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Press release

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Nordic Outlook: Recovery & monetary policy divergence
Riksbank will cut its key interest rate twice to 0.25 per cent

Despite a cautious increase in the momentum of global economic growth, the battle by central banks against deflation risks is not yet won. In the United States, the economy is now accelerating steadily after weather-related setbacks during the winter. Meanwhile the euro zone has left its recession behind, but economic trends in the 18 member countries continue to diverge, while high unemployment and government and private debt problems persist and the process of political integration is not moving ahead. Emerging market (EM) economies are hampered by regulation and structural weaknesses. They have nevertheless shown resilience to serious new geopolitical turbulence and other problems. Overall, **the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) will show GDP growth of 2.1 per cent this year** (2.4 per cent according to the forecast in February's *Nordic Outlook*), **up from 1.2 per cent in 2013. Next year, growth will be 2.7 per cent** (unchanged forecast). The probability of a lower global growth outcome is somewhat larger than the probability of a higher outcome.

The underlying global price trend is dominated by disinflationary forces, thus compelling the world's central banks to be more expansionary during our forecast period. Deflation risks will make central banks more tolerant towards the risk of overshooting their inflation targets. In a short-term perspective, inflation will be lifted slightly by rising food and fuel prices – with the largest impact in emerging market countries – as well as by changes in taxation and in some countries also a weaker currency. Low global resource utilisation will continue to squeeze consumer goods prices along with wages and salaries. In the US, resource utilisation is higher than in Western Europe, contributing to inflation that is moving up towards the Federal Reserve (Fed) target. In the euro zone, however, further measures will be needed to prevent falling inflation expectations from raising real interest rates and thereby strengthening negative economic forces. While the Fed and the Bank of England (BoE) are expected to begin their key rate hiking cycles during the third quarter of 2015, the European Central Bank (ECB) must continue to loosen its monetary policy. In June the ECB will begin stimulative bond purchases. The Bank of Japan (BoJ) must increase its dose of stimulus further after enormous monetary easing in 2013-2014. Central bank decisions and a gradual economic upturn will lead to continued low and **only cautiously rising interest rates. This will allow room for rising stock markets in the medium term (6-24 months). We expect the EUR/USD exchange rate to reach 1.34 by the end of this year and 1.28 at the end of 2015**.

The Ukraine crisis has changed the global security policy arena. Its global economic and financial effects are difficult to quantify, since the crisis is still unfolding, but at present our main scenario is that a large-scale trade war and major disruptions in Russian energy deliveries to Western Europe can be avoided. The Russian economy has large structural problems, however. Political and economic isolation from other countries would increase the risks that Russia will move towards severe destabilisation. The Ukrainian economy, which has been stagnant in recent years, will shrink by 6 per cent in 2014. Its recovery in 2015 will be weak. The Russian economy will be close to recession this year and will see anaemic growth in 2015.

Global economic policy challenges are changing as acute crisis situations become fewer. Growing income and wealth gaps have shifted the focus of research and analysis by the International Monetary Fund (IMF) and the OECD towards a redistribution policy aimed at reducing the risks of prolonged economic stagnation. The purpose of such a policy is to decrease social and political risks while improving the effectiveness of monetary policy with regard to growth and inflation. Meanwhile central banks face greater challenges as asset prices climb and unemployment falls for both cyclical and structural reasons, but a larger element of political control in economic systems – both via economic policy and financial regulation – may also increase uncertainty and thereby also hamper growth.

In 2014-2015, global growth will benefit from welcome momentum from the US, Japan and the United Kingdom. The **US** will lead the economic recovery, with GDP growth of 2.6 per cent this year and 3.7 per cent in 2015. Not all growth-related issues have been resolved, for example when it comes to the underlying strength of business investments, but we expect growth to be supported by such factors as a stronger labour market, increased housing construction, the absence of federal fiscal tightening, rising asset prices and looser credit conditions. In **Japan**, economic activity is being sustained with the help of the government's "Abenomics" package (GDP will grow by 1.0 per cent this year and 1.3 per cent in 2015), and inflation will reach the BoJ's 2 per cent target thanks to the weak yen, higher energy prices and the recent consumption tax hike. But the government economy policy and indicators have not yet confirmed that Japan is on the right track in the long term. The **UK** has been responsible for the biggest upside surprise, with an economy that will grow by 3.0 per cent this year and 2.6 per cent in 2015.

The EM economies are now going through a phase of long-term downward adjustments in growth expectations after their rapid expansion in the 2000s decade. These countries also face various types of structural challenges. Meanwhile recent developments confirm our impression that their resilience to financial disruptions and geopolitical turmoil has increased – due to stronger public finances, better external balances and more robust exchange rate systems. **China's economy** is expected to deliver a gradually slower growth rate: from 7.7 per cent in 2013 to 7.2 per cent this year and 7.0 per cent in 2015, with Beijing accepting this process even though growth is below the official target of 7.5 per cent. **India's economy** is expected to grow by 5.0 per cent this year and 5.4 per cent in 2015. At the same time, there are reasons to continue warning against exaggerated hopes that a change of government in India will lead to extensive economic reforms.

The outlook for the Nordic countries remains divergent. The Norwegian economy is dominated by forces that are pulling in different directions. Headwinds include subdued capital spending in the oil and gas sector as well as weak housing investments. But the labour market has stabilised, along with the housing market, and decent real income increases will help sustain consumption. **We expect Norway's GDP to grow by 1.9 per cent both this year and next, which is somewhat below trend growth**. Norges Bank is being pushed closer to an interest rate hike, but looser monetary policies in the euro zone and in Sweden will persuade the central bank to wait until the summer of 2015. At the end of 2015 the deposit rate will stand at 2.00 per cent (1.50 per cent today). In Denmark there are increasingly clear signs that the economic recovery will gain a stronger foothold due to falling unemployment, rising home prices and rising optimism. **Danish GDP growth will be 2.0 per cent this year and 2.5 per cent in 2015**. The Finnish economy faces major challenges, however. Structural problems connected to the forest product and information and communication technology (ICT) sectors, plus relatively large exposure to Russia, are squeezing growth. **The Finnish economy cannot avoid a recession in 2014 (growth is expected to be -0.3 per cent)** and the subsequent recovery will be weak (**GDP will grow by 0.8 per cent in 2015**).

The Baltic countries are weighed down by nearby unrest, both via trade with Russia and lower investments. Meanwhile the Baltics have buffers that make them relatively immune to major growth slowdowns. These include strong real incomes, healthy public finances and small current account deficits. In addition, the small remaining exchange rate risk in Lithuania will disappear in May-June, when the country is expected to receive a go-ahead to join the euro zone in 2015. **GDP growth in Lithuania will be 2.7 per cent this year and 3.8 per cent in 2015. Corresponding GDP forecasts for Estonia are 0.5 and 2.3 per cent, and for Latvia 2.5 and 3.2 per cent**.

Swedish economic signals this spring have been mixed, with a special focus on the low inflation figure. The pace of recovery in the manufacturing sector has been disappointing, and this has contributed to a low rate of capital spending. But there are cautious signs of economic improvement. There is good potential for a strong upturn in consumption: solid real wage increases, tax cuts, low interest rates. Home prices rose by 5 per cent during 2013 and they are expected to climb as much during 2014 and then level out. **Unemployment will fall to 7 per cent** by the end of next year: still well above long-term equlibrium. **We expect GDP to grow by 2.7 per cent this year** (0.2 percentage points higher than in our February forecast), up from 1.5 per cent in 2013. **Next year we foresee Swedish GDP growth of 3.1 per cent** (0.1 percentage points lower).

Inflation in Sweden (both CPI and CPIF) **has probably bottomed out, but we expect price increases to remain worryingly low**. CPIF inflation (CPI excluding taxes) will amount to 0.5 per cent this year and 1.3 per cent in 2015, i.e. well below target. In the past six months, three things have increased the pressure on the Riksbank to act. First, **inflation** has shown downside surprises in a way that puts in question the Riksbank's forecasting ability and understanding of the driving forces of inflation. Other central banks, too, have been confronted with this fact. Second, **inflation expectations** have ended up at their lowest level in 15 years, which threatens the credibility of the Riksbank's inflation target. Third, the responsibility for and the shaping of **macroprudential oversight policy** has become clearer; to some extent this lessens the responsibility of the Riksbank for financial stability. The Riksbank has confirmed this shift in policymaking in various ways: **the inflation trend has assumed a more important role in its interest rate decisions**. In the prevailing low inflation environment, the krona also seems to have assumed a major role in monetary policymaking. **We expect the Riksbank to cut its key interest rate by 0.25 percentage points in early July and then, in October, cut it further to 0.25 per cent**. Not until the autumn of 2015 will the Riksbank begin to hike its key rate, which will reach 0.75 per cent in December 2015. Because of the Riksbank's rate cuts, the krona will come under pressure and have a low value during the coming year. **This year the EUR/SEK exchange rate will peak at 9.25-9.30**. After that, the krona will begin to appreciate, and by the end of 2015 it will stand at 8.60 per euro. Its movements against the US dollar will remain small and we expect the USD/SEK rate to peak at 6.80 and then remain at around 6.70 during 2015.

Swedish voter surveys are pointing to a change of government after the September parliamentary election, with the Social Democrats and Greens as the most likely governing coalition. Because of strong government finances and broad support for the existing fiscal policy framework, political changes in Sweden rarely have any major impact on financial markets. This time around, there is an unusually large risk of uncertainty. First, there may be **major changes in the political landscape** this autumn, with an untested governing constellation, blurred lines between the political blocks, new party leaders, and a large kingmaker party (the right-wing populist Sweden Democrats) that no one else wants to work with. Second, **several major political issues have been postponed. They will now require broad political decisions** in order to avoid weakening Sweden's position: high unemployment, taxes, housing construction, integration of immigrants, energy supply, schools and defence. Sweden is moving towards a redistribution policy in which both government revenue (taxes) and expenditures (public sector programmes) are increasing, yet our forecast is that public finances will remain strong, with a **stable government debt level of 40 per cent of GDP**. This year's budget deficit, 1.5 per cent of GDP, will fall to 0.5 per cent in 2015. Even though the political parties are now competing about who is the most loyal to the official budget surplus target, we still believe that this policy will be re-assessed and that **a balanced budget target will be introduced during the next parliamentary term of office.**

Key figures: International & Swedish economy *(figures in brackets are forecasts from the February issue of Nordic Outlook)*

International economy. GDP, year-on-year changes, %	2012	2013	2014	2015
United States	2.8	1.9 (1.9)	2.6 (3.3)	3.7 (3.7)
Euro zone	-0.7	-0.4 (-0.4)	1.0 (1.0)	1.6 (1.6)
Japan	1.4	1.5 (1.7)	1.0 (1.4)	1.3 (1.3)
OECD	1.3	1.2 (1.3)	2.1 (2.4)	2.7 (2.7)
China	7.7	7.7 (7.7)	7.2 (7.4)	7.0 (7.0)
Nordic countries	1.0	0.6 (0.6)	1.9 (2.1)	2.4 (2.4)
Baltic countries	4.2	3.0 (3.0)	2.1 (3.7)	3.3 (4.2)
The world (purchasing power parities, PPP)	3.3	3.2 (3.2)	3.6 (3.9)	3.9 (4.0)
Swedish economy. Year-on-year changes, %				
GDP, actual	0.9	1.5 (1.0)	2.7 (2.5)	3.1 (3.2)
GDP, working day corrected	1.3	1.5 (1.0)	2.7 (2.6)	2.9 (3.0)
Unemployment, % (EU definition)	8.0	8.0 (8.0)	7.9 (7.7)	7.5 (7.0)
Consumer Price Index (CPI) inflation	0.9	0.0 (0.0)	-0.1 (0.4)	0.9 (1.8)
Government net lending (% of GDP)	0.2	-1.4 (-1.4)	-1.5 (-1.7)	-0.5 (-0.8)
Repo rate (December)	1.00	0.75	0.25 (0.75)	0.75 (1.25)
Exchange rate, EUR/SEK (December)	8.58	8.86	9.00 (8.50)	8.60 (8.40)

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