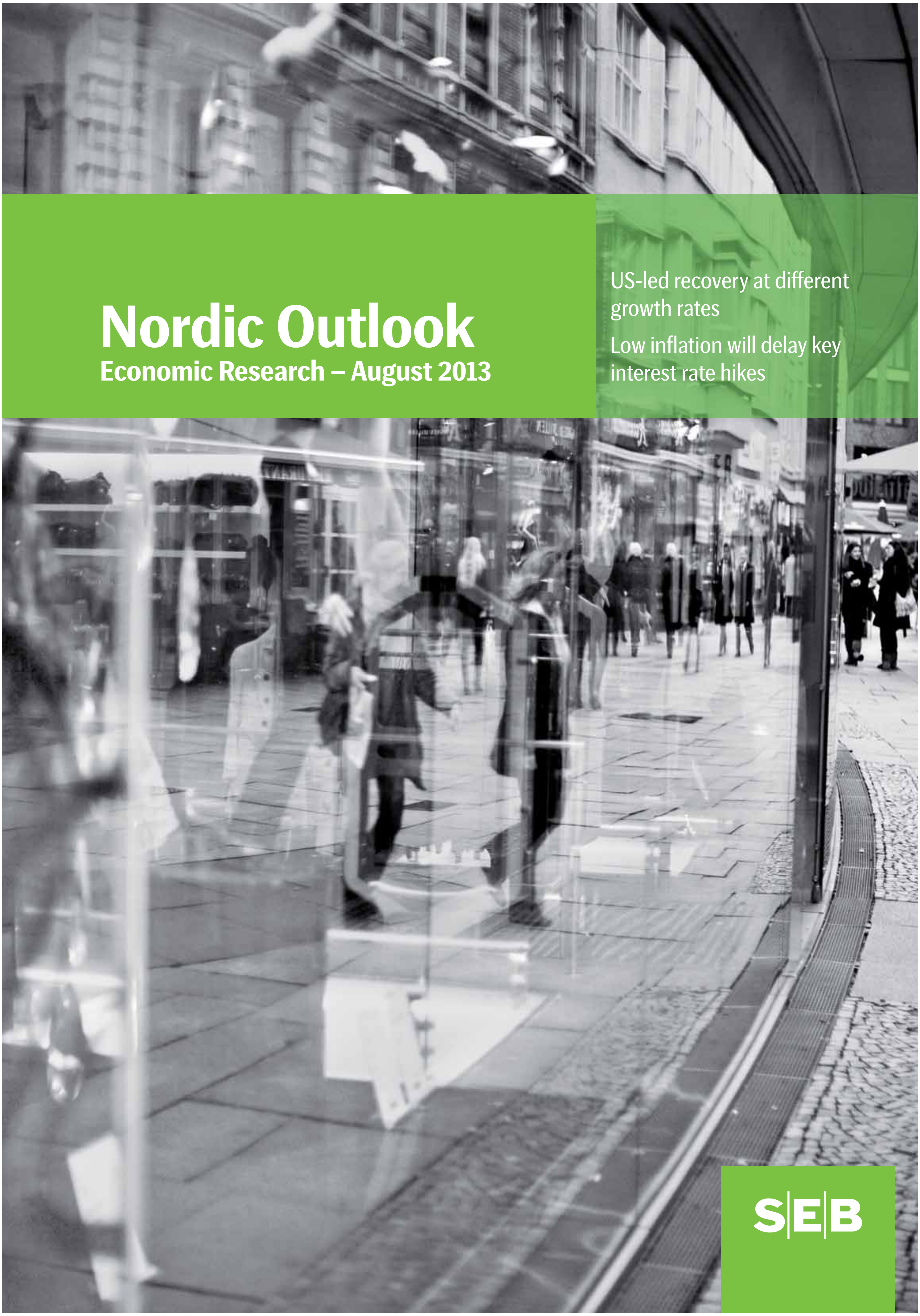
Nordic Outlook

Economic Research – August 2013

US-led recovery at different growth rates

Low inflation will delay key interest rate hikes



SEB

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US-led recovery, but big differences in growth rates

- **Economic stabilisation in the euro zone, but continued political challenges**
- **Structural problems hamper BRIC countries**
- **Continued low inflation**
- **Exit policy a challenge to start implementing**
- **Long-term yields will rise modestly, with persistent spread between US and Germany**
- **Differences in growth and monetary policy will buoy the USD**

Prospects for a stronger global recovery have improved recently. Leading indicators have signalled greater optimism among households and businesses in most industrialised countries. Meanwhile rising risk appetite has characterised financial markets. In the next couple of years, underlying conditions for global GDP acceleration will also improve. Fiscal headwinds will diminish, while continued strong monetary policy tailwinds support growth. The United States is poised for a fairly powerful, sustainable growth surge in 2014-2015, with a clear upturn in the housing market among its driving forces.

US economic growth will provide support to other parts of the world economy. The euro zone will gain greater opportunities to re-generate economic, financial and political stability. US growth will also increase global risk appetite and lift the stock market. In this environment the corporate sector, which has had strong balance sheets for a long time, will probably increase its capital spending and new hiring in 2014 and 2015.

Our generally rather positive scenario for the world economy is based on the forecast that **inflation will remain low**. Large output gaps in the US and Europe, combined with slowing growth in Asia, will create downward pressure on wages and salaries as well as on commodity and energy prices. This signals a slow normalisation of global inflation, in turn allowing central banks manoeuvring room to delay key interest rate hikes. This will also facilitate implementation of vital structural policy measures and continued fiscal consolidation, although it remains uncertain to what extent the authorities will take advantage of this opportunity.

But even given continued low inflation, central banks will face major challenges when they begin to normalise their monetary policies. Their exit policy must be implemented in an environment where new financial bubbles threaten to emerge over time. It is thus especially important for political leaders and central banks to reach agreement in 2014 on effective macroprudential tools that will reduce the risk of asset price inflation and financial imbalances.

Different parts of the world economy are now in different phases, among other things because the post-crisis healing process has varied in speed. Cyclical differences will persist over the next couple of years. Because of the euro zone's continued financial and political weaknesses, its recovery will be sluggish. Only in 2015 will it achieve trend growth. Japan's economy is now on its way up, stimulated by expansionary policies. But in the next couple of years, GDP growth will slow as stimulus effects fade and as policy makers face more difficult structural challenges. In emerging economies, a deceleration is now occurring, and due to structural problems, their GDP growth will not reach earlier levels over the next few years either.

Overall, GDP growth will still climb rather vigorously during the next couple of years. In the 34 countries of the Organisation for Economic Cooperation and Development (OECD), GDP growth will speed up from 1.2 per cent in 2013 to 2.4 per cent in 2014 and 2.8 per cent in 2015. **At the global level (and in terms of purchasing power parities, PPP), growth will climb from 3.2 per cent this year to 4.0 per cent in 2014 and 4.2 per cent in 2015.**

Global GDP growth

Year-on-year percentage change

	2012	2013	2014	2015
United States	2.8	1.6	3.3	3.7
Japan	2.0	1.9	1.4	1.0
Germany	0.7	0.5	1.7	2.0
China	7.8	7.5	7.4	7.0
United Kingdom	0.2	1.5	2.3	2.6
Euro zone	-0.6	-0.5	0.8	1.7
Nordic countries	1.2	0.8	2.4	2.5
Baltic countries	4.2	2.9	3.8	4.4
OECD	**1.5**	**1.2**	**2.4**	**2.8**
Emerging markets	**4.9**	**4.8**	**5.3**	**5.4**
World, PPP	**3.4**	**3.2**	**4.0**	**4.2**
World, nominal	2.7	2.5	3.2	3.5

Source: OECD, SEB

Fiscal headwinds will fade

Budget-tightening programmes aimed at getting public sector debt under control will continue to be implemented in various countries, but the growth-hampering effect of **austerity measures** will gradually fade. In the euro zone, the dose of austerity will shrink from 1.5 per cent of GDP in 2012 to 0.8 per cent in 2013 and then, according to current plans, reach neutral levels in 2014 and 2015. In the US, budget-tightening will peak this year, when it will be equivalent to 2.2 per cent of GDP, then dwindle to 1.0 per cent in 2014 and 0.7 per cent in 2015.

Fiscal tightening
Change in structural balance, per cent of GDP

	2012	2013	2014	2015
United States	1.3	2.2	1.0	0.7
Japan	-0.8	-0.4	0.5	1.1
United Kingdom	1.1	1.1	0.9	0.7
Euro zone	1.5	0.8	0.1	0.1
of which GIPS*	2.5	1.3	0.1	0.1
Nordic countries	0.0	0.2	0.2	1.0
OECD	1.2	1.0	0.5	0.6

Source: IMF, OECD, SEB * Greece, Ireland, Portugal och Spain.

Because of austerity measures and rising growth, budget deficits will shrink at a decent pace over the next couple of years. In many countries, the deficits are still so large that central government debt will continue rising as a percentage of GDP in a climate of rather weak growth. In the US and the euro zone, public debt will peak in 2014 at 110 and 96 per cent of GDP respectively, but in Japan it will level out only in 2015.

Public fiscal balance
Per cent of GDP

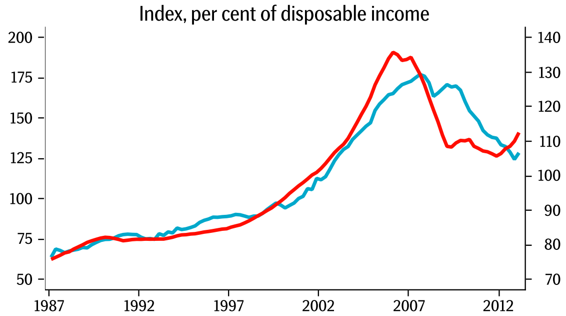
	2013	2014	2015	Debt*
United States	-5.5	-4.5	-3.5	104
Japan	-9.8	-7.5	-6.5	248
United Kingdom	-7.0	-6.4	-5.6	100
Euro zone	-2.9	-2.5	-1.9	95
OECD	-4.0	-3.5	-3.0	110

* Gross debt, 2015
Source: IMF, OECD, SEB

US: Pieces of growth puzzle fall into place

Due in part to powerful fiscal headwinds, this year GDP growth will fall to 1.6 per cent: the lowest reading since the financial crisis. Yet more and more factors point to a powerful acceleration in GDP growth during the next couple of years. The housing market is now in a rapid upturn phase, with rising prices and increasing construction activity. Household balance sheets are also benefiting from rising share prices, with several broad indices hitting record highs. Capital spending activity is also about to take off, driven by such factors as rising capacity utilisation and strong corporate balance sheets. There has also been a sharp expansion in energy production in the wake of technological advances. Overall, we predict that **GDP growth in the US next year will reach 3.3 per cent and then increase somewhat further to 3.7 per cent in 2015**.

US: Home prices and household debt
Index, per cent of disposable income



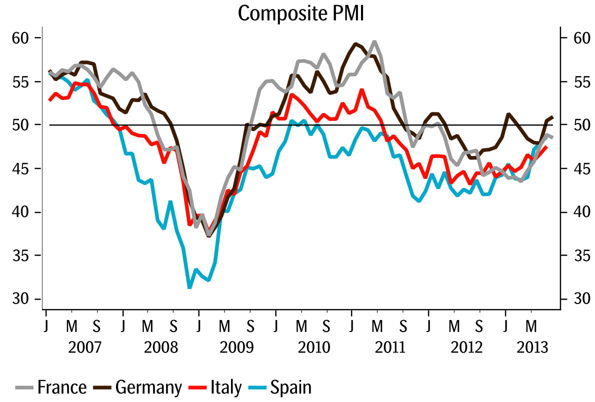
Source: Federal Reserve, Standard & Poor's, SEB

In recent years, unemployment has fallen significantly faster than the modest growth occurring to date would normally lead to. This labour market improvement has stabilised demand, but it also raises questions about how large the amount of slack in the economy actually is. Our view is that the downturn in labour supply is now at an end and that productivity growth will rise at the pace of increasing resource utilisation. Looking ahead, this means that the downturn in unemployment will continue at a rather slow pace despite accelerating GDP growth. **The US unemployment level will reach 7.0 per cent in mid-2014 and 6.0 per cent in the third quarter of 2015.**

Euro zone: Stabilisation, but continued major challenges

The **euro zone remains the weakest part of the world economy**, but here too there has been some stabilisation. Household and business confidence has improved somewhat, albeit from low levels. The second quarter showed positive GDP growth after six quarters of a shrinking economy. The euro zone seems to have strengthened its immunity to trouble spots during 2013, as exemplified by this summer's political crises in Greece and Portugal. There are several reasons for this. The European Central Bank's large balance sheet is eliminating various liquidity and solvency risks in the euro zone. The US and German economies are showing vigour, helping sustain the export sector in southern Europe. The outlook is also getting better because of improvements in several crisis-hit countries, among other things due to lower wages. Overall, we thus see the potential for a slow rise in euro zone GDP. Next year, growth will be 0.8 per cent: still below trend. Only in 2015 will there be a certain degree of recovery, with GDP growing by 1.7 per cent.

Recovery in purchasing managers's indices
Composite PMI



Source: Markit Economics

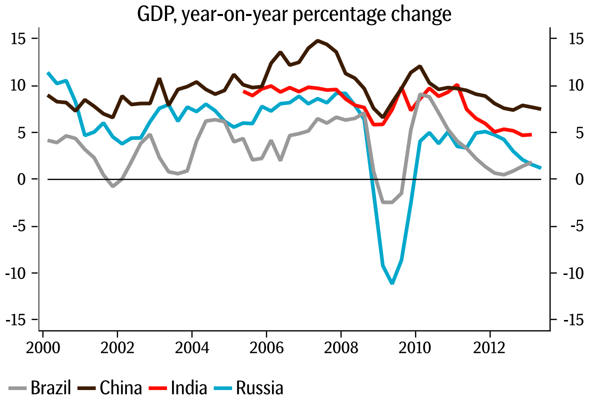
Yet the crisis is far from over. Many complex problems remain to be resolved and the processes will probably be time-consuming. A fragmented credit market with continued high interest rates is a major impediment to the economies of southern Europe. In Spain, banks are struggling with a continued weak housing market and a high percentage of bad loans. In this environment, even solvent companies have trouble borrowing money. Our euro zone scenario includes further aid to Greece by means of a debt restructuring, probably during the first half of 2014. There is a high risk that Portugal and Ireland will also demand further debt relief. Record unemployment is a high price that crisis-hit countries must pay for their earlier negligence and for the shortcomings in the functioning of the euro system. Protests against both austerity policies and necessary steps aimed at achieving deeper economic policy cooperation will expose governments to strong pressures. The May 2014 election to the European Parliament may also mean less EU decisiveness until a new Parliament and a new European Commission are in place by the autumn of 2014.

Structural obstacles to BRIC growth

Growth is continuing to decelerate in emerging economies, especially in Asia and Latin America. **Compared to the previous decade, growth has slowed in all four BRIC countries.** In Brazil, India and Russia, the growth rate has fallen by roughly one half, and the Chinese economy is now also slowing. A **return to their previous high growth figures is unlikely**. The reasons vary from one economy to another, but they have in common that structural factors are behind the slowdown. **Reforms rather than stimulus measures are the solution** that will enable growth to rebound from its current levels.

Economic deceleration in the BRIC countries

GDP, year-on-year percentage change



Source: National statistical offices

China's economic performance during 2013, after a new national leadership took office in March, has demonstrated the difficulty of bringing about a shift of priorities from exports and capital spending to private consumption. **However, the prospects of a soft landing are good,** since there is room for policy makers to take steps that will help sustain the economy.

The Nordic countries will benefit from the international recovery

The 2012 slowdown affected the Nordic countries to varying degrees. Despite being helped by a weaker euro (to which the Danish krone is pegged), Denmark and Finland were the hardest hit. The international recovery will help speed up growth in all of the Nordics in 2014 and 2015, but the domestic driving forces differ from one country to another. The economies of Sweden, Norway and Denmark will see above-trend growth in 2014 and 2015, while Finland is struggling to a greater extent with structural problems. In **Sweden**, rising employment and expansionary fiscal policy will contribute to private consumption, which will boost growth in 2014 and 2015. In **Denmark**, inflation has fallen and home prices have stabilised, helping household confidence rise to a five-year high. In **Finland**, low capacity utilisation, rising unemployment and a tight fiscal policy are holding back capital spending and consumption. Although the economy will recover somewhat in the next couple of years, this recovery will be weaker than in other Nordic countries. In **Norway**, rapidly growing capital spending will slow in 2014, but exports and good real household income increases will fuel vigorous growth.

Nordics and Baltics, GDP growth

Year-on-year percentage change

	2012	2013	2014	2015
Sweden	0.7	1.2	2.6	3.2
Norway	3.1	1.1	2.7	2.3
Denmark	-0.4	0.4	2.0	2.5
Finland	-0.8	-0.3	1.3	1.6
Estonia	3.2	1.5	3.3	3.5
Latvia	5.6	3.5	4.8	5.0
Lithuania	3.7	3.2	3.5	4.5

Source: OECD, SEB

Baltics will continue to top EU growth table

The Baltic countries have topped EU growth statistics since 2011. The region will continue to show the fastest growth in the EU over the next couple of years as well, except that Estonia will see a temporary dip in growth this year. In all three countries, growth is largely being driven by rising private consumption. Exports are increasing at a modest pace, but faster than in many other countries. The Baltics have managed to preserve the improvement in competitiveness they achieved after internal devaluations. Potential threats that may lead to poorer economic performance are structural labour market problems in the Baltics and economic deceleration in Russia.

Latvia's euro zone accession in 2014 is expected to have only a minor economic impact in the short term. Lithuania's government is working hard to qualify the country as a euro zone member by 2015; we still believe that the chance of success is about 50 per cent. It will be difficult to lower inflation fast enough for convergence reports in the spring of 2014, but unexpectedly weak recent price pressures combined with political intervention to influence price trends may open the door to Lithuanian membership as early as 2015.

The risk picture: This time is different?

The relatively vigorous recovery in the United States will have financial and real consequences for the entire world economy. Yet we still end up with a forecast in which different global regions find themselves in rather different cyclical phases. Domestic factors will thus play a decisive role in the growth process. The euro zone remains saddled with the aftermath of its deep systemic crisis, with austerity measures, uncertainty and a fragmented credit market hampering growth. In Japan, developments are very much driven by how the government's new economic policies (Abenomics) are being executed and received. In emerging economies, internal structural problems dominate the outlook. In the Nordic countries, too, country-specific conditions play a relatively large role in our forecasts.

The main upside risk in our forecast is that the US recovery, if/when it has materialised, may have larger contagious effects than we have expected. There is a rather common tendency for "de-coupling discussions" to show up at the beginning of international upturns and downturns. This was the situation in 2008, for example, in a mirror image of today's situation. At that time, most observers argued that Germany and the euro zone, due to new trade patterns and less tendency towards financial bubbles, could resist the American downturn. Ultimately, however, the correlation between economies usually turns out to be greater than forecasters predict. This is especially true of the relationships between economies in the Western world.

The main downside risk is that the normalisation of central bank monetary policies (exit policies) will turn out to be more difficult to implement and have larger consequences for the real economy than we have expected. This applies to a number of domestic risks related to how financial markets will react to key interest rate hikes in both the US and other parts of the world. But above all, there is a risk that changes in US monetary policy may cause problems for countries/regions in divergent cyclical phases. This is true of both the euro zone and emerging economies. Another part of the picture is that global debt today is higher than in 2007, which means that higher interest rates will have a major impact on consumption, capital spending, credit markets and government finances. **Overall, we end up concluding that the risk picture is rather symmetric**. In our assessment, both a scenario of faster recovery and a scenario of new growth reversals have a 20 percent probability.

Alternative scenarios

Year-on-year percentage change

	2014	2015
A. Clear contagious effects from the US upturn (20%)		
United States	3.5	4.2
Euro zone	1.3	2.5
OECD	**2.6**	**3.4**
Emerging market economies	6.2	6.4
B. More severe economic consequences from exit policies (20%)		
United States	2.4	2.5
Euro zone	-0.5	0.5
OECD	**1.3**	**1.7**
Emerging market economies	4.0	4.0

Source: SEB

Energy market shake-up

Technological advances (horizontal drilling combined with the new rock fracturing technology popularly known as "fracking") have unleashed a potentially huge increase in oil and gas production from shale formations, especially in North America. These advances will have far-reaching consequences for the energy market **in terms of global trade patterns, geopolitics and pricing dynamics**. Once consequence is that the upside oil price risk for the nearest couple of years has been substantially reduced, since oil supply will grow faster than demand. However, supply disruptions in the Middle East and North Africa could still potentially drive up oil prices.

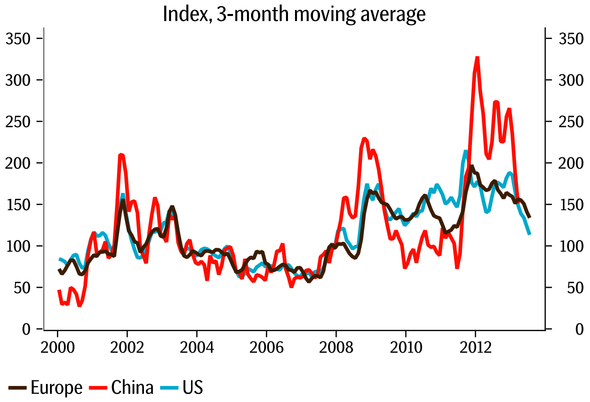
The US is projected to once again become the world's biggest oil producer, though it is not considered likely to become self-sufficient in crude oil. It is only in the most optimistic scenario that the US becomes self-sufficient, and then not before 2035 at the earliest. The increasing crude oil production in the US and Canada is, however, already changing global oil trading patterns. For example, the countries around the Atlantic are now net exporters of crude oil. Oil producers in West Africa have thus taken their residual crude production and started to compete with OPEC for market share in Asia.

Crude oil production capacity is likely to grow faster than demand in the next couple of years. This implies that OPEC's reserve production capacity will grow by nearly 50 per cent, from 2.8 million barrels per day in 2013 to 4 mb/d in 2014, and a bit more in 2015. OPEC will thus need to cut production in order to keep oil prices stable at around USD 100/barrel. Such a cut is manageable for OPEC as a whole and Saudi Arabia in particular. We thus expect that despite the new shale oil supply, crude oil **will trade at around USD 100/barrel in 2014 and 2015**, largely in line with today's forward prices. If ongoing military conflicts and political issues in the Middle East and North Africa were to ease, for example by reducing tensions related to the Iranian nuclear programme, then oil supply would increase to a level that could potentially lead to more serious friction within OPEC and push prices lower.

Shale oil will also eventually emerge from other regions of the world. However, the US Department of Energy estimates that technically recoverable shale oil only constitutes about 10 per cent of total global oil reserves. This implies that new investments in traditional non-shale crude oil production will also be needed in the long term. Estimates show that such investments are not viable if crude oil prices are clearly below USD 100/barrel. **Oil prices should thus not be able to remain much below USD 100/barrel for an extended period** of time before this starts to hamper necessary investments in new traditional oil extraction.

But although our analysis points to a main scenario of relatively stable oil prices, further ahead we can foresee major geopolitical consequences from the new energy supply situation. For example, it would not be unreasonable if the **US fundamentally re-evaluates its broad, costly involvement in the Middle East**, given a situation of sharply lower foreign oil dependence. Shale oil deposits in various former Soviet republics may **change the balances of power in this part of the world to Russia's disadvantage**. This is especially true of Ukraine, which could strengthen its position in a tense relationship with Russia with the aid of shale oil. In a risk scenario of falling oil prices, **domestic political consequences in the Middle East and North Africa may be significant**. After the "Arab spring" of 2011, many countries face major challenges in meeting the growing demands of their populations for social benefits and services. These demands may be impossible to meet if their oil revenues fall dramatically.

Economic policy uncertainty
Index, 3-month moving average



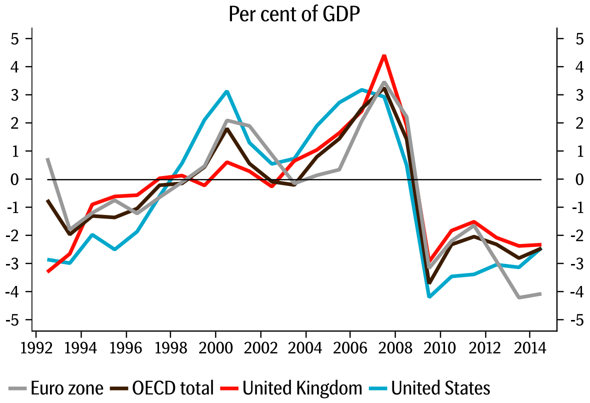
Source: Economic Policy Uncertainty

The degree of economic policy uncertainty implies both risks and opportunities. The index of economic policy uncertainty is based, among other things, on the volume of the news flow about issues related to policy and forecast divergences. Such uncertainty has decreased in recent years but remains high. Budget battles in the US Congress, crisis management in the euro zone and last spring's leadership change in China have probably helped keep uncertainty levels high. Among the consequences is that companies are postponing capital spending and hiring, since they view the long-term economic policy ground rules as unclear. Fed analyses, for example, indicate that this kind of uncertainty has pushed up US unemployment by 1-1½ percentage points. **There is thus global growth potential if uncertainty can be reduced.**

Continued strong deflationary forces

The general inflation climate in the OECD countries will continue to be dominated by strong deflationary forces connected to low resource utilisation in the industrialised countries. Because emerging economies are now decelerating, this also creates downward pressure on commodity prices. In addition, energy prices are being squeezed by increased crude oil and gas production in North America. Food commodity prices have also recently shown a falling trend, which may eventually have a sizeable impact on consumer prices.

Large output gaps in industrialised countries
Per cent of GDP

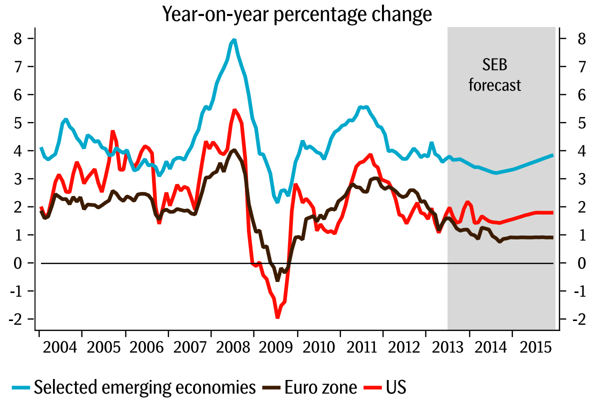


Source: OECD

The risk that inflation may fall to uncomfortably low levels is greatest in the euro zone. Smaller crisis-hit countries are already in deflation, and inflation is also on its way down in Italy and Spain. There are some signs that rising wages and salaries in Germany might facilitate the rebalancing process in the region, but German inflation does not appear likely to end up especially far from the euro zone average. We expect the weak recovery to **keep inflation as low as 1 per cent throughout our forecast period**.

In other Western economies, the picture is somewhat different. In the **United States**, core inflation is about 1.7 per cent and the pace of its downturn has slowed. Inflation will remain low, but we believe that future growth will be strong enough to ensure that inflation slowly rebounds in the latter part of our forecast period. A similar profile is also likely in **Sweden and Norway**, although inflation will not reach their central bank targets. In the **United Kingdom**, we have seen a divergent pattern of above-target inflation. We believe that inflation peaked at 2.9 per cent in June and that price pressure in the coming year will weaken as food and commodity inflation slows and pressure from earlier administrative price hikes and the depreciation of the pound vanishes from the statistics.

CPI inflation is falling
Year-on-year percentage change



Source: Eurostat, BLS, SEB

The low productivity growth of recent years poses a certain upside risk in our inflation forecast, since it pushes up unit labour cost. However, we do not believe that the expansion of central bank balance sheets will cause any major inflation pressure. To begin with, this money moves at a sluggish pace; for example in the euro zone, broad measures of money supply are still increasing very slowly. In addition, **the correlation between money supply and inflation is weak in the short and medium term**. We do not foresee any significant inflation risk until resource utilisation reaches such high levels that bottleneck problems begin pushing wages and profit margins higher.
Also worth noting is that the recent upturn in US interest rates and yields is not due to higher inflation expectations but has instead been driven by rising real interest rates. This indicates that inflation expectations are well-established, providing a further argument against a monetarily driven inflation process.

Renaissance for exit strategies

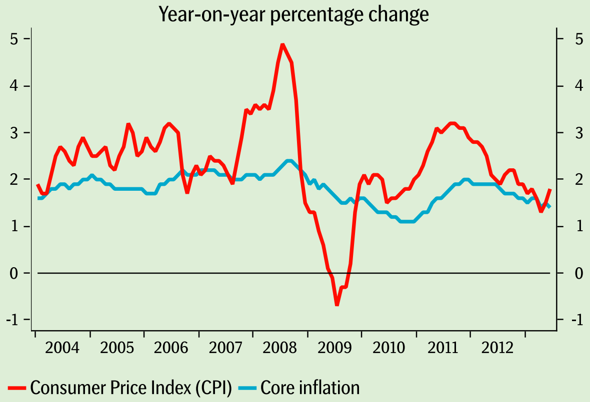
Global monetary policy is approaching a **crossroads**. Greater financial stability and brighter economic prospects will reduce

Weak inflation response a headache for exit policy

Looking at the inflation process in the OECD countries over a long period, it is striking how stable underlying inflation has been. During the period of financial excesses in 2004-2007 that preceded the financial crisis, underlying inflation was low and stable despite high resource utilisation. Since the outbreak of the crisis, the inflation response due to exceptional low resource utilisation has also been rather limited.

Stable core inflation in the OECD countries

Year-on-year percentage change



Source: OECD

Underlying price and pay behaviour has been relatively insensitive to changes in the level of economic activity, which has both positive and negative aspects. This sluggishness has helped avoid a general deflation process, despite low resource utilisation and falling asset prices. Although wage and salary increases have been subdued, they have still helped maintain household purchasing power at a decent level. Yet a sluggish inflation response delays various adjustment processes. Rigid real wages in various sectors and regions keep unemployment up. Differences in competitiveness between southern Europe and Germany, for example, are narrowing at a very slow pace.

For central banks, stable core inflation is positive in many ways. It has helped create widespread support for long-term inflation expectations. This, in turn, has been important in enabling the banks to implement exceptional stimulus measures without major credibility problems. Meanwhile credibility has a flip side. Because underlying **inflation is so stable, it works badly as a signalling system for stabilisation policy**. Faith in inflation targets among economic players may thus paradoxically fool central banks into making monetary policy mistakes.

In fact, the concept of a stable connection between resource utilisation (output gaps), on the one hand, and underlying inflation on the other has been a major cornerstone of inflation targeting policy. In some important working papers such as "Rethinking Macro Policy" by Blanchard et al, the International Monetary Fund (IMF) has analysed the consequences of this connection, which is referred to as "the divine coincidence". There are two different main avenues of fresh thinking:

- When inflation does not signal clearly enough how high resource utilisation and the consequent overheating risks are, central banks can supplement their market guidance by establishing threshold levels of unemployment (and inflation expectations). These may then be more or less connected to explicit assessments of difficult-to-determine unemployment equilibrium yardsticks. Developing signals in this way now seems rather uncontroversial in the central bank world.
- A more controversial issue is how to manage the risk of asset market bubbles. In the last decade, central banks were lured into a false sense of security by low inflation. Interest rate hikes came at a late stage, and then as a reaction to rising commodity prices, which had furthermore already caused sizeable economic deceleration. The development of macroprudential supervision as a separate and independent policy field may ease the burden on interest rate policy makers to a rather great extent when it comes to managing asset prices and financial stability. But discussion about the usefulness of interest rate policy in this field will probably remain controversial at most central banks.

the need for emergency interventions by central banks. Instead there will be a gradually increasing focus on **ensuring a normalisation of the inflation rate and preventing the re-emergence of financial imbalances.**

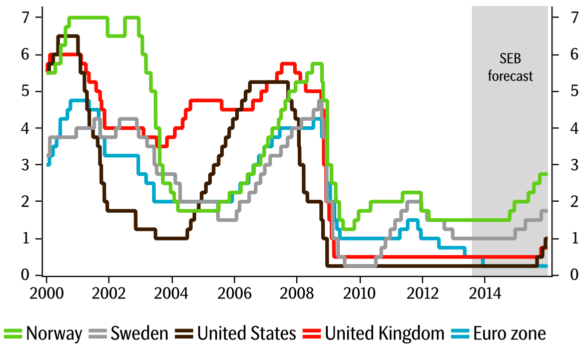
The low inflation environment will create manoeuvring room and help both conventional (interest rate) and unconventional policies (central bank balance sheets) to remain strongly expansionary throughout our forecast period. However, there are many aspects that monetary policy must take into account when designing exit strategies: 1) the direction and credibility of fiscal policy, 2) rising asset prices and the risk that new bubbles may be created further ahead, 3) the development of alternative macroprudential tools, 4) the sensitivity of economies to rising interest rates and yields. Right now central banks are testing new communicative concepts and signalling systems. Among other things, this will mean that future changes in interest rates or securities portfolios will be linked to predetermined thresholds such as unemployment levels. In this way, central banks would like to **steer market expectations** towards continued low interest rates. Another purpose is to increase the **impact of national monetary policies** as far as possible and de-couple expectations from the consequences of an upturn in US market interest rates.

Over the next year the Bank of Japan, and to a diminishing extent the Fed, will be the main central banks that will expand their securities portfolios. The ECB is also expected to supply more liquidity via a new round of Long-Term Refinancing Operation (LTRO) loans, which will go to banks. The ECB will also lower its refi rate from 0.50 to 0.25 per cent late in 2013.

The Fed will wait until autumn 2015, when unemployment has fallen to 6.0 per cent, before beginning a cautious rate hiking cycle. Its key interest rate will stand at 1.0 per cent at the end of our forecast period. Before that, the Fed will carry out a gradual tightening by allowing its bond portfolio to shrink. The Bank of England will begin key rate hikes late in 2015, while the ECB and Bank of Japan will abstain from rate hikes during our forecast period.

Key interest rates remain low - Fed first major central bank to hike its rate

Per cent



Source: Macrobond

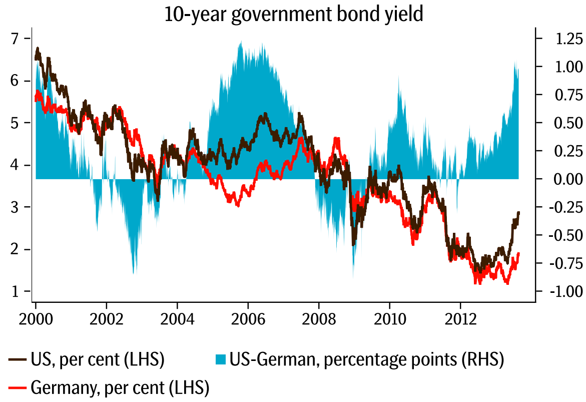
The Nordic central banks will begin their key interest rate hikes before the Fed. Sweden's Riksbank will raise its repo rate for the first time at the end of 2014 and continue until it reaches 1.75 per cent at the end of 2015. In Norway, Norges Bank will hike its deposit rate by 50 basis points as early as the second half of 2014 and by another 75 basis points during 2015, bringing it to 2.75 per cent by year-end. Inflated home prices will cause headaches mainly for the Bank of England and Nordic central banks, since downward home price corrections in these countries were largely absent during the financial crisis years.

Germany-US yield gap will persist

The Fed and US long-term yields will set the tone of the global fixed income market over the next couple of years. Our conclusion is that the yield on a 10-year US Treasury note will stand at 3.15 per cent at the end of 2014. At the end of 2015, the corresponding yield will be 3.70 per cent. This implies a modest upturn of 80 basis points compared to August 2013. The historical pattern indicates that the risk is on the upside and that a further steepening of the curve due to rising long-term yields may occur. As the Fed begins its key interest rate hikes in the second half of 2015, the yield curve will become flatter.

US-German yield gap at high levels

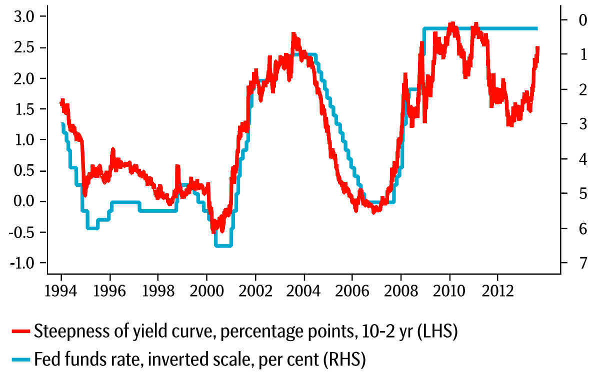
10-year government bond yield



Source: Macrobond

Today the long-term yield gap between US and German government bonds is about 100 basis points, which has been the maximum level in recent decades. Looking ahead, the economic and financial prospects for the euro zone and Germany compared to the US do not indicate that this yield gap will narrow. Yields in Germany are thus essentially expected to follow their US counterparts and a gap of about 100 basis points will persist during the next couple of years. We predict that a German 10-year bond will yield about 2.70 per cent at the end of 2015.

US: Room for some further steepening of the yield curve



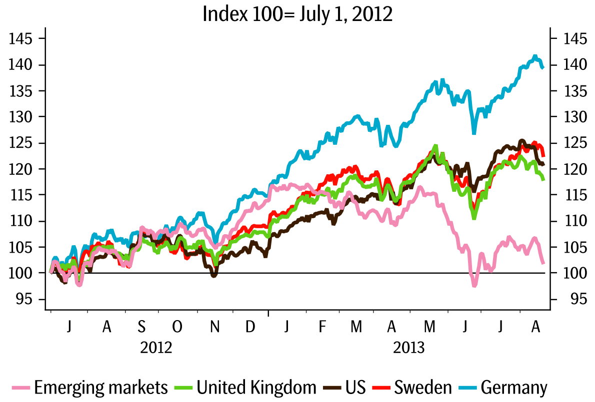
Source: Macrobond, Federal Reserve

The upward movement of bond yields is limited because of the persistent low-inflation environment, and markets assume that central banks will be prepared to expand/resume securities purchases if developments jeopardise the economic recovery or financial stability.

Stock exchanges in countries like the US, Germany and the UK have reached new record levels in recent months. The stock market thus seems to be insensitive to bad news regarding continued political uncertainty in southern Europe, poorer economic signals from the emerging economies and so on. Nor did the Fed's statements that the time is approaching to phase out its quantitative easing (QE) policy have lasting effects. Companies have delivered cautiously positive guidance in this summer's interim reports. So far this year, the global stock market (according to the MSCI index) has risen by 14 per cent.

Stock market indices

Index 100= July 1, 2012



Source: Macrobond, SEB

We are repeating our conclusion from recent issues of *Nordic Outlook* – **a cautiously positive price trend**. The attractiveness of alternative investments, for example bonds, will remain weak. Share valuations still do not appear too high. Although the market will need to "become accustomed" to the Fed's tapering of its securities purchases, central bank policies will remain highly expansionary over the next couple of years. The improved US growth outlook is important to both the global economy and risk appetite in general. We also expect energy and commodity prices to remain under downward pressure, improving the earnings prospects of companies while making a continued low interest rate policy possible. The modest upturn in long-term yields that we foresee is also compatible with cautiously rising share prices. A sharper upward yield reaction would pose a downside risk for the stock market.

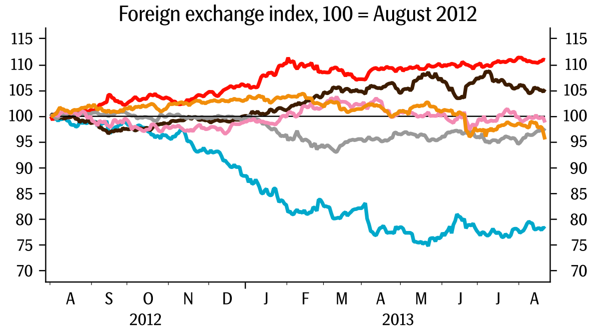
Monetary policy will drive the FX market

Differences in the strength of the recovery and divergent monetary policies will be crucial to the performance of the foreign exchange (FX) market in the next couple of years. We believe that over time, the dollar will appreciate against a number of currencies, including the euro and the Japanese yen, but the economic stabilisation in the euro zone has led to a substantial decline in the risk premium related to the euro. We also see signs that investors are again buying euro-denominated assets, resulting in positive capital flows into the euro zone. Overall, this means that we are delaying dollar appreciation a bit; we expect the **EUR/USD exchange rate to be 1.33 at the end of 2013**, but the dollar will then gain strength and the **rate will fall to 1.20 by the end of 2015.**

The yen has weakened sharply in 2013 due to the Japanese central bank's vigorous actions to drive up inflation. Over time, we believe that this policy will increase pressure on Japanese investors to increase their foreign asset weighting, with further yen depreciation as a consequence. **We expect the USD/JPY exchange rate to rise gradually to 110 at the end of 2014 and to 115 at the end of 2015.**

Sharp yen depreciation and slight euro rebound

Foreign exchange index, 100 = August 2012



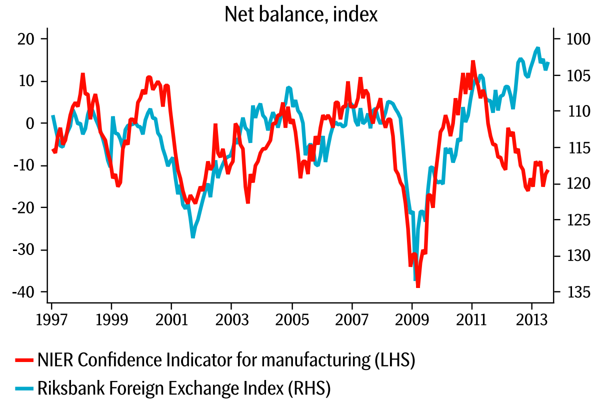
Source: Bank of England

Due in part to a weak economy and expansionary monetary policies, the British pound (GBP) has remained weak since its sharp decline during the financial crisis. In recent months there have been various signs that the UK economy is rebounding, but we expect this recovery to occur relatively slowly and monetary policies to remain expansionary for years to come. Looking ahead, a weak pound is also needed in order to maintain British competitiveness. We thus expect the pound to weaken against the USD, though to a lesser extent than the euro. **At the end of 2015, the GBP/USD exchange rate will stand at 1.48, but the EUR/GBP rate will drop to 0.81**.

The Swedish krona has been established at stronger levels than before the financial crisis. Low valuations have previously been a clearly positive driver of the Swedish krona, but today it is not so far from its equilibrium exchange rate. The attractiveness of the krona's strong fundamentals will also decrease as signs of stabilisation in the euro zone become more numerous. However, a more positive trend in the rest of Europe should also benefit the krona, which has traditionally appreciated when the world economy has improved. **We expect the EUR/SEK rate to be 8.40 at the end of 2014, with further krona appreciation to 8.20 at the end of 2015**.

Krona usually appreciates during economic upturns

Net balance, index



Source: NIER, The Riksbank

The Norwegian krone still appears to be undervalued, but significant further appreciation is being effectively countered by Norges Bank. Although it will still be a while until it happens, the Scandinavian central banks will probably be among the first to tighten their monetary policies. This is likely to benefit the Scandinavian currencies over time. **We thus expect the EUR/NOK exchange rate to stand at 7.70 by the end of 2014 and 7.65 at the end of 2015**.

- **No interest rate hikes until 2015 due to low inflation and new macroprudential tools**
- **Cost-benefit analysis and macro picture justify QE tapering as soon as possible**
- **Tricky balancing act – communication and tools will ease exit policy's interest rate risk**
- **Three building blocks of long-term yields will allow smooth upturn in next few years**

Expansionary monetary policy sets records

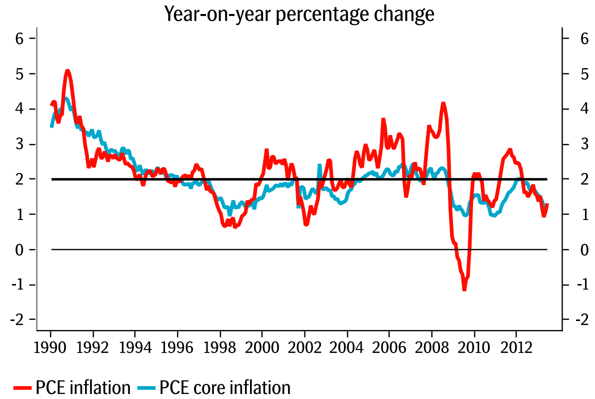
Since December 2008, the Federal Reserve's key interest rate has been 0-0.25 per cent. During the preceding 12 months or so, **it had slashed this rate by 5 percentage points**. The Fed has also **quadrupled its balance sheet over the past five years** from USD 800 billion to 3.2 trillion (around 20 per cent of GDP), mainly by enlarging its securities portfolio. This change is equivalent to conventional interest rate cuts of another **3 percentage points**, according to IMF/SEB calculations.

The Fed's securities portfolio USD billion	**Treasury securities**	**Other securities**	**Total**
January 2007	779	0	779
August 2013	1,982	1,314	3,296
Change	**+1,203**	**+1,314**	**+2,517**

Source: Federal Reserve

Low inflation pressure: Well below 2% target

Year-on-year percentage change



Source: BEA

This ultra-loose policy has been justified by **extensive slack in the economy** (the output gap), i.e. high unemployment and unused industrial capacity equivalent to **4-6 per cent** of GDP during and after the 2008-2009 recession. This is historically large. Downward pressure on wages, energy prices and so on has helped keep inflation pressure low. The Fed's favourite inflation measure, the personal consumption expenditure (PCE) deflator, is around 1 per cent, well below its 2 per cent target. **Looking ahead, low inflation will give the Fed great freedom to prioritise growth and employment**.

Two in(ter)dependent monetary policy tools

The Fed has revised its monetary policy a few times. Today (August 2013) it uses the following **two main tools** – the **key interest rate** and **securities purchases** – whose purpose is to influence the price of money and guide short-term interest rate expectations, as well as lead to quantitative easing (QE):

- The **key interest rate** (federal funds rate) will remain at 0-0.25 per cent at least as long as 1) unemployment exceeds 6.5 per cent, 2) the Fed's 1-2 year inflation forecast is not above 2.5 per cent and 3) inflation expectations are stable.
- **Purchases of Treasury and mortgage-backed securities** totalling USD 85 per month may be reduced and modified 1) due to changes in the labour market and inflation outlook or 2) if cost-benefit analysis (see box below) of these purchases leads to a conclusion different from today's. The Fed seems to have reached a consensus that when unemployment stands at around 7.0 per cent, its securities purchases should have been phased out.

These two main strategies complement each other but are not mutually dependent, i.e. **phasing out securities purchases will not change the prospects of an interest rate hike**.

A growing securities portfolio – its purposes

Transmission between unconventional monetary policy, such as purchases of Treasury/mortgage securities, and the economy go via different channels: 1) pushing up the **relative price** of bonds/equities; 2) **supplying money** and facilitating **monetary expansion** and increased **lending**; 3) **signalling** future expansionary monetary policies and thereby bolstering optimism among households, businesses and financial market players.

A growing securities portfolio – its risks

An overly expansionary unconventional monetary policy risks leading to: 1) **excessive risk-taking** and **misallocation** of resources to tangible/financial investments; 2) **postponement of balance sheet adjustments**; 3) **political passivity** and an absence of reforms; 4) a more poorly functioning **interbank market**; 5) **monetary inflation** when the credit multiplier works better (today there are only 3 dollars in the banking system for each dollar the Fed creates, as opposed to a normal 8-9 dollars).

Many factors influence the Fed's decisions

Aside from this macroeconomic "control panel" created by the Fed itself, there are additional factors on which the Fed and the US must take a position:

- **The confidence perspective.** Under more normal economic conditions, an overly large securities portfolio in the Fed's balance sheet may be viewed as unreasonable central bank subsidisation of federal deficits/debt and the housing market, which is clearly divergent from historical patterns.
- **Global implications.** There is growing irritation about US exit policy. This summer's interest rate upturn will make economic recovery harder in Europe and elsewhere and is creating undesired credit tightening in developing economies. Countries whose currencies are tied to the US dollar, for example in the Middle East, are also forced to accept rising interest rates. Negative secondary effects on other countries are smaller if the main purpose of the exit policy is to promote a stronger US economy, which will support global growth.
- **Increased politicisation.** The independence of central banks is being questioned more today than in many years. The Fed faces criticism from various quarters for prioritising Wall Street (the financial service system) before Main Street (households/businesses). An exit policy that drives up home mortgage rates may generate new criticism from both politicians and voters. One outcome may be that the selection of a new Fed chairman will be more politically charged than is desirable from a central bank independence perspective.
- **Macroprudential tools.** Alternative instruments other than the key interest rate will have a restraining effect on future interest rate hikes, but it is uncertain when a sufficiently powerful and effective arsenal of such tools will be in place.
- **Financial stability.** An exit policy that drives up interest rates quickly will risks creating unrealised market losses in the American financial system and elsewhere. This, in turn, may lead to a credit contraction that hampers recovery. The IMF estimates that an interest rate upturn of 150 basis points will generate unrealised losses in the range of USD 500 billion.
- **Fiscal policy.** In the unlikely event that the US Congress agrees on a federal fiscal roadmap that more quickly reduces the budget deficit, this will increase pressure on the Fed to launch its exit policy later and at a slower tempo.

Steps towards launching an exit policy

From a purely technical standpoint, the Fed possesses both simple and effective tools to implement its exit policy, both conventional and unconventional. The challenge is to achieve optimal timing from economic, fiscal and political perspectives.

When the timing is right, it will be reasonable for the Fed to carry out its exit policy according to the following timetable: 1) Monthly **securities purchases will be reduced gradually over a 9-12 month period** and eventually cease completely. But as long as the Fed's balance sheet is growing, monetary policy is moving in a more expansionary direction. We believe that a decision to taper monthly purchases will be made in September and that they will end next summer at the latest.

2) **The Fed will completely/partially stop reinvesting Treasury and mortgage securities that have matured**. This means that its balance sheet will shrink, both on the asset and liability side. Monetary policy will thus become less expansionary. We expect this to occur in the autumn of 2014. 3) The Fed will focus entirely on changes in the structure of the **liability side in its balance sheet** and absorb liquidity, for example, by paying interest on bank reserves, using reverse repos or issuing central bank certificates. This action will reduce the risk of monetary inflation. Liquidity-draining will occur in 2015. 4) The Fed will choose, after clear communication and guidance, to **raise its key interest rate from today's 0-0.25 per cent**. Our forecast is that such rate hikes will begin during the second half of 2015 and that the key rate will stand at 1.0 per cent by year-end. Rate hikes will be supplemented by increased use of various macroprudential tools.

Although the Fed earlier considered the possibility of actively beginning to reduce its securities portfolio by means of **direct sales, such a scenario seems very unlikely at present**. Even taking a passive approach by allowing the portfolio to gradually mature may seem too aggressive; according to the IMF it will take around five years for the Treasury securities portfolio to normalise "automatically". For the housing-related portfolio, this may take close to 30 years. One challenge for the Fed will be to justify its large holdings of mortgage-backed securities.

The Fed will have no major problems **maintaining a large bond portfolio** for many years to come (see the earlier risk discussion). Yield increases may admittedly create unrealised losses for the Fed, but if securities are held until maturity these losses will not occur. The **Fed's earnings** will be adversely affected, however, since the financing of the bond portfolio will become more expensive as the key interest rate moves upward.

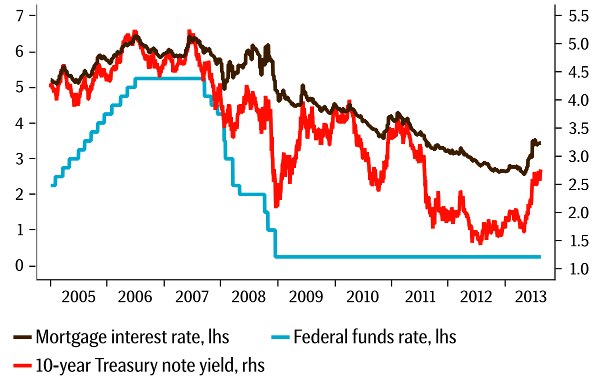
Various countries' holdings of US Treasury securities, USD billion

Country or region	Holding	Country or region	Holding
China	1,316	Luxembourg	144
Japan	1,111	Hong Kong	138
OPEC countries	266	Ireland	126
Brazil	256	Singapore	92
Caribbean	253	Norway	74
Taiwan	189	Germany	63
Switzerland	187	Turkey	60
Belgium	171	Canada	60
United Kingdom	155	Mexico	59
Russia	151	Others	807

In the coming months, a likely Fed strategy is to try to **prevent rapid upturns in long-term yields**. The bank will need to increase the transparency of its monetary policy. It is now sending signals aimed at highlighting the inflation situation more clearly. This is important because it will give the Fed greater manoeuvring room to carry out its reduction in monthly purchases, while underscoring that it will take time before the first interest rate hike materialises. We expect the Fed to take steps towards greater transparency, for example, by making the inflation target symmetrical and introducing a lower tolerance threshold of 1 or 1.5 per cent. Because of the low inflation outlook, the Fed can also reduce its unemployment threshold from 6.5 per cent to a level that the Fed regards as long-term, which is 5.5-6.0 per cent.

Fed worried about upward pressure on interest rates

Per cent



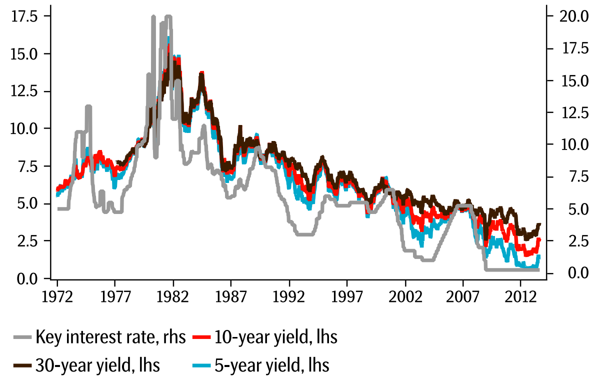
Source: Federal Reserve, Macrobond

The Fed – one of three building blocks of long-term yields

The outlook for the Fed's monetary policy will play a key role in how long-term US yields can be expected to move in the future. Over the past 30 years, yields on 10-year Treasury notes have fallen from 8 to 2 per cent. Since early May 2013, yield has risen by more than 1 percentage point. This upturn may be viewed in part as one effect of diminished uncertainty about US economic performance, but it may also reflect worries about decreasing demand for Treasury securities once the Fed ends its purchases, while global investors have less need to look for super-safe investments. Only part of the yield increase so far – about 25 per cent – can be explained by rising inflation expectations during the period.

Low interest rates and yields

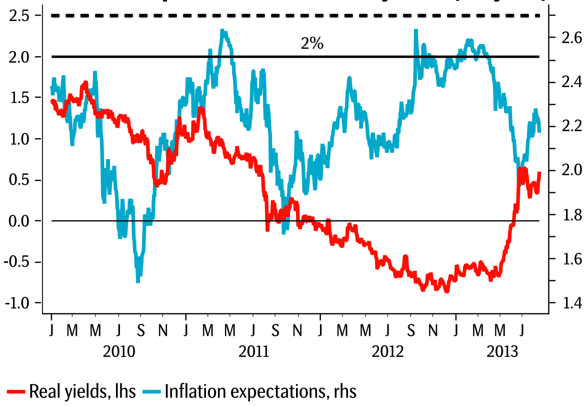
Per cent



Source: Federal Reserve, Macrobond

These developments again throw a spotlight on what happened in the spring of **1994**, when the Fed was about to normalise monetary policy after what was then regarded as a long period, 17 months, of a low key interest rate (3 per cent). The reaction was strong; the 10-year yield climbed by around 200 basis points during 1994. Many observers regard 1994 as an **operational and communicative failure by the Fed**, even though it was obvious that monetary policy needed to be tightened.

Inflation expectations and real yields (10-year)



Source: Macrobond

Globalisation of production chains and financial systems, as well as international cooperation related to economic policy frameworks, are contributing factors behind the high degree of co-variation between long-term yields in different countries, despite differences in economic, financial and institutional conditions. Although the upturn in European yields, for example, has so far not been as large as in the US, the trend of US yields will greatly influence the global yield environment.

To clarify the picture of the future long-term yield trend, we begin with the **three main building blocks** of yields: *expected short-term (real) interest rates, expected inflation* and *term premium*, i.e. compensation for the extra risk involved in holding an investment for a given extended period of time. The three boxes below present our **conclusions about these forces** and their underlying components over the next year.

Building block 1: Expected key interest rate

Overall: downward pressure (↘) on long-term yields

1	Current key interest rate	→
2	Central bank intentions and communication	↘
3	Market's short-term interest rate expectations	↗
4	Alternative policy tools	↘
5	Return requirements on tangible investments	→

Today's US **key interest rate is** 0-0.25 per cent, which undoubtedly also affects long-term yields. In addition, the Fed's **intention** and **communication** are clear: the central bank's own projections show that an interest rate hike will not occur until 2015, As mentioned earlier, the Fed's current strategy is to persuade observers to increase their focus on the inflation situation. Resources in the economy are going on stream at a slow pace, so the inflation outlook remains favourable. The Fed's communicative ability is continuing to improve, another indication that long-term yields will be pushed down thanks to a lower risk premium for unexpected and undesired policy steps.

Market expectations are nevertheless likely to push long-term yields upward as the growth outlook improves. When **alternative (macroprudential) tools** are in place, for example affecting household debt and reducing the risk of asset price inflation, future yield increases can be postponed. The return requirements on tangible assets are affected, among other things, by the **underlying strength of the economy**. Some forces will pull the other way, for example higher structural unemployment, unfavourable demographic trends, high public debt and a more predictable energy landscape. Overall, there are many indications that businesses and financial investors will move in the direction of lower return requirements.

Building block 2: Expected inflation

Overall: downward pressure (↘) on long-term yields

1	Central bank credibility	→
2	Fluctuations in inflation	→
2	Economic and monetary developments	↘
4	The symmetry of the inflation risk outlook	↘

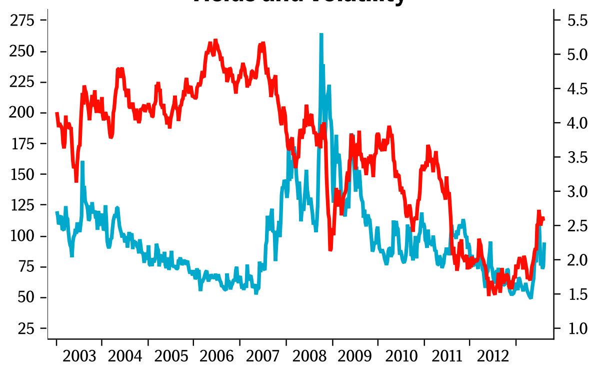
There are many indications that the **credibility of central banks** has helped stabilise inflation expectations at a comfortable level. It is reasonable to assume that this credibility will persist. In addition, inflation **volatility** has decreased, despite large fluctuations in commodity/energy prices in recent years due to weather-related factors and geopolitical conflicts. Looking ahead, we also expect downward price pressure on energy. Central banks also possess the tools needed to prevent monetary expansion from triggering higher inflation. They will also continue to be helped by the **globalisation of production chains**, which has pushed prices down. In addition, the world economy continues to operate with plenty of idle resources. At present, **there is still a major risk that inflation will instead be too low**.

Building block 3: The term premium

Overall: upward pressure (↗) on yields

1	Interest rate volatility	↘
2	Automatic hedging against yield movements	↗
3	Structural (safe-haven flow) investments	↗

Yields and volatility



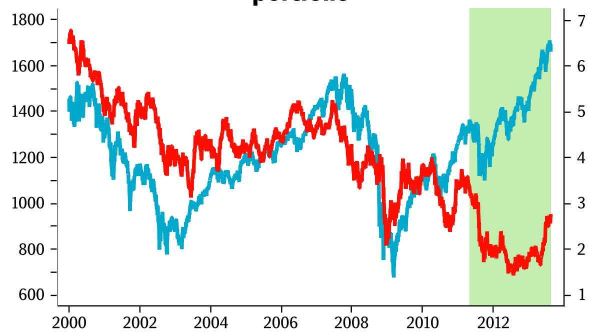
— 10-year yield, per cent, rhs — Volatility index, lhs

Source: Macrobond

Variations in interest rates may be connected to cyclical and structural forces. **Volatility** has fallen for an extended period, though it has increased recently from record-low levels. This is probably related to low interest rates and an unsymmetrical risk regarding future capital gains. The term premium for a portfolio manager has also been squeezed due to automatic hedging, since rising/falling interest rates go hand in hand with falling/rising share prices. A rising yield (= market price decline) has thus been offset by a rising stock market. This risk-reducing correlation has not existed in recent years, however.

A reasonable explanation for the reversal of the pattern is found in **structural capital flows**: the Fed launched a vigorous unconventional monetary policy by means of bond purchases, while such factors as conversion risk in the euro zone and large savings surpluses in Asia channelled investment capital to US Treasury bonds. These flows have decrease and will shrink further in the future, which has pushed long-term yields upward. This effect will probably be softened because dollar markets can be sustained by cyclical capital flows when the US economy assumes a leadership position in the global recovery. Meanwhile the dollar retains its role as the world's most important reserve currency, which in itself makes American bonds remain attractive.

Autohedge between equity and fixed income portfolio



— 10-year yield, per cent, rhs — S&P 500, index, lhs

Source: Standard & Poor's, Macrobond

Where is the 10-year Treasury yield headed?

Our review of the three main building blocks of long-term yields, including an analysis of Fed monetary policy, supports the perception of **a slow upward adjustment in yields**. The yield upturn in excess of 100 basis points that has already taken place, and that has caused an equally large upturn in American mortgage interest rates with the same maturity, has not only worried US policy makers but also governments around the world. There is a risk that last spring's yield upturn will set the stage for a further upturn in the term premium, due to greater volatility. In addition, future yield increases may go hand in hand with downward pressure on share prices, removing "automatic" yield caps and increasing risk and thus term premiums. Structurally positive flows that support yields will also decrease due to the Fed, but to some extent this yield effect can be softened because cyclical flows will push yields down. But the Fed is likely to continue basing its confidence-building and arguments on its assessment and monetary policy strategies to the effect that it will take time before a key rate hike. We share this conclusion and also agree that the inflation picture is favourable for a continued low yield scenario.

Our forecast is that a 10-year US Treasury note will yield 3.15 per cent at the end of 2014 and 3.70 per cent at the end of 2015. Meanwhile we expect its German equivalent to stand at 2.30 per cent in 2014 and 2.70 per cent in 2015.

Increasingly strong growth prospects

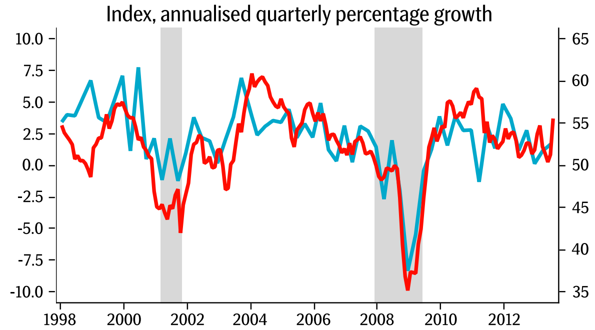
- **GDP growth 3+ per cent in 2014 and 2015**
- **Home price upturn has accelerated**
- **Capital spending will pick up in 2014**
- **Fed will raise key rate to 1 per cent in 2015**

So far, the US economy has been characterised by sluggish recovery since its dramatic GDP decline in 2008-09. In 2010-12, annual **GDP growth was about 2 per cent**. This year, very tight fiscal policy is the main reason why growth will reach only 1.6 per cent. Although Congress avoided the fiscal cliff that loomed early in 2013, it still allowed broad automatic expenditure cuts (the "sequester") to take effect last spring.

Yet underlying prospects for a recovery are increasingly favourable. The housing market is now undergoing a rapid upturn phase, with rising prices and growing construction activity. Household balance sheets are benefiting from rising stock market prices, with several broad indices reaching all-time highs. Manufacturing is also in an expansionary phase; in July the Institute for Supply Management (ISM) purchasing managers' index stood at 55.4: its highest level since 2010. Next year fiscal headwinds will also diminish, as the dose of austerity falls from nearly 2 per cent to 1 per cent of GDP. Overall, we estimate that **GDP growth next year will accelerate to 3.3 per cent**. In 2015 the demand side will strengthen further, while supply side restrictions will not yet have an impact, and **GDP growth will climb to 3.7 per cent**.

ISM index points towards accelerating GDP growth

Index, annualised quarterly percentage growth



Composite ISM manufacturing index (RHS)
Gross domestic product (LHS)

Source: ISM, Markit, SEB

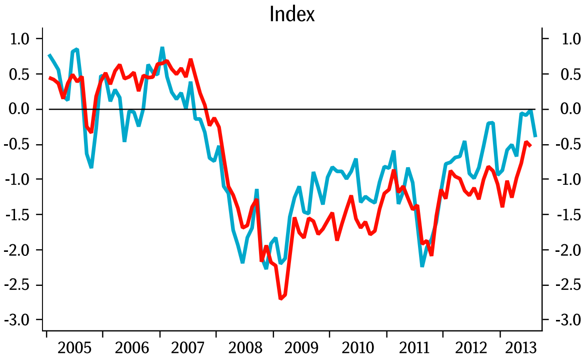
The US Federal Reserve is expected to announce a tapering of its monthly bond purchases as early as this September, ending these purchases in mid-2014. It will begin raising the federal funds rate in the third quarter of 2015. We believe that registered unemployment will reach 6.0 per cent by then.

Increasingly favourable consumer climate

Tax hikes plus higher petrol (gasoline) prices led to weakening consumer confidence early in 2013. Since then, an improved labour market and rising asset prices have lifted sentiment, and confidence indicators are close to their highest levels since 2007.

Normalisation of household optimism

Index



Conference Board University of Michigan

Source: Bloomberg, Conference Board, SEB

Household consumption rose by 1.8 per cent during the first half of 2013. Fiscal tightening will again restrain consumption growth in the second half, contributing to a full-year increase of only 2.0 per cent. Looking a bit further ahead, most factors indicate that consumption growth will accelerate, among them less fiscal tightening and a stronger labour market, but the most important driver behind consumption growth is wealth effects and changes in household balance sheets:

- **Household debts** in the fourth quarter of 2012 were equivalent to 110 per cent of income, a downturn of 24 percentage points since their 2007 peak. During the first quarter of 2013, the debt ratio rose to 111 per cent: the first quarterly upturn in four years. It is still too early to determine whether a reversal is already under way, but we are sticking to our earlier assessment that deleveraging will come to an end in the course of 2013.
- **Household wealth** has largely recovered its USD 16 trillion loss between 2007 and 2009. Measured in nominal terms, wealth is now above its 2007 level. Gross wealth in financial and real assets now stands at 700 per cent of income, compared to 789 per cent in 2007.

Empirical studies indicate that changes in wealth influence consumption over a three-year period. The impact of earlier losses has now worked its way through. **Looking ahead, the wealth increase of the past few years will have a dominant ef-**

fect on consumption. However, the upturn of recent years is mainly attributable to rising share prices, while the home price recovery is still just beginning. This will soften the impact on consumption, since financial wealth is more concentrated among high income earners with low sensitivity to changes in asset prices. Looking ahead, though, the home price upturn will probably become the dominant force.

Overall, we expect that given their asset and liability situation, households will continue to draw down their savings a bit, even though their savings ratio of 4-4½ per cent in recent months is the lowest in five years. However, we do not believe that the savings ratio will fall especially much further. A sizeable share (about 2/3) of the debt downturn is due to banks having written off the debts of households with weak repayment capacity. This will probably lead to **significantly greater caution among lenders than before the financial crisis**. The likelihood of excesses similar to those that characterised the pre-crisis credit market is therefore low. This will contribute to a more subdued consumption upturn. Overall, we expect consumption, measured as annual averages, to grow by **2.7 per cent in 2014 and by 3.1 per cent in 2015**.

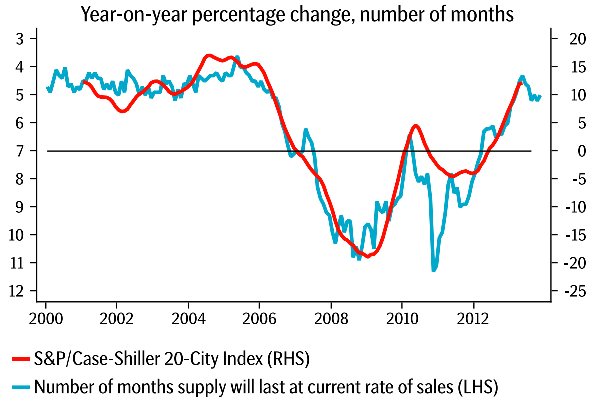
Rapid upturn in home prices

The upturn in US home prices has recently accelerated. The year-on-year increase in the Case-Shiller 20-City Index (the 20 largest urban areas) is now above 12 per cent; **in the past five months alone, prices have risen more than 7 per cent**. This is a more vigorous upturn than we had expected earlier. The recovery has been driven by record-low mortgage interest rates and a general improvement in economic conditions, especially in the labour market. The supply of homes has also been favourable for a price increase, since the number of foreclosure sales has steadily diminished, while new construction has not yet really taken off. As a result, the number of homes on sale has rapidly decreased in recent years to historically low levels.

Looking ahead, various factors indicate that the rate of price increases will slow somewhat. Mortgage rates have recently rebounded, while the number of homes on sale has again increased. The upturn is due to a slow recovery in new single-family home construction, while existing homes are increasingly being offered for sale, stimulated by the higher price level. Yet new home sales remain at historically low levels.

Growing supply will slow price upturn

Year-on-year percentage change, number of months



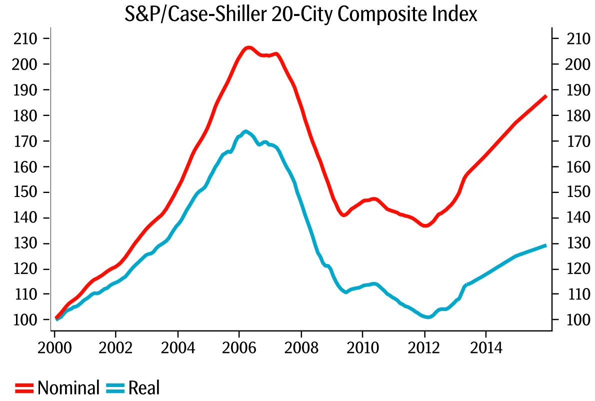
Source: Standard & Poor's', NAR

In addition, there is a speculative element in the housing market, which has probably contributed to the recent rapid price upturn. This is mainly a question of institutional investors buying bankruptcy properties to rent out. However, there are various signs that **interest in the rental business is fading, since home prices are climbing significantly faster than rents**.

Overall, there are thus indications of a more subdued price trend ahead. But even with slightly lower monthly increase rates in the second half, base effects will cause the Case-Shiller 20-City Index to **reach 12 per cent for the full year 2013. After that, we expect slower rates of increase: 8 per cent in 2014 and to 6 per cent in 2015**. According to our forecast, the nominal price level at the end of 2015 would thus stand about 10 per cent below its 2006 peak. This implies that about 70 per cent of the price decline during the crisis years will have been recovered at the end of our forecast period, but measured in real terms (deflated by the CPI), only 40 per cent of the price decline will have been recovered.

Home prices (nominal and real)

S&P/Case-Shiller 20-City Composite Index



Source: Standard & Poor's

Optimism in the construction sector was depressed for a long time, consistent with falling activity, but rising prices have helped brighten the outlook substantially in recent months, according to the National Association of Home Builders (NAHB) index. Looking ahead, there are many indications that construction will continue to increase. For example, a record-large percentage of households say they are planning home purchases. Overall, this will keep residential investments growing at a healthy pace in the next couple of years. During the second quarter of 2013, residential investments increased by more than an annualised 13 per cent rate, and we expect **growth of around 15 per cent yearly during 2013-2015**. Residential investments in 2015 would thus be equivalent to about 4 per cent of GDP, compared to a peak of 6½ per cent in 2005 and a low of 2½ per cent during 2010.

Capital spending surge on the way

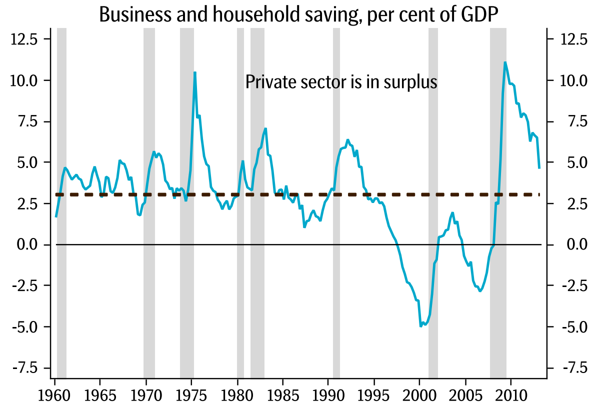
So far during the recovery, non-residential capital spending activity has been low, leading to a decline in capital stock. Aside from low capacity utilisation, uncertainty about fiscal policy has also hampered capital spending activity. This was especially clear in 2013. Low capital spending seems to have had negative repercussions on the supply side of the economy. Measured as productivity plus labour force growth, data indicate that the

potential US growth rate has fallen to as low as **around 2 per cent**. Before the crisis, most assessments of potential growth rate pointed to around 3-3½ per cent.

Now that uncertainty is easing, a **capital spending rebound is in the cards**. Technological advances in oil and gas extraction (see box) will help reinforce this trend. Stronger capital spending will be the main driving force behind the growth surge in 2014 and 2015. **Total capital spending growth will accelerate from 5.5 per cent in 2013 to 11.3 per cent in 2014 and 12 per cent in 2015**. Looking ahead, this is one reason we believe that GDP growth will be more productivity-driven and that potential growth estimates will again rise.

Still room for private saving to fall

Business and household saving, per cent of GDP



Source: SEB

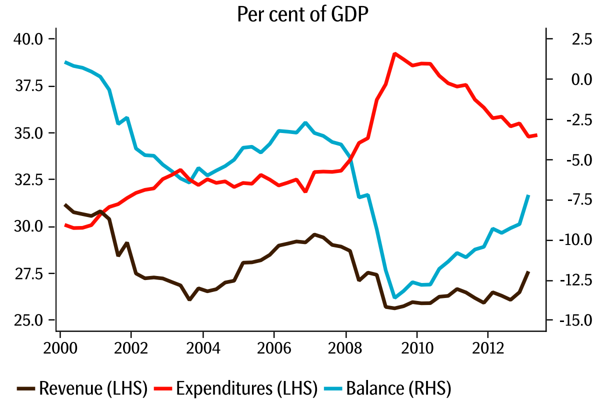
Budget-tightening will ease in 2014

Automatic federal expenditures cuts (the sequester) combined with certain tax hikes have contributed to a rapid improvement in public finances. The budgetary impact of tax hikes and improved economic conditions has also been underestimated. As a result, **fiscal tightening has been more powerful than expected and will reach over 2 per cent of GDP this year**.

Aside from restraining growth, broad front-loaded cost-cutting runs the risk of **damaging long-term economic expansion** due to lower capital spending, smaller educational investments education and higher unemployment that might become structural. Since the US, unlike southern Europe, has enjoyed market confidence and thus a greater degree of freedom, fiscal policy seems unnecessarily austere and front-loaded.

Public finances improving faster than expected

Per cent of GDP



Source: US Bureau of Economic Analysis

Despite the improved situation, the US government again risks hitting its debt ceiling this autumn. Our assessment is that the ceiling will be raised. Budget austerity is already tough, and we do not believe that anyone wants to take political responsibility for further cutbacks that will squeeze growth.

In 2014, the effects of budget-tightening will diminish to about 1 per cent of GDP. The public sector deficit will fall to 5.5 per cent of GDP in 2013 and then to 3.5 per cent in 2014 and 2015, which implies that debt as a share of GDP will stabilise at 110 per cent. The federal deficit will decline from 4.5 per cent in 2013 to 3.0 per cent in 2015. The improved budget balance may possibly occur even faster, due to payments into the Treasury from previous recipients of emergency aid. For example, so far in the 2013 fiscal year the mortgage institutions popularly known as Fannie Mae and Freddie Mac have remitted USD 82 billion (equivalent to 0.5 per cent of GDP).

Energy revolution and industrial renaissance

New technologies for extracting oil and gas from shale rock formations (which include "fracking") have led to an upturn in US energy production after a long-lasting downtrend. Production of crude oil and other petroleum products has increased by 30 per cent in the past five years, while natural gas production has risen by 25 per cent. In 2012, extraction from shale formations accounted for 30 per cent of total crude US oil production and 40 per cent of natural gas production.

The energy boom has already had a positive impact on the American economy. US energy production represents 1.5 per cent of GDP, which means that the direct production effect only contributed 0.1 per cent of GDP in 2012, but technical restrictions on gas exports have squeezed domestic prices far below international levels. This has given American companies a competitive advantage, while helping to free up household purchasing power.

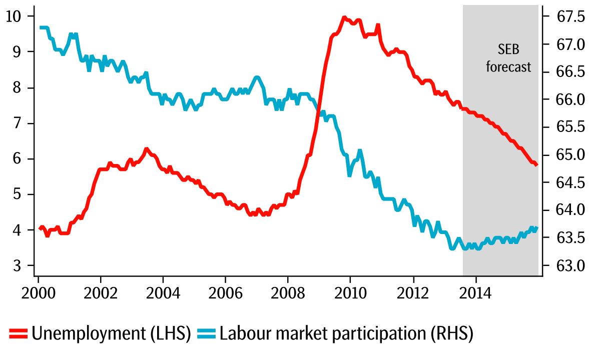
In a longer perspective, this new situation may persuade businesses in energy-intensive sectors such as petrochemicals and metals to move production back to the US. Commentators have often drawn far-reaching conclusions about advances in the energy field helping to spark a broad industrial renaissance in the US. Other factors that might make manufacturing in the US home market more attractive include rising wage costs in emerging economies and more volatile maritime shipping costs. Yet IMF calculations indicate that the direct cumulative effects of the energy boom in a 10-year perspective would not exceed 1 per cent of GDP. If US industry is to regain lost ground on a major scale, an improved cost situation must be paired with a lengthy period of higher capital spending as well as structural investments in such fields as education.

Stronger labour market

Employment increases have averaged just over 190,000 per month during 2013. Job creation is expected to accelerate somewhat this autumn, bringing the full-year increase to a monthly average of about 200,000. We expect the job increase to continue at a rate of 210,000 per month in 2014 and then increase to 220,000 per month in 2015.

Lower labour market participation pulling down unemployment

Per cent



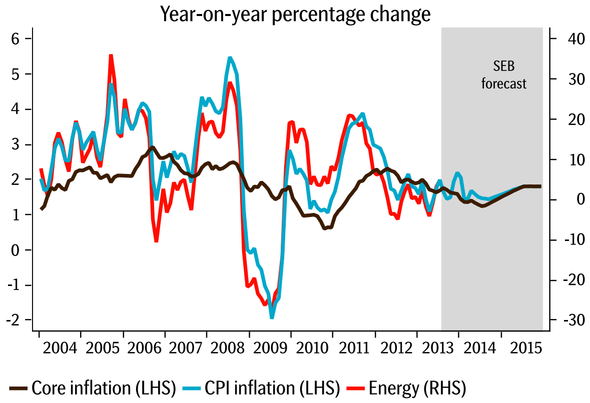
Source: BLS, SEB

Unemployment was 7.4 per cent in July and is projected to fall to 7.0 per cent by June 2014 and reach 6.0 per cent during the third quarter 2015. Measured as full-year averages, **unemployment will be 7.5 per cent in 2013 and 7.0 per cent in 2014. In 2015**, the average will fall further to **6.2 per cent**. At the end of 2015, the jobless rate will stand at 5.8 per cent: slightly above equilibrium unemployment.

Our job creation and unemployment forecasts are based on assumptions about a better-functioning supply side. The reason why the employment upturn will accelerate only marginally in 2014 and 2015, despite significantly stronger GDP growth, is that we expect faster productivity growth ahead. We also believe that labour market participation will stabilise and rebound slightly in the latter part of our forecast period.

Continued low inflation

Year-on-year percentage change



Source: BLS, SEB

Continued low inflation pressure

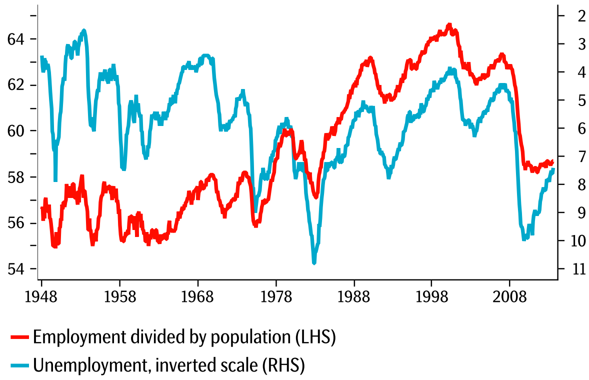
The inflation rate has accelerated in recent months and was 2.0 per cent in July, but the upturn has largely been driven by rising petrol prices. At 1.7 per cent core inflation is lower, but the cool-down in core inflation has slowed in recent months, and **worries about deflation are unlikely to prevent the Fed from starting to taper its bond purchases in September**. Looking ahead, the general picture of a low inflation environment will nevertheless persist, driven by falling energy prices, low resource utilisation and other factors. **Our assessment is that CPI inflation will end up at 1.7 per cent in 2013 and 1.6 per cent in 2014. In 2015, inflation will climb somewhat and will reach 1.7 per cent**.

Multi-stage exit policy

The link between macro forecasts and interest rate policy has become clearer, now that the Fed has provided an explicit connection to the inflation and labour market picture (see also the theme article on US monetary policy). According to current signals, the Fed's key interest rate will remain at 0-0.25 per cent at least as long as 1) unemployment exceeds 6.5 per cent, 2) the Fed's 1-2 year inflation forecast is not above 2.5 per cent and 3) inflation expectations are stable. As for its unconventional policy, the Fed seems to have reached a consensus view that its securities purchases will have been phased out when unemployment has reached 7.0 per cent.

Different employment yardsticks, different messages

Per cent



Source: BLS, SEB

Some factors complicate this picture and may require further clarifications by the Fed. For example, this applies to the risk that inflation will be undesirably low. We thus believe that the Fed will also launch a downside tolerance threshold equivalent to 1 or 1½ per cent inflation. The fact that unemployment has fallen largely because many people have given up and left the labour force may also have an impact, we believe. Since the amount of slack in the economy is larger than registered employment indicates, the Fed will probably be more inclined to hold off longer. We thus believe that the **Fed will begin interest rate hikes only when unemployment has fallen to 6.0 per cent**.

In light of our macroeconomic forecast, **we believe that the Fed will approve a tapering of securities purchases in September 2013** and that these purchases will end by mid-year 2014, when unemployment is at 7.0 per cent. During the third quarter of 2015, when unemployment will be 6.0 per cent according to our forecast, key interest rate hikes will begin. **Towards the end of 2015, the federal funds rate will stand at 1.0 per cent.**

Japan hoping Abenomics will speed recovery

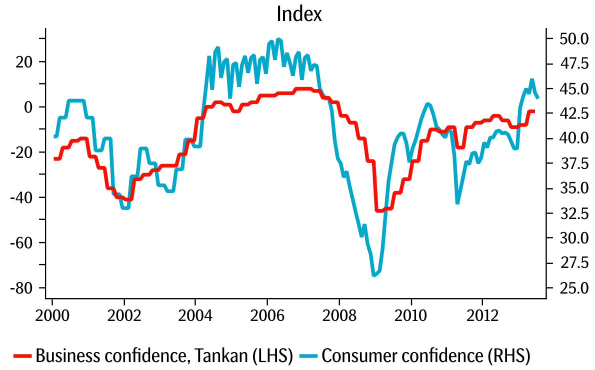
- **Indicators are pointing cautiously upward**
- **Growing confidence in Abenomics, but the economic outlook remains uncertain**
- **More political manoeuvring room, but Abe hesitant about structural policy and tax hike**
- **Bank of Japan continues vigorous support**

Japan's recovery shows **continued broad-based momentum**, but the overall level of economic activity remains relatively weak after a strong start to 2013. This summer's upper house **election gave the Shinzo Abe administration a stronger political position**; the prime minister now commands a majority in both houses of parliament, increasing his manoeuvring room to implement the third and final stage of "Abenomics" – structural/reform policy – after launching aggressively expansionary fiscal and monetary policies.

Yet there are many questions about the future direction, implementation and medium-term impact of Abe's policies. **We expect GDP growth of 1.9 per cent** in 2013, a bit higher than predicted in May's *Nordic Outlook*, **1.4 per cent in 2014** (unchanged forecast) and **1.0 per cent in 2015**: above trend throughout the period. Underlying deflation pressure will persist. **This year, inflation will exceed zero (0.3 per cent)** and rise to **2.5 per cent in 2014** and **1.5 per cent in 2015**. These forecasts are highly dependent on the government's planned September/October decision to hike the consumption tax from 5 to 8 per cent in 2014 and to 10 per cent in 2015.

Abenomics is boosting household and business optimistm

Index



Source: The Bank of Japan, Japanese Cabinet Office

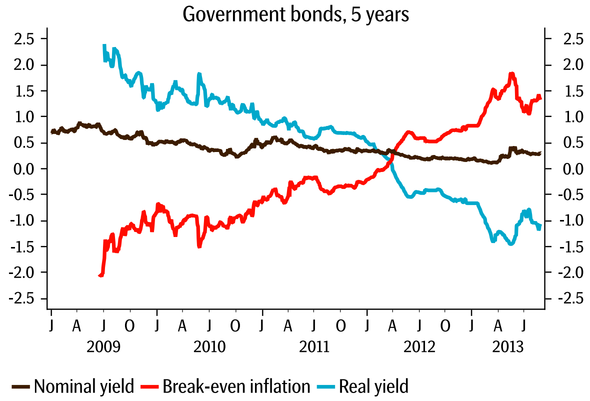
Optimism among manufacturing and service businesses – but especially among households – has strengthened in recent months. In the Tankan survey, manufacturing show the highest index level for more than five years, and 26 of 31 sectors showed a better outlook. Among households, greater optimism is clear in most age categories, not only older people who have seen their shareholdings gain value. Household confidence has reached levels not recorded since before the autumn 2008 Lehman Brothers collapse. The positive expectation effects of Abenomics are due to rising share prices, a weaker yen and increased public investments. **Household consumption is more stable, while business investments have stopped falling**. Meanwhile earnings levels are rising, especially among export firms. But if this optimism is to result in further consumption, production, capital spending, as well as a sustainable upturn in growth and rising inflation, the Abe administration must continue to deliver in a purposeful way.

Abenomics – what it will deliver

Prime Minister Shinzo Abe has given his name to an economic policy with three "arrows": 1) a big fiscal stimulus package (2 per cent of GDP) including higher public investments; 2) a nearly unlimited expansionary and radical monetary policy that will double the monetary base by purchasing long-term (up to 40-year) government securities, a new 2 per cent inflation target and reduced central bank independence; 3) a growth/structural policy including an enlarged labour supply, improved education and health care and greater efficiency in the agricultural and energy sectors.

Rising break-even inflation

Government bonds, 5 years



Source: Bloomberg, Macrobond, SEB

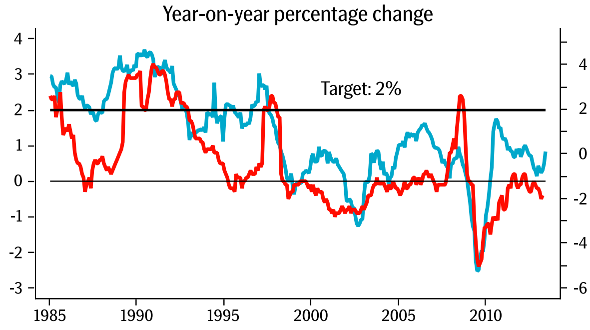
The Liberal Democratic Party (LDP) and its partner New Komeito together won 135 of 242 upper house seats, **opening a window of opportunity, since the next elections are not due for 3-4 years**. The government thus has no excuse for not taking advantage of the political situation to pursue its radical policies, which enjoy widespread voter support. Yet a lingering element of scepticism is reflected in the low turnout for the summer's upper house election, falling public support for the government and resistance to reform policies within Abe's own

LDP. Abe is also showing a tendency to play the nationalist card, a sign that the government is worried that support for its economic policies might evaporate. This autumn, Abe is expected to reshuffle his cabinet in an attempt to strengthen his own position, given the new parliamentary situation.

During the summer, Japan has noted its highest inflation in five years, very much due to the 20 per cent weakening of the yen, which among other things boosted the price of the imported energy required because most Japanese nuclear power plants have been inactive since the Fukushima disaster. **Inflation expectations have also risen among businesses, households and investors**, reflecting the fact that imported inflation and tax hikes are expected to push CPI inflation upward towards the Bank of Japan's 2 per cent target. Yet the economy still has a large amount of slack, equivalent to 2 per cent of GDP, while the country is subject to an international price squeeze that intensifies deflationary forces in Japan.

Wage growth an important key to sustainable inflation

Year-on-year percentage change



Source: Statistics Bureau of Japan, Japanese Ministry of Health

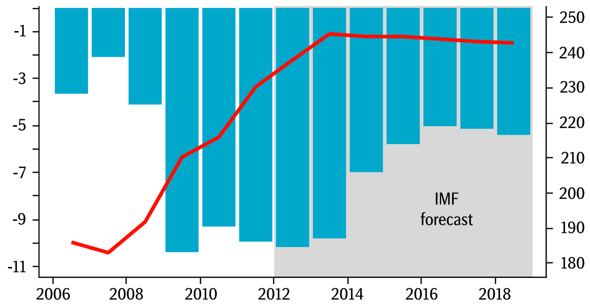
Achieving **sustainably rising inflation** in the next couple of years requires that **wages and salaries climb**, pushing up underlying inflation. This means, in turn, that the earnings upturn the export sector enjoys because of the weaker yen also benefits wage-earners. Unemployment is expected to remain stable, at or just below 4 per cent. But without rising wages and salaries, it will be difficult to raise the consumption tax. The Abe administration has begun to vacillate on the issue, well aware that prime ministers Takeshita (1988) and Hashimoto (1997) were forced from office soon after raising this tax.

One or more consumption tax hikes were Japan's "promise" to the G20 countries to take steps towards a long-term plan for stabilising public sector debt and bringing it down as a percentage of GDP. Assuming that the tax can be increased, Japan's public sector debt can **level off at around 250 per cent of GDP late in our forecast period**, the highest level ever recorded for an OECD country. In 2014/2015, the public sector deficit is expected to decrease as the earlier stimulus package is phased out. Meanwhile fiscal challenges will increase in the medium and long term. A rapidly ageing population will lower Japan's production capacity and increase public expenditures for pensions and health care. A necessary element of Abenomics' "third arrow" is a policy that will boost labour market participation by Japanese women.

Since last spring, the yield on a 10-year Japanese government bond has risen from 0.50 to around 0.85 per cent. The Bank of Japan obviously wants to avoid volatility in yields. Today the central bank's target is to buy JPY 50 trillion worth government bonds annually (about USD 500 billion, equivalent to 10 per cent of GDP and thus to Japan's entire budget deficit). An isolated Japanese yield increase, if it occurs, will primarily affect Japanese investors and the BoJ, since only a limited share of this debt stock is held abroad. **Our forecast is that the central bank will try – successfully – to stabilise Japanese long-term yields at close to or just below 1 per cent**.

Japan's public sector debt expected to peak at 245% of GDP

Per cent of GDP



Source: IMF

Abenomics risks credibility problems unless it succeeds in delivering sustainably higher growth and rising inflation. Spending public funds using new money printed by the central bank is the easy part of Abenomics, since it requires no short-term sacrifices by the Japanese. But structural policies will entail greater social and political challenges. Meanwhile, in the absence of a long-term plan for managing government debt, investors are more likely to demand higher compensation to buy Japanese government securities, for example. **This may rapidly alter Japan's economic prospects**.

The Bank of Japan is now working proactively and communicatively, like the Fed, Bank of England and ECB, to persuade international observers that its key interest rate will remain low for an extended period. The contest to be **the world's No. 1 financing currency will thus intensify**. We expect Japan to win that contest, which will have a weakening effect on the yen. Meanwhile we expect Japanese investors to diversify their domestic portfolios and be attracted by higher yields in the US and elsewhere. Our assessment is that the yen is still about 10 per cent overvalued in effective terms. **Our forecast is thus that the USD/JPY exchange rate will be 102 at the end of 2013 and reach 115 at the end of 2015**.

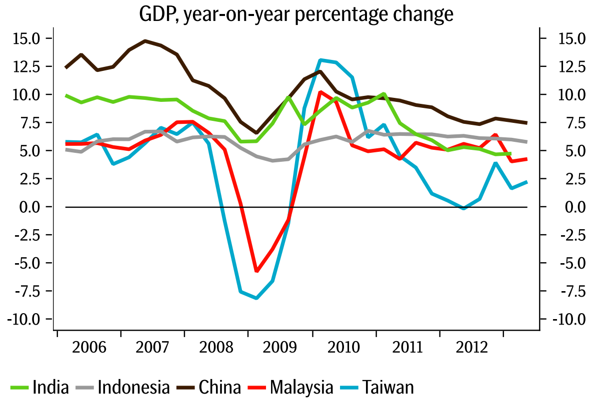
Continued below-trend growth

- **QE tapering worries hurting Asian markets**
- **China: High tolerance towards slower growth**
- **India: No clear recovery in sight, financial turbulence**

Despite **continued below-trend growth**, Asian emerging economies are still the fastest-growing in the world. After a broad slowdown early in 2013, **growth appears to have bottomed out in the second quarter**. Yet exports remain sluggish and volumes are lower than a year ago for most of these economies. Europe is the biggest drag on exports, but China's weak imports are also impacting exports of neighbouring countries. Commodity exporters like Indonesia and Malaysia are the most vulnerable, since they have also been hit by lower commodity prices. Looking ahead, potential improvements in US demand are expected in 2014 and 2015 and should help exports recover. **Growth in the region will remain around 6 per cent in 2013 and 2014, followed by a minor acceleration in 2015**.

Asia: GDP growth

GDP, year-on-year percentage change



Source: National statistical offices

Despite a slight recent increase, **inflation pressure** in the region **remains low**. Below-trend growth plus weak structural price pressure means that inflationary impulses are expected to remain subdued. This provides conditions for expansionary monetary policies but **the recent pressure that currencies in the region have experienced implies that more central banks,** similarly to Indonesia, **might be forced to hike interest rates** to try to stem currency weakness.

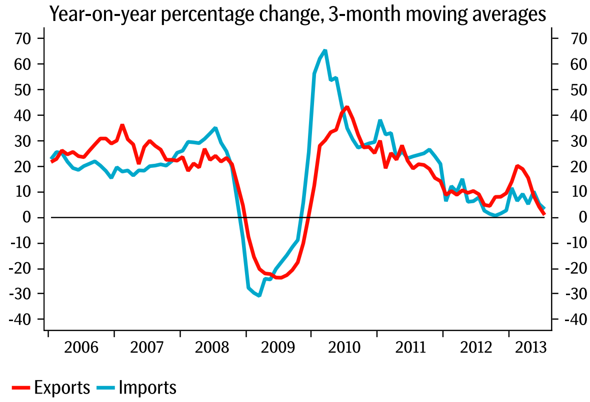
Speculation about a tapering of the US Federal Reserve's quantitative easing (QE) measures has had a severe impact on the financial markets of emerging Asian countries. Except for the Chinese yuan, **most currencies weakened in late May and during June**. In July and early August there was a rebound but **worries have returned recently** and the Indian rupee and the Indonesian rupiah have been extra hard hit. Currency depreciation can benefit export-dependent economies that have struggled with weak external demand, but in India's case it is associated with various stabilisation policy problems. **Stock markets in the region have taken a beating as well** but thanks to floating exchange rates, sizeable foreign currency reserves and strong government finances, **the economies of the region are nevertheless more resilient to financial turbulence** than during the crisis of the 1990s.

China: Tolerating slower growth

In the second quarter, China's year-on-year GDP growth was 7.5 per cent, a deceleration from 7.7 per cent in the first quarter. Growth is still largely being driven by capital spending, which was behind 5.9 percentage points of the GDP increase. There are signs of a stabilisation in growth. The official purchasing managers' index has stagnated at just above the neutral 50 point level during the past three quarters. The Markit/HSBC PMI declined appreciably during the summer (probably driven by the larger share of small and medium-sized companies in its sample; see *Nordic Outlook*, May 2012) but the preliminary reading for August points at a substantial recovery. Export performance is weak, although trade statistics for July were better than expected. There is greater uncertainty than usual about trade statistics, since the authorities have come down hard on inaccurate reporting undertaken for tax reasons, but our assessment is that the underlying export growth is between 5 and 10 per cent.

Weak trend for exports and imports

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



Source: National Bureau of Statistics of China

Recent trends in industrial production and retail sales point towards a stabilisation. Construction sector activity has levelled out, but the large number of completed properties will hold back future residential construction. Home prices are continuing to rise, but the increase has slowed.

In March the official growth target for 2013 was set at 7.5 per cent, thereby serving as a floor for growth. Recently, the perception that **the government is prepared to tolerate slower growth** has gained strength, and during the summer uncertainty arose about the level of the growth target. The government's lower limit now seems to be 7 per cent, but **the likelihood that growth will fall below 7 per cent this year is very small**. This picture was reinforced by July figures pointing to a stabilisation or slight improvement in growth during the immediate future. In the longer term, the shift in growth model implies that growth will continue to slow. **We expect China's GDP growth to end up at 7.5 per cent in 2013 and 7.4 per cent in 2014. In 2015, growth will decelerate to 7.0 per cent**.

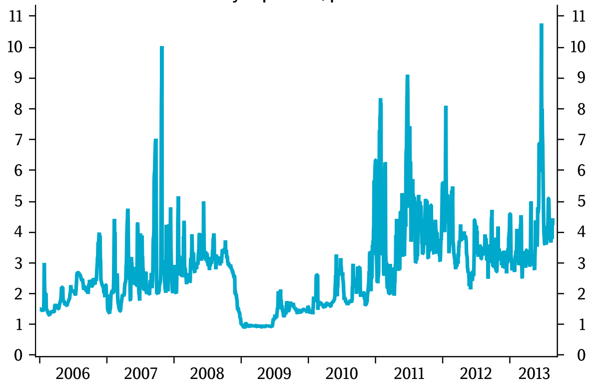
In July, the government announced **measures to support growth**, including tax cuts for small enterprises and a reduced regulatory burden on export companies. Furthermore, already planned **infrastructure investments will be accelerated and new initiatives will be added**, among them improved electricity networks and wastewater systems in cities. These projects nevertheless extend over a long period and do not represent a major new stimulus package, but if the economic deceleration should intensify, there is an increased likelihood of more extensive stimulus measures.

The government's main priority is to **avoid a worsening of labour market conditions**. During the growth slowdown of 2009-2010, the labour market weakened sharply and a large-scale stimulus programme was launched to prop up the economy. So far, there are **no clear signs that the deceleration in growth has had an impact on the labour market**. The employment downturn in manufacturing indicated by PMI sub-indices has so far been offset by an improvement in the services. Demographic changes (see box) will help the economy weather lower growth without sharply rising unemployment.

The government's reluctance to launch large-scale stimulus programmes despite slower growth implies that the new political leadership is emphasising a clear shift from earlier economic priorities. This policy is consistent with the goal of abandoning the old growth model largely driven by capital spending and exports. Recently, a clearer picture of a more **reform-friendly political leadership** has emerged. Groups of experts have been appointed and assigned to re-assess fiscal and monetary policy, land reform and potential for a reduction in bureaucracy. Their proposals are expected in October. There are also clear examples of reform ambitions in the financial sector. In June, a widespread **liquidity shortage** arose, among other things driven by seasonal tax payment effects related to the end of the first half. These effects are nothing new. What was new was that the central bank held off from pumping liquidity into the economy, causing a sharper and more persistent increase in interest rates than previously.

People's Bank of China disciplines market players

7-day repo rate, per cent



Source: ChinaMoney

One explanation behind this action is that the **People's Bank of China (PBoC) wishes to discipline market players** to ensure that they will not take for granted their access to cheap interbank loans. The central bank admittedly backed down in the end and pumped in liquidity, causing interbank rates to drop. Yet the result was a tightening of credit growth; in July the increase in "total social financing" (the broadest measure of lending) slowed. Yet credit growth is still unsustainably high and needs to be restrained. A credit slowdown would hurt short-term growth but would decrease the risk of a hard landing later on.

In July the **PBoC removed the bank lending rate floor**. Since interest rates are currently well above the previous floor, no major effects are expected in the short term. But this step is of **great symbolic importance** and underscores the ever-larger role of market forces. The next important step will be to remove the ceiling on banks' deposit rates. But such a step will require having a bank deposit guarantee system in place.

Diminishing demographic support for growth

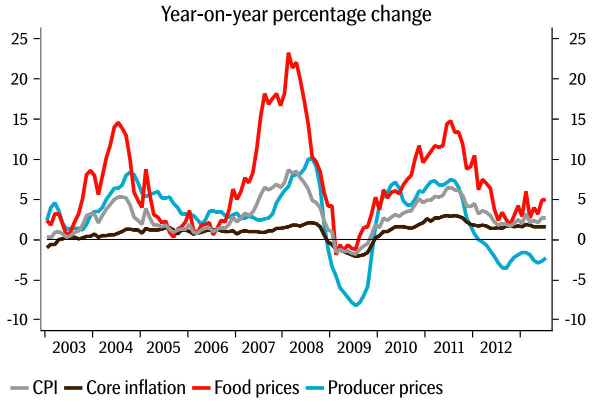
Conditions vary between countries, but in many Asian emerging economies such as China, South Korea and Singapore, **favourable demographic trends now represent a diminishing source of support for economic growth**. In the past three decades, China's GDP has benefited because a growing percentage of the population has been of working age. The Asian Development Bank (ADB) estimates that favourable demographics contributed an annual 2 percentage points to GDP growth per capita in the 1980s. During the past two decades, demographic have made a more limited contribution: around 0.7 percentage points per year.

China nevertheless faces a very **abrupt shift**, and **demographics will pull down growth**. The share of the population who are of working age is expected to peak as early as 2015, while total population will reach its peak around 2030. China is now beginning to feel the effects of its one-child policy and of social changes in previous decades, in the form of later marriages and childbirths, which have led to a very low fertility rate. The result has been a sharply higher percentage of older people in the population. In the short term, there is no solution to this problem in itself, but its negative impact on economic growth can be eased by greater immigration, higher female labour force participation and higher retirement ages. The one-child policy is now also being further eased. However, one consequence of lower labour supply will be that the **Chinese economy can grow at a significantly slower pace without causing unemployment to begin rising**.

In July, the inflation rate remained at 2.7 per cent. Looking ahead, we expect inflation to rise somewhat, driven by food prices, but our scenario of **low inflation pressure remains**. Core inflation is still below 2 per cent and producer prices are falling year-on-year. As full-year averages, **we expect inflation to end up at 2.8 per cent in 2013 and 3.2 per cent in 2014**. **In 2015 we foresee inflation of 3.4 per cent.**

Continued low inflation pressure

Year-on-year percentage change



Source: National Bureau of Statistics of China

China's key interest rate has been unchanged since it was lowered in July 2012. **Our assessment is that the rate will remain at 6.0 per cent until the second quarter of 2014, when we expect a 25 basis point hike.** During 2013 the yuan has continued to appreciate against the US dollar and has gained nearly 2 per cent. Official willingness to allow currency appreciation in a situation of slackening growth reinforces the picture of a policy shift. One explanation is that the authorities want to bring the yuan's value closer to a market level. Our assessment is that they will slow yuan appreciation in order not to put further pressure on the export sector. **We expect the USD/CNY exchange rate to stand at 6.10 at the end of 2013 and 6.00 at the end of 2014. At the end of 2015 it will stand at 5.90 per USD.**

India: No clear recovery and heavy pressure on the currency

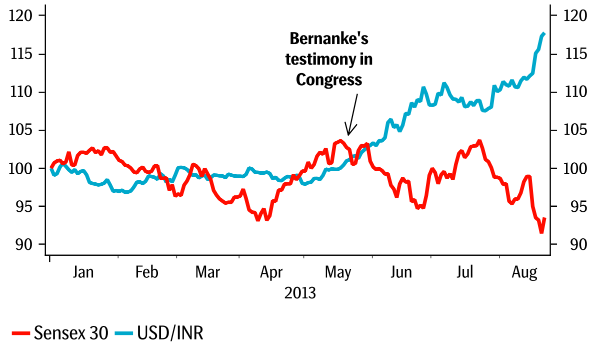
India's year-on-year growth rate accelerated slightly in the first quarter to 4.8 per cent, from 4.7 per cent in the preceding quarter, indicating that the economy has bottomed out. Yet at present, **there are no signs of a clear recovery**. Purchasing managers' indices remain at historically low levels. Industrial production remains weak and continued weak non-oil imports and sluggish car sales reinforce the picture of very subdued domestic demand. Export performance has also been weak, although there was a substantial rebound in July. **GDP is expected to climb by 5.0 per cent in 2013 and 5.6 per cent in 2014. In 2015, growth will accelerate to 6.0 per cent**.

The rupee is one of the emerging market currencies most severely affected by worries about a tapering of the Fed's quantitative easing. Since Fed Chairman Ben Bernanke's congressional testimony on May 22, the currency has lost more than 15 per cent against the dollar. India's sizeable current account deficit (about 5 per cent of GDP) makes the rupee very sensitive to fluctuations in market sentiment. The Reserve Bank of India tightened liquidity in the second half of July, helping temporarily stabilise the currency. But worryingly, the rupee has weakened again and stands at a record-low level against the USD. New RBI Governor Raghuram **Rajan**, who takes office in early September, will be forced to focus on further steps to try to stabilise the rupee. **We expect the INR to trade at 65.0 per USD at the end of 2013 and 60.0 at the end of 2014. At the end of 2015 it will stand at an estimated 55.0 per USD**.

The bond market has also been affected by worries. Yield on 10-year government bonds has climbed by more than one percentage point since the end of May. As in other emerging economies, the Indian stock market weakened dramatically in June. After a recovery in July, the downturn recently gained new momentum. Due to relatively thin stock market trading and the large influence of foreign investors, the effects of worsening global market sentiment are extra powerful.

Worries about Fed asset purchases hurt India's stock market and currency

Index 100 = 2013-01-01



Source: Bombay Stock Exchange, Macrobond

The weaker rupee is helping exports but also risks impacting the economy due to rising import prices. Wholesale price index (WPI) inflation has levelled out in recent months but rose to 5.8 per cent in July; mainly driven by rising food prices. Measured as annual average, **WPI inflation will end up at 5.7 per cent in 2013 and 6.0 per cent in 2014 and 2015**. Since the last cut in early May, the key interest rate has remained at 7.25 per cent. **The RBI prioritises currency stabilisation,** and the potential for continued monetary policy easing has vanished, since rate cuts would counteract efforts to sustain the rupee. Rather, our assessment is that the RBI will hike the **key interest rate twice to 7.75 per cent in 2013.** In **2014**, we expect the currency to have stabilised, which will open the way for **two key rate cuts**.

Fiscal policy is still hampered by India's big budget deficit. The weakening of the rupee also causes an increase in the cost of energy subsidies. On the plus side, **the government has recently pursued a somewhat more active reform policy**, including liberalisation of foreign investments in telecoms and defence. New restrictions on gold imports have been imposed to stem the large trade deficit. Since in practice neither fiscal nor monetary policy can stimulate the economy, and since it will take time before the government's reforms have an impact, **we expect annual growth to be stuck at around 5-6 per cent annually during our forecast period**.

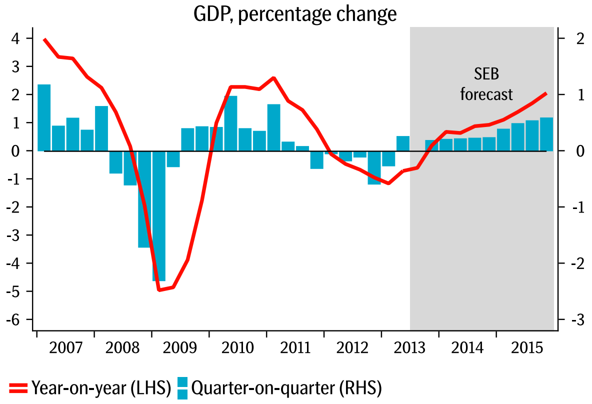
Growth on the way back, despite many storm clouds

- **The real economy is stabilising**
- **Political and financial uncertainty persists**
- **Inflation will remain very low**
- **ECB will launch further stimulus measures**

After six quarters of falling GDP, the **euro zone left behind its recession** in the second quarter of 2013, when growth compared to the preceding quarter reached 0.3 per cent. Vigorous action by the European Central Bank (ECB) has stabilised financial markets and sharply reduced the risk of a euro collapse. The real economy in crisis-hit countries also looks more stable than before. Earlier improvements in competitiveness and current accounts have now been supplemented by an end to falling GDP. Looking ahead, the euro zone economies will benefit from the continuous strengthening of the US economy. We expect GDP to level out in the third quarter after its strong second quarter figure and then begin a slow upturn in the fourth quarter. **As annual averages, GDP will fall by 0.5 per cent in 2013 and then climb by 0.8 per cent in 2014 and by 1.7 per cent in 2015**.

The euro zone is leaving its recession behind

GDP, percentage change



Source: Eurostat, SEB

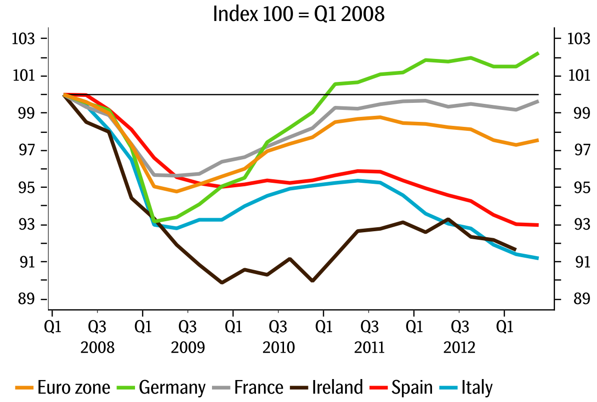
Yet the euro zone will continue to suffer from more profound problems than other regions in the world economy. As a result, its **recovery will be lethargic** and fraught by imbalances, risks and uncertainty. In most countries, GDP remains well below its pre-crisis level, which is one reason why unemployment remains dangerously high. Given our growth projections, of larger euro zone countries only Germany and France will exceed 2008 pre-crisis levels at the end of our forecast period.

Fiscal austerity will continue to hamper growth in crisis-hit countries during 2013 and 2014, but the dose will gradually decrease. In 2015 the contribution of fiscal policy to growth will be largely neutral. **Tight credit market conditions will probably be a more important restraint** to the economies of southern Europe. In Spain, banks are struggling with a continued decline in home prices and a high percentage of bad loans. In this environment, even solvent companies have problems borrowing money. According to the IMF, there is a continued need for the banking sector to shrink its balance sheets. Alternative tools are needed and have been presented, for example via the European Investment Bank (EIB) and a German-Spanish small business loan partnership. Before losses in the banking system are taken, banks are recapitalised and economic growth curves have rebounded, it is difficult to foresee a significant change and increased bank lending.

Economic policy makers are facing major challenges and difficult trade-offs. We expect the ECB to expand its stimulus efforts, among other things by **cutting its refi rate from 0.50 to 0.25 per cent** in December. Meanwhile the ECB must take into account the risks that its own stimulus measures may weaken political resolve. This applies both to the implementation of various countries' crisis programmes and structural reforms as well as more long-term questions concerning the shape of euro zone cooperation. Now that the economy is starting to move in the right direction, it is especially important for structural policy to focus on sustaining growth and creating jobs. Meanwhile, it is important to quickly put in place the planned **banking union and supervisory mechanism**.

Few countries have regained lost GDP since 2008

Index 100 = Q1 2008



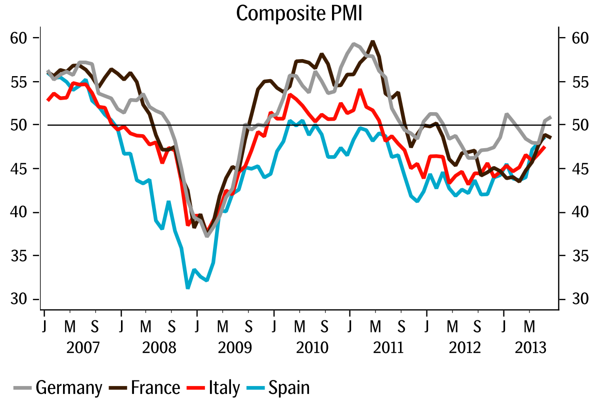
Source: Eurostat

Some bright spots in the indicators

Indicators have shown improvements in recent months, although the brighter picture is not without ambiguities. After bottoming out at 88.6 in April 2013, the EU's Economic Sentiment Indicator (ESI) rose to 92.5 in July. The ESI noted upturns in all four large euro zone countries (Germany, France, Spain and Italy). Purchasing managers' indices (PMIs) have also improved, and these four countries are now very close to each other at around the growth threshold of 50. Sub-indices for manufacturing are somewhat better. Manufacturing indicators provide a somewhat brighter picture of the situation than actual output, but the latest monthly production readings showed an upturn. We expect this trend to intensify during the autumn.

Purchasing managers' indices recovering

Composite PMI



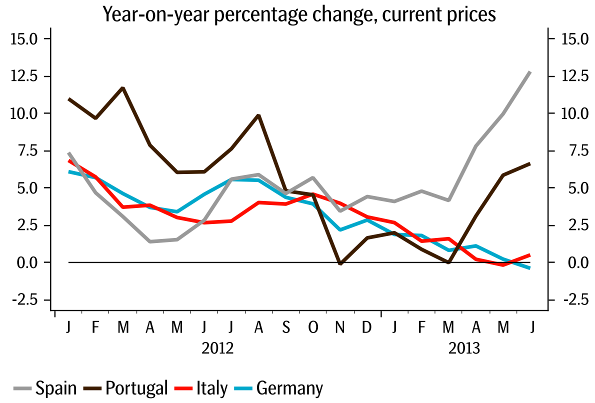
Source: Markit Economics

GDP will bottom out late in 2013

Foreign trade statistics show a decent export upturn in several crisis-hit countries. In Spain, for example, exports of consumer and capital goods rose by 9 per cent in the first five months of 2013, while the number of tourists increased. Looking ahead, exports will enjoy support from a weaker euro and a stronger international economy, especially in the US. Pay cuts in various crisis countries have helped narrow the differences in internal competitiveness compared to Germany. Yet more questions remain. The pay cuts seem to have ended already in crisis countries, and the question is whether this process has gone far enough. It is also worrying that Italy and France are continuing to lose competitiveness. Overall, euro zone **exports will increase by 4.0 per cent in 2014 and 4.5 per cent in 2015**. Exports will contribute 0.3 per cent to GDP growth in 2013 and 2014, rising to 0.5 per cent in 2015.

Export upturn in Spain and Portugal

Year-on-year percentage change, current prices



Source: Macrobond

Domestic demand remains weak but will gradually improve. Capacity utilisation is rising but is still at a low level, delaying the recovery in **capital spending activity**. According to IMF studies, the correlation between yardsticks of political uncertainty and capital spending has increased sharply since the financial crisis, underscoring the importance of reducing political uncertainty.

Households, especially in southern Europe, continue to be pressed by **fiscal austerity, high unemployment and uncertainty connected to political and economic developments**. Low inflation is nevertheless supporting real income growth. Consumer confidence has also improved in recent months, albeit from low levels. Consumption will remain weak throughout our forecast period but will recover somewhat in 2014 and 2015. **Measured as annual averages, euro zone consumption will fall by 1 per cent in 2013 and then rise by 0.5 per cent in 2014 and 1.0 per cent in 2015**.

Overall euro zone GDP fell by 0.3 per cent in the first quarter and then rose by 0.3 per cent in the second quarter. We expect a slight drop during the third quarter, followed by slowly rising GDP. Measured as annual averages, **GDP will fall by 0.5 per cent in 2013 and then increase by 0.8 per cent in 2014**. We expect a further improvement in **2015, when GDP will grow by 1.7 per cent, slightly above trend**.

GDP, selected countries

Year-on-year percentage change

	2012	2013	2014	2015
Germany	0.7	0.5	1.7	2.0
France	0.0	0.2	0.8	1.5
Italy	-2.8	-1.7	0.6	0.8
Spain	-1.9	-1.4	0.4	1.5
Greece	-6.4	-5.0	-1.0	0.0
Portugal	-3.2	-2.2	0.3	0.7
Ireland	0.9	0.9	1.5	1.5
GIPS countries	**-2.4**	**-1.7**	**0.3**	**1.2**
Euro zone	**-0.6**	**-0.5**	**0.8**	**1.7**

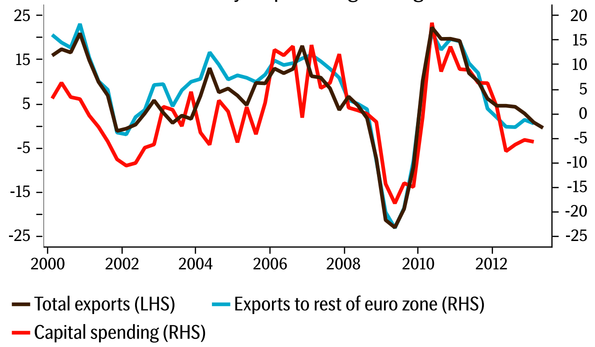
Source: Eurostat, SEB

Germany: Recovery after weak start to 2013

The German economy showed signs of weakness in late 2012 and early 2013. In light of strong underlying fundamentals, we view this slump as temporary and believe that Germany will remain the anchor that gives the euro zone a growth dynamic and stability. Because of its heavy dependence on exports (50 per cent of GDP in 2012, up from 35 per cent in 2000), the country will benefit when US growth takes off and when the recession in southern Europe eases and moves toward an end.

Germany: Export upturn needed before capital spending can take off

Year-on-year percentage change



Source: Macrobond

Recent developments have shown that Germany is affected by the crisis in southern Europe. There is a strong association between capital spending on the one hand and exports, mainly within the euro zone, on the other. Consequently, one important prerequisite for a surge of German capital spending activity is that recovery and thus import demand continue to stabilise elsewhere in the euro zone.

It is also vital to get consumption moving, both for the sake of German growth and the potential for rebalancing the euro zone economies. Wage and salary agreements will apparently provide pay increases of 2.5 to 3.0 per cent. Total pay increases will be somewhat higher, allowing decent real wage growth. Fiscal policy will be neutral or mildly expansionary throughout our forecast period, but we do not believe that German political leaders are especially responsive to international calls for more vigorous fiscal stimulus measures. Unemployment has stood at a historically low 5.4 per cent since July 2012 and shows no signs of rising, which will help keep consumer confidence well above that of other large euro zone economies.

Overall, **there is thus potential for an upturn in private consumption**, but we anticipate that German households will remain relatively cautious and that the increase will be modest. Consumption growth in 2013 will be 0.8 per cent and then increase to 1.0 per cent in 2014 and 1.2 per cent in 2015. This will help **GDP growth to increase from 0.5 per cent in 2013 to 1.7 per cent in 2014 and 2.0 per cent in 2015**.

Less than a month before the September 22 federal parliamentary (Bundestag) election, opinion polls indicate that Angela Merkel's centre-right CDU/CSU-FDP governing coalition will receive a mandate to remain in power. The margins are narrow, however, and our assessment is that the main alternative to the incumbent government will be a "grand coalition" between the Christian Democrats (CDU/CSU) and Social Democrats (SPD). Regardless of the election outcome, we believe that German policy towards the EU and euro zone will remain largely unchanged. However, German politicians are likely to avoid decisions about bail-out programmes and the future of the euro zone until after the September election.

France: Hesitant recovery

In growth terms, France did relatively well in 2008-2009 when its GDP fell less than that of Germany, but its performance since then has been weaker. The economy was in recession, with falling GDP in Q4 2012 and Q1 2013. GDP has largely remained the same since 2011: still below pre-crisis level. Households are squeezed by weak job growth, escalating unemployment (11.0 per cent in June) and rising taxes. Meanwhile capital spending is hampered by weak demand and uncertainty among businesses. In manufacturing, the purchasing managers' index has risen since bottoming in January to just below 50 (49.7). French banks are continuing to shrink their balance sheets. According to IMF studies, this is nevertheless occurring without major adverse effects, since low demand is the main thing holding back credit growth.

New challenges lie ahead

The ECB's actions have recently contributed to an environment where instability in one country does not automatically spread to other countries. For example, political turbulence due to the resignation of two Portuguese government ministers triggered rising yields. Contagion to other crisis-hit countries was small, and yields have again fallen. Until long-term cooperation issues in the euro zone are resolved, and as long as large imbalances persist, there is a major risk of recurrent financial instability. In the near future, this perhaps applies especially to Greece and Spain. We foresee that **Greece's government debt** (about 160 per cent of GDP in 2012) **will need to be restructured once again**, this time burdening the finances of the ECB and euro zone countries. **Spain** is still grappling with a high proportion of bad loans (10-11 per cent) and falling home prices and **is expected to receive further bank support**. Below is a chronological review of selected events that may affect financial markets:

September 13, 2013 – Reviews of aid programmes for Cyprus, Portugal and Ireland. No major surprises expected.

September 22, 2013 – Bundestag election in Germany. Merkel's coalition is leading in opinion polls. No major changes in EU/euro zone policies are expected in the near future, regardless of the election outcome. Freeze on discussions about the future of the euro zone until the election.

Autumn 2013 – Ruling of the German Constitutional Court on the OMT programme. The consensus is that the court will not say no but may limit the scale of the ECB programme.

October 14 and November 14, 2013 – Reviews of aid programmes for Spain (Oct) and for Portugal, Ireland and Greece (Nov). Our main forecast is that Spain will need further support for its banking sector. Relief for Greece (longer-term loans, lower interest rates and debt write-downs) is expected. A debt restructuring risks contagious effects, and Portugal and Ireland in particular may want similar relief. In order to avoid this, Greece's debt restructuring target will be set at a level above or equal to current debt levels in these countries (about 120 per cent of GDP). Portugal may also receive longer-term loans, lower interest rates and more time to repay its loans.

End of 2013 / spring 2014 – The bail-out programmes for Ireland, Portugal and Greece will be terminated. Even if no further bail-outs are needed, the programmes will continue because of interest rate concessions and extended maturities.

May 22-25, 2014 – Election to the European Parliament. The election may strengthen Euro-sceptical parties in various countries. The EU's decision-making capacity may diminish before the election and before a new European Commission is put in place during the autumn of 2014.

Economic policy is creating uncertainty about where France is headed. The country has been criticised for certain tax hikes and for its lack of structural reforms. Public sector austerity has improved the structural balance, but due to weak economic performance the actual budget deficit is still above the EU limit of 3 per cent of GDP. We expect a deficit amounting to 4 per cent of GDP in 2013, followed by a slow improvement.

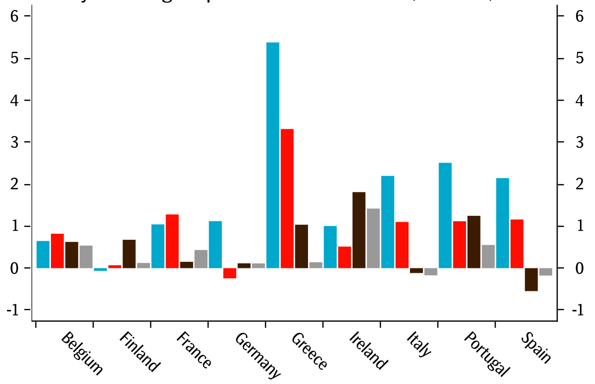
Exports are also stumbling at the moment but will improve with the help of demand from Germany and the US. In the longer term, though, there are questions about competitiveness and the strength of French exports. Real effective exchange rates do not look alarmingly strong, but the current account has gradually deteriorated since the late 1990s, and in 2012 the deficit totalled 2.3 per cent of GDP. This has played a part in the deterioration of France's net external position from a balance in 2007 to -22.5 per cent of GDP (the IMF has estimated -35 per cent of GDP as a threshold value). Overall, we expect a weak recovery. **GDP will increase by a marginal 0.2 per cent in 2013 and then rise gradually to 1.5 per cent in 2015**, which is around trend growth.

Milder austerity policies

Budget-tightening programmes remain in place but will be less extensive over the next few years. Measured as change in structural saving, the dose of austerity will decrease sharply. In Greece, Portugal and Spain, fiscal policy will be relatively neutral in 2015, while austerity in Ireland will be equivalent to 1.5 per cent of GDP. In the euro zone as a whole, the growth-slowing effect of austerity policies will shrink from **0.8 per cent of GDP in 2013 to 0.1 per cent in 2015**. The actual budget deficit will fall from 2.9 per cent of GDP in 2013 to 1.9 per cent in 2015. Public sector debt will peak at 95 per cent of GDP in 2014 and then fall slightly as a percentage of GDP.

The diminishing effect of fiscal austerity

Year-on-year change in public structural balance, 2012-15, % of GDP



Source: IMF

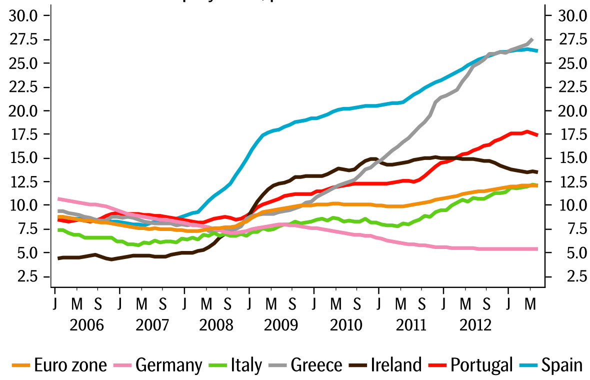
Unemployment will remain high

In recent months, **unemployment** in the euro zone as a whole has **levelled out at a bit above 12 per cent**. Divergences remain large, with the German jobless rate at a record-low 5.4 per cent. In southern Europe the level is well above the average, but some bright spots are discernible. In several of the hardest-hit crisis countries, unemployment has fallen in the past few months. From April to June, unemployment in Spain fell from 26.5 to 26.3 per cent and in Portugal from 17.8 to 17.4 per cent.

This may be connected to an unusually strong seasonal upturn in tourist sector employment. In Italy and France, however, the jobless rate is continuing to climb.

Weak labour markets in southern Europe

Unemployment, per cent of labour force



Source: Eurostat

Looking ahead, because of modest economic growth the improvement in the labour market will occur slowly. In the euro zone as a whole, we predict that **annual average employment will remain at the same level in 2014 as in 2013, 12.1 per cent, and then fall to 11.5 per cent in 2015**.

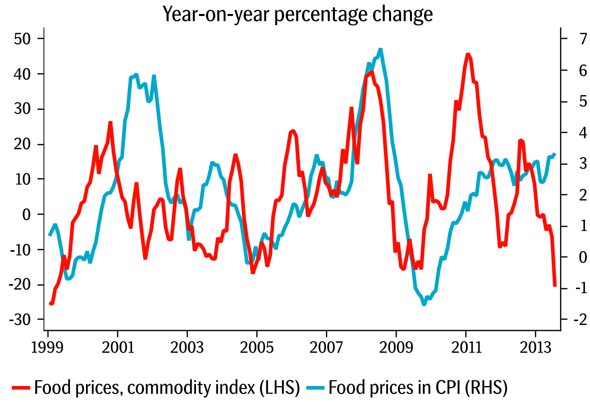
Despite our somewhat more positive assessment of the labour market than in the May issue of *Nordic Outlook*, high unemployment in many countries will mean **persistent political and social risks that may create obstacles to the continued reform process**. Migration inside Europe will increase in the wake of divergent unemployment levels, and there is a risk that some countries may be drained of highly educated workers. This may cause labour shortages in some sectors to occur relatively early during the recovery process.

Continued low inflation pressure

In recent months, euro zone inflation has largely fluctuated between 1 and 1.5 per cent. In July, core inflation amounted to 1.1 per cent while Harmonised Index of Consumer Prices (HICP) inflation stood at 1.6 per cent. In Germany, HICP inflation is now 1.9 per cent, which is slightly above the euro zone average. The situation in southern Europe is mixed. June inflation in Greece was -0.3 per cent, in Spain 2.2 per cent and in Portugal 1.2 per cent.

Falling food prices will pull down inflation

Year-on-year percentage change

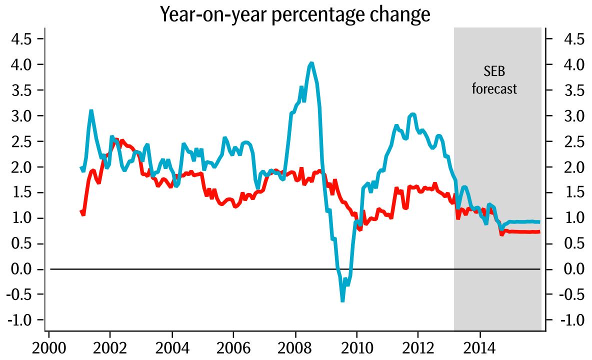


Source: Eurostat

The downward inflation trend will continue over the next few months before **inflation stabilises at around 1.0 per cent**. Looking ahead, energy prices will make a rather neutral contribution while food prices will pull down inflation. In the longer term, inflation will be squeezed by weak growth in the real economy and persistent low credit demand. We see a clear risk of damaging deflationary tendencies in various countries, but we believe that the shift to positive growth combined with a weaker currency will enable the euro zone to avoid a general deflation process. Measured as annual average, **HICP inflation will be 1.0 per cent in 2014 and 0.9 per cent in 2015**.

Low inflation pressure

Year-on-year percentage change



HICP — Core HICP

Source: Eurostat, SEB

Further ECB stimulus measures

The economic and monetary outlook will give the ECB room for further stimulus measures to support economic growth, lower deflation risks and reduce credit market fragmentation. Continued high public and private debts will make euro zone economies sensitive to rising market interest rates. In addition, **euro appreciation in the past year is roughly equivalent to a refi rate hike of 1 percentage point**. This will hamper the recovery and rebalancing process.

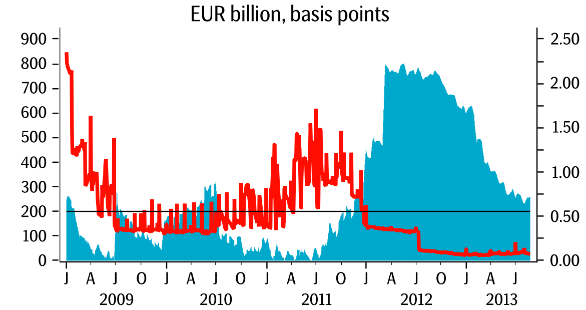
We expect the **ECB to lower its refi rate in December 2013** and then let it remain at 0.25 per cent in 2014 and 2015. We also expect the ECB to **supply new long-term liquidity** (Long-Term Refinancing Operation, LTRO) and **signal its readiness to use the Outright Monetary Transactions programme**, provided that the German Constitutional Court approves OMT this autumn. Because the EIB and some banks at the national level can provide corporate loans, this eases some of the pressure on the ECB to launch new unconventional policies.

In July, the ECB took a new communicative step aimed at guiding short-term interest rate expectations. The bank declared that its **refi rate would remain at today's level or lower for an extended period of time**. This step is obviously aimed at reducing the risk that the Fed's imminent exit policy measures will push up market interest rates in the euro zone as well, thereby countering the ECB's expansionary monetary policies. In order to further push down the euro overnight index average (EONIA) interest rate towards zero, the ECB has also announced that it is prepared to introduce a negative deposit rate, but our assessment is that because of technical challenges the ECB will not introduce negative interest rates.

With the help of LTRO, the euro system today has surplus liquidity of about EUR 250 billion. The pace of repayments from banks is currently around EUR 5 billion per week. **If the surplus falls below EUR 200 billion, this tends to push up the EONIA rate**. External imbalances between euro zone countries also remain large, posing refinancing risks in the event of a loss of confidence. This is an indication that the ECB will choose to offer new LTRO loans in an effort to improve the functioning of the banking system in southern Europe and keep interest rates low.

Reduction in surplus liquidity may push up EONIA

EUR billion, basis points



— EUR 200 bn in surplus liquidity, lhs ■ ECB, Surplus liquidity, lhs
— EONIA, rhs

Source: Bloomberg, ECB

The ECB is currently under intensive international pressure from individual countries and organisations to do more to support the recovery. Meanwhile there are limits to how far the ECB can go in its ambition to create a respite that will allow political progress. The ECB has already demonstrated its readiness to go very far, and in some respects even to exceed its mandate, in order to save the euro project. The fragmentation of the credit market is partly a task for the ECB, but it is also a result of macroeconomic and political uncertainty as well as political deadlocks connected to national elections and the election to the European Parliament.

Gradual recovery on solid ground

- **Tight budget and slow wage growth**
- **Continued weak pound boosts exports**
- **First key interest rate hike late in 2015**

This year the UK began a sustainable recovery after its earlier financial crisis and last year's stagnation. All purchasing managers' indices climbed rapidly to well above the growth threshold of 50 in July (manufacturing 54.6, construction 57.0 and services a full 60.2). We should not read too much into this, however; they indicate an economy reverting from crisis levels, not an impending sharp upswing. Even after second quarter growth of 0.7 per cent, GDP remains 3.3 per cent below its first quarter 2008 peak. Because of **forces that hamper domestic demand, we predict a moderate recovery**, but faster than forecasted in the May *Nordic Outlook*. **GDP will rise 1.5 per cent this year, 2.3 per cent in 2014 and 2.6 per cent in 2015.**

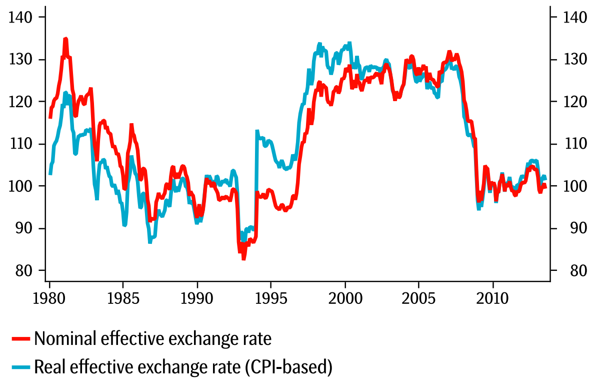
Households have slowly begun to open their wallets again. Second quarter GDP growth was largely consumption-driven. But since real income kept falling, the household savings ratio fell from 7-8 per cent in 2010-2012 to 4 per cent early in 2013, a bit below the long-term average. Households are unlikely to keep rapidly reducing their saving, given high unemployment. Rising home prices will contribute to higher credit volume, but we believe households will be cautious about taking out large loans due to high debt. Real wage growth will also be negative this year, though inflation apparently peaked at 2.9 per cent in June. Price pressures will subside this coming year as food and commodity inflation slows and earlier administrative hikes and pound depreciation vanish from the figures. Nominal pay will grow by 1 per cent this year. **In 2014, zero real wage growth awaits. Not until 2015, when the labour market begins to strengthen more clearly, will real wages rise.** Households are squeezed by government **budget consolidation**, though its impact is starting to ease. Austerity culminated at 2.1 per cent of GDP in 2011 but will remain at about 1 per cent yearly in 2012-2014. In 2015 we expect austerity effects to shrink to 0.5 per cent of GDP, partly because it will be an election year. Overall, consumption growth will be modest in the next couple of years.

Capital spending will be weak this year due to low capacity utilisation. **In 2014 a decent upturn will begin**, due to a low investment ratio, strong company balance sheets and more construction, which has already begun to build up momentum.

Exports will be the only vigorous growth engine in the coming year, fuelled by a **weak pound and the large share of exports destined for the US** (17 per cent of the total). Export growth has been modest so far, but currency depreciation has a somewhat delayed effect and the global economy will gradually strengthen. The 4-5 per cent decline in the pound from year-end 2012 until this summer should have a greater impact in the second half of 2013. Since the Bank of England (BoE) is continuing its accommodative policies, the pound will remain at historically weak levels; we predict a gradual strengthening from GBP 0.86 today to 0.81 per euro in December 2015, but a weakening against the USD. The relatively rapid inflation of recent years (exceeding the BoE's 2 per cent target since 2009) has only had a minor impact on the UK's real effective exchange rate. Competitiveness remains good.

Historically weak pound = good competitiveness

Index 100 = 2010



Source: BIS

The BoE recently started issuing monetary policy guidance. It will not consider a key rate hike and cut its asset purchases (QE) until unemployment, which was 7.8 per cent in June, falls to 7 per cent. In its latest inflation report, the BoE predicts that this will occur in the third quarter of 2016, but adds that three factors may change the playing field even if unemployment has not fallen to this level: 1) if the inflation forecast is at or above 2.5 per cent in an 18-24 month perspective; 2) if inflation expectations are not stable; 3) if monetary policy threatens financial stability. **We predict that the first rate hike (from 0.50 to 0.75 per cent) and the beginning of QE tapering will occur in the final quarter of 2015.** By then, unemployment will be close to 7.0 per cent. But the factor triggering a decrease in monetary stimulus will be the greater risk of financial instability further ahead. **Rising home prices** – which began a rapid climb in 2013 after remaining relatively stable for several years following a sharp downward correction in 2008 – are expected to gradually **intensify a "bubble debate"** that will also affect the BoE. But when it hikes its key rate, the BoE is unlikely to explicitly warn about a home price bubble. Instead it will revise its inflation forecast upward, due to the risk of home price inflation.

The worst is over – but no immediate upswings

- **Brighter German outlook stabilises industry**
- **Continued low inflation helps households**
- **Modest growth prospects for Russia**

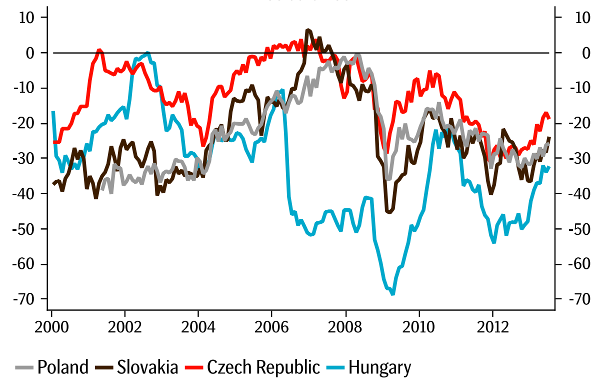
There are many signs that **growth in Eastern (including Central) Europe bottomed in the first half of 2013**, as *Nordic Outlook* forecasted in May. We still expect **sluggish recovery** in most countries over the next couple of years. Exports will begin to strengthen this autumn due to a brighter German outlook, but overall euro zone demand will awaken later. The US upturn is less important, since that country is a minor export market. Continued fairly good real wage growth, calm commodity prices, low core inflation and low interest rates will fuel private consumption. But given job uncertainty, many households will postpone major purchases until 2014, when labour markets begin to stabilise. Credit markets are thawing slowly, partly due to abnormally tight conditions after the euro zone crisis. Only Russia will show rapid credit growth, but slower than in recent years. Capital spending will remain depressed in the short term, with a slight upswing only in 2014-2015: in EU countries partly due to new funds from the long-term EU budget.

In the second quarter, growth rose slightly in several countries – though not in Russia – but remained weak primarily in southern and eastern parts of the region. Croatia, Slovenia and Ukraine were among countries stuck in recession. **In recent months, indicators have also risen** in many places. This is most evident in Central Europe, while manufacturing remains stagnant in Russia and especially Ukraine. Poland's purchasing managers' index (PMI) climbed above the expansion threshold of 50 to 51.1, its highest in a year and a half. In the recession-plagued Czech Republic, PMI rose from 51.1 in June to 52.0 in July, highest since March 2012. But Russia's manufacturing PMI sank to 49.2 in July after a temporary upturn in June; for the first time in two years, the index is now below 50. Eastern European consumer confidence has trended higher since its low last winter. Russian household optimism is now historically relatively high, while levels in Central Europe remain modest.

The improvement in manufacturing is mostly tied to exports. Central Europe in particular is **beginning to enjoy support from a stronger Germany**. Households are cheerful largely because of **sharply lower inflation** since late 2012; Hungary's inflation has gradually fallen from 6.5 per cent to below 2 per cent and Poland's from 4 per cent to a record-low 0.2 per cent in June. Lower price pressure has strengthened real wages – recently also boosting consumption a bit – while gross pay increases have been subdued because of growing unemployment.

Rising household optimism

Net balance



Source: European Commission

Most countries in the region will not reach their potential growth until 2015. We expect **Polish GDP to rise by 1.5 per cent in 2013 and by 3.1 and 3.7 per cent in the following two years**. We are still relatively pessimistic about **Russia's** growth prospects; **GDP will increase by 1.8 per cent this year, 2.9 per cent in 2014** (potential growth is about 3 per cent) and **3.4 per cent in 2015**. This comparatively low long-term growth capacity reflects structural obstacles, for example in the labour market. Major reforms and investments will be needed to achieve the government's 5-6 per cent growth target; Russia averaged 7 per cent in 2000-2077 before the global crisis. Oil prices, which will fall a bit to about USD 100/barrel in 2014, will continue to give support to Russian growth over the next couple of years.

To some extent, **economic stimulus measures are fuelling** the region's recovery. Poland's central bank cut its key rate from 4.75 per cent in November 2012 to a record-low 2.50 per cent in July (clearly signalling that this is the bottom, which we also believe). Last spring, Hungary launched measures to stimulate bank lending. Ukraine boosted capital spending appropriations in its budget. This summer, Russia introduced a capital spending programme, mainly for infrastructure, totalling 0.6 per cent of GDP (and partly using expected private capital). The country's central bank has initiated a version of quantitative easing and is expected to cut its key interest rate this autumn.

Eastern European currencies have recently stabilised a bit after large depreciations in May-June, when the region was hard hit by a sell-off of emerging market assets during the global interest rate upturn, which was largely connected to worries about the Fed. We predict **gradual appreciation over the next year or so**, starting this autumn, after Fed policies become clearer. A stabilisation in China may also have some positive implications for Eastern European financial markets.

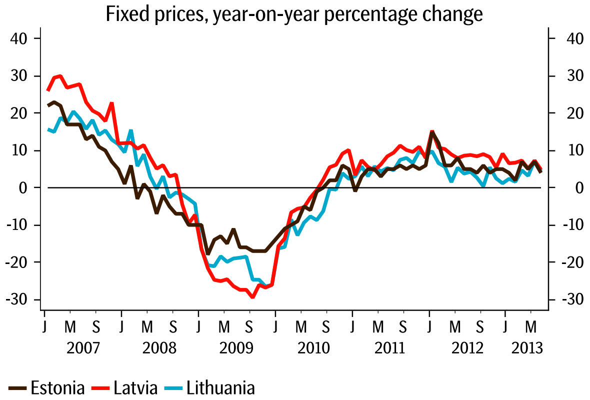
Rise in real income driving continued good GDP growth

- **Latvia and Lithuania to top EU again in 2013**
- **Decent exports, but Russian dip worrisome**
- **Little impact expected when Latvia adopts euro; Lithuania takes steps to do the same**

Since 2011, the Baltics have recorded the fastest growth of all EU countries. In the next couple of years, they will retain this top position – led by Latvia, once hardest-hit by the crisis. Estonia will report a temporary slump this year, however. After a slowdown in all three countries in 2013, **growth will rebound to 3.3-4.8 per cent in 2014 and 3.5-5.0 per cent in 2015**. This is somewhat above their potential growth of 3-4 per cent. One consistent theme in the region is that growth is **largely driven by stable, rising private consumption**. Retail sales expanded at a 5-6 per cent rate in all three countries in the second quarter.

Stable retail sales growth

Fixed prices, year-on-year percentage change



Source: National statistical offices

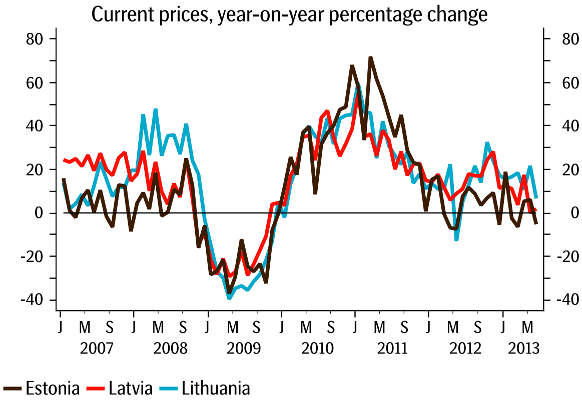
There are several factors behind the recovery in consumption over the past few years: pent-up household purchasing needs after the 2008-2009 depression, rebounding wage and salary growth (high in Estonia, moderate in Latvia-Lithuania), low inflation (in Latvia and Lithuania), an unexpectedly rapid drop in still-high unemployment (8-12 per cent in the second quarter) and relaxation of belt-tightening policies – earliest in Estonia, where budget discipline has been historically stronger than in Latvia and Lithuania. We expect **continued good real income increases**, although inflation will climb somewhat in Latvia and Lithuania and labour market improvements will generally be more sluggish than to date. This will lay the groundwork for a continued upswing in consumption.

Capital spending will be weak this year, decelerating after rapid growth in Estonia and Latvia during the past few years. Lithuanian fixed investments will increase slightly after last year's downturn. Construction and residential activity will gradually continue to increase. Efficient use of EU structural aid (compared to other EU countries in Eastern Europe) generally points to **decent capital spending growth in the next couple of years** as new funds become available from the new EU budget.

Exports are rising at a modest pace after slowing from double-digit growth in recent years and are still performing better than in many other countries. One major reason is that the Baltics **have strengthened and preserved their competitiveness after earlier internal devaluations**, when nominal pay was cut by 12 per cent in Estonia and Lithuania and 19 per cent in Latvia. Estonia has seen some deterioration in competitiveness so far this year due to higher cost increases and earlier weak productivity, but in the next couple of years we expect wage pressure to ease somewhat and productivity to improve. Looking ahead, Baltic exports will slowly strengthen due to gradually higher demand from Western Europe; for Estonia, Sweden and Finland are especially vital markets. But one **impediment compared to prior years is the slowdown in Russian economic growth**. Russia is Lithuania's biggest market by far (nearly 20 per cent of exports) and number three for Estonia and Lithuania (over 10 per cent of exports for both).

Decent exports, but shaky in Estonia this year

Current prices, year-on-year percentage change



Source: National statistical offices

We expect **relatively balanced economic performance in the Baltics during 2014-2015**. This implies that current account deficits will remain relatively small or modest. Public finances are also under control. Budget deficits remain relatively low, even in Lithuania, which started 2013 with a large negative figure due to unexpectedly weak consumption and the technical effects of a new VAT system. Thus there will be no repetition of earlier severe external or internal imbalances in the Baltics. Yet **sizeable imbalances, and related political challenges, remain in the labour markets**. All three countries are struggling with high youth unemployment, job matching problems and the impact of the latest large emigration wave connected to the financial crisis; an earlier wave occurred after EU membership in 2004. For example, many employers in Lithuania, with its 12 per cent jobless rate, cite labour shortages – especially in IT, manufacturing and construction.

Estonia: Temporary reversal

Estonia's growth decelerated unexpectedly hard in the first half of 2013; second quarter GDP rose by 1.3 per cent year-on-year. The capital spending slowdown after last year's excessive surge was more powerful than expected; for example, government investments financed by funds from emission rights fell sharply. Exports, which weigh heavily in the Estonian economy, were also not strong enough to offset stable imports. Meanwhile private consumption is maintaining momentum. In 2014, households will also benefit from real wage increases of some 3 per cent (nominally about 5.5 per cent) and a further decline in unemployment. Exports will strengthen somewhat and the base effect from the above-mentioned capital spending will disappear. Meanwhile the government investments remain weak in several years. We are **lowering our 2013 growth forecast substantially to 1.5 per cent and adjusting downward the growth prospects also for 2014 and 2015, to 3.3 per cent and 3.5 per cent, respectively**.

Latvia: Robust performance

The Latvian economy remains stable. Second quarter growth was 4.3 per cent year-on-year, while inflation was strongly depressed to somewhat below zero. Households will drive expansion via real wage hikes of 4 per cent this year (nominally 4.5), tax cuts, growing employment even in domestically oriented sectors and an increase in the minimum wage next year. Inflation will climb relatively fast in the wake of higher economic activity and, to some extent, also due to Latvia's imminent euro zone accession: from an average of 0.5 per cent this year to nearly 3 per cent in 2014. But this poses no threat to the positive consumption trend. **GDP growth will strengthen gradually, to 4.8 per cent in 2014 and 5.0 per cent in 2015.**

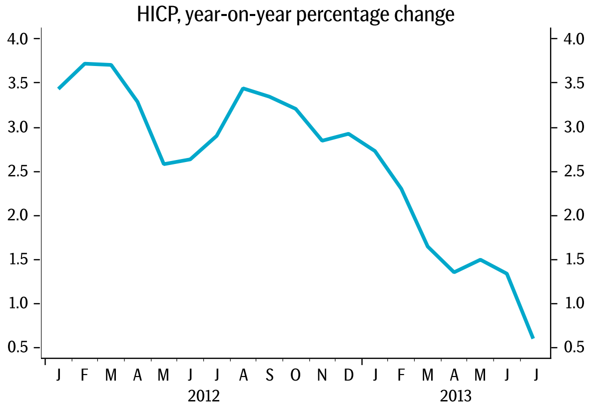
Euro zone accession in 2014 will give capital spending an extra push this year and next, when we also expect the government to abandon the austerity policy required to date in order to squeeze the budget deficit to a sustainably low level in line with the EU convergence criterion. We foresee only **small short-term economic effects from euro zone membership**: 1) As expected, the currency conversion rate will equal the previous peg of 0.702804; the real effective exchange rate has also been at a balanced level for years after the necessary wage and price cuts. 2) Exchange rate risk will disappear. But market confidence in the lats was restored long ago after the acute currency instability of 2008-2009. 3) Access to ECB aid and the euro zone crisis fund will strengthen the country's credit-worthiness; as early as this summer, S&P and Fitch both raised Latvia's credit rating to BBB+. 4) Inflation will get an upward push. A number of companies, for example in the restaurant trade, will take the opportunity to raise prices, while some households will hoard goods for fear of price hikes. Historical experiences from other countries' transitions into the euro zone indicate that this inflation effect is only 0.2-0.3 per cent.

Lithuania: Domestic demand bounces back

In Lithuania, exports have been the main economic engine during the past year. Only recently has consumption begun to surge. One important reason is that real wages have started to grow following the crisis; in this respect, Lithuania is lagging behind Estonia and Latvia. The housing and construction markets have also begun to awaken, though home prices remain sluggish, another difference to the other Baltics. Second quarter GDP growth of 3.7 per cent year-on-year was on a par with the first quarter, but its composition was more balanced. Exports have continued to increase strongly but received an extra push last spring from positive base effects after a closure at the country's export-heavy oil refinery one year earlier. We predict **relatively broad-based GDP growth of 3.5 per cent in 2014 and 4.5 per cent in 2015**.

Rapid downturn in Lithuanian inflation

HICP, year-on-year percentage change



Source: Statistics Lithuania

Since spring, inflation has been below expectations (0.6 per cent in July). We are lowering our full-year forecast from 2.5 to 2.0 per cent. In 2014 we expect an upturn to 2.8 per cent. It is notable that demand-driven price pressure is weak, commodity prices are calm and good harvests should push down food prices a bit this autumn/winter. Given the government's strong ambition to qualify Lithuania for the euro zone, the risks in our inflation forecast are on the downside, since administrative price cuts may occur. The government recently postponed fee hikes on tobacco and alcohol until March-April 2014 instead of January 1, probably a tactical manoeuvre to ensure the lowest possible inflation before next spring's EU evaluation in the run-up to euro zone accession. The Maastricht inflation criterion says that average inflation for March 2013-March 2014 may not be more than 1.5 percentage points above the three lowest-inflation EU countries.

Over the past six months, we have stated that Lithuania's euro ambition to join the euro zone by 2015 has a 50-50 chance of succeeding. Above all, it will be difficult to bring inflation down fast enough. Another challenge will be to get the budget deficit below 3 per cent of GDP this year, although we predict that the government will succeed. We are sticking to our forecast that **Lithuania has an even chance to qualify by 2015, but if inflation continues its downside surprises in the next few months, the country might well make it into the euro zone in 2015**.

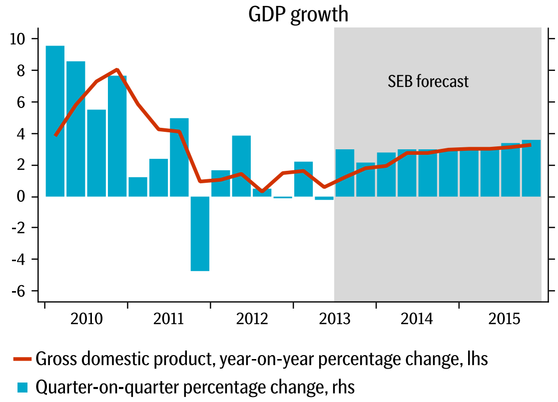
Consumption will boost economic growth

- **Strong households driving growth**
- **Manufacturing and capital spending weak in the short term**
- **Unemployment will not decrease until 2014**
- **Key rate will reach 1.75 per cent during 2015**
- **Alliance prepares for election year with even more expansionary fiscal policy**

In recent months, economic signals in Sweden have been mixed but have largely confirmed a picture of shaky first half 2013 performance. We have revised our full-year 2013 growth forecast downward from 1.3 to 1.2 per cent after the weak second quarter GDP figure, but the decline was probably a consequence of an exaggerated first quarter figure. Looking ahead, there are indications that an increasingly optimistic household sector combined with gradually improving international economic conditions will lead to a significant growth surge. **We have revised our GDP growth forecast for 2014 slightly upward to 2.6 per cent** (2.7 per cent working-day adjusted) and we expect a further acceleration to 3.2 per cent (3.0 per cent working day adjusted) once the world economy takes off in 2015. The Swedish economy will thus continue to grow faster than the OECD average.

Recovery on track

GDP growth



Source: Statistics Sweden, SEB

A continued expansionary fiscal policy will help sustain growth. We expect the government to propose reforms totalling SEK 35 billion (about 1 per cent of GDP). Compared to 2013 policies, these measures will focus to a greater extent on households, increasing their income by nearly SEK 20 billion (more than 1 per cent) during 2014: mostly through tax cuts. Because of this expansionary fiscal policy and good real wage increases, household consumption will grow by nearly 3 per cent in 2014. **Private consumption will thus be Sweden's most important growth engine**.

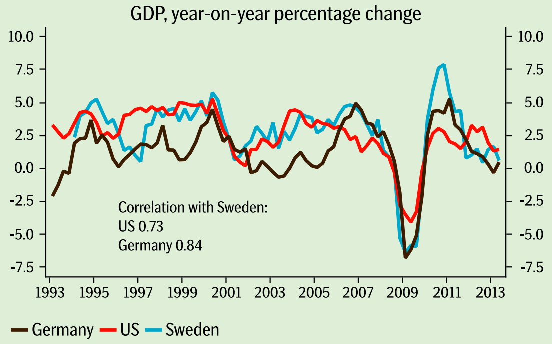
Due to the Riksbank's concerns about household debt, rising home prices and the improved growth outlook, we believe that it will abstain from further key interest rate cuts. However, low inflation and high unemployment make it likely that the bank will leave its repo rate unchanged at 1.0 per cent until the end of 2014. **The Riksbank will nevertheless be one of the first central banks to raise its key rate** and begin its rate hiking cycle before the US Federal Reserve. We foresee a repo rate of 1.75 per cent by the end of 2015.

Higher correlation with German growth, but trend will follow US

Due to a similar industrial structure and extensive trade, the Swedish economy is sensitive to Germany's economic outlook. Swedish GDP growth also has a somewhat stronger historical correlation with German GDP than with American. **Yet co-variation with the US is significantly larger than that country's relatively small share of Swedish exports (6 per cent) indicates.** This reflects the key role of the US in the world economy and financial markets, as well as the Swedish economy's sensitivity to global economic cycles. Another vital observation is that Swedish trend growth is much closer to that of the US than that of Germany; our forecasts for these countries are thus quite consistent with the historical pattern.

Swedish growth strongly correlated with US and Germany

GDP, year-on-year percentage change



Source: Macrobond

Sluggish start for manufacturing

Exports and industrial production fell sharply during the first half of 2013, but both the purchasing managers' index (PMI) and the National Institute of Economic Research (NIER) business sentiment index for the manufacturing sector trended upward. Today these indices are signalling a gradual recovery during the second half. Because of continued problems in the euro zone and a downward adjustment of forecasts for emerging market economies, the recovery appears likely to be weak compared to historical upturns. Yet it is **difficult to see any strong reasons why the Swedish manufacturing sector cannot keep pace with the US-led recovery over time**.

During the first half of 2013, capital spending was very weak, including sizeable declines in both manufacturing and residential construction. Statistics Sweden's capital spending survey indicates a continued decline in manufacturing during the remainder of the year. Because of low capacity utilisation, industrial capital spending is likely to bottom out in early 2014. However, there are signs of an upturn in housing starts, with residential investments rising significantly next year.

Exports and capital spending
Annual growth, per cent

	2012	2013	2014	2015
Total exports	**0.8**	**-0.4**	**4.3**	**6.2**
Merchandise	-0.7	-2.0	4.5	7.0
Services	4.2	3.0	4.0	4.5
Capital spending	**3.2**	**-3.0**	**3.0**	**5.5**
Manufacturing	7.5	-3.0	4.0	7.5
Housing	-8.2	0.0	10.0	10.0

Source: Statistics Sweden, SEB

Yet this upturn will not solve the structural housing shortage. **Because of population growth and a long period of low construction, there will be heavy demand for housing in the next couple of years**. The government has taken steps to ease rules on sub-letting and has now raised the issue of changing regulations that may delay construction and make it more expensive. This applies, for example, to the Planning and Building Act and various kinds of building codes. Because of political deadlocks, however, major changes are likely to be delayed at least until after the September 2014 election. This means that during our forecast period, the upturn in residential construction is likely to be modest (see "Theme: Housing" in *Nordic Outlook*, February 2013).

Inventory investments made a relatively sizeable contribution to growth during the first half of 2013. This is surprising, since companies usually reduce their inventories when the economy slows. The continued increase in inventories during this cyclical phase **indicates that stock-building will be less than normal during the coming upturn**.

Consumption ready to take off

In recent months, the favourable conditions enjoyed by the household sector have become even more apparent. Despite modest nominal wage and salary increases, low inflation is contributing to solid real income growth. Next year, the government's fiscal stimulus measures will focus on the household sector. We expect household resources to increase by more than SEK 20 billion during 2014, mainly in the form of tax cuts. In 2015, stimulus measures will be smaller but growing job creation will contribute to continued strong income.

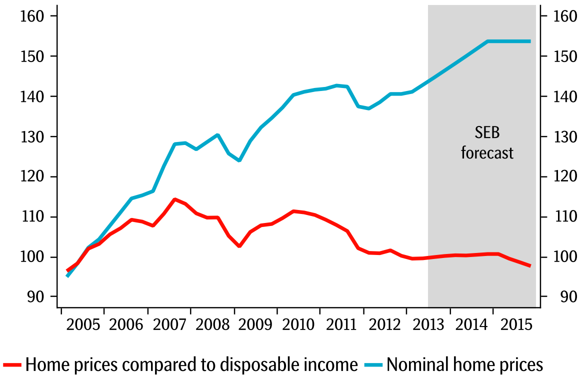
Although their income increased rapidly in 2012, households have been cautious about increasing their expenditures so far during 2013. This is in line with historical patterns when the economic outlook is uncertain and the labour market is weak. The economic stabilisation that is now discernible has already had an impact in the form of a **significant upturn in household confidence**, which is now above its historical average for the first time since mid-2011. This supports the view that consumption is about to accelerate. We have revised our forecast of private consumption growth in 2014 upward to 2.7 per cent. In 2015 there will be a further upturn as the labour market improves. During 2015, consumption will be driven by a downturn in saving, although real income will continue to increase at a relatively healthy pace.

Household income and consumption
Year-on-year percentage change

	2012	2013	2014	2015
Consumption	1.5	2.0	2.7	3.0
Income	2.5	2.9	2.8	1.7
Savings ratio, % of disp. income	11.4	11.7	12.2	10.8

Source: Statistics Sweden, SEB

Nominal home prices continue to climb
Index 100 = 2005



Source: Macrobond, SEB

Home prices will continue to rise

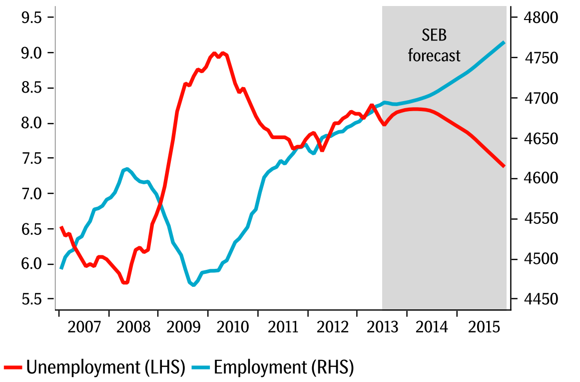
The housing market outlook has continued to strengthen gradually, driven by falling mortgage interest rates, higher income and rising share prices. Home prices have climbed by about 2 per cent so far this year, and we expect an increase totalling 5 per cent during 2013 and by the same percentage next year. A combination of a low supply of homes, an increasingly strong labour market and rising income will probably result in a continued upturn in prices. However, high debt will make households sensitive to changes in interest expenses, and we believe that **Riksbank rate hikes will be enough to cause home prices to level out in 2015**. Public discussions concerning macroprudential tools will also help hold back price increases. Our forecast implies that compared to household income, home prices will have remained at a relatively constant level over a 10-year period.

High unemployment despite job growth

Labour market signals have been somewhat stronger than expected in recent months. Unemployment has fallen somewhat, but the seasonal pattern during the summer can vary greatly from year to year. We believe that unemployment will climb a bit over the next few months and then stabilise. During the past year, the **unemployment upturn has been driven by rising labour market participation**, yet the number of jobs is continuing to increase at a slightly higher rate than GDP growth shows. Short-term indicators also foresee a continued gradual rise in employment during the second half.

Employment will continue to rise

Per cent

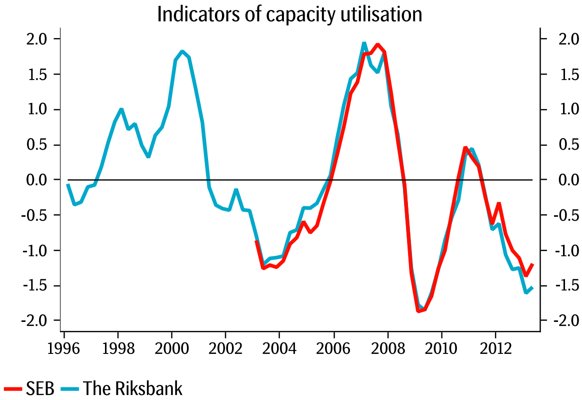


Source: NIER, Riksbank, Statistics Sweden, SEB

Unemployment will only begin to decrease in the spring of 2014, since the labour force will keep expanding at a rapid pace. **The higher jobless rate will mainly be due to increased labour market participation**, among other things because the number of people on sick leave or disability retirement will continue to fall in the next couple of years. A relatively rapid population increase, driven by net immigration, will also contribute to the increase in labour supply.

Economic slack pointing towards key rate cut

Indicators of capacity utilisation



Source: The Riksbank, SEB

The Riksbank has stated that much of the influx into the labour force consists of people with little formal education and immigrants who, for various reasons, have difficulty finding employment. This may be one reason why higher labour force participation has pushed up the non-accelerating inflation rate of employment (NAIRU) somewhat in recent years, but this change is rather marginal and does not alter the fact that **resource utilisation is currently very low and will remain lower than normal throughout our forecast period**.

Wage round almost completed

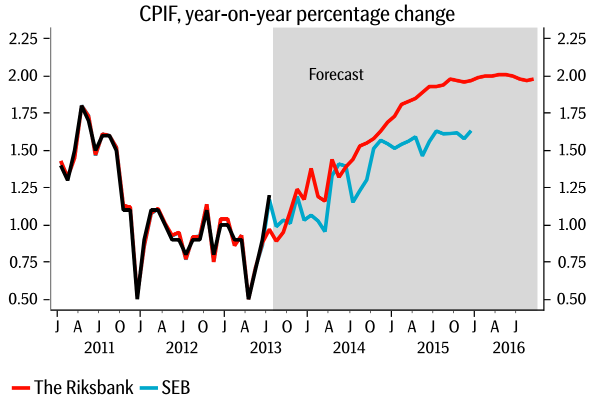
So far the year's wage round has proceeded according to our forecast, and there is no indication that the norms established by the industrial collective agreements will not serve as benchmarks for the rest of the labour market. The big remaining agreements are in the public sector: central government employees (September), certain teachers and health care employees (August and October). The agreements will 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 wage and salary increases in the next three years of somewhat below 3 per cent.

Below-target inflation in 2015 as well

Inflation pressure is very low. Underlying CPIF (CPI inflation excluding interest rates) has continued to fluctuate at just below one per cent. Low inflation is being driven by low pay increases, weak international price pressure and the krona appreciation of recent years. These factors will also **help keep inflation low during the next couple of year**s, although the effects of krona appreciation will fade somewhat (see the theme article *"Inflation trends and target fulfilment"*).

Divergent views of underlying inflation pressure

CPIF, year-on-year percentage change



Source: The Riksbank, Statistics Sweden, SEB

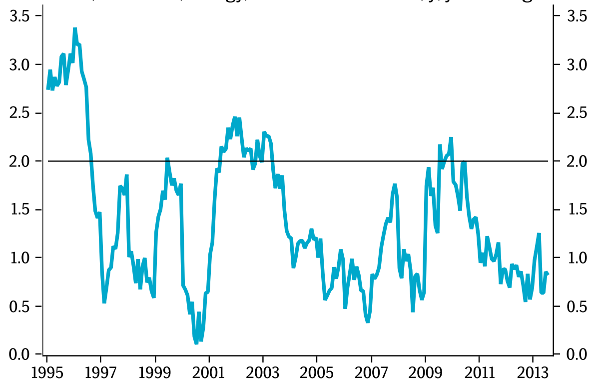
Another reason for lower inflation pressure is that international prices for energy and other commodities, which have risen in recent years, have now weakened. The main drivers are new oil and gas extraction techniques and generally lower GDP increases in the emerging economies. Falling food commodity prices in recent weeks are a downside risk and will lead to a downward revision of our inflation forecast if they persist.

The upside inflation risk consists of **rising unit labour cost due to low productivity growth in recent years**. However, this trend is not unique to Sweden and has not driven inflation in other countries. The downturn in productivity is also caused by weak economic growth, and we foresee good potential for a recovery as GDP accelerates.

CPI inflation has mainly been below zero during the past six months due to falling interest rate expenses. The effects of the Riksbank's interest rate cuts are now fading, and CPI will gradually move closer to CPIF. When the repo rate is hiked in 2015, CPI inflation will rise even faster, reaching 2.3 per cent at the end of 2015.

Core inflation almost always below 2 per cent

CPIF, excl. food, energy, alcohol and tobacco, y/y % change



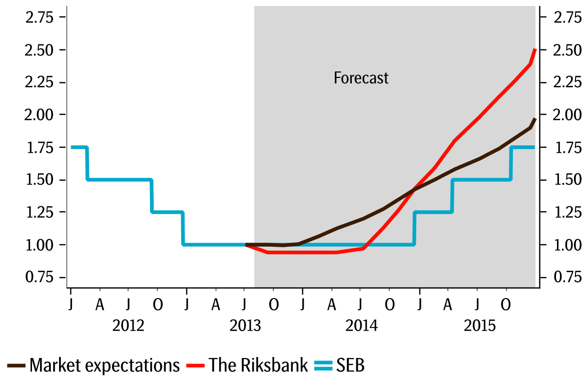
Source: Statistics Sweden

No more repo rate cuts, but first rate hike will not occur for some time

The Riksbank left the repo rate path unchanged at its monetary policy meeting in July. The bank continued to signal an approximately 25 per cent probability of another interest rate cut and indicated that the first rate hike will occur in mid-2014. The Riksbank is unlikely to adjust its forecasts of growth, the labour market and inflation significantly in the near future. Combined with diminished downside risks in the international economy, this indicates that further rate cuts are not in the cards. Due to low resource utilisation and inflation plus the continued expansionary policies of leading central banks, however, **we expect the first rate hike to be postponed until the end of 2014**. There will then be two additional rate hikes in 2015, bringing the repo rate to 1.75 per at the end of the year. The Riksbank will thus be one of the first central banks to begin normalising its interest rate.

Repo rate expectations

Per cent



Source: The Riksbank, Bloomberg, SEB

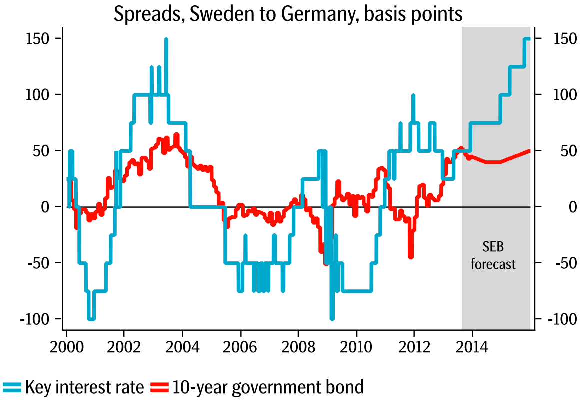
A combination of low inflation and low resource utilisation, on the one hand, and rising home price and increased lending to households on the other will continue to pose a dilemma for the Riksbank. New macroprudential measures, for example further pressure on banks to tighten mortgage repayment requirements or new increases in risk weighting of mortgage loans, will ease some of the pressure on interest rate policy.

Bond yields will rise from low levels

Swedish bond yields have moved upward as international yields have increased. Swedish 10-year sovereign bond yields have climbed somewhat more than their German counterparts, but less than their American ones. The spread against Germany is close to the highest levels recorded for the past 15 years. Behind this are toned-down expectations of Riksbank rate cuts as well as less demand for safe AAA bonds from international investors, but our models are signalling that **the yield upturn has been too fast. We expect the yield spread to narrow during the second half of 2013**. As the time for the Riksbank to hike its key interest rate approaches, however, the margin is likely to widen again. The spread between Riksbank and ECB key interest rates is expected to be record-wide at the end of 2015, justifying a 10-year yield spread of 50 basis points. At the end of 2014, the Swedish 10-year sovereign yield will stand at 2.70 per cent and at the end of 2015 it will be 3.20 per cent.

The yield spread to Germany will narrow

Spreads, Sweden to Germany, basis points



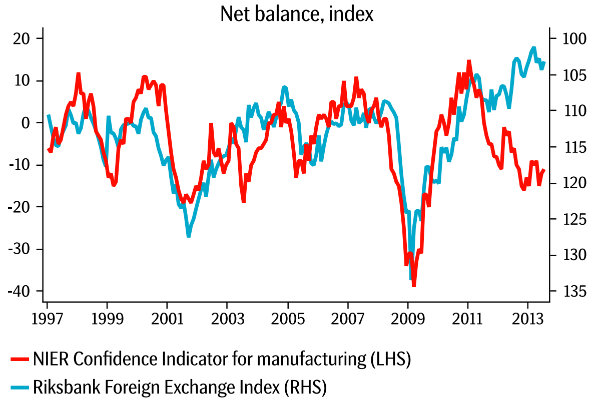
Source: Macrobond, SEB

Economic cycle and Riksbank boost krona

Although the krona has weakened by about 3 per cent during the spring and summer, the trade-weighted KIX exchange rate index is close to the strongest levels recorded since Sweden adopted floating exchange rates in the early 1990s. In real terms, however, the appreciation is significantly smaller and we believe that **the krona is still somewhat undervalued**, as evidenced by a continued very large current account surplus.

Krona usually appreciates during economic upturns

Net balance, index



Source: NIER, The Riksbank

Historically, the krona has appreciated at the beginning of economic upturns. Our forecast that the Riksbank will hike its key interest rate before the Fed and ECB indicates that the cyclical appreciation of the krona may be stronger than usual this time, but that it will not occur until 2014 when we get closer to policy rate hikes. On the other hand, the krona generally starts its cyclical recovery from significantly weaker levels. Overall, we still expect a historically strong currency; the EUR/SEK exchange rate will stand at 8.40 at the end of 2014 and at 8.20 at the end of 2015. There will be a marginal weakening against the dollar, and the USD/SEK rate will stand at 6.61 in December 2014. The KIX index will fall to a level of 99.5, meaning that in trade-weighted terms the krona will reach its strongest level since 1992.

Burst of fiscal stimulus before 2014 election

Public finances will worsen in 2013. Both economic conditions and expansionary fiscal policy will contribute to this trend. Yet the **deficit** will end up at **2.1 per cent of GDP in 2013**, which is modest in an international perspective. The economic improvement in 2014 and 2015 will have a positive impact on the budget balance. Meanwhile expansionary fiscal policy will continue, keeping the deficit at about 2 per cent of GDP during 2014 and 2015. **The 2013 borrowing requirement of SEK 165 billion** is mainly due to National Debt Office (NDO) intermediation of a loan to the Riksbank in order to strengthen its currency reserve. The underlying deficit is actually about SEK 100 billion better. In 2014 and 2015, the borrowing requirement will be SEK 63 and 50 billion respectively.

Central government debt will increase from 32.4 per cent of GDP in 2012 to 36 per cent of GDP in 2013 and will then largely level out. The increase between 2012 and 2013 is largely due to the NDO's borrowing on behalf of the Riksbank. Partly offsetting this is our assumption that the government will sell SEK 20 billion worth of state-owned assets this year and 10 billion the next. When economic conditions improve (or deteriorate), cyclical effects on the public sector balance are often underestimated. This means that there is a high probability of a faster improvement in the budget balance than we have forecasted.

Public finances

Per cent of GDP

	2012	2013	2014	2015
Net lending	-0.9	-2.1	-2.2	-1,8
Gen. gov't gross debt	37.6	41.0	41.1	40,5
Central gov't debt	32.4	36.0	36.3	35,7
Borrowing req., SEK bn	25	160	63	50

Source: Statistics Sweden, SEB

Fiscal policy makers are taking further steps in an expansionary direction. One year ago, Finance Minister Anders Borg and the non-socialist Alliance government left behind their previous cautious attitude towards deficit spending. There were several reasons for this. Unemployment is high and there is plenty of slack in the economy. In addition, interest rates on sovereign borrowing are low and there is international pressure for countries with current account surpluses to stimulate demand. The approaching September 2014 election also makes it natural to add further stimulus measures. **We expect that fiscal stimulus measures, totalling SEK 25 billion (0.7 per cent of GDP) this year, will expand further to SEK 35 billion (0.9 per cent of GDP) in 2014**. In terms of stimulus, 2015 will be a calmer year. When they begin a new term of office, governments make their tough decisions, and a larger proportion of reforms will be financed through cost-cutting. Stimulus measures will total SEK 10-15 billion that year.

But despite the many good reasons for expansionary measures, these policies threaten Sweden's existing target: a public surplus of 1 per cent of GDP over an economic cycle, thereby opening up the government to criticism. In our assessment, however, this will be of minor importance to the government in the next couple of years. If it wishes to stick to the official budget surplus target, there will be room for a tighter fiscal policy a bit further in the future. Sweden's low central government debt also raises the question of what is a reasonable level for the surplus target and government debt. After the election, the government in power will certainly have to present its views on these issues in order to preserve the credibility of the surplus target.

The budget bill for the election year 2014 (which the government will submit to Parliament on September 18) will give the four parties in the governing coalition an important opportunity to make their respective strategies clear to their voters. The Centre Party and Christian Democrats are under especially heavy pressure, since in opinion polls they are close to the 4 per cent voter threshold needed to win any seats in Parliament. Our assessment is that the reforms will be apportioned in such a way that all the governing parties can win support based on their respective core issues. The reform list will be more demand-oriented as the election approaches, covering many of the pocketbook issues dear to voters. We believe that the government's reform measures will include **an additional step in the earned income tax credit reform, a higher threshold for paying central government income tax, lower taxes for pensioners and a narrowing of differences in unemployment insurance fees, as well as investments in infrastructure, research and education**. In order to soften criticism from companies about the strong krona and to improve Sweden's competitiveness, corporate taxes and employer-paid social insurance fees may be lowered.

The leftist opposition (Social Democrats, Left Party and Greens) currently enjoys larger support in public opinion surveys than the ruling Alliance, which is putting pressure on the government. Meanwhile the election is still far away, and it is doubtful whether it will be possible to form a majority government unless at least one party crosses the dividing line between the leftist and non-socialist blocks. We believe that the dose of stimulus measures will be about the same regardless of what constellation of parties forms a government, although a Social Democratic-led government may pursue somewhat more demand-oriented policies than a continued Alliance government.

Theme: Inflation trends and target fulfilment

- **Unusual for core inflation to top 2 per cent**
- **International price trends and a strong krona will keep imported inflation down**
- **Difficult to achieve the inflation target without new price shocks**

The Riksbank's potential for achieving its 2 per cent inflation target can be analysed in various ways. This article provides a review of **historical trends** for price trends in various product categories. It also discusses the main drivers behind inflation and how these may operate over the next couple of years.

CPI has averaged 0.7 percentage points below the Riksbank target during the past 20 years. **The corresponding CPIF figure (CPI excluding interest expenses) is 0.4 points**. Inflation has been pushed up by energy prices, which have added more than 0.3 points annually. Core CPIF (excluding energy, food, alcohol and tobacco) has increased by a yearly average of 1.4 per cent since 1995, but only 1.1 per cent since 2004. Only during a few short periods has core inflation exceeded two per cent (during 1995, 2001-2 and 2009-10). The main drivers during these periods have been a temporarily weak krona exchange rate and higher international inflation.

Average inflation, by product categories

	2004-2013	1995-2013	Weight
CPI	1.3	1.3	100
CPIF	1.5	1.6	100
Energy	3.9	4.2	8.7
CPIF ex energy	1.3	1.4	91.3
Food	1.8	1.1	13.5
Alcohol & tobacco	3.0	2.8	3.9
Core CPIF	1.1	1.4	73.9
Imported goods & services	-0.8	-0.3	25.3
Home prices	5.3	4.0	6.2
Domestic goods & services	1.8	2.1	42.4

In general, inflation has been particularly low for goods, whereas service prices have risen by more than two per cent annually. Goods prices have been squeezed by growing internationalisation and productivity. The gap between inflation trends for goods and services is similar in most developed countries. In a small economy like Sweden, the exchange rate is important. But today the krona exchange rate today is not so far from its 1994 and 1995 levels. Although there have been large fluctuations, the exchange rate has thus not been an important driver of average inflation since 1995.

The outlook for the next couple of years can be analysed on the basis of international price trends and domestic cost pressure. We see no strong reasons why downward international price pressure should ease significantly. Looking ahead, we also expect the krona to appreciate. Overall, this indicates that prices of imported goods will continue to fall, at least in line with the historical average.

Services have a significantly lower productivity growth trend, which explains the higher price increases. The outlook over the next couple of years is a little more uncertain than for goods. The three-year collective pay agreements concluded this year point to annual wage and salary increases slightly below 3 per cent per year, which is about 0.5 percentage points below the average since 1995. Productivity growth has been weak in recent years, but the main reasons behind this are probably cyclical. We thus believe that productivity growth will accelerate as demand rises. Our productivity forecast is still rather cautious, which is one contributing reason why domestic inflation will climb towards the historical average.

Some CPI components require specific analysis. For example, rising home prices have lifted CPI by an average of 0.3 points since 1995. The impact of home prices on CPI occurs very slowly. Average change over a 20-year period is an often used as an approximation. This means that home prices will continue to lift CPI over the next couple of years, even though they have been at an unchanged level since 2008, but that in the longer term, their contribution is likely to decrease.

Price increases for energy and to some extent food have largely been driven by movements in international commodity markets. Due to economic expansion in emerging economies, the long-term price trend will probably be upward, but the next couple of years will instead be characterised by downward price pressures. This is due to such factors as rapid technological developments for oil and gas extraction (see box, page 20), which is reflected in a downward trend for forward oil prices. As for food, a downward adjustment in prices is under way from levels that were driven higher by earlier crop failures and poor harvests. This indicates that prices in these product categories will increase more slowly than their historical trend in the next two years.

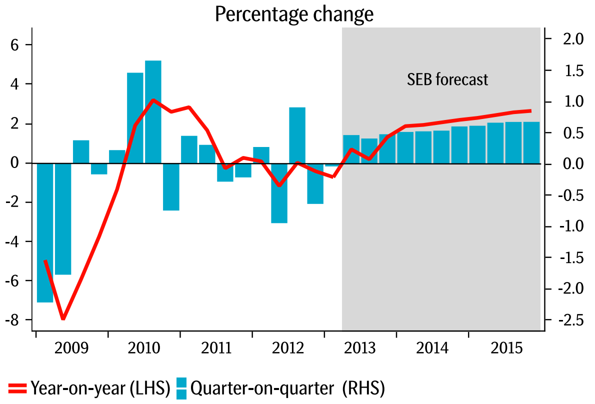
One criticism of the above analysis is that future price shocks may affect new areas in the Swedish CPI basket. Such shocks have historically tended to raise inflation rather than lower it. However, we have taken such risks partly into account, since our inflation forecast is somewhat above what can be justified by underlying drivers such as inflation expectations, wages and salaries, exchange rates and international price and productivity trends. Overall, we thus **reach the conclusion that it will be very difficult to achieve 2 per cent inflation in a medium-term perspective**.

Tentative signs of recovery

- **Growth still elusive at start of 2013**
- **Short-term dip in manufacturing**
- **Consumer confidence jumps**
- **Current account past seasonal drop**

Danish growth continued to be elusive at the start of 2013, with first quarter GDP falling marginally. However, we expect growth to revert to recovery speed for the rest of 2013. The first quarter saw an outsized drop in public spending that we expect will reverse. Also, the firmer global recovery should spill over positively into the Danish economy. The recent surge in consumer confidence to a five-year high, rising real wages and a stabilising housing market suggest that consumers could potentially be emerging from their multi-year hibernation. **We expect growth of 0.4 per cent this year, increasing to 2.0 per cent in 2014 and 2.5 per cent in 2015**. This is a small upward revision of 2013 and 2014 compared to the last *Nordic Outlook*.

Recovery in GDP
Percentage change



Source: Macrobond, SEB

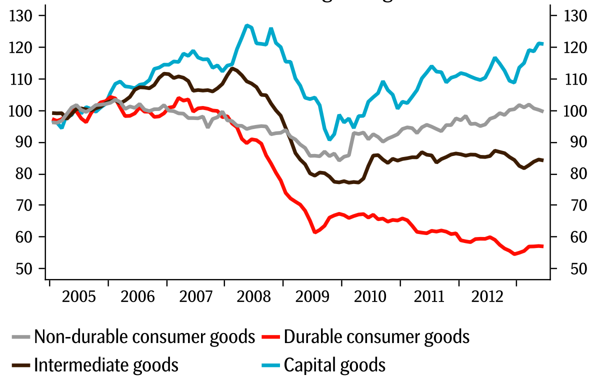
Manufacturing stalled in the second quarter

After a strong start to the year, manufacturing waned a bit in the second quarter, which is consistent with the global dip in leading industrial indicators. The recent pick-up in global PMIs suggests that the manufacturing cycle should turn higher in the third quarter. The Danish PMI also signals recovery, but the more reliable industrial confidence indicator is providing a more downbeat message for the time being.

Looking at the slightly longer trend, measures of production-based activity point to an acceleration in 2013 compared to 2012. In particular, the marked increase in capital goods suggests that business investments are picking up. The higher activity we expect going forward should also reverse the downward trend in capacity utilisation, which in turn might sustain an upturn in corporate capital spending.

There has also been a stabilisation in the production of durable consumer goods, particularly furniture. If sustained, this would end the continuous downward trend since 2007.

Industrial production soft in second quarter
3-month moving average

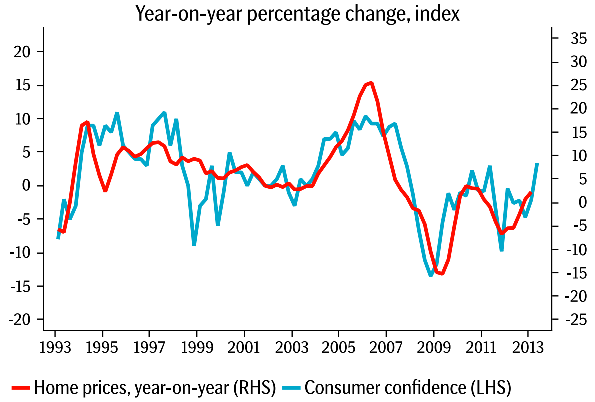


Source: Statistics Denmark

Consumer confidence jumps

A noticeable development since *Nordic Outlook* in May has been a jump in consumer confidence to the highest level in five years. This suggests that consumption could finally be reviving.

Consumer confidence up with house prices
Year-on-year percentage change, index

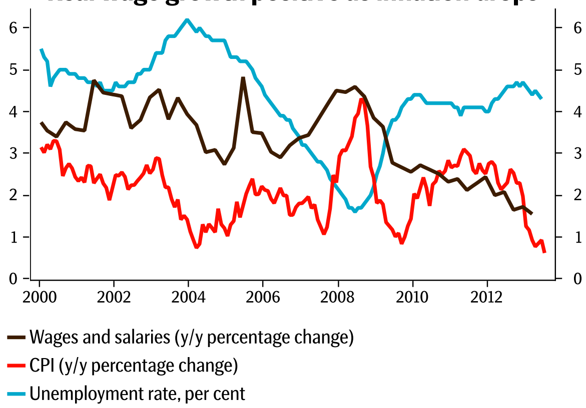


Source: Statistics Denmark

The move could be related to a stabilisation in residential prices, which typically correlate closely with consumer sentiment. The stabilisation in real estate prices is not uniform; there are large regional divergences, with Copenhagen in particular seeing a frothy trend.

Another positive factor has been the drop in inflation, which has resulted in **positive real wage growth** after several years of falling consumer purchasing power. The year-on-year inflation rate dropped further to 0.6 per cent in July, the lowest rate since records began in 1967. The downturn was driven by food, leisure activities and transport. We expect **inflation** to stay low: **0.7 per cent this year, rising to 0.9 per cent and 1.4 per cent in 2014 and 2015**, respectively. Since we project wage growth above these levels, the period of falling real wages should be over.

Real wage growth positive as inflation drops



Source: Statistics Denmark

The unemployment rate is also lower, although this is largely related to the labour force shrinking as people lose their jobless benefit entitlements. With the expected growth trajectory, employment should pick up, underpinning a more pronounced consumption revival. That said, deleveraging will continue to act as a drag on consumer spending.

Public spending plunged 2.9 per cent in the first quarter, bringing it back to the level of a year earlier. The main culprit was a marked drop in central government purchases. This development is puzzling in light of the government's budgets and we expect a large share of the drop to be reversed quickly, contributing to growth snapping back in 2013.

We expect a **public deficit of 1 per cent of GDP in 2013**. As the government plans to reduce its cash position at the central bank, the stock of **government debt is expected to drop**. In 2015 we expect a public surplus. Combined with higher GDP growth, **this should cause the public debt/GDP ratio to fall below 40 per cent**.

Current account is past seasonal dip

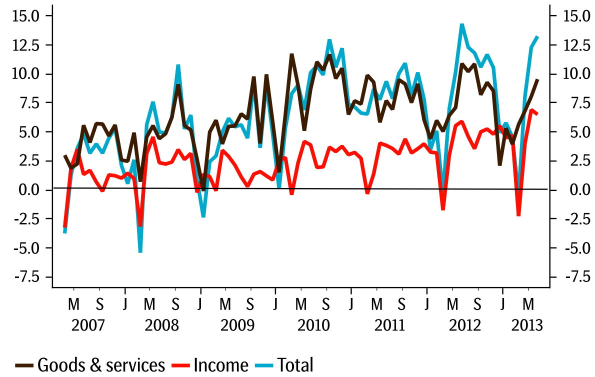
As always, the Danish business cycle is closely linked to international developments. The expected recovery thus presupposes that global growth will accelerate through 2015.

The trade balance improved in the second quarter, partially due to lower imports after larger gains early in the year than domestic economic activity justifies. But merchandise and service exports also rose, supporting the notion of a global recovery. Additionally, with the seasonal drop in income-related transfers behind us, the current account has reverted to a double-digit surplus (measured as DKK billion per month).

Due to a chronic current account surplus, at the end of the first quarter Denmark's net financial assets vs. the world totalled 657 billion kroner or 37 per cent of GDP. This accumulation of foreign wealth, which yields return to Danish savers, means gross national income rose 0.2 per cent in 2012 even though gross domestic product fell by 0.4 per cent.

Current account rebounds

Billions DKK

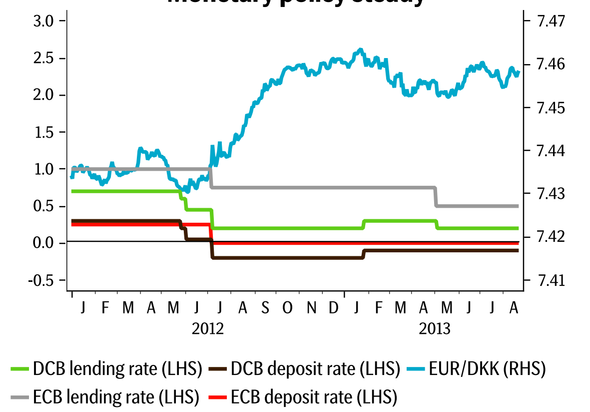


Source: Statistics Denmark

Monetary policy has been steady

Danish government bond yields have risen along with German yields. The 10-year spread has widened slightly, currently standing at around 5 basis points.

Monetary policy steady



Source: Macrobond

The Danish krone has traded marginally on the strong side of its central parity against the euro since the central bank unilaterally increased interest rates in January. After following the ECB lending rate cut in May, monetary policy has been steady. **If the ECB cuts its lending rate to 25 basis points in December, we expect the Danish central bank to cut its lending rate from 20 to 10 basis points.**

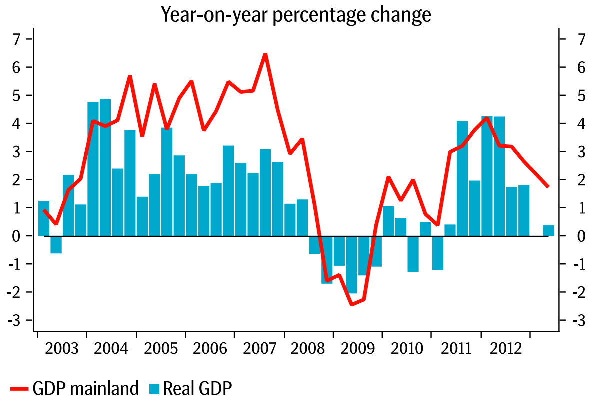
Solid growth to resume in 2014

- **Growth has slowed to well below trend**
- **Momentum to pick up in 2014**
- **Norges Bank still on hold for now**

There is no mistaking the weaker momentum over the past year. Growth in Norway's mainland GDP – excluding oil/gas and shipping – was thus a lacklustre 0.2 per cent from the first to the second quarter and 1.7 per cent year-on-year. However, spurred by strong investment in the petroleum sector and rebounding exports of oil and gas, sequential growth in overall GDP picked up to 0.8 per cent for the quarter, though the level was only 0.4 per cent higher than a year earlier.

Growth has slowed to well below trend

Year-on-year percentage change



Source: Statistics Norway

Growth is well below trend, but the spring slowdown should prove transitory. Looking at the supply side, mainland GDP would have been up 2.3 per cent year-on-year in the second quarter excluding a weather-related drop in electricity output. Meanwhile, apart from near-stalling private consumption, other demand components were healthy: sequential growth in non-oil final domestic demand (excluding inventories) picked up on a turn in investment, and exports of non-petroleum goods continued rising. In the end, what dented growth in the second quarter was the very volatile and unreliable inventory and statistical discrepancy component which subtracted a full 1.1 percentage points from the quarterly change in overall GDP.

Private consumption should recover after summer. In a slightly longer perspective, a gradual recovery in Norway's main export markets in Europe will stimulate non-petroleum exports, while non-oil business investment should be stronger next year. At the same time, however, capital spending growth in the petroleum sector should slow quite a bit in 2014.

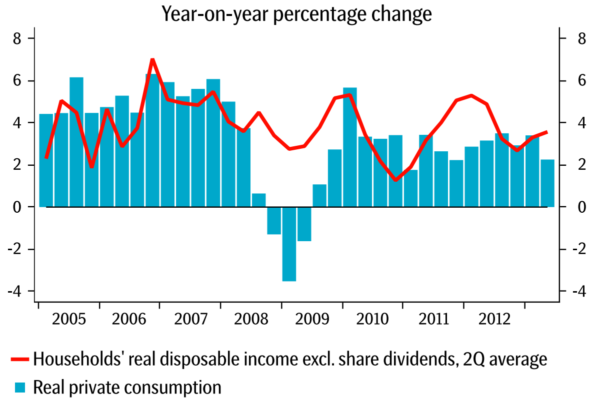
Due to softness in the spring, we **have lowered our forecast for this year's growth in overall and mainland GDP quite noticeably to 1.1 per cent and 2.1 per cent** respectively, but growth **should pick up to 2.7 per cent in 2014** on both measures.

Consumers took a breather last spring

The quarterly changes in household domestic spending on goods and, to a lesser extent, overall private consumption have been a bit choppy over the past year. Following a spurt in early 2013, sequential growth was only 0.2 per cent in the second quarter and the year-on-year rate slowed to 2.2 per cent. The better part of the slowing was due to softer domestic spending on goods, which declined slightly in the second quarter.

Income is running ahead of spending

Year-on-year percentage change



Source: Statistics Norway

At least part of the moderation up until mid-year should prove transitory as growth in real disposable income has continued to run at a healthy clip. We have nonetheless revised the full-year forecast downward to **3.0 per cent in 2013**, while consumption should be up **3.2 per cent in 2014**.

Employment growth has admittedly stalled according to the Labour Force Survey, which in April-June was almost unchanged from the second quarter of 2012. (At that time, year-on-year growth was a sturdy 2.6 per cent.) The broader national accounts data paint a better picture, including employees not registered as residents of Norway, paints a better picture, showing employment up 1.1 per cent in the year to the second quarter.

The LFS unemployment rate rose sharply from a low of 3.0 per cent in spring 2012 to 3.7 per cent on average in the three months to April. However, it eased to 3.4 per cent for the entire second quarter, in part reflecting a slightly lower participation rate. We expect unemployment to be relatively unchanged going forward.

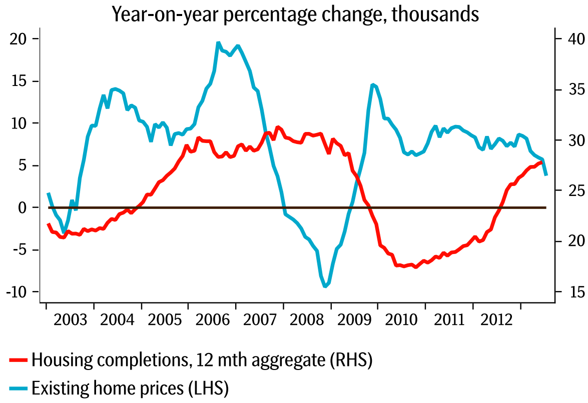
Housing market starts to cool

The housing market has seen a distinct slowing so far in 2013. We have previously assumed that existing home prices would experience a 10-15 per cent correction within two to three years, somewhat more than the peak-to-trough decline from late 2007 to end-2008. This expectation was premised on a shift in the persistent demand-supply imbalance of recent years, with housing completion trailing household formation.

The correction has seemingly arrived early. Existing home prices in seasonally adjusted terms declined in four of the six months to July, but we are hesitant to call this a definite downturn just yet. Home completions have started to catch up and homes under construction are at record-high levels. In addition, tighter loan-to-value requirements may have lowered demand. However, the year-to-date number of homes for sale was a bit lower as of July than in 2012, while existing home sales slipped only one percent year-on-year in the second quarter, suggesting that the market is holding up. Moreover, other fundamentals have yet to decline as they did up until late 2007, when sharply higher interest rates made quite an impact.

Home prices have slowed as supply has picked up

Year-on-year percentage change, thousands



Source: Nef, Statistics Norway

We still expect a marked correction. However, home prices are likely to remain flat in the near term. This implies that the year-on-year change will continue to slow over the remainder of 2013 relative to the 3.9 per cent rate in July (which was the slowest rate since late summer 2009).

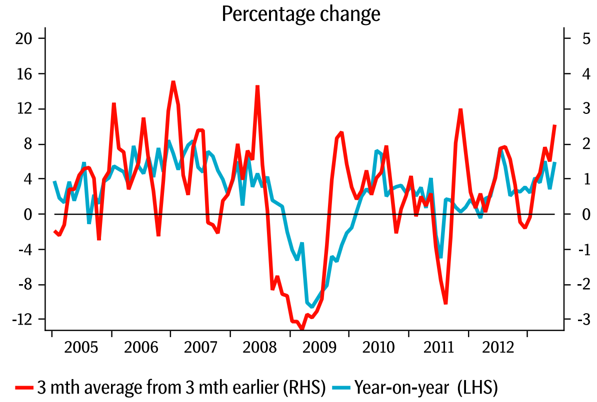
Manufacturing production remains healthy

Production in the manufacturing sector – i.e. excluding energy and mining – increased a solid 2.5 per cent from the first to the second quarter, the strongest quarterly upturn in five years, and was up five per cent year-on-year. Meanwhile, oil and gas extraction rebounded 7.5 per cent in the second quarter after technical problems slowed production in the previous one and as a number of new fields came on stream. However, output was still well below the year-earlier level.

Manufacturing production seems to have been running somewhat ahead of demand, which suggests moderation in the near term. Output of investment goods has surged 27 per cent over the past two years, fuelled by very strong capital spending growth in the petroleum sector (which should moderate to a less hectic pace). Production of intermediate goods has been surprisingly resilient, considering that it includes export-related business, while weak foreign demand is partly to blame for slower production of consumer goods.

Manufacturing production has firmed

Percentage change



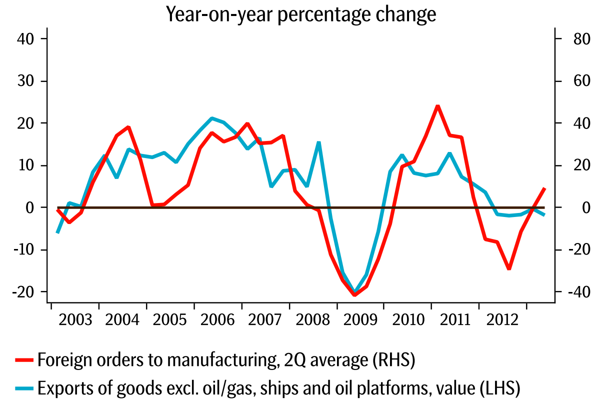
Source: Statistics Norway

Exports should start to recover

Improving conditions in Norway's main export markets in Europe should stimulate manufacturing production in the medium term. Manufacturers reported declining foreign orders in the most recent Business Tendency Survey but expected an improvement in the current quarter. Moreover, actual order inflow from foreign markets rebounded in the second quarter (note, though, that such orders are measured in value and affected by changes in prices and the exchange rate).

Stronger orders suggest recovering exports

Year-on-year percentage change



Source: Statistics Norway

Exports of traditional goods – excluding oil/gas, ships and oil platforms – show signs of rebounding. In nominal terms, such exports were up on average in May-July from the previous three-month period and saw the first annual increase in a year except for a marginal and brief up-tick last autumn.

It is widely perceived that weakness in Norwegian exports and related manufacturing has reflected the sluggish state of Continental Europe. While shipments to the hardest hit PIGS countries have indeed plunged, **it is worth noting that declining exports to Sweden** (with a 10 per cent export share in 2012) **are as much to blame**. In fact, exports of traditional goods to Sweden were 11 per cent lower in January-July than a year earlier while the aggregate for the past 12 months was 20 per cent below the level in 2008. In contrast, exports to other

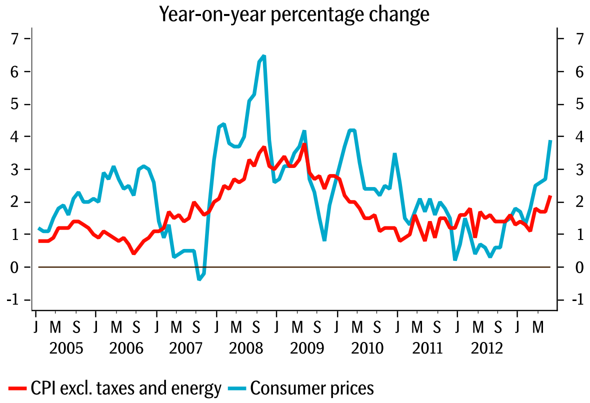
EU countries (half the total) are a more modest five per cent lower than in 2008 but have increased year-to-date. In addition, exports to the US have dropped even more so far in 2013, offset by a strong increase in exports to Asia.

Finally, an upside inflation surprise

Inflation has been surprisingly soft during most of the expansion. However, the short-term trend in core CPI, excluding taxes and energy, started to pick up in spring and posted a massive upside surprise in July as the year-on-year rate lifted to 1.8 per cent. While not "high" in an absolute sense, the rate is nonetheless the highest since early 2010 and up from 1.2 per cent on average in 2012. Meanwhile, overall CPI inflation jumped from 2.1 per cent in June to 3.0 per cent in July, with an added boost from electricity prices.

Inflation stepped up markedly in summer

Year-on-year percentage change



Source: Statistics Norway

Part of the most recent step-up in core inflation should prove temporary. Nevertheless, **domestic inflation has shifted upward**. At the same time, previous appreciation of the NOK may suggest that import prices will turn south again after recording their first positive annual rate in July since October 2011. In all, **we are raising our forecast for core CPI inflation slightly to 1.5 per cent for 2013 but are keeping it at 1.9 per cent for 2014**.

Norges Bank still on hold

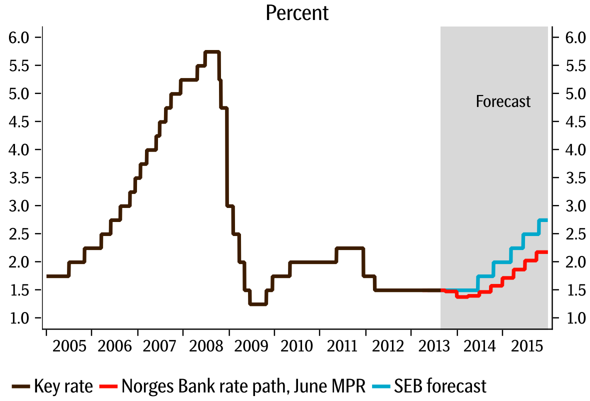
Norges Bank was surprisingly dovish in the June *Monetary Policy Report*, stating a 50/50 chance of a 25 basis point cut of the key 1.50 per cent deposit rate at the upcoming September meeting. At that time, the domestic economy seemed at a crossroads and the bank revised its growth and inflation outlook lower. So far, economic data cautiously support our view that the slowdown seen during the spring will prove transitory. The risk of financial imbalances is keeping Norges Bank from cutting its key interest rate but is hardly a reason for hiking the rate anytime soon. Macroprudential measures are in place and banks have started to adapt to higher capital requirements by raising mortgage interest rates.

At the same time, Norges Bank's long-held view that too low and lower-than-expected inflation is an argument for lower rates no longer holds. Absent a downside CPI surprise in August as large as the upward one in July, the central bank's forthcoming inflation forecast will not foresee any downward revision as has been the common feature of the previous reports. In addition, while the NOK appreciated following the most recent inflation numbers, it remains weaker than Norges Bank has assumed. Consequently, **we expect the bank to keep its deposit rate on hold at 1.50 per cent in September but to maintain a dovish bias**.

Admittedly, the timing of when Norges Bank will start to hike its key interest rate remains uncertain. However, the bank has changed stance swiftly back and forth over the past year and a half and we thus regard it too early to dismiss a hike next summer. Such a move is not likely to be acknowledged until the December *MPR* at the earliest. A confirmation of an upward shift in domestic inflation, proof of an ongoing recovery in the euro zone and a floor in key rates abroad will be necessary before Norges Bank changes its stance. Our long-term forecast remains largely in line with Norges Bank's own rate path. **We expect a total of 50 basis points in rate hikes in 2014 followed by another 75 bps in 2015, leaving the key rate at 2.75 per cent by end-2015**.

Norges Bank key rate and expectations

Percent



Source: Norges Bank, SEB

Spread to tighten

Activity in the Norwegian bond market has been very lacklustre throughout the summer months, which has weighed on the relative performance of Norwegian government bonds. The 10-year spread vs. Germany is close to an all-time high, but there are few explanatory factors besides liquidity and supply.

We expect Norges Bank's dovish bias, the high yields compared to other triple-A rated government bonds and strong credit quality to trigger renewed buying. With supply having been tripled over the past two years, we expect annual supply in 2014 to remain close to the current NOK 70 billion. **The 10-year spread vs. Germany should tighten to 85 bps by the end of 2014.**

The **Norwegian currency** has weakened as a result of a still-dovish monetary policy and foreign selling of oil-related stocks. In the near term, Norges Bank will try to verbally hold the NOK in check, but the **outlook is brighter in the medium term**. As activity in the domestic economy picks up and risk appetite improves following a stronger global recovery, the NOK should thus correct its current undervaluation against most G10 currencies. Eventually, a shift in monetary policy will favour the krone. We expect the **EUR/NOK exchange rate to reach 8.00 by year-end 2013 before moving further downward to 7.70 by the end of 2014**.

Politics moving to the right

- **A change of government is all but certain, but no lasting impact on markets**
- **The broad outline of economic policy is unlikely to changed**
- **Structural reforms more of an issue**

When assessing the implications of a likely change of government after the **September 9 general election**, it is worth remembering that Norway's history of minority governments over the past 50 years has favoured consensus on the broad outlines of economic policy. Of the 21 governments formed since 1961, only five have commanded a majority in the Storting and 11 of them have been some sort of a coalition. Moreover, a **change of government is the norm**, since only five incumbents have been re-elected in the 13 general elections since 1961 (and no one twice).

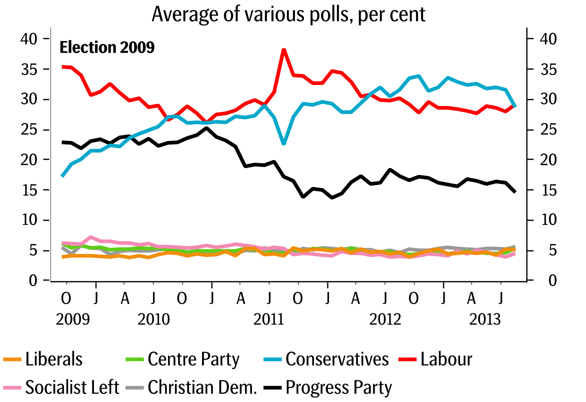
Compromises across the political spectrum have thus been frequent on far-reaching issues such as the fiscal policy rule (see below), the introduction of an inflation target and pension and tax reforms. Differences between parties thus mainly concerns welfare spending vs. lower taxes and private service providers vs. public services.

Non-socialist bloc well ahead in polls

Opinion polls in general strongly suggest that the present red-green coalition of the Labour Party, the Socialist Left Party and the Centre Party, which first took office in 2005, will be ousted by the non-socialist block.

Opinion polls

Average of various polls, per cent

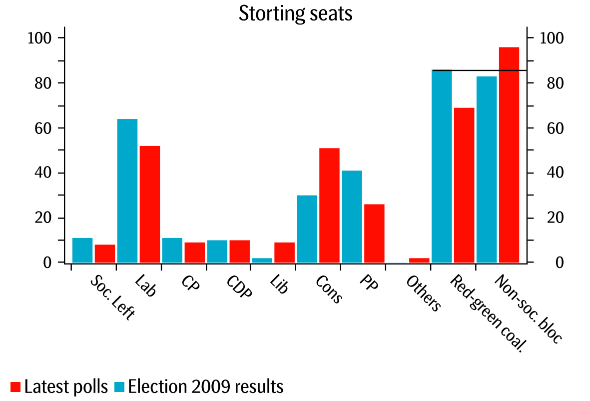


Source: www.pollofpolls.no

Admittedly, Labour has historically fared better on election day than the summer polls have suggested, but the lead for the non-socialist parties at the time of writing seems too wide to be overcome. However, some uncertainty persists regarding the size of the two blocks. The polls thus suggest that one of the smaller parties on either side of the aisle risks failing to achieve the 4 per cent threshold for obtaining any of the 19 additional compensatory seats on top of the ordinary 150 seats distributed proportionally in each of Norway's 19 counties.

Polls show non-socialist bloc in lead

Storting seats



Source: www.pollofpolls.no

According to a few previous polls, the Conservative Party and the Progress Party (populist and immigration-sceptic, but also campaigning to improve the welfare system) could win a majority in the next parliament. However, the **Conservatives are eager to form the broadest possible coalition**. The Christian Democratic Party and the Liberals have expressed reluctance to participate in a government alongside the PP.

Hence, if the non-socialist block gains majority in parliament, it is still uncertain whether it will result in a four-party coalition, a two-party coalition of Conservatives and the Progress Party (with or without an absolute majority), or a triumvirate minority government of Conservatives, CDP and Liberals (as in 2001-05). In any event the leader of the Conservative Party, Erna Solberg, will become the new prime minister.

Progress Party no "threat" to sound policy

Concerning economic policy, one key question for markets is what a new government including the Progress Party (which has never been in office before) would imply for fiscal policy.

First, the party is often criticised by its rivals for being too lax on fiscal spending. Second, in 2001 it was the sole opponent in Parliament to the introduction of the fiscal policy rule, which limits spending from Norway's abundant petroleum income. Under the rule, over a full economic cycle the structural non-oil budget deficit shall be limited to no more than 4 per cent of the Government Pension Fund Global, Norway's sovereign wealth fund (with total assets of NOK 4.4 trillion at mid-2013, equivalent to about 160 per cent of GDP).

The Progress Party has frequently proposed changing the fiscal policy rule, among other things to increase infrastructure investment and separate government investment from other spending in the budget. While some changes might be introduced by a new non-socialist government, it is very unlikely that the effect will be to increase spending of petroleum revenues beyond what the present rule allows. Some limitations will remain in place.

As for the inclusion of the Progress Party in a new government, the first thing to note is that its strength relative to the Conservative Party is about to change sharply compared with the two previous general elections, in which the former came out ahead. The Conservatives will thus be dominant in any new government – if the polls are to be trusted, the party will command almost twice as many Storting members as the Progress Party – guaranteeing a "sound" fiscal policy.

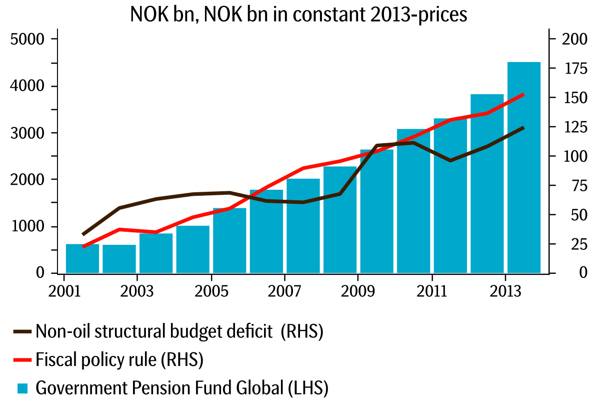
This will still be the case even if the Progress Party should be at the helm of the Ministry of Finance. If so, it will resemble what happened after the election in 2005 when the leader of the "free-spending" Socialist Left Party became Finance Minister, a wise strategic move by the Labour Party that soon "disciplined" the Socialist Left.

It's the economy...

Concerning the near-term outlook for fiscal policy, it is worth noting that **the current government will present the fiscal budget proposal for 2014 in early October**. In case of an election defeat, the proposal will be as tight as possible so the non-socialists will have a tough start. As such, it will be very hard for any new government to make much of an impact by presenting a supplementary budget a month later, though it will likely be somewhat more expansionary. It will instead wait to make its impact fully felt in the spring budget due next May.

Fiscal policy leeway

NOK bn, NOK bn in constant 2013-prices



Source: Ministry of Finance

Moreover, whether or not **fiscal policy** will move in a more expansionary direction in the medium term **depends more on how the economy evolves than who is in office**. In contrast to what happened under the non-socialist coalition in office in 2001-05, the present red-green government may pride itself on the fact that the structural non-oil budget deficit has been well below the 4 per cent limit in recent years. However, rather than any active policy measures, this has been more of an effect of the economic cycle and a stronger-than-expected increase in the Government Pension Fund Global. Moreover, what really matters is the fiscal policy effect measured as the change in the non-oil structural budget deficit in any year. As such, there is little difference between the present and former governments.

In any case, the "under-spending" of petroleum income relative to what the fiscal policy rule allows for – almost NOK 30 billion in 2013 – leaves plenty of leeway for any new government. Among other things, the Conservatives and the Progress Party have promised to cut taxes – like the wealth tax to help private-owned small businesses – while still aiming at maintaining spending in such fields as welfare and education.

The bottom line when it comes to fiscal policy is thus that any change of government is **unlikely to have a lasting impact on interest rates or the exchange rate**.

Structural changes more likely to be felt

Rather than any "dramatic" changes in the broad outlines of economic policy, a change of **government is likely to make its mark on structural issues**. Among other things, a non-socialist government will increase private-sector involvement in health care and education. Likewise, the Conservatives have long argued for introducing more flexible working hours and tightening sick leave compensation (which will be fiercely contested by labour unions).

Some changes in banking regulations are also likely. The Conservatives have emphasised the importance of harmonising banking regulations and capital requirements in the Nordic region. As such, the proposal for a 35 per cent floor on risk weighting of mortgages is unfavourable compared to Sweden's 15 per cent floor. Regardless, the Norwegian Financial Supervisory Authority is most likely to propose a lower floor.

In all, macroprudential measures are not likely to be reversed (though some politicians have considered reversing the tightening of loan-to-value ceilings on mortgages from 90 to 85 per cent to help first-time home buyers). Hence, we do not expect any impact on monetary policy here either.

However, a non-socialist government is expected to put greater emphasis on the total impact of the banks' capital requirements, which may affect the level of the counter-cyclical capital buffer. Norges Bank also weighs in other requirements on banks when advising on the level of such a buffer. In any event, the counter-cyclical buffer is expected to be fully implemented next summer.

Finally, the four non-socialist parties agree on considering changes to the structure of the Government Pension Fund Global, Norway's sovereign wealth fund. One proposal being discussed is splitting the GPFG into different funds "competing" with each other, or establishing different funds for different asset classes. However, any such changes would take a long time to be implemented.

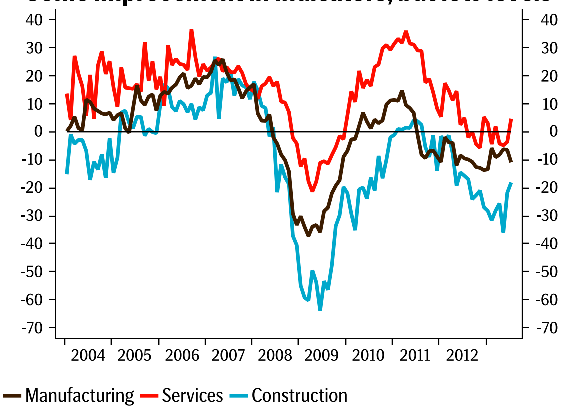
GDP will fall in 2013, followed by a slow recovery

- **Continued weak exports**
- **Inflation falling more than expected**
- **Households squeezed by unemployment and low real wage increases**

The outlook remains weak, although during the first quarter of 2013 the Finnish economy **left recession behind and grew by 0.3 per cent** compared to the preceding quarter. Exports and industrial output remain subdued. Households, previously a growth engine, are being squeezed by rising unemployment and slower pay increases. According to Statistics Finland's GDP indicator, the second quarter was also sub-par. **Measured as annual averages, GDP will fall by 0.3 per cent in 2013**. A gradual recovery will occur this autumn, and **GDP will grow by 1.4 per cent in 2014 and 1.6 per cent in 2015**.

Rapid growth will not return in the near future. Indicators showed slight improvement in May and June for domestically oriented sectors (services and construction), but their levels are still low. Sentiment remains weak in manufacturing and has worsened, although a gradual improvement of demand from other euro zone countries and especially the US will provide support in 2014 and 2015.

Some improvement in indicators, but low levels

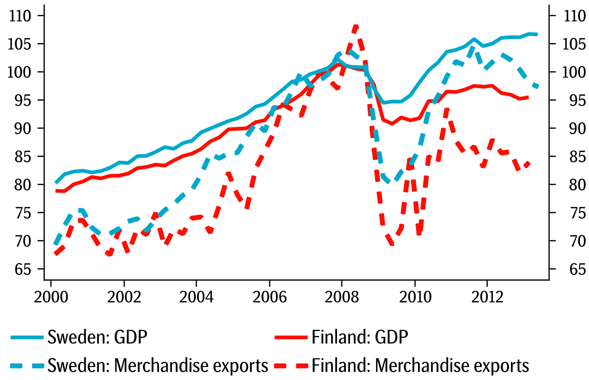


Source: European Commission

Low international demand, especially because of the euro zone recession, has severely affected Finland's exports. Net exports averaged a negative GDP growth contribution of 0.7 per cent annually in 2008-2012. Since 2008, exports have fallen from 49 to 39 per cent of GDP. The problems are both cyclical and structural (see the box in *Nordic Outlook*, May 2013). In June, exports fell by 5.7 per cent compared to one year earlier. The entire first half was weak. Industrial production was also low, in line with export performance. We expect a slight recovery during the autumn. Measured **as annual averages, exports will be largely unchanged in 2013**.

Weak exports behind GDP decline and slow growth

Index 100 = 2008

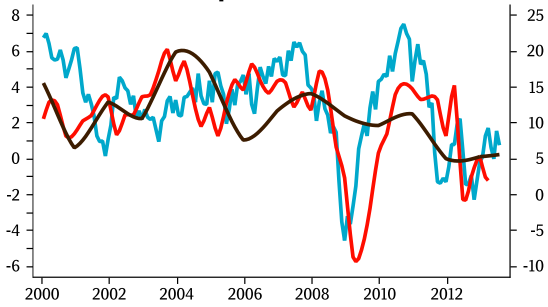


Source: Eurostat

Low demand and capacity utilisation are pushing down capital spending levels in various sectors. Demand is soft in the construction sector, especially for housing, in which investments are decreasing and the number of building permits fell by 10 per cent during January-May 2013. As international economic conditions improve, capital spending will slowly rebound, but because of spare capacity this will occur with a certain delay. Measured as annual averages, **total capital spending will fall by 0.2 per cent in 2013**. In 2014 and 2015 it will increase by 2.5 and 4 per cent, respectively. Because of the low investment ratio and low capital spending levels for several years, when economic conditions improve there will be an underlying need for new investments.

Households, which showed resilience in 2012, are now being squeezed by high unemployment, public sector cost-cutting and lower pay increases. Although decelerating inflation is providing support, **real household income will be essentially unchanged in 2013 compared to 2012**. After that, a slight improvement will occur. Consumer confidence has indeed recovered somewhat since the autumn of 2012, but it remains at a low level. We expect a continued slow upturn as the labour market stabilises this autumn and as exports begin to recover. Retail sales are being pushed down by weak car sales. Even luxury cars sales are showing stagnation (measured year-on-year in current prices). **Consumption will be largely unchanged in 2013 compared to 2012 and will then increase by 1 per cent annually in 2014 and 2015**. Household hesitation is also reflected in weak consumer lending; the rate of increase in lending slowed from around 5 per cent in the second half of 2012 to below 3 per cent in June 2013. Home prices have remained unchanged since 2011. One stabilising factor is that prices have not fallen sharply as in other countries. Weak economic performance in the near future points towards a continued flat price trend.

Household consumption, income and confidence



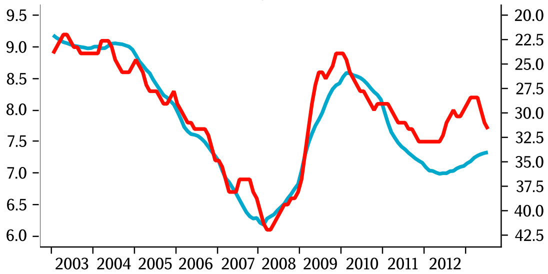
Real disposable income, year-on-year percentage change (LHS)
Household consumption, year-on-year percentage change (LHS)
Consumer confidence (RHS)

Source: Statistics Finland

The labour market situation deteriorated during the autumn of 2012, and unemployment rose from 7.5 to 8.2 per cent. This upturn was mainly due to fewer jobs, not an enlargement in the labour force as has been the case in Sweden, for example. The number of job vacancies did not fall along with the upturn in unemployment, which may be an **indication that the upturn is partly structural**. Unemployment is now falling slightly at the same time as the number of vacancies alsa falls. Continued slow economic growth, which will reach its trend rate only in 2015, will nevertheless keep unemployment at just below 8 per cent well into 2014. Measured as annual averages, **unemployment will be 7.9 per cent in 2013, 7.7 per cent in 2014 and 7.6 per cent in 2015**.

Unemployment will fall only slowly from present level

Per cent, thousands



Unemployment, seasonally adjusted (LHS)
Job vacancies, 12-month moving average (RHS)

Source: Statistics Finland

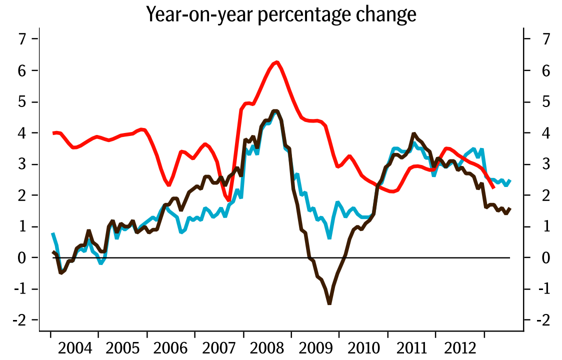
Finland's weak export performance and deteriorating current account balance are largely due to structural problems. Price trends for export products have been weaker than for imports (falling terms of trade), while pay increases have been faster than in competing countries such as Sweden (see the box in *Nordic Outlook*, May 2013). Measured in real effective exchange rates, however, Finland's competitiveness is not alarmingly bad.

Rising unemployment and weak growth are now also having an impact on wage formation. During the spring of 2013, pay increases were slightly over 2 per cent, resulting in unchanged real wages after accounting for inflation. Pay increases will remain slow in 2014 and then rise marginally to 2.5 per cent. This means that **real wages will be largely unchanged or will rise only slightly** throughout our forecast period.

HICP inflation fell from 3.5 per cent in December 2012 to around 2.5 per cent in recent months: still above the euro zone average. Finland's seemingly stubborn inflation was nevertheless partly due to tax increases within the framework of the government's deficit-reduction measures. Earlier estimates from the Finance Ministry that the VAT increase would raise prices by 0.6 percentage points seems to have been excessive, since companies have not passed the entire increase through to consumers. HICP inflation will continue downward. Measured as annual averages, it will be 2.2 per cent this year, 1.9 per cent in 2014 and 1.8 per cent in 2015.

Falling price and pay increases

Year-on-year percentage change



CPI (national measure) Wages and salaries HICP inflation

Source: Statistics Finland, Eurostat

Public finances have been affected by the country's recent listless real economic performance. The budget deficit increased to 2.3 per cent of GDP in 2012, and weak economic conditions are wiping out the deficit-reduction effects of the government's austerity policy. The shift to a more expansionary policy that we see in Sweden and elsewhere is conspicuously absent in Finland, and we expect **a continued austerity policy**. The public sector deficit will improve slightly in 2014 to 2 per cent of GDP and will remain at that level in 2015. Gross public debt will increase slightly this year to 54 per cent of GDP and stabilise after that at just above that level. In its budget proposal for 2014, the Finance Ministry urges the government to sell state-owned shareholdings equivalent to EUR 490 billion to make funds available to reduce central government debt. When this will occur, or what companies it will affect, remains unclear.

Due to low public debt compared to the euro zone average and a limited budget deficit, Finland's sovereign borrowing continues to enjoy top credit ratings. Sovereign loan yields have climbed since early May 2013 in line with Sweden and Germany. The yield spread to Germany has meanwhile remained stable at between 20 and 30 basis points during the past year.

Economic data

GLOBAL KEY INDICATORS

Yearly percentage change

	2012	2013	2014	2015
GDP OECD	1.5	1.2	2.4	2.8
GDP world	3.4	3.2	4.0	4.2
CPI OECD	2.3	1.8	2.0	1.8
Export market OECD	2.5	3.0	7.2	8.4
Oil price, Brent (USD/barrel)	111.7	108.0	102.5	100.0

US

Yearly change in per cent

	2012 level, USD bn	2012	2013	2014	2015
Gross domestic product	16,420	2.8	1.6	3.3	3.7
Private consumption	11,286	2.2	2.0	2.7	3.1
Public consumption	3,151	-1.0	-2.4	-1.2	-1.0
Gross fixed investment	2,386	8.3	5.5	11.3	12.0
Stockbuilding (change as % of GDP)		0.2	0.0	0.0	0.0
Exports	2,214	3.5	2.1	5.3	5.2
Imports	2,730	2.2	2.5	5.6	5.8
Unemployment (%)		8.1	7.5	7.0	6.2
Consumer prices		2.1	1.7	1.6	1.7
Household savings ratio (%)		5.6	4.3	4.6	4.8

EURO ZONE

Yearly change in per cent

	2012 level, EUR bn	2012	2013	2014	2015
Gross domestic product	9,490	-0.6	-0.5	0.8	1.7
Private consumption	5,455	-1.3	-1.0	0.5	1.0
Public consumption	2,044	-0.4	0.0	0.1	0.8
Gross fixed investment	1,741	-4.3	-1.0	1.2	2.2
Stockbuilding (change as % of GDP)		-0.6	0.0	0.0	0.0
Exports	4,328	2.7	2.8	4.0	4.5
Imports	4,079	-0.8	2.5	3.8	3.8
Unemployment (%)		11.4	12.1	12.1	11.5
Consumer prices		2.5	1.5	1.0	0.9
Household savings ratio (%)		7.2	7.2	6.9	6.9

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2012	2013	2014	2015
GDP				
United Kingdom	0.2	1.5	2.3	2.6
Japan	2.0	1.9	1.4	1.0
Germany	0.7	0.5	1.7	2.0
France	0.0	0.2	0.8	1.5
Italy	-2.8	-1.7	0.6	0.8
China	7.8	7.5	7.4	7.0
India	5.4	5.0	5.6	6.0
Inflation				
United Kingdom	2.8	2.6	2.3	2.2
Japan	0.0	0.3	2.5	1.5
Germany	2.0	1.6	1.9	2.0
France	1.5	1.5	1.6	1.7
Italy	3.3	2.1	2.0	2.0
China	2.6	2.8	3.2	3.4
India (WPI)	7.5	5.7	6.0	6.0
Unemployment (%)				
United Kingdom	8.1	7.9	7.6	7.3
Japan	4.4	4.0	3.9	3.9
Germany	5.5	5.5	5.5	5.4
France	10.7	10.9	11.2	11.0
Italy	10.7	12.2	12.0	11.5

EASTERN EUROPE

	2012	2013	2014	2015
GDP, yearly change in per cent				
Estonia	3.2	1.5	3.3	3.5
Latvia	5.6	3.5	4.8	5.0
Lithuania	3.7	3.2	3.5	4.5
Poland	2.0	1.5	3.1	3.7
Russia	3.4	1.8	2.9	3.4
Ukraine	0.2	-0.7	2.0	3.4
Inflation, yearly change in per cent				
Estonia	3.9	3.2	2.5	2.6
Latvia	2.3	0.5	2.9	3.4
Lithuania	3.2	2.0	2.8	3.5
Poland	3.7	1.0	2.3	2.7
Russia	5.1	6.5	5.1	5.0
Ukraine	0.6	2.5	6.0	6.5

FINANCIAL FORECASTS

		Aug 22nd	Dec 13	Jun 14	Dec 14	Jun 15	Dec 15
Official interest rates							
US	Fed funds	0.25	0.25	0.25	0.25	0.25	1.00
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.50	0.25	0.25	0.25	0.25	0.25
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	0.75
Bond yields							
US	10 years	2.90	2.90	3.10	3.15	3.40	3.70
Japan	10 years	0.75	0.90	1.00	1.10	1.20	1.20
Germany	10 years	1.92	2.00	2.30	2.30	2.50	2.70
United Kingdom	10 years	2.89	3.00	3.30	3.30	3.50	3.70
Exchange rates							
USD/JPY		99	102	104	110	112	115
EUR/USD		1.33	1.33	1.30	1.27	1.22	1.20
EUR/JPY		132	136	135	140	137	138
GBP/USD		1.56	1.56	1.55	1.53	1.49	1.48
EUR/GBP		0.86	0.85	0.84	0.83	0.82	0.81

SWEDEN

Yearly change in per cent

	2012 level, SEK bn	2012	2013	2014	2015
Gross domestic product	3,561	0.7	1.2	2.6	3.2
Gross domestic product, working day adjusted		1.0	1.2	2.7	3.0
Private consumption	1,718	1.5	2.0	2.7	3.0
Public consumption	956	0.7	0.8	0.8	0.8
Gross fixed investment	669	3.2	-3.0	3.0	5.5
Stockbuilding (change as % of GDP)	-1	-1.1	0.3	0.1	0.2
Exports	1,736	0.8	-0.4	4.3	6.2
Imports	1,516	0.0	-1.2	4.0	6.1
Unemployment (%)		8.0	8.1	8.0	7.5
Employment		0.6	0.9	0.4	0.9
Industrial production		-4.3	-2.0	3.5	5.0
Consumer prices		0.9	0.0	1.0	2.0
CPIF		1.0	0.9	1.3	1.6
Hourly wage increases		3.3	2.7	2.8	3.0
Household savings ratio (%)		11.4	11.7	12.2	10.8
Real disposable income		2.5	2.9	2.8	1.7
Trade balance, % of GDP		2.6	2.6	2.8	2.9
Current account, % of GDP		7.0	6.3	6.4	6.1
Central government borrowing, SEK bn		25	160	63	50
Public sector financial balance, % of GDP		-0.9	-2.1	-2.2	-1.8
Public sector debt, % of GDP		37.6	41.0	41.1	40.5

FINANCIAL FORECASTS	Aug 22nd	Dec 13	Jun 14	Dec 14	Jun 15	Dec 15
Repo rate	1.00	1.00	1.00	1.25	1.50	1.75
3-month interest rate, STIBOR	1.21	1.20	1.20	1.50	1.75	2.00
10-year bond yield	2.48	2.45	2.70	2.70	2.95	3.20
10-year spread to Germany, bp	56	45	40	40	45	50
USD/SEK	6.52	6.54	6.57	6.61	6.80	6.86
EUR/SEK	8.70	8.70	8.54	8.40	8.30	8.20
TCW	117.1	117.2	115.8	114.3	113.8	112.9
KIX	103.2	103.3	102.0	100.7	100.3	99.5

NORWAY

Yearly change in per cent

	2012 level, NOK bn	2012	2013	2014	2015
Gross domestic product	2,655	3.1	1.1	2.7	2.3
Gross domestic product (Mainland Norway)	2,106	3.4	2.1	2.7	2.7
Private consumption	1,151	3.0	3.0	3.2	3.1
Public consumption	579	1.8	2.3	2.2	2.0
Gross fixed investment	560	8.0	5.8	4.5	3.5
Stockbuilding (change as % of GDP)		-0.2	-0.9	0.2	0.1
Exports	1,029	1.8	-1.5	2.6	2.2
Imports	772	2.4	1.5	4.8	4.2
Unemployment (%)		3.2	3.5	3.5	3.7
Consumer prices		0.7	2.0	1.8	2.3
CPI-ATE		1.2	1.5	1.9	2.3
Annual wage increases		4.3	3.5	3.8	4.0

FINANCIAL FORECASTS	Aug 22nd	Dec 13	Jun 14	Dec 14	Jun 15	Dec 15
Deposit rate	1.50	1.50	1.50	2.00	2.25	2.75
10-year bond yield	2.90	2.75	3.05	3.15	3.40	3.60
10-year spread to Germany, bp	98	75	75	85	90	90
USD/NOK	6.10	6.02	5.96	6.06	6.31	6.40
EUR/NOK	8.14	8.00	7.75	7.70	7.70	7.65

DENMARK

Yearly change in per cent

	2012 level, DKK bn	2012	2013	2014	2015
Gross domestic product	1,820	-0.4	0.4	2.0	2.5
Private consumption	901	0.5	1.0	2.0	2.5
Public consumption	520	0.7	0.0	1.2	0.6
Gross fixed investment	323	-0.1	-0.2	3.6	5.5
Stockbuilding (change as % of GDP)		-0.3	0.6	-0.2	0.0
Exports	992	0.2	0.1	4.3	4.8
Imports	912	1.0	2.4	4.1	4.9
Unemployment (%)		4.6	4.2	4.0	3.5
Consumer prices, harmonised		2.4	0.7	0.9	1.4
Hourly wage increases		1.5	1.5	1.5	2.0
Current account, % of GDP		5.6	6.0	6.0	6.0
Public sector financial balance, % of GDP		-4.1	-1.0	-0.5	1.0
Public sector debt, % of GDP		45.7	44.0	42.5	39.0

FINANCIAL FORECASTS	Aug 22nd	Dec 13	Jun 14	Dec 14	Jun 15	Dec 15
Lending rate	0.20	0.10	0.10	0.10	0.10	0.10
10-year bond yield	1.97	2.05	2.35	2.35	2.55	2.75
10-year spread to Germany, bp	5	5	5	5	5	5
USD/DKK	5.59	5.60	5.73	5.87	6.11	6.23
EUR/DKK	7.46	7.45	7.45	7.45	7.45	7.45

FINLAND

Yearly change in per cent

	2012 level, EUR bn	2012	2013	2014	2015
Gross domestic product	193	-0.8	-0.3	1.3	1.6
Private consumption	109	0.2	0.0	0.9	1.0
Public consumption	48	0.6	0.0	0.2	0.3
Gross fixed investment	38	-1.0	-0.2	2.5	4.0
Stockbuilding (change as % of GDP)		-1.2	0.0	0.0	0.0
Exports	78	-0.2	0.3	3.3	4.0
Imports	80	-1.0	1.0	3.0	4.0
Unemployment (%)		7.7	8.1	8.0	7.8
Consumer prices, harmonised		3.2	2.2	1.9	1.8
Hourly wage increases		3.2	2.2	2.2	2.5
Current account, % of GDP		-1.8	-2.0	-2.0	2.0
Public sector financial balance, % of GDP		-2.3	-2.2	-2.0	-2.0
Public sector debt, % of GDP		53.0	54.0	55.0	55.0

Economic Research available on Internet.
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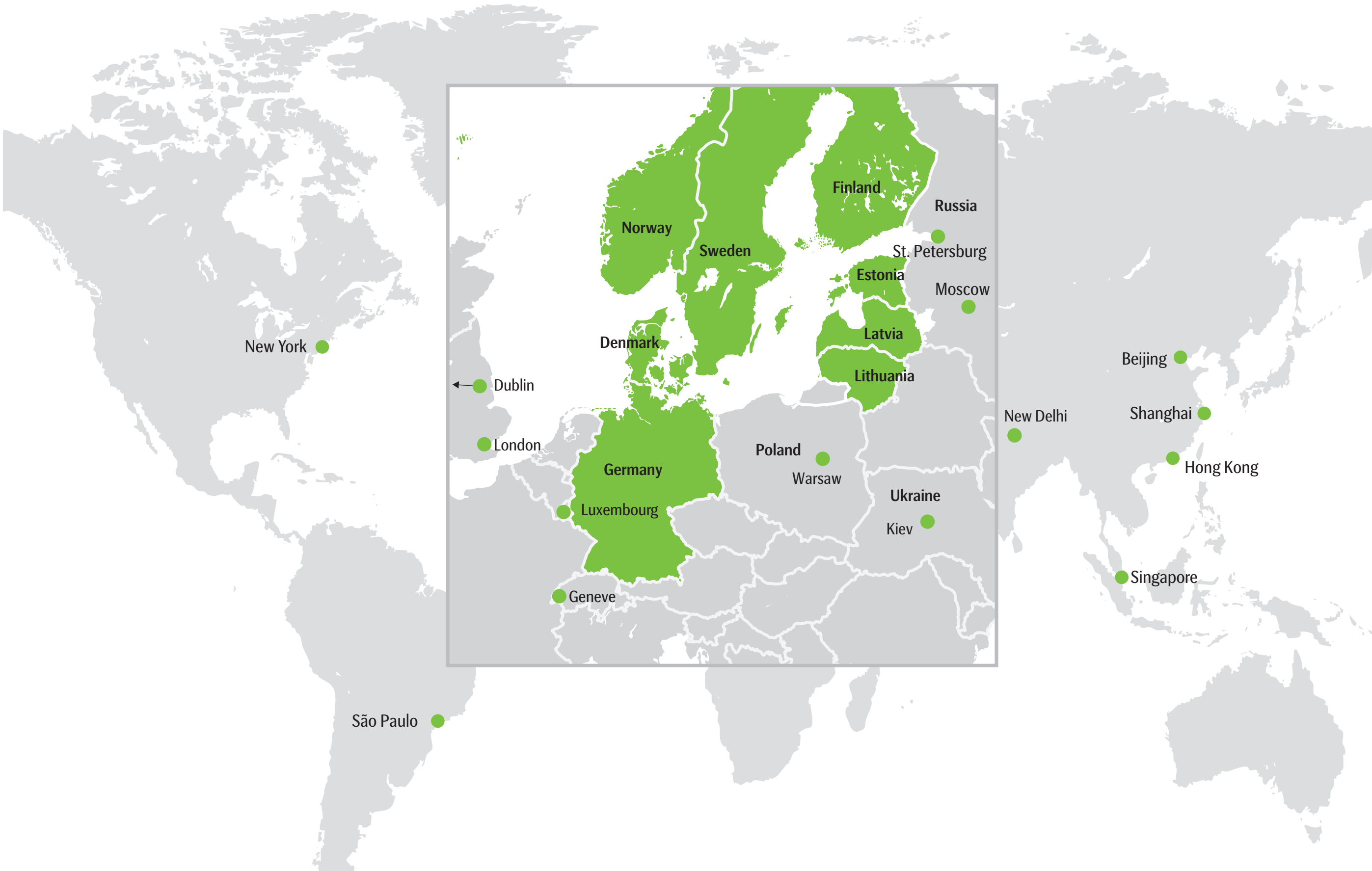

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