of earlier value-added tax hikes are two reasons behind the decline. Weak demand and low pay increases are also beginning to have a broader impact in the form of slower price increases. Lower inflation rates are a euro zone-wide trend, although there are clear differences between countries. Greece has deflation and in Ireland it is at a low 0.6 per cent. In Spain, inflation has fallen from 2.6 per cent in March to 1.5 per cent in April. We are also seeing the same movement in Germany; inflation in April was 1.1 per cent.

Low inflation pressure

Year-on-year percentage change



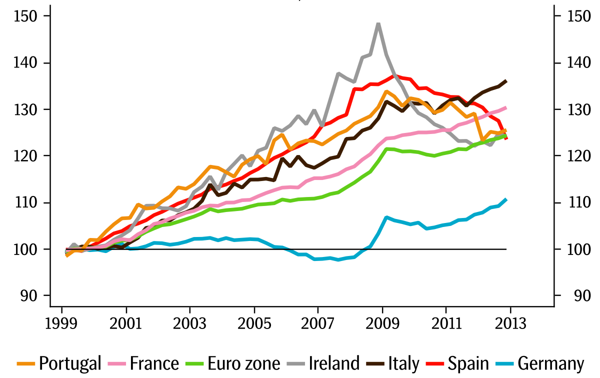
Source: Eurostat, SEB

Continued slow growth and rising unemployment are creating deflationary pressure in the euro zone. We thus expect inflation to keep being pushed downward. **Harmonised Index of Consumer Prices (HICP) inflation will reach 1.1 per cent at the end of 2013 and 0.9 per cent at the end of 2014.** Measured as annual averages, inflation will be 1.4 per cent in 2013 and 1.0 per cent in 2014. Core inflation will fall from an average of 1.2 per cent in 2013 and to 1.0 per cent in 2014.

Low inflation will give the ECB more room to continue pursuing expansionary monetary policy. Because inflation is also very low in Germany, this will delay the rebalancing process in the euro zone. In other respects, however, adjustments have progressed further than the inflation picture indicates. For example, unit labour costs have fallen in Greece, Spain and Portugal while they have risen more than 10 per cent in Germany over the past 3-4 years. Worryingly, the competitiveness of countries like Italy and France continues to deteriorate. Current account balances in southern Europe have also improved relatively sharply in recent years, but this is mainly due to falling imports and to a lesser degree due to increased market shares for exporters.

Competitiveness is improving in some countries

Unit labour cost, index 1999=100



Source: OECD, SEB

ECB being pushed into more drastic action

The task of the ECB has become more complex in the past year. Economic growth is weak and divergent, while inflation is showing a falling trend, with increasing deflation risks as a consequence. Peripheral euro zone countries are facing a challenging combination of low or negative growth, high bond yields, large budget deficits and high public and private sector debt, as well as political uncertainty.

The ECB's clear intention to do "whatever it takes" to save the euro and its launch of the Outright Monetary Transactions (OTM) programme – together with the European Stability Mechanism bail-out fund – have reduced the liquidity problems of euro zone countries, lowered borrowing costs and reduced the solvency problems of countries like Spain and Portugal. The ECB has hardly any choice but to continue along the same path. Trying to "wait out" structural reforms might well lead to destructive economic trench warfare, with very large risks. At the same time, expectations about the ECB's role as a crisis manager may sometimes seem unreasonably high. There is still a continued large probability of disappointments, due to delays in restructuring and growth policies.

The ECB's decision to lower its refi rate to 0.50 per cent in May was economically logical but will not solve the credit problems of southern Europe in particular. **A further rate cut to 0.25 per cent** (and an even narrower key rate corridor) **is probable and justifiable**. But the focus will be on keeping the euro overnight index average (EONIA) close to 0 per cent by offering unlimited liquidity to the banking system. We believe that the ECB will decide not to set its deposit rate at below 0 per cent, since the adverse effects – for example on the functioning of the interbank market and systemic challenges – would outweigh the favourable effects.

The crises in the euro zone at a glance

The following is a review of recent developments in crisis-hit euro zone countries and a table that summarises a large number of variables for all euro zone countries. Our aim is to develop a comprehensive risk assessment based on these variables and how they compare to various types of benchmarks.

In **Greece**, reform efforts are expected to continue slowly. The recession is still under way and there is still a risk that the country will abandon the euro: a risk that is primarily connected to political uncertainty and social turbulence after years of recession, austerity and high unemployment. Disagreements with the Troika about disbursements of bail-out loans will not stop continued support. Yet there are bright spots. The budget deficit has fallen, though less than expected, and the current account balance has improved. This trend will continue, but at a slow pace. The gentler euro zone attitude towards fiscal austerity means that further belt-tightening will probably be postponed.

Economic growth in **Ireland** has brought upside surprises, and exports have been spurred by improved competitiveness. In March, the country issued 10-year government bonds. Since Ireland again has access to market funding, this paves the way for an application to activate the OMT programme. Ireland might thereby serve as a good example of the ECB's serious intentions with OMT.

In **Italy** a broad centre-left coalition headed by Prime Minister Enrico Letta has taken power. The government has promised to ease austerity measures, on grounds that "On austerity alone, Italy will die." We thus expect a shift away from former Prime Minister Mario Monti's strategy towards a gentler fiscal policy. There is a risk that structurally important reforms in the pension system and labour law will be postponed as policy softens. The economy will remain weak, but the country will probably avoid acute funding problems. Given the risk of a new election if the government has problems agreeing on its policy direction, there is still political uncertainty.

The recession in **Spain** is continuing. There will thus be some easing of austerity here as well, but it is difficult to see any end to the downward spiral, with public and private deleveraging leading to rising unemployment and continued home price declines. These developments, in turn, are contributing to the rising share of bad loans. Our main scenario is still that Spain will need further bail-outs, primarily driven by the need for further recapitalisation of the banking sector. The country has used almost EUR 40 billion of EUR 100 billion approved and the additional amount is likely to be sufficient going forward. Spain will continue to experience great political uncertainty fuelled by high unemployment, criticism of belt-tightening and the 2014 independence referendum in Catalonia.

The economy in **Portugal** is heavily affected by the crisis in Spain, which receives nearly 25 per cent of the country's exports. When the constitutional court invalidated parts of the government's austerity programme this spring, this created temporary concerns. Yet market reactions were small and the government unveiled new belt-tightening proposals to ensure continued disbursement of bail-out loans and extension of loan maturities. This included raising retirement age to 66, cutting the number of state employees by 30,000 and extending the work week for public employees from 35 to 40 hours.

Cyprus is now taking steps to bring down its public sector deficit and shrink the banking sector. This will lead to a deep recession, and we expect GDP to fall by 10-15 per cent in 2013-2014, but the financial spill-over effects on other countries have been relatively short-term.

An earlier construction boom has created problems for the banking sector in **Slovenia**, which is now in fragile condition. In addition, due to the country's weak macroeconomic performance it probably needs a bail-out soon. Previous capital injections have not been sufficient to create stability. The economy is larger than that of Cyprus (0.4 per cent of euro zone GDP, compared to 0.1 per cent), but the banking sector is far smaller. The bail-out package can thus be limited in size, and spill-over effects in other countries will probably be small. The government has recently presented a consolidation programme to be able to hold off external support including privatisations and a VAT hike.

*% **% of GDP	Share of GDP*	Gov. debt**	Gov. balance**	Private debt**	Current account**	NIIP**	Banking system**	NPL*	Unemployment*	Political risk	**Total risk**
Malta	0.07	73.1	-2.6	210	-1.5	5.7	800	8.2	6.5	82	**Average**
Estonia	0.19	10.5	-0.5	133	1.3	-57.8	125	3.7	9.4	66	**Low**
Cyprus	0.20	86.5	-5.5	288	-8.8	-71.3	750	10.7	14.2	64	**High**
Luxembourg	0.25	20.5	-1.5	326	7.0	107.8	2200	0,4	5.7	95	**Low**
Slovenia	0.43	53.7	-4.4	128	0.6	-41.2	130	13.2	9.9	72	**Average**
Slovakia	0.82	52.4	-4.8	76	-1.2	-64.4	75	5,3	14.5	78	**Average**
Ireland	1.59	117.2	-7.7	310	2.4	-96	900	18.7	14.1	83	**High**
Finland	1.80	53.4	-1.7	179	-0.6	13.1	310	0.5	8.2	98	**Low**
Portugal	2.51	120.6	-5.0	249	-6.4	-105.0	325	9.0	17.5	70	**High**
Austria	2.78	74.3	-3.0	161	2.2	-2.3	340	2.7	4.7	90	**Low**
Greece	2.82	161.6	-6.6	125	-7.7	-86.1	225	17.2	27.2	49	**Hög**
Belgium	3.48	99.8	-3.0	236	-0.2	65.7	320	2.8	8.2	75	**Average**
Netherlands	5.72	70.8	-4.1	225	9.3	35.5	400	3.1	6.4	89	**Low**
Spain	11.90	88.4	-10.2	218	-3.1	-91.7	325	11.2	26.7	51	**High**
Italy	17.91	127.1	-2.9	129	-2.4	-20.6	250	11.7	11.5	66	**Average**
France	20.38	90.3	-4.6	160	-1.9	-15.9	410	4.3	11.0	67	**Average**
Germany	27.15	81.6	0.1	128	6.5	32.6	320	3.0	5.4	73	**Low**
Critical level		80	-3	160	-3	-35	300			70	

Source: IMF, Eurostat, European Commission, World Bank, SEB. NIIP: Net international investment position. NPL: Non-performing loans.

Weaker pound will boost British economy

- **Recession threat averted**
- **Above-target inflation again this year**
- **No new monetary stimulus programmes**

The British economy expanded in the first quarter of 2013 and thus avoided a new recession, defined as two consecutive quarters of negative growth. Looking ahead, the weaker pound will boost exports. Our assessment is that **GDP will grow by 1.1 per cent this year and 1.6 per cent in 2014**, slightly above the consensus forecast for 2013. Inflation, which has exceeded the Bank of England's 2 per cent target since late 2009, will remain stuck at high levels. **Inflation will be 2.0 per cent this year and 2.1 per cent in 2014**. The latest BoE minutes shut the door to new monetary stimulus, but the situation may change when Mark Carney takes over as governor this summer.

Inflation is exceeding pay increases

Year-on-year percentage change

Source: ONS, SEB

Despite help from negative real interest rates and quantitative easing, **GDP per capita is about 7 per cent below its 2007 peak**. At the corresponding time after the recessions of the 1970s, 80s and 90s, GDP per capita was between 5.5 and 7.5 per cent above its previous peak. One reason why the recovery has not taken off is that **inflation has exceeded wage and salary growth** since 2008. This has undermined purchasing power and thus made deleveraging more difficult. Household confidence indicators remain at low levels, but home prices are moving upward after several years of stagnation. **Private consumption will grow by 1.4 per cent annually in 2013-2014**, far below the 3.5 per cent average during the last economic upturn, which ran from 1992 to 2007.

Because of weak consumption, the British economy needs other growth engines, but **industrial production is showing no signs of an imminent upswing**. A weighted average of business surveys indicates a stagnating economy. So far the main impact of the weaker pound has been to push import prices higher, but we foresee improved competitiveness gradually **paving the way for an export-driven recovery**. This assumes that the euro zone, the UK's most important export destination, will gradually move to somewhat firmer ground.

The downgrading of UK sovereign creditworthiness by the Moody's and Fitch rating agencies was expected, and market reactions were small. Yet the downgrades were **a major reversal for Chancellor of the Exchequer George Osborne**, who had justified fiscal austerity by citing his ambition to preserve the UK's AAA status. Because of the stagnating economy, the government's **target date for achieving structural balance has been postponed** and will probably not be achieved until 2016-17. Our forecast is that austerity policies will remain in place, again averaging some 1 per cent of GDP in 2013 and 2014, but that policy battles are likely to heat up as the 2015 general elections draw closer. The government not only faces criticism from the opposition, but the IMF is also recommending less belt-tightening in order to get the economy moving faster. Meanwhile Prime Minister David Cameron's EU policy headaches are worsening. His Tories are divided, and the UK Independence Party is gaining ground on its signature issue: UK withdrawal from the EU. The September 2014 referendum on Scottish independence will also help fuel political uncertainty.

Despite a stagnating economy, inflation keeps springing upside surprises. In March, prices rose by 2.8 per cent. Inflation expectations, measured as the difference between yields on nominal and index-linked bonds, reached their highest level in five years. The risk of **1970s style stagflation** is raising the bar for additional monetary stimulus measures. Our main scenario is that **monetary policy will remain unchanged** even after Mark Carney, who has previously indicated support for aggressive expansionary programmes, has taken over as BoE governor in June. The Bank of England's balance sheet is larger compared to GDP than those of the ECB, Fed and Bank of Japan, **but the most important BoE interest rate will not be raised during our forecast period**.

During 2013 the UK's **currency has lost ground against both the euro and the dollar**, but after the BoE's latest monetary policy minutes were published, however, the pound climbed again. Our forecast is a **EUR/GDP exchange rate of 0.84 at the end of 2014**, compared to 0.84 today. The pound will weaken from today's 1.53 to 1.43 against the USD. Looking ahead, a weaker pound is the key to more investment- and export-driven growth.

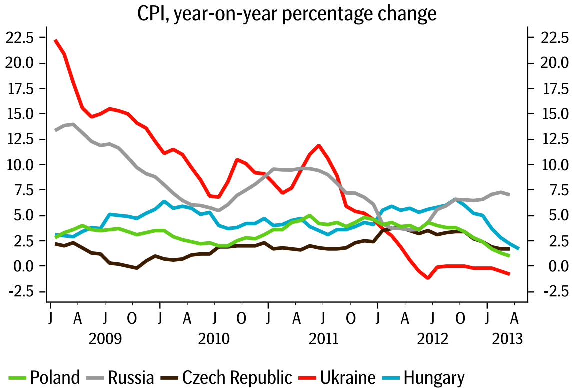
Growth has bottomed out, but recovery is sluggish

- **Continued downward pressure on inflation**
- **Economic stimulus measures launched**
- **Russia slower, but stimulus and oil may help**

Economic growth in Eastern (including Central) Europe has bottomed out in the past six months. **Sluggish recovery** will start this autumn. Indicators have recently fallen. Short-term growth will remain hampered by weak Western European demand, rising unemployment and – in southern parts of the region – pressure on banking systems. Yet domestic demand is rising, due to better funding terms in the past six months for governments, companies and banks as well as sharp domestic interest rate declines. In Poland, Hungary and elsewhere, purchasing power has also strengthened due to a sizeable decline in inflation. Inflation is expected to remain low – squeezed in the short term by a global commodity price slide.

Inflation in selected countries

CPI, year-on-year percentage change



Source: National statistical offices

Lower price pressure and weak growth will also pave the way for stimulus measures, and not only via continued monetary easing as in Poland which is expected to make an additional rate cut. **Three examples**: **1. Hungary**, which in April launched its BoE-inspired "Funding for growth" programme, which includes allowing banks to borrow from the central bank at zero interest provided they lend the money to small and medium-sized businesses. **2. Ukraine**, which just expanded the capital spending element of its 2013-2014 economic plan. **3. Russia**, which is moving towards enacting an extra infrastructure programme, financed via the National Wealth Fund in order not to burden the federal budget, and to make some credit policy stimuli measures.

Overall, **Eastern European growth will increase somewhat in the next 6-12 months**, helped by a cautiously improving outlook in the West as well as higher consumption and capital spending. Meanwhile **the north/south divergence of the past two years will persist: the Baltics, Russia and Poland will show continued decent growth** in 2013-2014, while the Czech Republic, Hungary and Ukraine will slowly improve from around zero growth. Croatia and Slovenia will move towards recession again in 2013. We expect both Ukraine and Slovenia to receive international bail-out loans this year to resolve their external balance and banking crises, respectively. We also expect Ukraine to devalue its currency. The northern part of Eastern Europe is more resilient to the global slowdown and the euro zone debt crisis, largely because its economies and banking sectors enjoy relatively good fundamentals.

Russia's economic performance is worse than expected. Year-on-year growth was a mere 1.6 per cent in the first quarter of 2013. The manufacturing purchasing managers' index (PMI) is still above the expansion threshold of 50 but fell from above 52 last winter to 50.6 in April due to weaker external demand and lower oil prices. Capital spending is also weak, and previously robust retail and credit growth has faded. Russia's low unemployment now also seems to be levelling out at about 5.5 per cent (just below equilibrium). Yet positive forces may help domestic demand ahead. Inflation has probably peaked at just above 7 per cent this spring and is slowly falling. After a pause since September 2012, the central bank will cut its key interest rate this summer and autumn by 75 basis points to 7.50 per cent. The federal government will also deviate from its budget discipline. Its 2013-2015 budget target is to make fiscal policy clearly less expansionary, mainly by curbing expenditures. But the government will allow this year's deficit to be somewhat larger than projected. Last but not least, we foresee oil prices – oil and gas account for half of federal revenue – rebounding to USD 110/ barrel. In 2013, a balanced budget would require oil prices of USD 115-120/barrel. Overall, growth will recover in the second half of 2013. **GDP will climb by 2.5 per cent this year and 3.2 per cent in 2014 – a noticeable downward revision** since *Eastern European Outlook* in March 2013 and well below consensus. Risks are skewed to the downside.

Poland's growth decelerated abruptly in the second half of 2012 and **showed continued weakness** early in 2013. First quarter year-on-year growth slowed to 0.4 per cent, and a weak manufacturing PMI of 46.9 in April, down from 48.0 in March, indicate no immediate improvement. But consumer confidence has bottomed out and recovered somewhat since winter. GDP growth will rebound in the second half, fuelled by stronger real wages in the wake of falling inflation, historically low interest rates and decently competitive exports, sustained by German demand. Next year, capital spending will climb with the help of EU funds. **We are lowering our annual growth forecast by a few tenths of a per cent**, due to the lower outlook for Western European and Russian growth, to **1.8 per cent in 2013 and 3.3 per cent in 2014**, well above consensus.

Balanced growth, still topping the EU

- **Households are leading the expansion**
- **Competitiveness under control, with some questions about Estonia**
- **Green light for Latvia to join euro zone**

For the third straight year, in 2013 the Baltics will be the fastest-growing economies in the EU, though activity is expected to cool in Latvia and Lithuania. **In Latvia, we expect GDP to grow by 3.5 per cent and in Estonia and Lithuania by 3.3 and 3.2 per cent, respectively.** The Estonian forecast for 2013 has been lowered clearly after unexpectedly weak GDP growth in the first quarter. The weakness was partly explained by decreased public investments funded by revenues from emission rights, which were large in 2012. The three economies are **driven by good domestic demand**, but the rapid capital spending growth of the past two years in Estonia and Latvia will slow sharply. Capital spending in Lithuania will only increase slightly after last year's downturn. Exports will show decent increases despite Western European weakness and a slowdown in Russian growth; Russia is Lithuania's biggest market by far (19 per cent of exports) and No. 3 for Estonia and Latvia. In **2014, when the world economy picks up speed, growth in the Baltic countries will become even more balanced. Estonia's GDP increase** will be **3.7 per cent** while **Latvia's growth will rebound to 4.8 per cent and Lithuania's to 3.5 per cent**. In 2013-2014 only Latvia will thus exceed potential growth, which we estimate at 4 per cent in all three countries.

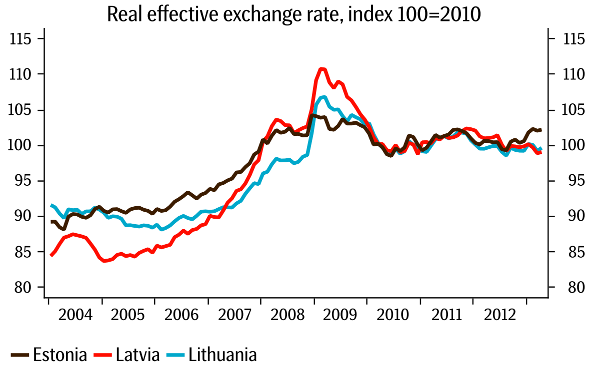
In the past 3-4 months, the European Commission's business and household sentiment indicator has kept climbing in Lithuania but fallen slightly in Latvia and Estonia. The downturn in the latter countries is closely related to the global slump and to manufacturing. Household optimism remains more robust.

Private consumption has gradually rebounded after the deep crisis of 2008-2010. Retail sales are not spectacular but have chugged along at a healthy pace. In the past year, 12-month sales growth has been 3-8 per cent: fastest in previously hardest-pressed Latvia. During the overheating of 2005-2007, retail sales rose 10-25 per cent a year, fuelled by excessively rapid pay and credit growth. Pent-up post-crisis purchasing needs are one important factor behind the recovery in consumption. Purchasing power and eagerness to shop are also benefiting from pay hikes, a continued gradual downturn in still-high unemployment, low interest rates and in Latvia and Lithuania by milder fiscal austerity. **Public finances are under control** in all three countries and 2013 budget deficits are expected to be small.

Exports will grow this year and in 2014 at a modest pace of 5-9 per cent, after **decelerating from high double-digit levels** in the past 2-3 years. This is still decent expansion, compared to many other countries. **Export competitiveness has strengthened** and has been preserved after earlier internal devaluations. Over the past five years, all three countries have gained market shares: those of Estonia and Lithuania have soared. This year, too, there will probably be market gains, though small. **Real effective exchange rates have also been notably stable** since the wage and price cuts of 2008-2010, but as we have stated before, **cost trends in Estonia are worth a warning**. Since late 2012 there has been a tendency towards real appreciation pressure there. The reason is high wage and salary growth. In recent years, productivity growth has lagged behind pay increases, and only recently have there been signs that productivity has begun to take off. Pay increases in Estonia this year will be 7-8 per cent, compared to 3.5-4 per cent in Lithuania and Latvia. Differences in pay increases partly affect the inflation picture. This year inflation will remain subdued in Latvia and Lithuania. It will also fall in Estonia but remains at a relatively high 3.3 per cent, even though economic growth is below potential.

Stable competitiveness after internal devaluations, but some cost pressures in Estonia

Real effective exchange rate, index 100=2010



Source: BIS

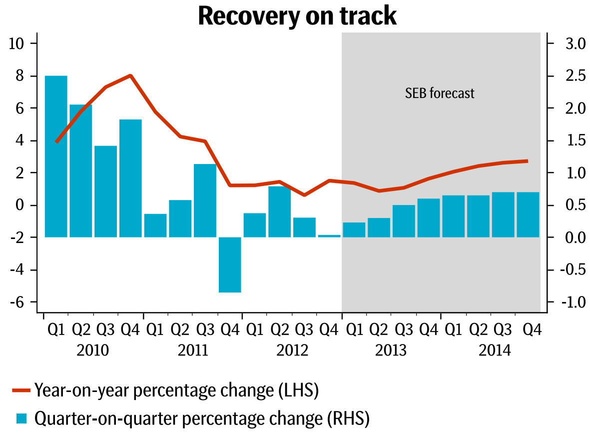
We expect Latvia to convert to the euro in 2014 as planned. The country meets all the Maastricht criteria by wide margins, including sustainable reductions in inflation and budget deficits. Convergence aiming at future euro zone accession was also one of the main objectives of the EU/IMF-led 2008-2011 bail-out loan programme. Another reason why we believe that Latvia will get the green light after this spring's evaluations by the European Commission and ECB is that the EU probably wants to show that the euro process is alive despite the crisis in various euro zone countries. **There is a 50-50 chance that Lithuania will achieve its target of euro zone accession in 2015**. It will be difficult to bring down inflation fast enough for an evaluation in the spring of 2014.

Slow recovery will continue

- **Euro zone weighing down manufacturers**
- **Strong households will keep consuming**
- **Unemployment will rise further**
- **Riksbank will cut key rate on low inflation**

After a weak finish to 2012, growth now looks set to recover, mainly driven by domestic consumption. Weaknesses in the euro zone continue to hamper Swedish manufacturers, leading to subdued exports and capital spending. We thus anticipate below-trend growth this year followed by modest acceleration during 2014. Our forecast is that **GDP will grow by 1.3 per cent and 2.5 per cent in 2014**: a largely unchanged picture since *Nordic Outlook* in February. Employment has been stronger than expected, but because of a larger labour supply the jobless rate will still climb during most of 2013.

Recovery on track



Source: Statistics Sweden, SEB

Given falling resource utilisation and continued low inflation, the Riksbank will cut its repo rate to 0.75 per cent in July. Continued expansionary monetary policies elsewhere in the world are one reason why we believe that the Riksbank will leave its key interest rate at this low level throughout our 2013-2014 forecast period.

The government has signalled that its fiscal policy will remain expansionary next year. We believe **fiscal stimulus will increase further** from SEK 25 billion 2013, equivalent to 0.7 per cent of GDP, **to SEK 35 billion**, or 0.9 per cent of GDP, in 2014.

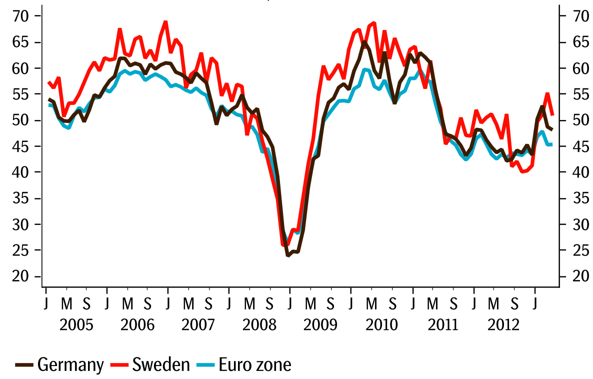
Shaky recovery for exports

Export sector indicators have recovered after falling during late 2012 but most of them remain at low levels, signalling that the recovery for merchandise exports will occur gradually. **Exports will climb by 1.5 per cent in 2013 and 4.5 per cent in 2014.**

The recovery in world trade is the most important driving force behind this slightly stronger Swedish export performance, but recent broad downturns in purchasing managers' indices (PMIs) show that the international economy is still fragile. The relatively strong krona also makes Sweden's export sector extra sensitive to international disappointments.

Indicators point to slow recovery

PMI, new orders



Source: Markit

Capital spending resisted the downturn relatively well during 2012, though housing investments fell by about 10 per cent. Statistics Sweden's capital spending survey nevertheless shows that businesses have become more cautious. Industrial companies, for example, plan to trim their capital spending during 2013. Plans for service sectors are more mixed but generally indicate a deceleration compared to 2012. Weak demand and falling resource utilisation are holding back capital spending. A stabilisation in the number of housing starts indicates that the decline in residential investments will gradually slow this year. Altogether, we predict that **capital spending will increase by 1-2 per cent this year and then accelerate to 3 per cent during 2014**.

Households on firmer ground

For the household sector, the recovery has been stronger than for companies. The household confidence indicator is now at its highest level since late 2011. Households are buoyed by strong income growth and high savings. Most indications are that consumption will continue to rise gradually at about the same rate as during 2012. An unexpectedly strong labour market and a trend towards new home price increases further reinforce the picture of resilient households.

The risk of a **short-term decline in home prices has greatly diminished**. Short-term indicators show home prices rising by more than 5 per cent this year. Due to the inflated price level, combined with measures to curb lending, prices look set to level out next year. A new period of significant price increases in the near future would heighten the risk of undesired price declines further ahead. We thus believe that the government, Riksbank and Financial Supervisory Authority will take action if home prices begin trending clearly upward again.

Household income and consumption
Year-on-year percentage change

	2011	2012	2013	2014
Consumption	2.1	1.5	2.0	2.3
Income	3.5	2.5	2.9	2.8
Savings ratio, % of disp. income	10.2	11.4	11.7	12.2

Source: Statistics Sweden, SEB

Rigid bureaucracy hampers housing construction

Structurally low housing construction is instrumental in pushing up home prices. A theme article in the February *Nordic Outlook* contrasted the low level of housing starts with the strong population growth of the past 5-10 years. This problem is gradually receiving more attention in political discourse. The politicians who are responsible are under increasing pressure.

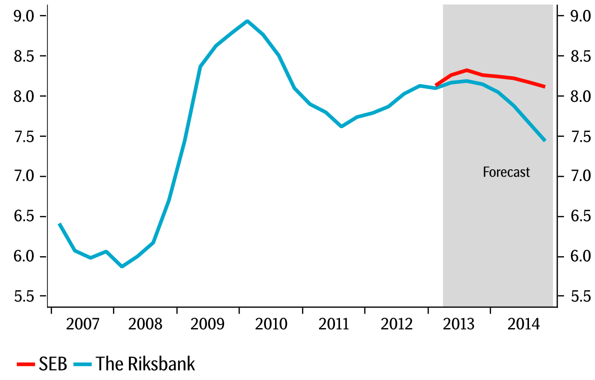
At present, the government's focus seems to be on loosening tough rent controls and easing the bureaucratic process that surrounds residential construction. At the beginning of 2013, for example, authorities began allowing somewhat more flexible rents when sub-letting, and in May a government report proposed amendments to the Planning and Building Act, but the process is moving very slowly and the government is likely to have difficulty getting a parliamentary majority to support its proposals. The changes in sub-letting rules, for instance, ended up being less far-reaching than in the government's original proposal. Moreover, an amended Planning and Building Act cannot go into effect until mid-2014. Major steps to increase housing construction are not possible until 2015, but there is a risk of continued political deadlock even after the September 2014 election. Also hampering the construction of single-family homes and tenant-owned cooperatives is the ambition of authorities to limit lending to households. Taken together, most indications are that residential construction will remain low in the next few years.

Job growth but higher unemployment

Employment weakened late last year, but short-term indicators are now showing a stabilisation. We have therefore adjusted our forecast in a more optimistic direction and expect the positive trend to continue this year and then accelerate somewhat as economic growth gains momentum in 2014.

Despite job growth, unemployment has risen since mid-2012. This is because the labour supply has increased more than in our forecasts (see theme article). One important reason is government measures to reduce sick leaves and early retirements. Stronger incentives to work, due to the earned income deduction, have probably played a part. Another reason is higher labour force participation by people above the official retirement age of 65. We expect the participation rate to keep climbing. This will contribute to rising unemployment during most of 2013, with only a marginal decline next year.

Unemployment continues to rise
Per cent



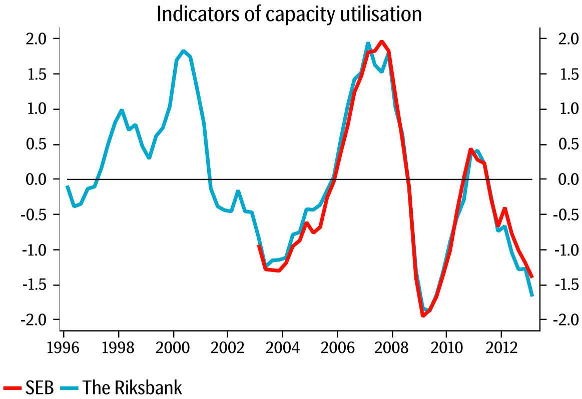
Source: Riksbank, National Institute of Economic Research, Statistics Sweden, SEB

Wage round is on schedule

This year's wage round looks likely to turn out well, despite some clashes and various strike and lockout threats. Three-year collective agreements have now been concluded for much of the Swedish labour market, and industrial agreements have mainly served as benchmarks. More negotiations remain, but there is little risk of major labour disputes or pay hikes that diverge from the industrial norms. The agreements signify cost increases of 2.2-2.3 per cent a year over the next three years and pay hikes of around 2 per cent. These agreements represent a clear downshift compared to 2012 and are among the lowest three-year contracts concluded in the past two decades. We expect total annual wage and salary increases in the next three years to end up somewhat below 3 per cent.

Despite rising employment, the combination of higher jobless rates and below-trend growth has resulted in a continued decline in capacity utilisation. The level is now close to 2009 lows and below the bottom level recorded in the aftermath of the economic crisis of the early 2000s.

Economic slack pointing towards key rate cut
Indicators of capacity utilisation



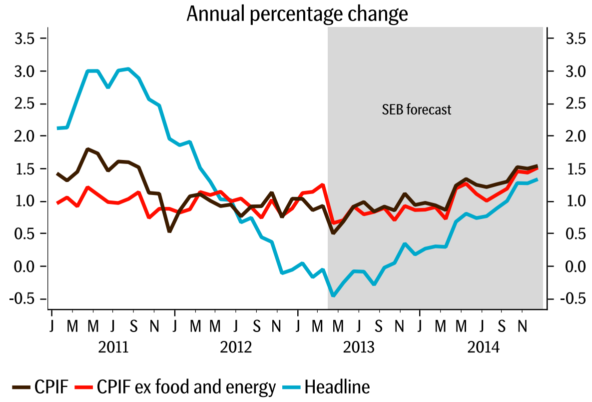
Source: The Riksbank, SEB

Inflation will remain low

Inflation pressure continues to be very low, with Consumer Price Index (CPI) inflation around zero and underlying CPIF inflation (CPI excluding interest rates) at about 1 per cent. Inflation would have been even lower if the effect of re-weighting in January had followed its normal pattern. A positive contribution to CPI of 0.1 per cent was now recorded, compared to an earlier average of -0.25 per cent.

Inflation pressure continues to be low

Annual percentage change

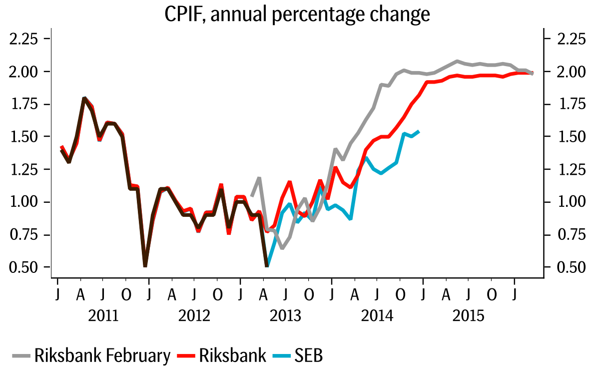


Source: Statistics Sweden, SEB

Most indications are that inflation will remain low during the next 1-2 years. We expect the krona to continue appreciating, which will help blunt inflation throughout our forecast period. Rising energy and commodity prices have kept inflation up in recent years, but looking ahead we anticipate negative contributions to inflation in both 2013 and 2014 from these factors. The rate of pay increases is now also slowing compared to 2013, which will also help hold down inflation.

View on core inflation pressure differs to some extent

CPIF, annual percentage change



Source: Riksbank, Statistics Sweden, SEB

The only inflationary threat is attributable to low productivity growth, which drives up unit labour cost. A productivity-driven surge of inflation in Sweden has often occurred in low-growth situations, but this time the upturn in unit labour cost is significantly smaller than it was, for example, in 2001 and 2009. The inflation upturn in those years was also driven by a substantial weakening of the krona in the wake of economic slowdown; this time the currency effect will be the opposite. Higher unit labour costs are the driver of the Riksbank's forecast of an inflation rebound in 2014, but our assessment is that the Riksbank is overestimating the impact on prices.

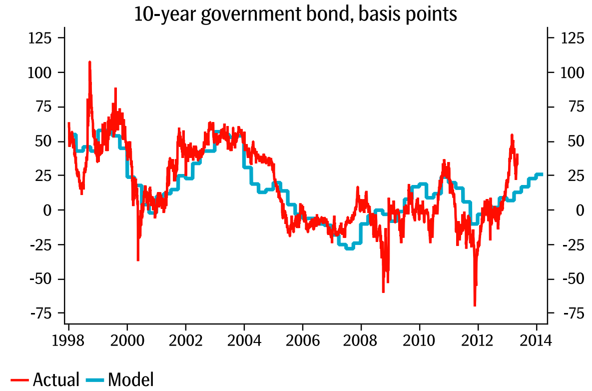
Reluctant Riksbank will cut repo rate in July

The Riksbank is torn between a macroeconomic forecast that is ever more clearly signalling the need for lower interest rates, on the one hand, and worries about the consequences of rising home prices and higher household debt burdens, on the other. Our assessment is that falling resource utilisation, low inflation and a recovery that is not really taking off will weigh more heavily and that the Riksbank will lower its key interest rate to 0.75 per cent in July. Continued stimulus by the world's major central banks will also influence this decision to some extent, among other things indirectly via the effects of an appreciating currency on inflation.

After that, we predict that the repo rate will remain at 0.75 per cent throughout 2014. We interpret the lower repo rate path in the Riksbank's *Monetary Policy Update* in April as a first step towards signalling longer-lasting low interest rates. The Riksbank's dilemma in managing combined low inflation and rising home prices and household borrowing is becoming increasingly clear, however. The Riksbank will probably become more and more explicit in its desire for regulations that will slow the growth of household borrowing. Measures to increase principal payments on home mortgage loans are the most likely. This can probably be achieved through recommendations from the Financial Supervisory Authority and Swedish Bankers' Association rather than through legislation. Further increases in the banks' risk weights for home mortgage loans may also be considered.

Spread to Germany falling

10-year government bond, basis points



Source: Macrobond, SEB

Narrower bond yield spread to Germany

Swedish 10-year sovereign bond yields have mainly been lower than their German counterparts since the financial crisis broke out in 2008. In the past 3-4 months, the situation has been the opposite. In February the spread reached its widest since 2002. Because of improved international risk appetite, investments in Sweden as a "safe haven" have diminished. In addition, the National Debt Office's borrowing of SEK 100 billion for the Riksbank's currency reserve during the first quarter led to a temporary increase in the supply of Swedish sovereign bonds.

In recent months, the spread against Germany has again narrowed. We believe that this trend will continue and that the spread will be 20 basis points at the end of 2013 and stays at that level 2014. Our key interest rate forecasts imply that the ECB will lower its refi rate by 0.25 per cent to 0.50 per cent below the Riksbank's key rate. This is a sign that Swedish sovereign bond yields will be somewhat above German ones in a slightly longer perspective. Given the modest upturn expected for German yields, this means that 10-year Swedish sovereign bond yields will rise to 2.00 per cent by the end of 2014.

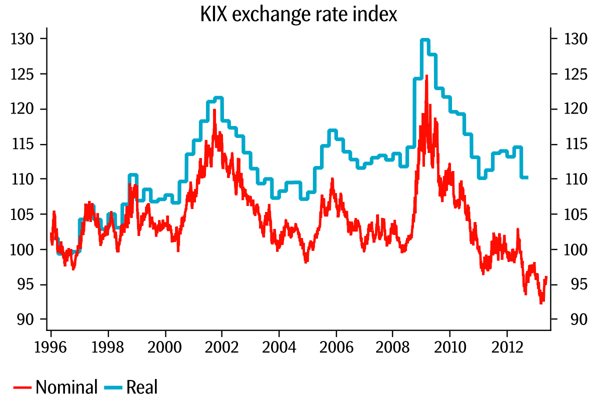
The krona will appreciate further

The Riksbank's surprising downward adjustment of its repo rate path in April signified that the trend prevailing since mid-2012 had ended. Even though currency rate indices are still close to their strongest readings since the mid-1990s, we believe that the appreciation of the krona will resume during the second half of 2013.

The krona has historically risen when the economy has improved and the current account balance is still strong. Both the US and the euro zone suffer from structural problems and are pursuing very expansionary monetary policy, which is also expected to contribute to a stronger krona. Offsetting this is the fact that our long-term model is signalling that the krona is close to its long-term value.

Krona continues to strengthen

KIX exchange rate index



Source: Macrobond, SEB

We thus predict a cautious downturn in the EUR/SEK exchange rate to 8.30 at the end of 2013 and further to 8.00 at the end of 2014. Since the US dollar is expected to appreciate against the euro, we expect the USD/SEK rate to rise somewhat. In TCW trade-weighted terms, the krona will appreciate to 111 at the end of 2014, which is 5 per cent stronger than today.

Continued expansionary fiscal policy

Public finances will weaken somewhat during our forecast period due to expansionary fiscal policy and slow growth. The marginal **net lending** surplus in 2011 turned into a small deficit in 2012, which will grow to 1.5 per cent of GDP in 2013 and then continue widening to 2.0 per cent in 2014. The central government **borrowing requirement will increase from SEK 25 billion to SEK 154 billion in 2013**. This is partly driven by the economic cycle, but it is mainly due to National Debt Office borrowing in order to strengthen the Riksbank's currency reserve (this does not affect net lending). Partly offsetting this is our assumption that the government will sell SEK 17 billion worth of state-owned assets per year. If these nonrecurring effects are excluded, the borrowing requirement is roughly SEK 60-70 billion. **This year, central government debt will increase from 32.4 per cent of GDP 2012 to 35.8 per cent of GDP 2013.** Here, too, the change is mostly due to National Debt Office borrowing for the Riksbank aimed at strengthening the currency reserve.

We expect Swedish fiscal policy to become more expansionary in 2014. This means that the government will complete the shift that it began in the last budget bill. Total **fiscal expansion** this year – including the spring budget's additional spending on education, training and infrastructure – will end up at **about SEK 25 billion** or 0.7 per cent of GDP, in line with our forecast. We believe that **the budget bill for 2014 will be more expansionary, SEK 35 billion or 0.9 per cent of GDP**. A number of factors point towards continued expansion: high unemployment and extensive idle resources in the economy, weak demand and low central government debt. Since 2014 is an election year, and some of the parties in the governing Alliance are struggling with low public support, this will increase pressure for additional reforms aimed at clarifying their political principles. Probable new reforms, in addition to infrastructure, education and labour market policy, are an additional step of the earned income tax credit reform, lower tax for pensioners, increased child allowances and lowering of differences in unemployment insurance fees.

Public finances

Per cent of GDP

	2011	2012	2013	2014
Net lending	0.0	-0.7	-1.5	-2,0
Gen. gov't gross debt	38.3	37.4	40.7	40.8
Central gov't debt	33.1	32.4	35.8	36.2
Borrowing req., SEK bn	-68	25	154	63

Source: Statistics Sweden, SEB

There is increasingly heated debate on Sweden's fiscal policy framework among economists and representatives of interest organisations. In light of low government debt and weak resource utilisation, most of them advocate a change that will open the way to even more expansionary fiscal policies, but the Finance Ministry and the Social Democratic leadership continue to support the current regulations. It is apparently of great political value to be perceived as the foremost guarantor of strong government finances.

Yet sometimes this debate seems unnecessarily polarised. There are good reasons to adjust the level of the budget surplus target, while retaining the rest of the fiscal framework. Over time, this target has actually assumed a greater tightening effect on the central government. Net lending in the old age pension system is now around zero, instead of the surplus of about 1 per cent of GDP reported in 1998-2002. Assuming that the local government sector is in balance, this requires the central government to run a surplus of 1 per cent of GDP to meet the target. It used to be sufficient for the central government to be in balance. This was also a basic concept when the target was formulated in the 1990s (as a surplus of 2 per cent of GDP, since the surplus in the premium pension system was included in net lending at that time).

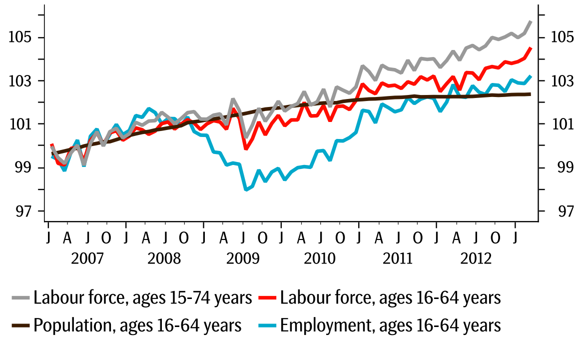
Although the central government has halved its debt as a percentage of GDP since the late 1990s, the target has thus implicitly become tighter. In light of this, changing the budget target to a balance in net lending and thus also in the central government budget would be very logical. Maintaining a target that is not met during a rather long period risks undermining the credibility of the framework, especially since there is no discussion among responsible political leaders about suitable budget surplus and government debt targets in today's economic policy environment.

- **Rising supply pushing up unemployment**
- **Sharp decline in number of people taking sick leave and early retirement**
- **More and more continue working after 65**

Sweden's combination of rising employment and increasing unemployment is due to a strong underlying trend in labour supply. The number of people in the Swedish labour force has increased by more than 5 per cent since the economic crisis broke out in 2007. Although the number of jobs has increased by more than 3 per cent, unemployment is above 8 per cent. As the chart indicates, employment has grown significantly faster than the population. It is especially remarkable that the labour force is increasing so sharply considering the weak economic situation; periods of weak job growth are often characterised by a labour force reduction.

Employment and labour force rising faster than population

Index 100 = 2007



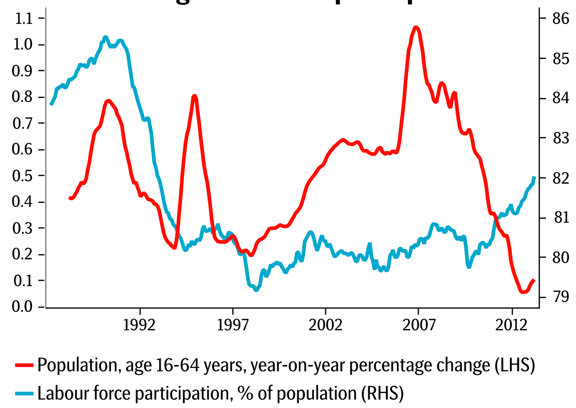
Source: Statistics Sweden

There are two main trends that explain the strong growth in the labour force. The most important component is that labour force participation among people below the official retirement age of 65 has risen by nearly 3 percentage points. Another important reason is a sharp upturn in the number of people who continue to work after the official retirement age. The number of employed individuals aged 65-74, who are included nowadays in the official measure of employment, has doubled to 150,000. This increase is equivalent to nearly half (1.3 percentage points of 3) of the total increase in employment since 2007. The upturn is partly an effect of an increase in the number of people in this interval, but the employment rate (number of jobs divided by population) among those aged 65-74 has increased by 50 percent from 10 per cent to 15 per cent.

Sharp decline in sick leave figures

For years, labour force participation remained at a low level after having falling during the early 1990s economic crisis. This was partly due to a rising average number of student years among younger people. Another rather important explanation was a sharp increase in the number of people taking sick leave and early retirement. The number of people in these groups rose by 125,000 during the period 1999 to 2005.

Increasing labour force participation rate

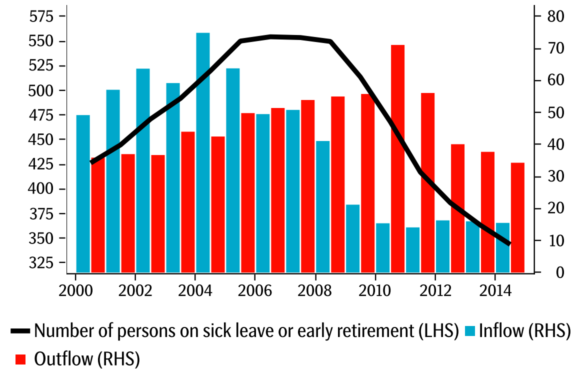


Source: Statistics Sweden

The government's review of the sick leave registration process and increased incentives to work have helped reduce the number of people taking sick leave and early retirement by 200,000 in the past 4-5 years. This downturn is largely the same size as the upturn in labour force participation.

Despite some signs that the above trends are slowing, we believe labour force participation will continue to increase in 2013 and 2014. We estimate that the number of people on sick leave or early retirement will fall by 15,000 to 20,000 per year during 2013 and 2014. Meanwhile we expect the percentage of people over 65 who work to continue rising, though at a slower pace.

Decrasing number of persons on sick leave or early retirement



Source: NIER

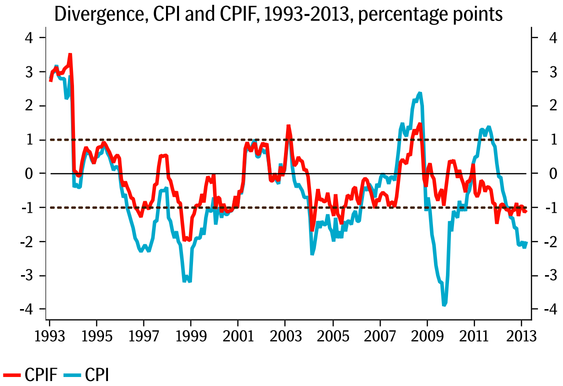
For example, the Riksbank has revealed that an increasing percentage of the unemployed are people with little formal education and immigrants who have difficulty finding jobs for various reasons. This may have contributed to a rising level of equilibrium unemployment. Yet we draw the conclusion that partly because of the rising labour supply, the risk of labour market bottlenecks is very small during the next couple of years, which among other things is supported by resource utilisation indicators.

- **Growing inflation targeting problems – macroprudential tools needed**
- **CPI target fulfilment assymetric: inflation too low 70 per cent of time**

Swedish inflation targeting policy turns 20 this year. It has been an important sub-component of the stabilisation policy framework that has served Sweden well since the early 1990s. But never before have both the targets and techniques of monetary policy been the object of such intensive debate, both domestic and international, as today: *What are the shortcomings of inflation targeting policy? What responsibility do central banks have for the global crisis? How should boundaries be drawn between monetary and fiscal policies?* Perhaps the **most important conclusion from the past 10-15 years is that price stability does not automatically lead to financial stability**.

Large divergences from the 2 per cent target

Divergence, CPI and CPIF, 1993-2013, percentage points



Source: Riksbank

Since the Riksbank's inflation targeting policy became operative in 1995, CPI inflation has **fallen below the 2 per cent target nearly 70 per cent of the time**. If we use the CPIF measure (with stable interest rates), the corresponding figure is 65 per cent. CPIF inflation was 2 per cent on average during the period 1995-2003. Since 2004 **CPIF inflation** has been 1.5 per cent on average and **below target more than 80 per cent of the time**. Add to this that our forecasts until the end of 2014 show that neither CPI nor CPIF will reach the 2 per cent target. **The inflation figures are not symmetric.** This indicates that monetary policy has been too tight. Measured as CPI, the general price level should be 11 per cent higher in order to be entirely in line with the target, viewed over the entire 20-year period.

During the first ten years, the bank's key interest rate could have been lower. Although the repo rate fell in real terms, it was from a level of around 5-6 per cent. During the same period, Sweden reported a negative credit gap (below-trend credit growth) that reflected deleveraging by both households and businesses in the aftermath of the 1970s and 1980s bubble economy. A comparison between Sweden, the US and the euro zone using a broader measure for the degree of expansion or contraction also shows that Sweden had tighter conditions than other countries. More aggressive rate cuts would hardly have created any problems in an environment where the surplus target for central government finances was working. The justification for the excessively tight policy was to quickly generate market confidence in the inflation target.

The past ten years are more difficult to evaluate. Although inflation has fallen below target, monetary policy has been neutral or expansionary. It seems fairly obvious that the Riksbank, like other central banks, was too late in adjusting for the price-squeezing effect of globalisation on production processes. In that situation, cutting the key interest rate further while the credit gap shifted from negative to positive would have further fuelled household debt and home prices. The environment for pursuing monetary policy has been exceptional in the past 5-6 years. Inflation has been pushed further downward, but the growth rate in lending to households and businesses has remained at relatively high levels. This is the **dilemma facing the Riksbank today**: there is clearly room to lower the key interest rate from a purely inflation-based perspective, but there is no such room if the Riksbank factors in household debt and escalating home prices.

Surprisingly stable inflation expectation levels among various groups in society, and other measurements, show that despite its errors in forecasting both inflation and the repo rate compared to other forecasters, the Riksbank still enjoys public confidence. This is something that is also true of other central banks, however. Wage earners have probably been winners more than losers as a result of the Riksbank's sometimes successful and sometimes unsuccessful monetary policy. The inflation target has been an important starting point in wage rounds. Because inflation has turned out to be lower, this has boosted real wages. It is interesting to note that the latest Swedish wage round will have difficulty creating real pay increases in two or three years if the Riksbank is successfully keeps inflation at 2 per cent. There are many indications that in practice, more people believe inflation will be lower than this.

Some observers argue that more aggressive rate cuts would have generated more jobs, but in recent years it is difficult to find companies that have complained about excessive interest rates. **The problem has been weak demand, which has largely been determined by international factors.** The krona has been undervalued during the past 20 years, a fact that meanwhile should have eased the adverse impact of rising real wage costs on the export sector in particular.

Twenty years have passed. *How will the next decade look?* The Riksbank is not alone in finding itself in uncharted territory. Inflation targeting policy is likely to survive in some form, but the trend seems to be towards a greater focus on some kind of nominal GDP target. However, a more important question for both the Riksbank and other central banks is what new macroprudential tools will be developed and who will own them.

Growth is elusive, but gradual recovery expected

- **Growth drops due to lower exports**
- **Collapse in inflation lifts real wages**
- **Fiscal growth packages have limited effect**
- **Fall in current account is seasonal**

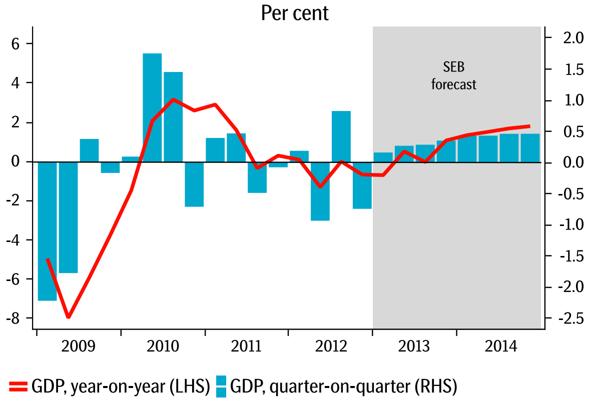
Danish growth remains elusive, with fourth quarter GDP dropping 0.7 per cent on the back of falling exports. Indicators point to weak momentum early in 2013. However, the picture should improve as the global recovery gains traction and not least the expected trough in euro zone growth materializes. The stabilisation in real wages after the collapse in inflation will also contribute positively. We have revised our growth estimate for 2013 downward compared to the last *Nordic Outlook* mainly due to the poor fourth quarter numbers. **We expect growth to be 0.2 per cent this year, increasing to 1.6 per cent in 2014.**

Real wage growth turning supportive

Private consumption has been flat for years due to the housing bust. Consumer confidence remains subdued, while retail sales and car registrations dropped early in 2013. Unemployment continues to be fairly stable, but this is not entirely positive. It is partially related to people dropping out of the labour force as their right to unemployment benefits ends.

Gradual recovery in GDP

Per cent



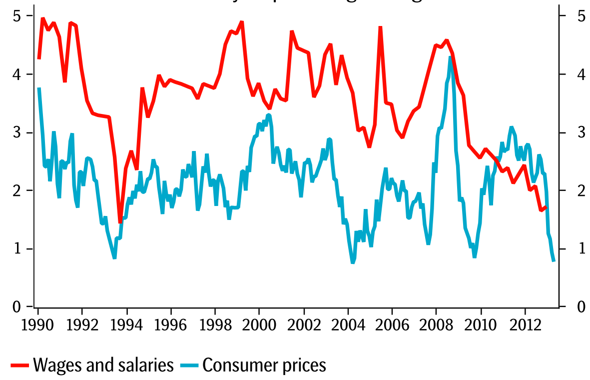
Source: Macrobond, SEB

On a more positive note, property prices have increased in the two first months of 2013. To some extent this could be a seasonal phenomenon, but still house prices are up 2 per cent from last year while apartments are up 8 per cent. The Danish mortgage system means lower interest rates are being transmitted to households although higher fees are a counterbalancing factor. Mortgage institutes are also trying to persuade borrowers to take longer maturity loans and reduce the share of interest-only mortgage loans. These trends make sense from a financial stability point of view, but act as minor cyclical headwinds.

Looking ahead, real wage and salary growth has turned from headwind to tailwind. Nominal wage growth is still subdued and is likely to stay so in the near future. But a significant drop in year-on-year inflation in March to 0.9 per cent means that consumers are seeing real wages rise. The latest drop in inflation is partly related to lower food and beverage prices and a drop in transportation costs. **We expect inflation to be 0.8 per cent in 2013, rising slightly to 1.2 per cent in 2014.** Thus, real wage growth should stay positive.

Real wage growth positive as inflation collapses

Year-on-year percentage change



Source: Macrobond

While housing investments have been flat for a while, corporate capital spending has been surprisingly resilient, posting solid gains in the second half of 2012. As investments are running ahead of capacity utilisation, some short-term weakness could be expected.

Manufacturing activity has lost momentum in recent months and a drop in confidence suggests that Denmark is experiencing a short-term correction in line with the global picture. We do expect a trough within a few months as the global cycle turns.

Fiscal policy is more expansionary, but new measures have muted effect

After lagging budgets for the first half of 2012, public sector consumption rose significantly in the third and fourth quarter.

The government won parliamentary support for two “growth packages”. The first package mainly lowers the corporate tax rate from 25 to 22 per cent and reduces energy taxes for companies. The package is fiscally neutral, for example also reducing transfers to students and slowing public salary growth. If anything it is slightly growth-negative in the short term. The second “growth package” prolongs tax rebates on housing-related services and lowers the tax on beer and sodas (the latter is meant to improve the competitiveness of retailers close to borders). The growth impact from this package is also expected to be muted. The minister for economic affairs and the interior has stated that fiscal manoeuvring room has been used. We expect fiscal policy to be less supportive going forward relative to the second half of 2012.

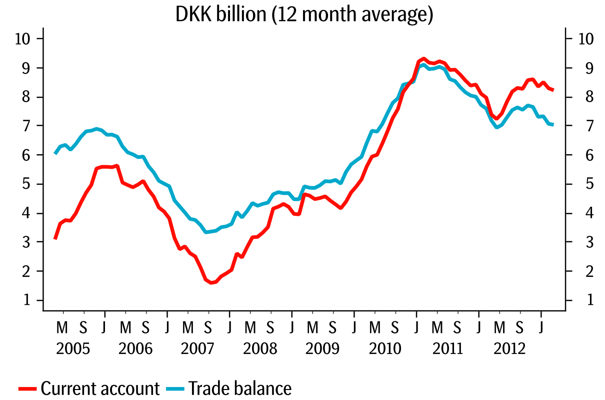
The public budget deficit was 4.1 per cent of GDP in 2012, but a significant share of this was due to pre-payment of an early retirement scheme, thus reducing the central government’s long-term obligations. **We expect the deficit to drop to 1.5 per cent this year and next.** The government plans to reduce its cash position at the central bank, which has accumulated on the back of several years of over-funding. As a consequence, public gross debt is expected to fall from 45.7 per cent of GDP in 2012 to 42.5 per cent in 2014.

Drop in current account is seasonal

The current account has weakened in recent months, culminating with a negative figure in March. One factor is lower export growth due to the global slowdown, combined with fairly resilient imports. Exports to EU countries have generally fallen, with Sweden and the UK in the lead. There has also been a drop in transfers, particularly in March, but this is a seasonal phenomenon. The current account should improve again from April as transfers normalise and exports turn more supportive on the back of the expected global recovery. In this connecting a trough in euro zone growth is a crucial assumption, given the large Danish exposure to this region.

Underlying current account trend holding up

DKK billion (12 month average)



Source: Statistics Denmark

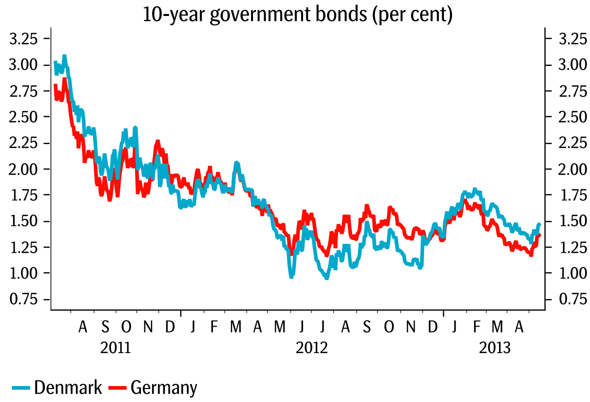
There has generally been good demand for Danish assets in 2013, with foreigners being net buyers and Danish investors repatriating. This is probably related to uncertainty after the Italian election and the Cyprus bail-out. Danish government bond yields have increased recently and the spread to Germany has increased slightly since the turn of the year.

Central bank lowers lending rate

The combination of a current account surplus and supportive portfolio flows has resulted in upward pressure on the krone versus the euro. At present, the currency is in territory that is neutral for monetary policy.

The yield spread to Germany has increased

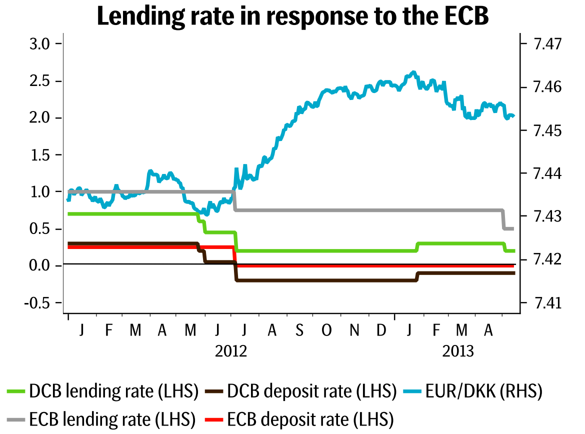
10-year government bonds (per cent)



Source: Macrobond

The central bank lowered its lending rate from 0.30 to 0.20 per cent after the European Central Bank lowered its refi rate from 0.75 to 0.50 per cent. Normally the Danish central bank follows the ECB, but it cited limited manoeuvring room as rates approach zero as the reason for the smaller rate cut. An ECB cut in the lending rate to 0.25 per cent would likely lead to another cut of 10 basis points by the Danish central bank. The deposit rate is the de facto policy rate, given the large deposits and limited lending at the central bank. It is currently -0.10 per cent and has been negative for almost a year. As a guide to the ECB, which is flirting with negative deposit rates, the Danish experience suggests a limited effect on credit growth (see the last *Nordic Outlook* for a deeper analysis). However, the Danish experience does suggest a marked negative effect on the currency.

Lending rate in response to the ECB



Source: Macrobond

In February Lars Rohde, former CEO of the large pension company ATP, took over as governor of the central bank. He has continued to be vocal in public debate and has signalled increased transparency by holding press conferences in connection with the central bank’s quarterly reviews. However, he has not announced any changes to the operations of the central bank or introduced new views on major policy issues.

Still not quite like others

- **Mainland GDP recovered in the first quarter**
- **Weak exports will slow growth in 2013**
- **Norges Bank on hold until summer 2014**

Underlying momentum in the Norwegian economy firmed at the start of the year following a deceleration in late 2012. Private consumption of goods revived solidly in the first quarter as expected, but exports were weak, led by a sharp drop in exports of oil and gas. However, this was more about production problems than any slump in demand.

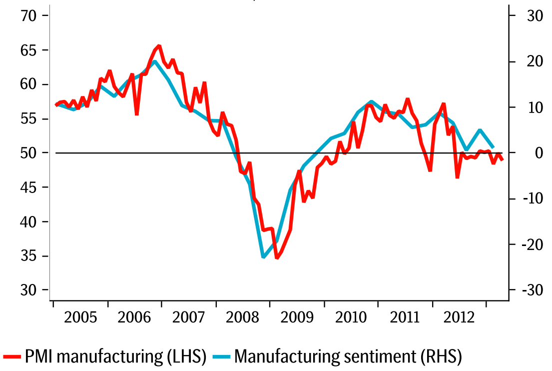
We are nonetheless trimming our forecast, with a more marked slowing due to weak exports and a drag from the inventory component. **Overall GDP is expected to increase by 1.7 per cent in 2013**, well below the 3.1 per cent rate in 2012, and by **2.4 per cent in 2014**. Meanwhile, **growth in mainland GDP** – excluding oil/gas and shipping – should slow from 3.4 per cent last year to a trend-like **2.7 per cent in 2013 and 2.9 per cent in 2014**.

Decent momentum in manufacturing

Overall industrial production has been weak since mid-2012, and the 6.1 per cent sequential drop in the first quarter from the previous one marked a third consecutive quarterly decline. Weakness has centred on oil and gas extraction, which in the first quarter was 10 per cent lower than a year earlier. Here, some recovery seems likely as gas extraction in particular has been hampered by production problems, including difficulties at the vast Troll field in February and a shut-down of the third-largest gas field for the entire month in March.

Surveys suggest slower momentum

Index, net balance



Source: Statistics Norway, Macrobond

Production in the manufacturing sector – i.e. excluding energy and mining – has held up better, rebounding from a slight decline in the final quarter of 2012 (the first in more than a year) to show 1.0 per cent sequential growth in the first quarter.

However, surveys suggest softer momentum ahead. The manufacturing purchasing managers' index has languished at or below the 50 threshold since last June on weakness in new orders. Moreover, the quarterly sentiment survey, which has been the better indicator in the past, declined from a net balance of 5.1 in late 2012 to 1.1 in the first quarter. Here, too, sluggish order inflow was the main driver for the decline, in addition to rising inventories of finished goods. The level of the sentiment indicator is marginally below the long-term average, which should be consistent with slightly sub-par activity.

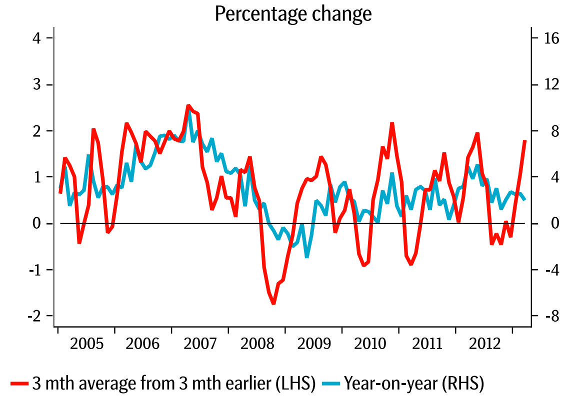
At the same time, the sentiment survey saw manufacturers within all main sectors expecting firmer demand in the current quarter, including an improvement in foreign orders. In the recent past, however, such expectations have proved misplaced. Production expectations, which in the previous survey correctly signalled firmer momentum over the winter, are nevertheless consistent with continued modest year-on-year growth.

Strong consumption at the start of the year

Momentum in private consumption slowed noticeably during the second half of 2012, hampered by stalling domestic spending on goods. While this mirrored moderating growth in real household disposable income, the extent of the slowing was surprising amid rising consumer confidence, which improved further in the first quarter.

Retail sales turned sharply in early 2013

Percentage change



Source: Statistics Norway

The first quarter of the year saw a solid revival, however, as non-auto retail sales in inflation-adjusted terms gained a solid 1.8 per cent from the previous quarter. Domestic spending on goods on the monthly indicator was up 1.6 per cent. On the latter measure, the upturn following marginal growth in late 2012 is all the more impressing as the strong gain in the first quarter was pulled down quite markedly by a weather-related plunge in spending on electricity and fuel.

The solid recovery lifts our forecast for **full-year growth in private consumption to 3.4 per cent** in 2013, even though momentum should slow going forward. At the same time, the revival at the start of the year is reassuring in the face of an apparent shift in the labour market.

Unemployment creeping up in early 2013

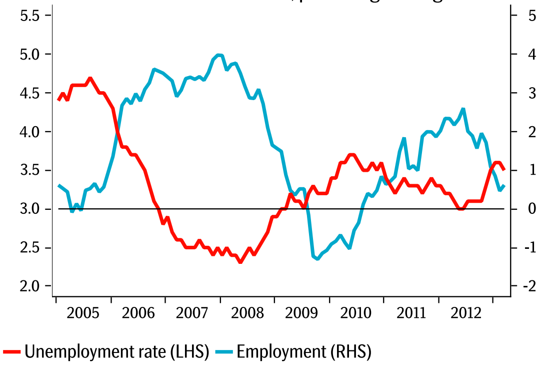
After rising at a robust pace up until mid-2012, employment fell slightly during the second half, according to the Labour Force Survey (LFS). It held up better as measured in the national accounts which include employees not registered as residents of Norway.

However, LFS employment increased 0.3 per cent in the first quarter. The slight improvement is in line with our assessment in February's *Nordic Outlook*, but as the labour forces increased in line with job creation, the LFS unemployment rate stayed at 3.5 per cent in the first quarter. This yields a rather marked increase by Norwegian standards from 3.1 per cent in the third quarter of 2012.

We still regard the increase in LFS unemployment as somewhat exaggerated. Admittedly, the less volatile measure of registered unemployment has crept higher, but so far the increase is more modest and the unemployment rate (including those in labour market programmes) is lower at 3.1 per cent and on a par with the average in 2012. Nonetheless, the **LFS unemployment rate should average 3.4 per cent in 2013**, up from 3.2 per cent in 2012, while **job growth should be halved from 1.9 per cent to 0.9 per cent in the current year**.

A shift in labour markets

Per cent of labour force, percentage change



Source: Statistics Norway

Home prices show signs of stabilising

Residential investment has turned substantially higher in the past couple of years and should continue to add to overall growth in 2013 as well. However, housing starts have slowed since mid-2012, but tend to be quite choppy: the recent moderation resembles the one in late 2011/early 2012 which proved transitory, and orders suggest a reacceleration. The average level in the first quarter was nonetheless 19 per cent higher than a year earlier. Housing completions show a similar volatile pattern, but it is worth noting that the 12-month aggregate to March was the highest since spring 2009.

Moreover, following years of lagging behind, completions are starting to catch up with household formation. In turn, an improving supply-demand balance should eventually put a lid on

Don't blame demand for subdued inflation

It is very hard to argue that subdued core inflation in recent years has been demand-driven. This observation should have consequences when it comes to monetary policy. In fact, growth in households' domestic consumption of goods and services was a solid 2.6 per cent on average in 2010-2012; overall consumption was stronger as spending abroad has surged. Over the same period, core inflation on the CPI-ATE measure averaged 1.2 per cent, one percentage point less than in 2007-2009 and half the 2.5 per cent medium-term target that guides monetary policy.

Most of the slower core inflation has been due to food and non-alcoholic beverages, clothes and shoes, furniture and household appliances, and post and telecommunications. In terms of demand, it is interesting to note that the same four groups in the most recent three-year period showed stronger growth than overall domestic consumption.

Instead, subdued price trends partly reflect a stronger NOK, since import content is very high. In this regard, Norges Bank can influence the exchange rate by setting interest rates (though the relationship between the exchange rate and relative interest rates is not constant). However, there is little the central bank can do when it comes to generally weak price impulses from abroad, shifts in foreign trade patterns that have affected prices of imported goods or structural changes in the form of fierce competition in some market segments, which should be welcome developments anyway. Hence, other than the NOK, stronger domestic inflation is decisive for any lift.

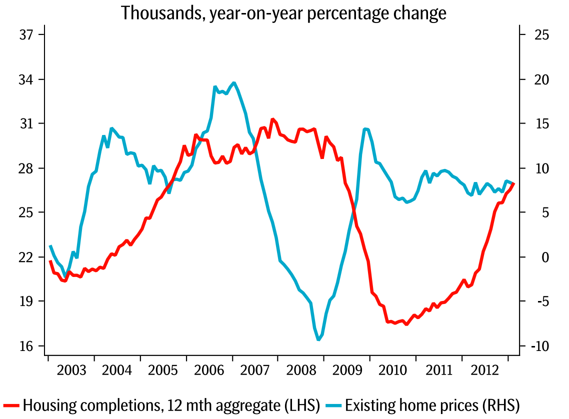
As demand is healthy enough to begin with, a lower key interest rate is unlikely to have a noticeable effect by itself. Of course, lower interest rates might spur aggregate demand to such an extent that it put further pressure on resources and hence wage growth. In this regard and assuming still-soft import prices, wage growth must probably show a persistent 4-4.5 per cent increase (most likely towards the upper end of the range) to lift domestic inflation sufficiently to reach the 2.5 per cent inflation target in the medium term.

However, the question remains whether it is desirable to use monetary policy by cutting rates further to quicken the pace of inflation via stronger wage growth. For starters, the competitiveness of Norwegian exporters has deteriorated sharply for a number of years as wage growth has been constantly higher than among foreign competitors. Moreover, persistent economic weakness abroad, especially in Norway's main European markets, is putting a lid on exports. Even if the krone should depreciate somewhat, relatively high cost growth in Norway that could quicken the pace of inflation might lead to a further deterioration in competitiveness. This cannot be the way to go. The last two sentences are actually a verbatim quote from the Norges Bank Governor's annual address in February 2012.

existing home prices, which show signs of levelling out. While prices were still up 6.6 per cent in the year to April, they have barely increased since late 2012. It is still too early to draw firm conclusions, but demand might have started to ease. This is evident from a moderation in short-term credit growth and surveys showing lower credit demand from households. If sustained, these trends support our expectation of a downward correction in home prices, but the timing remains uncertain.

Home prices have stabilised

Thousands, year-on-year percentage change



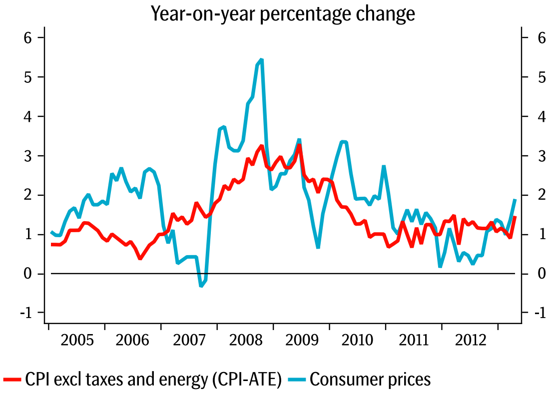
Source: Statistics Norway, Nef

Finally, an upside inflation surprise

Core consumer prices have been soft since mid-2010, showing no signs of any real upward trend shift despite relatively high wage growth and an economy operating at normal capacity. Part of this owes to a persistent decline in prices of imported goods (to a certain extent reflecting a stronger currency), but surprisingly benign domestic inflation has been as important.

A subtle shift in the making

Year-on-year percentage change



Source: Statistics Norway

However, core inflation rose quite noticeably in April as the year-on-year rate jumped from 0.9 per cent to 1.5 per cent on the CPI-ATE measure, the highest since last March. Admittedly, the better part of the jump was narrowly based, but there are signs of a subtle, though modest acceleration in the making. While wage growth will slow from 4.0 per cent in 2012 to 3.5 per cent in 2013, the upside surprise in April leaves **our forecast for core CPI** unchanged at **1.3 per cent in the current year** and **1.9 per cent for 2014**.

Norges Bank on hold until next summer

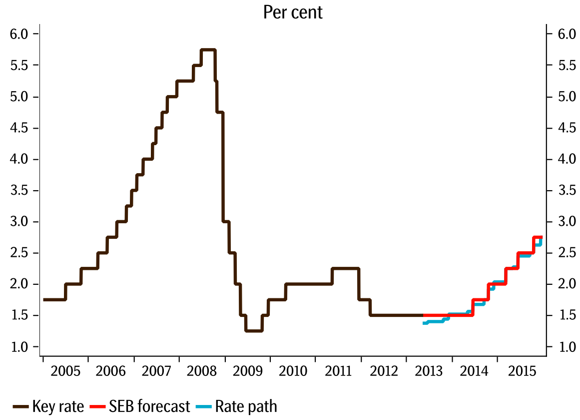
Norges Bank left the deposit rate unchanged at 1.50 per cent at its monetary policy meeting in May. The Board thus argued that recent developments had been broadly as expected, while a NOK exchange rate on the weak side of the bank's trajectory likely was an important factor for the on-hold decision.

The neutral statement following the meeting contrasted quite sharply with the decidedly dovish assessment at the meeting in March. At the time, Norges Bank lowered its inflation forecast and predicted that core CPI will remain well below the 2.5 per cent medium-term target over the forecast horizon, ending 2016 at 2.1 per cent. The bank slashed its optimal rate path, effectively putting off three hikes until the end of 2014.

In our view, the absence of a rate cut in March despite a much lower inflation forecast and the on-hold decision in May amid the 50/50 chance of a cut implied by the rate path suggests an acceptance of inflation staying low for longer. As such, key rates have been left on hold to keep monetary policy "robust", one of the bank's three criteria for "an appropriate interest rate path", though the inflation target is the most prominent one.

Norges Bank will hike key rate in 2014

Per cent



Source: Norges Bank, SEB

Obviously, any changes in key variables – especially the exchange rate – will be imperative going forward, but we see the **deposit rate staying at 1.50 per cent until next summer. In June 2014, the central bank will start a cautious hiking cycle and will make a further rate cut by 25bps by the end of 2014.**

Dovish monetary policy keeps NOK in check

The Norwegian currency continues to score high on a relative basis in the G10 sphere. However, for some time Norges Bank has been trying to fight off large foreign portfolio managers buying NOK by an accommodating monetary policy outlook to weaken the currency. Flows have also weakened on the back of lower oil prices. We expect the EUR/NOK exchange rate to be stuck in a 7.30/7.70 range for the remainder of the year. A marked appreciation would trigger rate cut expectations while Norway's solid fundamentals continue to trigger foreign NOK buying on weakness.

Norwegian government bonds will be supported by Norges Bank's dovish bias, low global yields and the recent NOK 66 billion redemption of the shortest government bond. Supply will amount to NOK 70 billion this year, of which NOK 34-39 billion remains for the second half. By the end of the year, we expect a 10-year yield of 2.10 per cent and a spread above Germany of 60 bps.

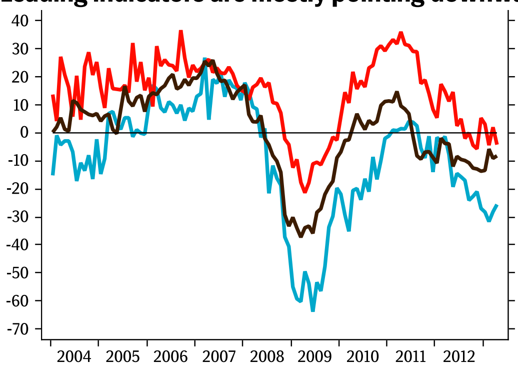
Zero growth in 2013 and weak recovery

- **Structural problems hampering growth**
- **Falling inflation benefits households**
- **Continued tight fiscal policy**

In recent months, indicators have **delivered downside surprises**. The economic outlook appears weak. GDP fell by 0.5 per cent in the fourth quarter, and early 2013 has been weak. Exports and industrial output have fallen in recent months. Household income is a bit stronger due to pay increases and falling inflation, but rising unemployment is keeping household confidence and consumption down. The Statistics Finland GDP indicator also signals a weak first quarter. Our first quarter forecast is zero growth, which means that Finland will barely escape a new recession. After that, a modest recovery will occur. Aside from weak international conditions, the economy is hampered by structural problems in the manufacturing sector. **In 2013 as a whole, GDP will fall by 0.2 per cent; in 2014 it will grow by 1.6 per cent.**

There are no signs of an imminent rebound. The European Commission's manufacturing indicator has largely remained at the same weak level since late 2011. The service sector was more resilient in 2012, but its indicator has now fallen and has fluctuated around zero in recent months. The worst future outlook is in construction, where uncertainty among both households and businesses is pushing down investments.

Leading indicators are mostly pointing downward



— Manufacturing — Services — Construction

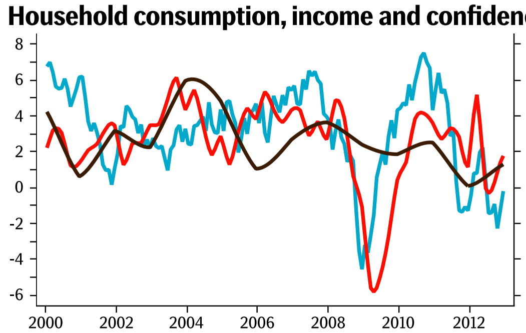
Source: European Commission

Exports have performed weakly, falling in current prices by 4.3 per cent during the first quarter of 2013 (see box). Exports were also weak compared to countries like Sweden and Germany, especially factoring in Finland's bigger decline in 2009. The low level of capital spending in other countries is hitting Finnish industry hard, but we expect the downturn to slow this year and production to increase during the second half. Measured as annual averages, **exports will increase by a mere 0.5 per cent in 2013 and 3.0 per cent in 2014**. The current account deficit will remain around 2 per cent of GDP in both years.

Capital spending fell by 2.9 per cent in 2012. The trend was especially weak late in the year. Indicators are at low levels, especially for construction investments. Except for the acute crisis years 2009 and 2010, capital utilisation is at its lowest level of the 21st century. **Overall capital spending will be unchanged in 2013 compared to 2012 and will increase by 3.5 per cent in 2014.** A slight increase in construction will prop up capital spending up this year.

Household consumption drove Finland's economic growth in 2012 and will also remain an important force in 2013 and 2014, but the outlook for households appears worse than before. The labour market has weakened more than expected, as reflected in low consumer confidence. Cyclical areas such as car sales are falling, as are retail sales excluding cars. Offsetting factors are that wage and salary increases are at a decent level of more than 3 per cent and that inflation has fallen, thus strengthening real purchasing power. **Household consumption will increase by 0.4 per cent in 2013 and 1.3 per cent in 2014.**

Household consumption, income and confidence



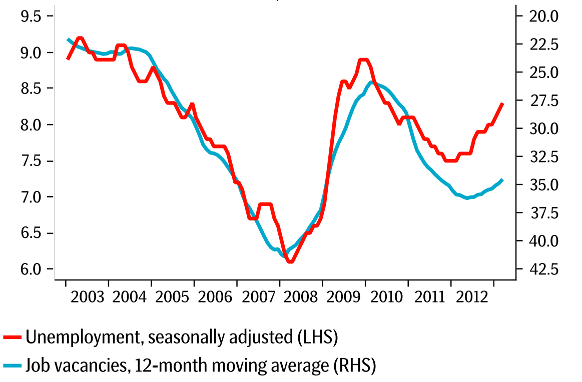
— Real disposable income, year-on-year percentage change (LHS)
— Household consumption, year-on-year percentage change (LHS)
— Consumer confidence (RHS)

Source: Statistics Finland

The labour market resisted weak growth during the first half of 2012, but since then unemployment has risen from 7.6 per cent in June 2012 to 8.3 per cent in March 2013. **The number of jobs and hours worked is now falling**; compared to Sweden, the upswing in unemployment is due to fewer jobs, not an increase in the labour supply. Assuming below-trend growth, unemployment will continue to increase slightly to just above 8.5 per cent towards the end of 2013 before levelling out and beginning to fall. Measured as annual averages, **unemployment will be 8.4 per cent both in 2013 and 2014**. Wages and salaries will climb by more than 3 per cent this year, strengthening household income but weakening Finland's competitiveness in an environment where a number of euro zone countries are reporting very low increases or even decreases in pay levels.

Unemployment is rising

Per cent, thousands



Source: Statistics Finland

After peaking in December 2012 at 3.5 per cent, HICP inflation has now fallen rapidly. VAT and indirect tax hikes have kept inflation up, but these effects are now disappearing. In March, inflation was 2.5 per cent, and we expect a slight continued decline. **HICP inflation will be 2.3 per cent in 2013 and 2.1 per cent in 2014** (the national CPI measure continued to fall in April). Core inflation will remain in line with HICP.

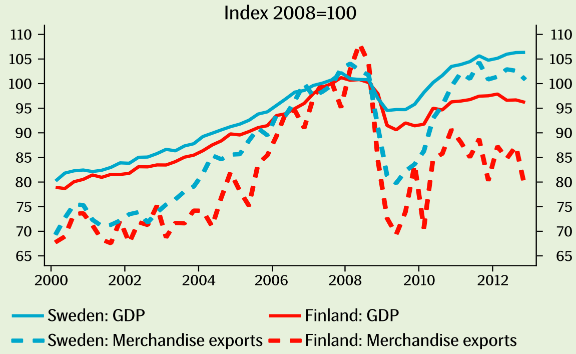
Public finances have provided downside surprises. The government has pursued a tight fiscal policy in order to bring down its budget deficits, but the weak economic situation is having the opposite effect. In 2012 the budget deficit increased to 1.9 per cent of GDP. Gross public debt rose from 34 per cent of GDP in 2008 to 53 per cent in 2012. **Fiscal policy will remain tight**, but because of the weak economy the deficit will stay at 2 per cent of GDP in 2013 and then shrink somewhat. Public debt will continue to climb. Despite budget deficits and increasing debt, the country enjoys **continued confidence in financial markets**. Yields on Finnish 10-year sovereign debt have fallen during 2013 to historically low levels. The yield spread to Germany has climbed somewhat this year and has recently fluctuated between 20 and 30 basis points.

Why is the recovery weaker in Finland than Sweden?

The Swedish and Finnish economies demonstrate similarities as well as differences. Their sectoral structures have great similarities, and in the 1990s both countries implemented major fiscal consolidation and structural reforms.

Weak exports behind GDP decline and weak growth

Index 2008=100

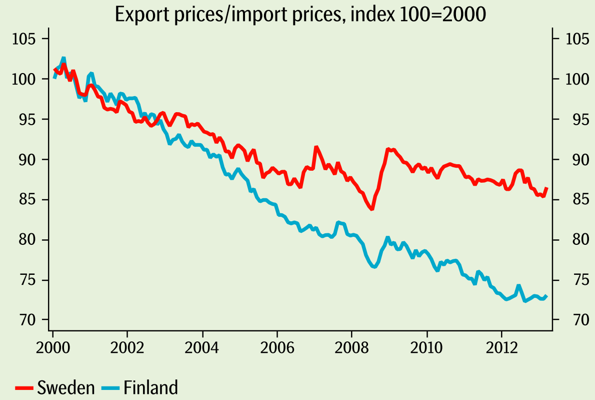


Source: Eurostat

Since the economic crisis struck in 2008, however, their paths have diverged. After a sharp GDP decline in 2009, Sweden regained far more lost ground than Finland. Finnish exports have fallen from nearly 50 per cent of GDP to around 40 per cent. Finland's current account balance has weakened over a long period, shifting from a surplus of some 8 per cent of GDP to a deficit equivalent to 2 per cent of GDP. Meanwhile the public sector is in deficit. Finland's poorer performance is largely due to falling merchandise exports and can be connected to problems in the information and communications technology (ICT) sector, where value-added is still far below its pre-crisis level. The forest product industry has also reported a major decline in output.

Terms of trade

Export prices/import prices, index 100=2000



Source: Statistics Sweden, Statistics Finland

The country's terms of trade (export prices divided by import prices) have also generally deteriorated for years. The trend during the late 1990s and early 2000s was similar to that of Sweden, but since then the trend in Finland has been substantially worse. Price trends in the ICT sector have played an especially big role in the weak trend of export prices.

Finland's competitiveness has deteriorated relative to Sweden, and now that a number of crisis-hit euro zone countries are adjusting their costs, Finland is being squeezed further. Taken together, these factors have contributed to the country's deteriorating current account balance, also putting pressure on public finances because of lower tax revenue and higher unemployment expenditures.

DENMARK

Yearly change in per cent

	2012 level, DKK bn	2011	2012	2013	2014
Gross domestic product	1,820	1.1	-0.5	0.2	1.6
Private consumption	901	-0.5	0.6	0.3	1.5
Public consumption	520	-1.5	0.2	1.8	0.6
Gross fixed investment	323	0.2	2.2	1.3	3.0
Stockbuilding (change as % of GDP)		0.3	-0.3	0.2	-0.1
Exports	992	6.5	0.9	-0.2	3.3
Imports	912	5.6	2.5	0.3	3.2
Unemployment (%)		4.1	4.6	5.0	4.8
Consumer prices, harmonised		2.8	2.4	0.8	1.2
Hourly wage increases		1.7	1.5	1.5	1.5
Current account, % of GDP		5.6	5.6	6.0	6.0
Public sector financial balance, % of GDP		-2.0	-4.1	-1.5	-1.5
Public sector debt, % of GDP		46.4	45.7	44.0	42.5

FINANCIAL FORECASTS	Jan 16th	Sep 13	Dec 13	Jun 14	Dec 14
Lending rate	0.20	0.10	0.10	0.10	0.10
10-year bond yield	1.37	1.45	1.50	1.65	1.80
10-year spread to Germany, bp	5	0	0	0	0
USD/DKK	5.77	5.87	5.91	6.11	6.21
EUR/DKK	7.45	7.45	7.45	7.45	7.45

NORWAY

Yearly change in per cent

	2012 level, NOK bn	2011	2012	2013	2014
Gross domestic product	2,655	1.2	3.1	1.7	2.4
Gross domestic product (Mainland Norway)	2,106	2.5	3.4	2.7	2.9
Private consumption	1,151	2.5	3.0	3.4	3.3
Public consumption	579	1.8	1.8	2.1	2.1
Gross fixed investment	560	7.6	8.0	6.5	4.7
Stockbuilding (change as % of GDP)		0.1	-0.2	-0.5	-0.1
Exports	1,029	-1.8	1.8	-1.1	2.4
Imports	772	3.8	2.4	2.5	4.6
Unemployment (%)		3.3	3.2	3.4	3.4
Consumer prices		1.2	0.8	1.8	1.7
CPI-ATE		0.9	1.2	1.3	1.9
Annual wage increases		4.2	4.3	3.5	3.8

FINANCIAL FORECASTS	May 16th	Sep 13	Dec 13	Jun 14	Dec 14
Deposit rate	1.50	1.50	1.50	1.75	2.00
10-year bond yield	2.08	2.05	2.10	2.35	2.55
10-year spread to Germany, bp	76	60	60	70	75
USD/NOK	5.82	5.91	5.91	6.07	6.13
EUR/NOK	7.51	7.50	7.45	7.40	7.35

SWEDEN

Yearly change in per cent

	2012 level, SEK bn	2011	2012	2013	2014
Gross domestic product	3,555	3.7	0.8	1.3	2.5
Gross domestic product, working day adjusted		3.7	1.2	1.3	2.7
Private consumption	1,718	2.1	1.5	2.0	2.3
Public consumption	957	1.1	0.8	0.8	0.7
Gross fixed investment	670	6.4	3.4	2.0	2.9
Stockbuilding (change as % of GDP)	-9	0.5	-1.1	-0.1	0.1
Exports	1,733	7.1	0.7	1.4	4.4
Imports	1,514	6.3	-0.1	2.0	3.7
Unemployment (%)		7.8	8.0	8.2	8.1
Employment		2.3	0.6	0.5	0.3
Industrial production		6.8	-2.9	1.2	3.5
Consumer prices		3.0	0.9	-0.1	0.8
CPIF		1.4	1.0	0.9	1.2
Hourly wage increases		2.6	3.3	2.7	2.9
Household savings ratio (%)		10.2	11.4	11.7	12.2
Real disposable income		3.5	2.5	2.9	2.8
Trade balance, % of GDP		2.6	2.5	2.4	2.7
Current account, % of GDP		7.3	7.0	6.3	6.4
Central government borrowing, SEK bn		-68	25	154	63
Public sector financial balance, % of GDP		0.0	-0.7	-1.5	-2.0
Public sector debt, % of GDP		38.3	37.4	40.7	40.8

FINANCIAL FORECASTS	**May 16th**	**Sep 13**	**Dec 13**	**Jun 14**	**Dec 14**
Repo rate	1.00	0.75	0.75	0.75	0.75
3-month interest rate, STIBOR	1.20	1.00	1.00	1.00	1.00
10-year bond yield	1.70	1.70	1.70	1.85	2.00
10-year spread to Germany, bp	38	25	20	20	20
USD/SEK	6.64	6.69	6.63	6.72	6.75
EUR/SEK	8.58	8.50	8.35	8.20	8.10
TCW	116.9	115.8	113.5	112.1	111.2

FINLAND

Yearly change in per cent

	2012 level, EUR bn	2011	2012	2013	2014
Gross domestic product	194	2.8	-0.2	-0.2	1.6
Private consumption	110	2.3	1.6	0.4	1.3
Public consumption	48	0.4	0.8	0.0	0.2
Gross fixed investment	38	7.1	-2.9	0.0	3.5
Stockbuilding (change as % of GDP)		1.3	-1.6	0.0	0.0
Exports	77	2.9	-1.4	0.5	3.0
Imports	78	6.1	-3.7	1.5	3.0
Unemployment (%)		7.8	7.7	8.4	8.4
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		-1.5	-1.9	-2.0	-2.0
Public sector financial balance, % of GDP		-0.8	-1.9	-2.0	-1.6
Public sector debt, % of GDP		49.0	53.0	53.0	52.5

EURO ZONE

Yearly change in per cent

	2012 level, EUR bn	2011	2012	2013	2014
Gross domestic product	9,487	1.6	-0.6	-0.7	0.7
Private consumption	5,451	0.2	-1.3	-1.0	0.4
Public consumption	2,040	-0.1	-0.4	0.0	0.1
Gross fixed investment	1,749	1.6	-4.1	-1.5	1.5
Stockbuilding (change as % of GDP)		0.1	-0.7	0.0	0.0
Exports	4,326	6.6	2.7	2.5	3.8
Imports	4,072	4.4	-0.9	2.5	3.8
Unemployment (%)		10.1	11.4	12.3	12.4
Consumer prices		2.7	2.5	1.4	1.0
Household savings ratio (%)		8.0	7.7	7.6	7.7

US

Yearly change in per cent

	2012 level, USD bn	2011	2012	2013	2014
Gross domestic product	15,864	1.8	2.2	2.0	3.2
Private consumption	11,250	2.5	1.9	2.3	2.8
Public consumption	3,050	-3.1	-1.7	-3.4	-1.6
Gross fixed investment	2,095	6.6	8.7	7.5	11.4
Stockbuilding (change as % of GDP)		-0.2	0.1	0.1	0.0
Exports	2,191	6.7	3.4	2.4	5.2
Imports	2,721	4.8	2.4	2.3	5.3
Unemployment (%)		8.9	8.1	7.6	6.9
Consumer prices		3.1	2.1	1.6	1.6
Household savings ratio (%)		4.2	3.9	3.3	4.5

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2011	2012	2013	2014
GDP				
United Kingdom	1.0	0.3	1.1	1.6
Japan	-0.6	2.0	1.7	1.4
Germany	3.2	1.0	0.3	1.3
France	2.0	0.0	-0.2	0.6
Italy	-0.5	-2.8	-1.7	0.3
Inflation				
United Kingdom	4.5	2.8	2.0	2.1
Japan	-0.3	-0.2	0.3	2.5
Germany	2.5	2.0	1.7	2.0
France	2.7	1.5	1.2	1.6
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	4.0	3.9
Germany	5.6	5.5	5.6	5.5
France	9.9	10.6	10.9	11.2
Italy	8.4	10.6	11.8	11.8

EASTERN EUROPE

	2011	2012	2013	2014
GDP, yearly change in per cent				
Estonia	8.3	3.2	3.3	3.7
Latvia	5.5	5.6	3.5	4.8
Lithuania	5.9	3.6	3.2	3.5
Poland	4.5	2.0	1.8	3.3
Russia	4.3	3.4	2.5	3.2
Ukraine	5.2	0.2	0.0	1.8
Inflation, yearly change in per cent				
Estonia	5.0	3.9	3.3	3.3
Latvia	4.2	2.3	0.8	3.5
Lithuania	4.1	3.2	2.5	2.8
Poland	3.9	3.7	1.6	2.5
Russia	8.5	5.1	6.3	5.2
Ukraine	8.0	0.6	5.5	6.5

FINANCIAL FORECASTS

		May 16th	Sep 13	Dec 13	Jun 14	Dec 14
Official interest rates						
US	Fed funds	0.25	0.25	0.25	0.25	0.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.50	0.25	0.25	0.25	0.25
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50
Bond yields						
US	10 years	1.87	2.00	2.20	2.35	2.50
Japan	10 years	0.83	1.00	1.10	1.20	1.20
Germany	10 years	1.32	1.45	1.50	1.65	1.80
United Kingdom	10 years	1.86	2.05	2.10	2.25	2.40
Exchange rates						
USD/JPY		102	106	110	115	120
EUR/USD		1.29	1.27	1.26	1.22	1.20
EUR/JPY		132	135	139	140	144
GBP/USD		1.53	1.48	1.45	1.42	1.43
EUR/GBP		0.84	0.86	0.87	0.86	0.84

GLOBAL KEY INDICATORS

Yearly percentage change

	2011	2012	2013	2014
GDP OECD	1.8	1.3	1.3	2.3
GDP world	3.8	3.3	3.6	4.2
CPI OECD	2.7	2.3	1.8	1.8
Export market OECD	5.8	2.4	4.5	6.4
Oil price, Brent (USD/barrel)	112.3	111.8	110.0	110.0

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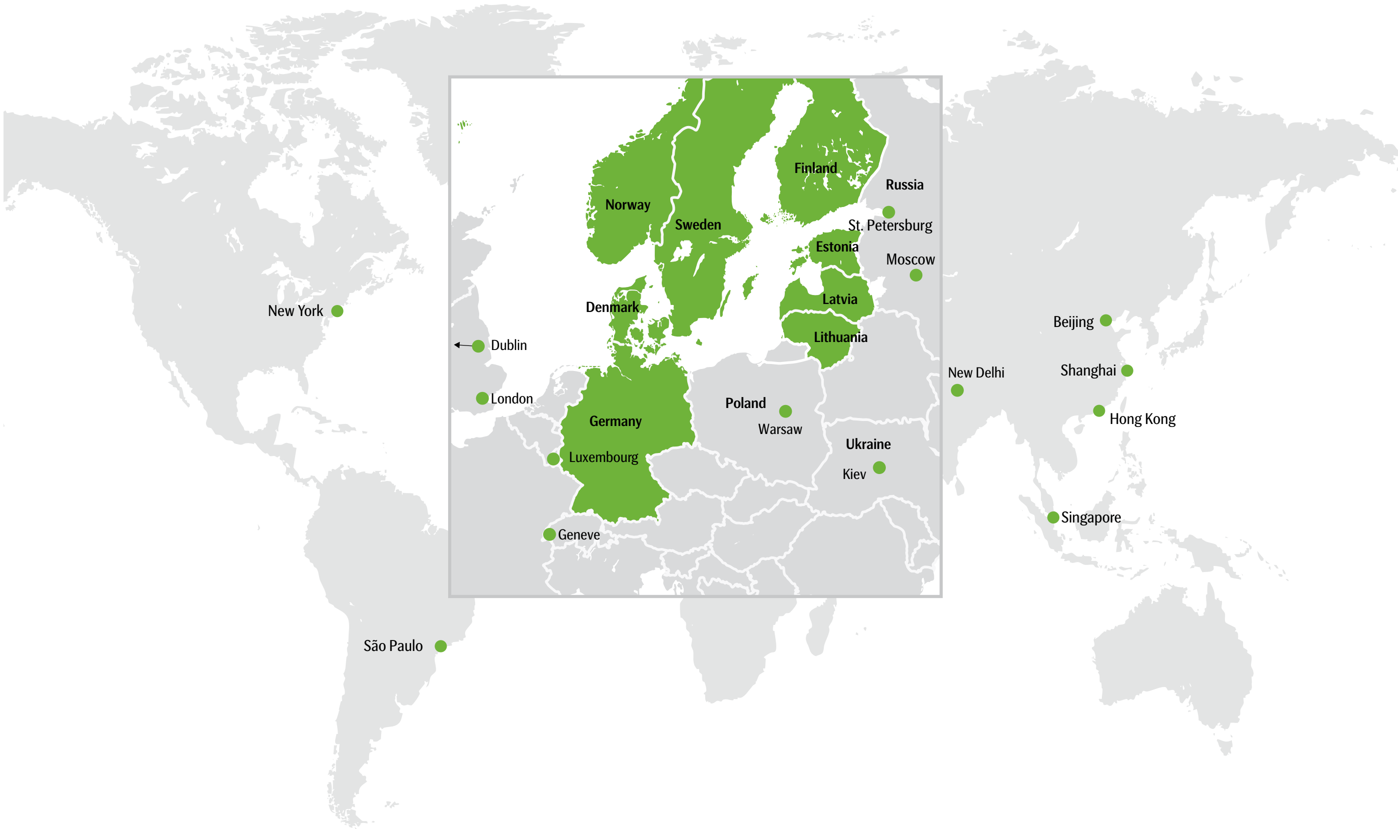

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