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Press release

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Nordic Outlook: Recovery with shift in global growth engines
Time for re-assessments – low inflation putting pressure on Riksbank

Global economic growth is gradually climbing on to firmer ground – with the occasional backward step – but remains **dependent on powerfully expansionary monetary policies**. Fiscal austerity is approaching an end in the United States and Europe, but public sector debt remains high. There is a clear shift in world economic growth engines – from emerging market (EM) economies towards the mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) – but this is not problem-free. With fewer acute crises, there is now more time to focus on the **long-term effects of globalisation, the global recession and the crisis policies that are being pursued**. This includes examining job growth and the distribution of income and wealth, the driving forces of inflation, central bank exit policies, the risk of low long-term growth (stagnation: see the theme article), the relationship between risks and returns and the need for debt relief even in Western economies. **This is undoubtedly a time for re-assessments**.

Overall, the 34 OECD countries will enjoy 2.4 per cent GDP growth this year (up from 1.3 per cent in 2013), **rising to 2.7 per cent in 2015**. This implies small upward adjustments compared to the November 2013 issue of *Nordic Outlook*. The **US** recovery is becoming more and more self-sustaining, and the economy will experience a growth surge this year as fiscal policy headwinds ease. In **Japan**, "Abenomics" has succeeded in lifting asset prices and optimism, as well as inflation and growth, but there are big questions about the ability of this government economic policy offensive to generate sustained higher growth. The **euro zone** has left its recession behind – though not the risk of deflation – while many political and economic problems remain unsolved.

Low global resource utilisation will squeeze wage and salary growth and lead to continued low price increases; disinflationary forces will dominate in 2014-2015. But the inflation gaps between developed economies are widening, creating dilemmas for central banks. In the US there are signs of slightly rising inflation pressure, while the euro zone is continuing to struggle with the risk of deflation; given underlying euro zone inflation of only 0.5 per cent, there is an increasing likelihood that already falling inflation expectations will reach troublingly low levels. This will make it necessary for the European Central Bank (ECB) to increasingly use its balance sheet to avoid a Japanese-style scenario. Meanwhile, the Bank of Japan will adding another USD 700 billion to its monetary base during 2014, but the bank must be thoroughly prepared to take even further steps to prevent the Japanese economy from relapsing into deflation. Because of low inflation in Japan and the euro zone, government debt problems are worse than in the US, for example.

The problems of emerging market economies are again a focus of attention in early 2014, but our conclusion is that the effects of these problems on global economic growth will be small. Fundamental conditions are radically different compared to the Asian financial crisis of the late 1990s, for example; debt is lower and external balances are in better shape, while EM countries today have more robust exchange rate systems and ample currency reserves. In various large economies, however, growth is being impeded by regulations and structural weaknesses. In some countries the situation is also worsened by deep-seated political instability. The US Federal Reserve (Fed) has announced a phase-out of its monetary stimulus programme, which will affect global risk appetite but in the long run is expected to have limited effects on the supply of global investment capital to EM countries. **China's GDP growth will be slightly lower this year, 7.4 per cent**, compared to 7.7 per cent in 2013. **This deceleration will continue in 2015 as well, to 7.0 per cent**. India's GDP growth will be 5.0 per cent this year and 5.4 per cent in 2015.

The US growth engine is firing on several important cylinders: unemployment is falling towards around equilibrium levels (5.5 per cent); the **wealth position** of households is record-strong and home prices are expected to climb about 15

per cent by 2015; **residential investments** will take off, partly with the help of demography; **fiscal policy** will not be a drag on the economy. Since cyclical components are so depressed (the average age of factories and machinery is the highest in more than half a century), there is significant potential for recovery. **The Fed will taper** its monthly bond purchases, ending them during 2014, but its remaining purchases will nevertheless total USD 450 billion, bringing its overall bank reserves to around USD 3 trillion. Given a more normal money multiplier, the supply of dollar liquidity can increase even when the monetary base decreases. The size of the Fed's bond portfolio will remain unchanged during 2015, not shrinking until 2016 in a way that will result in decreased monetary stimulus. At present, US inflation risks are small but increasing. The Fed's first **key interest rate hike will not occur until the summer of 2015**, and at year-end 2015 the federal funds rate will stand at 1.25 per cent.

The economic outlook in the euro zone is slowly improving. The recession is over, and the ECB's actions have helped lower the risk premiums for crisis-hit euro zone countries. Record-high unemployment and a banking system that is not yet in shape to supply credit to businesses in a normal way are impeding growth. Further economic policy integration is necessary in order to save the euro project, but integration policy is on the back burner due to uncertainty about the upcoming election to the European Parliament, the appointment of a new European Commission and shaky cooperation between Germany and France (see theme article). **GDP growth of 1.0 per cent in 2014** (up from -0.4 per cent in 2013) and **1.6 per cent next year** will depend on global recovery and further ECB actions; we are maintaining our forecast of quantitative easing or other balance sheet policy measures in the spring of 2014. There is room for a key interest rate cut, but we do not believe that the ECB will introduce negative deposit rates. Among other things, this implies that the euro will weaken, benefiting crisis-hit euro zone countries and France. **The EUR/USD exchange rate will fall to 1.28 at the end of 2014 and 1.25 by the end of 2015**.

The Nordic countries are taking different paths, depending on their exchange rate systems and the structure of their housing and labour markets, which to some extent puts into question whether any shared Nordic model exists. In **Denmark**, the housing market now seems to be moving towards recovery, which will lay the groundwork for consumer-driven growth. **We expect GDP growth to reach 2.0 per cent in 2014 and 2.5 per cent in 2015**, which is above trend. In **Finland**, the economy continues to be squeezed by deteriorating competitiveness, unfavourable price trends for importan and export goods and structural difficulties in the information and communications technology (ICT) sector. A weaker euro will provide some support. **GDP growth will be 0.8 per cent this year and 1.4 per cent in 2015**. In **Norway**, there is extensive focus on the housing market. Although home prices in Norway run the biggest risk of decline among Nordic countries (see theme article), our forecast is that this decline will be moderate. Given lower activity in the oil sector, **GDP growth will reach 2.1 per cent this year and 1.8 per cent in 2015**. Norges Bank is nervously tracking home prices, and the central bank's first key interest rate hike from today's 1.50 per cent will occur in the spring of 2015. By year-end, the deposit rate will stand at 2.00 per cent.

Growth in the Baltic countries will accelerate somewhat. Private consumption will play a big part in the recovery, driven by good real income increases, while exports rebound. **Latvia** and **Lithuania** will continue to top EU statistics in 2014-2015 with **GDP growth of nearly 5 per cent yearly** in Latvia and **3.5-4.5 per cent** in Lithuania. **Estonia**, which showed a significant drop in growth last year, will gradually recover to yearly growth of **2.5-3.0 per cent** during our forecast period. Inflation in the three Baltic countries will be low this year, with price increases of about 2 per cent, but there are increasing signs of labour shortages ahead. Lithuania is moving towards joining the euro zone. This spring, the ECB and Brussels are expected to give the green light to the country's membership application.

The Swedish economy has been characterised by lacklustre recovery so far, but **activity will now accelerate** with the help of stronger private consumption, a brighter outlook for the export sector and increased housing construction. **GDP growth in 2014 will be 2.5 per cent, speeding up next year to 3.2 per cent**. Weak export and production data have been somewhat out of step with increasingly strong indicators, for example in the manufacturing sector. A clearer decline in unemployment is now beginning, after a long period of increased labour supply due to population growth and higher labour force participation (among other things connected to policies pursued by the government; see the theme article). **Unemployment will stand at 7.6 per cent at the end of this year and 6.8 per cent at the end of 2015**. Inflation will

remain low: underlying CPIF inflation will reach 1.5 per cent at year-end 2015, well below the Riksbank's 2 per cent inflation target. The risks to the Swedish economy are mainly connected to the housing market.

The Riksbank has finished cutting its key interest rate, but the first rate hike will not occur until the spring of 2015. The central bank resolved tensions in December by adjusted its inflation path for 2014 sharply downward. It consequently lowered the repo rate once it had again shifted its focus to the inflation target. Because of continued low inflation, with downside risks, **during 2014 the Riksbank will remain under pressure to cut its key rate further**, which will probably create new divisions in its Executive Board. We expect a stronger labour market and uncertainty about resource utilisation to be among the Riksbank's main arguments for issuing a warning about possible monetary tightening. We believe that this will require a clearer Riksbank analysis of the problems in the labour market; public discourse on these issues may become intensive in the absence of signs that wages and salaries are rising rapidly. Stricter macroprudential oversight policies during 2014 (weighting of mortgage loans and stricter capital requirements, combined with warnings of further tightening) will ease pressure on monetary policy, leading to calmer credit market expansion and a complete halt in home price increases by 2015. We expect a first key rate hike in **April 2015 to 1.00 per cent**, from today's 0.75 per cent. The rate hike will thus occur somewhat ahead of the Federal Reserve and the Bank of England, and well before the ECB. By the end of 2015, the repo rate will stand at 1.25 per cent. This will help to strengthen the krona. **The EUR/SEK exchange rate will be 8.50 and the USD/SEK rate 6.65 at the end of 2014. They will be 8.40 and 6.70, respectively, at the end of 2015**. This will also squeeze inflation.

Our forecast of Swedish public sector finances shows a deficit amounting to 1.7 per cent of GDP in 2014 and 0.8 per cent in 2015. Public sector debt will remain relatively stable at around 40 per cent of GDP during our forecast period. The Alliance government and the opposition Social Democrats are both advocating a cautious fiscal policy in the run-up to the September 2014 parliamentary election. There is a major risk that this will cause them to miss an opportunity for stimulus measures that may benefit the Swedish economy, both cyclically and structurally, and that their fiscal policies will be pro-cyclical – excessively tight in a situation of low resource utilisation. The cyclical sensitivity of government finances is often underestimated, and it is highly probable that government finances will bring upside surprises ahead. If Sweden retains its current official budgetary surplus target, government debt will fall to just above 10 per cent of GDP, assuming nominal GDP growth of some 4 per cent yearly. **We believe that the economic arguments are strong enough that the surplus target, now 1 per cent of GDP, will be replaced during the next parliamentary term of office by a target of fiscal balance in the public sector**.

Key figures: International and Swedish economy *(figures in brackets are forecasts from the November 2013 issue of **Nordic Outlook**)*

International economy. GDP, year-on-year changes, %	2012	2013	2014	2015
United States	2.8	1.9 (1.7)	3.3 (3.3)	3.7 (3.7)
Euro zone	-0.7	-0.4 (-0.4)	1.0 (0.8)	1.6 (1.6)
Japan	1.4	1.7 (1.8)	1.4 (1.7)	1.3 (1.3)
OECD	1.3	1.3 (1.2)	2.4 (2.3)	2.7 (2.7)
China	7.7	7.7 (7.7)	7.4 (7.4)	7.0 (7.0)
Nordic countries	0.9	0.6 (0.5)	2.1 (2.2)	2.4 (2.5)
Baltic countries	4.1	3.0 (3.0)	3.7 (3.7)	4.2 (4.2)
The world (purchasing power parities, PPP)	3.3	3.2 (3.2)	3.9 (3.9)	4.0 (4.1)
Swedish economy. Year-on-year changes, %				
GDP, actual	0.9	1.0 (0.7)	2.5 (2.5)	3.2 (3.2)
GDP, working day corrected	1.3	1.0 (0.7)	2.6 (2.6)	3.0 (3.0)
Unemployment, % (EU definition)	8.0	8.0 (8.0)	7.7 (7.8)	7.0 (7.4)
Consumer Price Index (CPI) inflation	0.9	0.0 (0.0)	0.4 (0.6)	1.8 (1.9)
Government net lending (% of GDP)	-0.5	-1.4 (-1.6)	-1.7 (-1.8)	-0.8 (-1.3)
Repo rate (December)	1.00	0.75 (0.75)	0.75 (0.75)	1.25 (1.25)
Exchange rate, EUR/SEK (December)	8.58	8.86 (9.00)	8.50 (8.50)	8.40 (8.25)

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