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Press release

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Nordic Outlook: US holds the key to economic recovery
Low inflation will delay Riksbank's key interest rate hikes

The obstacles to a global acceleration in Gross Domestic Product (GDP) will become fewer in the next couple of years. Fading fiscal headwinds will combine with continued strong monetary policy tailwinds. The **United States** is poised for a sustainable growth surge in 2014-2015 and will achieve annual **growth of around 3.5 per cent**. This will also give the **euro zone** greater opportunities to re-generate economic, financial and political stability, despite divergent and **sluggish GDP growth of 0.8 per cent in 2014** and **1.7 per cent in 2015**, following negative growth of 0.5 per cent this year. Global risk appetite will strengthen. This will lead to positive stock market performance, while industrial companies with strong balance sheets will be able to increase their capital spending and hiring during 2014 and 2015. Overall, **GDP growth in the 34 countries of the Organisation for Economic Cooperation and Development (OECD)** will accelerate from 1.2 per cent this year to **2.4 per cent in 2014** and **2.8 per cent in 2015**. Yet major cyclical differences in growth between countries and regions will persist, posing challenges to international economic policy cooperation.

Our relatively positive global scenario is based on two important assumptions: that inflation will remain low and stable, and that the low interest rate policies of central banks will be underpinned by **macroprudential policies**. There is a large quantity of idle economic resources in the US, Europe and Asia, which exerts downward pressure on wages and salaries as well as on commodity and energy prices, allowing **central banks manoeuvring room to postpone key interest rate hikes** and focus on sustaining growth and employment. This will also facilitate the implementation of vital restructuring policy measures and fiscal consolidation, although it is uncertain to what extent political leaders will take advantage of this opportunity. **Global monetary policy is approaching a crossroads**. Frequent emergency interventions will be replaced by the main task of ensuring a normalisation of inflation rates and preventing the re-emergence of financial imbalances. The communicative talents of central banks will be put to the test when it comes to persuading financial markets that they are in control of the situation and can ensure a continued low inflation environment. This also requires that over the next couple of years, political leaders and central banks can reach agreement on the way forward for macroprudential policies.

The US Federal Reserve will not raise its key interest rate until the second half of 2015, after more than six years of a zero interest rate. The federal funds rate will stand at 1.0 per cent at the end of 2015. Due to an improved economic and financial outlook, the Fed will decide as early as this September to begin “tapering” its quantitative easing (QE) programme. Such a decision will reduce the prevailing financial uncertainty and can easily be re-assessed if long-term yields continue to rise sharply. The **Bank of England** will keep its key interest rate at 0.50 per cent until late in 2015, when it will carry out its first rate hike. The European Central Bank (**ECB**) will help sustain the euro zone economy with a further key interest rate cut to 0.25 per cent in December 2013 and then stay put at this level in 2014 and 2015. The ECB will also offer new Long Term Refinancing Operation (LTRO) loans for the purpose of improving the functioning of the banking system in southern Europe and keeping interest rates low. The **Bank of Japan** will continue with its aggressive bond purchases and zero interest rate. Because of differences in monetary policies and economic conditions, the **EUR/USD exchange rate will decline from 1.33 at the end of 2013 to 1.27 at the end of 2014 and 1.20 at the end of 2015**.

The main upside risks in our forecast is that the **faster growth rate in the US will have larger positive contagious effects on other countries than in our main forecast**. On the other hand, there are big remaining challenges that carry downside risks. The risk of new reversals in growth is mainly connected to the continued

financial and political weaknesses of the **euro zone** and to the potential of **emerging market countries**, and their willingness, to reform their economies. While stronger US growth is positive for the world economy, changes in **US monetary policy** – less stimulus and eventual tightening – may cause economic and financial problems for countries and regions that are in divergent cyclical phases from the US and have not yet achieved sufficient strength to cope with higher interest rates and yields. This is true, for example, of the euro zone, which will still need a number of years before achieving its private sector debt deleveraging targets. Excluding the financial services sector, **global debt today is higher than in 2007**. This means that higher interest rates will have a major impact on consumption, capital spending, lending and government finances.

The euro zone crisis will remain complex and protracted, but immunity to trouble spots has strengthened during 2013, as exemplifed by this summer's political crises in Greece and Portugal. There are several reasons for this. The ECB's large balance sheet essentially eliminates various liquidity and solvency risks in the euro zone. The US and German economies are also showing vigour, helping sustain the export sector in southern Europe. The outlook is also getting better because of improved competitiveness in several crisis-hit countries, among other things due to lower wages. Although positive ***changes*** in various macroeconomic variables are welcome, ***levels*** of debt, unemployment and other variables demonstrate that the path back to a more normal situation will still **take a number of years**. High unemployment poses a risk of political unrest and opens the way for euro-sceptical parties to strengthen their position in various countries. Our scenario includes further aid to Greece by means of a new debt restructuring, probably during the first half of 2014. Portugal and Ireland need further debt relief as well. The economic curves in Italy and France will also have to rebound. In recent months, political cooperation and integration efforts have shown signs of deceleration. There is a great risk of political paralysis over the coming year, due to the May 2014 election to the European Parliament and the delay until a new Parliament and a new European Commission are in place.

China's economic performance during 2013, after a new leadership took office in March, has demonstrated the difficulty of achieving an optimal shift in emphasis between two growth mechanisms. Private consumption must be strengthened at the expense of exports as well as public and private sector capital spending. **China's GDP will decelerate to 7.5 per cent in 2013 and slow down further to a growth rate of 7.0 per cent in 2015**. In the three other BRIC countries – **Brazil**, **Russia** and **India** – there is also a clear deceleration, connected to lower global economic activity but also to structural factors. Generally, the BRIC countries will have difficulty reverting to their earlier high growth rates. Reforms rather than fiscal stimulus measures are the recipe for a new growth surge. The same conclusion applies to **Japan**. "Abenomics" will provide a short-term upswing in growth and inflation, and after this summer's election the governing coalition led by Shinzo Abe has strengthened its political position and gained a 3-4 year window for implementing its policies, but it is unfortunately showing worrisome signs of ambiguity. However, the consequences of a tapering in the US Federal Reserve's QE policies need not be so severe. The effect will be more psychological than quantitative and will thus be transitory. We expect improved global economic prospects to restore risk appetite and confidence in emerging economies with sound fundamentals.

The slowdown has maintained a tight grip on the Swedish economy during 2013. Growth will reach only 1.2 per cent this year. But the outlook is improving, and growth will be above trend as well as above the OECD average during our forecast period. The strong economic situation of households will be the main driver. The government's fiscal timulus measures will provide an additional SEK 20 billion in cash to households – more than 1 per cent of their income. Low inflation will result in yearly **real wage increases** of around 1-1.5 per cent. Positive economic signals from Germany, the US and other countries with which the Swedish economy normally shows a high correlation indicate that **exports will rebound**. The growth rate will accelerate but will be held back somewhat by uncertainty in the euro zone. **GDP growth will reach 2.6 per cent in 2014 and 3.2 per cent in 2015**. This will help **push down unemployment to 7.9 per cent at the end of 2014 and to 7.3 per cent at the end of 2015**.

The Riksbank has thus stopped cutting its repo rate, but the first rate hike will be postponed until the end of 2014. By the end of 2015, the repo rate will stand at 1.75 per cent (compared to 1 per cent today). The Riksbank will thus be one of the first central banks to begin a cautious normalisation of its key interest rate. Slow rate hikes

will be made possible by continued **low inflation pressure** as well as by discussions about alternative tools – and possible decisions – **in the macroprudential field** during 2014. Home prices will climb by some 5 per cent both this year and next and then slow in 2015, once the Riksbank has begun hiking its key rate; the driving forces behind higher prices are primarily a structural housing shortage and to some extent also improvements in household income. Our forecast implies that home prices will thus have risen entirely in line with household income.

The Riksbank faces several trade-offs. We expected the krona, measured in effective exchange rate terms, to reach its strongest level since 1992 by the end of our forecast period. Meanwhile international price pressure is weak and Swedish pay increases over the next couple of years will end up at historically low levels. This implies that inflation will probably be well below 2 per cent throughout our forecast period. It will also be difficult for the Riksbank to diverge unduly from the **low interest rate environment in other countries** without triggering a sharp appreciation in the krona. The government has now announced expansionary **fiscal policy** measures equivalent to SEK 25 billion. This will not change conditions either, since the Riksbank's analyses have already factored in SEK 30 billion in fiscal reform measures during 2014-2015. **Underlying CPIF inflation will reach 1.6 per cent in December 2015**, thereby confirming the conclusion in our analysis of historical inflation trends: it will be **very difficult to reach the Riksbank's inflation target** of 2 per cent in a medium-term perspective. A majority of the central bank's Executive Board members seem to have concluded that they are prepared, to some extent, to **re-assess the role of household debt** in key interest rate decisions, once macroprudential policies are in place. We are assuming the a consensus about macroprudential policies will be reached during 2014, which will greatly ease the burden on traditional interest rate policy.

Sweden's central government debt will increase from 32.4 per cent of GDP in 2012 to 35.7 per cent in 2015. We estimate that the government's dose of fiscal stimulus will end up at SEK 35 billion in 2014, in other words **SEK 10 billion more** than the government has announced so far. We do not anticipate any major surprises in the government's September 18 budget bill beyond what has already emerged, for example income tax cuts, a narrowing of differences in unemployment insurance fees, an easing of employer-financed sick pay fees and investments in infrastructure, research and education. **We expect the dose of stimulus in 2015 to be SEK 10-15 billion**, regardless of the September 2014 parliamentary election outcome. An estimated budget deficit amounting to 2 per cent of GDP in 2014 and 2015 threatens the existing budget surplus target. But if the government wishes to stick to the surplus target, there will be room for tighter fiscal policy a bit further in the future.

In general, the Nordic countries will benefit from the 2014-2015 international recovery, but the domestic driving forces differ from one country to another. While Sweden, Norway and Denmark will experience above-trend growth during our forecast period, aided by household consumption, Finland will continue to lag behind due to structural problems. Low capacity utilisation, rising unemployment and a tight fiscal policy will lead to Finnish GDP growth of around 1.5 per cent in 2014 and 2015. In Denmark, falling inflation and a stabilisation of the housing market will boost household optimism, stimulating consumption and enabling the economy to rebound from 0.4 per cent growth this year to 2.0 per cent in 2014 and 2.5 per cent in 2015. In Norway, rapidly growing capital spending will slow next year, but we expect GDP growth in both 2014 and 2015 to be in the vicinity of 2.5 per cent. Norges Bank will begin raising its key interest rate next summer, bringing it to 2.0 per cent at the end of 2014 (1.5 per cent today). During 2015, Norway's key rate will be raised in three further 25 basis point steps to 2.75 per cent.

The three Baltic countries – Estonia, Latvia and Lithuania – have had the fastest GDP growth in the European Union since 2011. We expect them to show relatively balanced economic performance in the next couple of years. One common thread is private consumption, which will benefit from pent-up purchasing needs and good real income increases. We also expect exports and higher capital spending to gradually help sustain **GDP growth**, which will end up **in the 3.5-4.5 per cent range** following this year's deceleration. It will then reach **3.5-5 per cent in 2015**, with the highest growth in Lithuania and the lowest in Estonia. We expect Latvia to experience a slight capital spending upturn related to joining the euro zone on January 1, 2014. Lithuania's euro zone accession in 2015 remains uncertain, but if inflation continues its downside surprises this autumn, there is a more than even chance that Lithuania will qualify to convert to the euro.

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Key figures: International and Swedish economy

International economy. GDP, year-on-year changes, %	2012	2013	2014	2015
United States	2.8	1.6	3.3	3.7
Euro zone	-0.6	-0.5	0.8	1.7
Japan	2.0	1.9	1.4	1.0
OECD	1.5	1.2	2.4	2.8
China	7.8	7.5	7.4	7.0
Nordic countries	1.2	0.8	2.4	2.5
Baltic countries	4.2	2.9	3.8	4.4
The world (purchasing power parities, PPP)	3.4	3.2	4.0	4.2
Swedish economy. Year-on-year changes, %				
GDP, actual	0.7	1.2	2.6	3.2
GDP, working day corrected	1.0	1.2	2.7	3.0
Unemployment, % (EU definition)	8.0	8.1	8.0	7.5
Consumer Price Index (CPI) inflation	0.9	0.0	1.0	2.0
Government net lending (% of GDP)	-0.9	-2.1	-2.2	-1.8
Repo rate (December)	1.0	1.0	1.25	1.75
Exchange rate, EUR/SEK (December)	8.58	8.70	8.40	8.20

For more information, please contact
Robert Bergqvist, +46 70 445 1404
Håkan Frisén, +46 70 763 8067
Daniel Bergvall, +46 8 763 8594
Mattias Bruér, +46 8 763 8506
Olle Holmgren, +46 8 763 8079
Mikael Johansson, +46 8 763 8093
Andreas Johnson, +46 8 763 8032

Press contact
Anna Helsén, Press & PR
+46 70 698 4858
anna.helsen@seb.se

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