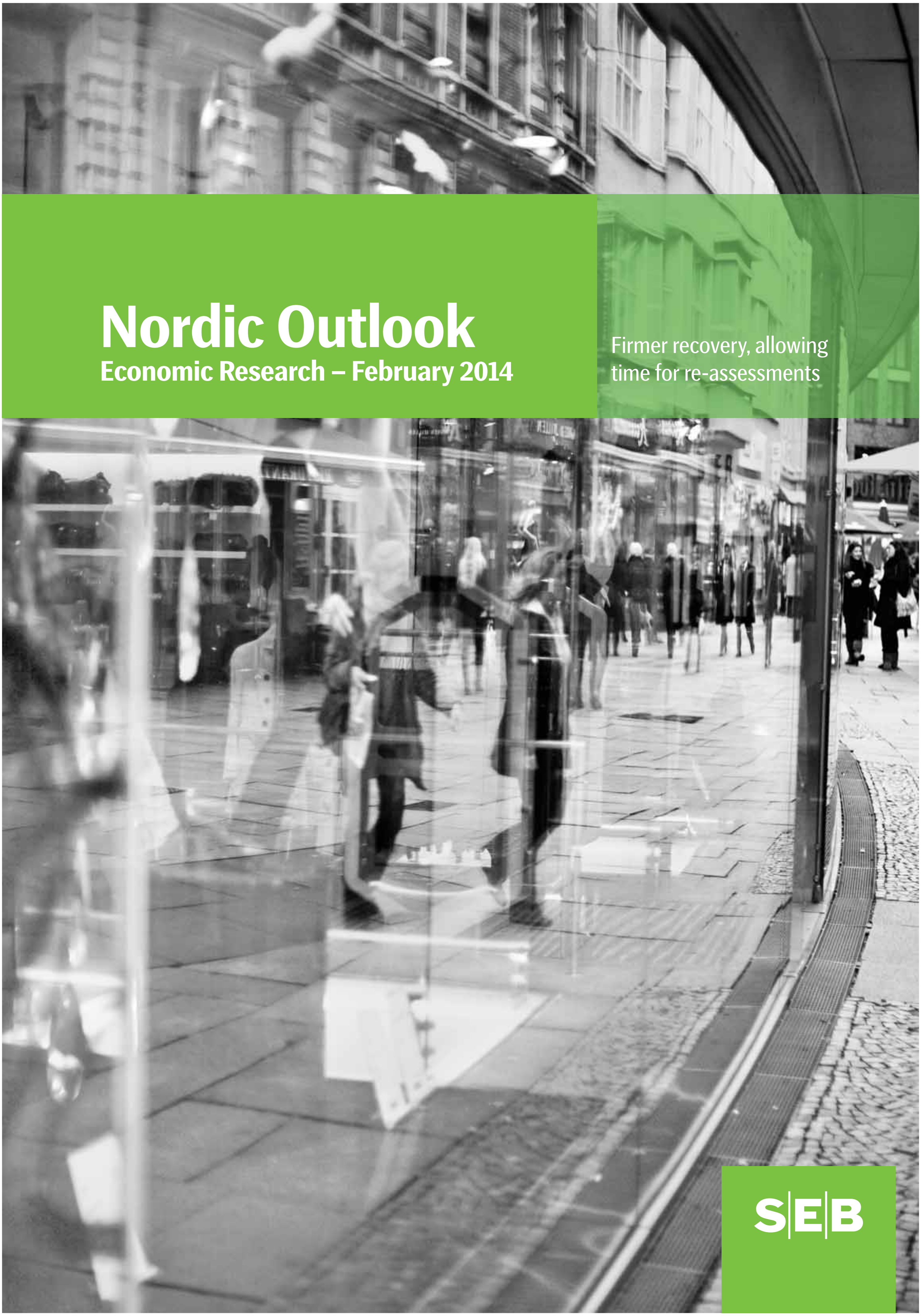

Nordic Outlook

Economic Research – February 2014

Firmer recovery, allowing time for re-assessments

SEB

Contents

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Firmer recovery, allowing time for re-assessments

- **US economy surging as fiscal policy eases**
- **EM: Structural problems but no new crisis**
- **Euro zone lags behind despite stabilisation**
- **Continued low inflation but bigger gaps**
- **Central bank stimulus keeping yields down**
- **Rising USD as Fed begins normalisation**

The global economy is gradually reaching firmer ground. Developments in affluent industrialised countries have, in various ways, moved in the right direction. The recovery in the **United States** is becoming more and more self-sustaining and we expect a relatively powerful acceleration in growth as fiscal policy headwinds ease. In **Japan**, the first phases of the government's economic policy offensive have been successful, but the real test of Abenomics remains: laying the groundwork for sustainably higher growth. The **United Kingdom** economy has surprised on the upside, while inflation has fallen faster than expected. The **euro zone** still faces major political and economic problems but now seems to have left its recession behind. The actions of the European Central Bank (ECB) have also greatly reduced the risk premiums for crisis-hit countries.

There has been a clear shift in global growth engines. While the outlook for the 34 countries of the Organisation for Economic Cooperation and Development (OECD) has brightened, the **problems in many emerging market (EM) economies have become increasingly evident**. Various large EM economies are hampered by regulations and structural weaknesses, and the situation in some countries is also worsened by deep-seated political instability. This turmoil will probably dominate much of 2014, especially in countries with current account deficits and low foreign direct investments. Looking ahead, however, we foresee opportunities for more stable development as the global recovery progresses. The risks of a severe crisis similar to the Asian financial crisis of the late 1990s are small.

We foresee an upturn in overall GDP growth in the OECD countries, from 1.3 per cent in 2013 to 2.4 per cent in 2014 and 2.7 per cent in 2015. In 2014, this implies a small upward revision. Our forecast for the EM economies, however, has been adjusted slightly downward, and economic acceleration during the next couple of years will be very modest. **Altogether, we predict global economic growth of 3.9 per cent this year and 4.0 per cent in 2015.**

Generally speaking, we see room for continued expansionary monetary policies during the next couple of years. This is one reason why **long-term yields will move up slowly and stock markets in the industrialised countries may climb a bit more**. However, the differences in terms of inflation risks and resource utilisation between the US, on the one hand, and the euro zone and Japan, on the other, are about to widen. The US Federal Reserve (Fed) will phase out its securities purchases by the end of 2014 and begin hiking its key interest rate in mid-2015. The Bank of England (BoE) and the Scandinavian central banks will also raise their key rates in 2015. The ECB is moving in the opposite direction and will need to undertake new measures to strengthen lending and counter the risks of euro zone deflation and stagnation. For example, we expect the ECB to launch GDP-weighted quantitative easing (QE) later this spring. Differences in monetary policy are one reason why the spread between US and German bond yields will remain at a relatively high level. We also believe this will eventually **help weaken the euro** against the US dollar in this environment.

Global GDP growth
Year-on-year percentage change

	2012	2013	2014	2015
United States	2.8	1.9	3.3	3.7
Japan	1.4	1.7	1.4	1.3
Germany	0.7	0.5	1.7	2.1
China	7.7	7.7	7.4	7.0
United Kingdom	0.1	1.9	2.8	2.6
Euro zone	-0.7	-0.4	1.0	1.6
Nordic countries	0.9	0.6	2.1	2.4
Baltic countries	4.1	3.0	3.7	4.2
OECD	1.3	1.3	2.4	2.7
Emerging markets	4.9	4.7	4.9	5.1
World, PPP*	**3.3**	**3.2**	**3.9**	**4.0**
World, nominal	2.6	2.5	3.2	3.3

Source: OECD, SEB * Purchasing power parities

The acute crisis now appears to be over. This will allow a change of focus related to economic analysis and economic policy discourse. In monetary policy, assessments of traditional questions such as productivity trends, resource utilisation, equilibrium unemployment and the driving forces behind inflation will be important and will determine how exit strategies will be crafted. Attempts by central banks to supplement their inflation targets with unemployment thresholds, for example, have not proved entirely successful. Both the Fed and the BoE will probably be forced to back away from the thresholds they have signalled so far, since unemployment has fallen faster than expected while inflation has remained low.

In a slightly calmer economic climate, there is greater scope to analyse the long-term consequences of the crisis policies being pursued. The need to repair balance sheets has again led to pumped-up asset prices. The consequences of increasing wealth gaps have gained increased attention in public discourse. This is especially true of the risk that these gaps will **eventually impede growth, due to weaker consumption and capital spending** (our "secular stagnation" theme article discusses the general risks of lower long-term growth).

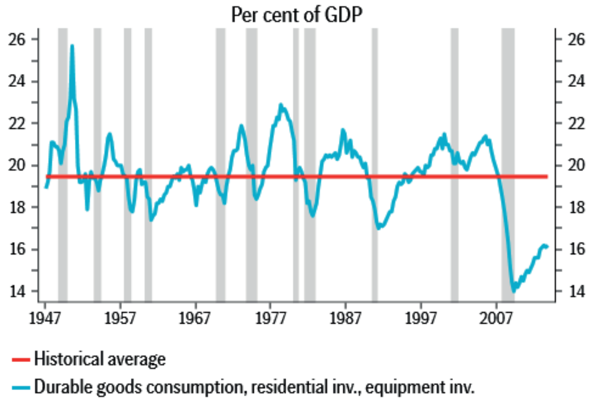
Fiscal policy also faces re-assessments. Austerity measures are coming to an end both in Europe and the US. In the next couple of years, we expect fiscal policies to have a largely neutral effect on growth. But given the high level of debt in many crisis-hit countries, further belt-tightening may be needed in the future to stabilise the situation. In countries squeezed by high unemployment, demographic strains and deflationary tendencies that drive up real interest rates, such a policy may carry great risks. **This is why unconventional measures like wealth taxes and debt relief are being discussed.**

US growth is gaining momentum

Our view that the US economy is entering a period of strong, self-sufficient growth has been confirmed in recent months. **The fiscal policy playing field has become clearer** and the contrast between 2013 and 2014 is striking: the contractive effect of fiscal policy has declined from 1.7 to 0.2 per cent of GDP. **The economy is also being stimulated by increasing wealth due to rising share and home prices**. Household debt deleveraging is probably over, and in an improved labour market environment, we expect a downturn in saving to drive an upturn in consumption. Although the consensus forecast has moved higher, our forecast of 3.3 per cent US growth this year and 3.7 per cent in 2015 is well above consensus.

Three most cyclical sectors: Still a huge upside

Per cent of GDP



Source: BEA, SEB

The most cyclical elements of demand remain very depressed, indicating that there is sizeable potential for recovery. But since household saving has fallen to a fairly low level, it is nevertheless important for the consumer-led recovery to be broadened by a genuine upswing in capital spending activity. We see good potential for this. Stronger capital spending usually follows in the wake of a surge in consumption. In relation to GDP, business investments are far below historical averages, while corporate earnings are close to record levels. Productivity-raising investments should thus enjoy high priority. There is also a great need: **the average age of factories and machinery** is the highest recorded since the late 1950s. A less uncertain fiscal playing field should also contribute to higher capital spending.

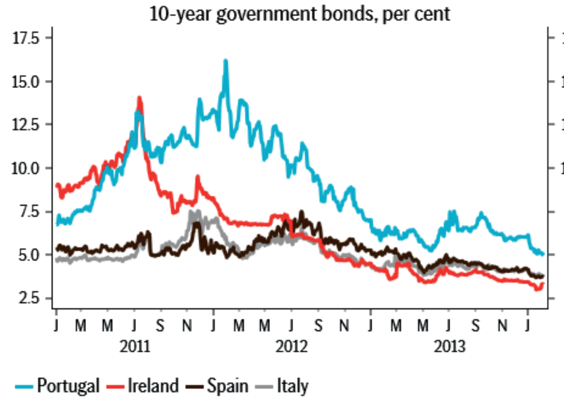
Increasing capital spending is also important to ensure that the supply side of the economy will be adequate for a lengthy recovery. Unemployment has fallen relatively fast in recent years, despite the fairly sluggish recovery to date. This is partly a reflection of the slow growth in productivity in recent years. In a situation where demographic factors are pushing down the labour supply, productivity needs to improve so that labour shortages will not force the Fed to act earlier than it has signalled so far.

Continued challenges for the euro zone

In Europe, the British economy has shown upside surprises. Stronger competitiveness, milder fiscal policy and rising home prices have contributed to accelerating growth. Although unemployment has fallen rapidly, there is plenty of slack in the economy and thus the potential for long-term, more productivity-driven growth.

Falling yields and narrowing spreads

10-year government bonds, per cent



Source: Macrobond

In the euro zone, too, the outlook is slowly improving. The recession seems to be over, and the European Central Bank's actions have helped push down risk premiums for crisis-hit euro zone countries. Yet record-high unemployment and a **banking system that is not in shape to supply credit to businesses in a normal way** are among factors impeding growth. The German economy continues to show signs of strength, but the rebalancing process will have difficulty gaining momentum as long as German fiscal policy remains tightly controlled and the behaviour of German households and businesses is dominated by caution. Overall **euro zone GDP will grow by 1.0 per cent this year, which is below trend. Next year, growth will accelerate to 1.6 per cent**.

Further economic policy integration is needed in the euro zone. But with the countries holding the EU presidency this year (Greece and Italy) preoccupied with domestic crisis-related problems – as well as elections to the European Parliament and appointment of a new European Commission – not much is likely to happen in 2014. Shaky cooperation between Germany and France (see theme article) is another factor hampering political advances in the euro zone.

Financial turbulence but no new EM crisis

Financial turbulence, with falling stock markets and weaker currencies in many EM countries, has characterised the beginning of 2014. Some countries have been especially hard hit. For example, the central banks in Argentina and Turkey have been forced to raise interest rates sharply. This instability has spilled into Western stock markets. Several factors are behind the weakening of risk appetite, for example continued uncertainty about the consequences of monetary policy changes in the US, worries about growth in China and political crises in several countries. But at a more fundamental level, **it is all about an ongoing re-assessment of diminished growth expectations in EM economies** compared to the preceding decade. Structural problems are a major reason for decelerating growth in many economies.

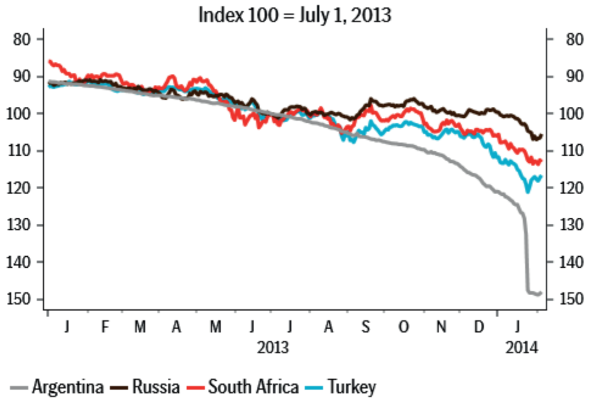
Our view, however, is that comparisons with the Asian financial crisis of 1997 are quite exaggerated and that the **EM countries are not generally threatened by a serious new crisis**. Fundamental conditions are radically different from the 1990s. Many developing economies, especially in Asia, are now significantly more resilient. Debt is lower, external balances are more solid while exchange rate policy has switched from fixed to floating currencies, and currency reserves are large.

The effects of this turbulence on economic growth will thus probably be small. Market unrest last May and June does not seem to have had any major impact on GDP growth in EM countries. Small, open economies are expected to benefit from recent currency depreciation by boosting their exports, but domestic demand will be hampered in those countries that are forced to tighten their monetary policy. In many EM countries such as India and Russia, growth will remain weak, but the main reason is unresolved structural problems.

We should be careful about drawing general conclusions, though. Because of **major differences in country-specific conditions**, the impact of market turbulence has varied. For example, Argentina and Turkey had been very hard hit, while other economies such as China and Mexico have been more or less untouched. In some countries, market instability can be explained by long-time economic policy mismanagement (Argentina, Venezuela), in others by political crises (Thailand, Ukraine) and in many other economies by structural problems (BRIC countries). But there are also examples of economies with brightening prospects (South Korea, Mexico, the Philippines). Generally speaking, countries with current account deficits, such as South Africa, Indonesia and India, are particularly sensitive to economic stresses.

Pressure on emerging market currencies

Index 100 = July 1, 2013



Source: Macrobond

Financial **turmoil is likely to persist for much of 2014, although we do not expect it to deepen**. The trend towards diversified performance by EM countries will probably continue. A large number of elections will be held during 2014 (for example in Brazil, India and Indonesia), which will contribute to continued political uncertainty. Uncertainty about future bond yield trends in developed countries is also likely to persist for another while.

Balanced risks

As earlier, the upside risk in our forecast is that the US economic recovery **will have larger contagious effects on other parts of the world economy** than we have expected. Our growth scenario, to which we assign 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 – will create obstacles to such a development. This will also affect the Nordic economies, whose recovery in our main scenario is weaker than normal.

The short-term downside risks have decreased in the 34 mainly affluent OECD countries – among other things because questions about the US federal budget have been resolved and systemic risks in the euro zone have decreased. Looking ahead a bit further, there are still risks connected to the normalisation of monetary policy. This is especially true if the Fed begins its exit strategy at such an early stage that countries in divergent cyclical phases will have problems. Although it is not our main scenario, there are also risks that the Fed's monetary policy might make underlying problems in EM economies harder to manage and do more harm to their growth. **Overall, we have lowered the risks of a poorer economic scenario from 25 to 20 per cent.** In addition, the downturn in our negative scenario is milder than in the November issue of *Nordic Outlook*.

Alternative scenarios

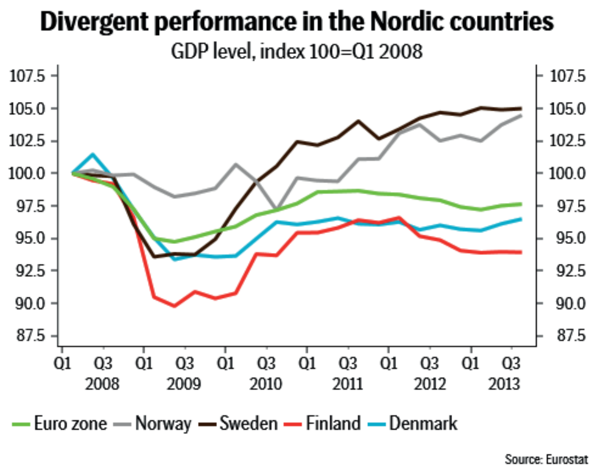
GDP, year-on-year percentage change

	2014	2015
A. Larger contagious effects from the US upturn (20%)		
United States	3.7	4.2
Euro zone	1.5	2.5
OECD	**2.8**	**3.4**
Emerging market economies	6.2	6.4
B. Risks connected to the Fed's exit policy (20%)		
United States	2.8	2.0
Euro zone	0.5	0.5
OECD	**1.6**	**1.2**
Emerging market economies	3.5	3.0

Source: SEB

Nordic countries taking different paths

The crisis of recent years has affected the Nordic countries in varying ways, both during upturns and downturns. Different conditions related to **exchange rate systems and the structure of the housing and labour markets have played a major role**, for example. Norway initially weathered the crisis best, avoiding the GDP declines that occurred in nearly all other industrialised countries. In the other Nordic countries, GDP fell by between 5 and 10 per cent.



In Sweden, the 2010-2011 recovery was significantly stronger than in the other Nordic countries, partly supported by a weak currency. The deep crisis in the Danish housing and construction markets has hampered the country's recovery so far. Finland has been dominated by structural problems in several key export sectors, including unfavourable price trends in the world market. Comparing GDP levels since the crisis began in 2008, we can see a clear split: Sweden and Norway are 5 per cent above their pre-crisis levels, while Denmark and Finland are a few per cent below. It is thus difficult to find evidence that any general Nordic growth model exists.

Looking ahead, the pattern may change to some extent. The Nordic countries face varying challenges. In **Denmark**, the housing market now seems to be starting to rebound. This will lay the groundwork for a consumer-driven recovery, with above-trend growth of 2.0 per cent in 2014 and 2.5 per cent in 2015. The country's current account surplus has grown during the crisis, and the central bank must continue to maintain lower interest rates than the ECB in order to keep the Danish krone within its narrow band against the euro.

The Finnish economy is being squeezed by deteriorating competitiveness, unfavourable price trends for import and export goods and structural problems in the information and communications technology (ICT) and forest product sectors. These problems are now about to spread into the domestic economy, for example due to rising unemployment. In this environment, households and businesses are hesitant about spending, causing the economic recovery to continue falling behind the other Nordic countries. Finland's GDP growth of 0.8 per cent in 2014 and 1.4 per cent in 2015 will be below trend.

In **Norway** the oil sector and exceptionally strong public finances have helped the domestic economy remain resilient, but the high cost situation is creating competitiveness problems, despite the recent weakening of the Norwegian krone. Other sources of pressure are highly indebted households, falling home prices and lower oil sector activity. However, we believe that the housing market will make a soft landing, creating conditions for a gradual recovery. Altogether, GDP will rise by 2.1 per cent in 2014 and 1.8 per cent in 2015.

After its strong 2010-2011 recovery, growth in **Sweden** has been sluggish in recent years. This is mainly because exports have lagged behind countries like Germany, but the domestic economy has been stimulated by an expansionary fiscal policy, rising home prices and higher employment. Looking ahead, we expect broader-based growth, with GDP increasing by 2.5 per cent in 2014 and 3.2 per cent in 2015. The biggest downside risk is that Sweden, like so many other countries, may finally suffer from a decline in home prices.

Nordics and Baltics, GDP growth
Year-on-year percentage change

	2012	2013	2014	2015
Sweden	0.9	1.0	2.5	3.2
Norway	2.9	0.8	2.1	1.8
Denmark	-0.4	0.4	2.0	2.5
Finland	-1.0	-1.3	0.8	1.4
Estonia	3.9	1.0	2.6	2.9
Latvia	5.0	4.2	4.8	4.8
Lithuania	3.7	3.4	3.5	4.5

Source: OECD, SEB

Mounting labour shortages in the Baltics

Economic growth in the Baltic countries will accelerate a bit. Private consumption will remain a key force, driven by good real household incomes, while exports will rebound after a noticeable slump in late 2013. Latvia and Lithuania will continue to top the EU in 2014-2015, with growth of nearly 5 per cent in Latvia and 3.5-4.5 per cent in Lithuania. Estonia, which showed a big slowdown in 2013, will gradually recover; growth will be between 2.5 and 3.0 per cent in 2014 and 2015.

Inflation will remain low this year, with prices increasing by about 2 per cent in all three countries and upside risks. Labour shortages are expected to be an increasing problem as unemployment, which has fallen significantly in recent years, approaches structural equilibrium levels. Latvia's euro zone accession on January 1, 2014 is expected to result in minor initial economic effects. Lithuania is also on its way towards joining the euro zone; there is a high probability that after evaluations this spring, the European Commission and ECB will give the go-ahead for Lithuania membership.

Fiscal policy: weaker headwinds

In recent years, austerity measures have squeezed demand in various parts of the world. But **fiscal headwinds are now decreasing in most countries**. Meanwhile improved economic conditions are helping reduce public sector deficits. Once the recovery spreads to highly taxed parts of the economy such as employment and wages, government net lending often exceeds expectations. We believe that this historical pattern will be repeated.

In the euro zone, fiscal policy is moving towards being neutral, although some countries still have underlying belt-tightening needs. In the US, because of this winter's budget agreement, fiscal policy will be largely neutral in 2014. In Japan, fiscal policy is shifting from expansionary in 2013 to contractive in 2014. In the US, public debt will shrink in relative terms as GDP growth accelerates. The euro zone has bigger problems with government debt; the debt ratio will not get much help in shrinking while inflation and growth are so low. This means that despite lower average budget deficits, debt in the euro zone is more problematic than in the US.

Public finances

Budget balance as a percentage of GDP

	2012	2013	2014	2015
United States	-8.3	-5.8	-4.7	-3.9
Japan	-10.1	-9.5	-6.8	-5.7
United Kingdom	-7.9	-6.1	-5.9	-4.0
Euro zone	-3.7	-3.1	-2.6	-2.3
OECD	-5.9	-4.8	-4.0	-3.2
Fiscal stance*	0.7	1.3	0.7	0.5

* Change in structural balance, OECD countries

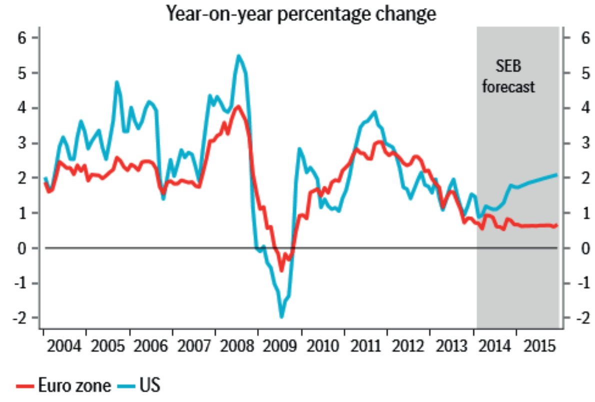
Source: IMF, OECD, SEB

Widening US-euro zone inflation gap

Inflationary pressures in developed economies remain low. After a temporary commodity-driven upturn in 2010 and 2011, the trend of inflation in most countries has been downward. In a globalised world, many driving forces are shared. In the past 2-3 years, producer prices of consumer goods have been squeezed in the world market. The dominant underlying force is low resource utilisation, which leads to pressure on wages and salaries. Our general scenario is that **disinflationary forces will continue to dominate**. Resource utilisation will remain low, and price pressure on consumer goods in the world market will continue. Meanwhile commodity prices are being held back by slower expansion in emerging economies. Lower prices for agricultural products during 2013 will also push down food prices at consumer level, with a time lag.

Consumer Price Index inflation

Year-on-year percentage change



Source: Eurostat, BLS, SEB

In the November 2013 issue of ***Nordic Outlook*****, we also highlighted tendencies towards greater regional gaps in the inflation pattern**. The UK underwent a period of much higher inflation than other large industrialised countries, driven by a weak currency, low productivity and tax hikes. In the past six months, however, inflation has fallen unexpectedly fast and our forecast is that this year the Bank of England will fulfil its 2 per cent inflation target for the first time since 2004.

However, we are seeing increasingly clear tendencies towards wider gaps between the US and euro zone inflation environments. In Greece, consumer prices are now falling sharply, while inflation in other crisis-hit euro zone countries is around zero. In Spain, especially, inflation has fallen steeply in the past six months. Deflationary tendencies in southern Europe are a highly logical consequence of the need to adjust competitiveness and price levels. Complicating the situation, though, is that French and German inflation is also trending downward and is well below 2 per cent. Such low German inflation makes euro zone rebalancing harder and means that the process must occur in an environment of excessively high real interest rates. This increases the burdens on indebted governments, households and businesses. Because of the weak recovery, the risk of damaging deflation remains high. **However, our main forecast is that the ECB's actions will enable the euro zone to avoid a general deflation**, but that inflation measured by the Harmonised Index of Consumer Prices will average as little as 0.6–0.7 per cent in 2014 and 2015. Core inflation will be even lower, at 0.5 per cent in both years.

Divergent inflation expectations

5-year break-even inflation, per cent

Source: Bloomberg, SEB

In the US, the picture is more complex. Resource utilisation is still low enough to keep inflation down during the next couple of years. **Our forecasts indicate price increases below 2 per cent in 2014 and 2015**, but the risk picture is different from that of the euro zone. Various indicators, including the Fed's Beige Book, are showing that labour shortages are appearing in some sectors and that wages and salaries are beginning to move. In an environment of stagnating productivity, this means rising unit labour costs. It is not self-evident that companies can pass these higher costs onward to consumers, but there is a strong historical correlation between unit labour costs and inflation. Inflationary impulses may also come via rents and health care costs.

Also worth noting is that on various occasions, the Fed has tended to underestimate inflation in similar economic situations. This was the case in 1993 and especially in 2003, when the central bank focused on deflation risks but then shifted direction and began hiking interest rate the following year. Although there are important differences compared to the current situation, there are similarities – such as a prolonged period of monetary stimulus combined with a lethargic labour market recovery.

Time for re-assessments by central banks

Central banks are now facing the task of starting to normalise their monetary policies in an environment where many economic and financial correlations are uncertain. Let us identify a few areas that are current topics of this global central bank discussion.

Inflation dynamics. Various central banks have called for a more in-depth analysis of the driving forces behind low inflation, for example connected to sectoral price and wage developments, the size of output gaps and productivity growth. The absence of clear correlations between resource utilisation and inflation complicates the task of monetary policy, especially in terms of communication.

Asset price inflation. Rising home and share prices are about to reach levels that go beyond what repairing balance sheets in various sectors justifies. The interplay between fiscal and macroprudential policy plays an important role in this context. The division of responsibility between various branches of public policy need to be clarified, and public discourse about the role of monetary policy when it comes to preventing price bubbles is about to intensify again.

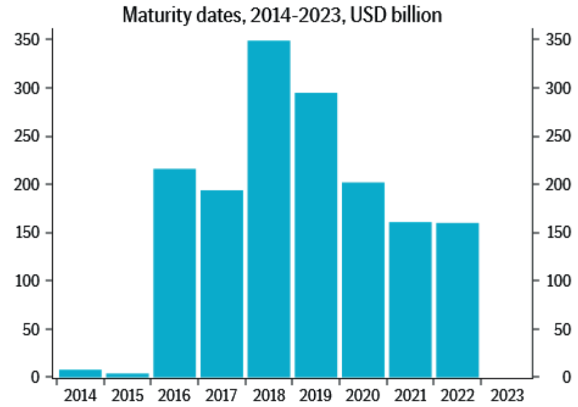
Communication and expectations. There is a great need to manage interest rate expectations, and various interesting attempts have been made, but the attempt to connect interest rate policy to unemployment and other thresholds has not been so successful. Both the Fed and the Bank of England (BoE) will probably need to adjust their signals soon, which will reduce the credibility of the method.

Coordination. There is mounting pressure on central banks to coordinate their exit policies. The challenge for a number of leading central banks will be to strike a balance between following domestic mandates and pursuing policies that help lead to global stability.

On the whole, monetary policy will move in an even more expansionary direction during 2014. We foresee no key interest rate hikes by the Fed, ECB, BoE or Bank of Japan (BoJ). But their **balance sheets will grow**. The Fed's monetary base (bank reserves) will increase by about 20 per cent (USD 400-500 billion) during 2014 to about USD 3 trillion. According to our rule of thumb, this is equivalent to a key interest rate cut of 50 basis points. The BoJ will expand its monetary base by USD 700 billion in order to reach the target of JPY 270 trillion (USD 2.7 trillion) by the end of 2014. According to our forecast, the ECB will also initiate quantitative easing measures starting this spring, with monthly bond purchases of about USD 40 billion.

The Fed's government bond portfolio

Maturity dates, 2014-2023, USD billion



Source: The Fed

During 2015, central banks will start cautious interest rate hikes. Norges Bank will raise its key rate in March and the Riksbank in April 2015; at the end of 2015 the Norwegian key rate will stand at 2.0 per cent and the Swedish key rate at 1.25 per cent. The Fed and BoE will hikes their key rates in the summer of 2015. By year-end the American key rate will be 1.25 per cent and the British key rate 1.00 per cent. Since the maturity profile of the Fed's government bond portfolio shows limited maturities in 2015 (about USD 4 billion), the total size of the Fed's balance sheet will represent a continued powerful stimulus. Not until 2016 will the portfolio decrease by about USD 200 billion. Both the ECB and BoJ will keep their key interest rates unchanged during our entire forecast period.

Unchanged or even reduced balance sheets (monetary bases) can continue to provide liquidity support. The **money multiplier**, which ultimately determines the money supply, is "sluggish" in many countries and regions. This is partly due to large credit risks, lack of confidence, uncertainty about future regulations and requirements and low demand for credit. For example, the US money multiplier stands at around 3-4 compared to its historical average of 10. This means that the monetary base of about USD 3 trillion, which given today's multiplier provides a money supply of USD 9-12 trillion, has the potential to ultimately provide as much as USD 30 trillion in new money if the multiplier becomes more normal.

Long-term yields rising at different paces

Unlike the discussions last spring about reducing monetary stimulus, the Fed's decision to gradually begin phasing out its bond purchases has not contributed to pushing long-term yields higher. We see several reasons for this. Through its forward-looking signals, the Fed managed to persuade the market that key interest rate hikes will occur only well into the future. Expectations of new ECB monetary easing have increased after low inflation figures have been reported. Worries about emerging markets have also reduced risk appetite and helped exert renewed pressure on long-term yields.

Falling US yields in advance of QE decisions

10-year bond yield

Source: Macrobond

Further ahead, the outlook for long-term yields will be influenced by increased differences between the US and the euro zone in the outlook for both growth/inflation and monetary policy. Given our belief that EM worries will not evolve into a serious crisis of global dimensions, we expect long-term US yields to rise gradually again. One reason for this is that real interest rates are still relatively low from a historical perspective, while the inflation picture will gradually normalise. A fragile recovery and strong disinflationary forces imply that the euro zone needs continued low interest rates. This underlies our forecast that the ECB will launch quantitative easing (QE) this spring.

The experience in the US has been that market yields have fallen in advance of the central bank's QE decisions but have then turned upward again. A successful QE programme by the ECB may help stabilise and eventually raise inflation expectations, which should be reflected in a renewed gradual increase in bond yields once the programme has been launched. In light of this, we expect German long-term yields to remain flat this spring, but we foresee 10-year yields ending up close to 2 per cent by year-end and 2.20 per cent by the close of 2015. This implies that the yield gap between the US and Germany will continue climbing to historically high levels of around 130 basis points.

Potential for higher equity prices

Last year the stock market was unexpectedly strong. Total global market capitalisation rose by 18 per cent (measured in USD) to nearly USD 64.5 trillion, equivalent to 90 per cent of global GDP. **The year's increase in value, USD 10 trillion**, surpassed the previous peak from 2007. Several factors helped lift stock markets to record levels: powerful **monetary stimulus**, signs of more **self-sufficient US growth** and an economic and financial turnaround with **fewer acute trouble spots** in the euro zone.

The positive stock market trend in 2012 and 2013 will provide **valuable support to economic growth ahead**. Household and bank balance sheets are being "repaired" at a rapid pace, stimulating increased private consumption and lending. Companies will also have good access to capital at an attractive cost of funding via both the stock and bond markets.

Despite the 2013 stock market surge and the most recent downward correction, we are repeating the view of equities we have expressed in recent issues of *Nordic Outlook*: **cautiously positive stock market performance during the coming year**. But this conclusion is surrounded by greater uncertainty than before. The 2013 upturn has not yet been generally supported by rising profitability; instead, a lack of investment alternatives has been an important driver. Company interim reports for the first quarter of 2014 will thus need to confirm expectations of better profitability and brighter prospects, while also showing signs of increasing willingness to make business investments.

A global recovery combined with monetary stimulus will help sustain the stock market during the next few years. Continued good dividend yields combined with risks of negative returns on fixed income investments will also drive the stock market. But although many signals point to a stock market upturn during 2014 as a whole, there are risks of more disappointments during the next six months due to higher risk aversion in an environment where there are questions about the future of developing economies and central bank policies.

Rising US dollar late in 2014

Expectations regarding central bank monetary policies remain very important to exchange rate trends. As earlier, we believe that the **US dollar will eventually come out on top in its battle with the euro**. The main reasons are divergent monetary policies that favour the USD as the Fed gradually phases out its bond purchases, while the ECB implements further easing. Persistent growth gaps between euro zone countries and the US will also benefit the USD. So far, however, an appetite for financial assets in the euro zone and a sharp improvement in the trade balance have propped up the euro. This situation may persist for some time, suggesting that there will be little change in the EUR/USD rate during the first half of 2014, but by the end of 2014 the dollar will strengthen to USD 1.28 per euro and by the end of 2015 to USD 1.25.

The pound has benefited from the strong recovery in British growth. The continued decline in unemployment has also helped bring forward the expected date of the first key rate hike by the Bank of England to late 2014, but inflation has fallen rapidly. Looking ahead, we expect it to be below target. We thus believe that **current expectations of a tightening in monetary policy are too aggressive** and need to be adjusted. This may cause the pound to come under renewed downward pressure. The GBP/USD exchange rate will fall during the second half and stand at 1.54 at the end of 2014.

We remain negative in the long term concerning the yen. There are still questions about the extent to which the Japanese government can implement measures to strengthen the economy in a longer perspective. There is also a risk that the tax hike that has been approved will again reduce household demand. This implies a risk that **current bond purchases will not be enough to permanently boost inflation in Japan**. Expectations that the BoJ will eliminate its target of expanding the monetary base to JPY 270 trillion and instead institute open-ended securities purchases may thus gain a foothold. Combined with a generally strong dollar, we thus believe that the USD/JPY exchange rate will be 112 at the end of 2014.

The Norwegian krone has been under pressure since Norway's economic growth decelerated clearly. Although the krone has dropped significantly since Norges Bank signalled that key rate hikes will not happen soon, **the krone seems far from cheap in light of the labour cost trend**. We thus believe that the currency will remain under pressure and we expect the NOK/SEK exchange rate to move towards parity late this year. This implies that the EUR/NOK rate will be at 8.50 at the end of 2014 and at 8.30 by December 2015.

The Swedish krona has appreciated by about three per cent in trade-weighted terms since the Riksbank's key interest rate cut on December 17. Given our forecast that underlying inflation will bottom out and that the Riksbank will leave its key rate unchanged, we believe that **in the long term, the krona may benefit from stronger domestic demand and rising global growth**. There are also increasing expectations that new ECB measures will lead to general downward pressure on the euro against most currencies. We are thus maintaining our forecast of a EUR/SEK exchange rate of 8.50 at the end of 2014. We expect a further strengthening of the krona to 8.40 by the end of 2015, when the Riksbank has started to hike its key rate. The USD/SEK rate will be 6.64 at the end of this year and 6.72 at the end of 2015.

Theme: Secular stagnation – different risks require different policy responses

- **Big gap compared to earlier GDP trend**
- **Deflationary tendencies and wider wealth gaps increase the stagnation risk**
- **Supply-side problems lead to different policy conclusions**
- **Rising productivity gives central banks more room to manoeuvre**

The past 4-5 years have been characterised by a fragile, lack-lustre recovery. The most common interpretation has been that this weakness follows the historical pattern after financial crises with sharply falling asset prices. The need to repair balance sheets normally leads to a fairly long period of weak demand (6 to 8 years). But once this adjustment is over, **there are good prospects of a return to sustained high growth**.

Recently, however, some observers have discussed the risks that we are facing an even longer period of weak growth – "secular stagnation". This debate was initiated by Larry Summers' IMF speech in November 2013. Since then Mark Carney, governor of the Bank of England, and others have contributed their views. One thesis is that the risk of secular stagnation would make a significantly more expansionary economic policy necessary, but this conclusion is not self-evident. **Depending on whether stagnation tendencies arise from the supply or the demand side of the economy, the policy responses will be completely different.**

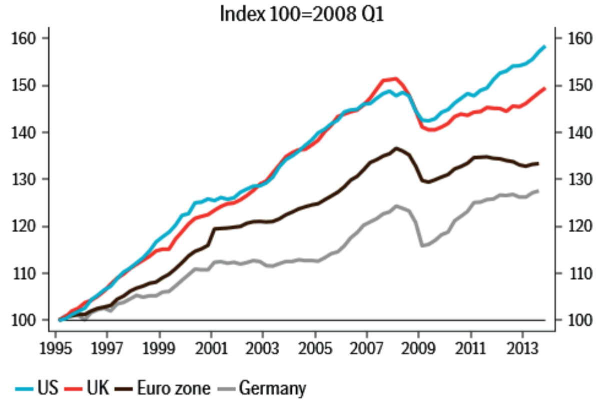
At the global level, we can point to factors suggesting that **for a long time, the world economy has suffered from a chronic shortage of demand and a savings surplus**, for example due to low consumer demand in various large emerging economies and lack of willingness to invest in developed economies. During the 2000s, these problems may have been hidden because demand was driven up by unsustainably rapid credit growth. After the financial crisis broke out, however, demand side weaknesses have been further accentuated, partly because of the need for public debt consolidation. Growing wealth and income gaps, especially in the US, also help to restrain demand due to the relatively low consumption propensity of the wealthiest households.

In this case, the economy can get stuck in a liquidity trap. The equilibrium real interest rate (one that causes savings and investment intentions to come together) is negative. Despite exceptionally low nominal interest rates, the actual real interest rate – due to low inflation – tends to be higher than is consistent with equilibrium in the economy. To avoid long-term (secular) stagnation, monetary policy must **focus all its tools on pushing down the real interest rate** – for example by driving up inflation – and fight the kind of deflationary processes that characterised the world economy in the 1930s and that have affected Japan in recent decades. Expansionary fiscal policies should also be used, for example in the form of infrastructure investments. In this analysis, the regulatory macroprudential measures now about to be enacted risk making the situation worse, since they will **slow down lending and boost effective interest rates for households and businesses**.

A different kind of analysis assumes that **the problems mainly stem from the supply side of the economy by weakening production capacity**. A low level of capital spending, declining labour force participation and rising equilibrium unemployment might mean that the output gap is currently not as wide as is normally assumed. Other underlying causes may be slower population growth and stagnating productivity. This makes the problem situation different. Bottleneck problems and inflation symptoms risk emerging relatively soon, despite low economic growth. Such stagflationary tendencies would create dilemmas for central banks. For credibility reasons, **central banks may be forced to begin normalising monetary policy** significantly earlier than current signals indicate, and earlier than financial markets have priced in.

Big gap to earlier growth trend

Index 100=2008 Q1



Source: Eurostat, BEA

The fact that different types of risks lead to such different policy conclusions illustrates to what extent economic policy finds itself in unknown, treacherous terrain. **Our main forecast is nevertheless that generally speaking, the risk of stagnation is relatively small at global level.** One reason for this is that productivity can probably recover after a long period of weak growth. Traditional cyclical economies of scale, investment recovery and more efficient resource allocation as the situation in the banking sector normalises are important driving forces behind this forecast. However, we see reasons why we will need to make downward adjustments for a number of countries compared to the growth trend that predominated before the crisis. There is also a rather large risk that in a somewhat longer perspective, the Japanese economy will relapse into stagnation. In the euro zone, too, there is a major risk that a high effective real interest rate will prevent a number of countries from moving towards economic equilibrium.

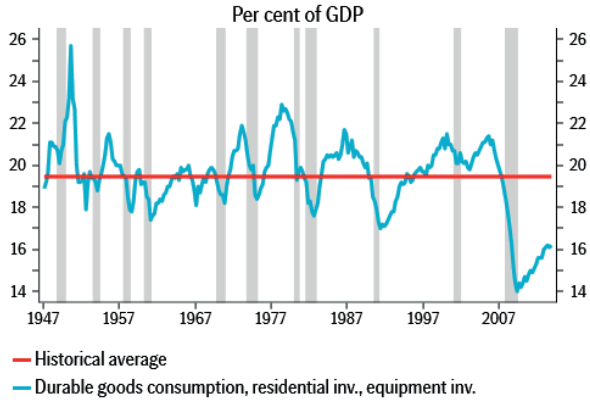
Positive growth spiral taking hold

- **Private consumption accelerating**
- **Good conditions for an investment rebound**
- **Unemployment will fall to 6 per cent in 2014**
- **Key interest rate hikes starting in mid-2015**

Since our last *Nordic Outlook* was published in November, most statistics have surpassed market expectations. Over the last few weeks, however, bellwether indicators on business confidence and employment have surprised firmly to the downside. We believe, however, that the economic hiccup will be temporary: **conditions are in place for continued economic expansion at a healthy pace, driven by households**. The wealth position of households is at a record level, while their deleveraging is probably over. If we factor in an increasingly strong labour market, our conclusion is that private consumption will shift to higher gear in 2014, as will business investments. December's congressional budget agreement also reduces the risk of new political deadlocks, although a new agreement on the federal debt ceiling must be put in place shortly. **The shift to an almost neutral fiscal policy this year**, compared to a headwind amounting to 1.7 per cent of GDP in 2013, is a weighty argument for predicting stronger growth. The upside is mainly in the most cyclical sectors of the economy, supporting this scenario and pointing to an upturn that will last for several more years. Overall, we are sticking to our prediction of strong US growth in the next couple of years. **In 2014 and 2015, GDP growth will be 3.3 and 3.7 per cent, respectively**. Although the consensus has moved upward, our scenario for the real economy remains clearly above the average forecast in the market.

Three most cyclical sectors: Still a huge upside

Per cent of GDP

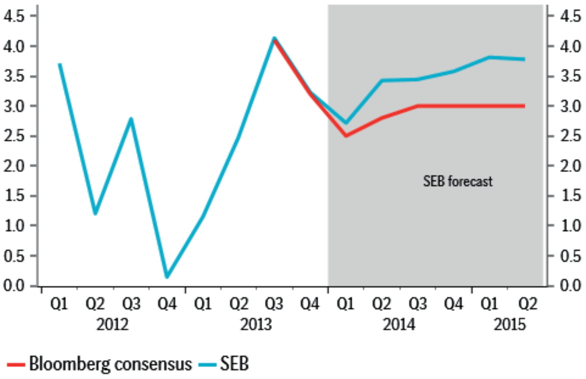


Source: BEA, SEB

Inflation will remain low during the next couple of years, but we see reasons to warn about possible wage-driven inflation, since the labour market looks increasingly tight. **Unemployment**, which has fallen faster than expected, will reach 6 per cent as early as this year. This indicates that the US Federal Reserve's **first key interest rate hike will occur in mid-2015**. At the end of 2015, the key rate will be 1.25 per cent.

Real GDP: Still on the optimistic side

Annualised



Source: BEA, SEB

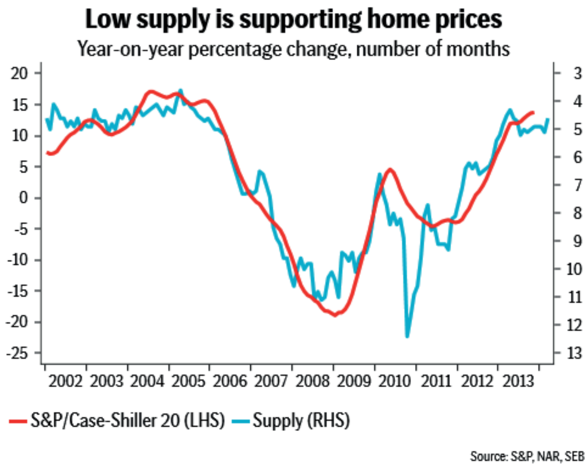
Households waking up in earnest

Despite tax hikes and cuts in government expenditures, household consumption grew by 2.0 per cent in 2013, in line with the preceding years. **Driven by income growth and wealth effects, a clear acceleration in consumption is now in the cards**. The large wealth build-up of recent years, combined with historically low borrowing costs, also promise higher consumption growth via the wealth channel. The entire debt build-up in 2002-2007 has been reversed, with household debt falling from 125 per cent of disposable income in 2007 to 101 per cent, which is the same level as a decade ago. This is another indication that the household sector is well-positioned to contribute more to economic growth. Confirming this picture, consumer lending is rising by nearly 6 per cent year-on-year, the number of homes that are worth less than their mortgage loans is shrinking rapidly and the number of foreclosure sales is some 30 per cent lower than one year ago.

Rising asset values explained over half of last year's consumption upturn, according to our calculations. We predict that they will boost consumption by 1.5 percentage points this year as well. Overall, we believe that **household consumption will grow by 2.9 per cent this year and 3.1 per cent in 2015**. Real disposable income will grow a bit more slowly than consumption in 2014-2015, and the **household savings ratio will fall to 3.5 per cent by the end of our forecast period**.

Housing market upturn will broaden

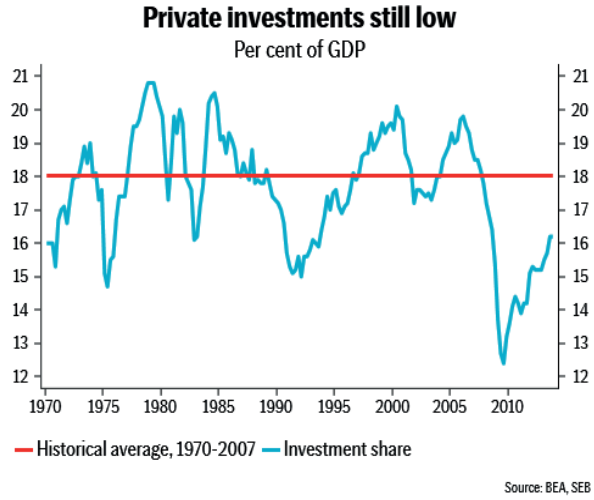
Despite rising mortgage interest rates, the housing market is continuing to strengthen in line with our forecasts. So far, the multi-family housing segment and institutional investors – which have largely bought homes to rent out – have been important as market drivers. **In 2014, demand will broaden as first-time buyers**, who make up the bottom of the housing market pyramid, **assume an expanding role**. Employment in the 25-34 age category, which includes many first-time buyers, has now regained most of its recession losses and will soon reach new record levels. Underlying demographic demand, which is large and growing in this age category, indicates a **continued need for housing investments in the next couple of years**. In addition, after a downward trend since the mid-2000s, the percentage of all homeowners aged under 35 has begun to rise again. Housing starts will continue upward to 1.2 million in 2014 and 1.4 million in 2015, measured as annual averages. The upside is significant; historically speaking, housing starts usually peak at nearly 2 million, while today's indicators are already compatible with a level of around 1.7 million. Residential investments will increase by an average of 12 per cent in 2014-2015, equivalent to an annual **GDP growth contribution of 0.4 percentage points**.



According to the Case-Shiller 20-City Index, home prices are currently increasing by nearly 14 per cent year-on-year, which is on a par with peak pre-crisis figures. Despite the upturn, home prices are nearly 20 per cent below their 2006 peak in nominal terms and 30 per cent taking inflation into account. Looking ahead, the supply situation will be compatible with a deceleration in price increases. For the first time in four years, it is cheaper to rent than to buy a home. We believe **home prices will climb by 8 per cent in 2014 and 6 per cent in 2015**, unchanged compared to our previous estimates.

Good prospects for an investment rebound

One of the distinguishing features of this economic cycle so far is that the growth in capital stock has been the weakest recorded. In volume terms, this growth has averaged 1 per cent during the past five years. **Companies have thus focused on dividends and share repurchases** instead of organic investments in their business. Several years of neglected capital spending are now becoming evident in the form of stagnating productivity. Productivity growth as weak as we are now seeing is common late in a business cycle, but hardly in the middle, where we probably are today.



But there are now many indications that a turnaround in business investments is on its way. Stronger capital spending usually follows in the wake of stronger consumption growth. Compared to GDP, corporate capital spending is far below historical averages, while corporate earnings as a percentage of GDP are close to record levels. Rational companies should be trying to defend their profit margins by directing cash flows and money sitting in their balance sheets towards productivity-raising investments during the next couple of years. There is a great need; **the average age of factories and machinery is 22 years**, which is the highest such figure since the late 1950s. Now that Republicans and Democrats have managed to reach a two-year federal budget agreement, fiscal uncertainties are less than for a long time, while borrowing costs remain low for companies. The upturns in industrial indicators such as the ISM survey of order bookings support the perception that a capital spending upturn is on the way; the weather-related plunge in January will be temporary. **Business investments will thus contribute 1-1.5 percentage points to annual GDP growth in the next couple of years**.

Income inequality is skyrocketing

The gap between low and middle income earners – who spend most of their income – and high income earners with a significantly lower inclination to consume has widened to a chasm in the past five years. The increasingly unequal distribution of US incomes, which is larger than at any time since the Great Depression of the 1930s, is sometimes cited as a reason to be pessimistic about the economy. According to the IMF, growing income gaps may become an obstacle to lasting growth, make this growth more vulnerable and shortening the expansionary phase by up to one third. While income distribution is a factor to keep our eyes on – especially with regard to social tensions in US society – **employment and wage trends will be the most important economic factors** during the next couple of years, in our judgement.

Energy sector strengthens trade balance

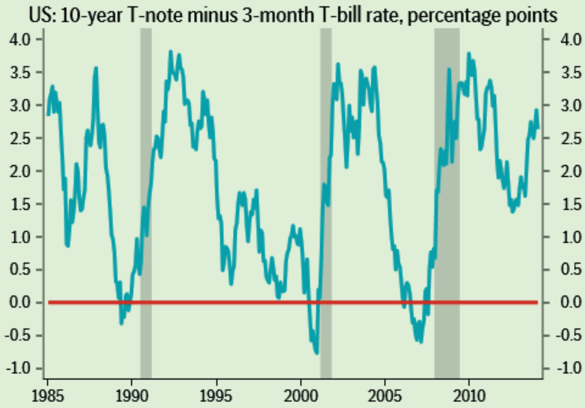
The trade deficit has steadily improved, falling to a **four-year low at the end of 2013**. This improvement is clearest in the energy sector; the year-on-year percentage decline in oil imports is in double digits, while energy exports are increasing by 22 per cent. The US bilateral deficit with the OPEC petroleum-exporting countries has trended downward, nearly halving during the past two years. If this improvement continues, bilateral trade with OPEC may show surpluses within a few years. Such a development might have both economic and geopolitical consequences. Although exports are expected to rise somewhat faster than imports in 2014-2015, **foreign trade will provide neutral contributions to GDP in the next couple of years**. The current account deficit, which stands at just above 2 per cent of GDP, will remain flat.

Higher long-term yields will not sabotage the recovery

The Fed has started, and will probably complete, the phase-out of its stimulative bond purchasing programme during 2014. We believe this will contribute to rising long-term yields. Historically speaking, there is nevertheless **no reason to worry that higher long-term yields will sabotage the recovery**. This is because the slope of the yield curve, not the level of long-term yields, is the relevant economic indicator; the correlation between the yield curve and real GDP growth is 70 per cent, which is twice as much as that of short-term interest rates or long-term yields alone.

Recessions follow yield curve inversions

US: 10-year T-note minus 3-month T-bill rate, percentage points



Source: Macrobond, SEB

Instead, when the Fed raises its key interest rate to such an extent that short-term rates match or exceed long-term yields, economic downturns usually follow. **Rising short-term interest rates are not yet in the cards, however**. The Fed has made its forward guidance regarding the key interest rate dramatically clearer. According to the Fed, the key rate will be kept at its current level until well after unemployment has fallen below 6.5 per cent. The forward-looking stock market is also indicating that the likelihood of a recession in 2014 is negligible. Last year, broad share price indices rose by more than 20 per cent. Over the past 60 years, such a large stock market upturn has never been followed by an economic downturn the year after. On the contrary, **real GDP growth usually amounts to an average of 4 per cent after stock market rallies such as the one last year**.

Fiscal policy headwind is fading away

One reason for our positive view of the economy is that the fiscal headwind, which amounted to 1.7 per cent of GDP last year, is calming down. **Fiscal policy will be nearly neutral this year and in 2015**. Given our economic and fiscal assumptions, the **federal budget deficit will continue to shrink**. In 2015 it will be equivalent to 3.9 per cent of GDP, compared to a peak of 12.9 per cent in 2009.

At the same time, the **political playing field is clearer and the risk of new breakdowns smaller**, although the deadline for raising the federal debt ceiling is again fast approaching. This is because the budget agreement reached in December 2013 not only averted the most harmful expenditures cuts from the "sequester" and eased the 2014-2105 fiscal headwind compared to earlier estimates, but above all it demonstrated a functioning climate of collaboration between Democrats and Republicans. The upcoming interim election in November is also likely to soften political conflicts, especially since the Republicans got most of the blame for last autumn's debacle.

Unemployment will fall below equilibrium

The US economy created 2.2 million jobs in 2013: a strong figure, given the powerful fiscal headwind then prevailing. The job upturn has also been broad-based. Meanwhile the average working week, as well as overtime, has increased. We believe that **employment will increase by an average of 200,000 jobs a month in 2014 and 220,000 in 2015** – a higher level of job creation than last year. At the same time, unemployment fell by 1.2 percentage points in 2013 to 6.7 per cent, despite historical correlations showing that the year's GDP growth was compatible with a slight upturn in unemployment.

Okun's law broke down in 2013

Year-on-year % change, year-on-year change, percentage points

Source: BEA, BLS, SEB

The downturn in unemployment was driven by **a continued decline in labour market participation, which reached a 35-year low**. Structural factors explain most of the recent decline. For the third year since measurements began in 1949, the labour force shrank in 2013. Older cohorts drove this trend – four fifths of the people who left the labour force were 55 or older – which indicates a structural decline. It also indicates that relatively few left the labour force due to resignation regarding their prospects for landing a new job.

There are many signs of continued downward pressure in labour market participation. The massive baby boomer generation (78 million) has begun to reach retirement age, which means that at least 1.5 million people a year will retire over the next 15 years. If the downturn in participation continues – or if participation stabilises at current levels – unemployment will probably keep falling faster than the Fed's forecasts during the next couple of years as well. According to our own forecasts, labour market participation will shrink further this year. In light of this, we predict that **unemployment will reach 6 per cent as early as the end of 2014** and fall further to 5.4 per cent by the end of 2015. Our labour market forecast is thus five tenths of a percentage point below the Fed's latest forecasts for both 2014 and 2015.

As early as 2015, unemployment below equilibrium – which is 5.5 per cent according to the Fed – will open up the possibility of a wage-driven inflation cycle. **The trend of average hourly and weekly wages has rebounded**, but remains at low levels. According to the national accounts, which are based on a substantially broader set of statistics, wages and salaries are rising at nearly 4 per cent year-on-year, resulting in **decent real wage growth, since price increases are so low**.

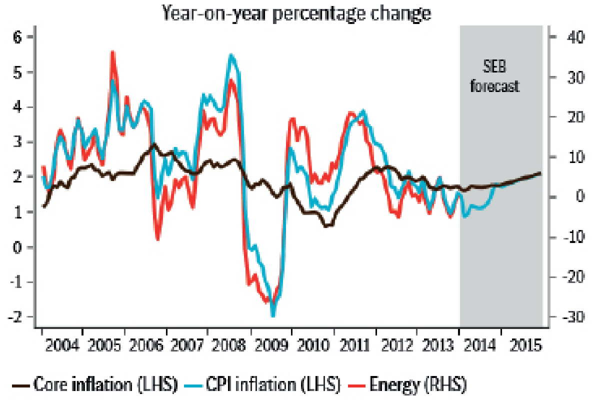
Tendencies towards higher wage pressure were also noted in the Fed's latest Beige Book, which points out **labour shortages** in such sectors as technology, construction, transport, restaurants and manufacturing that account for some 35 per cent of private sector jobs. This may be a large enough share of jobs for a wage and income spiral to take hold. In that case, there is a **risk that the Fed may be forced to raise its key interest rate earlier and at a faster pace** than indicated by market pricing.

Low inflation but increased upside risks

One central economic theme last year was falling inflation in the industrialised world, leading central banks to **focus on keeping deflation at bay**. Our main scenario is that this low inflation environment will persist, indicating that the Fed can keep its key interest rate unchanged for quite a while despite falling unemployment. According to the Fed's forecasts, inflation will not exceed 2 per cent in the next couple of years. **Our forecasts point to price increases of 1.3 per cent in 2014 and 1.9 per cent in 2015**.

Continued low inflation

Year-on-year percentage change



Source: BLS, SEB

At the same time, the American inflation picture is more complex than in Europe, for example, and there may be reasons to warn about potentially higher US inflation. According to the NFIB's small-business survey, both hiring plans and pay levels are on their way up, while the Beige Book shows labour shortages in certain sectors as well as the beginning of wider pay increases. To what extent this will spill over into rising consumer prices will depend on whether companies can pass on the cost to households. Meanwhile **even modest pay hikes can lead to rising unit labour costs** in an environment of stagnating productivity. Historically, the correlation between unit labour costs and inflation is over 80 per cent. Inflation surprises may also appear via rents and health care costs.

Historical experience also shows that the **Fed has previously been caught unaware by rising inflation during similar stages of the business cycle**. In 2003, too, the deflation risk was regarded as dominant, yet inflation took off and interest rates were raised sharply as early as the following year. In 1993 there were also few observers who thought that the rate hiking cycle would begin by the year after. Although there are differences between earlier business cycles and the current one, there are also similarities, such as lengthy loose monetary policy cycles combined with sluggish labour market recoveries.

Key interest rate hikes moving closer

As planned, the Fed will continue to taper its bond purchases by USD 10 billion at each monetary policy meeting during 2014. This means that the central bank's balance sheet will continue to expand by another USD 450 billion to around USD 4.5 trillion, which is equivalent to 25 per cent of GDP. **Monetary policy will thus continue to ease this year**, though at a slower pace. According to the rule of thumb we use, bond purchases in 2014 will be equivalent to an implicit interest rate cut of 50 basis points, compared to 125 points last year.

In 2015, monetary policy normalisation will begin. We predict that the first key interest rate hike will occur at midyear, when unemployment will stand at 5.8 per cent according to our forecasts. So far the Fed is sticking to its unemployment threshold of 6.5 per cent as an indication of when it is time to begin discussing rate hikes in earnest, but the importance of this threshold has recently diminished. Current signals from the Fed are compatible with rate hikes in the middle of 2015, in our assessment. If our labour market forecast is reasonably correct, however, the market will probably begin pricing in earlier rate hikes, even if inflation remains low. Forward contracts today already point to a 25 per cent probability of a key rate hike within one year. At the end of our forecast period in December 2015, we foresee a federal funds rate of 1.25 per cent.

Economic optimism is being put to the test

- **Tax hikes will hamper growth...**
- **...and boost inflation**
- **Companies gear up, households less cheery**

The government's aggressive economic policy led to a flying start for Japan's economy in 2013. Business confidence rose, the yen weakened and the stock market rose 57 per cent: its best performance in 41 years. But **now that fiscal policy is tightening, economic optimism is being put to the test**, determining whether Prime Minister Shinzo Abe has what it takes to revitalise the economy in the long term and leave deflation behind. The key will be the enactment of large-scale structural reforms – the "third arrow" of Abenomics, his new economic policy. Our forecast is cautiously optimistic: **GDP will grow 1.4 per cent this year and 1.3 per cent in 2015**, slightly above consensus. Consumption tax hikes, combined with exceptionally loose monetary policy, will **boost consumer prices 2.4 per cent this year and 1.7 per cent in 2015**.

Abe fever has faded sharply among consumers. Household confidence hit a 2013 low in December. As part of efforts to curb runaway government debt, the consumption tax will go up from 5 to 8 per cent in April 2014. We expect this to have a **clear impact on second-quarter household consumption**, in line with earlier experience. The last such tax hike, 2 percentage points, occurred in 1997. Strong consumption precedes a hike, followed by a steep drop when it goes into effect. In 1997 a recession followed, but that is not in our forecast this time around. Today's banking system is stronger and corporate debt is lower. Unless the tax hike kills the recovery, the next hike (to 10 per cent) is planned in October 2015; a decision is due before the end of 2014. **Consumption will rise by a yearly average of 1 per cent in 2014-2105**, half the level of 2013.

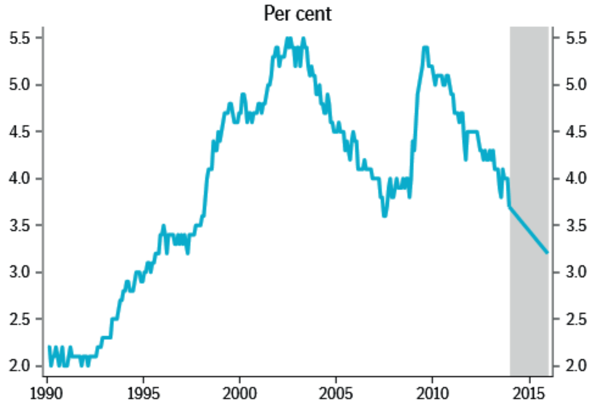
Both the latest **Tankan survey and other business confidence indices exude optimism**. The Tankan survey indicates that confidence among manufacturers has climbed to its highest level since 2007; for the business sector as a whole, expectations are at a 22-year high. Machinery order bookings are rising 10 per cent year-on-year, and investment plans indicate 5 per cent growth, but our forecast is more cautious; after falling by 1.5 per cent last year, **business investments will increase by less than 2 per cent yearly in 2014-2015**.

Exporters such as car giants Toyota, Nissan and Honda are benefiting from last year's 20 per cent yen depreciation against the US dollar. **Export growth will average nearly 5 per cent yearly in 2014-2015**. According to our equilibrium models, the yen is slightly undervalued in trade-weighted terms. Meanwhile the **Bank of Japan's expansion continues unabated**; the BoJ is buying 70 per cent of new government bonds, for example; its balance sheet is expanding rapidly. With the Fed meanwhile tapering its stimulus dose this year and starting rate hikes in 2015, the trend towards a weaker yen will continue; **a dollar will cost 118 yen at the end of 2015.**

Japan also needs continued monetary stimulus to offset fiscal policy, which is shifting from expansionary to contractive. The effect of the consumption tax hike and corporate tax cuts will be a **fiscal headwind of 0.5 per cent of GDP this year**. The budget deficit – 9.5 per cent of GDP last year – will shrink to 7 per cent in 2015. To stabilise government debt as an ageing population drives up health care costs, **Japan will need major structural reforms that boost potential growth**. New economic zones do not go a long way. Female labour force participation must increase, along with immigration, especially in the construction sector where there is an acute labour shortage in the run-up to the 2020 Tokyo Summer Olympics. Foreigners account for only 1 percent of the labour force today.

Unemployment will continue to fall

Per cent



Source: Macrobond, SEB

The Abe administration's highest priority is to end Japan's 15-year deflation. Tax hikes will push up inflation in 2014-2015, but to meet the 2 per cent target in the long term, it is vital that companies begin raising wages and salaries again; pay and price increases usually drive each other. Government attempts to get companies to raise pay have been fruitless so far: only 8 of 105 companies in one recent survey plan pay hikes. Average pay has fallen by 18 per cent since 1997, partly because the number of workers on short-term contracts with poorer conditions has soared. They now account for a third of the workforce. **Unemployment**, which fell to 3.7 per cent in December, **will continue downward to 3.2 per cent by the end of 2015**. Such low unemployment usually leads to rising wages and salaries in any event.

Increase in exports will drive a cautious acceleration

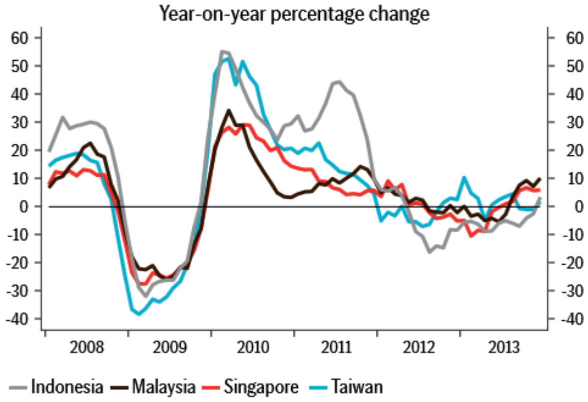
- **China: Credit slowdown dampening growth**
- **India: Weak growth, change in government**

In most of the emerging Asian economies, GDP growth is estimated to have been somewhat higher in the fourth quarter of 2013 than in the previous quarter. Economic **activity is expected to continue increasing gradually in 2014 and 2015**, but the two biggest economies in the region, China and India, are clear exceptions. In China, growth appears to be slowing down cautiously. In India, although economic activity seems to have bottomed out, it is difficult to see any strong reasons for a more substantial recovery to start.

The latest purchasing managers' index figures indicate progressively rising activity in the region. This upturn is expected to continue, fuelled in large part by **an export surge** supported by rising external demand. The cautious recovery in the second half of 2013 was driven largely by higher exports to the US, but demand from Europe is now also starting to improve. Intra-regional trade is clearly expanding. Stronger export demand will mainly benefit small, open economies (Singapore, Taiwan), while the positive effects will be limited for commodity-exporting economies (Indonesia, Malaysia).

Asia: Exports are taking off

Year-on-year percentage change



Source: National statistical offices

Strong labour markets and low inflation will also help sustain growth based on increased domestic demand. Continued accommodative monetary policies in most economies will also contribute to growth, although some central banks have already begun hiking their key interest rates.

During 2013, financial market turbulence caused by worries about the Fed's tapering of its monetary stimulus hit many Asian emerging economies hard, especially India and Indonesia. During the autumn the storm faded, but new market worries arose in January. We believe they are transitory, however. Their stock market and currency impacts on India and Indonesia have been relatively limited. We forecast continued stabilisation and recovery in capital flows to emerging Asian economies, among other things because large speculative positions that were divested last summer have probably not been rebuilt to any great extent. Countries with large external imbalances, such as India and Indonesia, nevertheless face the largest risks – especially if US and global interest rates should rise sharply.

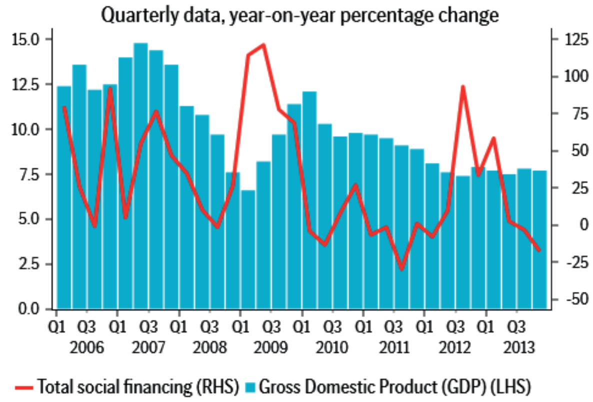
Thailand is being shaken by a serious political crisis; a new election February 2 has not been a solution. The crisis has had an impact on both the stock market and the currency. There are also early signs that tourism is beginning to suffer and important infrastructure projects have been delayed. If the crisis worsens, negative growth effects risk intensifying and the long-term investment climate may deteriorate significantly.

China: Reform efforts crucial to growth

As we predicted in the last *Nordic Outlook*, China's growth acceleration during the third quarter was temporary. In the fourth quarter, GDP growth cooled slightly to 7.7 per cent year-on-year. **Full-year 2013 growth** thus also ended up at **7.7 per cent**. The Third Plenum of the Chinese Communist Party Central Committee in November resulted in a broad, ambitious reform programme. 2014 will be a crucial year as the new leadership is expected to deliver substantial reforms. **Reform efforts will be central to growth during the next couple of years**; the most important measure will be a **tightening of unsustainably rapid credit growth**. The credit slowdown has begun; using the broadest measure, "total social financing" has fallen year-on-year for three consecutive quarters. The credit slowdown has started to impact capital spending; the deceleration is especially apparent in infrastructure investments. An important issue will be the risks related to the so called shadow banking system.

Credit slowdown expected to push growth lower

Quarterly data, year-on-year percentage change



Source: People's Bank of China

Although structural reforms can be expected to yield some long-term positive growth effects, the greatest benefit of successful reform efforts will be to reduce the risk of an economic hard landing. Early indications are positive; reform efforts seem to have started off at a healthy pace.

The government will probably unveil its 2014 growth target in March. The target is likely to remain at 7.5 per cent, but achieving this as credit growth decelerates and reforms are being implemented may be challenging. A lowering of the target to 7.0 per cent to make more room for a credit slowdown thus cannot be ruled out. So far there are no clear signs of a weaker labour market, which might lead to social unrest, but if growth falls below 7 per cent, the authorities will probably initiate stimulus measures. Our main scenario is that growth will cautiously decelerate. **We expect China's GDP growth to end up at 7.4 per cent in 2014 and 7.0 per cent in 2015.** Our forecast for 2015 is below consensus.

Purchasing managers' indices, both the official index and the one compiled by HSBC/Markit, have fallen in recent months, confirming the picture of a weak ending to 2013. The sub-index for large firms, dominated by state-owned heavy industrial companies, declined and this trend is expected to continue as capital spending decelerates.

Due to the problem of excess invoicing for tax reasons, foreign trade statistics are more uncertain than usual. In December, exports rose by slightly more than 4 per cent year-on-year. The full-year 2013 increase was just below 8 per cent. Because of increased demand, especially from the US and Europe, **we expect exports to climb about 10 per cent in 2014**, but continued yuan appreciation is a restraining factor. Imports have recently shown decent growth, but this is largely due to an upturn in imported intermediate goods for the export sector. At present, imports are thus not a good indication of domestic demand. We expect China to maintain its trade surplus during the next couple of years as exports surge in response to increased economic activity in other countries, while a slower pace of investment dampens import demand.

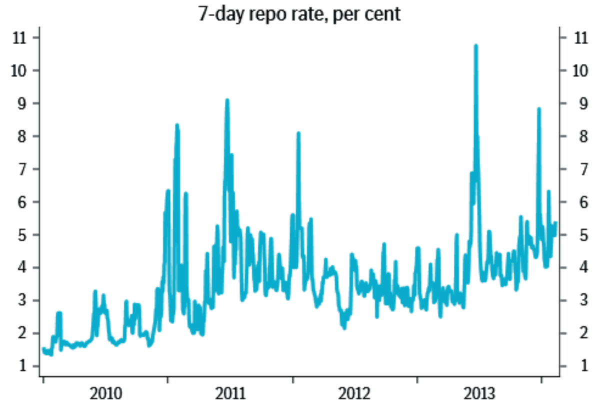
China's **currency reserve keeps increasing** and reached USD 3.8 trillion in the fourth quarter of 2013. The People's Bank of China (PBoC) is continuing its large-scale market interventions to restrain yuan appreciation. In 2013, the yuan appreciated by around 3 per cent against the US dollar. A number of factors indicate that the currency will continue to strengthen at about the same pace in 2014. The main reason is faster monetary policy tightening than in the US, with rising interbank and deposit rates. The yuan also enjoys support from China's current account surplus and capital inflows. **At the end of 2014, we expect the USD/CNY exchange rate to be 5.90. At the end of 2015 it will be 5.80.**

In December, inflation fell to 2.5 per cent, driven by a major slowdown in food prices, but we expect inflation to rise again in January. Chinese New Year, which falls at the end of January 2014, usually drives up food prices temporarily in the weeks before the celebrations. Full-year 2013 inflation ended up at 2.6 per cent, well below the target of 3.5 per cent. **We expect low inflation pressure to persist in 2014 and 2015**, driven by the slowdown in economic activity and credit growth. Core inflation will remain below 2 per cent, and producer prices will still fall year-on-year. **We expect full-year 2014 inflation of 3.0 per cent. In 2015, we foresee inflation of 2.9 per cent.**

In December and January, a seasonal increase in demand for liquidity again led to rising interest rates. At first the PBoC was unwilling to carry out liquidity injections, in order to discipline market players. Interbank rates climbed substantially, although they did not reach the same high level as in June. Since then, interest rates have fallen, but the long-term trend is clearly upward. The PBoC's actions should be viewed as part of its efforts to tighten credit growth. Due to liquidity management using repo transactions, the role of the key interest rate has greatly diminished. This rate has remained at 6.0 per cent since the last cut in July 2012. **We believe that the key interest rate will be kept unchanged at 6.0 per cent in 2014.**

Central bank driving up short-term interest rates

7-day repo rate, per cent



Source: ChinaMoney

Statistics published in late December show that the debts of local authorities at the end of June 2013 were equivalent to around one third of GDP (CNY 17.9 trillion). This represented an upturn of about 67 per cent since the previous study at the end of 2010. Although this increased debt has not been used for consumption, but mainly for infrastructure and other investments, the return on these investments is often low and extends over a long period, while the loans have short maturities. So far, local authorities have been able to roll over the loans, and defaults are unusual. In addition, China's total public sector debt is not remarkably high. Adding local authority debts to those of central government, total public debt ends up at 50-60 per cent of GDP. **Local debt** poses **no acute threat** to the financial system, **but its rapid expansion must still be slowed**. Bank balance sheets are being weighed down by unproductive lending, while borrowers avoid taking the consequences of bad investment decisions.

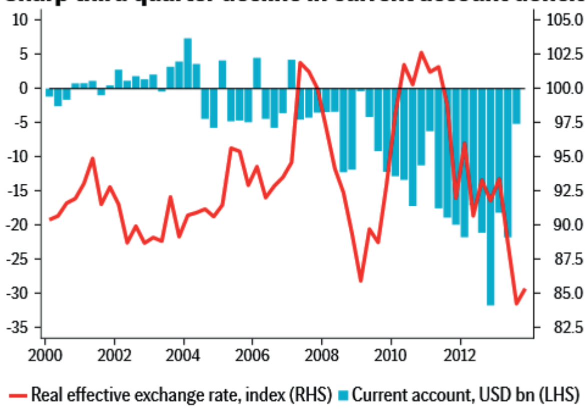
India: No clear upswing in growth

While most countries in Asia are showing a cautious acceleration in growth, Indian economic performance remains weak. **There are still no signs of a clear recovery**, although growth has probably now bottomed out. GDP increased by 4.8 per cent year-on-year in the third quarter of 2013, somewhat faster than the previous quarter. Economic indicators point to a weak close for 2013. The purchasing managers' indices are at low levels; the service sector sub-index is far below the neutral 50 mark. The consumer confidence measure developed by the Reserve

Bank of India (RBI) recovered somewhat in the fourth quarter but is still at a very low level.

Final hard data have also remained weak, but exports are one of the few bright spots. They have increased strongly in the past six months, driven by the dramatic decline in the rupee. Meanwhile imports have fallen, and the trade deficit shrank in 2013 for the first time since 2009. Reforms aimed at slowing large-scale gold imports have yielded positive results. The current account deficit decreased sharply in the third quarter.

Sharp third quarter decline in current account deficit



Source: BIS, Reserve Bank of India

Although exports help sustain growth, India's economy is mainly driven by domestic demand; private consumption is equivalent to around 60 per cent of GDP. There are few signs of improvement in domestic demand. Manufacturing sector performance remains weak; in November, industrial production was down 2 per cent year-on-year. In the absence of retail sales statistics, automobile sales are an important indicator of consumer demand. Here, too, demand is weak; the latest figures indicate a decrease of around 10 per cent year-on-year. **We estimate that GDP increased by 4.7 per cent in 2013. In 2014 we expect growth to end up at 5.0 per cent, and in 2015 growth will accelerate to 5.4 per cent.**

There is little chance of stimulating the economy using monetary or fiscal policy. Due to continued high inflation, the RBI must continue its tight monetary policy, while the ambition of trying to bring down budget deficits will keep fiscal policy contractive. The weak economy and the lack of reforms make the upcoming parliamentary election extra important (see box).

Last autumn's trend towards rising inflation finally reversed in December when wholesale price index (WPI) inflation dropped sharply, ending up at 6.2 per cent. A clear deceleration in food price inflation was the main reason and was, in turn, probably the result of a favourable monsoon, which usually leads to lower agricultural prices. Full-year 2013 inflation ended up at 6.3 per cent. The RBI is eager to bring down inflation pressure, and in January a panel proposed adopting a 4 per cent Consumer Price Index (CPI) inflation target. Monetary policy should become more transparent and interest rate decisions should be taken by a committee rather than by the central bank governor. In our assessment, inflation pressure will ease during the next couple of years; measured as annual averages, **we believe WPI inflation will end up at 5.6 per cent in 2014 and 5.2 per cent in 2015**.

Despite weak economic activity, the Reserve Bank of India was forced to hike its key interest rate by 50 basis points last autumn in order to prop up the currency, but also to combat high inflation. As we predicted in the November issue of *Nordic Outlook*, monetary policy has continued to tighten; in January, the RBI raised its key interest rate by another 0.25 percentage points to 8.0 per cent, with concern about inflation as its main argument. Although the rate of inflation fell sharply in December, the expected introduction of an inflation target will mean that the RBI will want to see a more lasting downturn in inflation. Under RBI Governor Raghuram Rajan, the focus of India's monetary policy has begun a clear shift from stimulating growth to bringing down inflation. In our assessment, **the key interest rate will be hiked once more in 2014 to 8.25 per cent**. Since bottoming out in late August, the rupee has appreciated by around nine per cent against the USD. When financial market turbulence resumed in January, however, the rupee weakened again, though the currencies of several other EM countries were significantly harder hit. A continued tight monetary policy and a shrinking current account deficit will help prop up the rupee; uncertainty in conjunction with the election may, however, temporarily weaken the currency. **At the end of 2014, we expect to rupee to stand at 59.0 per USD; at the end of 2015, the INR/USD rate will be 55.0.**

The parliamentary election in India

A parliamentary election is due no later than May, but we believe it will probably occur in April. Weak growth is creating a great need for reforms and making the election outcome more important. The incumbent coalition government led by the Congress Party under Prime Minister Manmohan Singh enjoys little public confidence after a term of office marked by falling economic growth rates, weak reform efforts and allegations of corruption. A change of government is expected. Opinion surveys and local elections indicate that the opposition **BJP, headed by Narendra Modi**, will greatly strengthen its position and form a government. The BJP can cite successful reform efforts and high economic growth in Mr Modi's home state, Gujarat. Although the BJP is expected to do well in the election, it is unlikely that the party will achieve its own parliamentary majority; no party has done so since 1984.

Many are hoping that the election will help re-ignite the economy and that a BJP government can replicate the business-friendly reforms in Gujarat at the national level; BJP's success in December's local elections triggered rising stock market prices. But BJP will probably be forced to work together with regional parties that ordinarily resist far-reaching reforms. Modi is also controversial among many voters, and his ability to work with other parties is untested. There is thus a **great risk that the election will lead to a weak coalition government** that, despite good intentions, will find it difficult to implement necessary reforms at the national level in practice.

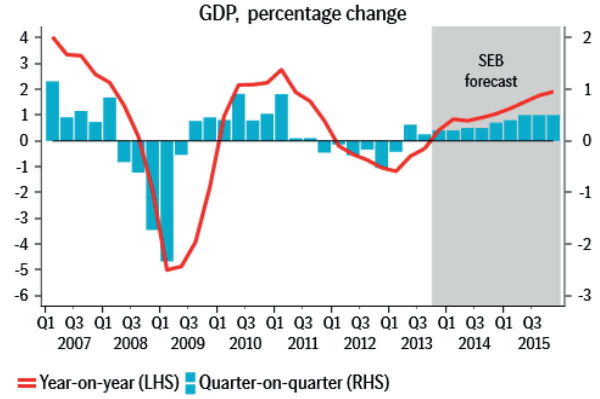
Uneven recovery

- **Indicators point to continued recovery**
- **Cheaper borrowing for crisis-hit countries**
- **High unemployment and low inflation**
- **Neutral fiscal policies**
- **QE the next step for the ECB**

The euro zone economic outlook is slowly improving. The recession is over and we expect the region to show positive fourth quarter GDP growth, both quarter-on-quarter and year-on-year. The last time this happened was in the third quarter of 2011. Fiscal policies will largely be neutral in 2014-2015, while competitiveness will improve. As annual averages, **GDP will grow by 1.0 per cent in 2014 and 1.6 per cent in 2015** – which means growth close to trend in 2014 and slightly above trend in 2015 – but continued imbalances will impede the recovery, causing the region to lag behind in the US-led global recovery. **Northern Europe is on more stable ground than southern countries**, which are continuing to struggle with the legacy of the crisis. In the short term, there is a **risk of disappointments**, since the financial climate and sentiment indicators have improved in a way that has not yet been confirmed by real economic data.

Euro zone on firmer ground, but slow recovery

GDP, percentage change

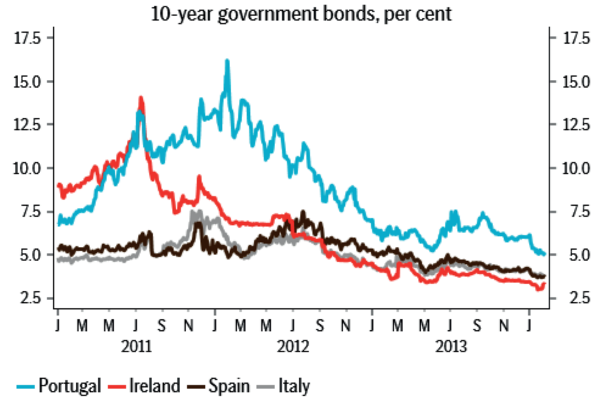


Source: Eurostat, SEB

The European Central Bank's programmes, verbal interventions and the market's increased search for returns have boosted confidence, helping bring about a **decline in euro zone bond yields and spreads**. The downturn in 2013-2014 is clearest in Portugal, Ireland and Spain. Also contributing have been successful sovereign bond issues in Ireland and elsewhere, but due to generally falling inflation combined with weak economic growth, we believe that the **ECB will unveil more tools and act even more resolutely**. We are sticking to our forecast that the ECB will launch a more straightforward quantitative easing (QE) programme and provide new LTRO long-term loans to banks, enabling the ECB to stimulate lending and reduce deflation risks. This policy would also boost the chances of decoupling euro zone yields from developments in the US. We expect that yields may fall somewhat further in the near term and that the subsequent upturn will be smaller than in the US.

Falling government bond yields

10-year government bonds, per cent



Source: Macrobond

GDP, selected countries

Year-on-year percentage change

	2012	2013	2014	2015
Germany	0.7	0.5	1.7	2.1
France	0.0	0.2	0.7	1.4
Italy	-3.0	-1.8	0.5	1.0
Spain	-1.9	-1.3	0.6	1.5
Greece	-6.4	-4.0	0.0	1.0
Portugal	-3.2	-1.7	0.7	1.0
Ireland	0.2	0.3	1.7	2.0
GIPS countries*	-2.4	-1.5	0.7	1.4
Euro zone	**-0.7**	**-0.4**	**1.0**	**1.6**

* Greece, Ireland, Portugal and Spain

Source: Eurostat, SEB

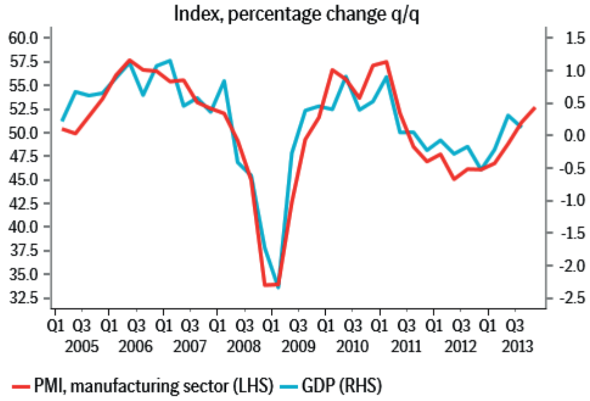
Further economic policy integration is necessary, but with the countries holding the EU presidency this year (Greece and Italy) preoccupied with their own crisis-related problems, elections to the European Parliament and a change of Commission, not much is likely to happen in 2014. The exception is the process related to the banking union, but legal criticisms from Parliament about the December 2013 finance ministers' agreement demonstrate that problems remain to be solved in this area as well. ECB stress tests and reviews of bank balance sheets will be an important step in reversing the decline in lending. This process should eventually help reduce uncertainty. Falling bond yields in crisis-hit countries also increase the probability that these countries will be able to generate their own funding without international support.

Indicators are sending positive signals

Indicators – both purchasing managers' indices (PMIs) and the European Commission's economic sentiment indicator (ESI) – have improved clearly in the past year and **are signalling that the economy will improve**. The manufacturing PMI has been above the growth threshold of 50 since July 2013. We can expect a pause in the upturn since hard data are lagging behind. Manufacturing PMI's converged at around the 50 mark last autumn, but since then **the trend in different countries has diverged**. In recent months, France in particular has been disappointing, with a PMI that has stayed below 50 (48.8 in January). This raises questions about the state of the euro zone's second-largest economy. Spain is stuck at around 50. In Greece, Italy and Ireland, future prospects look brighter.

PMI is pointing to faster growth

Index, percentage change q/q



Source: Eurostat, Markit

Weak increase in exports and production

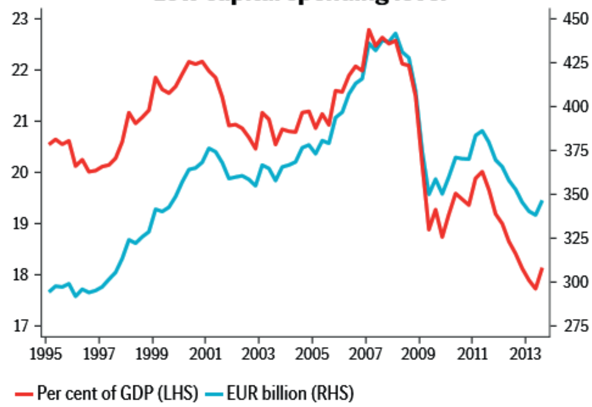
Industrial production, which declined year-on-year between November 2011 and August 2013, is rising. Although we can expect a minor short-term slowdown in growth, production will expand in 2014 and 2015. The export trend is moving in the right direction, **sustained by improved competitiveness as well as stronger external demand**. Among the crisis-hit countries, the export upswing is clearest in Portugal and Spain. According to the OECD's measure of unit labour cost, Ireland, Greece and Spain have greatly improved their cost situation. The latest trend is that costs are continuing downward in Greece, while they have levelled out in Spain and Ireland, but it is worrisome that Italy and France are still not moving closer to the cost situation in Germany. **Overall, exports will grow by 3.8 and 3.9 per cent in 2014 and 2015**. As exports increase, imports will also recover from depressed crisis levels. The contribution of net exports to GDP growth will thus be only marginally positive in 2014 and 2015.

Weak increase in capital spending

Companies in the euro zone have generally become more upbeat, but this is not yet reflected in capital spending activity. Capacity utilisation is well below the historical average, although the quantity of idle resources in the economy is smaller now than a year ago. Bank lending to non-financial companies is also continuing to fall; the latest monthly figures showed a downturn of 3.8 per cent year-on-year.

But after two years of falling business investments, a weak upturn occurred in 2013. Several factors indicate that capital spending will continue its slow rise. Because of the low investment level, new capital spending is necessary merely to preserve existing production capacity. Meanwhile the international economy is gaining strength and fiscal policies are becoming more neutral and predictable, bolstering optimism. But it is reasonable to believe that companies want to see clearer signs that demand is really climbing before they make large-scale capital spending decisions. It will thus be some time before the investment cycle takes off in earnest. **Capital spending will increase by 1.7 per cent in 2014 and 3.0 per cent in 2015**.

Low capital spending level



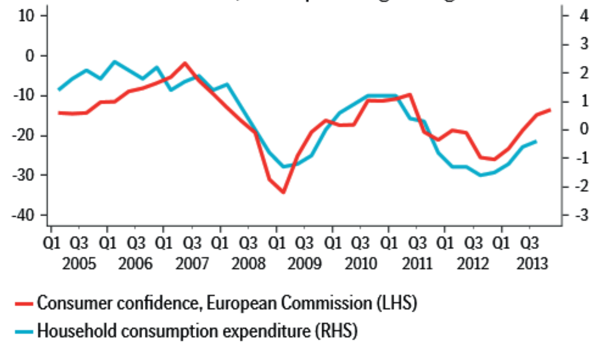
Source: Eurostat

Household optimism is improving

Household confidence has improved, albeit from low levels. We can expect further improvement as fiscal policies ease and labour markets stabilise. In crisis-hit countries, wages and salaries remain depressed because of efforts to regain competitiveness, but low inflation will allow room for some real wage increases. After having fallen or shown weak growth for a couple of years, retail sales improved at the end of 2013, even though the December figure was weak. Even highly cyclical segments like car sales have begun to recover. Although a slight correction is likely after the latest strong figures, we foresee an increase in consumption. After a downturn of 0.6 per cent in 2013, **we expect household consumption to grow by 0.8 per cent in 2014 and by 1.4 per cent in 2015**.

Consumer confidence indicates increased consumption

Net balance, annual percentage change



Source: Eurostat

Germany: Continued stable growth

Indicators are pointing towards continued stable growth in the German economy. The PMI for the manufacturing sector rose in

January 2014 to 56.3, while the service and construction PMIs are close to 54. This picture is supported by other indicators, such as the ESI and the IFO business sentiment index. Industrial production, which showed weakness in 2012 and much of 2013, rose late in 2013 (4.7 per cent year-on-year in November). Exports have performed similarly, while consumption and consumer confidence are also both on the rise. Unemployment continues to fall slowly. Because of the strong domestic economy and better international economic conditions, growth will gain a decent momentum despite sluggish performance elsewhere in the euro zone. **GDP will grow by 1.7 per cent in 2014 and 2.1 per cent in 2015**.

Germany's current account surpluses – 6 to 7 per cent of GDP in recent years – have led to international criticism and calls for a more expansionary economic policy. Yet we do not expect the new "grand coalition" of Christian Democrats (CDU/CSU) and Social Democrats (SPD) to implement any major policy shifts. The public sector showed a balance in 2013, and a small surplus will emerge in 2014 and 2015, but public debt is about 80 per cent of GDP, which limits the government's room for reform. The coalition agreement states that reforms must be financed. The agreement includes a minimum wage hike, a lower retirement age and motorway fees for non-Germans. It also indicates that EU policy will be largely unchanged.

France: Weak economy leading to policy re-assessments

In recent months, weak macroeconomic data and political uncertainty have contributed to rising concerns about the French economy. Measured quarter-to-quarter, GDP fluctuated between plus and minus during 2013, and indicators point towards weak performance. PMI has fallen, while it has climbed in several other euro zone countries. Household confidence has declined, and retail sales slowed late in 2013. At nearly 11 per cent, unemployment is at its highest so far in this century (up from 7.4 per cent early in 2008) and is expected to remain largely at the current level throughout our forecast period. **GDP growth will end up at a weak 0.7 per cent in 2014 and then climb to 1.4 per cent in 2015.**

Standard & Poor's has downgraded French sovereign borrowing to AA. Any economic crisis in France might cause a resurgence of debate on the existence of the euro, but so far market reactions have not been alarming; the yield spread against Germany stayed at about 50 basis points throughout 2013. Aside from the weak economy, there has been a focus on political decisiveness. President François Hollande is struggling with declining popularity in opinion polls, while support for the EU-sceptical Front National has grown ahead of local elections in March and the election to the European Parliament in May. In mid-January, Hollande promised reforms to reduce public spending, ease the tax burden and reduce the social insurance charges that companies pay for their employees. The latter may be a way of imposing an internal devaluation in an attempt to counter the negative effects of a strong euro on French companies. These measures represent a significant shift from Hollande's earlier economic policy, in which fiscal consolidation was largely achieved through tax hikes.

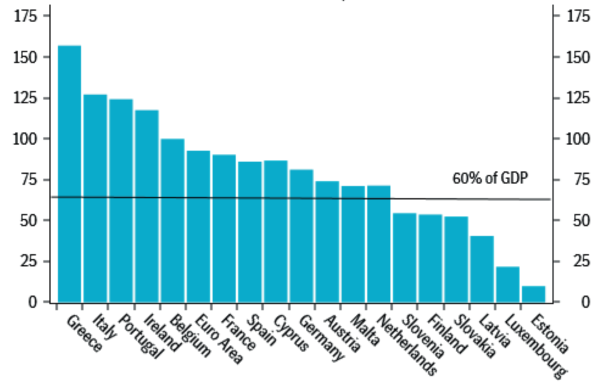
Towards a neutral fiscal policy

In 2014 and 2015, fiscal policy in the euro zone as a whole is moving towards being largely neutral, measured as change in structural saving, but the crisis-hit countries need further measures. In the long term, an ageing population will require austerity measures or tax hikes. **The public sector balance will gradually improve** from -3.1 per cent of GDP in 2013 **to -2.6 per cent of GDP in 2014 and -2.3 per cent in 2015**. The overall deficit will thus be smaller than 3 per cent of GDP for the first time since 2008.

Because of smaller deficits and somewhat stronger real growth, gross public debt will peak at 96 per cent of GDP in 2014 and then fall slightly in 2015. Partly due to very low inflation, however, nominal GDP will show very weak growth in most countries. This will make it harder to bring down the high debt ratios accumulated after the crisis had hit.

Few countries with low public debts

Per cent of GDP, 2012



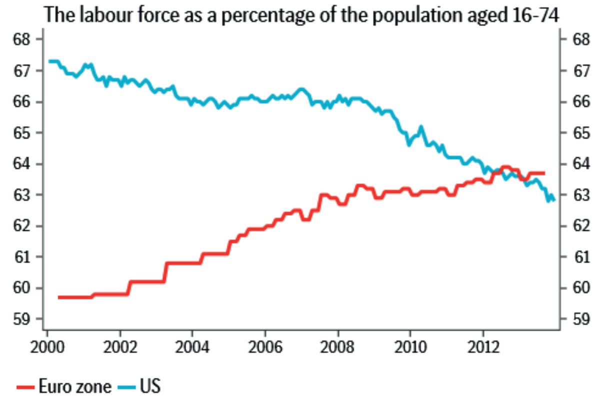
Source: Macrobond

Unemployment stuck at record level

Labour market developments largely illustrate the situation in the region; it does not seem to be worsening, but at the same time the road to normality will be long. In the euro zone as a whole, unemployment has remained unchanged at 12.1 per cent since April 2013. As in other areas of the economy, divergences are wide. In Greece and Spain, unemployment is at record-high levels, above 25 per cent, while in Germany it remains at a record-low 5.2 per cent (November 2013).

Divergent labour force participation

The labour force as a percentage of the population aged 16-74



Source: Eurostat, BLS

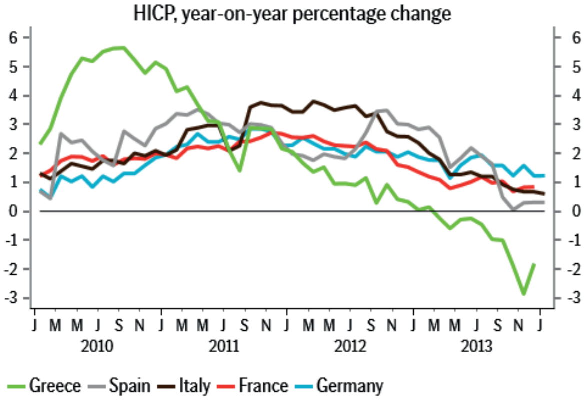
We expect unemployment in the euro zone as a whole to remain largely at its current level during 2014 and then fall to slightly above 11 per cent by the end of 2015. **As annual averages, unemployment will be 12.1 per cent in 2013, 11.9 per cent in 2014 and 11.5 per cent in 2015**. The long period of high jobless rates has probably pushed equilibrium unemployment higher. We estimate that it is now around 9 per cent in the euro zone. Despite high unemployment in a number of countries, **labour force participation has not been affected to any great extent**. Although there has been a decline in crisis-hit countries, the degree of participation is meanwhile increasing in Germany. Unemployment is thus not being pushed down by falling participation, as in the US.

Low inflation will become even lower

Inflation is low and will remain so during our forecast period. In December, it fell to 0.8 per cent. Low price increases or deflation in crisis-hit countries are pushing down the regional average, but even in countries like Germany (1.2 per cent in December 2013) and France (0.8 per cent) inflation is well below the ECB's medium-term target of close to but below 2 per cent. Low inflation in Germany, especially, makes it harder to carry out the necessary rebalancing in the euro zone, in an environment with major risks of a serious deflationary spiral.

Inflation is low and will fall further

HICP, year-on-year percentage change



Source: Eurostat

Various structural and cyclical factors indicate that the rate of price increases will remain low during the next couple of years. Falling commodity prices in 2013, especially for agricultural products¸ will help push down consumer prices during 2014. Underlying weak demand and a declining rate of wage and salary increases are pushing down underlying inflation, although low productivity growth is softening the downward pressure on unit labour costs to some extent. Our forecast is that the euro zone as a whole will avoid deflation, provided that the ECB acts forcefully to keep inflation expectations up. Measured as annual averages, **inflation according to the Harmonised Index of Consumer Prices (HICP) will be 0.7 and 0.6 per cent annually in 2014 and 2015**. Underlying inflation, excluding food, alcoholic beverages, tobacco products and energy, will be 0.5 per cent in both years.

The ECB will do more with its balance sheet

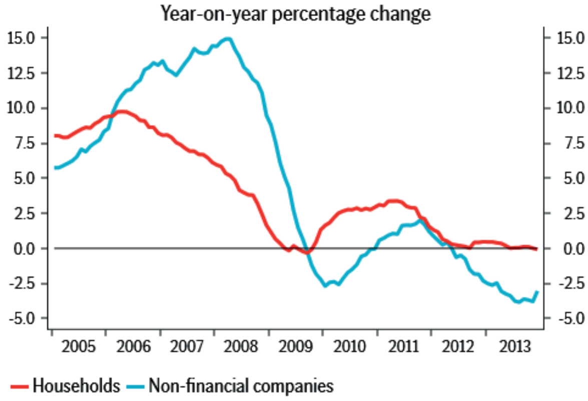
There is still heavy external pressure on the ECB, for example from the IMF and the G20 countries, to **use its balance sheet** to a greater extent to reduce the **deflation risk** and improve the euro zone's **credit supply**. Surplus liquidity in the ECB system peaked at EUR 850 billion in March 2012 with the help of Long-Term Refinancing Operation (LTRO) loans. Today the surplus is about EUR 130 billion, reflecting the banks' LTRO repayments as economic and financial conditions improved. In its *Monthly Bulletin* for January 2014, the ECB cautiously warned that limited liquidity may create **undesired volatility in short-term market rates**. ECB guidance since the expected key interest rate cut in November to 0.25 per cent has also been clear, signalling a loose approach: **we have the tools** (negative interest rates, loans to banks, bond purchases), **are prepared and will act vigorously at the proper time**.

The deflation risk in the euro zone persists. Meanwhile the ECB is facing a challenge: its examination and testing of 130 banks may reveal weaknesses that risk making an already poor credit supply, especially in southern Europe, even worse. If the second pillar of the banking union – a resolution mechanism – had been approved, pressure on the ECB to support the banking sector would not have been as heavy. But there is little prospect that the European Parliament will have time to approve the proposal before ending its session in the run-up to the EU election in May.

Our conclusion is that the disinflationary forces in the euro zone are strong enough that the **ECB will initiate bond purchases** (quantitative easing, QE) later this spring, though some ECB Governing Council members have shown only modest interest in activating this tool immediately. Monthly purchases, which are expected to be GDP-weighted, may total EUR 40 billion in order to underscore that the measure has a monetary policy purpose and is not intended as direct financing of budget deficits. The ECB hopes that euro zone yields will remain decoupled from US monetary policy and that the value of the euro will also be pushed down. Some form of credit relief is also needed. We expect **new LTRO loans** to ease the liquidity situation and prevent forced sell-offs of crisis country government securities. The loans may perhaps be aimed at specific customer categories ("funding for lending"). ECB President Mario Draghi has, moreover, opened the door to possible **purchases of loan assets** (securitisation) for the private sector. However, we are sticking to our forecast from the November 2013 issue of *Nordic Outlook* that the ECB's key interest rate has probably bottomed out and that the bank will not introduce negative interest rates. The ECB will keep its policy rate at 0.25 per cent 2014-2015.

Bank lending is decreasing

Year-on-year percentage change



Source: ECB

- **German pushing for EU treaty changes**
- **Compromises delay the banking union**
- **French policy under re-assessment?**
- **German macro strength a complication**

German-French cooperation is vital to strengthening both the euro and EU projects. The following article first discusses some political aspects of the German-French relationship and then provides a review of key macroeconomic conditions.

The climate of cooperation has varied greatly in recent years. Chancellor Angela Merkel and President François Hollande made a re-set attempt – after external criticism for weak leadership – through a bilateral declaration in May 2013 before the EU summit of June 27-28: *"France and Germany – Together for a Stronger Europe of Stability and Growth"*. **But the relationship has never really taken off.** Since then, their cooperation has been sluggish and defensive rather than proactive – of course hampered by last year's German election.

Functioning Franco-German cooperation is vital for various reasons. The two countries are the **economic backbone** of the euro zone – 48 per cent of its GDP – and can thus provide growth support to southern Europe. They are also the biggest drivers of European development and integration, **often providing a political counterweight to the European Commission and Brussels**. Constructive German-French cooperation is also needed to give the **EU a weightier political voice in global politic**s, especially in an environment where the UK is moving in an EU-negative direction on many issues.

Germany's ambitions are clear in the ongoing movement towards a "genuine economic and monetary union". German politicians accept greater **federalism and centralisation** of decision making. **France's acceptance** of the proposals presented so far seems primarily based on a desire to **spread economic/financial risks** among the 18 euro zone countries, without simultaneously losing political independence.

But one obvious conclusion is that the stability and survival of the euro largely assumes indirect – and direct – German willingness to guarantee the debts of other countries economically / financially. Germany's net external receivables have grown by nearly EUR 1.1 trillion since 1999. But no such "guarantee" will occur without concessions, for example that other euro zone countries "contractually" relinquish economic policy independence.

The evolution of the EU banking union exemplifies the weaknesses Franco-German compromises can lead to. The first pillar of the union, the Single Supervisory Mechanism (SSM), has been a success. It was relatively easy to agree that the ECB would be mainly responsible. But when the second pillar – the Single Resolution Mechanism (SRM) – was unveiled in December 2013 things became more difficult. **The system is underfinanced and too slow and complex to provide the desired stability.** Today the European Parliament is considering the SRM. It is unclear when a decision will come.

Germany is now calling for more **far-reaching EU treaty changes** to make greater integration possible. But this is a gamble. Although the UK will be given a chance to make minor adjustments that will ensure British EU membership, other countries may also demand changes and any new treaties may also require approval by referendums. At present, France has chosen a comparatively low profile on treaty issues.

In recent years, German economic policies have generally been **characterised by purposefulness, perseverance and a symbiosis between politics and business**. Earlier reforms, mainly in the labour market, gave Germany its current economic strength. French economic policies, however, have **been erratic and short-sighted**. The latest signals indicate that France is about to shift its economic policies in a more pragmatic direction and try to deal with the country's weak competitiveness. There are certain parallels with President François Mitterrand's first years in power during the early 1980s, when he reversed course rather early after an initial period of daring, unsuccessful economic policy experiments. But today the question is whether President Hollande is strong enough to pull off such a policy shift.

In terms of the authority of the top political leadership, the situation is different. **Angela Merkel enjoys high credibility and strong support**, both at home and internationally. Her position is safe and she is now starting her third and probably last term of office as chancellor, enabling her to make more controversial, tough decisions. Hollande has now been president for nearly two years of his five-year term. **His image on the global stage is unusually weak for a president of France.** His domestic popularity figures are also very weak and he is pressed by strong factions within his own administration.

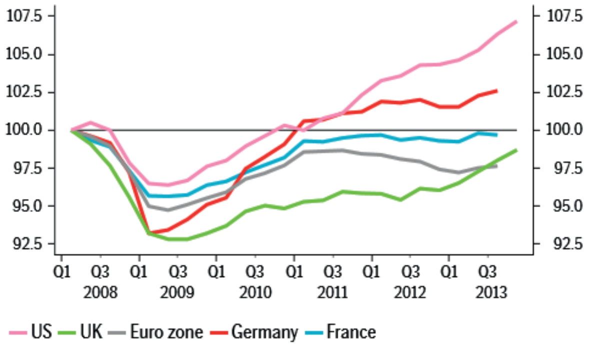
Germany is led by a Christian Democratic chancellor and France by a Socialist president, but this need not be such a big problem. In practice, their ideological differences are probably less given Merkel's East German background. Since late 2013 Germany's coalition government has included the Social Democrats (SPD). This also narrows the political distance between Germany and France. Historical experience also shows that ideological differences are not so important. **Smooth cooperation between CDU chancellor Helmut Kohl and Socialist president François Mitterrand** was crucial to European political breakthroughs in the 1980s and 90s. **In contrast, cooperation between Merkel and non-socialist president Nicolas Sarkozy was far from smooth** during the acute phase of the financial crisis a few years ago.

Economic divergence in several areas

Divergent economic trends in Germany and France are often viewed as a cause of political tensions. In recent years Germany's recovery has generally been strong, but French GDP growth has also been faster than in the UK and faster than the euro zone average. Looking ahead, the indicators look worse for France. One sign that the economy and banking sector are in worse shape is that lending to non-financial companies is falling in France but increasing in Germany.

Germany and France have recovered faster than the euro zone as a whole

Index 100=2008 Q1



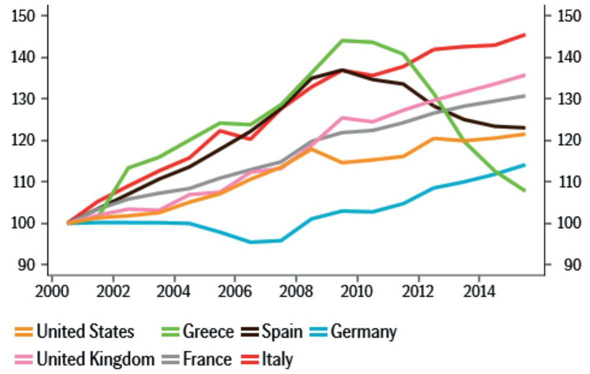
Source: Eurostat, BEA

Germany's **competitiveness** is far stronger than that of France. Despite similar productivity growth, unit labour costs are rising in France, leading to a loss of competitiveness compared to the euro zone average as well. In a global perspective, the situation of France is not especially alarming; French industry is relatively competitive. But while currency fluctuations may serve to cushion US and British exporters, for example, due to the euro project French industry is extra sensitive to competitiveness problems relative to Germany.

French **exports** as a percentage of GDP have been stagnant for a long time and are now well below the corresponding figure in Germany. French foreign trade is largely in balance, whereas Germany runs a large current account surplus. As a result, Germany has relatively large external net wealth position while France has a modest net debt.

Germany's unit labour cost has increased slowly

Index 100 = 2000



Source: OECD

The labour market also demonstrates Germany's strength. German unemployment is at historically low levels, while the jobless rate in France is slightly below the euro zone average and is at a historically high level. Labour force participation increased in Germany after the reforms of the early 2000s bore fruit. In France, the trend is flat and labour force participation is essentially at the euro zone average.

Comparing Germany and France – selected data

Per cent of GDP, 2012

	Germany	France	Threshold value
Current acct, 3-yr avg	6,5	-1,8	-4/+6
Intl net investm pos	42	-21	-35
Private sector debt	107	141	133
Public sector debt	81	90	60
Real exch rate, % change over last 3 years	-8.9	-7.8	±5
Unemployment, 3-yr average	6.2	9.9	10
ULC, 10 yr % change compared to EZ	-11	10,3	---

Source: European Commission (Macro Imbalance Procedure)

In a long-term perspective, France has more favourable **demography** than Germany. According to the Eurostat population forecast, Germany's population will decline while that of France will continue to increase. Favourable demography enables a country to cope better with long-term public sector obligations and debt.

Our overall conclusion is that **Franco-German cooperation is going through a bad patch and is not serving as the stabilising and driving force that the euro and EU projects need**. France faces challenges in shifting its economic policies in response to faltering competitiveness. The gap between the economic strength of the two countries has widened, although French weakness is sometime exaggerated.

Unemployment closing in on Bank of England threshold

- **Inflation will fall below target**
- **Improved household purchasing power driving upturn**
- **Interest rate normalisation starting in 2015**

The British economy has the wind in its sails. The jobless rate is rapidly falling and the banking system is back on its feet. Combined with positive sentiment indicators and new-found momentum in major export markets, this promises a continued upswing, despite the appreciation of the pound in the second half of 2013. **Real GDP will increase by 2.8 per cent this year and by 2.6 per cent in 2015**: a few tenths of a percentage point above the consensus among analysts. Meanwhile inflation has fallen with unexpected speed to 2 per cent, thus equalling the Bank of England (BoE) target for the first time since 2009 on a monthly basis. Price increases are still the fastest in the G7 countries but we foresee a continuing inflation slowdown, indicating that the BoE will follow the Fed and **raise its key interest rate in mid-2015**: half a year earlier than we predicted last November.

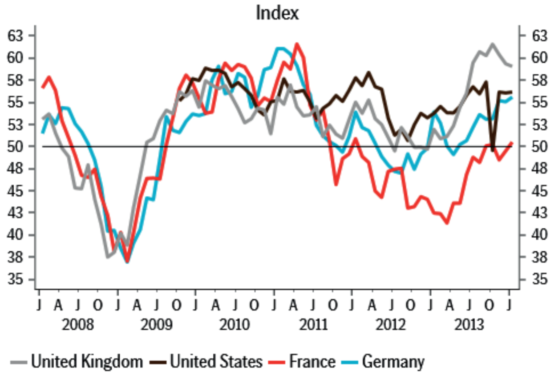
Despite negative real wage growth last year, the recovery chugged along, with households as the driving force. Retail sales volume rose by 7 per cent. Rising financial and tangible asset values persuaded households to cut back on saving. **British home prices continue to climb rapidly**, fuelling concerns about a housing bubble and questions about the durability of the recovery. One reason why we do not believe there is such a bubble is that household debt is falling, at least outside of London. Looking ahead, wages and salaries will climb faster, and **improved purchasing power will boost consumption by an annual average of 2.4 per cent in 2014-2015**.

After a decline in 2013, there is a rebound in capital spending. **Business confidence indicators are exuding optimism** – British purchasing managers' indices are at record-high levels, clearly surpassing equivalent measures in the US, Germany, France and elsewhere. Strong corporate balance sheets, with high percentages of liquidity, mean there are no obstacles to capital spending, but last year's pound appreciation and higher import demand are signalling negative contributions to GDP from foreign trade in 2014. **The pound will remain flat against the euro this year, then strengthen to GBP 0.81 per euro in 2015**, driven by a positive key interest rate spread.

As recently as August 2013, the BoE linked its first key interest rate hike to an unemployment threshold of 7 per cent. This jobless level was several years away, according to the bank's forecasts at that time, but since then unemployment has fallen rapidly to 7.1 per cent. The downturn is continuing, though at a slower pace. **Measured as annual averages, unemployment will be 6.6 per cent this year and 6.2 per cent in 2015**. Since productivity is beginning to regain lost ground – it has stagnated completely since 2008 and is 15 per cent below its long-term trend – the decline in unemployment is likely to slow down.

At the same time as unemployment drops below the BoE threshold – as early as this spring – the inflation outlook will give the central bank manoeuvring room. For the first time since 2004, inflation will now end up below the BoE's target measured on a full calendar year basis: **prices will increase by 1.7 per cent in 2014 and 1.7 per cent in 2015**. In our assessment, there is plenty of slack in the economy. In terms of levels, British GDP is still about one percentage point below its 2008 peak, while American GDP is now 7 per cent above its pre-crisis peak. We thus believe that the **BoE will soon scrap its unemployment threshold** and signal that key interest rate hikes are still distant. The strong recovery nevertheless justifies carrying out the rate hike a bit earlier than projected: the **BoE will raise its key rate for the first time in mid-2015**, some six months earlier than our November forecast. At the end of our forecast period, the key rate will stand at 1.00 per cent.

Composite PMI output index



Source: Markit, SEB

We believe that the Scots will vote for the status quo on the fateful issue of their region's independence when the referendum is held on September 18, 2014. Supporters of an independent Scotland are about 20 percentage points behind opponents in public opinion surveys. As earlier, our assessment is that the British government will soften its fiscal consolidation measures as the 2015 election approaches. The UK government **budget deficit**, which we estimate at 5.9 per cent of GDP this year, **will shrink to 4.9 per cent of GDP in 2015**.

Gradual recovery, largely with the help of Germany

- **GDP to drop despite more emergency aid**
- **Weak growth in Russia – need for reforms**
- **Broad-based upturn in robust Poland**

Most economies in Eastern (including Central) Europe – with Russia and Ukraine as notable exceptions – began a gradual recovery last autumn after bottoming out in the second quarter of 2013. The improvement is **clearest in the central region**, which recorded a relatively strong export surge but also cautious growth in private consumption, reflected in surveys of both manufacturers and consumers, as well as in hard data. Industrial production has risen at a decent pace in such countries as Poland, the Czech Republic and Hungary while remaining stagnant in Russia and shrinking in Ukraine.

Brighter outlook in Central Europe – Russia sliding

Purchasing Managers' Index (PMI), manufacturing

Source: Markit

It is obvious that the central part of Eastern Europe in particular has **benefited from faster growth in Germany and from the stabilisation of the euro zone economy and banking system**. There is extensive trade and banking integration in this particular part of the region; in Poland and the Czech Republic there is also significant German-owned industrial production. In Poland and Hungary, 25 per cent of exports go to Germany. In the Czech Republic (which is also an extremely open economy) the figure is 31 per cent, according to data from 2012. These countries are far less affected by weak Russian growth. Poland sends 5 per cent of its exports to Russia, while Czech and Hungarian figures are even lower.

We expect continued gradual economic recovery in most Eastern European countries during 2014-2015. **At first, exports will remain a key driver**. Private consumption will also strengthen over time. Consumption will be fuelled by good real wage growth, largely an effect of **sustained low inflation** attributable to still-idle resources (though these are small in Russia) and modest increases in commodity prices including food. But we expect no capital spending surge. Moderate industrial capacity utilisation and slowly thawing credit conditions are impeding private investment growth, though public sector investments will rise somewhat. More countries will probably follow initiatives this past year in countries like Poland, Ukraine and Russia to **make extra investments in infrastructure** (Russia's earlier investments were also partly connected to the Winter Olympics) to help sustain the economy. In Hungary and Slovakia, for example, we now expect the governments to loosen their fiscal policies generally – in Slovakia after two years of relatively tough austerity.

More emergency actions needed in Ukraine

Tough political conflicts and drawn-out protest actions in Ukraine are deepening the country's economic crisis. Extreme political uncertainty is harming both domestic demand and foreign trade. The risk of default has again seriously increased. The Russian emergency loan received just before Christmas is probably not enough to stabilise the economy in the long term. One possible scenario is that that Ukraine will also shortly receive an **aid loan package from the EU/IMF** and that the **central bank will continue to let the hryvnia depreciate**. Even assuming these additional aid measures, **the growth outlook remains weak**. **We expect GDP to decrease by 2 per cent this year, after zero growth in 2013**. Continued political uncertainty is hampering capital spending as well as private consumption. Inflation, which was -0.3 per cent last year, will rise to 4 per cent in 2014 due to currency depreciation and increased gas prices (the IMF will require Ukraine to lower subsidies); this will also hold back private consumption. Household costs for servicing foreign currency loans will also increase due to depreciation. A slight upturn in the vital agricultural and steel sectors will buoy the economy.

Late in 2013, higher agricultural production plus base effects from a weak fourth quarter of 2012 unexpectedly enabled Ukraine to end its negative GDP trend after five straight quarters; GDP rose 3.7 per cent year-on-year, according to official data. But the underlying economy remained weak, with a downturn in industrial production. The long period of falling GDP, a large current account deficit – 8-9 per cent of GDP in 2013 – and a gradually draining currency reserve are factors that led to an **acute financial crisis**. The protests that broke out in Kiev in November 2013 after President Viktor Yanukovych suddenly refused to accept a trade and integration agreement with the EU, served as a catalyst in this process. Investor confidence in Ukraine and its currency fell dramatically, which was instrumental in keeping the currency reserve very low. The market feared a default, and the risk premium on CDS contracts skyrocketed. Russia's unexpected emergency loan of USD 15 billion – of which USD 3 billion has been disbursed so far – removed the risk of an immediate default. After spiking, the CDS risk premium temporarily fell quickly. But market instability resumed in late January after violent clashes in response to the president's plans to restrict freedom of assembly, which were later reversed.

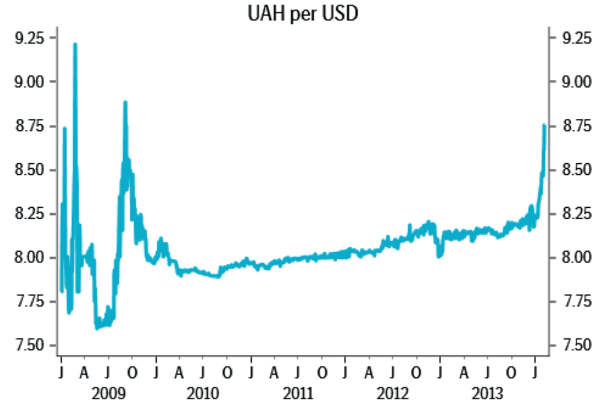
Right after receiving the Russian loan, Ukraine had the potential to meet its external funding needs for 2014. But continued protests and severely aggravated tensions have again worsened the economic situation. In addition, Moscow has indicated that it may freeze the loan. The **currency reserve remains weak**, covering only three months of imports in December, a critical threshold according to normal rules of thumb. The **current account deficit is unsustainably large** in the long run, requiring continued funding in the future.

Our overall assessment is thus that **Ukraine needs further financial aid. An agreement with the EU/IMF on an emergency loan – which would probably be of the same magnitude as the one from Russia – might also help ease political tensions**, since it would be perceived that the president is still holding the door open to integration with the EU further ahead. **Meanwhile the political outcome after the waves of protest is highly uncertain.** A presidential election is due in 2015 but will probably take place earlier. The shape of the government that will succeed the current interim cabinet, appointed in January, is also unclear. Ukraine will probably hold an early parliamentary election.

Aside from seeking immediate emergency loans, Ukraine is also trying to strengthen the growth outlook with the help of a weaker currency, improving export competitiveness. For a long time, the central bank has aimed at keeping the hryvnia stable against the USD. This required continued interventions in the past year. However, the hryvnia has gradually weakened from about UAH 8.00 to the dollar early in 2013 to 8.20-8.25 at year-end and about 8.90 in February in the wake of worsening political unrest. **Since the start of 2013, it has depreciated by about 10 per cent. An equally large gradual additional depreciation is expected.** Ukraine may eventually switch to a more flexible exchange rate regime; this was requested by the IMF when the 2010 emergency loan was approved.

The hryvnia is weakening

UAH per USD



Source: Macrobond

There is a major risk of a gloomier economic scenario than we have outlined. Given Ukraine's disorderly political outlook – largely connected to great uncertainty about the political future of President Yanukovych – an uncontrolled and even weaker economic and financial performance cannot be ruled out. For example, the hryvnia could plunge, resulting in dramatic effects on the Ukrainian economy.

Structural problems impede Russian growth

Russia will not serve as a strong growth engine for Eastern Europe. We are **slightly lowering our conservative growth forecast to 2.0 per cent in 2014 and to 2.4 per cent in 2015**, well below the 6-7 per cent achieved before the global crisis. Growth is being hampered by structural problems, including a poor demographic position, an overextended labour market and weak investments. Falling investments have been a key factor behind the marked deceleration in the Russian economy. Households – which were previously energetic consumers – are also starting to build up large debts, a trend that the central bank is trying to curb. This creates uncertainty about private consumption, despite relatively good real wages as inflation falls towards a historically low average of 5.7 per cent in 2014. We foresee no vigorous structural reforms in the Russian economy in the near future. GDP growth will thus continue to be sustained by stagnating oil prices of USD 100-110 per barrel. Balancing the government budget last year required an oil price of USD 110-115/barrel. Overall, 2013 probably ended with a small deficit. This is expected to rise gradually to 1.5 per cent of GDP in 2015 due to stable oil prices and weak economic growth. Meanwhile we expect the long-term decline in the current account surplus to continue. As recently as 2006, the surplus was nearly 10 per cent of GDP; it is now on its way down to a marginal 0.5 per cent of GDP in 2015. After a relatively large depreciation, the rouble is expected to recover only slightly in the coming year. According to the central bank's plan, in 2015 the exchange rate will float as Russia transitions to a pure inflation target. The bank recently took steps in that direction by widening the permitted fluctuation range of the currency.

Polish economy in good shape

We remain **optimistic about Poland**: growth will accelerate from 1.6 per cent last year to **3.1 per cent in 2014 and 3.4 per cent in 2015**. The latest data and indicators suggest that Poland has already begun a broad-based upturn. Private consumption has revived somewhat earlier than expected. The driving forces are stronger real wages after a sharp fall in inflation a year ago and forceful key interest rate cuts, which have begun to have an impact. The first rate hike is expected in early 2015. Poland is among the Eastern European countries with the best economic fundamentals. Although it is showing a moderate current account deficit and a relatively large budget deficit, both are manageable. This year, the government is expected to resume its budget consolidation after a temporary pause in 2013. This will help shrink the deficit below 3 per cent of GDP this year, opening the way for adoption of the euro, though this issue will not arise during our forecast period. The zloty has weakened moderately during this winter's EM-related turbulence. A reasonable long-term valuation as well as relative growth advantages and an early key interest rate hike compared to Western countries suggest that the zloty will recover further ahead and that the EUR/PLN rate will stand at 4.05 in December 2014.

Latvia, Lithuania still top EU growth – Estonia rebounds

- **Households will continue to set the pace**
- **Rising exports after deep slump late in 2013**
- **Labour shortages will threaten low inflation**

Growth in the Baltic countries will accelerate somewhat and become more broad-based as exports revive this year and join forces with the long-stable consumption upturn. Latvia and Lithuania will maintain healthy growth – still topping the EU statistics. **Latvia's GDP will rise by a very stable 4.8 per cent yearly in 2014-2015. Lithuania's yearly growth will reach 3.5 and 4.5 per cent, respectively** after a temporary slide in 2013 to 3.4 per cent. This was partly due to an unexpectedly strong deceleration in key oil exports. Estonia's growth rate is recovering after last year's significant drop to 1 per cent, caused by declining public sector investments (partly due to lower EU subsidies) and lower exports. **In 2014, Estonia's GDP will grow by 2.6 per cent and in 2015 by 2.9 per cent**.

We expect minor initial economic effects from Latvia's euro zone accession on January 1, 2014: a slight uptick in inflation and investments. Lithuania is also very **likely** to become the last Baltic country **to qualify for the euro zone, joining in 2015** in keeping with the government's target. Lithuania has met the Maastricht inflation criterion since September 2012, and its budget deficit appears to have fallen below 3 per cent of GDP last year. The European Commission and ECB are thus expected to give Lithuania the green light to join after this spring's evaluation of compliance with the Maastricht criteria.

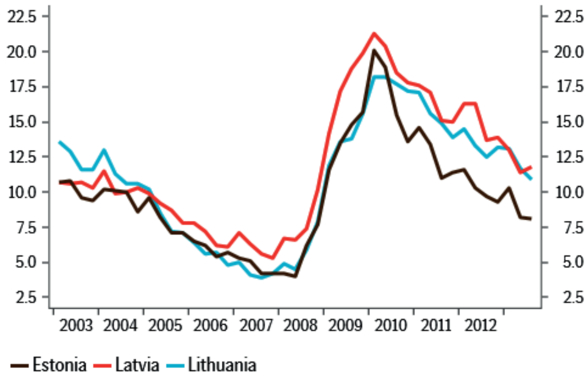
Growing private consumption will remain a major force behind growth in 2014. There will be continued strong demand for food, durable goods like home appliances and building materials. Consumption will enjoy support from good real income increases and historically high consumer confidence. In addition, home prices will keep increasing; in Lithuania, the upturn has only begun. **Business investment appetite is still low**, however, and will only increase slowly in the next couple of years. Manufacturing confidence basically remained flat in 2013, reflecting doubts about the future. Capacity utilisation levels are modest and do not indicate any acute capital spending needs either. In addition, public sector investments are hampered by less access to EU funding than before.

Exports slumped sharply in the second half of 2013 after a relatively strong start to the year; in October and November all three countries' exports fell, measured year-on-year in current prices. The decline was mainly due to weak external demand, for example from Russia, an important export destination: 13 per cent of Estonia's 2012 exports and as much as one fifth of Latvia's and Lithuania's went to Russia. In Latvia, another factor was lower production at the crisis-hit steel company Liepajas Metalurgs, and in Lithuania a production cut at the country's oil refinery. Our view remains that Baltic exports will gradually strengthen in 2014 due to higher growth in Western Europe as well as in nearby countries. Weak Russian growth will prevent a stronger export rebound.

Our GDP forecast implies that Estonia will remain below potential growth, estimated at 3-3.5 per cent in all three countries, with Estonia in the lower part of this range. This is one reason why **inflation in Estonia**, which has been well above that of Latvia and Lithuania in recent years, **will continue to slow this year** to an average of **somewhat below 2 per cent**, compared to 3.2 per cent in 2013. Lower electricity prices and low imported inflation will also keep inflation down. In both **Latvia and Lithuania, however, inflation will climb somewhat this year**, to about 2 per cent in 2013 from zero and 1.2 per cent, respectively. We have adjusted all our Baltic inflation forecasts downward.

Unemployment moving towards normalisation

Per cent. Note: The Baltic economies overheated in 2006-2008



Source: National statistical offices

Looking ahead two years, price pressures will grow. Our base scenario is that inflation upturns will be moderate because all three economies still have idle resources. The risks are on the upside, since **labour shortages** will be a growing problem in sectors like technology and construction. The jobless rate, nearly 20 per cent in 2010, has also fallen steadily. In Estonia, it is now expected to level out at around 8 per cent, equivalent to structural balance. In Latvia and Lithuania, it will keep falling from about 11 per cent, and in 2015 Lithuania will reach its equilibrium level of 8-9 per cent. Due to large emigration, including highly educated workers, as well as higher long-term unemployment and the disappearance of jobs during the crisis, equilibrium unemployment has climbed higher than a decade ago. Tighter labour markets imply a risk of higher wage and salary costs ahead. In 2014 we foresee 5-6 per cent pay hikes in the Baltics. Compared to 2013, this is a downturn in Estonia and an increase in the other countries.

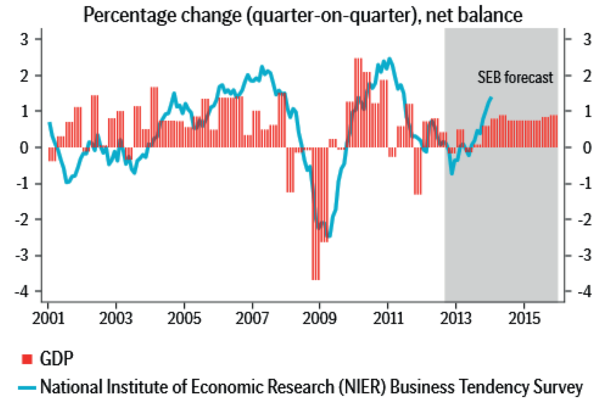
Lower unemployment as growth exceeds trend in 2014

- **Consumer-driven recovery on track**
- **Falling unemployment early this year**
- **Inflation will remain well below target**
- **No key interest rate hikes this year**
- **Risk of pro-cyclical fiscal policy**

The Swedish economic picture is mixed. GDP growth in the first three quarters of 2013 was weaker than expected, but forward-looking indicators suggest that growth accelerated late last year. The domestic economy is showing signs of strength, for example in terms of the labour market and consumer confidence, while the export sector is showing continued sluggish performance. Our forecast of **2.5 per cent GDP growth in 2014 and 3.2 per cent in 2015** is unchanged from November's *Nordic Outlook*. Such a forecast implies a far more lacklustre recovery than the 2004-2007 upturn after the IT (or dotcom) crisis, when GDP rose by a yearly average of 3.8 per cent. The main difference is weaker manufacturing sector expansion than historically. To a greater extent, the driving forces of the current upturn are private consumption and a relatively strong rebound in housing construction.

Indicators point to accelerating economic growth

Percentage change (quarter-on-quarter), net balance



Source: Statistics Sweden, SEB

Labour market indicators have strengthened over the past 3-4 months. We believe that **unemployment will turn downward in the first quarter of 2014**. A stronger labour market suggests that **December's repo rate cut was the last in this cycle**, but due to low inflation the Riksbank is still under pressure to cut its rate further. We believe the bank will leave the key rate unchanged in 2014, then begin cautious hikes in the spring of 2015 when the recovery is on firmer ground and unemployment falls closer to 7 per cent. We forecast two hikes and a **repo rate of 1.25 per cent at the end of 2015**.

Fiscal policy looks set to be a bit less expansionary than we expected in November. Both the government and the opposition Social Democratic leadership are pursuing a fiscally prudent strategy. The political price of not protecting the official budget surplus target seems to have risen. We fear this may lead to **excessively pro-cyclical fiscal policy in 2014-2015**.

Mixed signals from manufacturing

Despite rising sentiment indicators in the second half of 2013, industrial production and merchandise exports were weaker than expected, although a slight recovery was discernible in November and December. This may be due to the unusual combination of a strong krona and weak global demand, making it difficult for manufacturers to keep pace with the international expansion. But surveys from NIER and Statistics Sweden indicate that manufacturing capacity utilisation has risen by about as much as in Germany. Planned 2014 capital spending in manufacturing is also relatively expansionary. We thus believe there are reasons to suspect that official export and production figures for the second half of 2013 exaggerate the underlying weakness. We believe that **exports will grow at a decent pace in 2014**. Because of a historically weak recovery in the euro zone and emerging economies, the upturn will be modest. We expect total exports to grow by 3.5 per cent in 2014 and 6 per cent in 2015.

New housing will drive up capital spending

Total gross investments appear to have fallen by 1.5 per cent in 2013, mainly due to lower investments by manufacturers. Now that demand is picking up, **capital spending is very likely to begin rising again**. This is also supported by the latest Statistics Sweden survey, which says that manufacturers are planning an investment upturn of 5 per cent in 2014.

Residential investments rebounded last year after falling more than 10 per cent in 2012. The number of housing starts rose gradually during the first three quarters of 2013, and there are many indications that the upturn will continue this year. **Residential investments are expected to increase by about 20 per cent both this year and next**, contributing about half a percentage point annually to total GDP growth. The upturn in housing starts last year was driven mainly by new tenant-owned cooperatives, while rental flat and single-family home construction remains at very low levels. Even factoring in the forecasted upturn, **housing construction is very low**, especially considering the strong population growth of the past decade. The housing policy debate has recently intensified, but concrete proposals for boosting construction have so far been limited to minor changes in the rules for sub-letting and vague amendments to the Planning and Building Act. The absence of a strategy to speed up construction of rental units makes a stronger upturn in housing construction unlikely. It is also difficult to see how a sizeable upturn in new construction of owner-occupied housing will be compatible with the Riksbank's ambition to keep household debt from increasing.

Consumption will continue to drive growth

While the manufacturing sector is going nowhere, there are relatively clear signals that consumption is about to accelerate. Consumer confidence has trended upward since mid-2013 and is now well above its historical average. An increasingly strong labour market, along with rapidly rising wealth and incomes suggests that the upturn will continue this year. Retail sales of cyclically sensitive durable goods, in particular, rose late in 2013 and are now showing their fastest growth rate since 2011. Tax cuts equivalent to nearly 1 per cent of income and rising real wages are resulting in relatively large increases in income. Our forecast of roughly a **3 per cent upturn in consumption in both 2014 and 2015** is thus compatible with a marginal downturn in today's historically very high household saving.

The risk of weaker consumption growth remains linked to a fall in home prices. Although the price downturn in Norway has increased uncertainty, the low supply of homes in Sweden (see the Nordic housing market theme article) makes a similar trend unlikely in Sweden. We believe that **home prices will gain about five per cent this year** and then level out in 2015.

Household income and consumption

Year-on-year percentage change

	2012	2013	2014	2015
Consumption	1.6	2.0	2.7	3.0
Income	3.5	2.4	3.1	2.2
Savings ratio, % of disp. income	12.2	12.0	12.2	11.4

Source: Statistics Sweden, SEB

Unemployment is about to decline

Job creation has remained an upside surprise, but **sharply rising labour supply has helped keep unemployment from falling**. The labour supply is driven both by strong population growth and rising labour force participation. There are many indications that unemployment will start to fall early in 2014, driven by a combination of stronger job growth and a slower growth rate in the labour force. Hiring plans according to NIER's Business Tendency Survey, normally a very reliable employment indicator, have trended upward for 5-6 months. Meanwhile the sharp downturn in the number of people on long-term sick leave and with disability pensions is now slowing significantly (see theme article). Rapid population growth makes it likely that labour supply will keep rising at a high rate, even if labour force participation levels out. We believe that **unemployment will fall from 8 per cent in December 2013 to 7.6 per cent at the end of 2014 and to 6.8 per cent at the end of 2015**.

The percentage of the unemployed with little formal education or with non-Nordic origin has risen significantly in recent years, suggesting it may be difficult to push down unemployment. But the risks of increased wage pressure over the next couple of years are small. It is worth noting that not even the lowest unemployment rates during the past two decades (about 5.7 per cent) have fuelled inflation to any great extent. During the short periods when inflation has exceeded 2 per cent since 1995, the main driving forces have been a temporarily weak krona combined with large price increases for commodities.

Labour market

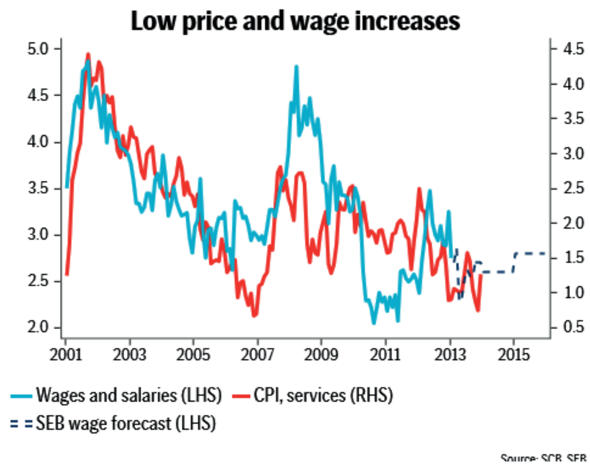
Year-on-year percentage change

	2012	2013	2014	2015
Employment	0.6	1.0	1.0	1.3
Labour supply	0.8	1.1	0.7	0.7
Unemployment, %	8.0	8.0	7.7	7.0
Productivity, GDP	0.6	-0.5	1.7	1.9

Source: Statistics Sweden, SEB

Inflation far below the Riksbank's target

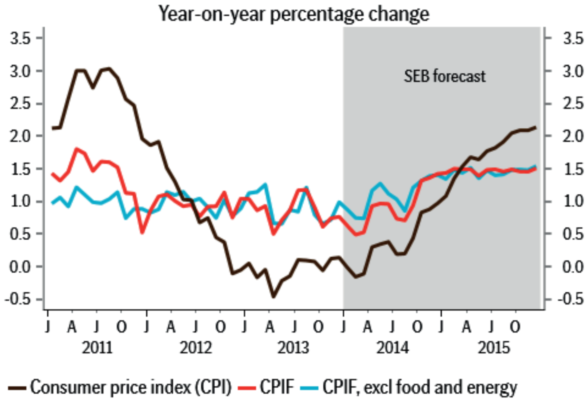
Despite a small upturn in December 2013, price pressures have remained very low, with CPIF inflation (CPI excluding interest rates) below 1 per cent and CPI close to zero. Collective pay agreements at historically low levels for the next 2-3 years, combined with low international price pressure, point to continued low inflation in 2014-2015. Food and energy prices, which often underlie short-term fluctuations in inflation, currently seem likely to pose a slight downside inflation risk this year.



Diminishing downward pressure from earlier krona appreciation and somewhat higher pay increases suggest that inflation will increase slightly during the second half of 2014. Yet we expect CPIF to remain well below the Riksbank's target throughout our forecast period. CPI inflation is projected to rise above 2 per cent during 2015, since the expected Riksbank key interest rate hikes will push up mortgage interest costs.

CPIF well below 2 per cent

Year-on-year percentage change



Source: Statistics Sweden, SEB

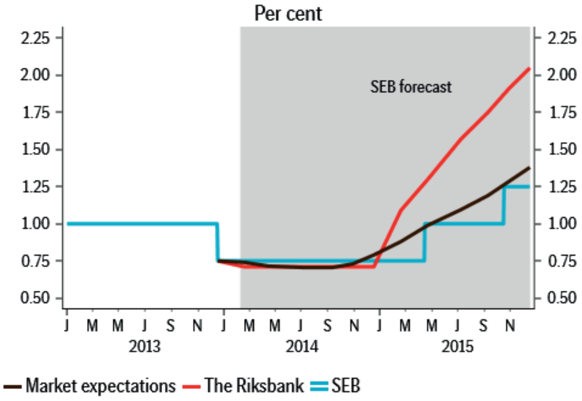
The main risk of higher inflation is that a stronger global economy will result in higher prices for energy and other commodities. Weak productivity growth could also lead to stronger inflation pressure, with a certain time lag, but this tendency is not unique to Sweden and has not caused higher inflation in other countries. Besides, it is likely that a large proportion of weak productivity is cyclical. With wages and salaries likely to increase significantly more slowly than the historical average in the next couple of years, and with clear downward pressure tendencies for many commodities important to CPI, downside inflation risks will be larger both in 2014 and 2015.

The inflation target regains lost ground

Stronger economic growth and falling unemployment suggest that **December's key interest rate cut was the last in this cycle**. Historical experience indicates that rate-hiking or rate-cutting cycles begin as early as about six months after unemployment has turned around. This would point to a hike by mid-2014. Corresponding patterns in various other countries have not, however, been applicable to the current recovery. For example, the Federal Reserve continued to increase monetary stimulus long after US unemployment had turned downward. We assume that continued low inflation and low resource utilisation will delay key rate hikes until spring 2015 and that the Riksbank will carry out only **two hikes, bringing the repo rate to 1.25 per cent at the end of 2015**.

Repo rate expectations

Per cent



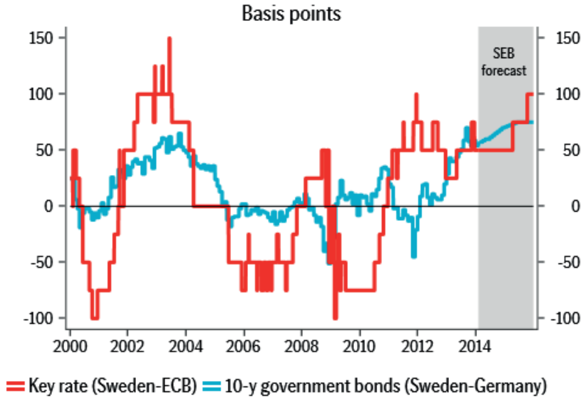
Source: The Riksbank, Bloomberg, SEB

The minutes of the Riksbank's last monetary policy meeting (December 2013) indicate a paradigm shift, with long-term low inflation becoming the focus of attention at the expense of financial stability. A majority of the Executive Board seems to have reluctantly accepted that financial stability has ended up under the purview of the Financial Supervisory Authority. We believe that low inflation will remain in focus. This implies that the Riksbank will continue to signal a downside risk in its repo rate forecast during much of 2014. It is also likely that one or more Board members will argue in favour of more interest rate cuts and **eventually dissent from a decision to leave the key rate unchanged**.

Despite lowering its repo rate path substantially in December, the Riksbank continues to signal rather sharp rate hikes in the longer term, with the rate being hiked at essentially every monetary policy meeting in 2015 and initially by more than 25 basis points. While most of the world's central banks are signalling low key interest rates for an extended period in order to support the labour market and minimise deflation risks, **the Riksbank thus chooses to emphasise that the repo rate must be raised** as soon as inflation begins to approach its target, probably because it wants to warn households not to take for granted that record-low interest rates will persist. This aspect is being accorded higher priority than supporting a labour market recovery. Criticism of the Executive Board's deliberations, both from politicians and economists, has become more articulate. This criticism will be hard to refute unless the Riksbank presents a clearer analysis of the problems in the labour market. We believe that such argumentation will be difficult for the bank in an environment of relatively low pay increases and with indicators pointing to persistently low resource utilisation. It is thus likely that the Riksbank will again have to backtrack from its monetary policy normalisation plans.

Spread to ECB/Germany

Basis points



Source: Macrobond

Spread against Germany will widen further

In line with international developments, Swedish sovereign bond yields have fallen in recent months. The downturn in Swedish 10-year bond yields has been somewhat larger than for their German counterparts, primarily due to the Riksbank's key rate cut in December. Yet the spread against Germany is close to the peak levels from the past 15 years. **We nevertheless believe that the spread will widen further**. Our forecasted quantitative easing (QE) by the ECB will exert downward pressure on German yields during the first half of this year. Although a slight probability of further Riksbank rate cuts will also keep Swedish yields down, as rate hikes approach during 2015, we predict that the spread against Germany will widen to 70 basis points at the end of 2014 and to 75 points at the end of 2015. This will be the widest yield spread since the mid-1990s. Because of a very modest upturn in German yields, these yields will still be as low as 2.95 per cent at the end of 2015.

Continued krona appreciation during 2014

The krona gained some 3 per cent in trade-weighted terms since the Riksbank cut its key rate on December 17. The EUR/SEK exchange rate has moved quickly from 9.10 to 8.80, and in the coming months there is a risk that Swedish inflation will provide a downside surprise. This would generate expectations of further rate cuts and cause foreign investors to sell SEK.

But given our main forecast that CPIF inflation will bottom out and the Riksbank will leave its key rate unchanged, we believe the krona can take advantage of relatively strong economic conditions. In addition, increasing expectations about new ECB measures will lead to general downward pressure on the euro against most other currencies. The krona should be one of the currencies that benefit from rising global growth. **We are thus sticking to our forecast that the EUR/SEK rate will be 8.50 at the end of 2014**, and we expect a somewhat stronger krona, at 8.40, by the end of 2015. We predict a USD/SEK rate of 6.64 at the end of this year and 6.72 at the end of 2015.

Increasingly cautious fiscal policy

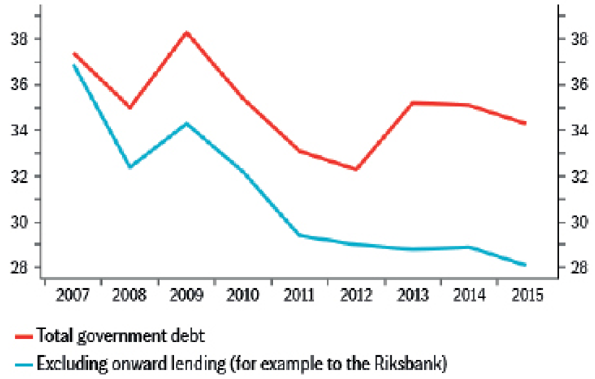
This year's fiscal policy look set to be somewhat less expansionary than we had expected earlier. Although Finance Minister Anders Borg has indicated that future reforms will need to be financed, we still believe that the spring budget bill will include minor stimulus measures, probably in the form of labour market programmes and infrastructure investments. Overall, we predict that **fiscal stimulus will be equivalent to 0.6 per cent of GDP in 2014 and 0.1 per cent in 2015**.

The Alliance government and the opposition Social Democratic leadership are currently trying to outdo each other in showing how important it is to protect the public finances and the official budget surplus target of one per cent of GDP. Several government agencies have also come to the conclusion that the government's budget is too expansionary and will require major belt-tightening after 2015.

This outcome of the September 2014 election is still uncertain, although the opposition enjoys a large lead in public opinion surveys. Our forecast, based on the government's fiscal stance, is not so dependent on the election outcome, but we will provide a more detailed analysis in the May issue of *Nordic Outlook*. The current public conversation risks leading to an unnecessarily tight fiscal policy, thereby **giving up opportunities for stimulus measures that may benefit the Swedish economy both structurally and cyclically**. Estimates of the cyclically adjusted budget deficit, which provide the basis for assessing future scope for reforms, are extremely uncertain. The models seem to underestimate the impact of the business cycle on public finances. Also noteworthy is that as a percentage of GDP, last year's deficit was lower than during the 2001-2005 economic slowdown. When the economy rebounded in 2006, deficits quickly turned into surpluses totaling 2-3 per cent of GDP. During the latest recession, the models also indicated there was no room in the budget for reforms and reached conclusions similar to those they are reaching now. The opposite was true during the following boom period, when the models indicated unreasonably large scope for reforms. This tendency to underestimate the impact of the business cycle on the budget leads to a pro-cyclical fiscal policy that is too cautious during economic downturns and too expansionary in boom periods.

Downward trend for government debt

Per cent of GDP



Source: Statistics Sweden

A closely related question is whether the targeted surplus, one per cent of GDP, may be revised some years from now to a target that average net savings should be in balance over a business cycle. When the surplus target was fixed at one per cent, the implicit assumption was that central and local government net savings would average zero, since the pension system generated a surplus of one per cent of GDP at that time. Due to increased pension payments, net savings in the pension system are now close to zero. This means that the government must generate a surplus, leading to a rapid decline in government debt. Assuming that nominal GDP grows by four per cent a year (and that the Riksbank pays back its loans to the National Debt Office), government debt will fall below 20 per cent of GDP within 10 years, even with a central government budget that is balanced on average. If the government reports a yearly surplus of one per cent of GDP, its debt will fall to just above 10 per cent of GDP. **Despite the mood of current discourse, we believe that these economic arguments are so compelling that a change will be implemented at the beginning of the next parliamentary term of office**.

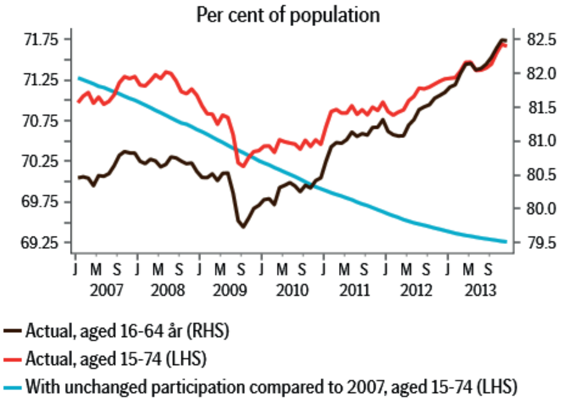
Theme: Major increase in Sweden's labour market participation rate

- **Strong increase in labour force participation despite economic headwinds**
- **Nearly 200,000 fewer in sick pay schemes**
- **Political measures an important driver**

In recent years, the Swedish labour market has been characterised by a rather unusual combination: **unemployment has stayed high even though employment has risen**. The reason is a big increase in labour supply, mainly driven by a major upturn in participation. Viewed in a long-term perspective, about **half of the participation rate drop in the early 1990s has been reversed**. This trend is remarkable given weak economic conditions and the fact that the large immigration of recent years has probably pushed down labour force participation.

Labour force market participation

Per cent of population



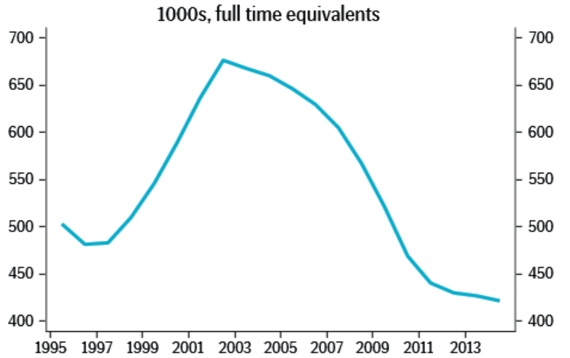
Source: Statistics Sweden

The proportion of the population 16-64 years of age in the labour force has increased by about three percentage points, **equivalent to 225,000 people**. The influx into the labour force has been largest for those aged 55-64, whose participation rate has risen by 5 points. There has also been an upturn among those aged 33-44, while younger age groups have noted largely unchanged labour force participation. The upturn is generally somewhat larger for women than for men. Labour force participation among those aged 65-74 has also risen quite a lot. The participation upturn in the total labour force (aged 15-74) has still been rather moderate, but this is because age structure has a strong restraining effect, since the number of people aged 65-74 has increased so sharply. This structural effect has **pushed down the participation rate by about two percentage points since 2007**.

The upturn in labour participation is mirrored by a downturn in the number of people with long-term sick pay and disability pensions. The number of people in these benefit schemes has decreased by 180,000 compared to 2007. The downturn now seems to have stopped, which suggests that in the future the labour force will grow at around the same pace as the able-bodied population.

Number of people with long-term sick pay or disability pensions

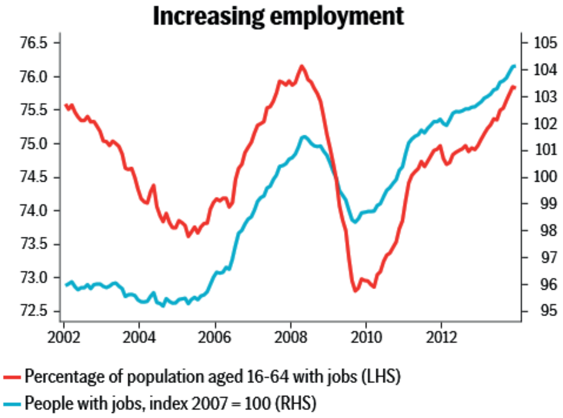
1000s, full time equivalents



Source: Statistics Sweden

The downturn in the number of people in benefit schemes began in 2004 and accelerated after the Alliance government succeeded the Social Democrats in 2006. A **tightening of the sick pay system** is the most important reason, but **increased incentives to work** – for example the earned income tax credit – have also played a role. Altogether, the five steps in this tax credit system mean that net income (assuming the same gross income) is now 10-15 per cent higher for low-paid employees and 5 per cent higher for medium- and highly-paid employees if they work instead of drawing social benefits. In addition, replacement rates in the social security system have been lowered.

Increasing employment



Source: Statistics Sweden

The big challenge ahead will be to bring down unemployment by ensuring that a larger proportion of Sweden's growing labour force can find jobs. Many of the unemployed are people with little formal education and with non-European origins, which might make this task more difficult since these groups have found it harder to gain a foothold in the labour market. Yet despite weak economic conditions, employment has risen by a full four per cent since 2007, indicating that government economic policies have achieved some success in the area of job creation as well. Tax deductions for renovation and household services could be part of the explanation.

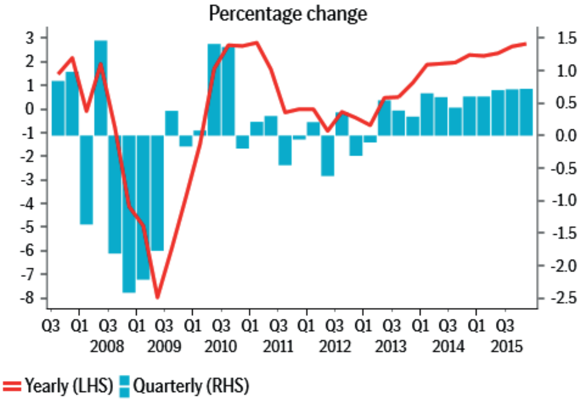
Faster recovery ahead

- **Finally, stronger growth**
- **Both external and domestic improvement**
- **Balanced budget due to temporary effects**
- **Coalition party leaves the government**

The Danish economy is expected to grow at a considerably faster pace in 2014 than in 2013. Although 2013 marked the end of years of stagnation, average growth for the year as a whole will be only around half a per cent, But with employment trending upward, consumer sentiment at a 6-year high and signs of improving growth on both sides of the Atlantic, **the Danish grow rate is expected to increase to 2 per cent in 2014 and 2.5 per cent in 2015** – in line with expectations in the November issue of *Nordic Outlook*.

GDP growth to accelerate

Percentage change



Source: SEB, Macrobond

Finally some growth

The key trigger for Denmark's return to positive growth is external. After a lengthy period of weak external demand due to crisis among some of its euro zone trading partners, 2013 finally offered relief and room for moderate optimism. The end of the euro zone recession last summer and expectations of further improvement promise a stronger export outlook for the Danish economy.

Although growth will likely stay muted in the euro zone, the change is significant enough to have a meaningful impact on Danish exports, especially since other key markets are expected to show improving demand as well. Thus, we expect Danish exports to grow more than 4 per cent in 2014 compared to around 1 per cent in 2013.

The improvement in exports will not materially change the level of current account surpluses Denmark is running. A milder fiscal headwind, improvements in the labour market, as well as better consumer sentiment are expected to boost domestic demand, as should an improved investment outlook in light of stronger global growth. Thus, demand for imported goods is expected to climb during the year, leaving room for only a small increase in the Danish trade surplus.

Danish consumers have been holding back for years now, but several things now point to improvements going forward. Developments in the labour market are still uneven, but employment posted a second consecutive quarterly increase in the third quarter, and home prices have also risen, although moderately, removing pressure from households to increase savings.

Predictions of a devastating euro break-up are also vanishing from news headlines, while global and Danish equity markets have offered strong returns – boosting optimism among consumers. On some measures, sentiment has not been stronger since prior to the financial crisis, so the stars are finally aligned for expanded consumer spending after half a decade of caution.

Household debt might still hold back consumer spending even if incomes pick up. It also exposes Danish households to the risk of interest rate increases in the future, since more mortgages today are variable rather than fixed rate loans. This seems to be a rather hypothetical risk right now. In fact, variable Danish mortgages rates are near all-time lows, so low that debt service costs if anything are a help to consumers.

Inflation still low

Krone-denominated inflation was pushed well below 1 per cent in 2013 as weak growth hit wages and the strong EUR block capped import prices. The weak commodity price trend also had the same general dampening effect on Danish inflation as we have seen in most other markets, but inflation trended upward starting in the early autumn.

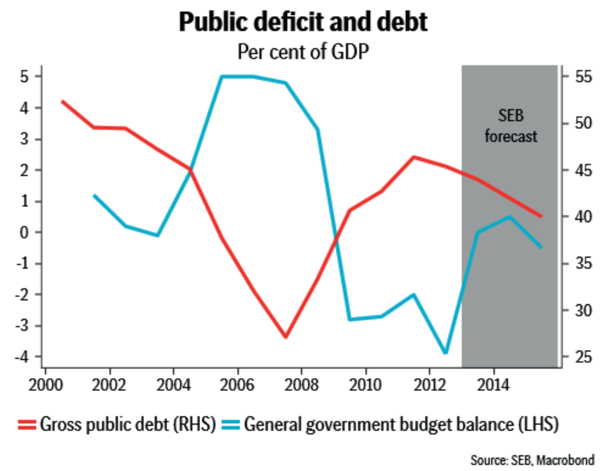
Wage and salary inflation is likely to rise from its all-time low of 1 per cent as employment starts picking up, but it will be a long time before this result in competitiveness concerns. Indeed, the consensus is starting to acknowledge that there has been no problem with competitiveness. And both to avoid outright deflation and to support household deleveraging, higher inflation should be welcomed.

Budget surplus in 2014

The numbers are not final yet, but recent data indicate that the general government balance ended 2013 very close to zero, a lot better than the government had expected until just a few months ago.

In recent years, the government has pursued a tight fiscal policy, even though the overall level of public debt in Denmark is lower than in most developed economies. However, in 2013 and 2014 this has given way to a modest easing, which in our view paradoxically helps narrow the deficit by reducing the cyclical component.

Another part of the improvement in 2013 stems from changes in the pension system that have had a temporary positive effect on public finances in 2013 as well as in the current year. The effect is around 1.8 per cent in each of these two years, so the expected 2014 surplus does get some technical help. Still, there is no mistaking the fact that **Denmark has relatively strong public finances compared to most other countries**, both when it comes to debt and deficits. In a post-credit crisis environment with significant fiscal challenges across the developed world, a position of fiscal balance stands out.



With our expectation of growth picking up to a level of 2 per cent in 2014 and further accelerating in 2015, overall public finances should stay very sound, with the deficit close to zero, despite the waning of the above-mentioned temporary effects in 2015. This development and the fact that **Denmark has a current account surplus of more than 7 per cent of GDP** means that it is on the verge of becoming one of the world's few twin-surplus economies.

Central bank's successful strategy

Denmark's central bank has stabilised the DKK after cutting some of its interest rates to negative territory two years ago. Today a fading crisis in the euro zone has reduced the upward pressure on the DKK, which is actually now trading a bit closer to central parity than normal.

Foreign exchange reserves in Denmark have dropped slightly as pressure has diminished in southern Europe. However, the general picture is more or less flat reserves for the past 2 years at a level 2-3 times the average prior to the Great Recession. The **current level of the EUR/DKK suggests that there is no longer a need for a negative spread to ECB rates**, and we expect DNB to close the gap over the coming months either in combination with an ECB rate cut or by unilateral action.

New initiatives might be needed should the European Central Bank launch the quantitative easing programme that SEB expects. If it does, the Danish central bank would prefer to use more traditional tools instead of following the ECB into QE.

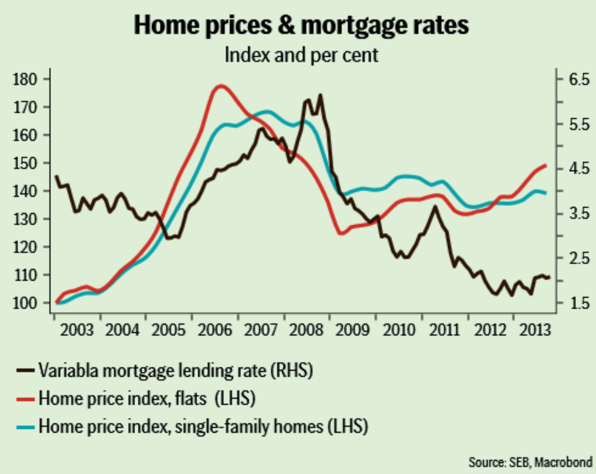
Change in coalition government

The Socialist People's Party withdrew from the Danish government at the end of January 2014. This comes after a steady drop in its popularity since entering the government. The party has had to accept the implementation of several initiatives going against its basic positions, which led to a build-up of discontent among leading party officials. The government's decision to sell part of the state-owned utility company, Dong Energy, to Goldman Sachs was the last straw.

The two other coalition parties, the Social Democrats and Social Liberal Party, will remain in government and no new election is expected. As the two remaining parties have been setting most government policies, few changes are to be expected.

Danish housing market recovering

The Danish housing market is slowly getting back on its feet after the longest downturn in recent years. Prices of single-family homes fell for five years after the 2007 crash, while flats had a shorter but more dramatic downturn from 2006 to 2009. For the past two years, the broad housing market has seen upward-trending prices. With an improving economy and labour market, as well as very low mortgage rates, we expect this recovery to continue. A positive feedback loop in the economy can thus be expected.



A growing share of Danish mortgages today are flexible rate loans, whereas 10-15 years ago they were all fixed rate loans. Interest-only loans have also become much more common. This means that the sensitivity of the housing market and the overall economy to short-term interest rates has grown considerably. In the current environment as well as in the next couple of years short-term rates should stay very low. This is related to ongoing structural weaknesses in the European economy and Denmark's fixed exchange rate regime vs. the euro.

The long-term vulnerability of the Danish mortgage market has increased because of the above-mentioned changes in mortgage financing, but we see the medium-term risk as limited.

Growth will rebound despite housing market downturn

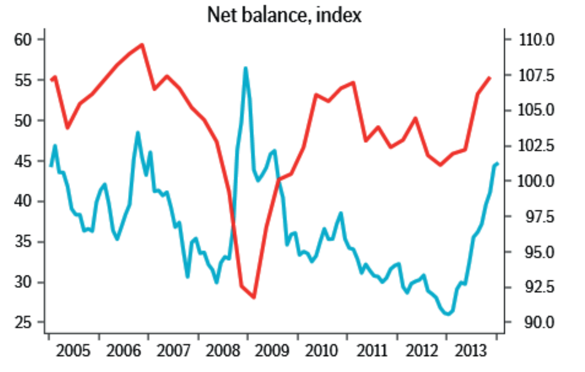
- **Housing market will make a soft landing**
- **Good real incomes will drive consumption**
- **Inflation will stay just below target**

Norway's economic growth will gradually recover in 2014 after last year's unexpectedly deep slowdown, mainly caused by weak consumption of goods but also declining exports. Growth will be driven by **stronger private consumption**, fuelled by improved real incomes and continued good employment growth for households. Meanwhile **exports will benefit** from a weaker krone and higher foreign demand. Capital spending growth will remain modest, however. Business investments will increase somewhat, but activity in the oil industry will slow significantly. A somewhat more stimulative fiscal policy than last year will contribute positively to domestic demand.

We expect overall growth of 2.1 per cent this year and 1.8 per cent in 2015; downward revisions by 0.3 percentage points compared to the November 2013 issue of *Nordic Outlook*. **Mainland GDP**, excluding oil/gas and shipping, **will increase this year by 2.2 per cent – which is below trend – and by 2.6 per cent in 2015**, following estimated growth of 1.8 per cent last year. The mainland forecast for 2014 has been lowered by 0.2 percentage points; we now expect the recovery to materialise somewhat later than previously estimated. The forecast assumes a soft landing in the housing market. The first year-on-year home price downturn was measured in December 2013. We predict that **the price decline during 2014 will be only 3-4 per cent measured as annual averages**, then **followed by a levelling out in 2015**. A price decline much larger than this poses the biggest risk to our GDP growth, monetary policy and exchange rate projections.

Exporters have become more optimistic

Net balance, index

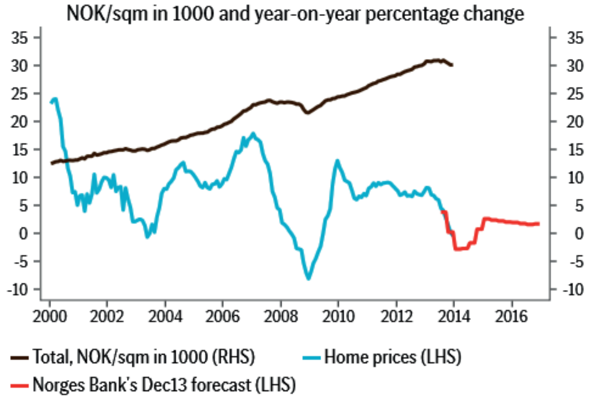


Source: Statistics Norway, Norges Bank

Hard data suggest that **growth remained below trend in the fourth quarter** (release date February 12). The third quarter improvement in consecutive mainland growth to 0.5 per cent from 0.3 in the second quarter was largely driven by stock-building. In recent months there have been certain **signs of an approaching economic acceleration**. During the fourth quarter, consumption of goods rose slightly – services held up nicely all last year – and exports began a cautious recovery. Although consumer confidence fell somewhat, this was largely due to increased pessimism about the country's economy. Perceptions of personal finances remained above historical averages, despite falling home prices and heavy media coverage about them. The manufacturing confidence indicator climbed further to its highest level since the first quarter of 2012. The indicator is now at a relatively high level historically and supports our forecast that exports of non-oil-related goods are about to accelerate. One partial explanation for the upturn in the indicator is probably that the decline in the krone is beginning to improve the business outlook via better competitiveness, although the cost situation is still high.

Norwegian home prices declining

NOK/sqm in 1000 and year-on-year percentage change

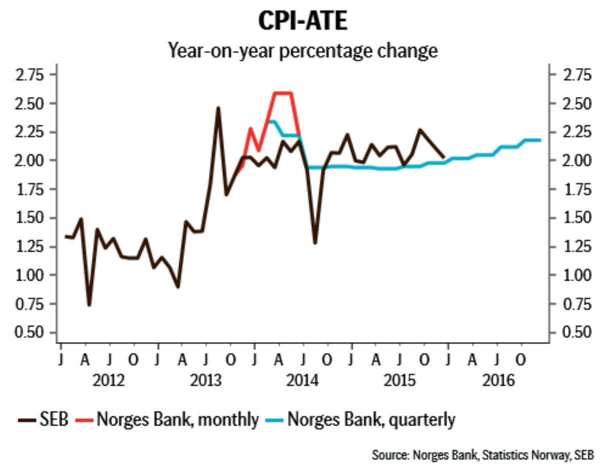


Source: Norges Bank, Norges Eiendomsmeglerforbund / Norwegian Association of Real Estate Agents (NEF)

One key starting point of our Norway analysis is, and has been, that **we see no bubble in the housing market**. Home price increases in recent years (averaging 8 per cent yearly in 2010-2012) can be explained by strong household income growth, improved standards via renovations etc. and the fundamental supply/demand situation. **The price correction now under way is largely psychological in origin**. Another factor contributing to the downturn is that banks have tightened requirements related to "advance sales", referring to those who sell before they buy. We still believe that the continued decline in prices will be controlled; in terms of sales volume and transaction times, a normalisation is now under way. Market supply and demand, as well as strong incomes and high savings in the household sector, point to a mild price adjustment. The number of building permits during 2013 decreased faster than we had thought – which will also lead to a better market balance as demand soon surpasses supply again. During 2015, we expect the downturn in residential construction that has already begun to help stabilise prices and the housing market in general. Another reassuring factor is that banks have largely already met their new capital requirements.

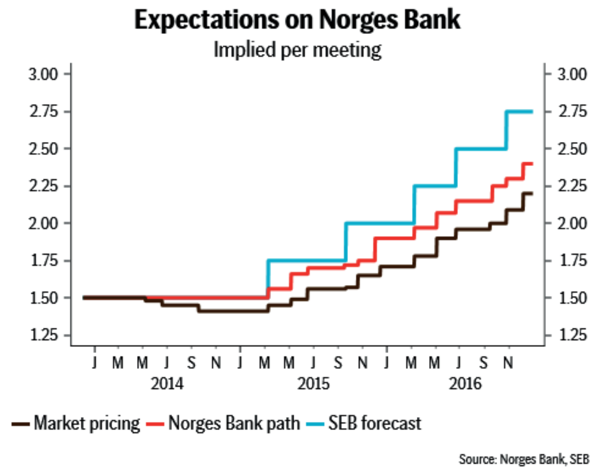
Private consumption was surprisingly weak last year, given the healthy trend in household disposable incomes, although the inflation upturn during the third quarter led to a temporary setback in purchasing power. Incomes look set to improve in 2014, and the labour market is still robust. **Consumption should thus recover** and is expected to grow by 2.7 per cent in 2014. A significant home price decline would pull down sentiment and consumption, but meanwhile there is little indication that the home price increase of recent years, in itself, has driven up private consumption. Nor has consumption been credit-led.

The labour market is relatively strong, although unemployment (both registered and according to the Labour Force Survey) rose somewhat in 2013 due to weaker economic growth. The latest LFS statistics for the fourth quarter showed a slightly bigger upturn than expected, to 3.5 per cent from a 3.4 per cent three-month average until November. The upturn was due to an increased labour supply, however; adjusted for this effect, unemployment was unchanged from the three preceding quarters. Unemployment is expected to climb marginally in 2014-2015. Job growth slowed somewhat in late 2013 but has weathered economic weakness nicely. Employment is predicted to increase this year somewhat faster than the full-year 2013 average of 0.7 per cent.



CPI-ATE inflation has stabilised at around 2 per cent year-on-year after last summer's comparatively sharp upswing, which was driven mainly by rents and food prices – items that had increased much less than expected in 2011-2012. The inflation outlook is mixed. Food prices will continue rising, while rent inflation will slow from historically high levels. Alcoholic beverage and tobacco prices will also have a dampening effect on inflation during the first half. Collective labour agreements this spring are expected to show that wage and salary increases will remain stable at around 3.5 per cent during 2014. However, **inflationary impulses are expected from the weakening of the krone,** which will boost imported inflation during the year. Overall **CPI-ATE inflation will remain relatively stable at slightly below the 2.5 per cent inflation target** this year and next. Our inflation path will stay somewhat below that of Norges Bank in the near future, but in the second half of 2014 and in 2015 ours will be a bit above the bank's.

Recent economic data have not given Norges Bank any reason to re-assess its monetary policy stance. Norway's growth and inflation outlook is quite uncertain, and the central bank's Monetary Policy Report in December signalled an unchanged key interest rate until the summer of 2015. We expect Norges Bank to keep the door open to a possible rate cut until the housing market has stabilised somewhat and the momentum of the economy strengthens. In other words, the risk of a rate cut should not be ignored, although this is not our base scenario. The next step for Norges Bank will be a rate hike, but given below-trend growth in the mainland economy, stable inflation and low key interest rates internationally, **the first key interest rate hike will not occur until March 2015. The deposit rate will stand at 2.00 per cent by the end of 2015**.



Norwegian government bonds have clearly been affected by a significant increase in supply since 2012, a weak krone and the fact that investors have shifted assets back into the euro zone. Looking ahead, we expect supply concerns and market volatility to fade, enabling Norwegian bonds to rebound compared to German ones. Downward pressure on German long-term yields early in 2014 will nevertheless lead to **persistently wide 10-year spreads in the coming months. Eventually the 10-year spread will shrink** from the current 105 basis points to 85 at the end of 2014 and then rise again slightly in 2015 when Norges Bank begins to hike its key rate. A downward trend in long-term yields, combined with the issuance of new long-term bonds in May, will lead to a flatter yield curve (2 years/10 years).

The krone has been pushed down by negative economic reports and a surprisingly dovish stance by Norges Bank. **Most krone depreciation is pas**t, but no discernible recovery can be expected in the short term either, considering the risk of an interest rate cut. Foreign banks have aggressively sold NOK on a net basis during the past year. Given the underlying high cost situation and the uncertain outlook for commodity prices and the Norwegian economy, we cannot rule out a continued sell-off. We predict that **the EUR/NOK exchange rate will be in the 8.30-8.60 range during 2014 and amount to 8.50 at year-end**.

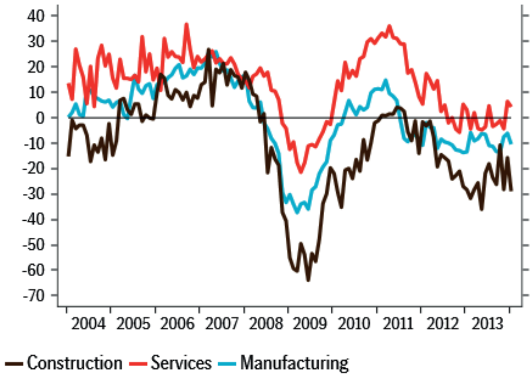
Weak recovery as households and businesses hesitate

- **Both structural and cyclical weaknesses**
- **Unemployment on the way up**
- **Exports will recover slowly**

Structural problems are reinforcing economic weakness, depressing growth and the labour market. The recession is barely over; quarter-on-quarter GDP growth was largely flat in 2013. Nearly all parts of the economy are performing poorly now. **Households are squeezed** by rising unemployment, low pay increases and tax hikes. Because of falling exports, idle capacity and weak demand, **businesses are hesitant to invest**. In the short term, it is hard to find bright spots, and Finnish economic growth is the weakest in the Nordic region. **We expect GDP to fall by 1.3 per cent in 2013, then climb weakly: by 0.8 per cent this year and 1.4 per cent in 2015**.

Indicators are not signalling any rapid recovery

Net balance



Source: European Commission

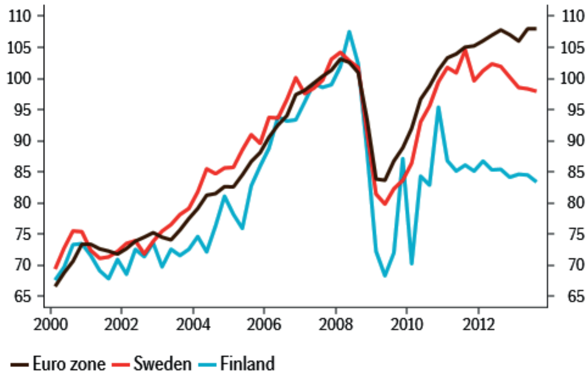
Indicators are generally at low levels. Although there has been a slight improvement in the manufacturing sector in recent months, if anything the index level is pointing towards lower growth than in our forecast for the first half, so the risks are on the downside. The service sector is more upbeat, since both domestic demand and service exports have recently shown better growth than the merchandise side.

Production and exports remain squeezed and have fallen in the past year. Compared to 2008, Finnish exports as a share of GDP have fallen by nearly 10 percentage points. Net exports have provided a negative growth contribution averaging 0.7 percentage points since 2008, but recently imports have fallen more than exports and net exports have begun contributing positively to growth. A comparison with two other export-dependent countries, Sweden and Germany, illustrates clearly how Finnish exports have lost ground. Finland's decline was deeper in 2008-2009 and its recovery has not been as strong. The product categories in which the decline was largest in 2008-2009, and which have also performed weakly since then, are electronics and the forest product industry. Finland has lost competitiveness over a long period, and an unfavourable trend in Finnish import and export prices has had an adverse effect on both business sector profitability and the current account balance. Heavy dependence on sectors that have long been under price pressure, and where no turnaround can be expected, is contributing to the weak trend.

The OECD's export order indicator points towards a continued weak trend, although a gradually improved international economic situation will benefit the country. **Exports will increase by 2.5 per cent in 2014 and 4.0 per cent in 2015**.

Merchandise exports have done poorly since 2008

Index 2008=100



Source: Macrobond

Weak economy and idle resources lead to low capital spending

Capital spending has fallen two years in a row, yet capacity utilisation is low. According to the European Commission's indicator, the situation is depressed in the construction industry. It is hardly surprising that construction companies see demand as the restraining factor. Weak residential investments are contributing to this. Modest household income growth and slightly falling home prices are holding down such investments. The number of new residential building permits is close to record-low levels. Low interest rates are not enough to persuade businesses and households to begin large-scale capital spending, in an environment of low demand and rising unemployment. The housing market is not expected to show any major signs of improvement. Still, due to pent-up capital spending needs, **business investments will slowly get under way towards the end of 2014. Total capital spending will increase by 0.5 per cent in 2014 and 2 per cent in 2015**.

Households are being squeezed

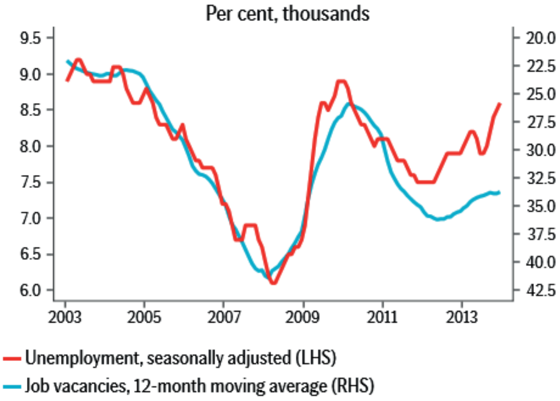
Finland's once relatively resilient households are now being squeezed from several directions. Unemployment is rising, fiscal policy austerity has included value-added tax (VAT) hikes, pay increases has decelerated and the housing market is shaky. Real household income will grow slowly in 2014 and 2015. Due to uncertainty, the household savings ratio will climb somewhat in 2014. The housing market is a major risk factor in our forecast. At present, home prices have levelled out, with some tendencies towards small price declines. Our forecast is that prices will be unchanged ahead. **Household consumption will rise by 0.4 per cent in 2014 and 0.8 per cent in 2015**. If the labour market should deteriorate more than expected, combined with a weaker general economic picture, there is a risk that households will become even more cautious and boost their saving, which would result in an even weaker consumption trend.

Unexpectedly fast upturn in unemployment

After a temporary downturn last autumn, **unemployment is now climbing again**. This upturn has been unexpectedly strong, in light of GDP growth and short-term indicators such as the number of job vacancies. At 8.6 per cent in December, unemployment is not far from the peak level observed in 2009. Because of below-trend economic growth, unemployment will continue to rise before turning downward in 2015. **Measured as annual averages, unemployment will be 8.5 per cent in 2014 and 8.3 per cent in 2015**. So far, the upturn in unemployment has been due to a rising labour supply, while the number of jobs has only fallen marginally (by 4,000) in the past year. Looking ahead, such factors as an ageing population will limit labour supply and contribute to lower unemployment.

Unemployment is close to its 2009 peak

Per cent, thousands



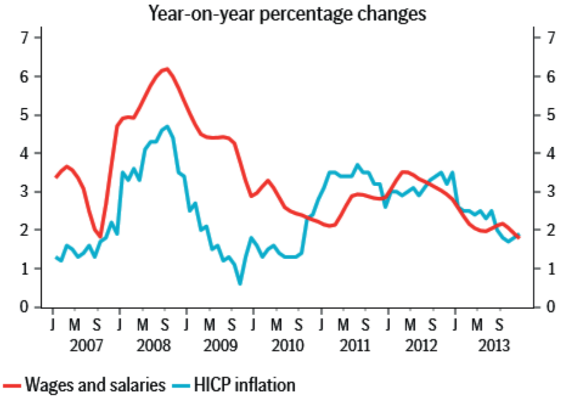
Source: Statistics Finland

Wage hikes and inflation on their way down

The collective labour agreements signed in 2013 represent a slowdown in the rate of pay increases in 2014-2015 compared to 2012-2013. This will benefit Finland's competitiveness, but at the same time it means household income growth will be weaker. Wages and salaries will climb by a bit over 2 per cent annually in 2014 and 2015. Despite increases in VAT and other indirect taxes, inflation is falling. The impact of tax hikes seems to be somewhat less than initial estimates indicated; in the prevailing environment, companies are having a hard time raising consumer prices. **HICP inflation will increase by 1.6 and 1.7 per cent annually in 2014 and 2015**, which means that real wages will rise slightly during our forecast period.

Decelerating price and wage increases

Year-on-year percentage changes



Source: Statistics Finland

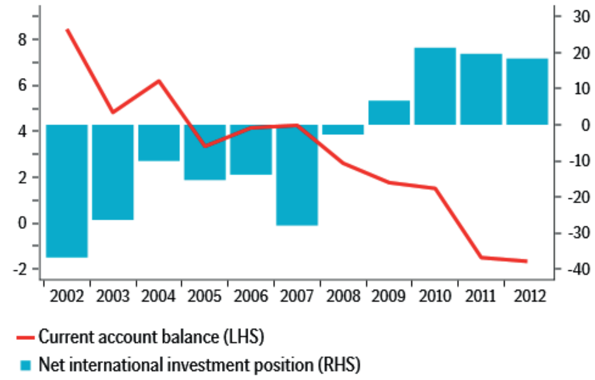
Continued deficits despite belt-tightening

Weak economic growth and rising unemployment are largely offsetting the positive budget effects from austerity measures. We expect the public sector deficit to have fallen to 2.3 per cent of GDP in 2013 and to remain at that level in 2014 and 2015 as well. Public sector debt is continuing to increase and will reach 60 per cent of GDP during 2014. Despite deficits, a rising debt level and underlying expenditure pressure from an ageing population, Finnish public finances are in relatively good shape, especially viewed in a euro zone perspective.

We expect Finnish economic policy to remain slightly contractive in 2014 and 2015; the shift towards stimulus we have seen during the crisis in Sweden is conspicuously absent. With large portions of the economy being squeezed, and with interest rates already record-low, a slight policy loosening might stimulate growth without harming financial market confidence in Finland. Despite public sector budget deficits, rising debt and current account deficits, the country as a whole has a net international investment position of nearly 20 per cent of GDP. Finland is among a shrinking category of countries with the highest credit rating, and government bond yields are at low levels, while the yield gap to Germany was stable at 20-30 basis points throughout 2013.

Worsening current account but net assets abroad

Per cent of GDP



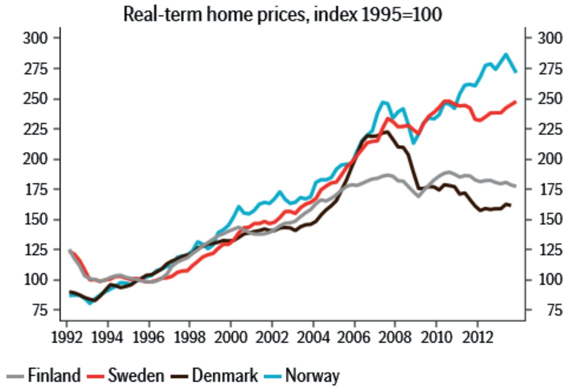
Source: Statistics Finland, Eurostat

- **High savings ratio and low supply providing support in Sweden**
- **Imbalances less in Denmark after price drop**
- **Norway runs the biggest price risks**
- **Rule changes and higher interest rates will generate uncertainty ahead**

Although home price trends mainly reflect domestic conditions, global property price cycles have often moved in tandem. This applies especially to the Nordic housing markets, reflecting such factors as mutually integrated economies and banking systems, as well as the major influence of international trends on these small, open economies. Developments since the 2007 financial crisis diverge, however, with a sharp price drop in Denmark of nearly 30 per cent in real terms, prices that have remained flat or fallen slightly in Finland and continued upturns in Sweden and especially Norway. These differences raise the question of whether there is reason to fear a major correction ahead in Norway and Sweden – a topical question given the price declines that began in Norway late in 2013.

Divergent Nordic home price trends since 2007 crisis

Real-term home prices, index 1995=100



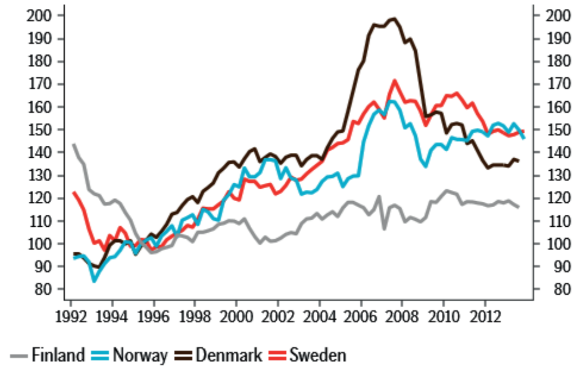
Source: National statistical offices

These divergent housing market trends reflect underlying differences in the four economies. Denmark and Finland have lagged behind since the financial crisis and have not yet managed to climb back to their 2007 GDP levels. In Denmark, however, the housing market downturn contributed greatly to the weak performance of the economy, rather than vice versa.

In the following table, we have compared a number of the factors that have internationally proven to pose an increased risk of major corrections in the real estate market. To obtain an overall picture, we have ranked the four Nordic countries by comparing their risks in terms of each variable on a scale from the largest (4) to the smallest (1) risk.

Home prices have stabilised in relation to incomes

Index 1995=100



Source: National statistical offices, OECD

Biggest price rises in Norway and Sweden

Comparisons of home prices are largely dependent on what base year we choose, but Sweden and Norway end up at the top regardless of whether we compare trends since 2000 or the mid-1990s, for example. In relation to disposable income – which is crucial to the ability of households to finance their homes over time – prices in Sweden and Norway have also increased faster than in the other Nordic countries. The gaps compared to Denmark are significantly narrower, indicating that the home price upturn in Norway and Sweden has partly been driven by strong income growth. In both Norway and Sweden, home prices measured in this way have also stabilised in recent years, although they remain somewhat above historical averages.

The Nordic housing market

Schematic ranking of risk factors from 1 to 4, where 4 represents the highest risk of a correction and 1 the lowest.

	Dk	Fi	Nor	Swe
Home prices (1995-)	1	2	4	3
Home prices in relation to disposable income	2	1	3	4
Debt ratio (household debt as % of disp. inc.)	4	1	3	2
Change in debt ratio (since 2000)	1	4	2	3
Residential investments as % of GDP	2	4	3	1
Divergence in savings ratio from hist. avg. (since 1995)	4	3	2	1
Total	**14**	**15**	**17**	**14**
Ranking	**1**	**3**	**4**	**1**

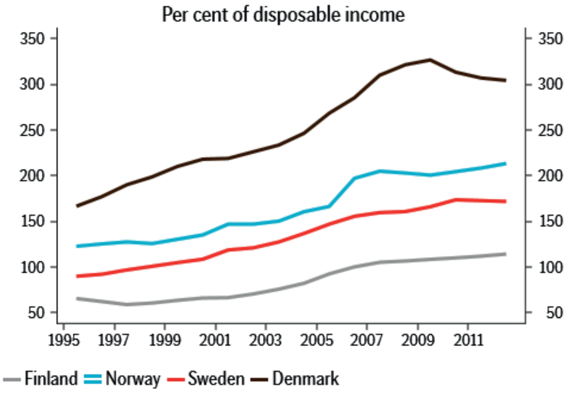
Source: National statistical offices, OECD, Eurostat

Nordic households heavily indebted – rapid increase from low level in Finland

Household debt as a percentage of disposable income is high by international standards in Sweden, Norway and especially Denmark. The debt level is affected by structural factors, such as the percentage of households who own their homes and differences in tax rules, ability to deduct interest expenses etc., and the shape of the health and welfare system. It may thus be relevant to see how household debt has evolved over time. Since the mid-1990s, Sweden and Denmark have seen the largest debt build-up. Since 2000, Finland has seen the largest increase and Denmark the smallest, reflecting some Danish household debt deleveraging since the financial crisis.

Danish households are highly indebted

Per cent of disposable income



Source: Eurostat, Statistics Norway, OECD

Structural reasons for Swedish debt upturn

Looking at the way household debts have changed over time, structural changes have also played a part, especially in Sweden. For example, a study by Sweden's Financial Supervisory Authority found that increased private ownership of homes, lower housing-related taxes and lower mortgage rates explain as much as some 90 per cent of the debt increase from the late 1990s until the crisis broke out in 2008, compared to just over 10 per cent in Denmark and zero in Finland (the FSA did not study Norway, given the special position that the country's oil wealth implies). Both Sweden and Finland also end up lower, and more in line with other countries, if household debt is compared to GDP.

Differences in construction and savings

One factor that has proven to be a risk factor internationally for declining home prices is a high level of residential construction. Meanwhile the risk of downturns has been less if the price rise has not been accompanied by an increased supply of housing. Sweden in particular diverges on this point. As a percentage of GDP, housing investments are at internationally low levels in Sweden and have remained flat for the past five years. Finland and Norway are higher in terms of both the level and trend of residential construction, while construction in Denmark has fallen from previously high levels since prices began to drop.

Another risk factor that reflects the extent to which households have used their increased real estate wealth to finance consumption is the level and trend of household saving. Low household savings ratios combined with current account deficits preceded the real estate crises in the US, Ireland and Spain, for example. A low savings ratio increases the risk that households will cut back on their consumption in order to restore their balance sheets after a property price slide. Again, it may be justified to compare changes over time rather than absolute levels. Sweden and Norway both end up at the top in terms of both the level of the household savings ratio and this ratio in relation to the historical average, whereas the savings ratio in Denmark and Finland are low in terms of levels and just above historical averages.

Biggest short-term price risk is in Norway

In an overall assessment based on the above factors, **Norway ends up at the top in terms of risks and Denmark and Sweden at the bottom**. We still expect a relatively mild downturn in Norwegian home prices. Because of Norway's very robust government finances, the country has a unique capacity when it comes to countering the negative consequences of a home price downturn on the economy. In itself, this represents a stabilising factor. The higher savings ratio also means that households are better equipped to handle a price downturn.

High household debt combined with a still-low savings ratio is a risk factor for Denmark. Yet the home price downturn since the crisis, combined with the fact that households have begun to deleverage, means that the risks of new home price declines are currently limited. In the short term, we expect home prices to continue recovering, with support from rising incomes.

In Sweden, rapid home price increases and high debt are partly offset by a low supply of homes and a high household savings ratio, but because of continued home price gains, the risk of an eventual correction cannot be ignored. Since the increase in debt can to a large extent be explained by structural changes in the economy, **Swedish real estate prices are sensitive to new changes in the ground rules**. One such change would be if the Riksbank should win support for its desire to limit interest deductions and/or increase real estate taxation. Here developments in the Netherlands can provide a cautionary example; less generous tax rules for mortgages, accompanied by pressure to boost principal repayments, have contributed to a downturn both in the housing market and in private consumption since the financial crisis. It is also interesting to note that the debt build-up in the Netherlands since the late 1990s can also largely be explained by structural factors (70 per cent) according to FSA calculations.

Looking ahead, increased construction may pose a risk of corrections in Sweden if the price rise has been driven largely by a housing supply shortage. New construction in Sweden showed signs of increasing late in 2013. Meanwhile the low level of construction has attracted greater political attention. However, we believe it will take time before sufficient measures are in place to achieve a level of residential construction in better balance with the population trend.

The real test for the housing market both in Sweden and the other Nordic countries will come when interest rates again begin to be raised, which will not happen until next year in Norway and Sweden, and even later in Denmark and Finland.

Economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2012	2013	2014	2015
GDP OECD	1.3	1.3	2.4	2.7
GDP world	3.3	3.2	3.9	4.0
CPI OECD	2.3	1.6	1.5	1.7
Export market OECD	2.5	3.7	6.5	6.8
Oil price, Brent (USD/barrel)	111.7	108.7	105.0	100.0

US

Yearly change in per cent

	2012 level, USD bn	2012	2013	2014	2015
Gross domestic product	16,420	2.8	1.9	3.3	3.7
Private consumption	11,286	2.2	2.0	2.9	3.1
Public consumption	3,151	-1.0	-2.2	-1.0	-0.4
Gross fixed investment	2,386	8.3	4.3	7.9	10.7
Stock building (change as % of GDP)		0.2	0.2	0.0	0.0
Exports	2,214	3.5	2.8	6.5	6.0
Imports	2,730	2.2	1.4	4.3	5.7
Unemployment (%)		8.1	7.4	6.4	5.7
Consumer prices		2.1	1.5	1.3	1.9
Household savings ratio (%)		5.6	4.5	4.1	3.9

EURO ZONE

Yearly change in per cent

	2012 level, EUR bn	2012	2013	2014	2015
Gross domestic product	9,484	-0.7	-0.4	1.0	1.6
Private consumption	5,450	-1.4	-0.6	0.8	1.4
Public consumption	2,040	-0.5	0.0	0.1	0.8
Gross fixed investment	1,739	-4.1	-2.5	1.7	3.0
Stock building (change as % of GDP)		-0.6	0.0	0.0	0.0
Exports	4,348	2.5	1.7	3.8	3.9
Imports	4,100	-1.0	1.0	3.8	3.9
Unemployment (%)		11.4	12.1	11.9	11.5
Consumer prices		2.5	1.4	0.7	0.6
Household savings ratio (%)		7.6	7.9	7.9	7.8

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2012	2013	2014	2015
GDP				
United Kingdom	0.1	1.9	2.8	2.6
Japan	1.4	1.7	1.4	1.3
Germany	0.7	0.5	1.7	2.1
France	0.0	0.2	0.7	1.4
Italy	-3.0	-1.8	0.5	1.0
China	7.7	7.7	7.4	7.0
India	5.1	4.7	5.0	5.4
Inflation				
United Kingdom	2.8	2.6	1.7	1.7
Japan	0.0	0.3	2.4	1.7
Germany	2.0	1.2	1.6	2.0
France	1.5	1.2	1.5	1.8
Italy	3.3	1.3	1.6	1.7
China	2.7	2.6	3.0	2.9
India (WPI)	7.5	6.3	5.6	5.2
Unemployment (%)				
United Kingdom	8.0	7.7	6.6	6.2
Japan	4.4	4.0	3.6	3.3
Germany	5.5	5.5	5.5	5.4
France	10.7	10.8	11.0	10.8
Italy	10.7	12.2	12.0	12.0

EASTERN EUROPE

	2012	2013	2014	2015
GDP, yearly change in per cent				
Estonia	3.9	1.0	2.6	2.9
Latvia	5.0	4.2	4.8	4.8
Lithuania	3.7	3.4	3.5	4.5
Poland	1.9	1.6	3.1	3.5
Russia	3.4	1.3	2.0	2.4
Ukraine	0.4	0.0	-2.0	3.0
Inflation, yearly change in per cent				
Estonia	3.9	3.2	1.8	2.2
Latvia	2.3	0.0	1.8	3.3
Lithuania	3.2	1.2	2.0	3.0
Poland	3.7	0.8	2.2	2.5
Russia	5.1	6.8	5.7	5.2
Ukraine	0.6	-0.3	4.0	6.0

FINANCIAL FORECASTS

		Feb 5th	Jun 14	Dec 14	Jun 15	Dec 15
Official interest rates						
US	Fed funds	0.25	0.25	0.25	0.25	1.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.25	0.25	0.25	0.25	0.25
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	1.00
Bond yields						
US	10 years	2.66	2.80	3.20	3.40	3.50
Japan	10 years	0.60	0.80	1.00	1.10	1.20
Germany	10 years	1.63	1.70	2.00	2.10	2.20
United Kingdom	10 years	2.68	2.75	3.05	3.15	3.25
Exchange rates						
USD/JPY		101	108	112	115	118
EUR/USD		1.35	1.34	1.28	1.26	1.25
EUR/JPY		137	145	143	145	148
GBP/USD		1.63	1.61	1.54	1.54	1.54
EUR/GBP		0.83	0.83	0.83	0.82	0.81

SWEDEN

Yearly change in per cent

	2012, level SEK bn	2012	2013	2014	2015
Gross domestic product	3,550	0.9	1.0	2.5	3.2
Gross domestic product. working day adjustment		1.3	1.0	2.6	3.0
Private consumption	1,718	1.6	2.0	2.7	3.0
Public consumption	956	0.3	0.8	0.8	0.8
Gross fixed investment	674	3.3	-1.5	3.0	5.5
Stock building (change as % of GDP)	-4	-1.3	0.0	0.1	0.1
Exports	1,722	0.7	-1.4	3.7	6.2
Imports	1,516	-0.6	-1.9	3.5	6.1
Unemployment (%)		8.0	8.0	7.7	7.0
Employment		0.6	1.0	1.0	1.3
Industrial production		-4.3	-3.5	2.5	3.5
Consumer prices		0.9	0.0	0.4	1.8
CPIF		1.0	0.9	0.9	1.5
Hourly wage increases		3.0	2.5	2.7	2.8
Household savings ratio (%)		12.2	12.0	12.2	11.4
Real disposable income		3.5	2.4	3.1	2.2
Trade balance, % of GDP		2.4	2.4	2.8	3.0
Current account, % of GDP		6.5	6.2	6.0	6.0
Central government borrowing, SEK bn		25	131	47	14
Public sector financial balance, % of GDP		-0.5	-1.4	-1.7	-0.8
Public sector debt, % of GDP		37.7	40.6	40.5	39.0

FINANCIAL FORECASTS	Feb 5th	Jun 14	Dec 14	Jun 15	Dec 15
Repo rate	0.75	0.75	0.75	1.00	1.25
3-month interest rate, STIBOR	0.95	0.95	1.00	1.25	1.55
10-year bond yield	2.21	2.30	2.70	2.85	2.95
10-year spread to Germany, bp	58	60	70	75	75
USD/SEK	6.53	6.46	6.64	6.71	6.72
EUR/SEK	8.84	8.65	8.50	8.45	8.40
TCW	118.5	115.7	114.5	114.3	113.8
KIX	103.2	100.8	99.8	99.5	99.2

NORWAY

Yearly change in per cent

	2012 level, NOK bn	2012	2013	2014	2015
Gross domestic product	2,830	2.9	0.8	2.1	1.8
Gross domestic product (mainland)	2,146	3.4	1.8	2.2	2.6
Private consumption	1,164	3.0	2.5	2.7	3.1
Public consumption	603	1.8	2.1	2.3	2.3
Gross fixed investment	584	8.3	6.5	3.1	2.1
Stock building (change as % of GDP)		-0.1	-0.4	-0.1	0.0
Exports	1,166	1.1	-2.8	2.2	1.6
Imports	796	2.3	1.6	3.3	3.8
Unemployment (%)		3.2	3.5	3.6	3.7
Consumer prices		0.8	2.1	1.9	2.1
CPI-ATE		1.2	1.6	2.0	2.1
Annual wage increases		4.3	3.5	3.5	3.7

FINANCIAL FORECASTS	**Feb 5th**	**Jun 14**	**Dec 14**	**Jun 15**	**Dec 15**
Deposit rate	1.50	1.50	1.50	1.75	2.00
10-year bond yield	2.67	2.70	2.85	3.05	3.15
10-year spread to Germany, bp	104	100	85	95	95
USD/NOK	6.24	6.42	6.64	6.67	6.64
EUR/NOK	8.45	8.60	8.50	8.40	8.30

DENMARK

Yearly change in per cent

	2012 level, DKK bn	2012	2013	2014	2015
Gross domestic product	1,826	-0.4	0.4	2.0	2.5
Private consumption	896	-0.1	0.4	1.7	2.3
Public consumption	519	0.4	0.2	1.3	0.6
Gross fixed investment	320	0.8	2.0	5.2	5.6
Stock building (change as % of GDP)		-0.2	0.3	0.0	-0.1
Exports	1,000	0.4	1.2	4.7	5.0
Imports	908	0.9	2.9	5.2	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	7.0	7.0	6.5
Public sector financial balance, % of GDP		-4.1	0.0	0.5	-0.5
Public sector debt, % of GDP		45.5	43.7	43.0	41.0

FINANCIAL FORECASTS	**Feb 5th**	**Jun 14**	**Dec 14**	**Jun 15**	**Dec 15**
Lending rate	0.20	0.25	0.25	0.25	0.25
10-year bond yield	1.68	1.75	2.05	2.15	2.25
10-year spread to Germany, bp	5	5	5	5	5
USD/DKK	5.51	5.57	5.83	5.92	5.97
EUR/DKK	7.46	7.46	7.46	7.46	7.46

FINLAND

Yearly change in per cent

	2012 level, EUR bn	2012	2013	2014	2015
Gross domestic product	192	-1.0	-1.3	0.8	1.4
Private consumption	109	0.3	-1.0	0.4	0.8
Public consumption	48	0.5	0.3	0.6	0.7
Gross fixed investment	38	-0.8	-2.0	0.5	2.0
Stock building (change as % of GDP)		-1.3	-0.4	0.2	0.0
Exports	78	-0.2	-1.8	2.5	4.0
Imports	80	-0.7	-2.0	2.5	3.5
Unemployment (%)		7.7	8.2	8.5	8.3
Consumer prices, harmonised		3.2	2.2	1.6	1.7
Hourly wage increases		3.2	2.1	2.0	2.0
Current account, % of GDP		-1.7	-1.7	-1.5	-1.5
Public sector financial balance, % of GDP		-2.2	-2.3	-2.3	-2.2
Public sector debt, % of GDP		53.6	58.0	59.0	60.0

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