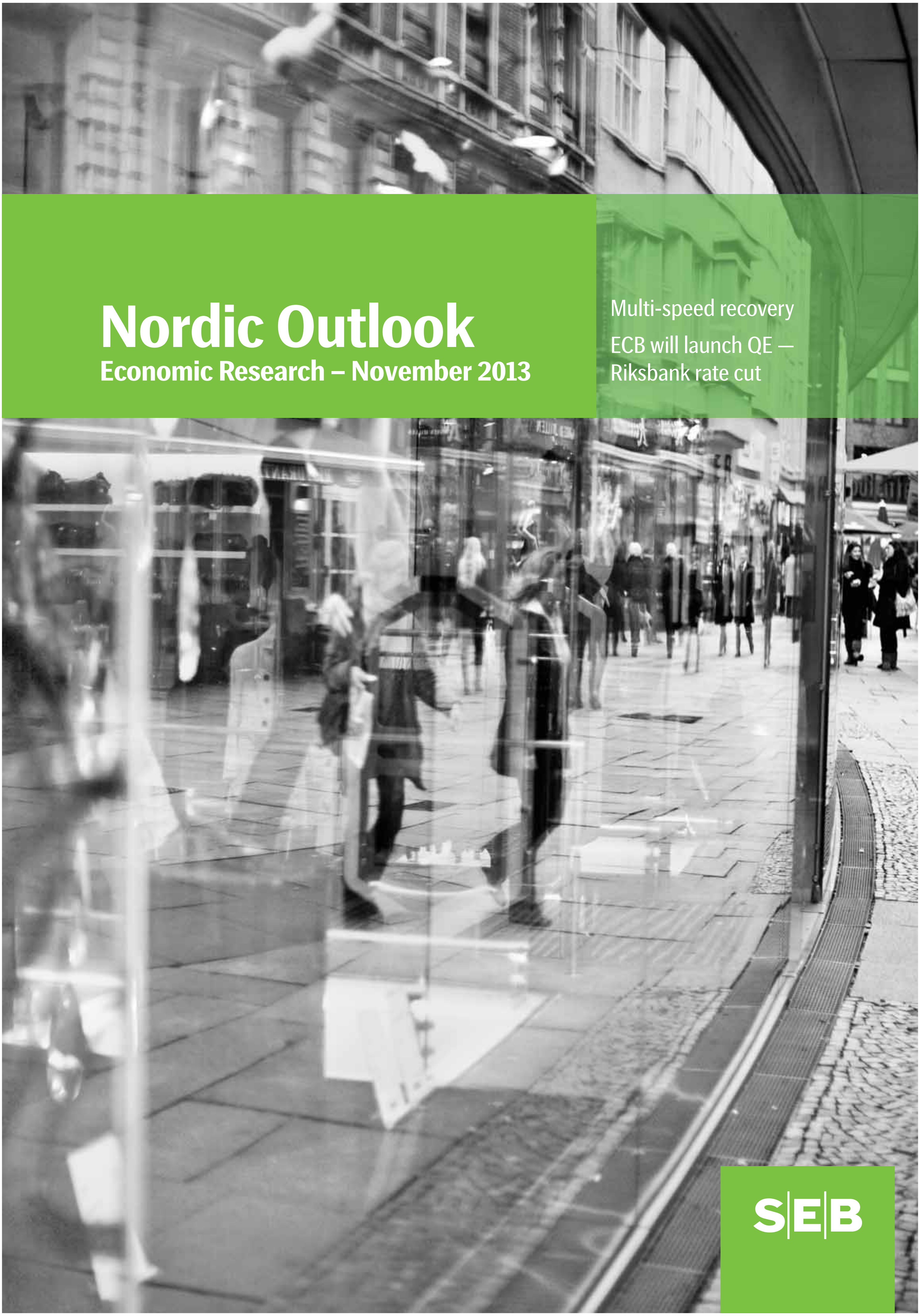

Nordic Outlook

Economic Research – November 2013

Multi-speed recovery

ECB will launch QE — Riksbank rate cut

SEB

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Recovery, but growing deflation risks in Europe

- **Faster US growth as fiscal policy eases**
- **Structural problems hurt BRIC countries**
- **Continued imbalances in the euro zone**
- **ECB will launch QE policy in spring 2014**
- **EUR/USD rate gradually approaching 1.20**
- **Still some lifting power in stock market**

The modest recovery in the world economy is continuing. Leading indicators in most countries support this. For example, the purchasing managers' index (PMI) in many countries is close to or above the growth threshold of 50. Just as in recent years, economic policy uncertainty increased after the summer: this time due to failure to achieve a budget agreement on time in the US Congress. But unlike 2010-2012, the impact on both economic indicators and risk appetite in financial markets has been small.

Over the next couple of years, the potential for global GDP acceleration will improve. In the United States, the fiscal headwind will diminish, while a stronger labour market, rising wealth and reduced household debt levels will set the stage for a self-sustaining expansion. Different parts of the world economy have varying potential for benefiting from the American upturn. **This implies that cyclical differences will persist during the next couple of years, among other things because the post-crisis healing process has varied in speed.** The continued financial and political weaknesses of the euro zone will force the European Central Bank (ECB) to launch quantitative easing (QE), but euro zone recovery will be sluggish and will only reach trend growth in 2015. 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 policy makers face more difficult structural challenges. In emerging economies, a deceleration is now under way; due to structural problems, GDP growth will not reach earlier levels in the next few years.

Overall, however, GDP growth will climb rather sharply in the next couple of years. In the 34-country Organisation for Economic Cooperation and Development (OECD), growth will increase from 1.2 per cent in 2013 to 2.3 per cent in 2014 and 2.7 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 3.9 per cent in 2014 and 4.1 per cent in 2015**. The differences compared to the August 2013 issue of *Nordic Outlook* are relatively small.

Global GDP growth

Year-on-year percentage change

	2012	2013	2014	2015
United States	2.8	1.7	3.3	3.7
Japan	2.0	1.8	1.7	1.3
Germany	0.7	0.5	1.7	2.0
China	7.7	7.7	7.4	7.0
United Kingdom	0.1	1.4	2.4	2.7
Euro zone	-0.6	-0.4	0.8	1.6
Nordic countries	1.1	0.5	2.2	2.5
Baltic countries	4.2	3.0	3.7	4.2
OECD	1.5	1.2	2.3	2.7
Emerging markets	4.9	4.7	5.1	5.2
World, PPP	3.4	3.2	3.9	4.1
World, nominal	2.6	2.4	3.2	3.4

Source: OECD, SEB

Because of low resource utilisation, inflation will remain low during the next couple of years. This makes room for central banks to support the recovery with **continued exceptional monetary policy stimulus measures**, thereby helping to keep interest rates generally low and ensuring that the upturn in long-term yields will be very moderate. It will also allow room for some additional share price increases.

However, we are seeing various types of tensions related to implementation of exit policies. **Differences in the inflation environment, especially between the US and the euro zone, are becoming apparent**. There are signs that inflation is on its way up in the US, while deflation risks keep growing in the euro zone. This risks leading to a situation in which the US will begin normalising its monetary policy while the euro zone recovery is still in a very fragile phase. Another source of tension is that **certain asset prices are in the process of rising far beyond what is needed for balance sheet repair**. There is a clearer risk that continued exceptional monetary policy stimulus will lead to new financial bubbles and undesirably large wealth gaps. 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.

US growth accelerates, Europe hesitates

Although US economic performance has been fairly flat so far this autumn and deep underlying political conflicts are again evident, we are sticking to our forecast of a rather substantial growth surge over the next couple of years. We predict that American GDP will grow by 3.3 per cent in 2014 and 3.7 per cent in 2015: well above consensus. **The fiscal headwind will diminish** from 1.7 per cent of GDP in 2013 to about ½ per cent in 2014. In addition, **the labour market is now on its way to gaining strength. Household and business balance sheets are also benefiting from rising home and share prices**. We believe that **debt deleveraging in the household sector has now ended** and that consumption is thus about to take off. A slight cooling in construction activity has been discernible, but this is probably temporary; the residential and construction sector will remain a cyclically important force in the recovery.

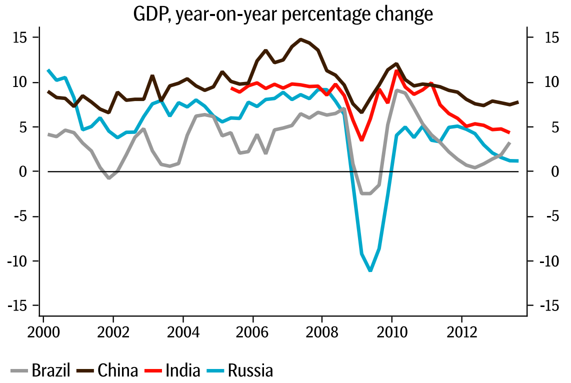
In Europe, we are seeing a fairly clear upturn in the British economy, with stronger competitiveness and milder fiscal policy helping to accelerate growth. In the euro zone, too, we see signs of stabilisation, but growth will remain well below trend during 2014. **Fiscal austerity is continuing to hold back crisis-hit countries**, though to a lesser extent than before. Meanwhile unemployment is record-high and the banking system is not yet in good enough shape to **supply credit to businesses** in a normal way. The German economy continues to show signs of strength, but a persistently large current account surplus is contributing to continued imbalances in the euro zone. The rebalancing process will be difficult to set in motion as long as Germany's fiscal policy is kept under tight control and its household and business behaviour remains cautious.

Structural problems in the BRIC countries

Viewed in a long-term perspective, growth in the four BRIC countries (Brazil, Russia, India and China) has decelerated sharply **due to structural weaknesses**, but in the short term they are showing divergent performance. Brazil's growth is accelerating. China also experienced higher activity in the third quarter, although the increase is expected to be temporary. India and Russia, however, are seeing a continued slowdown.

Economic deceleration in the BRIC countries

GDP, year-on-year percentage change



Source: National statistical offices

Structural weaknesses are the reason for decelerating growth in all these countries, but their problems differ. In **Brazil**, a consumption boom has driven up household debts to high levels, and capital spending must take over the role of growth engine. **Russia** is still suffering from heavy dependence on oil, combined with a poor business climate and a far-reaching demographic challenge. **India** is hampered by various structural problems such as over-regulated goods and labour markets, as

Downside risks outweigh upside ones

In the last *Nordic Outlook*, we discussed the risk picture based on the consequences of the American economic upturn and of the coming normalisation of economic policies. As earlier, the upside risk in our forecast is that **the US recovery will pull other parts of the world economy up with it** to a greater extent than we have expected. Our growth scenario, to which we attach a 20 per cent probability, largely follows historical correlations between the US and the rest of the world. In our main scenario, however, structural problems – especially in the euro zone – create obstacles to such a development.

Alternative scenarios

GDP, year-on-year percentage change

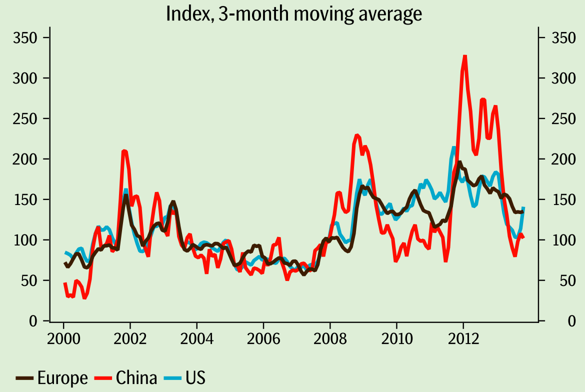
	2014	2015
A. Larger contagious effects from the US upturn (20%)		
United States	3.5	4.2
Euro zone	1.3	2.5
OECD	**2.6**	**3.4**
Emerging market economies	6.2	6.4
B. More severe consequences from policy problems (25%)		
United States	2.0	1.0
Euro zone	-0.5	-0.5
OECD	**0.5**	**0.5**
Emerging market economies	3.0	3.0

Source: SEB

The main downside risk is that various policy problems will have larger consequences for the real economy than we have expected. In the short term, new fiscal policy deadlocks in the US are the most obvious threat. For example, the index of economic policy uncertainty has climbed again in the US. Looking ahead a bit further, risks connected to the normalisation of monetary policy predominate. This is especially true if the Federal Reserve begins its exit strategy from quantitative easing at such an early stage that countries in divergent cyclical phases will have problems. **Overall, we end up concluding that the probability of a poorer economic scenario is 25 per cent**. This implies a slight adjustment in a negative direction, compared to our symmetric risk picture in August. Our negative scenario now also implies a deeper economic slowdown than before.

Economic policy uncertainty

Index, 3-month moving average



Source: Economic Policy Uncertainty

well as weak infrastructure. In **China**, economic expansion is hampered by the transition from a growth model driven by capital spending and exports to a model based on private consumption. As in Russia, a serious worsening of China's demography is also expected.

Nordic countries out of synch

The international recovery will benefit the Nordic countries in 2014 and 2015, although Finland will lag behind. In **Sweden**, export and manufacturing performance has been more sluggish than expected, but looking ahead we expect a broad recovery in which household purchasing power will be stimulated by rising employment, low inflation and expansionary fiscal policy. In **Denmark**, a consumption-driven recovery is beginning to gain a foothold. Employment is climbing and consumer confidence has returned, driven by such factors as rising home prices. In **Finland**, structural problems are undermining weak economic conditions, thereby hampering the recovery. Low capacity utilisation is holding back capital spending, and household consumption is subdued because of rising unemployment and a deceleration in the rate of pay increases. **Norway** will again see decent growth in 2014-2015 after this year's slowdown. Strong real income and reduced saving will lead to increased consumption, despite the downturn in home prices next year. Exports will gain strength, but activity in the oil industry will slow significantly. Inflation will calm down after its recent upward shift.

Nordics and Baltics, GDP growth

Year-on-year percentage change

	2012	2013	2014	2015
Sweden	1.0	0.7	2.5	3.2
Norway	3.1	0.9	2.4	2.1
Denmark	-0.4	0.4	2.0	2.5
Finland	-0.8	-1.0	1.2	1.6
Estonia	3.9	1.3	2.6	2.9
Latvia	5.0	4.0	4.8	4.8
Lithuania	3.7	3.3	3.5	4.5

Source: OECD, SEB

Baltics still top EU, but Estonia is lagging

Rising private consumption, driven by good real income, continues to fuel solid GDP growth in the Baltics, though Estonia is lagging behind. Exports and capital spending have been weak since last summer but will gradually strengthen over the next couple of years. **Latvia and Lithuania will continue to grow the fastest of all EU countries: Latvia's GDP will rise by 4.8 per cent yearly in 2014-2015. Lithuania's growth will end up at 3.5 and 4.5 per cent, respectively**. This is somewhat above potential, which is 3-4 per cent in all three Baltic countries. **Estonia's growth will gradually recover to 2.6 per cent in 2014 and 2.9 per cent in 2015** after this year's plunge to 1.3 per cent. Given continued weak inflation data this autumn, **there is a relatively high probability that Lithuania will** be the last Baltic country to **qualify for the euro zone, meeting the government's 2015 target**.

Stable commodity prices

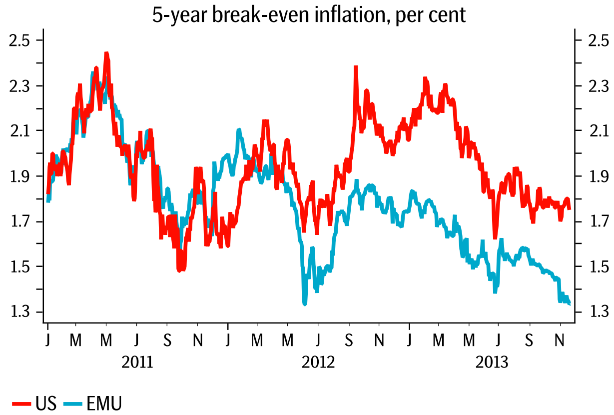
Commodity prices have been comparatively stable since late 2012, after an earlier significant cool-down for industrial and agricultural commodities. Signs that the world economy has bottomed out since last spring have helped to perpetuate the calm price trend for industrial commodities. In keeping with our assumptions about a gradual recovery in global growth, we expect a **gradual, cautious price upturn for industrial metals** over the coming year. Gold prices will be unchanged. The gentle deceleration in the Chinese economy will play a major role in holding back major commodity price hikes. As in our forecast in the last *Nordic Outlook*, we expect oil prices to **fall from this autumn's USD 105-110/barrel to an average of USD 102.5 in 2014 and USD 100 in 2015**. Behind this downturn is the fact that production will increase more than demand over the next couple of years. We expect Saudi Arabia to respond to large price declines by adjusting its production, thereby creating a floor of around USD 100 for oil prices.

Increasing deflation risks in Europe

Global inflation continues to trend downward. This decline is broad-based and partly driven by lower energy and food prices. But core inflation has also shown a downward trend, especially in Europe. Our general picture is that **deflationary forces will remain dominant**. Resource utilisation is low and the price squeeze on goods in the world market will continue.

Divergent inflation expectations

5-year break-even inflation, per cent

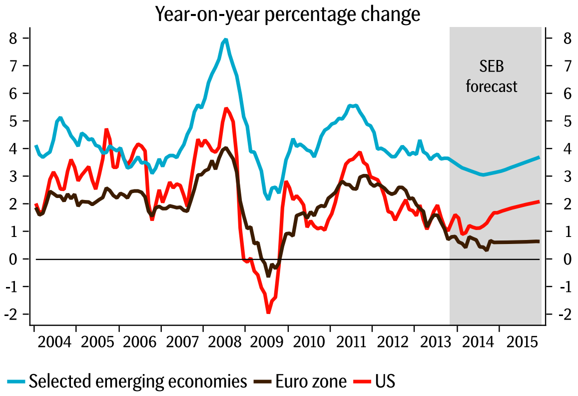


Source: Bloomberg, SEB

We can foresee a tendency towards increasing divergence between regions when it comes to inflation. For example, **deflation risks are far greater in the euro zone than in the US**. Several small crisis-hit countries are – or have been – in deflation, while inflation in Spain is around zero. The trend towards wage acceleration in Germany seems to have ended, and German inflation is too low to significantly facilitate the euro zone's rebalancing process. We expect the weak recovery to cause inflation to fall further, increasing the risk of damaging deflation. Similarities with Japan's deflation spiral of recent decades have thus increased. However, our basic forecast is that general deflation can be avoided but that HICP inflation will average as low as 0.5 per cent yearly in 2014 and 2015.

CPI inflation is falling

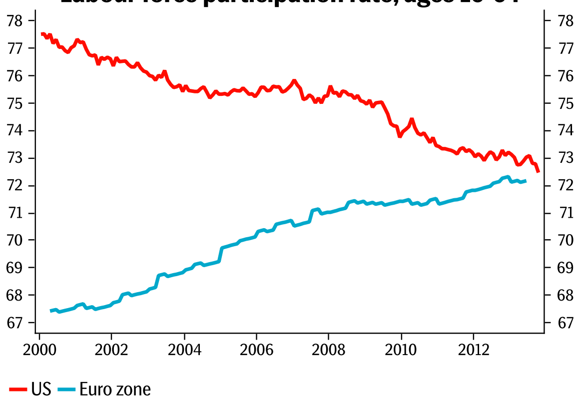
Year-on-year percentage change



Source: Eurostat, BLS, SEB

In the US, a large quantity of idle resources is also holding back inflation but several important differences in the inflation environment are apparent. The rate of pay increases has risen, though from low levels. The pace of credit and money supply expansion is significantly higher in the US, among other things because the banking sector has recuperated to a greater extent than in the euro zone. **Long-term inflation expectations are at a stable level in the US, while they have fallen in the euro zone**. There are also differences on the supply side that point in the same direction. For example, labour force participation has fallen in the US over a long period, while the trend has been the opposite in Europe. Our forecast of a turnaround in US labour force participation is important in ensuring that the Fed will not need to act in a way that threatens the fragile global recovery.

Labour force participation rate, ages 16-64



Source: Statistics Sweden

Fading fiscal headwind

The recovery continues to be hampered by fiscal austerity in large portions of the world economy, but its effect will be milder in 2014 and 2015 than in 2013. The time line for austerity measures in the euro zone, the US and Japan is divergent. In the euro zone, belt-tightening was at its toughest during 2011-2012 and in the US during 2013. Despite Japan's large budget deficit and high government debt, fiscal policy is expansionary this year, but we expect austerity measures to begin in 2014.

Public sector deficits are generally shrinking. Despite financial market worries about government finances in the crisis-hit countries of southern Europe, the deficit in the euro zone as a whole is lower than in the US, Japan and the UK. But deflation pressure in the euro zone makes the problem worse than in the US, where higher growth and inflation ahead will help keep debt down as a percentage of GDP.

Public finances

Budget balance as a percentage of GDP

	2012	2013	2014	2015
USA	-8.3	-5.8	-4.7	-3.9
Japan	-10.1	-9.5	-6.8	-5.7
United Kingdom	-7.9	-6.1	-5.8	-4.9
Euro zone	-3.7	-2.6	-2.6	-2.2
OECD	-5.7	-4.3	-3.8	-3.3
Fiscal direction*	0.7	1.6	0.5	0.6

*Change in structural balance, OECD countries

Source: IMF, OECD, SEB

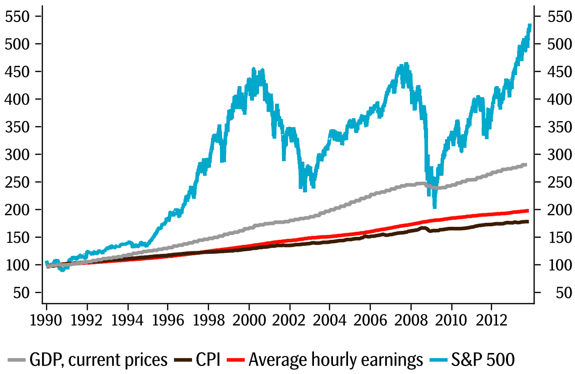
Central bank dilemma becoming clearer

Global **deflationary tendencies** remain very strong despite **monetary stimulus** that is **historic** in terms of **volume** (USD 12.5 trillion), **duration** (6 years) and **tools** (unconventional policies). High indebtedness and balance sheets in need of repair reduce the impact of monetary policy. For the ECB, inflation has even become so low that a deflation debate has gained a foothold. Various emerging market economies can note somewhat higher inflation, connected to currencies that have weakened and to various capacity shortages that require a somewhat tighter interest rate policy.

Low inflation gives Western central banks great **freedom to pursue expansionary policies** that support growth and the labour market. Meanwhile a number of stock market indices are setting new records. In some countries, the housing market is showing signs not only of stability but also of slightly feverish price upturns, for example in the UK and Sweden. In Germany, too, a clear upturn in prices is now being noted.

US: Stock market, GDP, inflation and earnings

Rebase 1990=100



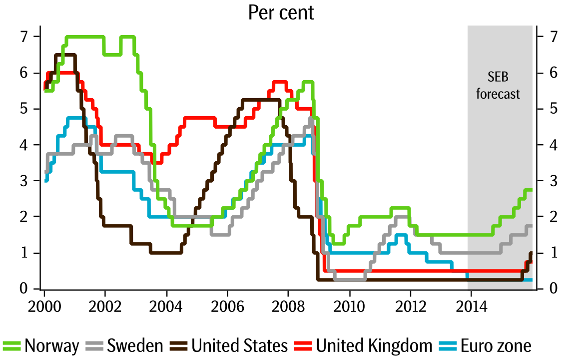
Source: Macrobond, SEB

Asset price inflation beyond what can be justified by the need to "repair" household and business balance sheets also raises questions. In the central banking sphere, we are beginning to see divergent opinions about the risks of new financial imbalances that are directly connected to the unconventional monetary policies that are being pursued. Although a number of countries have begun to take cautious steps in the field of macroprudential supervision, it is still unfamiliar territory with a lack of empirical facts and experience. Such new policies may gradually ease the pressure on monetary policy, but there is uncertainty about when this can happen and to what extent.

The Fed och the ECB will set the agenda for most central banks over the next couple of years. **The Fed will begin to phase out (taper) its bond purchases in March 2014**. To reduce the risk of a sharp interest rate upturn, the Fed will lower the threshold that determines when key rate hikes can begin: from an unemployment level of 6.5 to 6.0 per cent. Our forecast is that the Fed's first federal funds rate hike will occur late in 2015.

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

Per cent



Source: Macrobond

The ECB will keep its refi rate at 0.25 per cent throughout our forecast period. It will thus not introduce negative deposit rates, due to their undesirable effects on credit growth (especially in southern Europe) as well as potential risks of a dysfunctional interbank market. **However, during the spring of 2014 we expect the ECB to launch a traditional QE policy** similar to those used in the US, Japan and the UK. This will have several purposes: to "decouple" European interest rates and yields from US ones, make ECB monetary policy more independent and responsive to the euro zone's economic situation, make more capital available to bank balance sheets for lending and reduce the risk of deflation (read more in the theme article on page 12).

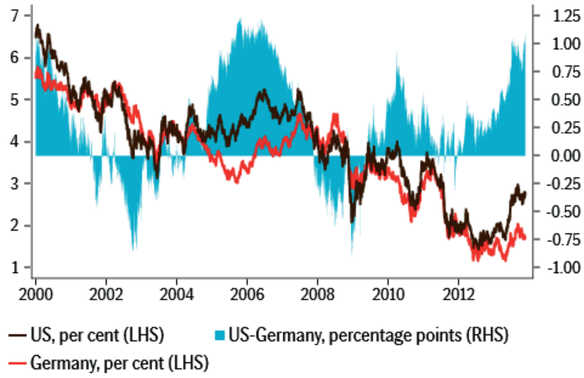
The Bank of Japan will continue its sharply expansionary policy as planned. The UK's new central bank governor must monitor the consequences of rising home prices and a broad-based recovery. Due to increased focus on the labour market and the slow downturn in unemployment, the Bank of England will not hike its key rate until the end of 2015. The Nordic central banks will be forced to adjust their situation to the global playing field. **Norges Bank in Norway will be the first to raise its key rate, in autumn 2014**, but the deceleration in the housing market may delay this hike. **Sweden's Riksbank will lower its repo rate this December to 0.75 per cent and raise it again only early in 2015**. At the end of our forecast period, the Riksbank's key rate will be 1.25 per cent and Norges Bank's 2.25 per cent.

Slightly rising long-term yields

A rapid run-up in bond yields would pose a threat to the economic recovery and financial stability of the euro zone, especially in a situation of low inflation or even deflation. Rising government interest costs would push up budget deficits and already high public debts. In the banking system, lending would be hampered by losses in bond portfolios. This autumn, the Fed has also expressed concern about the negative impact on growth of tightening financial conditions. It is thus in the interest of central banks to achieve a **controlled yield trend compatible with the underlying strength of the recovery**.

US-German 10-year yield gap at high levels

Per cent

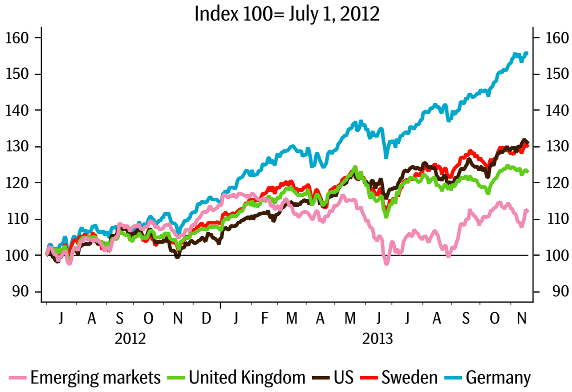


Source: Macrobond

In our assessment, there are also good prospects for a continued low interest rate environment in the next couple of years. Long-term yields will be pushed down by central bank stimulus measures, in the form of expanding balance sheets and continued zero interest rate policies. In addition, macroprudential supervision policies will be implemented and the low inflation environment will persist. But as global economic activity increases, **we expect yields on 10-year German and US government securities to rise moderately**; at the end of 2014, a German 10-year bond will have a yield of 2.10 per cent and at the end of 2015 2.50 per cent. Its American counterpart will yield 3.30 and 3.50 per cent, respectively, on these dates. We believe that a gradual tapering of the Fed's monthly bond purchases will have a moderate effect on the yield trend after a period of adjustment and transition. During the spring, we expect the ECB's quantitative easing policy to push down European yields and narrow the spreads between euro zone countries. The euro zone's QE policy will mean that the yield gap between the US and Germany will widen during 2014, amounting to 120 basis points at year-end. During 2015 we expect the spread to approach 100 basis points.

Stock market indices

Index 100= July 1, 2012



Source: Macrobond, SEB

Still room for rising share prices

Several stock market indices have reached **new record levels** this autumn, supported by further monetary stimulus in the US, Japan, Europe and elsewhere. The MSCI World Index has risen by 23 per cent so far during 2013. Financial market risk appetite has been sustained by a continued stable recovery in the US and cautiously positive signs that economic growth has bottomed out in the euro zone's crisis countries. The volatility of emerging market stock exchanges during the summer and autumn, the upturn in long-term yields since May and the US budget conflict have had little negative impact on the global stock market climate. But overall third quarter company earnings quarter **did not really live up to expectations**. This lowered the market's earnings forecasts in the short term, but the focus has shifted to hopes of a clear earnings improvement in 2014 and 2015.

We are maintaining the same **view of equities** that we have expressed in recent issues of *Nordic Outlook*: **cautiously positive during the coming year**. The US economy will continue to strengthen, despite expected Congressional budget conflicts during the coming months. American economic growth is important to global risk appetite. The situation of emerging market economies will stabilise, while global monetary stimulus will reach new record levels in the coming year. The Fed's tapering of its bond purchases during 2014 will have a negative short-term effect on the stock market, but this trend will be reversed by more positive economic signals. Good dividend yields and

Tax hikes as policy tools

Since the breakthrough of supply side economics in the 1980s, economic policy debate has been dominated by the question of how to design suitable tax cuts. In recent years, however, partly due to government fiscal crises, combined with widening income and wealth gaps, tax hikes have begun to be discussed to a greater extent. For example, the International Monetary Fund's latest *Fiscal Monitor* uses the heading "Taxing Times". One main question concerns whether taxes can be increased and be made more efficient and fair. In some countries, the advantages of tax hikes probably outweigh the disadvantages, such as reducing the incentive to work. Among other things, the IMF makes a comparison of the potential for boosting tax revenues in various countries, given their current tax structure, demography and several other parameters. Among OECD countries, Japan tops this list, with a gap between actual and potential tax revenue totalling 17.8 per cent of GDP. Next on the list are Switzerland (9.5), South Korea (7.4) and the US (6.1).

Room for tax hikes is being discussed both when it comes to indirect taxes (value-added tax etc.) and direct taxes on income and assets. In Japan, for example, raising the consumption tax is the easiest way of boosting tax revenue without causing major long-term damage to the economy. Because of wider income and wealth gaps, the IMF is also examining various ways of taxing high incomes and large fortunes. In the US, for example, the richest 10 per cent of households own a full 75 per cent of total wealth. Wealth taxes have normally been levied as annual fees, but a one-time levy on wealth is an alternative. Historically, such levies have been used surprisingly often, for example in various countries after the First World War, and in Japan and Germany after the Second World War. IMF calculations indicate that a one-time levy equivalent to 10 per cent of wealth would bring down central government debt to pre-crisis levels in the euro zone. As for income taxes, various studies indicate that a maximum marginal tax of 60 per cent maximises total revenue.

Although there are clear risks, both cyclical and structural, in pursuing a strategy of tax hikes, we should be aware that taxation policy is also entering a period when measures perceived as unconventional in recent decades will be under public discussion. In countries like the Nordics, with low government debt and relatively narrow income and wealth gaps, the need for such measures is naturally smaller. This may help strengthen the international competitiveness of these countries, in a climate where fiscally weaker countries are forced to hike taxes.

Distribution of wealth

Wealth held by different population categories
As a percentage of total wealth

	Top 10%	Bottom 50%
United States	74	1
France	61	4
Germany	57	1
Canada	51	5
Italy	49	12
Spain	48	12
United Kingdom	47	9
Japan	42	15

Source: IMF

One alternative strategy for reducing imbalances between assets and liabilities is to let inflation rise to such high levels that the real interest rate becomes clearly negative. Japan's new economic policy (Abenomics) has a clear target of keeping interest rates down while pushing up pay and inflation. One consequence of this is that the assets of pension funds are undermined. Other countries, including the US, may possibly adopt a similar strategy. The inflation strategy, too, is associated with major risks. But because the unconventional monetary policy pursued to date has contributed to rising asset prices, thereby widening wealth gaps, the possible use of other unconventional tools will be debated increasingly often.

the fear of negative returns in fixed income portfolios will also help create a positive stock market trend. The moderate yield upturn we predict is compatible with cautiously rising share prices. The **risks** to the stock market are, above all, connected to an **absence of improved company profitability** in fourth quarter 2013 and first quarter 2014 interim reports.

Key interest rates will drive the FX market

Central bank monetary policies continue to be among the most important driving forces for major currencies. The US dollar has been squeezed by signals that the Fed will delay phasing out its QE policy. This factor is in addition to the long-term trend in which the dollar is gradually losing its role as a global reserve currency. However, the Fed is expected to hike its key interest rate before the ECB and to start tapering its bond purchases this spring. The euro zone is still struggling with economic, financial and political problems. Another part of the picture is that the ECB will launch its QE policy, which will push down the euro. We are maintaining our scenario from the last *Nordic Outlook*: the **EUR/USD exchange rate will be 1.25 at the end of 2014 and 1.20 at the end of 2015**.

The yen will continue to weaken. **At the end of 2014, the USD/JPY exchange rate will stand at 110; at the end of 2015, 115**. In the short term, the yen will be pushed down by the Bank of Japan's aggressive monetary policy and its target of doubling the monetary base in a two-year period. Further ahead, the yen will be weakened by continued major structural challenges and questions about the ability of Abenomics to achieve results with its reform policies.

The Swedish krona and the Norwegian krone have weakened because Nordic central banks have been forced to soften their monetary policy. Our forecast that the Riksbank will low its key rate in December, while postponing its first rate hike, has meant that the krona is weaker than we forecasted in August. We now expect the EUR/SEK exchange rate to be at 9.00 at the end of 2013 and then the krona strengthens to **8.50 at the end of 2014 and 8.25 at the end of 2015**. The USD/SEK rate will be 6.80 at the end of 2014 and 6.90 at the end of 2015. **The EUR/NOK rate will be 8.00 at the end of 2014 and 7.90 at the end of 2015**.

Theme: Time for the ECB to launch traditional QE

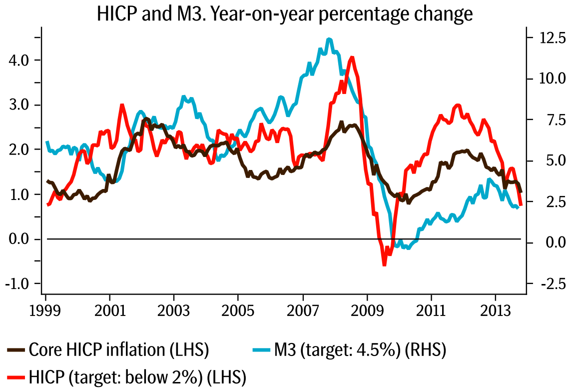
- **QE is needed when deflation risks are rising**
- **Even a defiant Germany can provide support, but approving QE is controversial**
- **Aim of LTRO loans is to secure financing for banks; ECB dislikes negative interest rates**

Because of mounting deflationary tendencies in the euro zone – driven by cyclical and structural forces – and continued credit market fragmentation, this spring we expect the European Central Bank to re-start its Securities Market Programme (SMP: see the box below). **The aim of large-scale securities purchases** – and thus a quantitative easing (QE) policy more similar to those being pursued in the US, Japan and the UK – is:

- To "lift away" assets from a financial system squeezed by recession and stressed by new regulations/requirements, facilitating **increased lending** to the private sector.
- To reduce risks of **deflation expectations, and deflation**.
- **To decouple** European monetary policy and interest rate developments from those in the US and reduce the risk of euro interest rates/yields incompatible with the economic situation.

Euro zone: Low inflation and money supply growth

HICP and M3. Year-on-year percentage change



Source: Macrobond

An EU treaty states that the *"the primary objective of the (ECB system) shall be to maintain price stability"*. This objective has been quantified: Annual medium-term euro zone inflation according to the **Harmonised Index of Consumer Prices (HICP)** shall be less than but **close to 2 per cent**. To achieve this target, aside from the refi rate, the ECB can utilise unconventional tools: *unlimited long-term loans to banks at fixed interest rates, varying collateral requirements for loans from the ECB* and *secondary market purchases of various securities, including government securities.*

The ECB's Securities Markets Programme

On May 10, 2010 the ECB decided to begin buying public and private securities (intervene) in the secondary market. Its objective was "to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism". The SMP was an outgrowth of two programmes, launched in the summer of 2009 and in November 2011, aimed at supporting the European covered bond market. Today the ECB's total covered bond holdings under these two programmes is EUR 57.5 billion. The SMP ended in September 2012 and was replaced by the Outright Monetary Transaction (OMT) programme. Securities purchased under SMP have been sterilised; this means that the increase in liquidity that arose due to the purchases has been withdrawn through various market operations. The SMP bond portfolio totals EUR 184 billion today.

One key difference between the securities purchases made so far by the ECB and the balance sheet policies of other central banks is that the ECB views interventions as a **supplement, not a substitute** for conventional interest rate policy. Its main objective has been to improve the monetary policy transmission mechanism, underscored both by the relatively short maturity of the securities and the neutralisation of the liquidity that arose, by means of other market operations. Thus the **ECB's securities purchases have not aimed at achieving more monetary stimulus**.

Has the zero lower bound been reached?

To initiate a traditional QE policy, the ECB must therefore believe that the **zero lower bound on interest rates has been reached** and that further monetary stimulus is needed in order for the ECB to achieve its price stability objective. To make this step appear credible, the ECB may need to a) establish a **size target** for securities purchases, mainly government securities but perhaps also mortgage-backed bonds, b) work with longer **maturities** than three years and c) not withdraw **liquidity** (sterilise interventions).

Percentages, 2013 capital key

Country		Country	
Germany	27.1	Finland	1.8
France	20.4	Ireland	1.6
Italy	17.9	Slovakia	0.8
Spain	11.9	Slovenia	0.4
Netherlands	5.7	Luxembourg	0.3
Belgium	3.5	Cyprus	0.2
Greece	2.8	Estonia	0.2
Austria	2.8	Malta	0.1
Portugal	2.5	**Totalt**	**100.0**

Source: ESM

To underscore that its QE policy and government securities market interventions are not aimed at financing fiscal deficits, but are a way for the ECB to fulfil its mandate, purchases are expected to be **"GDP-weighted"**. Securities purchases thus apply the ECB's "capital key" and include 27 per cent German, 20 per cent French and 18 per cent Italian bonds plus government securities from 14 other countries.

One criticism of this method of carrying out interventions is that a country like Germany hardly needs help in holding down its long-term yields. For countries like Italy, Spain and Portugal, however, higher US yields and their impact on the global bond market may a) jeopardise **fiscal consolidation programmes** in euro zone countries and b) lower the value of the banking system's bond portfolios, thereby reducing the **lending capacity** of the banks.

Yields in crisis-hit countries also benefit

Although Germany and France would account for the largest absolute interventions, all euro zone countries would benefit. Assuming stable or falling German yields – and constant credit spreads against countries like Greece and Portugal – absolute yields would also be pushed down in crisis countries. Credit spreads between euro zone countries could probably be narrowed, thus benefiting the Greek and Portuguese governments relatively more than the German government.

A decision to initiate a more vigorous QE policy would be **controversial**. Germany's Bundesbank has indicated its clear dissatisfaction with implementation of bond purchases under the OMT programme, arguing that it would **erase the boundary** between fiscal and monetary policies and, in the long run, make it harder for the ECB to achieve its price stability objective. It would also increase the risk of moral hazard. This criticism is justified – under normal circumstances. But the **new German government**, including Social Democrats, may have a more favourable attitude than the German central bank. In exchange for supporting such action, Germany is likely to demand **contracts between the euro zone countries** mandating the implementation of structural reforms. Germany's support is also likely to increase if Berlin foresees a worsening of the deflation problem and believes that it may actually **jeopardise the ECB's price stability objective**.

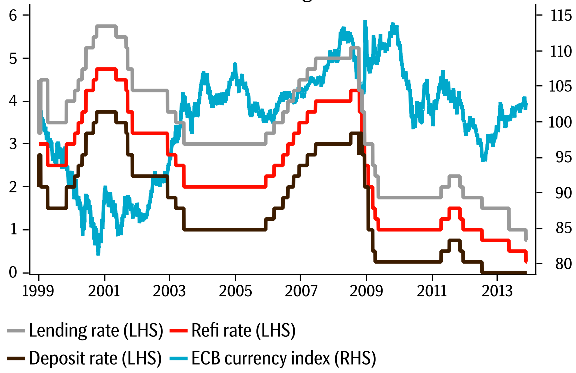
Negative interest and LTRO are alternatives

Negative deposit interest rates and new **LTRO loans** are other tools discussed to help the euro zone restore economic and financial stability. Negative deposit rates have cropped up repeatedly in ECB communications. Our interpretation is that this "threat" has been aimed at pushing Euro Overnight Index Average (EONIA) market interest rates as close to zero as possible; during 2013 the overnight rate has remained stable at below 0.1 per cent.

But negative deposit rates would risk creating a worse-functioning interbank market. In addition, **hopes of increased lending are incorrect**. One argument is that if it becomes more costly for the banking system to deposit money with the ECB, lending to the private sector (households and businesses) would increase. But lending to still highly indebted businesses in southern Europe is associated with significant credit risks. For the banks, it is safer – and probably cheaper – to pay to deposit money in the ECB even though it weakens banking systems. **Negative interest rates will thus probably remain a verbal tool in the ECB's arsenal**.

Euro zone: Squeezed interest rates, strong euro

EC refi rate, corridor and exchange rate index. Per cent/Index



Source: Macrobond

We continue to believe that **the ECB will announce a new round of long-term (LTRO) lending** within the next few months. The main reason is to secure long-term financing for banks and replace LTRO loans that fall due in about one year (December-February) and have not been repaid early. Offering new long-term LTRO loans at near-zero interest rates is aimed at:

a) reducing the risk that the liquidity problems of banks will become solvency problems, especially during a period when the banks will be stress-tested and the quality of their balance sheet assets will be reviewed;

b) preventing banks, which have been encouraged to some extent by governments to borrow money to buy the government bonds of crisis-hit countries, from now being forced to sell these bonds (with the consequent upward effect on yields).

The LTRO loans may also emulate features of the UK's **"funding for lending"** scheme. In other words, those banks borrowing from the ECB will have to verify an underlying demand, for example from small and medium-sized enterprises. Maturities may then need to be extended. Another assumption must be that the liquidity problems of the banking system are limited and that there is a desire by the banks – and regulators – to let their balance sheets grow. At present, it does not appear as if borrowing needs can be covered by such institutions as the European Investment Bank (EIB) or national investment funds.

ECB needs creativity and a mix of tools

Our forecasts indicate that euro zone **deflation risks will intensify** during the coming year and that the ECB has now reached its zero lower bound for conventional monetary policy. Launching **new LTRO loans** will ensure liquidity at banks during a difficult period but is not expected to provide the decoupling of US and European long-term yield trends that may be needed. We thus expect **traditional QE policy to be implemented during the spring**. This step is expected to mean that German/European yields can be decoupled from the risk of rising US yields. We thus expect German 10-year sovereign bonds to trade in a relatively stable way during 2014, which means that the **yield spread against the US will widen to 130 basis points in 2014 and then shrink in 2015**. We expect German 10-year yield to be 2.50 per cent and its US equivalent to be 3.50 per cent at the end of 2015.

Clearer sailing as fiscal headwind diminishes

- **Consumption will shift to higher gear**
- **Temporary housing market dip**
- **Mounting uncertainty about supply side**
- **Fed may lower unemployment threshold**

Just as conditions for a clear recovery began falling in place, a fiscal policy conflict again derailed the US growth juggernaut, though we believe that its impact will be small and transitory. But uncertainty has increased, both regarding the chances of future political agreement and – in the short term – the reliability of economic statistics. We are nevertheless sticking to our forecast that the economy will take off after New Year and that **GDP will grow by 3.3 per cent in 2014 and by 3.7 per cent in 2015, still well above consensus**. The fiscal headwind will diminish from 1.7 per cent of GDP this year to 0.5 per cent in 2014, contributing to the surge. Another reason is our assessment that household deleveraging has now ended.

This forecast assumes that a budget will be adopted as planned and that the US debt ceiling will be raised early next year. The Federal Reserve will keep an eye on fiscal policy events and not taper its bond purchases until March 2014, even though unemployment continues to fall. CPI inflation will remain low, averaging 1.7 per cent year-on-year in 2014-2015, but questions about the resource situation and the supply side of the economy will pose some inflation risks ahead.

Consumption shifting to higher gear in 2014

Despite this year's massive tax hikes and public expenditure cuts, private consumption has continued to increase by around 2 per cent year-on-year, which signals underlying strength. This autumn's Congressional budget conflict helped push down confidence indicators. According to the University of Michigan's October reading, consumer confidence fell to a 10-month low. But the correlation between confidence indicators and consumption has weakened in recent years. We believe the real economic effects of the partial government shutdown were small. **Looking ahead to 2014, we see several reasons for optimism about consumption**. The labour market is improving, especially for the well-educated. Hourly and weekly wages are steadily rising. Combined with rising share prices, household net wealth has reached new peaks in absolute terms. **Household consumption growth will average 1.9, 2.7 and 3.1 per cent, respectively, in 2013-2015**.

Temporary housing market dip

Rising mortgage interest rates have helped fuel greater uncertainty about the housing market situation. Between May and September, interest on 30-year mortgage loans climbed by 120 basis points, but it has since dropped by 20 points in response to the Fed's delay in tapering its bond purchases. Mortgage loan applications, new home sales and housing starts are well below earlier peaks, signalling slower growth in residential investments ahead.

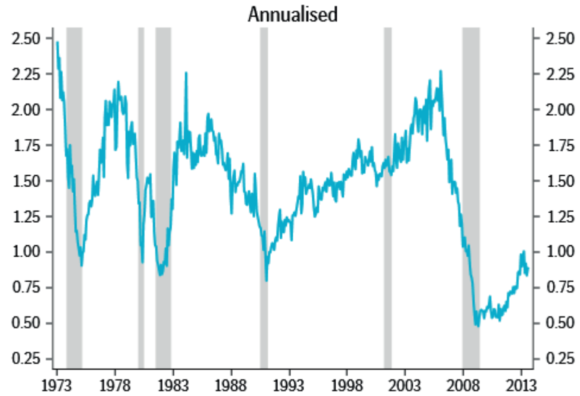
Meanwhile underlying demographic trends point towards a continued need for residential investments. The number of households increases yearly by an average of 1.3 million, while 300,000 homes are demolished. The oversupply of homes will quickly shrink, promising good investment conditions. Construction sector confidence remains at high levels. Home prices are also continuing upward; the **Case-Shiller 20-City Index** is currently rising at 13 per cent year-on-year but will decelerate to an **8 per cent upturn in 2014 and 6 per cent in 2015**. Residential investment will continue to increase rapidly, although there will be a slight downshift from this year's 14.5 per cent growth to an average of 12 per cent in 2014-2015.

Housing starts as an economic indicator

Housing starts are currently well below their peak in March 2013. Other housing market indicators are also below earlier peak readings. Since the housing market is one of the most cyclical sectors of the economy and an important transmission mechanism for monetary policy, this trend has led to some concerns about the economy. But our assessment is that **the dip will be temporary and new peaks will be achieved in 2014**. Aside from the double recession of the early 1980s, the peak in housing starts has not dropped below 1.8 million in the past 40 years. Current levels in the 0.9 million range thus indicate significant upside potential. Since the 1970s, **the economic upturn has also continued for 2-3 years after the beginning of a housing market decline**.

Housing starts: Room to grow

Annualised

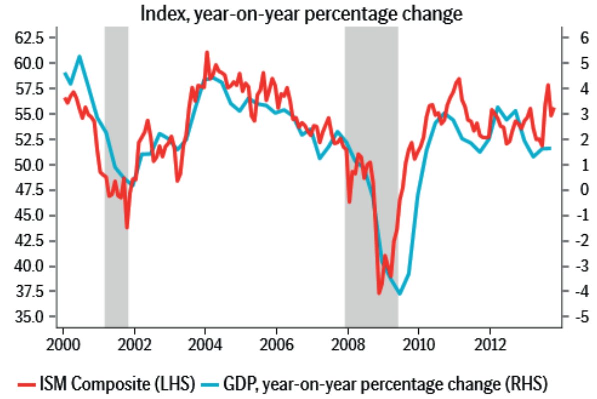


Source: Macrobond, SEB

Corporate capital spending will also add to the growth trend over the next couple of years. Despite the budget conflict, confidence indicators for large companies rose in October. **Our composite ISM index is compatible with 3-3.5 per cent GDP growth**. During 2013, small business confidence has also risen, but it remains at historically low levels.

ISMs suggest above 3 per cent GDP growth

Index, year-on-year percentage change



Source: ISM, BEA, SEB

Uncertainty about the fiscal playing field, among other things connected to President Barack Obama's health care reform, has nevertheless held back business hiring and investment decisions. But now that the health care reform has been launched, uncertainty will ease and there is good potential for a capital spending rebound. **Corporate earnings are high and the order situation is decent**. Technological advances in such fields as oil and gas extraction will give US manufacturers competitive advantages. Overall, **corporate capital spending will grow by an annual average of 11 per cent in 2014 and 2015**. Although export growth will double compared to 2013 – exports will increase by an average of 5.5 per cent in the next couple of years – foreign trade will still contribute negatively to growth in 2014-2015. The current account deficit will grow from 2.5 per cent of GDP this year to 3 per cent in 2015.

Unemployment will fall towards equilibrium

So far this year, employment increases have averaged 186,000 per month, essentially unchanged from 2011 and 2012. Because the fiscal headwind in 2013 was the third most severe on record, the underlying resilience of the labour market is impressive. We expect job growth to average 200,000 per month in 2014 and 220,000 in 2015. The reason why it will not be even stronger is that after slowing sharply during the past year, productivity growth will again accelerate.

Unemployment was 7.3 per cent in October and will continue to fall, according to our forecasts. By the end of 2015 it will be 5.8 per cent, which is close to equilibrium unemployment. In some areas, there are already reports of difficulties in recruiting qualified staff, and the trend of average wages and salaries will continue upward in the next couple of years.

Low inflation in the next couple of years too

Unlike the euro zone, for example, the US inflation picture is complex and there are factors that point to certain inflation risks in the long term. For example, the NFIB small business survey shows that both hiring plans and pay levels are on their way up. Historically, the **correlation between unit labour costs and inflation is more than 80 per cent**. Stagnating productivity growth means that even moderate pay increases show up as higher unit labour costs. Despite the build-up of money in the system, inflation has not yet taken off because the money supply multiplier is falling. But when **household debt increases once again, this should help speed up the velocity of money**. The Fed's monetary policies may also influence inflation in the long term via inflation expectations, although the aggressive monetary easing of the past four years has so far not affected the expectations picture.

According to established theory, however, inflation will fall as long as there is slack in the economy. When idle resources shrink, inflation continues to fall, but at a slower pace. Although we can raise various questions about the supply side (see the box below), it is possible to single out a number of measures that support our main conclusion that there are still plenty of idle resources in the labour market. In manufacturing, capacity utilisation is well below the historical average. Looking at the overall economy, the **output gap is sharply negative**.

Focus on labour force participation

Labour force participation peaked in 2000 at 67.3 per cent and stood at 65.4 per cent when the economic upturn officially began in the summer of 2009. **Contrary to economic theory, labour force participation has continued to fall during the recovery**, reaching levels most recently seen in the day of President Jimmy Carter in the late 1970s. The effect of this development on joblessness is significant; if labour force participation had remained at 65.4 per cent, unemployment would be at 9.9 per cent instead of today's level of 7.3 per cent.

There may be several reasons behind this decline. Reduced incentives to work are often highlighted in public discourse. A combination of housing subsidies, food stamps and health care benefits may exceed the minimum wage in some states. However, a study by the Boston Fed shows that a full 60 per cent of the decline in labour force participation in the past five years can be explained by structural factors, such as demography. Overall, this indicates that the quantity of idle resources in the labour market is perhaps not as large as official forecasts seem to show and that rising wages and prices are lurking in the future.

Okun's Law on the relationship between growth and unemployment also points to problems on the supply side of the economy. Historically, there has been a strong correlation between GDP growth and unemployment. According to Okun's Law, GDP growth of one percentage point above trend results in half a percentage point lower unemployment, and vice versa. Viewed over the past year, unemployment has fallen by 0.8 percentage points despite GDP growth of 1.6 per cent. This trend raises a warning flag and indicates **weakening in the supply side and lower potential economic growth**.

Against this backdrop, **most measures of inflation have fallen in the past two years**. In our assessment, this low-inflation environment will continue. **CPI inflation will end up at 1.3 per cent in 2014 and 2.0 per cent in 2015**.

Less fiscal austerity in 2014

This year's **fiscal headwind, 1.7 per cent of GDP**, was among the most powerful of the post-war period. Assuming that the broad federal expenditure cuts that took effect last spring (the "sequester") will continue to unfold as planned, **the tightening effect will be 0.5 per cent of GDP in 2014**. If anything, the tightening effect may be somewhat smaller if Congress decides to keep expenditures at their 2013 level. Under the current law, expenditure cuts will have a larger impact on defence in 2014. This increases the probability of a new agreement that will decrease the dose of federal austerity. In 2015 we assume that fiscal policy will be relatively neutral. Given our assumptions concerning the economy and fiscal policy, the **budget deficit will continue to shrink**. In 2015 it will be down to 3.9 per cent of GDP, compared to a peak of 12.9 per cent in 2009.

Looking ahead, the calendar is full of fiscal policy deadlines. The newly created Congressional joint budget committee has until **December 13** to present a budget proposal, but the likelihood that it will achieve this goal looked small initially – if the committee fails, the only thing at risk is its reputation. But according to recent reports, the budget negotiations are making progress, thus increasing the likelihood of a deal. When Congress returns from its Christmas break on **January 7**, it will have just over one week to negotiate a new budget agreement. This is because the temporary budget solution that re-opened federal operations in mid-October expires on **January 15**. On the same date, the next stage of the sequester takes effect, which means that the expenditure level will be lowered from USD 986 billion to 967 billion. Depending on the influx of tax revenue, it is unclear when the next debt ceiling agreement will have to be in place, but **mid-March** seems like the most reasonable answer. The official deadline for raising the debt ceiling, however, is **February 7**.

Fed may lower its unemployment threshold

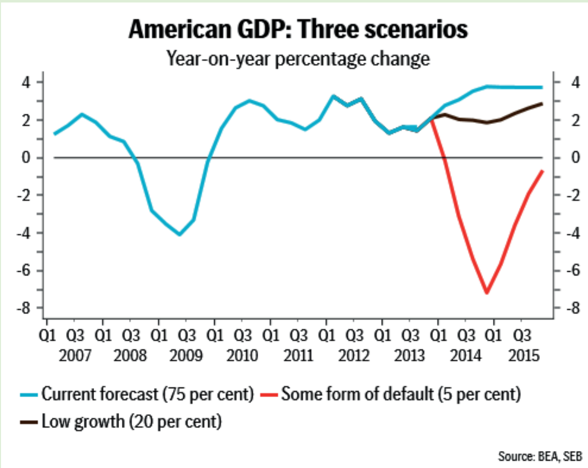
Although unemployment has fallen to just above 7 per cent, the Fed is continuing to use the same type of monetary policy as four years ago, when the jobless rate hit 10 per cent. A monetary policy adapted to an economy in crisis indicates that the target function of the central bank has changed and that **the Fed** – aside from monitoring unemployment and inflation – **wants to bring about a rebound in labour force participation**. In order to cut back its bond purchases, a decline in unemployment is thus probably not enough; labour force participation must begin to climb too. Our assessment is that these conditions will be in place early next year and that the **Fed will reduce its bond purchases starting at its meeting in March**. By that time, employment will also be growing by more than 200,000 people per month, according to our forecast. By the end of 2014, we expect the Fed's bond purchasing programme to be phased out.

To decrease the risk of a sharp upturn in interest rates and yields due to tapering, we believe that **the Fed will lower its threshold for the beginning of key interest rate hikes from an unemployment level of 6.5 to 6 per cent**. At a recent IMF conference, leading Federal Open Market Committee (FOMC) economists advocated such action, which strengthens our conviction that such a change is under way. They also indicated that the positive effects would be greatest if the threshold were lowered to 5.5 per cent, but this is not our forecast at present. The most logical date for lowering the unemployment threshold is when tapering is announced – in March, according to our forecast – but the decision may come earlier than this. We foresee that **the federal funds rate will be raised for the first time in the fourth quarter of 2015**, shortly after unemployment has fallen below 6 per cent. By the end of 2015 we expect a key interest rate of 0.75 per cent. The installation of **Janet Yellen** as the new Fed chairman will not do much to change the direction of monetary policy, in our view.

Fiscal policy creating downside risks

While we see good reasons to stick to our positive growth scenario – a GDP forecast 6-7 tenths of a percentage point above consensus for both 2014 and 2015 – economic performance may prove worse than this. One possibility is that GDP will continue growing at around 2-2.5 per cent in 2014-2015: at the same pace as in 2010-2013. A significantly stronger fiscal headwind than estimated, a sharper upturn in interest rates and yields due to tapering and/or stagnating home prices could lead to such a scenario. We estimate the probability of such a "low growth scenario" at 20 per cent.

Meanwhile there is a small risk (5 per cent) that a political stalemate and subsequent trench warfare could cause the economy to seize up, most likely at the time of the debt ceiling decision next spring. If, for example, the US government is forced to balance its budget with immediate effect, this could lead to a GDP decline of 4 per cent in 2014 and 3 per cent in 2015.



New economic policy is boosting growth

- **Temporary tax-driven slowdown in 2014**
- **Labour market will provide resilience**
- **Deflationary spiral is finally being ended**

The economic policy (Abenomics) launched late in 2012 by new Prime Minister Shinzo Abe led to a flying start for the Japanese economy, which grew at an annualised 4.1 per cent rate in the first half. We believe that the deceleration in the third quarter was temporary; growth will be higher both in this quarter and the next as households speed up their purchases before the consumption tax hike in April 2014. **GDP will grow by 1.7 per cent in 2014 and 1.3 per cent in 2015, according to our forecasts**, a bit above consensus for both years. The tax hike and exceptionally loose monetary policy will boost inflation, **ending the deflationary spiral**. **Unemployment will fall** to an annual average of 3.6 per cent in 2015.

Consumer confidence has recently weakened, perhaps reflecting official approval of the 3 percentage point tax hike in April. This tax hike will have **clear negative effects on consumption and GDP** in the second quarter of 2014. But thanks to new offsetting tax cuts and higher public expenditures, the recovery will not come to a halt. The stock market has also climbed 60 per cent in one year and the **labour market has shown resilience**. Unemployment fell to 4 per cent in September and job creation is robust. Car sales rose by no less than 17 per cent year-on-year in October, indicating that consumption will close this year strongly. As an annual average, consumption will increase by 1.8 per cent in 2013. **Next year, consumption growth will decelerate to 1.3 per cent and in 2015 to 1.1 per cent**, according to our forecasts.

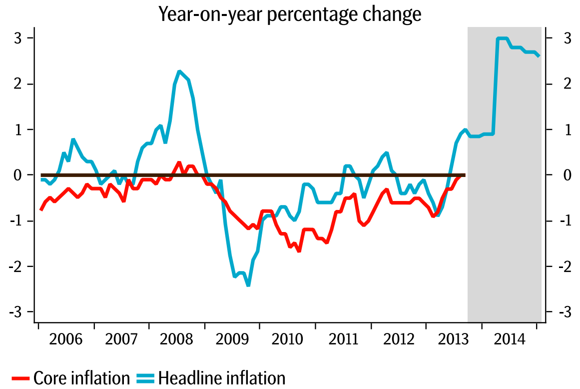
Business indicators exude optimism. Machinery orders are showing a clear recovery trend and the purchasing managers' index in manufacturing hit a three-year high earlier this autumn. In September, the Bank of Japan's quarterly Tankan survey showed across-the-board improvements compared to the June report, especially among big manufacturing companies. **Last year's sharp yen depreciation** is helping exporters; real exports have risen by 9 per cent so far on an annualised basis. Although the yen has strengthened slightly against both the euro and the US dollar since last spring, we believe that **exports will increase by an average of 6 per cent yearly in 2014-2015**, helping foreign trade contribute positively to growth over the next couple of years.

The government's stimulus program will lead to a continued rise in public sector consumption and investments, albeit at a significantly slower pace than in 2013, when public sector consumption is showing double digit growth. Larger appropriations for reconstruction work after the 2011 natural disaster and new investments to mitigate the effects of future natural disasters will provide economic stimulus. These investments are needed; reports claim that another earthquake in the Fukushima area might have catastrophic consequences.

Meanwhile the Bank of Japan is buying government securities at a rapid pace – we expect sovereign bond purchases of JPY 50 trillion per year, or about 10 per cent of GDP – with a target of **doubling the monetary base** between the end of 2012 and the end of 2014. The monetary base is now growing by more than 45 per cent on an annualised basis. Viewed since 2009, the increase is in line with that of the US. The aim is to drive up inflation to 2 per cent in a two-year period. Inflation, already at a five-year high, will rise sharply in 2014 as the tax hike takes effect. **Inflation will be only 0.3 per cent this year, but 2.4 per cent in 2014 and 1.7 per cent in 2015**. The trend of core inflation and inflation expectations – both break-even inflation and household inflation expectations – is pointing upward. Low unemployment will help fuel positive wage and salary inflation, which will keep inflation up as nonrecurring effects fade.

Sales tax lifting inflation

Year-on-year percentage change



Source: Macrobond, SEB

Ending the long deflationary spiral will resolve a core problem in the economy. Japan can thus hope to stabilise its **government gross debt, which will peak at just above 240 per cent of GDP** in 2015, the highest level ever recorded for an OECD country. An ageing population with rising health care expenses and lower total production capacity will challenge government finances, however. The country thus requires structural reforms to boost labour market participation by women. **The budget deficit**, which will exceed 10 per cent of GDP this year, **will shrink to 6 per cent of GDP in 2015**.

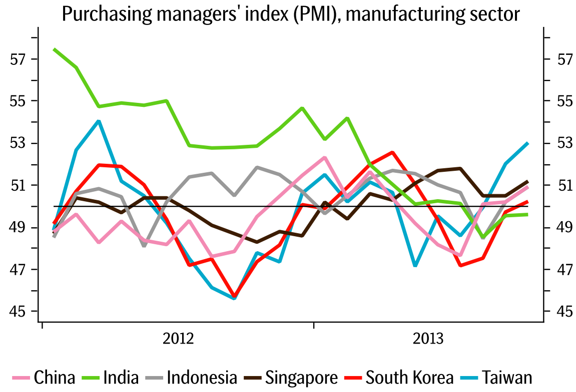
Nascent signs of a rebound in economic growth

- **Gradual acceleration in the region's growth**
- **...but structural slowdown likely in China**
- **Financial market stabilisation in India but weak growth**

Uncertainty about the US Federal Reserve's exit policy had a major impact on financial markets in emerging Asia last spring and summer, but the storm has faded, at least temporarily. In the region as a whole, there are also signs that growth is now gradually accelerating again. Purchasing managers' indices have improved this autumn, accompanied by signs that exports are beginning to take off. **We expect growth in the region to gradually climb towards trend in 2014 and 2015.** Rising external demand will provide support, while domestic demand will keep improving thanks to strong labour markets, orderly government finances and low inflation pressure, enabling most countries to continue expansionary monetary policies.

Asia: Increasing activity

Purchasing managers' index (PMI), manufacturing sector



Source: Markit

But as usual, divergences are wide. China has not been significantly affected by financial market turmoil, but its growth is gradually slowing. India and Indonesia, in contrast, have been hard hit by market instability. Both economies are also hampered by severe structural weaknesses. Indonesia, like India, suffers from a large-scale current account deficit and uncertainty in the run-up to next year's election. The growth rate has fallen five quarters in a row. This is expected to continue in 2014.

China: Continued slowdown expected after temporary acceleration

In the third quarter, year-on-year GDP growth accelerated slightly to 7.8 per cent. We thus expect China to achieve its growth target of at least 7.5 per cent in 2013. Much of the recent increase in economic activity has been driven by government infrastructure investments. It is unlikely that the authorities once again want a situation where growth is driven by large-scale stimulus measures. There are already signs that infrastructure investments are starting to shrink. Their stimulus effect will thus be temporary. A desire to decelerate credit growth, combined with the transition to a new growth model, will cause a gradual slowing in economic activity during 2014 and 2015. **We expect China's GDP growth to be 7.7 per cent in 2013 and 7.4 per cent in 2014. In 2015, growth will decelerate to 7.0 per cent.** One upside risk is that the global economic improvement will have a major impact on exports.

The Third Plenum: A platform for China's reform efforts

China faces various challenges and structural problems, such as an outdated growth model, heavy government influence on the economy and rapidly worsening demography. These problems will not solve themselves, but will require proactive reform efforts. The Third Plenum of the Chinese Communist Party Central Committee, which ended on November 12, is vital to these reform efforts. The plenum serves as a **platform where China's leaders present guidelines for reform efforts over the next several years** and is therefore of major importance to China's economic development.

It is still **too early to draw any certain conclusions about the policy implications of the Plenum**; more details of how its reforms will be implemented will be unveiled later. One striking formulation in the post-Plenum communiqué, however, is that the market must play a "decisive role" in resource allocation, in contrast to the earlier formulation of a "basic role". This is a clear **signal of continued extensive reforms towards a market economy**. Major positive effects could be achieved through a thorough reform of state-owned enterprises, but these companies themselves oppose change and the Plenum provided few indications of a desire for reforms in this area. In various other areas, especially financial sector reform but also the issue of the right to own farmland, reform efforts are expected to move faster. **A continued steady pace of reforms is essential in achieving a gentle deceleration of growth** and avoiding a serious crisis.

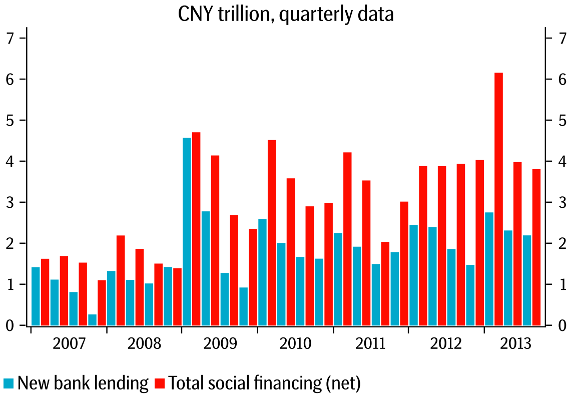
The purchasing managers' index in manufacturing has improved; this applies both to China's official index and the one compiled by HSBC/Markit. Both indices have remained above the 50 mark since August, and in October the official index was at its highest since April 2012. Retail sales and industrial production continue to chug along, while construction sector activity is stabilising, but exports have lost momentum. Monthly trade figures are volatile, but so far during 2013 export growth is below 10 per cent: a striking deceleration compared to 2011 and 2012. Import growth is also subdued.

Inflation has recently accelerated. In October it was 3.2 per cent. Aside from a temporary seasonal peak in February, this was the highest rate since April 2012. The upturn is largely explained by rising food prices. Now that vegetable and pork prices are easing, inflation is expected to level out. The general picture of low inflation pressure persists; core inflation has remained below 2 per cent since late 2011. Low inflation pressure is expected to continue in 2014 and 2015, thanks to slower growth in both the economy and lending. **We expect full-year 2013 inflation of 2.7 per cent, a 3.1 per cent rate in 2014 and 3.2 per cent in 2015.**

The key interest rate has been unchanged since it was lowered in July 2012. We believe it **will remain at 6.0 per cent until the second quarter of 2014**, when we expect **a 25 basis point hike** followed by **another hike in the third quarter**. The role of the key rate has diminished, though, since the most important monetary policy tool of the People's Bank of China (PBoC) is the repo transactions it uses to control liquidity in the financial system. Since a widespread liquidity shortage arose in the banking system in June, interbank rates have remained high, but this upturn has not impacted yields on corporate bonds, thus not affecting the real economy to any great extent. One important aspect is that the **liquidity shortage in June was created by the PBoC** in order to discipline market players. The currency reserve rose rapidly in the third quarter, indicating positive net capital inflows. In practice, there is thus no liquidity shortage. The central bank's action seems to have had some effect. **Credit growth** (using the broadest measure, "total social financing") **has continued to decelerate slowly**, but in October this deceleration was sharper than expected. Yet the increase is not unsustainably high, and the PBoC will continue to keep liquidity down.

Some deceleration in credit growth

CNY trillion, quarterly data



Source: People's Bank of China

Unlike many other Asian currencies, the yuan has not been affected by worries about Fed exit policy, but has instead strengthened slightly since last spring. **At end-2014, the USD/CNY rate will be at 5.90 and by end-2015 at 5.85.**

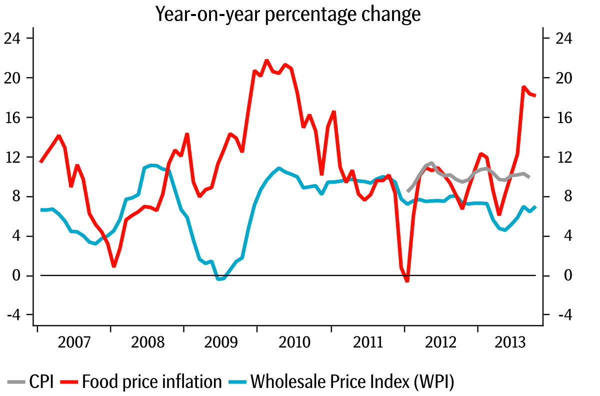
India: Financial market stabilisation but weak economic growth

This autumn the financial market turbulence connected to the tapering of the Fed's quantitative easing partly faded. The structural problems in the economy remain, however, and are reflected in weak growth; in the second quarter, GDP rose by 4.4 per cent year-on-year, a slowdown compared to 4.8 per cent the preceding quarter. The slowdown was broad-based, but the manufacturing sector showed especially weak performance. The purchasing managers' index remains below the 50 mark, but there are **some bright spots. Exports** have taken off in recent months, causing the trade deficit to shrink. A favourable monsoon period is expected to help boost agricultural output. **We expect GDP to rise by 4.6 per cent in 2013 and by 5.2 per cent in 2014. In 2015, growth will accelerate further to 5.5 per cent.**

Wholesale price index (WPI) inflation has accelerated, reaching 7.0 per cent in October. The weakening of the rupee has impacted fuel prices and, together with rising food prices, explains most of the acceleration. This is expected to be temporary, however. A good harvest along with this autumn's interest rate hikes will have a cooling effect. Measured as annual averages, **inflation will end up at 6.2 per cent in 2013, 5.8 per cent in 2014 and 5.5 per cent in 2015**.

Inflation has gained momentum again

Year-on-year percentage change



Source: Ministry of Commerce and Industry

Raghuram **Rajan**, who took over as governor of the Reserve Bank of India (RBI) in early September, has already launched various financial sector reforms, thus contributing to a calming of market turbulence. These reforms have helped the rupee to regain some of its earlier decline. **We expect an INR/USD exchange rate of 62.5 at the end of 2014 and 60.0 at the end of 2015**. Rajan is more hawkish than his predecessor and has already raised the repo rate by 50 points. We believe the **RBI will hike its repo rate by 25 basis points in December and by 25 points in January**, to 8.25 per cent.

The RBI's reforms cannot solve India's structural problems. Earlier government reform steps in the right direction have recently been followed by **questionable reforms** that will increase the cost of government food subsidies. Land purchase regulations also risk becoming even more complicated. The **parliamentary election** due no later than May 2014 decreases the likelihood that unpopular reforms will be implemented in the near future. Opinion polls point to a **change of government**. The governing coalition led by the Congress Party looks set to hand over power to the opposition **BJP**, headed by Narendra **Modi**. The results of the election will be crucial to India's chances of pushing through reforms.

Lacklustre recovery with increased deflation risk

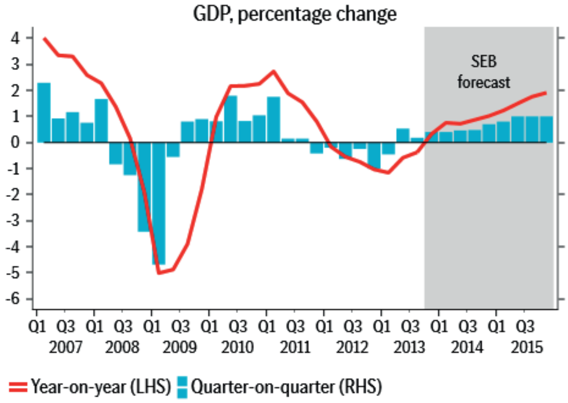
- **Unemployment stuck at record-high level**
- **Inflation problematically low**
- **Milder fiscal policies**
- **More easing from ECB - QE is the next step**

Growth is back, but the euro zone is still struggling with big problems. The recession is over, unemployment is no longer rising, budget and current account deficits are improving – but a large debt burden and high joblessness are weighing down the recovery. The European Central Bank (ECB) continues to prop up the financial system and will be pressed to do more; the region cannot yet stand on its own.

The international economic upturn, especially in the US, is helping euro zone exports. The scale of fiscal austerity in crisis countries is shrinking. **Yet the recovery is doubly unsynchronised**: the euro zone is not keeping pace with the US, and within the euro zone the legacy of the financial and structural crisis means that northern Europe is performing more strongly than southerly countries. After a strong second quarter growth figure, third quarter euro zone GDP was unchanged. This was in line with our forecast. As annual averages, **GDP will fall by 0.4 per cent in 2013 and then increase by 0.8 per cent in 2014 and 1.6 per cent in 2015**.

The euro zone is leaving its recession behind

GDP, percentage change



Source: Eurostat, SEB

Further economic policy integration in the euro zone is necessary in various fields. But with less acute pressure from financial trouble spots, the process is moving more slowly than the grandiose plans previously announced. Most vital in the near future is to make progress on the proposed banking union and common supervision of the banking system. Euro zone finance ministers have approved regulations that will entitle the ECB to oversee approximately 130 banks. But there are disagreements between countries; joint statements signal that the European Stability Mechanism (ESM) could be used to recapitalise banks; Germany meanwhile argues that this should happen only after bond holders accept write-downs. We assume that crisis resolution mechanisms will be in place by the time the ECB unveils the results of next year's stress tests, but due to these disagreements it is uncertain whether joint mechanisms like the ESM can be used if the stress tests demonstrate larger capital shortages in the banking sector than individual countries will be able to fund on their own.

Low inflation, worries about the economy and promises of long-lasting low interest rates from other leading central banks pushed the ECB to cut its refi rate by 25 points in early November, in line with our August *Nordic Outlook*. With a key rate already close to zero we expect **major new initiatives from the ECB**. During spring 2014 the **Securities Market Programme** (SMP) will be restarted and the **ECB will deliver quantitative easing** similar to what has been done in the US, UK and Japan. If liquidity should dry up in the banking system, aside from the short-term liquidity already promised, we expect the ECB to offer further LTRO long-term loans to the banking sector. We are also sticking to our prediction that **several countries will receive easier borrowing terms and in some cases more bail-outs**. Greece, and probably Portugal, will need debt relief, while Spain might have to utilise more funds to support its banks.

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	-1.8	0.6	0.8
Spain	-1.9	-1.3	0.4	1.5
Greece	-6.4	-5.0	-1.0	0.0
Portugal	-3.2	-2.2	0.3	0.7
Ireland	0.2	0.9	1.5	1.5
GIPS countries*	-2.4	-1.6	0.3	1.2
Euro zone	-0.7	-0.4	0.8	1.6

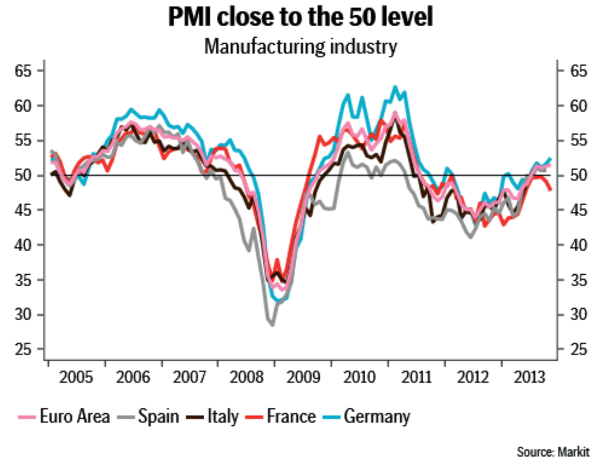
*Greece, Ireland, Portugal and Spain

Source: Eurostat, SEB

Indicators point to gradual improvement

Since last spring, indicators have clearly improved overall in the euro zone, but a flat trend has dominated the past 3-4 months. On the whole, indicators support our forecast of a **slow-paced recovery**. Purchasing managers' indices (PMIs) and the European Commission's sentiment indicator show a consistent picture. The manufacturing PMI is now above the growth threshold of 50 in Germany, Italy and Spain and a bit below it in

France. A similar recovery in forward-looking indicators can be observed in most crisis-hit countries.



Exports are slowly recovering

Exports have improved this year, but the clear upturn discernible in countries like Spain and Portugal in the second quarter has slowed perceptibly. Stronger international economic conditions combined with better competitiveness in crisis countries will provide future growth support, even if marginal in size. According to the OECD's measure of unit labour cost, Ireland and Greece in particular have regained competitiveness, while the situation has instead worsened in France and Italy. Looking ahead, a weaker euro will ease competitive conditions further, yet further nominal wage adjustments are needed in southern Europe. **Overall euro zone exports will increase by 3.7 per cent in 2014 and 2015**.

Capital spending upturn will be delayed

Domestic demand remains weak, squeezed from several directions. The euro zone remains stuck in a situation where uncertainty about the economy, bail-out programmes, banking sector problems and high unemployment are causing households and businesses to hesitate. Capital spending fell during the first half of 2013. Capacity utilisation is below its historical average, despite an upturn this year. This indicates that the recovery needs to progress a bit more before companies begin new large-scale capital spending.

Most fiscal austerity packages have now been implemented, but households will continue to be squeezed by cutbacks and high unemployment. Retail sales have shown a weak upward trend throughout 2013, but this has been volatile. Sales fell 0.6 per cent in September compared to the previous month but rose during the third quarter compared to the second. Stock market upturns are contributing to improved consumer confidence. This indicates a decent consumption upturn, but the differences between countries are larger than in manufacturing. **Household consumption will fall by 0.6 per cent in 2013 and then increase by a weak 0.6 per cent in 2014 and 1.4 per cent in 2015**.

Germany: Stable growth

The German economy's effect on the euro zone is two-edged. On the one hand, **Germany helps maintain growth and confidence**. For example, the euro zone as a whole has a stronger current account balance and lower public sector debt than the US. On the other hand, **imbalances within the euro zone are partly a result of Germany's success**. Competitiveness and export strength, combined with restrained domestic demand, create a very large German current account surplus (7 per cent of GDP in 2012). Calls for Germany to stimulate demand and bring down its current account surplus, which is mainly to countries outside the euro zone, are hard to implement since the surplus is largely in the private sector. Also, the current account surplus towards euro zone countries is shrinking. Although the public sector is largely in fiscal balance, public debt is about 80 per cent of GDP.

Indicators point to gradual improvement in growth, and export-dependent Germany will benefit from better international economic conditions in 2014, but restrained demand in the euro zone will continue to slow this trend. An export upturn is usually followed by a capital spending upturn, but with a certain lag. Domestic demand will be the main growth driver during the next couple of years but uncertainty about economic policies will continue will make households and companies cautious, despite low interest rates, low unemployment and good real wage increases **Overall GDP will increase by 0.5 per cent in 2013, 1.7 per cent in 2014 and 2.0 per cent in 2015**.

Negotiations to form a new government after the September election are under way and are expected to be completed by mid-December. **The focus is now on a grand coalition between Angela Merkel's Christian Democrats (CDU/CSU) and the Social Democrats (SPD)**. Several leading SPD politicians see a better chance of success in opposition. SPD will hold a membership vote on the government question early in December. Our main forecast is still that a CDU/CSU-SPD grand coalition will take office next month. A grand coalition would probably lead to minor policy changes, especially towards Europe. In domestic policy, SPD has called for social reforms such as a national minimum wage. If anything, we expect that with a grand coalition, Germany's attitude towards crisis policies will be a bit gentler but that calls for bail-out countries to report their actions and follow up the outcomes of austerity programmes will become tougher.

France: Weak recovery

The European Commission's sentiment indicator has improved in recent months, but the latest PMI fell slightly to just below 50. Companies are hesitant to invest before international demand takes off in 2014. Households have been relatively resilient, despite rising unemployment (11.1 per cent in September) and public sector belt-tightening. Overall, **GDP will increase by a marginal 0.2 per cent in 2013 and then rise to 0.8 per cent in 2014 and 1.5 per cent in 2015**. The public sector deficit is slowly shrinking, President François Hollande has record-low support in opinion polls and in November the country's sovereign credit rating was lowered by Standard & Poor's. Austerity packages (including higher VAT, a freeze on transfers to local governments, lower public sector pay costs and adjustments in pension indexing) will help improve fiscal balances. Meanwhile public finances are being squeezed by weak growth, which is keeping tax revenue down.

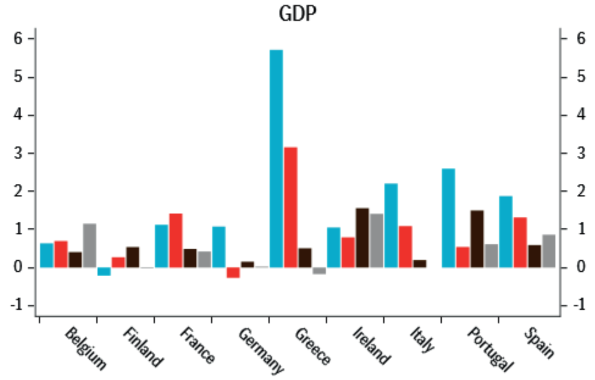
Austerity measures gentler, but not over

Fiscal policy is entering a gentler period. Measured as change in the public sector structural balance, euro zone fiscal policy will be largely neutral in 2014 and 2015. The public sector balance will improve from a deficit of 2.6 per cent of GDP in 2013 to 2,2 per cent in 2015. Gross public debt will hit 95.9 per cent of GDP in 2014, then fall slowly. The primary balance, excluding net interest, will be close to zero, although various euro zone countries still have fiscal consolidation needs. This applies not only to crisis countries but generally and is driven, among other things, by an ageing population.

Overall, this means that public finances in the euro zone as a whole are stronger than in the US, Japan and the UK. Yet because of the common currency and common monetary policy system, individual countries are subject to greater pressure. This is especially true because there are major differences between countries, and common tools for managing imbalances are still undeveloped.

The diminishing effect of fiscal austerity

Year-on-year change in public structural balance, 2012-2015, % of GDP



Source: IMF

Continued high unemployment

In recent months, unemployment in the euro zone as a whole has been at close to record levels, somewhat above 12 per cent. In our assessment, it has largely peaked in most countries, though it is worrisome that the upturn is continued in Italy (12.5 per cent) and France (11.1 per cent), for example. The divergences are wide: In Germany, unemployment was 5.2 per cent in September, the lowest since the 1970s. In Spain and Greece, it is above 25 per cent.

It is encouraging that unemployment has stopped climbing in some countries, but weak growth in the next few years can only push down jobless levels marginally. **As annual averages, euro zone unemployment will stand at 12.0 per cent in 2014 and 11.5 per cent in 2015**. A high jobless rate will hold back demand in euro zone economies and create major political and social problems. Looking further ahead, there are also risks that the unemployed will lose their skills and that well-educated workers will emigrate from countries mired in crisis situations. To some extent, the levelling out of unemployment we have seen is due to people leaving the labour force after long periods of joblessness. This is especially notable in Spain, though the drop in labour force participation is not as big as in the US, for example.

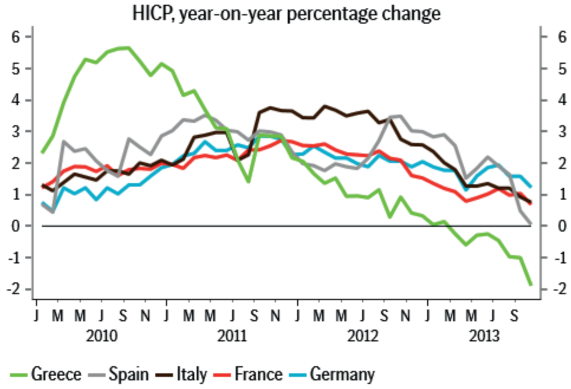
Very low inflation pressure

Inflation has fallen continuously since June and amounted to 0.7 per cent in October. Low, falling inflation is driven by low demand and falling wages due to high unemployment. The downturn applies to the entire euro zone but is most apparent in southern Europe. In Germany, inflation was 1.2 per cent in October, while it is close to zero in Spain. Greece has shown clear deflation throughout 2013.

Structural and economic problems indicate that inflation will be low for years to come. Aside from the temporary effects of hikes in indirect taxes or commodity price fluctuations, it is difficult to foresee any major forces driving higher inflation in the near future. In our assessment, the risks of damaging deflation have recently increased, but our main forecast is still that the euro zone as a whole will avoid a severe deflationary spiral. **HICP inflation will be 1.3 per cent in 2013 and 0.6 per cent in 2014 and 2015.**

Low inflation

HICP, year-on-year percentage change



Source: Eurostat

ECB: QE will be the next step

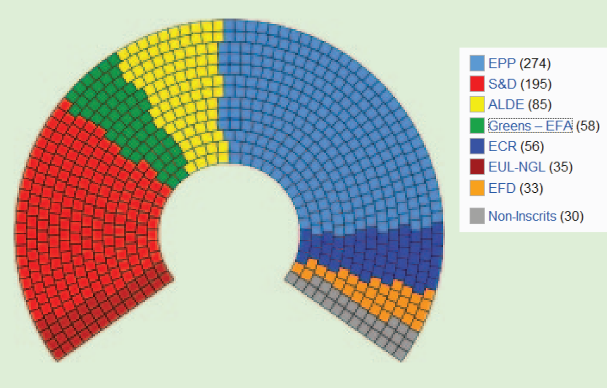
Falling inflation, weak economic conditions and the aggressive stimulus policies of other leading central banks have put **heavy pressure on the ECB to deliver further stimulus measures**. There are also problems in the banking sector, especially in southern Europe, and bank lending remains weak. Lending to households has been essentially unchanged in the past year, while lending to businesses is now falling at 3.5 per cent annually.

The lowering of the refi rate by 25 basis points in November came one month earlier than we had expected. The ECB's guidance is still that its key interest rate will remain at today's level (or even lower) for an extended period. In order to further push down the euro overnight index average (EONIA) interest rate, the ECB has also announced that negative deposit rates may be introduced. This is not in our main scenario, however. **The key interest rate has probably bottomed out, but the bank has more tools in its kit**. These include the Outright Monetary Transactions (OMT) programme, the Long-Term Refinancing Operation (LTRO) for banks and more straightforward quantitative easing (QE). We believe the ECB's first choice will be to activate the LTRO and QE options. New LTRO's ensures that the banking system has enough liquidity. QE, like what has been done by the Fed, BoE and BoJ, lifts assets from the banking system and keeps government yields low compared to the US and might also reduce yield spreads within the euro zone (see "Theme: Time for the ECB to launch traditional QE").

- **2014 EU election the most important one ever – Parliament will wield more power**
- **Debt levels, a banking union and political union high on the agenda in Brussels**
- **Uncertainty about election and its outcome will paralyse EU decision making next year**

In May 2014, the often "forgotten" EU parliamentary election will take place. Voter turnout has fallen, averaging only 43 per cent in the last election in 2009, but for several reasons this will be the most important of seven EU elections since 1979. It will provide an important **yardstick of public support** for EU crisis policies in recent years, including bail-out loans, crisis funds and austerity policies. It will be a chance to gain a **mandate** for the current roadmap towards further integration in the EU generally and the euro zone in particular, especially in economic, financial and political terms. It is expected to enable **anti-EU forces** to create coalitions and increase their influence on EU policies in the next five years. The European Parliament (EP) will enjoy **more power**[1] than before, in keeping with the Lisbon Treaty, and the **political colour of the new President of the European Commission** will have to reflect the political composition of the Parliament.

Composition of the European Parliament, November 2013



The new European Commission president, succeeding Portugal's José Manuel Barroso, is formally elected by the European Council but in practice by the Parliament. The hottest candidates of the **Party of European Socialists (PES)** today include EP President Martin Schulz (Germany), Helle Thorning-Schmidt (Denmark), José Luis Zapatero (Spain) and Pascal Lamy (France). Among candidates of the **centre-right European People's Party (EPP)** are Donald Tusk (Poland); Viviane Reding Luxembourg), Fredrik Reinfeldt (Sweden) and Christine Lagarde (France).

1) Starting in 2014, the European Parliament will gain more influence on such matters as regulation of the single market, changes in free labour market mobility, budget amendments and approval, agricultural policy reforms, approval of trade agreements and oversight of euro zone developments.

Some have suggested **launching candidates for Commission president even before the election**. This would give voters a chance to get a clearer picture of the direction of European cooperation in the next five years and give the impression of **a "real" election**. Today there are major differences between how the PES and EPP view such matters as crisis management. If the PES can choose the Commission president, it is reasonable to expect more growth- and job-oriented economic policies ahead and some easing of the current austerity policies. If the EPP wins, there is a greater probability that austerity policies will remain as they are.

Some key political events over the next year

Date	Event
Mid-December	German government negotiations likely concluded
Dec 19-20	EU summit meeting in Brussels
Jan 1, 2014	Latvia joins the euro zone
Jan 1	Greece takes over the EU Presidency
Feb 13-14	EU summit in Brussels
Spring	Proposed new steps towards political union unveiled
Mar 20-21	EU summit in Brussels
May 15-16	EU summit in Brussels (preliminary)
May 22-25	Election to the European Parliament
Jun 26-27	EU summit
Jul 1	Italy takes over the EU Presidency
Oct/Nov	New European Commission expected to take office

Anti-EU winds will affect the Commission

According to surveys conducted in September 2013 by Gallup and others, **43 per cent of EU respondents are euro-sceptics** and **40 per cent euro-optimists**, while 17 per cent are uncertain. EU/euro-sceptical parties in the 28 EU member countries have divergent political agendas, but have intensified their cross-border collaboration this autumn with the aim of creating a strong joint **parliamentary party group.**

Yet anything but a PES or EPP Commission President is unthinkable, even if EU/euro-sceptical parties expand their numbers and influence in the Parliament. History shows that the PES and EPP can often reach consensus solutions, lowering the risk of severe parliamentary reversals. But the more influence the EU/euro sceptical party group gains in Brussels, the more the EU – in the spirit of the Lisbon Treaty – must take its views into account in its political decisions. Political observers mainly warn of the effects on domestic politics. The stronger these EU/euro sceptics become, alone or in coalition with other parties, the **greater the potential for conflicts also arising at national political level**.

Because of the increased importance and power of the European Parliament, and the risk of large unforeseeable shifts in voter opinion – combined with the likelihood of continued weak voter turnout – traditional political parties will probably tiptoe quietly around many sensitive issues before the EU election and while awaiting the new European Commission. Our conclusion is that the EU will become **an organisation incapable of making vigorous decisions over the next year**. Meanwhile the countries holding the EU Presidency in 2014 – **Greece** (Jan-Jun) and **Italy** (Jul-Dec) – will find it difficult to drive the European agenda forcefully as they grapple with their own complicated domestic issues.

Three main issues require a firm approach

The EU and euro zone face a long list of economic, financial and political challenges. These include re-launching policies that will generate **capital spending**, **growth and jobs**, while facilitating **continued integration** in various politically sensitive fields. There are three main areas that will require the attention of political leaders soon: sustainable debt levels, a banking union and further steps towards a political union.

• **Re-establishing public sector debt stability**. Weak growth, low inflation (or even deflation) and rising long-term international yields, for example due to tapering of Fed bond purchases, are worsening the chances of reducing fiscal deficits and achieving sustainable debt levels. In fact, many EU countries run serious refinancing risks as long as public and private debt is high. EU countries that have now exceeded a threshold of 35 per cent of GDP in their foreign debt (the standard for the ECB, IMF, European Commission and others) are: **Bulgaria, Croatia, Cyprus, the Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania and Slovakia**. Many countries have the potential to find their own way out of these problems. Others require external help, for their own sake and that of others. Since the euro was introduced, **Germany** has increased its **receivables** from other countries by EUR 1.1 trillion.

Debt relief can occur in three ways: **1. Softening** interest and borrowing terms for indebted countries that have already received aid/bail-out loans; **2. Writing down** total debts, as in Greece, but requiring closer scrutiny if creditors outside the private sector must also participate; **3.** Moving all the way to euro zone **political union**. All three options involve tough political negotiations and decisions.

• **Banking system stability and the flow of credit**. Over the next six months or so, the ECB will conduct an asset quality review (AQR) – in collaboration with national financial supervisory authorities – of more than 130 banks, as well as risk assessments and stress tests to study their resilience in various scenarios. The results are expected during the second and third quarters of 2014. The aim is to **reveal weaknesses** in institutions and systems before the ECB takes over responsibility for overseeing these banks late in 2014. This represents the first step (of three) to create a banking union: the single supervisory mechanism (SSM).

In order to implement the SSM, two sensitive questions must be answered: *1. Whether one or more banks must be recapitalised, and how to achieve this, and 2. whether a bank needs to be restructured, and how to allocate responsibility.*

Today the European Stability Mechanism (ESM) has no way of providing direct aid, but must go via the balance sheets of individual countries. The parties are therefore discussing the potential for somehow – in the short term – providing a direct line to banks, for example via national crisis resolution funds. Once the SSM is in place and the ECB has taken over responsibility for oversight (November 2014) the ESM will be able to aid banks directly. Aside from the SSM, the aim is to put the single resolution mechanism (SRM) in place. This is necessary in order to deal with banks that are undergoing a crisis and to clarify, for example, who is responsible for supplying them with capital.

The mid-December EU summit will be a key step in showing where Germany stands on these issues after its new governing coalition has been formed. There are strong expectations that **Germany will make concessions** and accept proposals for temporary financing of banks and ways of dealing with banks in crisis. In exchange, Germany will receive assurances that individual countries will be tied more strongly to reforms and commitments.

• **The roadmap for a political union**. It is obvious that discussions of the plan unveiled in June 2012, aimed at creating stability in the euro project, have **seized up**. As recently as May 2013, Germany and France made an attempt to influence the process. Their strategy was clear: to ensure France the support of Germany in acting as a vital partner in European development, and to halt the European Commission's federalist ambitions. **Today France is handicapped** by complex economic and political challenges, including a president who enjoys record-low support among the French people. Since the UK is cutting back on its EU ambitions, French-German cooperation is a necessity if the EU and the euro project are to evolve further.

Achieving economic, financial and political stability in Europe will require increased integration and a more deeply rooted institutional structure. But at present, Europe and the EU are **not politically strong and unified enough** to implement the necessary changes in various treaties, for instance, without causing divisions between and within countries. This is why there is a continuous process of interpreting treaties as flexibly as possible. The chances of continuing to do this will diminish if the European Parliament becomes more EU/euro-sceptical.

Major political challenges await in 2014

In recent years, the EU and the euro project have shown occasionally surprising powers of survival under pressure. This is one reason to be **cautiously hopeful**. Successful negotiations to form a German government by December will not be enough to strengthen the EU's backbone during the coming year, given the weakness of European economic growth. Major issues need to be resolved quickly – government debts are weighing Europe down and credit markets are sputtering. The EU election and a new Commission with a different balance of political forces will not make the situation easier for Europe. **The EU faces a politically complex uphill struggle during the coming year**.

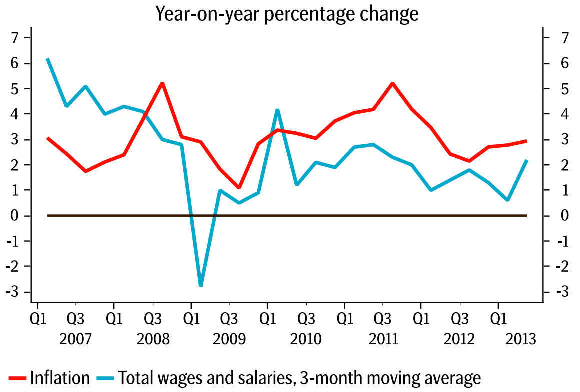
British growth will be among the EU's fastest

- **Consumption playing an ever-larger role**
- **Unemployment at 6.5 per cent by end-2015**
- **No new bond purchases, rate hike in 2015**

The British economy is on increasingly firm footing. Third quarter GDP growth was the strongest in more than three years and **the recovery is broad-based**. All main economic sectors – services, industrial production, construction and agriculture – are growing in volume, but GDP level remains 2.5 per cent below its previous 2008 peak. The service sector has grown past its previous peak but manufacturing and construction output is 12-13 per cent below peak. After 1.4 per cent **GDP growth** this year, the recovery will continue to speed up, with growth of **2.4 per cent in 2014 and 2.7 per cent in 2015**, slightly above consensus. Despite idle resources, inflation remains stubbornly above target and will fall below 2 per cent more permanently only in late 2014. **The Bank of England's first key rate hike, from 0.5 to 0.75 per cent, will occur in December 2015**. Unemployment, which fell to 7.6 per cent in the three months to September, is expected to have fallen below the BoE's critical 7 per cent level by then. The Bank, much like the Federal Reseve, may instead lower its threshold for the beginning of key interest rate hikes or simply downplay it.

Inflation is exceeding pay increases

Year-on-year percentage change



Source: ONS, SEB

Despite weak real wage growth, **households are helping to drive the recovery**. The retail sales trend is the strongest since 2008 and consumer confidence is close to a five-year high. Rising home prices – up more than 10 per cent year-on-year in the latest three-month period – are helping fuel greater optimism and higher consumption. But despite the home price upturn, lending to households is not growing. The pattern was the same when home prices recovered after the early-1990s recession. **Household consumption will grow by 2.1 per cent in 2014 and 2.4 per cent in 2015**, an acceleration compared to this year's 1.7 per cent. Real wages and salaries, which are still falling, will stabilise next year and grow in 2015. Government budget consolidation will also ease off as the 2015 election approaches, giving households some breathing space. **The budget deficit**, an estimated 6.1 per cent of GDP this year, **will shrink to just below 5 per cent in 2015**.

Business indicators point towards a continued positive trend. In October, the purchasing managers' index for services reached its highest level since 1997. A weighted average of service, manufacturing, construction and retail indicators is also at a 15-year high. **Industrial production**, which has trended upward for the past year, will accelerate in 2014. After falling this year, business capital spending will **grow by an average of more than 4 per cent in 2014-2015**. Yet foreign trade will hit a rough patch, and both the current account and trade deficits will remain stuck at high levels.

The focus on the labour market has intensified since the BoE began to factor unemployment into its guidance for future monetary policy. The central bank previously also kept an eye on productivity and capacity utilisation when estimating the amount of slack in the economy. But today the idea is that resource utilisation is reflected nicely by the jobless figure – businesses are expected to try to boost existing staff productivity before starting to hire new employees in earnest. This is consistent with experience in earlier cycles, but not with developments in recent years. **Rising employment accounts for some 80 per cent of the GDP upturn since 2009 –** higher productivity 20 per cent. This year, the pace of employment growth has also been historically compatible with a clear decline in joblessness. **Unemployment** will decrease gradually to **7.2 per cent in 2014 and 6.7 per cent in 2015**.

Since autumn 2007, **inflation has averaged 3.2 per cent**; only during 6 months of 2009 did it meet the BoE's 2 per cent target. A 25 per cent weakening of the pound, rising energy prices and a VAT hike are the most important reasons. Despite some deflationary pressures elsewhere, British inflation will remain sticky in the near term. New energy price hikes are on their way, and perhaps also tax and fee hikes. **Average annual inflation will be 2.0 per cent in 2014 and 1.7 per cent in 2015**. No further BoE bond purchases will occur and the bank will **hike its key interest rate from 0.5 to 0.75 per cent in December 2015**, while the European Central Bank leaves its key rate unchanged. This is an indication that **the pound will appreciate from its current GBP 0.83 per euro to GBP 0.79 in December 2015**.

Gradual recovery – major economies will diverge

- **Russia: Structural problems pose obstacles**
- **Poland: Regaining its starring role**
- **Ukraine: Devaluing its way out of crisis**

Nearly all economies in Eastern (including Central) Europe – with Ukraine as a notable exception – have begun a recovery this autumn after **bottoming out in the second quarter of 2013**. The improvement is clearest in central Europe, where growth is helped by higher German demand and a cautious resurgence of private consumption. In October 2013 Poland's manufacturing purchasing managers' index rose to 53.4. This is the highest PMI level since 2011 and has exceeded the expansion threshold of 50 for four months. Even in hard-pressed countries to the south such as Bulgaria and Croatia, the growth outlook has brightened a bit. But overall, **recovery will be modest in the next couple of years** in Eastern Europe. Not until 2015 will most countries achieve potential growth. The reasons are weak capital spending upturns and sluggish export growth due to listless demand in Western Europe and Russia. Fiscal austerity, though loosening, is also hampering growth to some extent.

In most countries, growth is initially being driven by higher private consumption and exports. Real wage growth, largely due to low inflation, is bolstering private consumption. Price pressure is restrained by lingering idle resources (though tight in Russia) and stable commodity prices. Capital spending is low, due to global uncertainty, moderate capacity utilisation in manufacturing and slowly thawing credit conditions.

With its relatively strong economic fundamentals, **Poland is regaining its prominent position** in the region after a deep domestic slump in the second half of 2012 and early 2013. The recovery will be export-led at first, but broad-based over time. Stronger real wages (after a sharp slowdown in inflation), powerful monetary stimulus and EU structural funds will fuel domestic consumption. A temporary softening of budget consolidation this year is also providing support. **GDP will increase by 1.5 per cent this year, 3.1 per cent in 2014 and 3.5 per cent in 2015**. Since inflation is below the 2.5 per cent target, the central bank will not begin hiking its key interest rate until early 2015, later than signalled (second half of 2014). The zloty will appreciate due to relative growth advantages.

Russian growth is now far slower than the 6-7 per cent that prevailed before the global crisis. The sharp deceleration this past year has been broad-based but is mainly due to weak capital spending. After an unexpectedly anaemic third quarter GDP outcome (continued year-on-year growth of 1.2 per cent), we are lowering our already cautious 2013 growth forecast from 1.7 to 1.4 per cent. Meanwhile an upturn in production indicators and somewhat better exports in recent months signal that the economy bottomed out this autumn. A strong labour market and good real wages will provide support as the economy loses support from oil prices, which are falling below USD 100/barrel. **GDP will grow by 2.3 per cent in 2014 and 2.8 per cent in 2015**, in line with potential growth nowadays. The resource situation is strained and the demographic trend is negative. Far-reaching reforms are needed to lift growth to President Vladimir Putin's 5-6 per cent long-term target. Inflation continues to fall due to stable food prices and slightly higher unemployment. In 2014, it will be a historically low 5.4 per cent.

Ukraine's weak performance since late 2012 **turned into a rapidly deepening crisis this autumn**. Third quarter GDP was down 1.5 per cent year-on-year: the fifth straight quarter of negative growth. The economy is being squeezed by falling steel exports, lower Russian demand and an overvalued currency. This helps explain why the current account deficit jumped to 8 per cent in 2012 – unsustainable in the long term. We expect no major improvement in 2013. Financial market confidence in Ukraine is severely strained and worsened during last summer's global turmoil related to future Fed exit policy. On November 1, S&P also lowered Ukraine's credit rating to the same junk status (B-) as Greece. Current account deficits and central bank interventions to support the hryvnia this past year have depleted the currency reserve. At USD 5 billion, the third quarter deficit was more than twice that of the second quarter. The reserve is at its lowest in more than six years and barely covers three months' imports – normally a critical threshold. Making the situation worse is that the government has a large short-term external borrowing requirement, though its debt is low. Furthermore, governments sudden reluctance to increased EU integration has reinforced political uncertainty.

We are sticking to our forecast in October's *Eastern European Outlook* that there will be a **devaluation of at least 10 per cent in the first quarter of 2014**. This will be coupled with a new IMF bail-out loan. In exchange, we expect the IMF to demand lower gas subsidies, among other things. Notably, for years the IMF's Ukraine reports have called for a more flexible exchange rate, instead of today's "semi-pegged" system in which the central bank tries to keep the hryvnia stable against the USD. An exchange rate adjustment would thus probably be accepted as part of coming to grips with the current account problem. Devaluation would help stimulate exports in 2014 but risk creating short-term strains in the banking system, since about 40 per cent of borrowing is in foreign currencies and the total percentage of bad loans is relatively high. We are lowering our growth forecast: **GDP will fall by 1.4 per cent this year, then rise by 1.7 per cent in 2014 and 3.2 per cent in 2015**.

Rising consumption drives growth – Estonia lagging

- **Latvia and Lithuania still topping EU growth**
- **Continued low to moderate inflation**
- **Lithuania on track to join euro zone in 2015**

Rising private consumption continues to generate good GDP growth in the Baltic countries, although the smallest economy – Estonia – is lagging behind. Exports and capital spending have been weak since last summer, resulting in unexpectedly slow growth in Estonia and Lithuania during the third quarter, but will gradually strengthen over the next couple of years. The predicted recovery in Estonian growth is greatly dependent on a rebound in external demand, mainly from Finland and Sweden, since consumption is losing some momentum and public sector investments will remain weak.

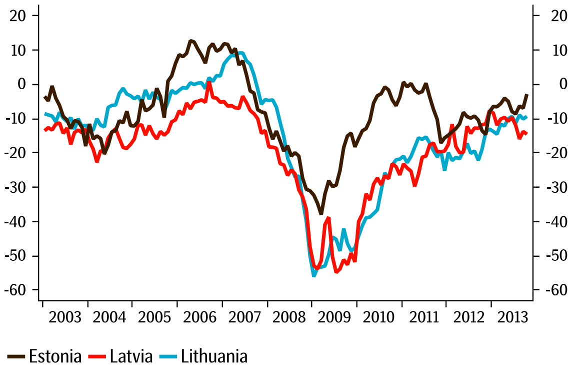
Latvia and Lithuania will continue to grow the fastest of all EU countries. Latvia's GDP will rise by 4.8 per cent yearly in 2014-2015 after this year's 4.0 per cent. **Lithuania's growth will end up at 3.5 and 4.5 per cent, respectively** after 3.3 per cent in 2013. This is somewhat above potential, which is estimated at 3-4 per cent in all three Baltic countries and means that inflation – now nonexistent in Latvia and Lithuania – will rise. The upturn will be moderate, though, due to low international inflation pressure and lingering idle resources, but labour shortages (also in Estonia) will be a mounting problem in sectors like technology and construction.

Estonia's growth will gradually recover to **2.6 per cent in 2014 and 2.9 per cent in 2015** after this year's plunge towards 1 per cent. The slowdown in 2013 is largely due to falling public investments – in turn mainly a consequence of declining EU structural grants – and sagging exports (Estonia is more export-dependent than Latvia and Lithuania). The relatively high inflation of recent years will slow because of modest growth, increasing competition in retailing and lower prices on public services like transportation and education. In 2014, inflation will be 2 per cent, below the other Baltics. Pay increases of 7-8 per cent this year will gradually diminish but pose an upside risk for inflation, since productivity growth so far has been unable to match wage and salary hikes.

In all three countries, private consumption will be fuelled by **continued good real income increases for households**. Job growth will continue, though at a slower pace than in 2013. Unemployment will fall a bit more in Lithuania and Latvia from an average of more than 11 per cent this year to 8.5-9.0 per cent in 2015. Estonia's jobless rate has already fallen nearly to a structural equilibrium level of 8 per cent (8.0 per cent in the third quarter of 2013) and is expected to level out there. Nominal wages and salaries will increase at a modest pace in Latvia and Lithuania, while the rapid pay hikes in Estonia will slow a bit. In 2014 we expect fiscal policy to be neutral in Latvia and to have only marginally tightening effects in Estonia and Latvia. Overall, this **sets the stage for a continued surge in consumption**. Pointing in the same direction are relatively good consumer confidence levels. We regard the dip in Latvian consumer confidence over the past six months as temporary, partly caused by uncertainty about the short-term effects of the country's euro zone accession on January 1, 2014.

Consumer confidence at relatively good levels

Per cent



Source: European Commission

After continued weak inflation data this autumn, **there is a relatively high probability that Lithuania will** be the last Baltic country to **qualify for the euro zone, meeting the government's 2015 target**. Average annual inflation in October was 1.4 per cent (with month-on-month deflation of 0.1 per cent). Since September 2012, Lithuania has met the Maastricht inflation criterion, and recently by wider margins. When the European Commission and ECB perform their evaluations, average annual inflation must not exceed that of the three lowest-inflation EU countries by more than 1.5 percentage points. Evaluation of Lithuania's convergence/euro zone application will occur next spring. Euro zone deflation pressures may pose obstacles for Lithuania, but deflation-hit countries are viewed as extreme cases and not included in the calculation. Lithuania thus appears set to meet all six criteria, including the condition that the slowdown in inflation (and other convergence criteria) must appear long-lasting. Lithuania also seems likely to meet the other key criterion, a budget deficit of no more than 3 per cent of GDP, but by a narrow margin: only a few tenths of a point in 2013. There is also a risk that the evaluators will think deficit reduction has occurred too fast, from 5.5 per cent as recently as 2011. But Lithuania's fiscal trend is strongly reminiscent of Latvia's deficit path. Last summer Latvia got the green light to join the euro zone in 2014. And like Latvia, Lithuania will probably be praised for its resolute handling of the deep economic crisis of 2008-2009.

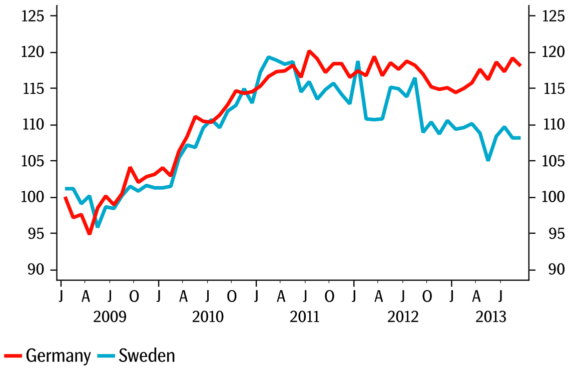
Low inflation a challenge to Riksbank's credibility

- **Shaky recovery for manufacturing sector**
- **Optimistic households step up consumption**
- **Unemployment will fall faster than expected**
- **Inflation far below Riksbank target**
- **Key interest rate cut in December; slow pace when hiking in 2015**

Economic indicators remain divergent, but taken together they still signal that **growth is about to accelerate**. Yet initially, this upturn seems likely to be more sluggish than expected. We have adjusted our GDP growth forecast to 0.7 per cent in 2013 and 2.5 per cent in 2014. This is 0.6 and 0.1 percentage points lower than in the August *Nordic Outlook*. Our 2015 forecast is unchanged at 3.2 per cent. Our downward adjustment in the forecasts is mainly due to weaker exports than expected.

Industrial production

Index 100 = 2009



Source: Macrobond, SEB

Upturn in manufacturing will be delayed

Despite signs of somewhat stronger international economic conditions, industrial production and merchandise exports continued to fall during the third quarter. Industrial production is significantly weaker in Sweden than in Germany (see chart). Merchandise exports show a similar pattern. The stronger krona exchange rate is one probable reason, but the manufacturing sector is not weak in all respects. For example, the downturn according to production data is not reflected in sentiment indices, in which most surveys show a relatively similar trend in Sweden and Germany. In our view, the upturn in sentiment is more reliable when it comes to assessing future developments. We thus believe that **Swedish industry can follow the international economy upward**. However, the acceleration in exports and industrial capital spending will be delayed compared to our earlier forecast. We expect exports to grow by 3.7 per cent during 2014, which is a downward adjustment by 0.5 percentage points.

Expansionary policy benefiting households

The government is continuing its expansionary fiscal policy. In 2013, this stimulus was equivalent to about SEK 25 billion (0.7 per cent of GDP), an amount largely matched in the 2014 budget. Due to continued high unemployment and next September's election, we expect further measures in the spring 2014 budget bill. We foresee reforms totalling SEK 30 billion (0.8 per cent of GDP) in 2014, **mainly aimed to households**. In 2015 we expect a mildly expansionary policy totalling about SEK 10 billion, regardless of what government is in office after the election. Since the budget without discretionary policy is contractive (for example due to benefit limits in the social insurance system official productivity requirements, nominally specified appropriations and thresholds for paying income tax that are not adjusted to the trend of income), fiscal policy will not be quite as expansionary as the reforms indicate. In addition, local governments have so far announced tax hikes corresponding to a 0.13 per cent increase.

Expansionary fiscal policy means that **Swedish public finances will remain in deficit for the next couple of years**. Net lending by the public sector will be 1.6 per cent of GDP in 2013, improving to 1.3 per cent in 2015. General government gross debt will be roughly unchanged between 2013 and 2015 at 40.5 per cent of GDP.

Public finances

Per cent of GDP

	2012	2013	2014	2015
Net lending	-0.9	-1.6	-1.8	-1.3
Gen. gov't gross debt	37.5	40.5	40.8	40.5
Central gov't debt	32.4	35.5	35.9	35.7
Borrowing req., SEK bn	25	127	66	17

Source: Statistics Sweden, SEB

The consumption upturn has barely begun, but the signals are clearer than in the manufacturing sector. Due to low inflation, real household income is rising at a healthy pace. In 2014, tax cuts of almost SEK 20 billion will boost household purchasing power by more than three per cent. In this area, too, the initial upturn signals are most apparent in various sentiment surveys, but there are also clear signs that retail sales and new car registrations are increasing. This supports our forecast that consumption will climb 2.7 per cent next year.

Single-family home prices have risen by about three per cent this year and prices of flats by more than 10 per cent. SEB's home price indicator has continued to climb and is now on a par with its historical peaks from 2007. **This signals a continued upturn in home prices.** Various countries that previously showed resilience are now beginning to see falling home prices, for example Australia, Canada and Norway, which is a warning signal. Yet the gap between new construction and population growth in Sweden seems unique in an international perspective. We expect home prices to climb by 5 per cent both in 2013 and 2014. Then prices will level out during 2015 when the Riksbank hikes its key interest rate and certain steps are taken to slow the pace of bank lending.

Continued strong employment

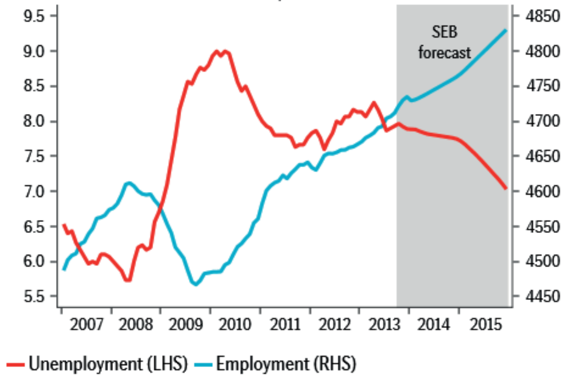
There has been a continued labour market trend of healthy job creation combined with persistent unemployment due to rising labour force participation. Short-term indicators actually suggest that the upturn in employment is about to accelerate, despite modest GDP growth. This employment increase is driven by service sectors: mainly education, health care and social services (see the theme article on this topic).

The expansion of the labour force in recent years has largely been driven by a reduction in the number of individuals on sick leave or disability retirement, largely due to tighter regulations and greater incentives to work. The effect of these policies will continue, but at a significantly slower pace. Meanwhile the working-age population is increasing at a rapid pace. Yet the labour force will still grow more slowly than the number of jobs, and **we expect unemployment to gradually shrink early in 2014**.

Much of the influx into the labour market consists of people with less formal education and immigrants who, for various reasons, have had difficulty finding employment. This may be one reason why increased 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 the resource utilisation is currently very low and will remain lower than normal during the next couple of years.

Employment will continue to rise

Per cent, thousands



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

Inflation far below the Riksbank's target

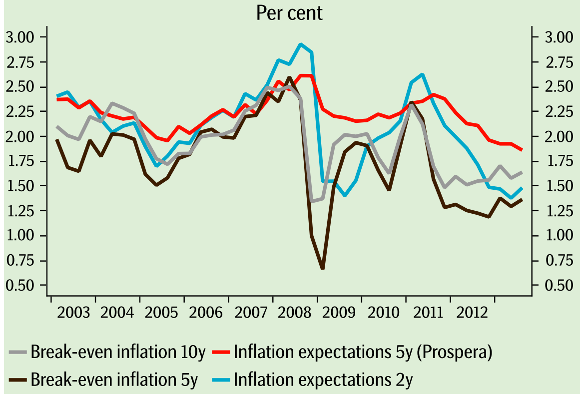
Inflation pressure is very low. CPIF inflation (CPI excluding interest rates) has mostly remained below one per cent during the past year. Inflation is being squeezed by low pay increases, weak international price pressure and the krona appreciation of recent years. These factors will also **help keep inflation low during the next couple of years**, although the effects of krona appreciation will fade somewhat. Another reason for lower inflation pressure is that international prices for energy and other commodities, which have risen in recent years, have now weakened. There is an upside inflation risk if rising unit labour cost, driven by low productivity growth, turns out to have a greater impact than expected.

A risk that inflation expectations will be too low

In the August 2013 issue of *Nordic Outlook*, we showed that CPIF inflation has averaged 1.5 per cent over the past 10 years. The average for the past three years is now falling towards one per cent, on a par with the lowest three-year figure ever.

Inflation expectations

Per cent

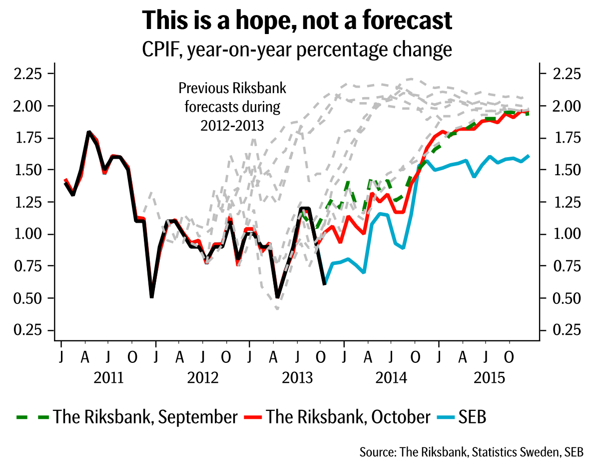


Source: The Riksbank, Bloomberg, SEB

This **low inflation has pushed down most measures of inflation expectations**. Even long-term inflation expectations are now beginning to fall below the Riksbank's target. According to Prospera's survey, five-year inflation expectations have fallen to 1.85 per cent, for example. The pricing in the inflation-linked bond market (break-even inflation) indicates expectations of 1.3 per cent in a 5-year perspective and 1.6 per cent in a 10-year perspective. The implicit five-year inflation expectations – used by the Fed and others as a measure of long-term inflation expectations – are now 1.9 per cent.

Historically, inflation expectations have largely been influenced by actual inflation, and current levels are not extreme. However, the period of depressed expectations is beginning to be uniquely long. For two years, five-year break-even inflation has been at a level lower than at any time except the worst period of the 2008-2009 financial crisis.

Another signal of falling inflation expectations is that many forecasters are beginning to predict CPIF of below two per cent even in the long term. The National Institute of Economic Research (NIER) and the Finance Ministry, for example, expect CPIF to be lower than two per cent for nearly five years. In wage negotiations, too, there is a discernible trend towards trade unions assuming that pay increases of two per cent yearly will result in higher real wages and salaries. Our conclusion is that if future inflation remains low (in line with our forecasts), expectations will fall to levels that will be challenging from a credibility perspective.



CPI inflation has mainly been below zero during the past six months due to falling interest expenses. When the repo rate is hiked in 2015, CPI inflation will rise faster than CPIF, reaching 2.2 per cent at the end of 2015.

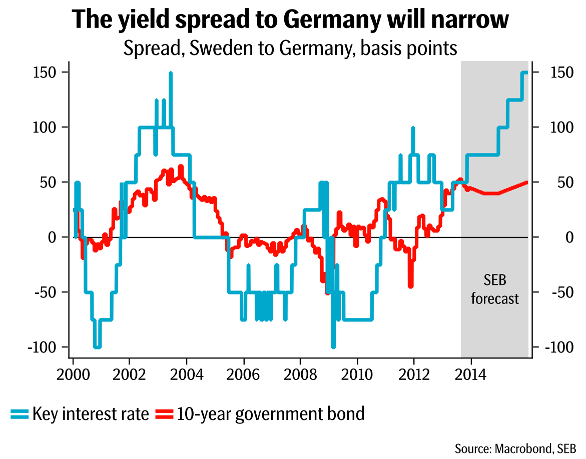
Riksbank will lower key rate in December

The Riksbank left the repo rate path unchanged at its monetary policy meeting in October but slightly increased the probability of a rate cut, while postponing the first rate hike by one quarter to the end of 2014.

Low inflation and high unemployment, combined with the European Central Bank's recent repo rate cut, have further increased pressure on the Riksbank to lower its refi rate again. The Riksbank's forecasts of economic growth and labour market developments are close to our own, but the bank's inflation forecast is significantly higher. The biggest difference concerns inflation during 2015 (see above CPIF chart), but the Riksbank's short-term forecast will also need to be adjusted downward after the unexpectedly low October figure. In our assessment, the risk of further declines in inflation expectations (see box) will **persuade the Riksbank to choose to lower the key rate at its December meeting, in order to strengthen the credibility of its inflation target**. We have also postponed the timing of the first rate hike to February 2015 and expect a further hike to 1.25 per cent late that year.

Yet the Riksbank faces a difficult dilemma. Home prices have gained new momentum, especially cooperative flats in greater Stockholm, Gothenburg and Malmö. This indicates that household borrowing will increase at a pace that the Riksbank perceives as discomforting, but now that the government has assigned the main responsibility for macroprudential oversight to the Financial Supervisory Authority, this changes the playing field to some extent. The FSA now has several tools in its kit: a mortgage loan ceiling, higher bank risk-weighting for mortgage loans, the build-up of counter-cyclical capital buffers and principal repayment recommendations for mortgage loans. We expect various measures to be implemented in July 2014.

These measures strengthen the argument that the repo rate can be lowered, but there are many indications that the Riksbank's interest rate policy will continue to take home prices and credit expansion into account. The central bank can cite its responsibility for preserving financial market stability. The Riksbank also seems prepared to point out risk scenarios that, though not highly probable, may lead to deflation if a future housing bubble should burst and trigger a deep recession. There is thus a risk that a majority of the bank's Executive Board will want to hold off on repo rate cuts until it is clear that the FSA's measures will be strong enough to slow the upturn in home prices and household lending.



Slight rise in bond yields

In recent months, Swedish 10-year sovereign bond yields have fallen, in line with their German and American counterparts. Despite a minor downturn in recent months, the spread against Germany remains close to the highest levels recorded for the past 15 years. We expect the yield spread to narrow during the coming six months, mainly because the Riksbank will lower its key interest rate. But as the time for the Riksbank to hike its key rate approaches, 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 75 basis points. At the end of 2014, the **Swedish 10-year sovereign yield will stand at 2.85 per cent and at the end of 2015 it will be 3.25 per cent**.

Economic cycle and Riksbank boost krona

The krona has continued to weaken during the autumn, but the trade-weighted KIX exchange rate index is still only 1.0 per cent from its strongest level during the past 30 years and is also about two per cent stronger than the 2012 average. In the **short term, we expect the krona to weaken further**, with the EUR/SEK exchange rate rising to 9.00 at the end of 2013 as an effect of the Riksbank's key interest rate cut.

The exchange rate effect of the key rate cut will be temporary, however. Next year we expect the international economic recovery to help strengthen the krona, consistent with the historical pattern. In addition, the Riksbank will probably hike its key interest rate earlier than the major central banks. We thus expect **the krona to strengthen to an EUR/SEK rate of 8.50 by the end of next year and 8.25 at the end of 2015**. The USD/SEK exchange rate will be 6.80 at the end of next year and 6.90 at the end of 2015.

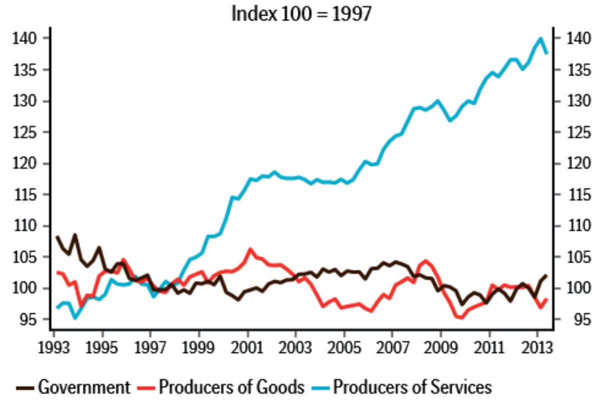
The risks of continued krona depreciation are mainly related to a reversal of the flows that benefited the krona during the most acute euro zone crisis. However, we believe that these flows mainly originated from long-term investors, for example central banks, that will largely retain their krona positions.

- **Major upturn in education sector**
- **200,000 new service jobs since 2009**
- **Upturn at staffing companies reflects broad demand for labour**

In recent years, employment in Sweden has risen sharply even though economic growth has been weak. In the following, we analyse what sectors have contributed to this upturn. Our conclusion is that there is a relatively broad-based upturn in service sectors and that employment in education and health care has undergone an especially strong increase.

Employment

Index 100 = 1997



Source: Statistics Sweden

Service sectors are trending upward

The upturn of recent years is part of a long-term trend; the number of people employed in service sectors has increased by a total of 30 per cent since the late 1990s. During the same period, the number employed in goods-producing sectors has largely stood still. The trend during the current economic slowdown is significantly different from the IT (or dotcom) crisis at the turn of the millennium, when service sector employment was largely unchanged for 3-4 years. The fact that productivity growth has been so weak in recent years can be interpreted as an indication that the output of service sectors, and thus GDP, has been underestimated.

The table below shows that employment rose by 200,000 people, or 4.5 per cent, after the economic recovery began in 2009. The upturn in service sectors is relatively broad, but is dominated by health care, social services and education, where the rate of increase has been 15-25 per cent. These sectors account for only 4 per cent of the total labour force, but are still behind nearly one fourth of the increase. The number of people employed in miscellaneous services has also increased strongly – especially in staffing companies, which saw an upturn of nearly 20 per cent.

More jobs in health care and education

The employment increase in health care, social services and education is partly an effect of the privatisation of formerly public sector activities, but the downturn in public sector employment is significantly smaller than the increase in the business sector. A comparison between statistics from the Labour Force Survey (LFS) and the national accounts indicates that about one third of the upturn of about 30,000 people in health care and social services offsets a decline in the number of public sector employees. However, the number of people employed in the educational sector has climbed both in the private and public sector.

The upturn in staffing companies also mirrors lower employment in other sectors, such as industry, trade and health care. Because other sectors use personnel on hire from staffing companies, the upturn in this sector reflects an underlying demand for labour in large portions of the business sector and also, to some extent, in the public sector.

Employment change

2013H1 vs 2009

	1000s	% change
Total	202	4.5
Goods	6	0.6
Agriculture, forestry etc.	13	14.6
Industry	-24	-3.6
Construction	17	5.8
Services	170	8.5
Trade and transport	18	2.4
Restaurant, hotel	25	17.2
Information, computer services etc	5	3.1
Bank and insurance	1	1.1
Real estate	5	7.9
Professional services, lawyers administrators, consulting	59	13.1
Staffing industry etc	36	17.8
Education, health care	44	22.1
Education	13	23.2
Health care	10	15.6
Attention and care services	20	27.2
Personal and cultural services	10	10.4
Public sector	22	1.7

The above table shows employment according to the national accounts. The Labour Force Survey (LFS) also divides employment by sectors, but the LFS is regarded as more uncertain and also includes more interruptions in time series due to changes in statistical methods.

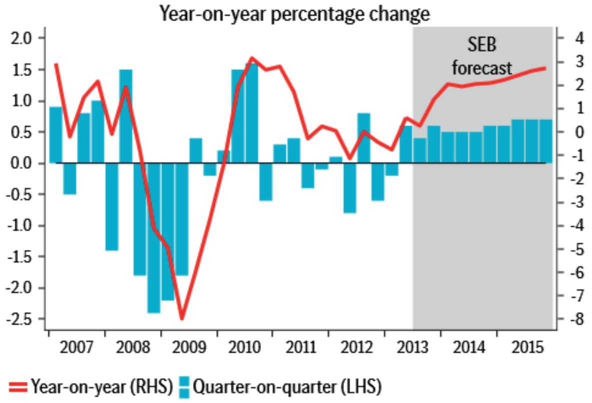
Gradual recovery continues

- **GDP growth returns to positive in 2013**
- **Employment posts first increase since 2008**
- **Current account surplus reaches new record**
- **Monetary policy: what will ECB do next?**

Danish growth returned to positive territory in the first half of 2013 amid signs that a consumer-led recovery is gradually gaining hold in the economy. Employment posted its first (small) annual increase since 2008 in the second quarter, consumer confidence is back in expansion territory and home prices are rising again. There are still headwinds from household debt reduction, low capacity utilisation and falling construction, but a strengthening global backdrop will allow a recovery to gain momentum in 2014. **We expect growth to be 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 our 2013 forecast compared to the last *Nordic Outlook*.

Recovery in GDP

Year-on-year percentage change



Source: Statistics Denmark, SEB

Improving domestic demand outlook

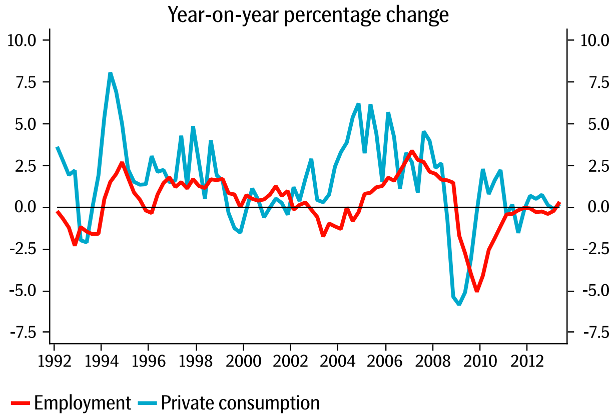
Consumption was a key driver in the double-dip recession of 2011 and 2012, but this year has seen a marked improvement in consumer confidence as several key factors turned positive.

Employment has started rising again after a long period of decline or stagnation. The 0.6 per cent annual increase in the second quarter was not explosive, but it was the **first increase since the fourth quarter of 2008**. Even modest growth, if sustained, will support both income and confidence. Meanwhile, real wage increases have turned positive even though nominal wage inflation at 1-1.5 per cent is at the lowest level ever recorded as inflation also remains close to the all-time low of 0.4 per cent reached in August.

Home prices have also started rising again, buoyed by the lowest adjusted-rate mortgage (ARM) rates ever. Falling home prices forced the financial sector to tighten credit conditions in 2011-12. While the pressure to reduce loan-to-value rates is still intact, rising prices will make the process easier for consumers. They will also help reverse the renewed decline in residential investment, which dropped more than 10 per cent in 2012. Housing starts have picked up in 2013, suggesting construction activity will stabilise in 2013 and provide a positive growth contribution in 2014.

Employment finally growing again

Year-on-year percentage change



Source: Statistics Denmark

Rising manufacturing sector confidence and improving demand prospects in European export markets also suggest a modest pick-up in non-residential investment after a couple of flat years. But with capacity utilisation still well below its long-term average, the near-term upside is limited: capital spending plans have stabilised, but there is no sign of increase yet.

All components of private domestic demand are thus showing signs of life at the same time. The improvement still falls far short of what counted as a recovery in the past, but **prospects for domestic demand growth look better than at any point since 2010**.

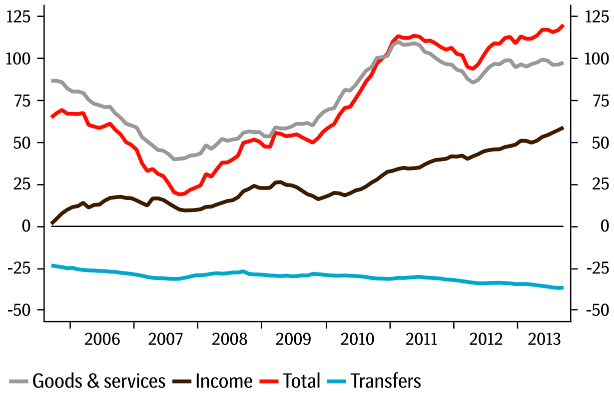
Current account reaches new record

Denmark's current account surplus is changing composition and this is likely to make it even more entrenched. The surplus in goods and services has stabilised at a high level, but financial income is rising fast.

In September, the 12-month rolling current account surplus hit a new record of DKK 120 billion, approximately 6.6 per cent of GDP. DKK 59 billion came from the income component, up from 46 billion a year before and a reflection of Denmark's rising net foreign wealth, which currently amounts to around 37 per cent of GDP. The income component only turned positive in 2005 and the surplus is likely to rise further as current account surpluses continue to accumulate in the coming years.

Record current account surplus

DKK billion



Source: Statistics Denmark

The largest contribution still comes from the trade surplus in goods and services, which has stabilised around DKK 100 billion annually in recent years. But the composition has changed here as well. Oil is no longer a direct contributor to the external surplus, on the other hand, oil exports were never a huge contributor to the current account story, but at the end of the last decade Denmark's energy trade balance showed a surplus of close to DKK 30 billion. Falling oil production in the North Sea and lower oil prices have eliminated that surplus today.

Part of the large trade surplus is likely a result of a temporary depression in domestic demand after the housing crash in 2008-2009, but the rising surplus on financial income suggests the current account surplus can stay close to the current level even as demand gradually recovers. A sustained surplus from financial income will eventually force Denmark to run an offsetting trade deficit in order to keep the DKK stable, but this is unlikely to happen any time soon.

Productivity concerns are overblown

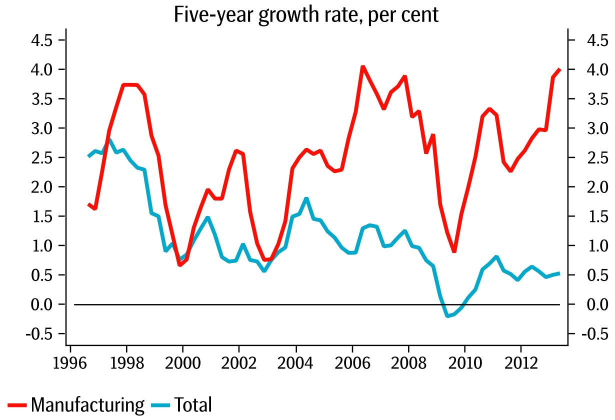
Alarm over falling productivity growth and deteriorating competitiveness has been a dominant theme in Denmark's economic discourse in recent years. The government has even set up a "productivity commission" to look into the problem. However, while it is true that GDP-level productivity data have not been pretty and unit labour costs therefore look unimpressive in international comparisons, a closer look at the data suggests that both trend growth and competitiveness are in better shape.

The manufacturing sector's productivity growth has thus been relatively stable at around 3 per cent both before and after 2000 – if anything, the trend appears to be rising. So competitiveness in the sector that is most exposed to competition probably has not been affected by rising unit labour costs. Other parts of the economy do show signs of a slowdown: the construction sector has shown negative productivity growth since 2000, for instance, but this is more likely to reflect the distorting effect of the real estate bubble than any structural flaw in the economy.

After 2008, productivity growth has slowed across all sectors. It is not unusual for productivity to slow during periods of weak activity, since employment typically does not decline by as much as would be justified by current demand. The recovery will thus at first appear to be relatively "jobless" as productivity normalises. In our view, Denmark can sustain growth of at least 1.5 per cent on a trend basis and could grow at a faster pace without creating inflation in coming years due to pent-up productivity gains from the crisis years.

Strong manufacturing productivity growth

Five-year growth rate, per cent



Source: Statistics Denmark, SEB

Monetary policy to change as ECB hits zero?

Denmark's monetary policy situation has been calm since the Nationalbank cut rates below zero and financial stress signs in the euro dissipated. The foreign exchange reserve has stabilised along with the currency, and bond spreads have levelled out slightly above zero.

Given the nature of the currency peg, it is normal for things to be rather bland most of the time. However, as the ECB has now reached the end of the line in terms of conventional monetary policy, some very interesting questions could arise in the coming months. There is a good chance that some kind of non-conventional weapon will be used, either in the shape of negative interest rates or QE, and this may force the Nationalbank to consider a change in its toolkit as well.

We think the ECB is unlikely to use negative interest rates, but it would be the simplest for Nationalbanken since it could just continue to set the relative interest rate to balance flows.

The situation would be more complicated if the ECB were to use quantitative tools instead. **Our base case is that the Nationalbank will not replicate an outright QE strategy, continuing at least initially to use interest rates to stabilise the DKK.** However, it is not clear in what direction they would need to move. Short-term rates would likely decline in the euro zone, putting upward pressure on the DKK. Long-term yields could go up in Germany if QE is convincing, though, which would mitigate the effect.

On balance, we suspect the net effect would be to require a slightly wider negative spread at the short-term end, while bond yields would be relatively unaffected.

Faster growth in 2014, though signals are vague

- **Consumption, exports will drive recovery**
- **Lower inflation after autumn 2013 spike**
- **Norges Bank will hike key rate more slowly**

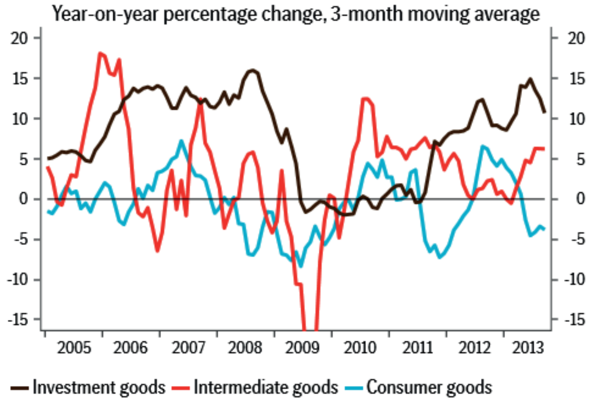
Our scenario remains that the Norwegian economy will gain momentum next year after its 2013 slowdown. This is despite mediocre, though improving, growth in the third quarter and still-vague signals in sentiment indicators of an approaching economic upturn. The conditions are in place for a **recovery in private consumption and exports**. There will also be some strengthening in business investments, but activity in the oil industry will slow significantly. **Fiscal policy will be somewhat more expansionary** next year under the new government. Predictions of greater fiscal extravagance are thus exaggerated. The picture of Norway's super-solid public finances remains intact. Altogether, **mainland GDP** – excluding oil/gas and shipping – **will increase by 1.8 per cent this year, 2.4 per cent in 2014 and 2.6 per cent in 2015**. Growth in the overall economy will end up at 0.9 per cent in 2013 and at 2.4 per cent in 2014, still somewhat below trend. We adjusted our forecasts downward (in *Macro Update*, October 22) by a few tenths of a per cent annually compared to the August 2013 issue of *Nordic Outlook*. We foresee a gradual downturn in home prices totalling about 10 per cent during 2014. An even larger price decline and weaker residential investments are the main downside risks in our GDP forecast.

The economy weakened relatively suddenly early in 2013, mainly through domestic consumption of goods but also via shaky export performance. Mainland growth amounted to a feeble 0.3 per cent in the second quarter, compared to the first. **In the third quarter, consecutive growth strengthened somewhat** to 0.5 per cent: marginally above our forecast and entirely in line with that of Norges Bank. But one weakness was that a sizeable proportion of the upturn came from the inventory component. Seasonally adjusted year-on-year mainland GDP growth also cooled to 1.5 per cent, the slowest pace since early 2011.

Momentum in the manufacturing sector (excluding energy and mining) has **held up surprisingly well**, although it moderated somewhat in the autumn. The previously sizzling investment goods industry is moving towards weaker performance because capital spending growth in the oil sector will drop significantly in 2014. Meanwhile prospects are improving for intermediate goods companies, which will benefit from increased external demand. It is also notable that business confidence is buoyed by optimistic non-oil exporters in particular. We predict that total exports of traditional goods (excluding oil/gas, ships and oil platforms) will increase by 3.5 per cent next year – with an upside risk. Exports will benefit from gradually higher demand in key European markets and from this autumn's relatively sharp depreciation in the krone.

Divergent picture in manufacturing

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



Source: Statistics Norway

Private consumption growth abruptly decelerated last spring, and consumption growth almost ground to a halt during the third quarter. But the picture has not been entirely clear; the national accounts may perhaps have underestimated actual consumption. The domestic goods portion has been persistently weak. In contrast, consumption of services and outside Norway (including positive signals in airline statistics) has been relatively strong. New car registrations have also climbed somewhat. The cool-off in consumption is also remarkable, in light of strong fundamentals in the household sector. Real disposable income increased by a solid 3.7 per cent year-on-year in the second quarter of 2013, but slowed a bit during the third quarter due to the impact of inflation. However, parts of the inflation spike proved to be temporary. Nominal wage and salary growth will be somewhat higher next year. We thus foresee **continued solid real income** growth next year, with households meanwhile **drawing down on saving**. Overall, this should provide support for a stronger increase in consumption, nearly 3 per cent during 2014.

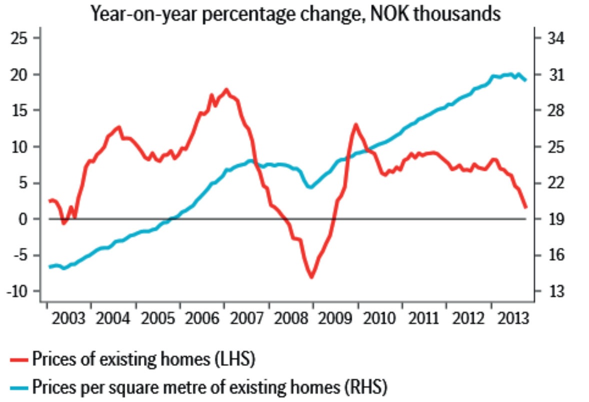
The labour market situation is comparatively stable, although indicators have recently diverged somewhat, depending on which measure is used. Employment growth (according to the Labour Force Survey) has recovered significantly since last spring. Meanwhile unemployment has risen, but this is driven by an increased labour supply, a trend that has slowed in recent months. **The labour market will remain relatively stable** during the next couple of years, and unemployment will end up around 3.5 per cent both in 2014 and 2015.

The housing market has cooled distinctly in the course of 2013, from price increases of 8 per cent year-on-year during 2010-

2012 to only 2 per cent in 2013. This noticeable slowdown is partly psychologically driven. High mortgage interest rates and increased residential construction, which has led to a better market balance, are other underlying factors that have contributed. No housing market crash is likely; we still believe that home values have not swelled into a bubble. The inventory of unsold homes has increased only marginally, and sales do not point towards any drastic deterioration. Macroprudential measures also seem to have worked, although there is not yet any evidence of a slowdown in lending to households. **We predict a home price decline of about 10 per cent in 2014** and then a stabilisation in 2015. Continued rapid population growth and lower residential construction will sustain home prices in a medium-term perspective.

The housing market has cooled significantly

Year-on-year percentage change, NOK thousands

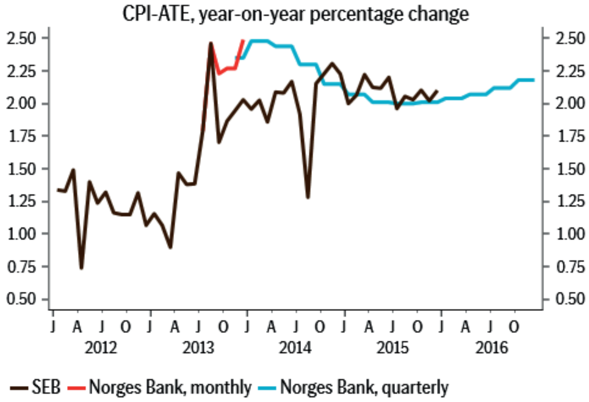


Source: Norwegian Association of Real Estate Agents, Statistics Norway

During the summer and autumn, inflation took a clear jump compared with the strongly depressed level of recent years, but the trend has been volatile: partly an effect of new data-gathering methods. The upturn was relatively broad-based, driven by categories of domestic goods whose prices have been puzzlingly depressed for a long time, such as food and rents. Prices of imported goods also rose faster because the krone weakened and the effects of its earlier appreciation disappeared from the statistics. Looking ahead, these factors will continue to have an upward effect on inflation and **we expect slightly rising CPI-ATE inflation during 2014**. Low international inflation pressure will avert an inflation surge, however, and exchange rate effects will also fade late next year. We predict that inflation will be somewhat lower than Norges Bank's inflation target throughout our forecast period.

Inflation will calm down after its recent spike

CPI-ATE, year-on-year percentage change

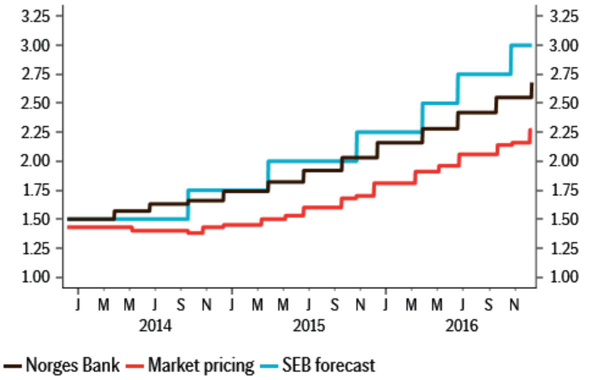


Source: Norges Bank, SEB, Statistics Norway

Norges Bank expects inflation to remain volatile during the next few months but the bank will regard them as temporary. Economic activity will instead determine whether Norges Bank should change its policies. We predict that over the next six months or so, the central bank will largely maintain its signal of unchanged interest rates in the short term. Norges Bank will thus not follow the example of the ECB's key interest rate cut, the main reasons being that Norwegian inflation has shifted upward and that import prices do not pose a downside risk after the weakening of the krone. At the same time, we do not foresee any large, rapid slide in home prices. Aside from signs of economic upturn, the NOK exchange rate will also play an important role in Norges Bank's future interest rate strategy; the krone must not become too strong. Low interest rates abroad will thus limit the upturn in Norwegian interest rates. Overall, we now predict that **the central bank will hike its deposit rate by 25 basis points to 1.75 per cent in September 2014 and that two further hikes will occur in 2015**, reaching 2.25 per cent.

Rate expectations

Per cent



Source: Norges Bank, SEB

Norwegian government bonds have performed poorly compared to Germany due to a large supply and weakened safe haven support, since financial turmoil in the euro zone has eased. We expect gradually smaller supply ahead which should be manageable for the market. Declining NOK volatility is likely to persuade foreign investors to buy Norwegian bonds, which are attractively priced. **The 10-year yield spread to Germany will shrink** from more than 110 basis points today to 80 at the end of 2014 and then rise only slightly in 2015.

Relative to unit labour costs, the **krone** is probably **overvalued** by 15-20 per cent against the euro. This is not a reason to believe that the krone will depreciate, but it indicates that the potential for appreciation is slightly limited. Meanwhile it perhaps explains why Norges Bank has been so stubborn in recent years about keeping the NOK weak. We predict that **NOK volatility will gradually wane and that the currency will strengthen**, but the long-term outlook is therefore less attractive. The EUR/NOK exchange rate will move from about 8.25 to 8.00 in December 2014 and further to 7.90 at the end of 2015. Our appreciation path for the krone is somewhat lower than in the last *Nordic Outlook*.

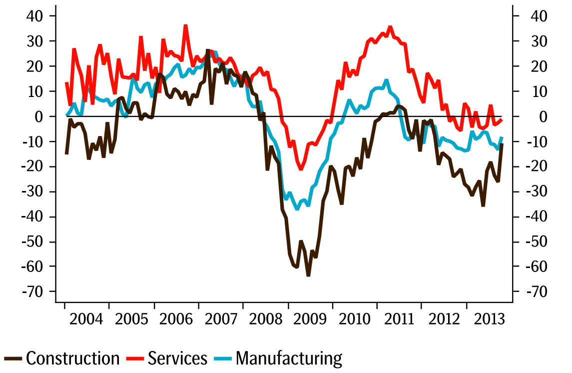
Structural problems undermine economic recovery

- **Weak export and capital spending trends**
- **Unemployment will level out at high level**
- **Falling inflation and low interest rates are bright spots for households**

After four quarters of negative growth, Finland left its recession behind with 0.2 per cent growth in the second quarter of 2013. Yet the outlook remains challenging. **Aside from cyclical weakness, the economy is plagued by structural problems**. Exports are weak and consumption is hampered by high unemployment and public sector austerity. A slight improvement in growth is expected at the end of 2013. Altogether, **GDP will fall by 1.0 per cent in 2013 and then increase by 1.2 per cent in 2014 and 1.6 per cent in 2015**.

Indicators are not signalling any rapid recovery

Net balance



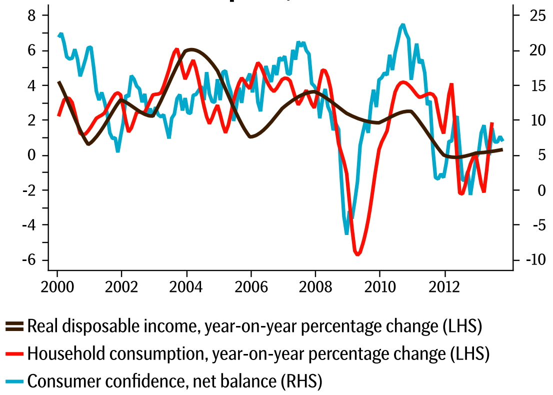
Source: European Commission

Indicators show weakness, but a slight improvement is discernible in construction. Manufacturing output fell by 2.8 per cent in September, though. Relatively high pay hikes, deteriorating terms of trade and problems especially in the information and communications technology (ICT) sector are squeezing production, exports and the current account balance. Exports have continued to fall this year as a share of GDP and are now 10 percentage points lower than when the financial crisis began. Over the past decade, the current account balance has fallen by 10 percentage points, showing a 2012 deficit equivalent to 1.6 per cent of GDP. **Exports will fall by 1.7 per cent in 2013, but then we expect an increase of 3.3 per cent in 2014 and 4.5 per cent in 2015**.

Capital spending has been weak during 2013, and capacity utilisation in manufacturing is now at a level that indicates continued declines in the next few quarters. Overall, we believe **capital spending will fall by 1.7 per cent in 2013,** then climb 1.0 per cent in 2014 and 2.0 per cent in 2015.

Household consumption made a positive contribution during 2010-2012, but since then consumption has slowed. Rising unemployment, a deceleration in the rate of pay increases and public sector austerity are reducing purchasing power, but low interest rates, falling inflation and low interest rates are providing some support. Consumer confidence has improved, compared to early in 2013. Consumption has recovered somewhat. **Consumption will fall by an annual average of 0.8 per cent in 2013, then grow by 0.6 per cent in 2014 and 1.1 per cent in 2015**. Aside from exports, home prices are a source of concern for the economy. Prices have been relatively constant in recent years but have fallen somewhat in recent months. Looking ahead, we expect unchanged or slightly falling home prices, adding some uncertainty to household confidence.

Household consumption, income and confidence



Source: Statistics Finland

Unemployment fell last summer but rose again in September and now stands at 8.1 per cent. In the next few months, **we expect it to climb further** before levelling out during the first half of 2014 and then beginning to fall. The rate of pay increases has decelerated and will remain at 2-2.5 per cent annually during our forecast period. As a result, inflation pressure will be subdued in the coming years. **We expect inflation to continue to fall** and bottom out at 1.5 per cent in early 2014 before very slowly rising again. In 2013 inflation will be 2.2 per cent, in 2014 1.6 per cent and in 2015 1.7 per cent.

Public finances are in better shape than in most other euro zone countries and showed a deficit equivalent to 2.2 per cent of GDP in 2012. The government will continue to pursue a tight fiscal policy, helping to keep the deficit at about this level despite weak GDP growth. There is still good market confidence in Finnish government finances, and the yield spread to Germany on sovereign bonds has been 20-30 basis points over the past year.

GLOBAL KEY INDICATORS

Yearly change in per cent

	2012	2013	2014	2015
GDP OECD	1.5	1.2	2.3	2.7
GDP world	3.4	3.2	3.9	4.1
CPI OECD	2.3	1.6	1.5	1.6
Export market OECD	2.5	3.7	6.3	6.8
Oil price, Brent (USD/barrel)	111.8	108.5	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	1.7	3.3	3.7
Private consumption	11,286	2.2	1.9	2.7	3.1
Public consumption	3,151	-1.0	-2.1	-0.6	-0.4
Gross fixed investment	2,386	8.3	4.7	10.0	11.1
Stockbuilding (change as % of GDP)		0.2	0.1	0.1	0.0
Exports	2,214	3.5	2.5	5.4	5.2
Imports	2,730	2.2	1.6	5.1	5.8
Unemployment (%)		8.1	7.5	7.0	6.2
Consumer prices		2.1	1.5	1.3	2.0
Household savings ratio (%)		5.6	4.4	4.6	4.8

EURO ZONE

Yearly change in per cent

	2012 level, EUR bn	2012	2013	2014	2015
Gross domestic product	9,484	-0.7	-0.4	0.8	1.6
Private consumption	5,449	-1.4	-0.6	0.6	1.4
Public consumption	2,041	-0.5	0.0	0.1	0.8
Gross fixed investment	1,740	-4.0	-1.0	1.7	3.0
Stockbuilding (change as % of GDP)		-0.6	0.0	0.0	0.0
Exports	4,348	2.5	2.5	3.7	3.7
Imports	4,100	-1.0	2.5	3.8	3.8
Unemployment (%)		11.4	12.1	12.0	11.5
Consumer prices		2.5	1.3	0.6	0.6
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	0.1	1.4	2.4	2.7
Japan	2.0	1.8	1.7	1.3
Germany	0.7	0.5	1.7	2.0
France	0.0	0.2	0.8	1.5
Italy	-2.8	-1.8	0.6	0.8
China	7.7	7.7	7.4	7.0
India	5.1	4.6	5.2	5.5
Inflation				
United Kingdom	2.8	2.6	2.0	1.7
Japan	0.0	0.3	2.4	1.7
Germany	2.0	1.6	1.9	2.0
France	1.5	1.2	1.5	1.8
Italy	3.3	1.4	1.6	2.0
China	2.6	2.7	3.1	3.2
India	7.5	6.2	5.8	5.5
Unemployment (%)				
United Kingdom	8.0	7.7	7.2	6.7
Japan	4.4	4.0	3.9	3.6
Germany	5.5	5.5	5.5	5.4
France	10.7	10.9	11.0	10.8
Italy	10.7	12.2	12.0	11.5

EASTERN EUROPE

	2012	2013	2014	2015
GDP, yearly change in per cent				
Estonia	3.9	1.3	2.6	2.9
Latvia	5.0	4.0	4.8	4.8
Lithuania	3.7	3.3	3.5	4.5
Poland	1.9	1.5	3.1	3.5
Russia	3.4	1.4	2.3	2.8
Ukraine	0.4	-1.4	1.7	3.2
Inflation, yearly change in per cent				
Estonia	3.9	2.9	2.0	2.6
Latvia	2.3	0.2	2.8	3.3
Lithuania	3.2	1.5	2.8	3.5
Poland	3.7	1.0	2.2	2.5
Russia	5.1	6.7	5.4	5.0
Ukraine	0.6	-0.3	5.3	6.0

FINANCIAL FORECASTS

		Nov 20th	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	0.75
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.25	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	2.76	2.75	3.00	3.30	3.40	3.50
Japan	10 years	0.61	0.80	1.00	1.10	1.20	1.20
Germany	10 years	1.71	1.70	1.70	2.10	2.20	2.50
United Kingdom	10 years	2.73	2.75	2.75	3.15	3.25	3.55
Exchange rates							
USD/JPY		100	101	105	110	112	115
EUR/USD		1.35	1.35	1.28	1.25	1.22	1.20
EUR/JPY		135	136	134	138	137	138
GBP/USD		1.62	1.61	1.54	1.52	1.53	1.51
EUR/GBP		0.83	0.84	0.83	0.82	0.80	0.79

SWEDEN

Yearly change in per cent

	2012 level, SEK bn	2012	2013	2014	2015
Gross domestic product	3,561	1.0	0.7	2.5	3.2
Gross domestic product, working day adjusted		1.3	0.7	2.6	3.0
Private consumption	1,718	1.6	2.0	2.7	3.0
Public consumption	956	0.7	0.8	0.8	0.8
Gross fixed investment	669	3.1	-2.0	3.0	5.5
Stockbuilding (change as % of GDP)	-1	-1.3	0.2	0.1	0.2
Exports	1,736	0.7	-1.4	3.7	6.2
Imports	1,516	-0.6	-1.0	3.5	6.1
Unemployment (%)		8.0	8.0	7.8	7.4
Employment		0.6	1.1	0.9	1.2
Industrial production		-4.3	-2.0	3.5	5.0
Consumer prices		0.9	0.0	0.6	1.9
CPIF		1.0	0.9	1.1	1.6
Hourly wage increases		3.0	2.6	2.6	2.8
Household savings ratio (%)		11.8	11.8	12.4	12.1
Real disposable income		3.1	2.7	3.3	2.4
Trade balance, % of GDP		2.6	2.3	2.6	2.7
Current account, % of GDP		6.6	5.9	5.6	5.9
Central government borrowing, SEK bn		25	127	66	17
Public sector financial balance, % of GDP		-0.9	-1.6	-1.8	-1.3
Public sector debt, % of GDP		37.5	40.5	40.8	40.5

FINANCIAL FORECASTS	NOV 20th	Dec 13	Jun 14	Dec 14	Jun 15	Dec 15
Repo rate	1.00	0.75	0.75	0.75	1.00	1.25
3-month interest rate, STIBOR	1.13	1.00	1.00	1.00	1.30	1.60
10-year bond yield	2.19	2.30	2.30	2.85	2.95	3.25
10-year spread to Germany, bp	48	60	60	75	75	75
USD/SEK	6.62	6.67	6.88	6.80	6.84	6.90
EUR/SEK	8.92	9.00	8.80	8.50	8.35	8.25
TCW	120.0	120.8	119.4	115.8	114.5	113.6

NORWAY

Yearly change in per cent

	2012 level, NOK bn	2012	2013	2014	2015
Gross domestic product	2,655	3.1	0.9	2.4	2.1
Gross domestic product (Mainland Norway)	2,106	3.4	1.8	2.4	2.6
Private consumption	1,151	3.0	2.5	2.8	3.0
Public consumption	579	1.8	2.3	2.2	2.1
Gross fixed investment	560	8.0	5.7	3.8	3.0
Stockbuilding (change as % of GDP)		-0.2	-0.9	0.2	0.1
Exports	1029	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		0.8	2.2	2.0	2.1
CPI-ATE		1.2	1.6	2.0	2.1
Annual wage increases		4.3	3.5	3.8	4.0

FINANCIAL FORECASTS	Nov 20th	Dec 13	Jun 14	Dec 14	Jun 15	Dec 15
Deposit rate	1.50	1.50	1.50	1.75	2.00	2.25
10-year bond yield	2.86	2.75	2.60	2.90	3.05	3.40
10-year spread to Germany, bp	115	105	90	80	85	90
USD/NOK	6.10	6.11	6.33	6.40	6.52	6.61
EUR/NOK	8.21	8.25	8.10	8.00	7.95	7.90

DENMARK

Yearly change in per cent

	2012 level, DKK bn	2012	2013	2014	2015
Gross domestic product	1,824	-0.4	0.4	2.0	2.5
Private consumption	901	0.5	0.4	1.6	2.2
Public consumption	522	0.7	-0.5	0.7	0.6
Gross fixed investment	315	-0.1	0.1	3.8	5.6
Stockbuilding (change as % of GDP)		-0.3	0.3	0.0	0.0
Exports	992	0.2	1.2	4.5	5.0
Imports	901	1.0	1.8	4.0	5.0
Unemployment (%)		4.5	4.5	4.3	4.0
Consumer prices, harmonised		2.4	0.7	0.9	1.3
Hourly wage increases		1.5	1.3	1.5	2.0
Current account, % of GDP		6.0	6.8	7.0	6.5
Public sector financial balance, % of GDP		-4.1	-1.5	-1.0	1.0
Public sector debt, % of GDP		45.4	44.0	43.0	41.0

FINANCIAL FORECASTS	Nov 20th	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	1.76	1.75	1.75	2.15	2.25	2.55
10-year spread to Germany, bp	5	5	5	5	5	5
USD/DKK	5.54	5.52	5.82	5.96	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	-1.0	1.2	1.6
Private consumption	109	0.2	-0.8	0.6	1.1
Public consumption	48	0.6	0.5	0.6	0.7
Gross fixed investment	38	-1.0	-1.7	1.0	2.0
Stockbuilding (change as % of GDP)		-1.2	-0.4	0.2	0.0
Exports	78	-0.2	-1.7	3.3	4.5
Imports	80	-1.0	-2.0	3.0	4.0
Unemployment (%)		7.7	8.1	8.2	8.0
Consumer prices, harmonised		3.2	2.2	1.6	1.7
Hourly wage increases		3.2	2.2	2.2	2.5
Current account, % of GDP		-1.7	-1.7	-1.5	-1.5
Public sector financial balance, % of GDP		-2.2	-2.2	-2.3	-1.8
Public sector debt, % of GDP		53.6	54.0	55.0	55.0

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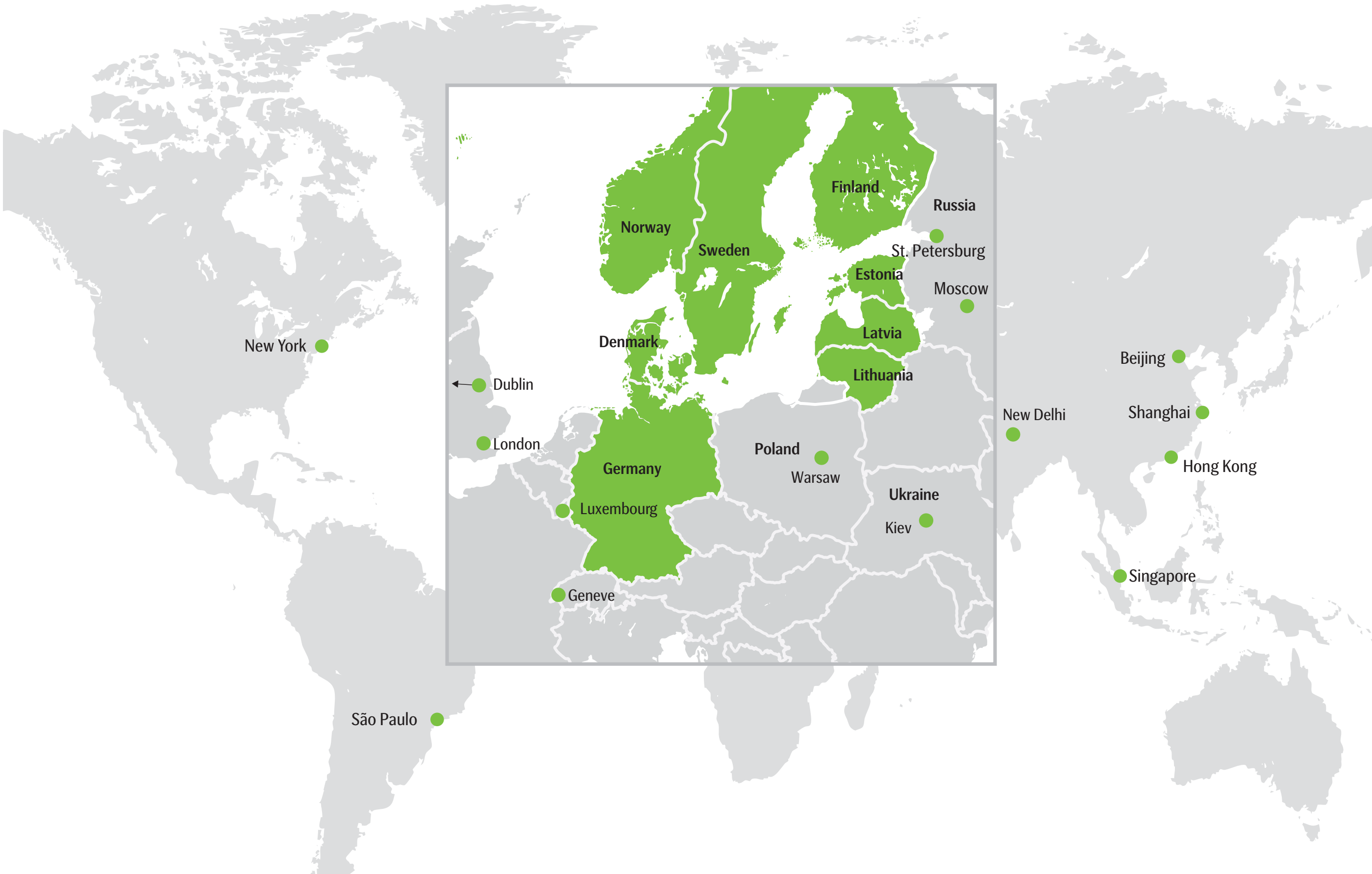

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