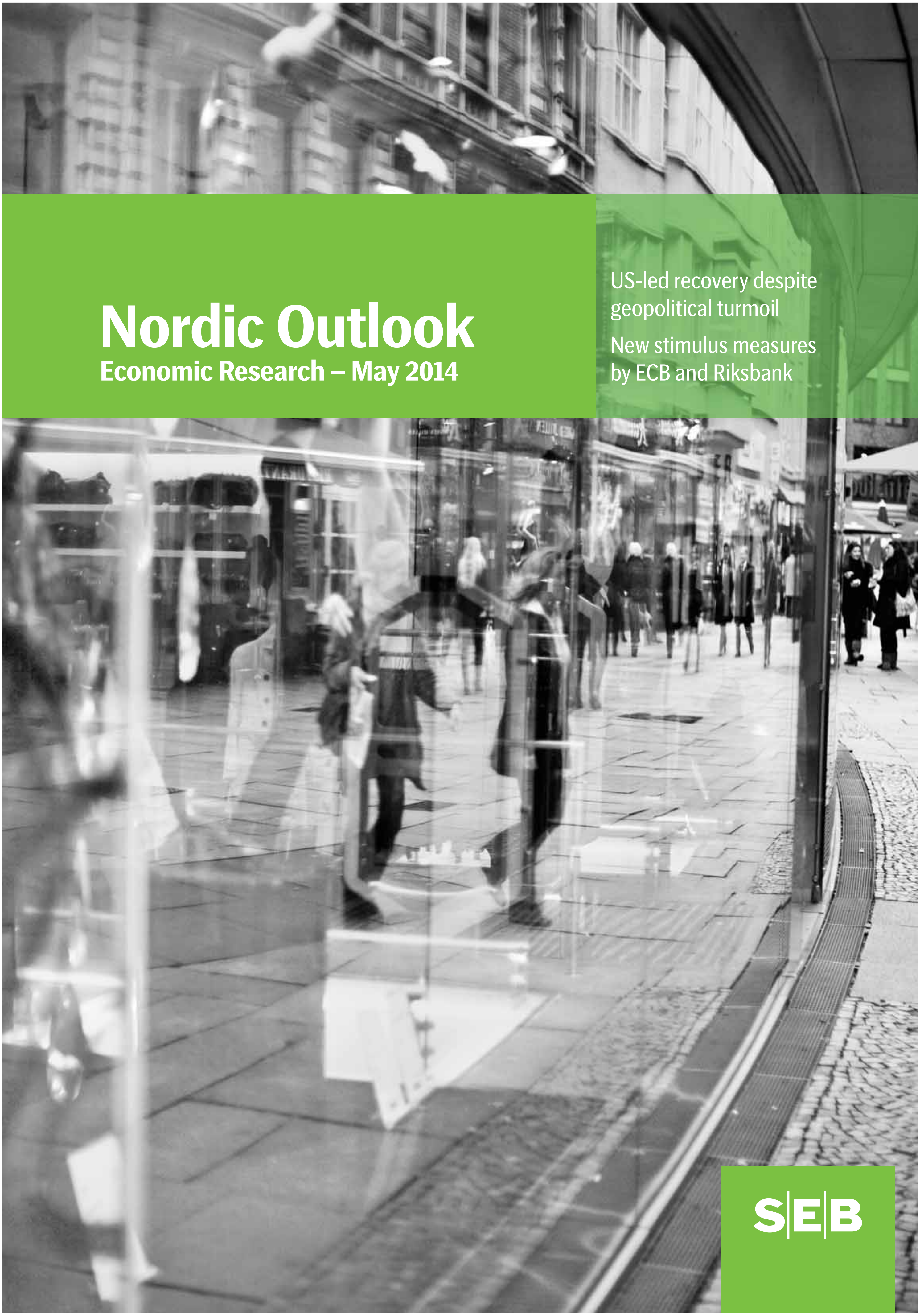
Nordic Outlook

Economic Research – May 2014

US-led recovery despite geopolitical turmoil

New stimulus measures by ECB and Riksbank



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Varied inflation trends mean monetary policy divergence

- **Upturn in US growth after winter slump**
- **EM sphere resilient to geopolitical worries**
- **Deflation risk driving ECB to implement QE**
- **Riksbank will lower key rate to 0.25 per cent**
- **Loose monetary policy supports equities**
- **US dollar will eventually appreciate**

The global economy is gradually reaching firmer ground, but this trend is marked by temporary setbacks and regional differences. The recovery in the **United States** lost momentum in the first quarter, when extreme weather conditions hampered economic activity. Based on strong indicators this spring, we expect a clear rebound in the second quarter but have still adjusted our full-year 2014 GDP growth forecast downward from 3.3 per cent in February's *Nordic Outlook* to 2.6 per cent. **Japan's** economic reform programme faces major challenges when it comes to permanent ending deflation and carrying out structural reforms. The **United Kingdom** economy has surprised on the upside, while inflation has fallen faster than expected. In the **euro zone**, the recession is over and financial worries have gradually eased. Unemployment and government debt have also stabilised, but at worryingly high levels.

A number of emerging market (EM) economies are hampered by regulation and structural weaknesses, but most countries have shown resilience amid the prevailing geopolitical turbulence. This is in contrast to the pattern last winter, when EM stock markets and currencies weakened sharply due to increased uncertainty about US Federal Reserve (Fed) monetary policy. The favourable trend has confirmed our view that we are not headed into a broad-based crisis of the type that affected Asian economies in the late 1990s.

In the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD), we foresee an upturn in overall GDP growth from 1.2 per cent in 2013 to 2.1 per cent this year and 2.7 per cent in 2015. In 2014, this implies a downward revision of 0.3 percentage points. We have also adjusted our forecast for the EM economies downward, among other things because we believe that Chinese authorities will accept growth of 7.2 per cent: somewhat below their formal target of 7.5 per cent. Total global growth will accelerate from 3.2 per cent in 2013 to **3.6 per cent in 2014 and 3.9 per cent in 2015**. This represents a slight downward revision for both 2014 and 2015 since our last *Nordic Outlook*.

Global GDP growth

Year-on-year percentage change

	2012	2013	2014	2015
United States	2.8	1.9	2.6	3.7
Japan	1.4	1.5	1.0	1.3
Germany	0.7	0.4	1.8	2.1
China	7.7	7.7	7.2	7.0
United Kingdom	0.3	1.7	3.0	2.6
Euro zone	-0.7	-0.4	1.0	1.6
Nordic countries	1.0	0.6	1.9	2.4
Baltic countries	4.2	3.0	2.1	3.3
OECD	1.3	1.2	2.1	2.7
Emerging markets	4.9	4.7	4.6	5.0
World, PPP*	**3.3**	**3.2**	**3.6**	**3.9**

Source: OECD, SEB * Purchasing power parities

Monetary policy will remain highly expansionary in the developed countries over the next couple of years. This is one reason why **long-term yields will only move up slowly and stock markets will climb a bit further**. Yet the differences in terms of inflation and resource utilisation between the US, on the one hand, and the euro zone and Japan, on the other, have recently widened. This has an impact on our monetary policy forecasts. We expect the Fed to end its stimulative purchases of securities in October 2014 and begin hiking its key interest rate in Q3 2015. The Bank of England (BoE) will also raise its key rate during 2015. The European Central Bank (ECB) will move in the opposite direction, and new stimulus measures will be required in order to strength lending and counter the risks of euro zone deflation and stagnation. **Our forecast is that the ECB will launch GDP-weighted quantitative easing (QE) in June.** Differences in monetary policy are one reason why the spread between American and German bond yields will remaint relatively wide. We also believe that the euro will eventually weaken against the US dollar in this environment, but in the short term the increased risk appetite resulting from the ECB's actions will lead to currency flows that support the euro.

A recovery moving towards firmer ground leads to a greater focus on 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 results of growing income and wealth gaps have gained increased attention in public discourse**, especially because wider gaps weaken the ability of monetary policy to stimulate growth. In February's *Nordic Outlook*, we discussed these problems in a "secular stagnation" theme article. Now the spotlight is increasingly aimed at the potential of fiscal and tax policies to strengthen the effectiveness of monetary policy (see the box entitled "Tax policy - a key that can unlock growth?")

Ukraine crisis – new security policy arena

In recent months, the crisis in Ukraine has escalated. The country is now on the brink of civil war. Meanwhile tensions between Russia and leading Western countries have worsened. The acute security situation appears likely to last for some time. Russia's already strained relations with the EU and US have deteriorated radically.

During the spring, we have adjusted our economic forecasts for the region downward (see *Eastern European Outlook*, March 2014). Ukraine is now entering a deep recession, while the Russia economy will stagnate this year. The political crisis is exacerbating an already weak economic situation largely caused by structural problems. Nearby countries that trade heavily with Russia, such as Finland and the Baltic countries, are clearly affected.

Our main global scenario is based on the assumption that a large-scale trade war between Russia and the EU/US can be avoided and that there will be no major disruptions in Russian energy deliveries to Western Europe. The general effects on the world economy will thus be relatively minor. For example, we are still forecasting that Central Europe will continue its recovery. A limited civil war in Ukraine would not change this main global scenario. Yet the costs of a sharp escalation of economic sanctions could be substantial, especially for Western Europe. Aside from broad trade disruptions and serious energy-related consequences, there are important financial links.

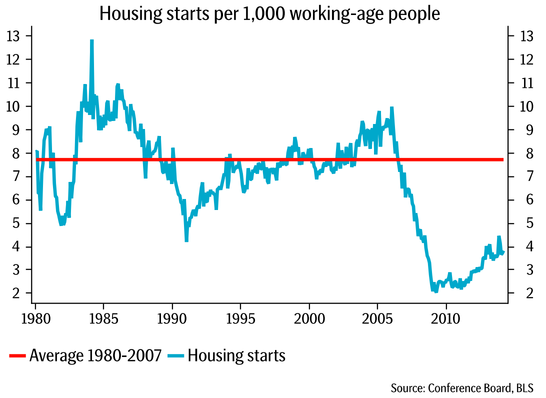
Our oil price forecast assumes continued relatively stable prices in 2014, enabling the Organisation of the Petroleum Exporting Countries (OPEC) to control market balance by boosting or cutting production. The conflict between Russia and Ukraine will nevertheless pose an upside risk if oil deliveries via the Black Sea are stopped.

Although we do not believe that the Ukraine crisis will affect the global economy more than marginally, more long–term changes may be on the way. The weak Russian economic growth of recent years needs to be dealt with through large-scale reform work, but there is a risk that these reform efforts will be more difficult if the conflict with Ukraine causes Russia to move towards a greater degree of political and economic isolation. Looking ahead, there is also a risk that other geopolitical trouble spots may flare up, for example when it comes to China's relations with neighbouring countries.

US will lead global recovery

Although the US recovery is slowly gaining ground, for some time it has been rather weak and vulnerable. Businesses have been cautious about new capital spending in a situation where capacity utilisation is still relatively low. Uncertainty about order bookings and the potential for carrying out price increases has hampered their desire to invest. Nor is household consumption gaining real momentum in an environment of low pay increases and restrictive fiscal policy. The stimulus effect of rising home and share prices is limited because it largely benefits households with relatively low marginal consumption ambitions. The weak first quarter in the US economy confirmed the picture of a global economy without a clear direction.

US: Big potential for increased housing construction

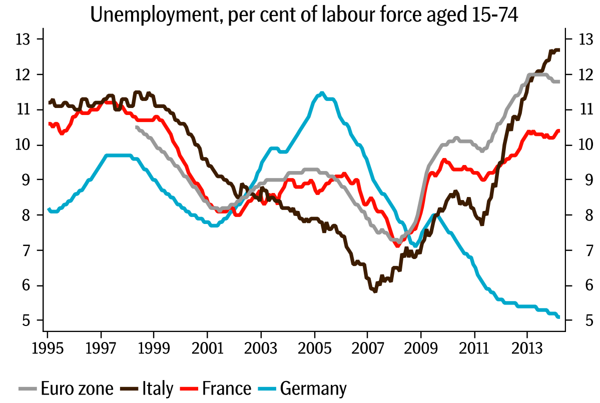


Yet we believe that we are now entering a phase of better momentum in the world economy. Indicators suggest a fairly powerful rebound in the US during the second quarter. **We are thus sticking to our view that US growth will accelerate rather sharply during the next couple of years.** Depressed production levels in cyclically sensitive sectors, such as housing construction, provide the potential for a long-lasting upturn. Meanwhile the fiscal policy playing field has become clearer and a fiscal tightening effect totalling 1.7 per cent of GDP in 2013 has given way to a largely neutral fiscal policy in 2014 and 2015. Household debt deleveraging is probably over, and in an improved labour market environment we expect reduced saving to drive a consumer upturn. Gradually rising capacity utilisation as well as easier credit conditions, which will benefit small and medium-sized businesses in particular, will finally help capital spending gain strength. American companies also enjoy low energy prices due to shale oil and gas production.

In Western Europe, the picture is more mixed. **The British economy has shown upside surprises**, with expansionary signals in manufacturing, while rising home prices will once again become a driving force for domestic demand**. In the euro zone, the trends in different economies continue to diverge. Germany's export sector is showing exceptional strength** but exports from southern European countries are also increasing as competitiveness is slowly restored. Generally speaking, domestic demand remains weak. In Germany, we are seeing a cautious upturn in consumption, driven by the strong labour market, but in most other euro zone countries households are squeezed by high unemployment, low pay increases and in some cases also continued tight fiscal policy. Unemployment in the euro zone as a whole now seems to have stabilised, **but in France and Italy the trend is worrisome and the need for reforms is increasingly obvious**. Overall, we expect a very slow recovery in the euro zone, where high unemployment and government debt problems persist. Meanwhile the process of political integration is not moving ahead. **This puts a growing burden on ECB stimulus measures and on efforts to reform the banking system.**

Euro zone: Divergent labour market trends

Unemployment, per cent of labour force aged 15-74



Source: Eurostat

Alternative scenarios

GDP, year-on-year percentage change

	2014	2015
A. Larger global effects from the US upturn (20%)		
United States	3.0	4.2
Euro zone	1.3	2.5
OECD	2.3	3.4
Emerging market economies	5.5	6.4
B. Worries tied to geopolitics or Fed policy (25%)		
United States	2.4	2.5
Euro zone	0.5	0.5
OECD	1.0	1.0
Emerging market economies	4.0	3.5

Source: SEB

The EM economies are going through a phase where they are gradually re-assessing their growth expectations after their rapid expansion in the 2000s decade. We expect GDP growth in the EM sphere as a whole to remain unchanged at a little below 5 per cent both in 2014 and 2015. Recent developments have generally supported our forecast that no widespread EM crisis is imminent. These economies are substantially more resilient than during the Asian financial crisis of the 1990s, for example, due to **lower public sector debt, stronger external balances and more robust exchange rate policies** including floating currencies. But they face various political and structural challenges. In China, growth continues to decelerate and the government seems to be accepting slightly lower de facto growth. If the downturn should become larger and have a significant impact on the labour market, there is room for economic policy counter-measures. India and Indonesia are more vulnerable due to weak external balances; Indonesia is also being squeezed because the Chinese deceleration is pushing down commodity prices. In India, many are hoping that the ongoing parliamentary elections will lead to a change of government that will speed up reform efforts, but we believe that these hopes may be exaggerated. The Russian economy is stagnating completely, as the effects of the acute crisis in Ukraine are added to underlying problems.

Downside risks slightly outweigh upside

There is a relatively low probability that the Ukraine conflict will escalate into a crisis with global consequences, but this conflict is one reason why we foresee somewhat larger downside risks than before. **We have thus raised the probability of our low-growth scenario to 25 per cent from the 20 per cent in February's *Nordic Outlook*.** The main downside risk is still that tighter US monetary policy might have larger negative global consequences than in our main scenario.

As in February's *Nordic Outlook*, we estimate the probability of a faster-growth scenario at 20 per cent. One potential event is that the contagious international effects from the US economic upturn will be clearer and more in line with historical norms.

Nordic countries continue to diverge

In terms of growth, the Nordic countries continue to follow partly different paths. In **Sweden**, the economic signals are mixed. Growth is being driven mainly by residential construction and household consumption, stimulated by good real income increases, but export recovery will be weak. GDP will increase by 2.7 per cent in 2014 and by 3.1 per cent in 2015. In **Norway**, too, the economy is being pulled in different directions. Headwinds include weakening oil and gas investments and weak housing investments. On the other hand, the labour market has stabilised, while good real income increases and a home price stabilisation suggest that consumption will pick up. GDP will grow by 1.9 per cent both in 2014 and 2015.

In **Denmark**, recent developments have confirmed our forecast that the recovery will gain momentum. Home prices are rising, unemployment is falling, the number of jobs is increasing and consumer confidence is close to pre-crisis highs. Meanwhile exports are performing well and current account surpluses are record-high. GDP will grow by 2.0 per cent in 2014 and 2.5 per cent in 2015. **Finland** is lagging further behind the other Nordics. A combination of structural problems in the forest product and the information and communication technology (ICT) sectors plus relatively large trade exposure to Russia is hampering growth. The economy moved into recession late in 2013, and GDP growth will be very weak: -0.3 per cent in 2014 and 0.8 per cent in 2015.

Nordics and Baltics, GDP growth

Year-on-year percentage change

	2012	2013	2014	2015
Sweden	0.9	1.5	2.7	3.1
Norway	2.9	0.6	1.9	1.9
Denmark	-0.4	0.4	2.0	2.5
Finland	-1.0	-1.4	-0.3	0.8
Estonia	3.9	0.8	0.5	2.3
Latvia	5.5	4.1	2.5	3.2
Lithuania	3.5	3.3	2.7	3.8

Source: OECD, SEB

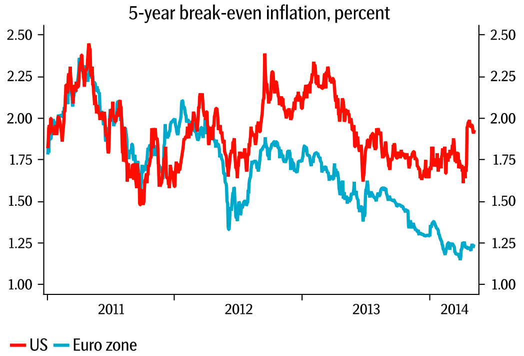
Nearby unrest weighs down the Baltics

The Ukraine crisis and Russian economic weakness are having an impact on economic performance in the Baltic countries. Large trade exposure to Russia is slowing exports. Heightened geopolitical uncertainty is holding back investments, among other things due to somewhat tighter credit conditions. Tourism, which is relatively important to the Baltics, is less affected. We are lowering our GDP forecasts somewhat compared to March's *Eastern European Outlook*. Estonia's GDP will increase by 0.5 per cent in 2014 and 2.3 per cent in 2015. Latvia's growth will reach 2.5 and 3.2 per cent, respectively. Lithuania's GDP will grow by 2.7 per cent and 3.8 per cent, respectively. **Our forecasts remain well below consensus.**

Meanwhile the Baltics have buffers that make the risk of recession small. Strong real wage growth will help sustain private consumption. Strong public finances and small current account deficits provide financial resilience. The small remaining exchange rate risk in **Lithuania** will also disappear in May-June when the country **is expected to receive a go-ahead to join the euro zone in 2015**: in line with the government's long-standing plan.

Divergent inflation expectations

5-year break-even inflation, percent



Source: Bloomberg, SEB

Widening inflation gaps

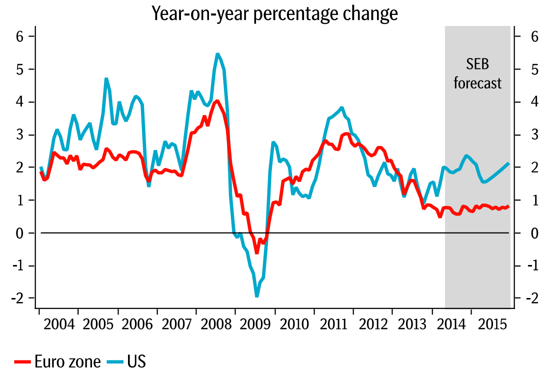
Inflation pressures in developed economies remain low. They have many driving forces in common. For example, **low resource utilisation continues to squeeze pay as well as profit margins**. In recent months, this trend has intensified and inflation has mainly shown downside surprises. This is clearest in Western Europe, above all in Sweden.

Short-term factors tend to lift inflation a bit. Rising food prices have their largest impact in the EM countries, but they also affect the Consumer Price Index (CPI) in developed economies. Higher petrol (gasoline) prices may also drive up inflation somewhat, along with changes in taxation such as the recent consumption tax hike in Japan. Looking ahead a bit further, minimum wage increases in such countries as Germany and the US may give rise to small inflationary impulses.

Looking ahead, however, the underlying trend will **continue to be dominated by disinflationary forces**. Resource utilisation will remain low and price pressure on consumer goods in the world market will continue. Tendencies towards wider gaps between the US and Western Europe, which we have highlighted in recent issues of *Nordic Outlook*, have nevertheless intensified. Deflation risks in the euro zone have generally increased in recent months. Inflation is decreasing in nearly all countries, and inflation expectations have fallen to worryingly low levels. Crisis-hit euro zone countries are in, or close to, deflation. When German inflation is as low as about one per cent, **it is hardly possible to implement an internal devaluation within the framework of the euro zone without broad deflationary tendencies**. Assuming that the ECB undertakes the actions described below, we expect the region as a whole to avoid deflation, but inflation will end up well below the ECB's target during the next couple of years. Measured as annual averages, HICP inflation will be 0.7 per cent in 2014 and 0.8 per cent in 2015.

CPI inflation

Year-on-year percentage change

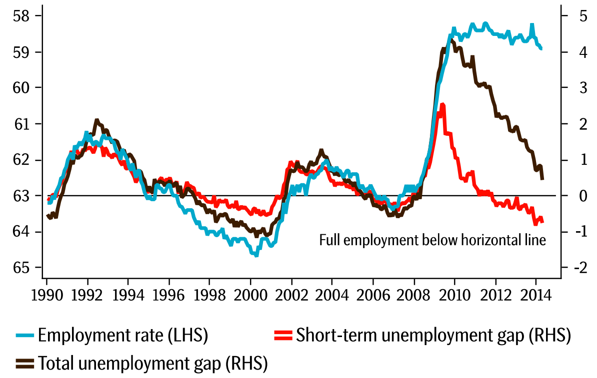


Source: Eurostat, BLS, SEB

In the US, the picture is a little different. One crucial question about the inflation trend and monetary policy is how much idle capacity ("slack") there is in the economy. Different measures such as employment rate, total unemployment and short-term unemployment provide completely different indications of the resource gap (see chart). The Fed and especially its Chair, Janet Yellen, have singled out to continued low pay increases, high involuntary part-time unemployment and few voluntary resignations as indicating that there is still quite a lot of slack. Our assessment is more pessimistic and we think there are reasons to view total unemployment as a rather representative measure of resource utilisation.

US: How much slack?

Per cent



Source: BLS, CBO, SEB

The latest monthly figure showed unemployment at 6.3 per cent, which is probably not far from equilibrium level. Various indicators, including the Fed's Beige Book, also show labour shortages in certain sectors, with wages and salaries beginning to move up. In an environment of stagnating productivity, this means rising unit labour costs. It is not self-evident that businesses can pass these on to consumer prices, but historically there is a strong correlation between unit labour costs and inflation. Inflation impulses may also occur via rents and health care costs. **Our forecasts indicate price increases of around 2 per cent in 2014 and 2015.** The Fed's favourite measure, the Personal Consumption Expenditure (PCE) deflator, will be a bit lower, but risks are on the upside.

Monetary policy in constant flux

Global monetary policy is rapidly changing and undergoing a constant series of experiments. For example, attempts to provide forward guidance with the help of threshold values for unemployment have not worked out so well, and several leading central banks are now being forced to take a step back. During the International Monetary Fund's spring meetings in April, participants discussed the challenges that **monetary policy is now grappling with**. These include the objectives and tools of central banks, to what extent their policies can be made more efficient through taxes (see box), the interaction between policy areas and central bank independence. Other focus areas were how the driving forces behind inflation are changing and how important economic models should be in monetary policy decision making. One IMF document, for example, advises central banks to make their monetary policy decisions based on ***"more art and less science"***.

Central banks will continue to increase their monetary base in 2014 by purchasing bonds and intervening in foreign exchange markets. Although stimulative bond purchases in the US are expected to end in October, the monetary base will grow by 20 per cent. In Japan, a 35 per cent increase is under way, and in the euro zone we expect the ECB's quantitative easing (QE) programme to contribute an increase of 5 per cent. During 2015, the expansion of the monetary base will be modest.

ECB taking deflation threat seriously

In a number of ways, the expansion of balance sheets has helped secure financial stability. This allows more room to focus on inflation. **Today the most important task is to minimise the risk of a destructive deflationary spiral.** A number of central banks have been surprised by low inflation. For some, such as the BoE and the BoJ, currency depreciation has led to higher inflation during various periods. Other inflation channels have been more double-edged. Higher global commodity prices or tax hikes provide only temporary inflation impulses and also hamper growth. Rising wages and salaries ease deflation risks, but this normally occurs at a time when demand and inflation have already taken off. The weak correlation between money supply and inflation limits the effectiveness of QE policies in countering deflation.

Tax policy – a key that can unlock growth?

One effect of the global financial crisis – and subsequent monetary policies – has been to significantly **widen income and wealth gaps** between households and countries. Meanwhile there is a risk of stagnation (see *Nordic Outlook*, February 2014: "Secular stagnation – different risks require different policy responses") This has led the International Monetary Fund (IMF) and the Group of 20 (G20) countries to focus attention on two areas where official actions may help improve both economic and social stability:

1. How can we ***avoid a long period of excessively slow growth****, stagnation, which poses a threat to the labour market?*
2. How can the ***effectiveness of monetary policy be improved*** *–for example by raising taxes?*

The long period of exceptionally loose monetary policy has contributed greatly to **rising asset prices**. It has facilitated the task of repairing household, company and bank balance sheets. But the **effects of monetary policy on economic growth have been disturbingly weak**.

The IMF has a major influence on global economic policy debate and has assumed a leading role in the discussion on the need for re-assessments. During the past year, the **IMF has published two main documents on economic inequality** and on how a **redistribution policy** can be designed to achieve a fairer allocation of incomes and wealth at the least possible cost to economic efficiency.

IMF analyses and ongoing debates (see, for example, the IMF's latest spring meeting on April 11-13) point out that higher income taxes, with more steeply progressive tax brackets, combined with wealth and real estate taxes, can

a) lead to higher, **more stable, fairer economic growth**,

b) reduce the risk of stagnation by strengthening the **effect of monetary policy on growth/inflation**, and

c) reduce public debt and/or free up fiscal resources for infrastructure investments and increased support to households whose inclination to consume is obviously higher than those households that have benefited most from the monetary policies that have been pursued.

A further piece of the puzzle in the field of taxation is that today the G20 countries are trying to improve their collaboration related to tax management in a globalised environment. This includes exchanging tax information, for example. The purpose is to reduce the chances for individuals and companies to use creative and "geographic" bookkeeping to avoid paying taxes.

Taken together, this indicates a greater interest in using tax increases to achieve higher economic growth. At the same time, we must be aware of the risk that this tax discussion will lead to greater uncertainty about future economic policy rules of the game, which in turn may hamper consumption and capital spending.

We will now see various central banks in Europe step up their fight against deflation. This is especially true of the ECB, since the risk of euro zone deflation is imminent and the damage is potentially large in light of high indebtedness and fragile real estate markets. We believe that the ECB will act on a broad front, with regular QE programmes and attempts to facilitate financing for companies through bank loans and bond issues.

The Riksbank's situation is both different from and similar to that of the ECB. Deflation risks have increased, but the monetary policy transmission mechanism has worked much better in Sweden. This is one of several reasons why home prices have kept rising. To some extent, monetary policy has been designed as a balancing act between meeting the inflation target and slowing the upturn in home prices and household borrowing. But now that main responsibility for macroprudential supervision in Sweden rests with the Financial Supervisory Authority (FSA), we expect the Riksbank to join the ECB in wholeheartedly fighting to preserve the credibility of its inflation target in an environment of falling inflation expectations and actual inflation far below target. This will probably lead to a shift in its approach to inflation risks and a less asymmetrical risk analysis, for example concerning exchange rates and wage formation (see the section on Sweden). **We expect the Riksbank to cut its repo rate to 0.50 per cent in July and to 0.25 per cent in October 2014.**

The international rate hiking cycle in the industrialised countries will begin in 2015. We expect Norges Bank in Norway to hike its key rate in June 2015. The Fed will end stimulative bond purchases in October 2014 and hike its key rate in Q3 2015. **By the end of 2015, the key rate will stand at 1.25 per cent, somewhat higher than indicated by market pricing.** This reflects our slightly gloomier view of the resource situation. The BoE will hike its key rate in Q3 2015, while the Riksbank will wait until October 2015 before raising the repo rate in two steps to 0.75 per cent. Both the ECB and the BoJ will leave their key rate unchanged during 2015.

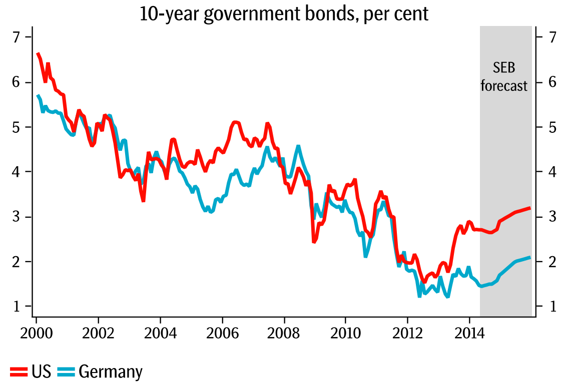
Cautious upturn in long-term yields

A continued global low-inflation environment and growth disappointments early in 2014 have pushed long-term yields lower. This is especially true in the euro zone, where the decline in yields has been further fuelled by speculation about additional monetary easing by the ECB. As a reflection of this, the spread between US and German 10-year yields has widened to about 115 basis points, the highest level since 2006. Now, as then, the yield gap is driven by wider differences in Fed and ECB monetary policies, which in turn are due to lagging euro zone economic recovery. **Looking ahead, we believe that this yield gap may widen somewhat further**, but historical experience suggests we are close to the limit on how much German and US long-term yields can be decoupled.

In the US we believe that during the autumn, long-term yields will gradually climb as the Fed's bond purchasing programme draws to a close and the market begins to discount future key interest rate hikes. Real long-term US yields will rebound from their currently depressed level of around 0.40 per cent, while inflation expectations will probably climb a bit. **By the end of 2014, American 10-year Treasuries will be trading at 2.90 per cent**, some 30 basis points above today's levels, and by the end of 2015 at 3.20 per cent. We expect German long-term yields to bottom out before the launch of the ECB's quantitative easing programme in June, followed by an upturn during the autumn to 1.70 per cent at the end of 2014 and 2.10 at the end of 2015. Such a yield path will follow the pattern in the US, where QE programmes – especially the first two – have helped boost inflation expectations and thus nominal yields while real long-term yields were pushed downward.

Cautious upturn in long-term yields

10-year government bonds, per cent



Source: Macrobond, SEB

The ECB has clearly indicated that it will act if contagious international effects contribute to an unwelcome tightening in the euro zone as well. However, a cautious upturn in German long-term yields – combined with continued downward pressure on yield spreads between Germany and crisis-hit euro zone countries – will mean that a tightening of financial conditions in the countries that are in the greatest need of stimulus can be avoided. **Rising yields in core countries of the magnitude that we foresee should therefore be acceptable to the ECB.**

The Riksbank's increased focus on low inflation, including its repo rate cut in December, has led to a certain narrowing of the long-term yield spread against Germany from its peak in the autumn of 2013. The 10-year spread is nevertheless still at a relatively high level, around 50 basis points. Given our forecast of repo rate cuts in two steps to 0.25 per cent, we foresee the prospects for **a continued narrowing of the spread to about 25 points**. During 2015, the spread will widen again as the Riksbank's rate hikes approach.

Norwegian bonds have mainly followed the trend of German yields. A large supply of bonds early in 2014 kept yields on long maturities up, but the bond supply is expected to ease during the second half of 2014. Meanwhile the ECB's quantitative easing programme should help narrow the yield spread against Germany for long maturities, as investors shift to higher-return fixed income assets. **We predict that the 10-year spread vs. Germany will narrow to 80 basis points by the end of 2014** and then widen to 95 points at the end of 2015.

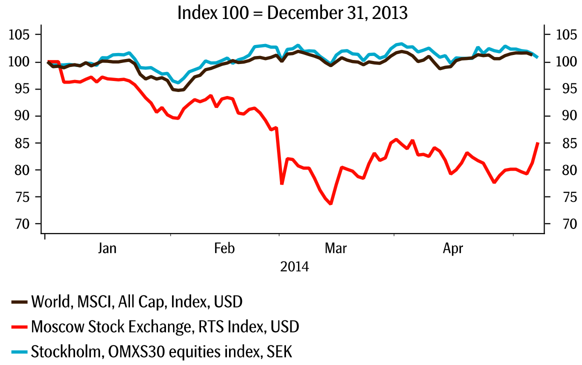
Potential for equities despite sluggish start

So far during 2014, stock markets have remained largely flat. During their 2013 rally, the MSCI World Index gained 18 per cent. **Yet stock markets have shown clear resilience to both increased geopolitical uncertainty and US growth disappointments.** Underlying risk appetite is due to several factors: continued expansionary monetary conditions and hopes that the ECB can deliver more stimulus, generally positive company reports and strong balance sheets, decreased worries about the performance of the EM economies and a lack of investment alternatives.

The stock market outlook remains cautiously positive. In a **short-term perspective** (the next 6 months), however, equity performance will be hampered by geopolitical uncertainty connected to the Ukraine crisis and lingering risks of global economic setbacks. In a **medium-term perspective** (6-24 months), the outlook is more positive. Although share valuations based on expected earnings appear strained, other valuation measures provide a more balanced picture. If we also assume that today's low interest rates will stay where they are for the foreseeable future, it is possible to argue that the risk premium on equities remains high. Global monetary policy will also continue to generate enormous liquidity at low interest rates in a gradually improving economic situation. The number of merger and acquisition (M&A) transactions seems to be increasing as well, which usually benefits the stock market.

Russian stock market decline has not spread

Index 100 = December 31, 2013



Source: Macrobond

In a **long-term perspective** (more than 2 years), however, the stock market outlook is more uncertain. The reason is the caution that characterises the future outlook of companies and their willingness to invest for long-term growth. This caution, in turn, is connected to the fact that the global economy is still struggling with surplus capacity and that there is uncertainty about the long-term growth trend. Increased uncertainty about long-term rules of the game and the business climate may also have an effect, for example connected to political interest in taxes and regulation.

Euro to defend its position for another while

So far this year, the foreign exchange market has been dominated by the search for yield. Currencies have strengthened in economies that show accelerating growth and, above all, have an inflation rate that is approaching the central bank target. This combination leads to rising expectations that monetary policy will eventually be tightened somewhat. **This environment favours commodity currencies, for example those of New Zealand, Australia and Norway.** The New Zealand dollar has been especially strong since the central bank began its key rate hiking cycle. Among the losers is the Swedish krona, since inflation and other data have brought downside surprises.

The US dollar has been unexpectedly weak so far in 2014. American macroeconomic statistics have not persuaded global asset managers, who have preferred to down-weight the USD in their portfolios. The Ukraine crisis has also led Russian market players to reduce exposure due to the risk of having their USD accounts frozen. Narrower yield spreads within the euro zone have also pushed the EUR/USD exchange rate upward by generating risk-tolerant flows into the euro. Furthermore, we have seen a strong correlation between changes in China's foreign currency reserve and the USD; recent Chinese market positioning has had a negative impact on the dollar. In the short term, the EUR/USD rate may continue to climb until the ECB reacts by initiating quantitative easing in June. Given our positive view of the US economy, however, we believe that the USD will eventually appreciate, and **historical experience indicates that higher US key interest rates have resulted in a stronger USD**. Overall, we believe that the dollar will begin to strengthen somewhat during the second half of 2014. By year-end, the EUR/USD rate will stand at 1.34 and by the end of 2015 at 1.28. Compared to our earlier forecasts, this implies a weaker USD.

In the short term, we believe that the Japanese yen will regain a bit of lost ground as speculative flows weaken while awaiting new stimulus measures from the BoJ. The USD /JPY rate will then move down to the 98-100 range. Looking ahead, we expect new monetary easing from the central bank in response to disappointments in Japan's economic performance. Meanwhile we anticipate that changes in investment policy by public pension funds will open the way for increased purchases of non-Japanese assets. **These factors will contribute to a rebound in the USD/JPY rate towards 104 by the end of 2014 and 115 at the end of 2015.**

Our forecasted Riksbank key rate cut will pull down the SEK. As earlier, financial institutions will sell the Swedish currency in response to expectations of looser monetary policy. **We believe that the krona will bottom out some time this autumn at around 9.25-9.30 per euro**, once the Riksbank has finished cutting rates. Further ahead, the krona will regain ground against the euro since the flow situation is positive. In addition, the ECB will be pursuing a much more expansionary monetary policy. We thus expect the EUR/SEK rate to fall towards 8.60 by the end of 2015. We predict that the krona will weaken somewhat against the USD, moving to around 6.70-6.80.

The Norwegian krone has appreciated recently as fears of looser monetary policy have diminished. A bit further ahead, the krone will be supported by Norges Bank's early position in the rate hiking cycle**, but the currency's upside will be limited by weak Norwegian competitiveness**. Our forecast is thus that the EUR/NOK rate will move towards 8.05 by the end of 2014 and to 8.00 at the end of 2015.

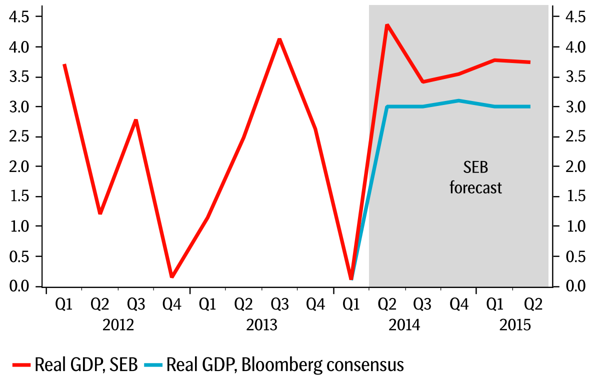
Economy regains momentum after weather-related dip

- **Households will drive grow as capital spending rebounds**
- **Unemployment will fall to 6 per cent in 2014**
- **Key rate will reach 1.25 per cent in 2015**

The American economy sputtered ominously in early 2014. However, far more upbeat statistics in recent weeks – for example regarding employment, retail sales, consumer confidence and industrial production – indicate that this dip was temporary and mainly weather-related. **The recovery will thus continue as planned, with households as the growth engine**, but business investments will also shift to higher gear after last year's slowdown. **GDP will increase by 2.6 per cent this year and 3.7 per cent in 2015**. This forecast is compatible with rising employment and a falling jobless rate – **unemployment will be 5.9 per cent at the end of 2014 and 5.3 per cent at the end of 2015**, lower than both the market's and the Fed's forecasts.

The recovery resumes

Annualised



Source: Bloomberg, BEA, SEB

Despite a higher inflation path than in our last *Nordic Outlook*, our scenario is still that inflation will remain low in the next couple of years, but we see reasons to **warn about wage-driven inflation**; plenty of historical examples show the Fed being taken by surprise in similar phases of the economic cycle as unemployment rapidly approaches equilibrium level. We are thus maintaining our assessment that the Federal Reserve's **first key interest rate hike will occur in mid-2015** and that the key rate will reach 1.25 per cent by the end of our forecast period: some 50 basis points higher than current market pricing. According to our forecast, the Fed will end its bond buying programme at the October monetary policy meeting.

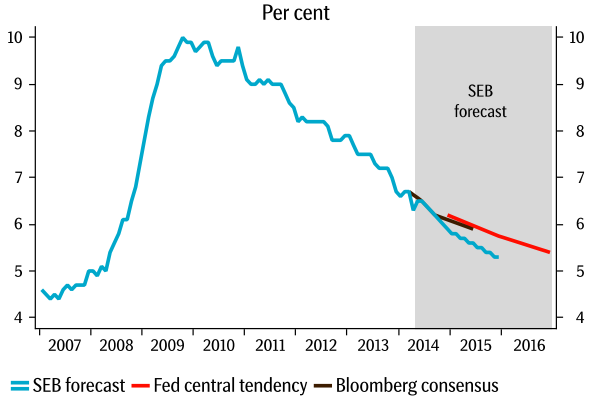
New labour market trends

The labour market recovery will generally continue more or less as planned. The number of job vacancies is at a six-year high. New job seekers were recently counted at 300,000: this is a seven-year low and a level historically compatible with 4 per cent real GDP growth and job growth of 250,000-300,000. We are not forecasting upturns quite this dramatic, since there is still some way to go before the labour market achieves normal mobility in terms of hiring and firing. Meanwhile last winter's labour market slump is history, and **we predict that employment will climb by an average of 200,000 per month in 2014**. In 2015 this rate will increase to 220,000. Unemployment will thus continue its speedy decline – especially considering that **trend employment growth has fallen to 80,000, according to the Chicago Fed**.

For the third year since measurements began in the late 1940s, the US labour force shrank last year, by 550,000, but in the first quarter it expanded by a full 1.3 million people. In the first quarter participation rose too – largely thanks to **Americans with no more than a high school diploma pouring into the labour market**. Although this category accounts for about 40 per cent of the working-age population, twice as many people with little education as people with higher education made themselves available to the labour market early in the year. In terms of hiring, the latest figures also favour those with less education. As a result, this year unemployment among the less educated has fallen much more than among those with post-secondary education.

Unemployment rate heading lower

Per cent



Source: BLS, Fed, SEB

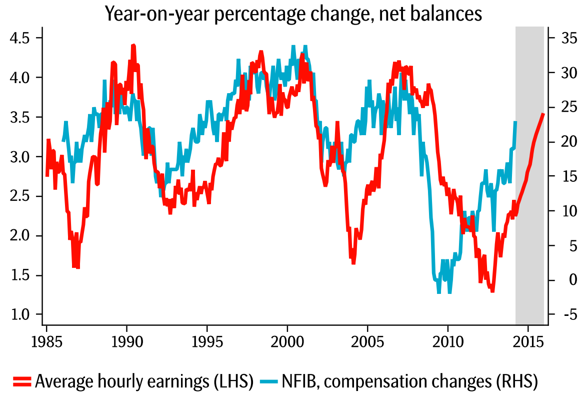
One conclusion is that the higher education system is pumping out new graduates for whom there is currently less demand. The "temporary" Emergency Unemployment Compensation (EUC) system introduced in 2008 shut down at the end of

2013, which also had an impact. It meant that 1.3 million former EUC recipients were left without government benefits, **boosting incentives to rejoin the labour market**. There has also been rising demand for less educated workers. Labour-intensive sectors such as construction, hotels and retailing top hiring statistics so far in 2014. A large influx of less educated workers into the labour market and onto payrolls has probably also held down average hourly wage hikes in recent months.

Whether businesses will continue to hire large numbers of less educated workers is important from a central bank perspective. **In that case, the Fed will gain support for its approach to the resource issue** (see the theme article). If it also turns out that the problem is the incentive structure, rather than the match between job seekers and jobs, this suggests lower structural unemployment. We will follow developments, but our main scenario is still that the lion's share of the decline in labour force participation in recent years is explained by retirements, as also indicated by analyses from both Fed district offices and the Bureau of Labor Statistics. This makes unemployment, which fell to 6.3 per cent in April, a valid measure of the resource situation in the labour market. **We predict that unemployment will fall to 5.9 per cent by the end of 2014 and to 5.3 per cent at the end of 2015**: a little bit lower compared to our earlier estimate and below the Fed forecast. With unemployment approaching its equilibrium level of around 6 per cent, this points to faster increases in average hourly wages during 2014-2015 – 3.5 per cent year-on-year at the end of 2015, according to our forecasts.

Wage growth rising

Year-on-year percentage change, net balances



Source: BLS, NFIB, SEB

Higher incomes will boost consumption

Turning to consumption, we see no reason to revise our earlier estimates very much either. Various measures of consumer confidence are moving upward, approaching historical averages. In March, car sales – which took a beating last winter – reached their highest level since before the financial crisis.

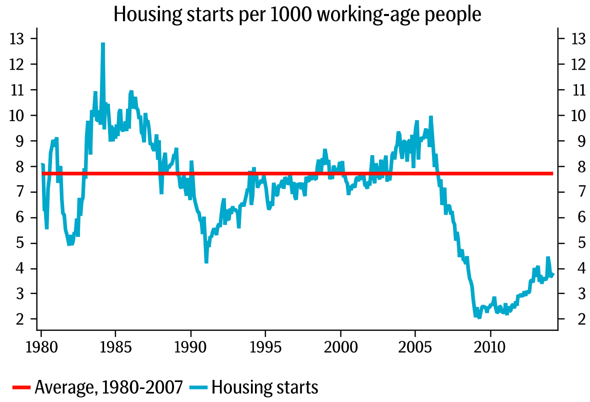
Lagging wealth effects from stock market and home prices, combined with stronger income growth, point to higher consumption growth in 2014-2015 than in prior years. Net household wealth is now USD 12 trillion higher than its pre-crisis peak, **while the loan-to-net wealth ratio has fallen to a 14-year low**. As in 2013, the wealth effect will contribute greatly to consumption: this year it will boost consumption by 1.5 percentage points. Wealth will also make a positive contribution in 2015, while rising incomes will play a more prominent role; average hourly wages will increase by 3.2 per cent in 2015, up from 2 per cent last year. **Overall household consumption will speed up to 3.2 per cent both this year and the next**. Real disposable incomes will increase a bit more slowly in 2014-2015 and the household savings ratio will fall to 3.5 per cent by the end of our forecast period.

Housing market still has plenty of energy

Residential construction and sales, as well as construction sector confidence, lost ground early in 2014. We believe this was a temporary weather-related slump; even though the GDP contribution of residential construction usually peaks early in a recovery, there are reasons to expect a **good construction market for another couple of years**.

Low residential construction

Housing starts per 1000 working-age people



Source: Conference Board, BLS, SEB

One reason for optimism is that **conditions for first-time buyers aged 25-34 have steadily improved**. During the first quarter, employment in this age category increased by more than 300,000 people after a similar upturn in the fourth quarter of 2013. The employment trend for first-time buyers over this six-month period was thus the strongest since 2000. An increasingly strong labour market is also benefiting other population categories. This will allow **room for an upturn in residential construction** – especially since housing starts are still depressed. Housing starts per 1,000 inhabitants stand at 3.7 today, compared to an average of 7.7 in 1980-2007. A normalisation to historical averages would translate to **1.8 million housing starts: nearly double today's level**. Pent-up home-buying needs might suggest an even higher level. Since 2008, residential construction has fallen about one million units per year short of US demographic demand.

Despite an upturn of more than 12 per cent last year, home prices according to the Case-Shiller 20-City Index are at the same level as seven years ago. A depressed supply of homes indicates continued high rates of price increases, yet we are sticking to our forecast of **slower price increases of 8 per cent in 2014 and 6 per cent in 2015**. So far the upturn in home prices has been driven by institutional investors who have transformed owner-occupied homes into rental properties. The share of first-time buyers remains remarkably low in historical terms, but looking ahead they will become a more important driving force, according to our forecasts.

High time for more capital spending

We see several reasons for stronger business investments ahead. The average age of factories and machinery is 22 years, which is the highest figure since the 1950s. In addition, for a change there is a two-year federal budget in place, which diminishes fiscal uncertainties. Meanwhile demand pressure in the economy is stronger than for many years. Furthermore, capacity utilisation is rising rapidly and is now at levels compatible with a capital spending surge of 7-10 per cent. Mounting **investor pressure** on companies to carry out growth-promoting capital spending – rather than focusing on dividends and share repurchases – may become the **catalyst of a capital spending upturn**. Business investments will grow by 8 per cent this year and by nearly 11 per cent in 2015, according to our forecasts. **The US current account deficit decreased rapidly last year to 1.9 per cent of GDP**: the lowest figure since 1997.

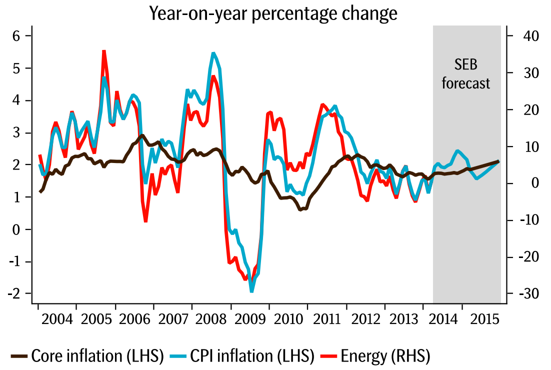
Low inflation with upside risks

High space heating costs and food prices will contribute to an upward revision in our inflation forecast, compared to the last *Nordic Outlook*. **Our forecasts point to price increases of 1.9 per cent this year and the next**. Although inflation will remain low, the lingering deflation risk that continues to give the Fed headaches will thus be priced out of the fixed income market.

As previously, we see upside inflation risks – mainly via wages and salaries, though rents and health care costs may also drive prices higher. According to the NFIB small business survey, pay levels are rising and **average hourly wages will continue to normalise, in keeping with our forecasts**. Their effects on inflation are uncertain: the impact on consumer prices will depend on whether businesses can pass on the cost to consumers, but even modest pay hikes can trigger rising unit labour costs when productivity growth is depressed. The voluntary minimum wage increases that have occurred in many US states nevertheless have only a weak impact on inflation, since so few people are affected. The national increase from USD 7.25 to USD 10.10 per hour proposed by President Barack Obama has little chance of getting through Congress.

Continued low inflation

Year-on-year percentage change



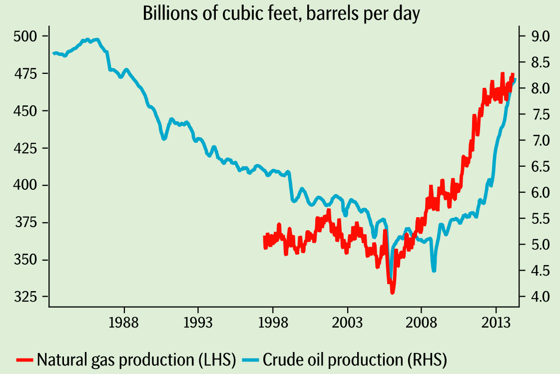
Source: BLS, SEB

The shale revolution is giving the US a big lift

The shale revolution that began in the US a decade ago is boosting employment and activity in the oil and gas sector. **In 2009 the US eclipsed Russia as the world's largest gas producer**. American companies that use gas in their production process enjoy a competitive advantage, since the price of gas in the US is one third of that in Europe and Japan. Shale gas has greatly reduced the need for energy imports, and within a few years the US will probably be a net exporter of gas. Oil production has also risen by 70 per cent since 2008, and according to the US Energy Information Administration (EIA) **by 2020 the US is expected to be the world's biggest oil producer**. Such a development is likely to have both economic and geopolitical consequences.

The shale revolution

Billions of cubic feet, barrels per day



Source: EIA, SEB

Whether shale gas and oil will change the long-term US growth outlook will depend, among other things, on how investments in closely related industries unfold. According to our calculations, the **shale gas revolution will contribute around two tenths of a percentage point a year to GDP growth in 2013-2015**. Of the most populous US states, Texas weathered the recession best and had the strongest recovery; unlike California, New York and Florida, it now has an employment level well above its pre-crisis peak. Large shale gas and oil deposits are probably one important reason behind the state's economic success.

The environmental impact of the shale gas revolution is uncertain: some observers claim that methane leakage into the atmosphere from shale gas is higher than in conventional gas extraction, but others claim the opposite. Such leakage will probably diminish as technology improves. However, the transition from coal to gas has greatly reduced US carbon dioxide emissions in the past 5-7 years; **in 2012 CO_2 emissions reached a 20-year low**. When the shale revolution eventually gains a foothold in other countries, most indications are that fossil fuel prices will be squeezed: new producer countries will increase the competition, and the power of the OPEC cartel will decline. Lower oil prices will boost real purchasing power and disposable incomes and will be positive news for global manufacturers. Renewable fuels will be left behind; declining oil prices will further increase the need to subsidise such energy sources.

"Obamacare" is under way

Despite a clumsy launch last October, the Affordable Care Act (ACA) is now operational. With 8 million Americans registered for private coverage, the Obama administration has exceeded its 2014 target. Many who previously had no coverage now have health insurance, and according to administration forecasts the number of uninsured will decrease by 20 million within a couple of years. **President Obama thus appears to have succeeded with a project that has eluded American political leaders for decades**. Yet it remains to be seen whether the right mix of people have registered – otherwise premiums are likely to skyrocket. In addition, only 2-3 million of the total number seem to have had no previous coverage, so the **number of uninsured is still expected to total 42 million at the end of 2014**, according to the Congressional Budget office. Health care reform remains a political hot potato in the run-up to the congressional interim elections on November 4, in which **scales are also staring to tip in favour of the Republicans in the Senate**. This would not be enough to enable Congress to repeal the ACA, however, since President Obama has veto power.

The shift in federal fiscal policy – from a headwind totalling 1.7 per cent of GDP last year to nearly neutral this year and in 2015 – is one reason for our positive view of the economy. Meanwhile the budget deficit will continue shrinking to 3.9 per cent of GDP in 2015: a sharp improvement compared to 2009, when the deficit peaked at 12.8 per cent.

Key interest rate hike in mid-2015

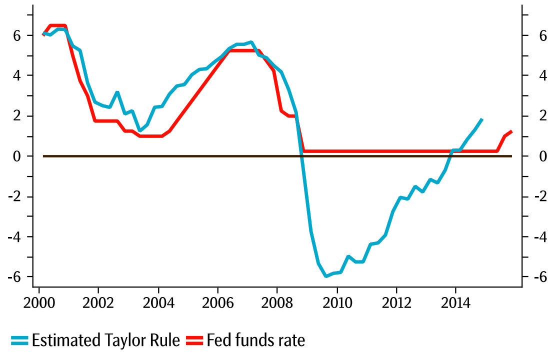
Viewed over the past 30 years, each monetary easing cycle has created its own bubble: real estate in the 1980s, technology shares in the 1990s and the credit market in the 2000s. **Excessively low interest rates are a bubble candidate this time around**; while aggressive central bank policies are squeezing the yields on risk-free sovereign debt, investors searching for returns are being forced into riskier securities. One scenario is that the market will begin to price in faster key interest rate hikes if the economy gains momentum in keeping with our forecasts. This has happened many times before: in early 1988, late 1993, early 1999 and late 2003.

Like just over a decade ago, inflation may be the catalyst for key rate hikes. In 2003, inflation was as low as it is today and deflation worries dominated the Fed. One year later, inflation had climbed sharply and key rates had climbed quite far. Right now, communication from the Fed is pointing to cautious rate hikes, even though the labour market is approaching full resource utilisation. But **monetary policy is naturally still data-dependent**: if inflation proves higher than expected, the central bank's interest rate path will be pushed upward this time around as well.

Since the 1960s, the rate hiking cycle has begun when the unemployment gap stood at an average of 0.9 percentage points. Fed forecasts currently indicate that the non-accelerating inflation rate of unemployment (NAIRU) – or equilibrium unemployment rate – is at 5.4 per cent, while other assessments are far higher than this. Based on the Fed's view of equilibrium unemployment and its historical reaction functions, the key rate hike should thus occur today since unemployment has reached 6.3 per cent, which our estimated Taylor Rule also indicates.

Taylor Rule suggesting hikes in 2014 already

Per cent

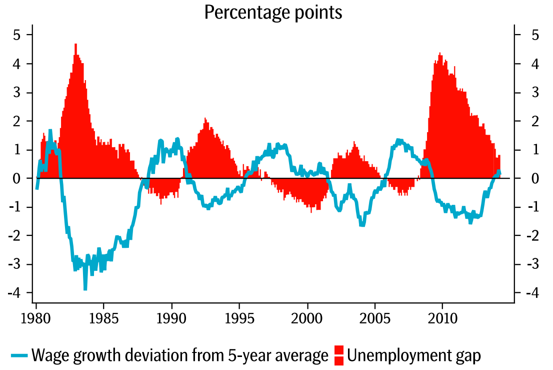


Source: BLS, Fed, SEB

But with the help of its published interest rate forecasts, speeches and guidance, the Fed has signalled that its **reaction function will be gentler this time around**. These signals indicate that the first rate hike will not occur until the first half of 2015 and that the key rate will then be hiked at a modest pace, compared to previous cycles. According to the Fed's forecasts, the median rate will be 1 per cent at the end of 2015 and 2.25 per cent at the end of 2016, even though inflation will be on target and unemployment will be below equilibrium, according to the Fed's forecasts several years into the future.

Early signs of wage growth picking up?

Percentage points



Source: BLS, OECD

The Fed bases its forecasts on the assessment that there is plenty of slack. New central bank Chair **Janet Yellen has highlighted the following indicators that support this thesis**: seven million involuntary part-time workers, low voluntary quits and new hires, and high unemployment using broader measures. The Fed also says that average hourly wage increases of just over 2 per cent are not compatible with a tight resource situation. Our assessment of the resource situation is a little less optimistic, and we are thus keeping our interest rate forecast unchanged. The Fed will begin hiking its key rate in mid-2015 and the **fed funds rate will stand at 1.25 per cent at the end of 2015**, about 50 basis points above market pricing. Bond purchases will end in October 2014.

Theme: How tight is the US labour market?

- **Short-term unemployment a relevant alternative as a resource indicator**
- **Pay increases key to the resource issue...**
- **... and possibly a more hawkish Fed**

Despite low average GDP growth of 2.2 per cent since the US recovery began in 2009, the jobless rate has fallen 3.7 percentage points since it peaked in 2010. Falling unemployment means that idle labour market resources are activated. A tight resource situation is usually reflected in faster pay increases. The Fed's main scenario is that there is still plenty of slack in the labour market and that inflation will remain low. According to the Fed, this suggests a slow normalisation of its key interest rate. Yet we see **initial signs that pay will rise faster**, which may change the central bank's forecasts.

Wages and salaries usually increase faster than their long-term trend when the unemployment gap – the difference between the actual jobless rate and equilibrium unemployment (NAIRU) – is closed. Although unemployment remains a bit above its equilibrium level (6 per cent according to the Congressional Budget Office's estimate and 5.4 per cent according to the Fed's estimate), pay is climbing faster today than its long-term trend, defined as a five-year moving average. One reason might be that equilibrium unemployment rose more than estimated during the crisis years. Analyses from the San Francisco Fed support this; according to these, the equilibrium level has risen as high as 6.7 per cent. Difficulty in finding qualified staff is also a recurring theme in the Fed's Beige Book, while small business surveys mention labour shortages. If estimated NAIRU is too low, the **Fed risks focusing on a jobless rate that is not compatible with price stability**.

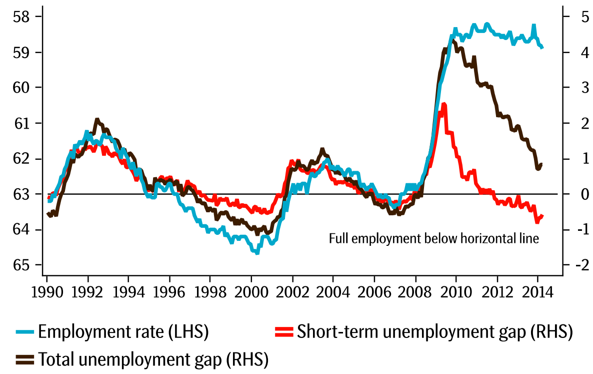
One alternative explanation is that **short-term unemployment explains wage/salary growth and inflation best**. The arguments for this are that employers ignore the long-term unemployed, who thus influence the wage formation process to a lesser degree. The share of long-term unemployed peaked at just over 20 per cent of the total jobless figure in earlier cycles but exceeded 45 per cent in 2010 and remains at a high 35 per cent today. For every additional month of unemployment, the probability of landing a job decreases. Most of the long-term unemployed eventually leave the labour force. Experience in both Sweden and Canada shows that the long-term unemployed can return to the labour force and to employment, but that it takes time and requires dedication and concerted political efforts.

Since the US recovery began, short-term unemployment has fallen steeply and reverted to normal levels. Using this yardstick, the **labour market gap has already closed** but it is still open in terms of overall unemployment. If we instead choose the employment rate as a measure of idle labour market resources ("slack") – which is dubious since so many people have left the labour force for demographic reasons – the labour market gap is wide open. The difference is obvious compared to **earlier cycles when the various measures of resource utilisation provided consistent messages**.

Our main conclusion is that the traditional measure of unemployment is the best indicator, but that short-term unemployment is better at explaining certain events. One example is the relatively mild slowdown in pay increases that occurred at the peak of the crisis in 2009-2010. At that time, the quantity of idle resources using a broader measure was at least as large as in the early 1980s, for example, when the slowdown in pay increases was more powerful.

How much slack?

Per cent



Source: BLS, CBO, SEB

Even if short-term unemployment proves to be the most relevant pay indicator, this will not automatically result in earlier and more aggressive key rate hikes. **There are many indications that the Fed will choose a broader interpretation of its employment mandate** than narrow (short-term) or traditional measures of unemployment (U3) offer. High involuntary part-time employment, continued low pay increases, few new hires, high unemployment according to broader measures and depressed voluntary resignations are factors that Fed Chair Janet Yellen has cited as arguments that the amount of slack in the labour market is fairly large. **The Fed thus believes that the adjustment of its key interest rates can occur slowly** and that the most important key rate (the federal funds rate) will be far below its neutral level in 2016, even though inflation is at target and the jobless rate will match equilibrium unemployment at that time according to the Fed's forecasts. However, we foresee inflation risks further ahead and believe **the Fed will hike interest rates at a faster pace than its current forecasts indicate**.

Lingering long-term doubts about Abenomics

- **Short-term deceleration due to tax hike**
- **Waiting for new structural reforms**

Abenomics – the policy package launched by Prime Minister Shinzo Abe in 2012 – gave the Japanese economy a jolt of energy, followed by a slowdown last autumn once the effects of earlier yen depreciation and fiscal stimulus measures faded. According to the quarterly Bank of Japan (BoJ) Tankan survey, companies have downgraded their outlook for capital spending and forward-looking business confidence fell from a high level in the first quarter, reflecting **greater uncertainty about April's increase in consumption tax** from 5 to 8 per cent. But the resulting fiscal tightening is being offset by infrastructure investments and corporate tax relief equivalent to 1 per cent of GDP from the October supplementary budget. On the other hand, this means Japan is falling behind schedule in reducing its budget deficits.

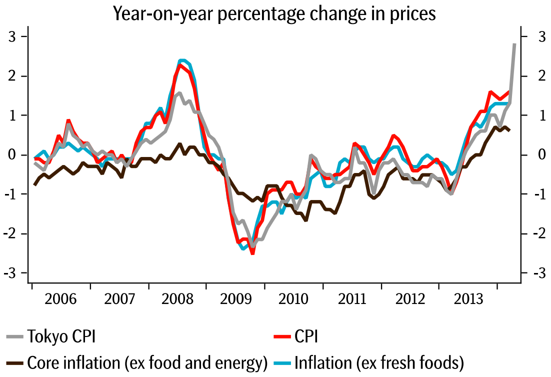
Foreign trade remains a source of disappointment. Although the yen has weakened by about 15 per cent in trade-weighted terms since January 2013, export volume has remained largely flat. Meanwhile imports have skyrocketed, driven by increased dependence on foreign energy following the Fukushima nuclear plant disaster. But anaemic export growth may partly reflect weather-related first quarter weakness in the US. The need to meet the surge of domestic demand preceding the tax hike may also have played a role. Meanwhile a rapid upturn in machinery orders is signalling higher investments ahead.

The labour market situation has continued to improve. In February, unemployment stood at 3.6 per cent, the lowest level since the summer of 2007 and just above the BoJ's estimated sustainable long-term jobless rate. The employment components in various business surveys show that companies expect to continue increasing their head count. A tighter labour market has not yet had much impact on wages and salaries. Some major companies have responded to the government's call for pay hikes in the year's wage negotiations, but other parts of the business sector – which have not benefited similarly from the weaker currency – continue to resist. Higher pay increases are essential if Japan is to break away from the grip of deflation, but there are still no convincing signs that this important piece of the puzzle is about to fall into place.

In the short term, the BoJ's efforts to drive up inflation to its 2 per cent target are going as planned, but this is due to the consumption tax hike, which also pushes down real incomes. Inflation in the Tokyo region jumped to 2.9 per cent. The stabilisation of the currency is now blunting inflation impulses from imports, and national inflation measures have remained flat in recent months. Long-term inflation expectations remain well below 2 per cent.

Consumption tax pushes up April inflation rate

Year-on-year percentage change in prices



Source: National statistical offices

Overall, there is great uncertainty about the underlying strength of the Japanese economy. In our Macro Update in March, we revised our growth outlook for 2014 downward from 1.4 to 1.0 per cent – below consensus – after an unexpectedly weak ending to 2013. At the same time, we stuck to our forecast of 1.3 per cent growth in 2015, which is in line with the consensus. We see no reason to further adjust these assessments now. Greater momentum in the global recovery should help drive future exports, while the next consumption tax hike in 2015 is a downside risk. We also believe that the **BoJ will announce expanded stimulus measures**, which will renew downward pressure on the yen. Since the central bank needs more information on the effects of the April tax hike, we believe that a decision on new monetary easing can occur in July at the earliest. In the short term, the economy may instead receive a helping hand from a change in the investment policy of the Government Pension Investment Fund (GPIF) that would increase the proportion of equities and foreign assets in its portfolio. This may be approved in June and could provide new support for the Tokyo Stock Exchange, with potential positive effects on household wealth and consumption.

The chances that Abenomics can sustainably boost growth still depend on structural reforms, the third "arrow" of Abenomics. These are not yet convincing. Mr Abe has promised new reform proposals this summer. The measures unveiled so far – including economic zones – need to be clarified, and new initiatives are needed – for example in order to boost labour market participation among women. Meanwhile the failure to achieve breakthroughs in negotiations on the Trans-Pacific Partnership (TPP) trade agreement is a setback in efforts to keep up pressure for agricultural reforms.

Financial resilience to geopolitical worries

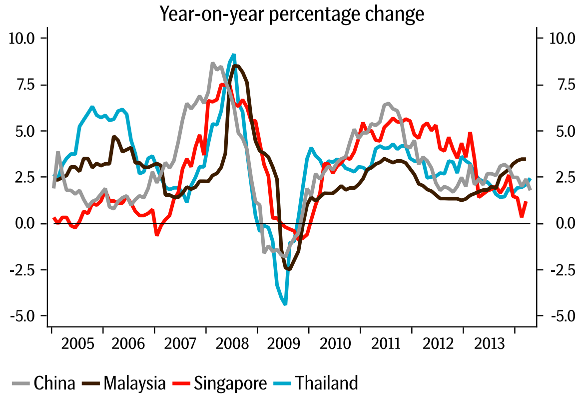
- **Gradual recovery in economic expansion**
- **China: Acceptance of slower growth**
- **India: Exaggerated reform hopes**

Emerging Asia is still growing faster than other parts of the world economy, but the pace of expansion is much slower than before the financial crisis. China's economic deceleration continued in the first quarter, hampering growth in the rest of the region. Since this deceleration is primarily driven by weaker capital spending, commodity-exporting countries such as Indonesia are affected the most. In recent years, growth has largely been driven by domestic demand that is stimulated by soft monetary policies, rapid credit expansion and strong labour markets, but in many places credit growth is unsustainably fast. In Singapore and Malaysia, lending has already begun to decelerate, but only in 2015 do we expect more widespread monetary policy tightening in the region. Yet slowing domestic demand in some economies will be offset by stronger external demand, mainly from the US. Most indicators point to **continued overall gradual recovery in growth in 2014-2015**, except that China is expected to keep slowing.

Inflation has recently accelerated somewhat, driven by rising food prices. Food represents a large share of CPI baskets in emerging economies and thus has a relatively large impact on inflation. Even if food price inflation keeps rising in the future, this does not change the general picture of a **historically low inflation** environment; core inflation is low and stable in most economies.

Continued low inflation pressure

Year-on-year percentage change



Source: National statistical offices

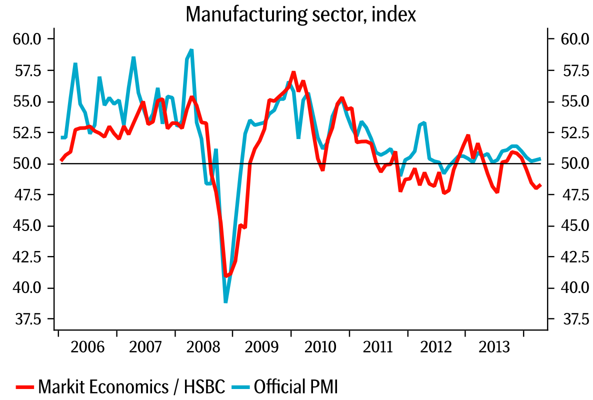
The financial market turbulence that generally characterised emerging markets in the summer of 2013 and early in 2014 has not recurred. This instability was due to greater uncertainty about future Fed monetary policy and thus had a global impact, but worries about the Ukraine conflict have mainly had regional effects. Stock markets and currencies in Asia have generally strengthened during the spring. Two clear examples are India and Indonesia, where the upturn has been driven by better fundamentals and by hopes that coming election results will speed up the pace of economic reforms.

China: Continued deceleration in growth

China's economic deceleration late in 2013 continued early in 2014. **First quarter GDP growth slowed to 7.4 per cent** year-on-year, down from 7.7 per cent in the fourth quarter. Purchasing managers' indices have been very weak in recent months. The official PMI is slightly above the growth threshold of 50, while Markit's index, which includes a larger element of small companies, has been below 50 since January.

Weak performance for purchasing managers' indices

Manufacturing sector, index

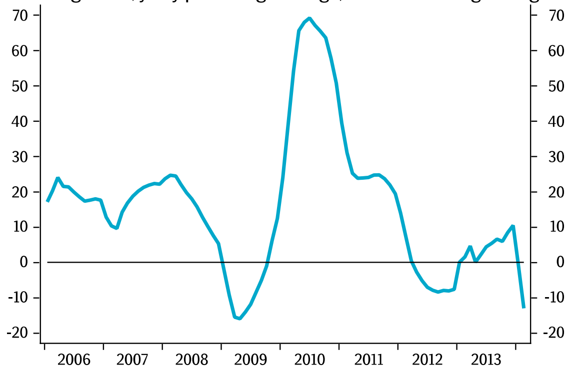


Source: China Federation of Logistics & Purchasing, Markit Economics

Most hard data were also weak early in 2014, although there were signs that the deceleration in economic activity was occurring more slowly towards the end of the first quarter. It is difficult to interpret export and import statistics due to over-invoicing for tax reasons. Performance has probably not been quite as weak as the data show, since the largest declines affected exports to Taiwan and Hong Kong, the destinations where over-invoicing problems are believed to be the most widespread. Industrial production has slowed further in recent months, but infrastructure investments are showing signs of stabilising, probably driven by the government's acceleration of already approved projects. In the manufacturing sector, however, capital spending is continuing to slow. Credit growth continues to decelerate; the clear upturn in new loans during March follows the usual seasonal pattern. We expect the authorities to keep slowing down lending, which will hold back capital investments; the seasonal recovery in property sales has been very weak and the number of transactions is well below last year's, although the data series is volatile. Home price increases have begun to lose momentum, and construction companies have responded to this weakening trend by cutting back the number of housing starts.

Deceleration in the housing market

Housing starts, y-o-y percentage change, 3-month moving averages



Source: National Bureau of Statistics of China

Speculation about a formal lowering of the 2014 economic growth target has proved incorrect; it remains at 7.5 per cent. Yet there is increased acceptance of somewhat slower growth. Unlike previous years, the target was set at "about" 7.5 per cent. Other official communication also signals that growth of around 7.2-7.3 per cent would be consistent with the target. Labour market developments will be crucial; a clear weakening would probably lead to more extensive government stimulus measures. But there are still no signs that slower growth has hurt the labour market, and the risk that a weaker labour market would cause widespread social unrest is regarded as small. The demographic trend will also contribute to a shrinking labour force, so the labour market will remain tight in the future. **We expect China's GDP growth to end up at 7.2 per cent in 2014 and slow to 7.0 per cent in 2015.**

Early in April, the authorities launched some minor stimulus measures, including a speed-up of already planned investments (railways, low-income housing) and tax relief for small businesses. More extensive stimulus measures will probably be initiated only if growth decelerates sharply or the labour market begins to weaken clearly, which is unlikely. The lack of large-scale stimulus is a sign that the authorities are not so worried about slower growth. Interbank rates have fallen since early in 2014 but now seem to have started bottoming out, since the central bank has again begun to absorb liquidity by means of repo transactions. We expect no dramatic easing of monetary policy ahead; lowering the reserve requirement for certain small rural banks led to a very limited increase in liquidity. This action was apparently intended to provide support to the agricultural sector and is not expected to be followed up by an easing of reserve requirements at the national level. Given continued low inflation and a budget deficit that is expected to end up around 2 per cent of GDP in 2014, there is underlying room for stimulus measures.

In March the inflation rate accelerated but inflation decelerated to 1.8 per cent in April, driven by falling food prices, and there is no sign of any inflation surge. Core inflation remains below 2 per cent and producer prices are still falling year-on-year. Looking ahead, the slowdown in economic activity and credit growth will also help keep inflation pressure low. **We expect full-year 2014 inflation of 2.8 per cent. In 2015, we foresee inflation of 2.9 per cent.**

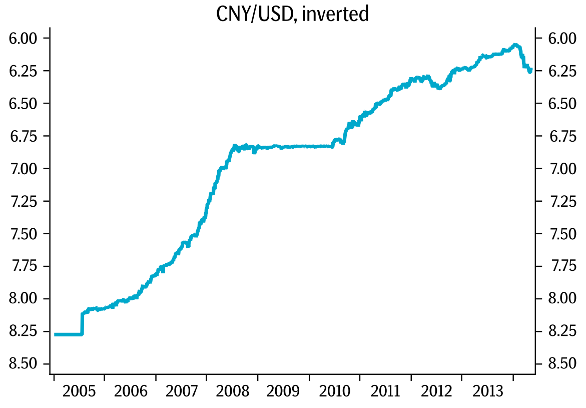
Early in 2014, two Chinese corporate bond defaults attracted great attention, but corporate bonds account for less than 10 per cent of total private sector loans outstanding. More defaults are likely, but the authorities have tools at hand to prevent any threat to the stability of the financial system. The rising percentage of bad bank loans has also attracted attention. Looking ahead, there are many indications that loan quality will continue to deteriorate, but starting from a very low percentage of bad loans compared to most other economies; this percentage is expected to increase to around 1 per cent by the end of 2014.Thanks to their reserves, banks will also be resilient to rising loan losses.

By Chinese standards, the **yuan has weakened sharply so far this year**: by some 3 per cent against the US dollar. This weakening has been engineered by the central bank, probably in order to counter large-scale capital inflows driven by expectations of continued yuan appreciation. Currency depreciation also stimulates the economy via exports, yet we believe the main purpose has been to prepare the market for increased two-way volatility. In mid-March the trading band for the yuan was expanded, and the exchange rate may now move by 2 per cent instead of 1 per cent around the reference rate set daily by the central bank. The previous expansion of the trading band occurred in April 2012, and these actions are steps along the way to towards a freely floating currency.

Despite this year's depreciation, the fundamental factors behind yuan appreciation remain in place. Monetary policy will tighten faster than in the US, with rising interbank and deposit rates. The yuan will also enjoy support from China's current account surplus and capital inflows. **We expect the USD/CNY exchange rate to be 5.90 at the end of 2014 and 5.80 at the end of 2015.**

Sizeable depreciation of the yuan

CNY/USD, inverted



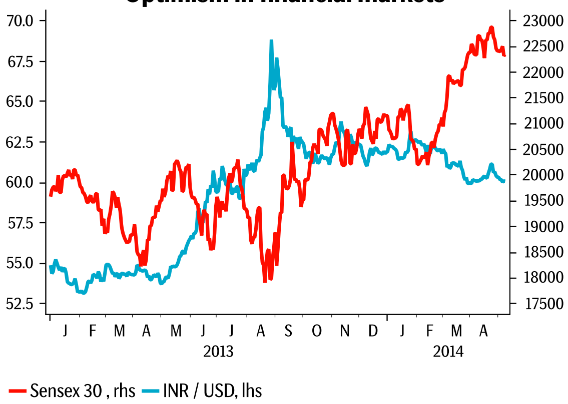
Source: Macrobond

India: Stronger currency but weak growth

Last year, financial market turbulence related to the Fed's plans to phase out quantitative easing had a major impact on India by weakening its stock market and currency. This spring, in contrast, markets have been predominantly optimistic. So far this year, the rupee has appreciated a bit against the US dollar and the stock market has reached new record levels. This positive trend is largely explained by hopes that the April-May parliamentary election will lead to a change of government and large-scale reforms that will re-ignite the economy. Better fundamentals have also played a role. The current account deficit fell sharply in the third quarter of 2013 and continued to narrow in the fourth quarter. This improvement was largely due to increased exports, but also smaller gold imports after restrictions were imposed. A reduced budget deficit has also contributed to fiscal stability.

Generally, however, there are few signs of GDP acceleration. In the fourth quarter of last year, the growth rate decelerated slightly to 4.7 per cent year-on-year, bringing **full-year 2013 GDP growth** to a weak **4.7 per cent**. Neither indicators nor hard data show clear signs of increased economic activity. Although purchasing managers' indices for manufacturing and services have rebounded from their lows of last autumn, they are well below historical averages. Last year's currency depreciation led to greatly improved exports, but in recent months export growth has slowed sharply. Looking ahead, increased demand from the West will provide some support, but exports account for only one fourth of India's GDP. Domestic demand will thus be crucial to growth but is showing no signs of acceleration. Capital spending is weak and industrial production has fallen year-on-year for four straight months. Nor is there any momentum in household demand. Car sales, an important indicator of consumer demand, remain very weak. Overall, this implies a very modest upturn in growth. **In 2014 we expect GDP to increase by 5.0 per cent, and in 2015 growth will accelerate to 5.4 per cent.**

Optimism in financial markets

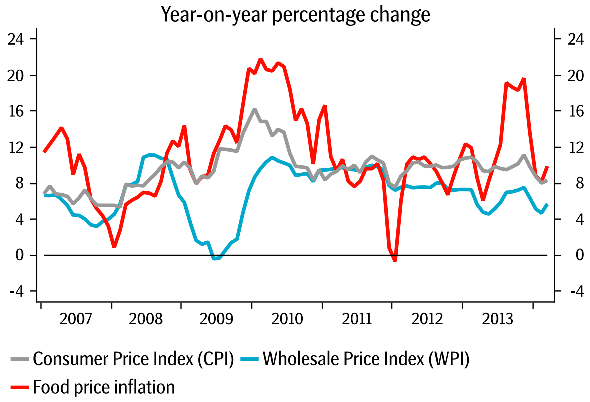


Source: Bombay Stock Exchange, Macrobond

The trend towards a lower inflation rate late in 2013 and early in 2014 reversed in March, when CPI inflation reached 8.3 per cent. Food accounts for half the CPI basket, so rising food prices have a major impact and complicate the Reserve Bank of India's long-term target: bringing down CPI inflation to 4 per cent. Household inflation expectations also remained at a very high level, and it has proved difficult to put a lid on core inflation. This year's monsoon is also expected to be weak, which will keep food price inflation high. Our assessment is thus that bringing down inflation pressure will be a slow process. However, since Raghuram Rajan took over as RBI governor last autumn, the central bank has shown its willingness to tackle inflation even if this hamper India's weak economic growth in the short term. **We expect CPI inflation to be 8.0 per cent in 2014, and 7.6 per cent in 2015.**

Easing inflation pressure will be a slow process

Year-on-year percentage change



Source: Ministry of Commerce and Industry

The RBI's focus on curbing inflation leaves no room for a relaxation of monetary policy. We believe that the bank's key interest rate hike in January will be followed by **another rate hike in the third quarter**, bringing the key rate to **8.25 per cent at the end of 2014**. Monetary policy will receive a little extra help from currency appreciation, which will hold back price increases on imported goods. Since bottoming out in late August 2013, the rupee has appreciated by more than 10 per cent against the USD and its real exchange rate has also strengthened. **At the end of 2014, we expect the rupee to stand at 59.0 against the US dollar; at the end of 2015 the INR/USD rate will be 55.0.**

The **parliamentary election** began in mid-April, and the results will be unveiled on May 16. Although public opinion surveys are more uncertain than in most developed countries, there are many indications that the opposition party **BJP** led by Narendra Modi will form a new coalition government with smaller regional parties. BJP is regarded as business-friendly. Its likely election success has generated **expectations of growth-stimulating reforms**. We believe that this optimism is exaggerated, however; BJP will probably not achieve its own parliamentary majority, and working together with regional parties will make far-reaching reform efforts difficult. There is thus a risk that growth will remain at around 5-6 per cent even beyond our forecast horizon.

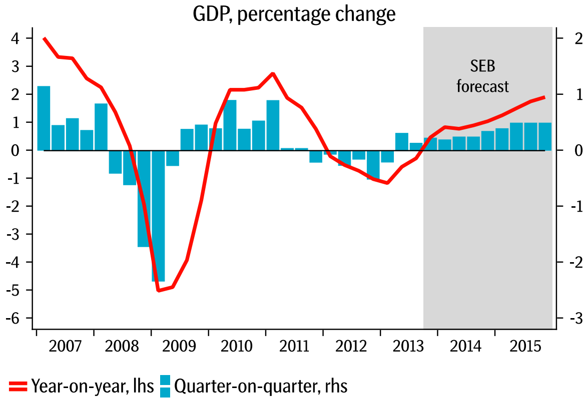
Deflation risks will require aggressive countermeasures

- **Indicators point to continued recovery**
- **High unemployment falling only slowly**
- **Neutral fiscal policies in 2014**
- **Inflation worryingly low**
- **ECB under pressure: QE in June next step**

The picture of **a weakly positive economic trend** has recently been confirmed. Late in 2013, year-on-year euro zone GDP growth was positive for the first time in nearly two years. Financial markets have mainly reacted positively, while bond yields and spreads have continued to fall early in 2014. **Indicators point to continued recovery**. Production and exports are improving, for example via continued German strength, but also because the GIPS countries (Greece, Ireland, Portugal and Spain) have regained some lost competitiveness. Household confidence is now strengthening as the labour market stabilises and fiscal headwinds subside. In the euro zone as a whole, fiscal policy is expected to be broadly neutral. Our forecast is that **GDP will grow by 1.0 per cent in 2014 and by 1.6 per cent in 2015**. Such a recovery is not strong enough to significantly ease imbalances in the labour market and public finances. The euro zone is also continuing to lose ground against most other major regions, especially the US.

The growth rate is slowly increasing

GDP, percentage change



Source: Eurostat, SEB

If the Russia-Ukraine crisis follows our main scenario, the consequences for the euro zone as a whole will be relatively small. Countries in the eastern part of the euro zone will be affected most, partly due to their larger trade exposure. For example, only 3 per cent of German exports go to Russia, while the figure is 10 per cent for Finland and 19 per cent for Latvia.

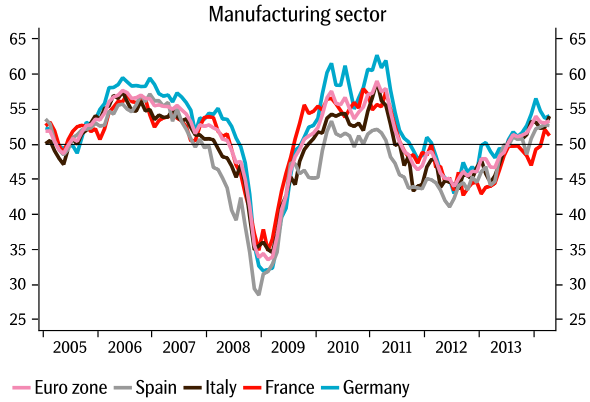
Due to **mounting deflation risks** combined with weak economic growth and falling bank lending, the **European Central Bank (ECB) will act more forcefully and with more tools than before**. We are sticking to our forecast that the ECB will initiate quantitative easing. It will probably approve this in June. We also believe that the processes surrounding stress testing of banks will lead to a better-functioning credit market, for example via recapitalisation of systemically important banks. Taken together, we believe these measures are sufficient to avoid outright deflation, although inflation based on the Harmonised Index of Consumer Prices (HICP) will be clearly below 1 per cent during our forecast period. Meanwhile the task of economic policy integration is moving sluggishly. Uncertainty in the run-up to the European Parliament elections and the replacement of the European Commission – as the countries holding the European Union presidency this year (Greece and Italy) grapple with their own domestic problems – will weaken the impact of these integration efforts.

Indicators point to economic improvements

Sentiment indicators have kept improving this spring. Purchasing managers' indices (PMIs) and the European Commission's Economic Sentiment Indicator (ESI) show a consistent picture of the situation. While manufacturing PMI fell a bit early in 2014, it remains well above the growth threshold of 50. Having diverged around the end of 2013 the PMIs in the four biggest countries (Germany, France, Spain and Italy) have converged at around 53 in April. France is lagging behind; the index fell to 51.2 in April. Of the crisis-hit countries, Greece is somewhat below the others but reached above 50 in April.

PMIs above 50 on a broad front

Manufacturing sector



Source: Markit

Weak increases in exports, capital spending

During the past six months, industrial production has shown positive year-on-year growth. Exports rose by 1.3 per cent in the fourth quarter of 2013, and monthly data point to a continued positive trend. Among crisis countries, the export trend is strongest in Portugal and weakest in Greece. Improved competitiveness is contributing to the positive trend. According to the OECD's measure of unit labour costs, competitiveness has improved the most in Greece and Ireland, followed by Spain. Looking ahead, exports will be a more important driver of growth as **international economic conditions gradually improve**. We believe that exports will increase by nearly 4 per cent annually in 2014 and 2015.

GDP

Year-on-year percentage change

	2012	2013	2014	2015
Germany	0.7	0.4	1.8	2.1
France	0.0	0.3	0.8	1.4
Italy	-2.4	-1.9	0.3	1.0
Spain	-1.9	-0.1	1.1	1.7
Greece	-7.0	-3.9	0.1	1.5
Portugal	-3.2	-1.4	1.0	1.3
Ireland	0.2	-0.3	1.7	2.2
GIPS countries	-2.5	-0.7	1.0	1.7
Euro zone	**-0.7**	**-0.4**	**1.0**	**1.6**

Source: Eurostat, SEB

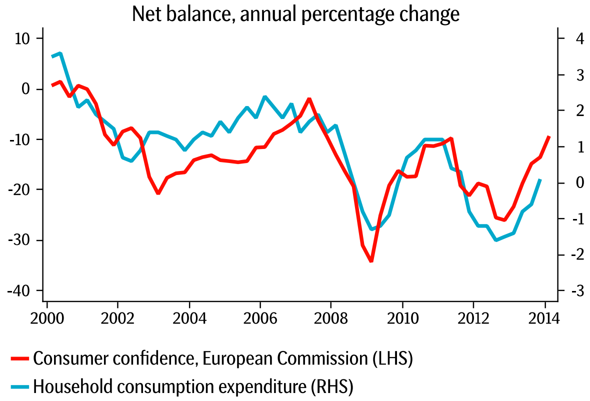
In the near term, **capital spending will be hampered by capacity utilisation that remains below the historical average**. Many businesses are waiting for a stronger recovery before approving large-scale investments. This is confirmed by a continuing decline in bank lending to non-financial companies. Improved business optimism should eventually lead to higher investments as production and exports improve. In addition, even during a lengthy economic slowdown, companies need to supplement existing capital stock. A slight upturn was discernible in the fourth quarter of 2013, when business investments rose by 1.1 per cent. Measured as annual averages, we believe that **capital spending will increase by 1.7 per cent in 2014 and 2.8 per cent in 2015**.

Household confidence is improving

After several years of weakness, consumption rose in the fourth quarter of 2013: the first upturn in two years. Retail sales climbed early in 2014 and more cyclically sensitive products such as cars also showed increases. Rising optimism, low interest rates, looser fiscal policies and the beginning of a slow decline in unemployment suggest that consumption will continue to rise slowly. After two years of declines, we expect an upturn of **0.8 per cent in 2014 and 1.3 per cent in 2015**. At the same time, important factors will limit future room for consumption. Continued high unemployment and a need to improve competitiveness suggest that pay increases will be low. **Real household incomes**, which have fallen during the past five years, will thus show a continued weak trend.

Consumption is increasing

Net balance, annual percentage change



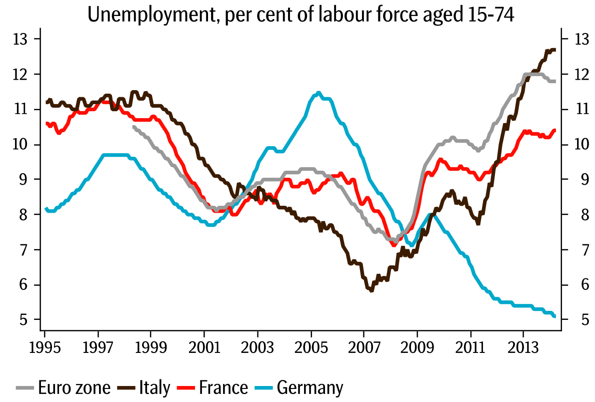
Source: Eurostat

Neutral fiscal policy, but high debts

The era of dramatic belt-tightening is over, and **euro zone fiscal policy will be largely neutral in 2014 and 2015**. Yet public finances remain under pressure due to an ageing population, the need to reduce debt ratios and remaining crisis-related measures in some countries. **The euro zone public sector deficit will shrink from 3.0 per cent of GDP in 2013 to 2.7 per cent in 2014 and 2.3 per cent in 2015**. Because of falling deficits, the public debt ratio will level out at about 96 per cent of GDP in 2014. Weak real growth combined with very low inflation will nevertheless hamper nominal GDP growth, contributing to continued high debt ratios.

German labour market continues to show strength

Unemployment, per cent of labour force aged 15-74



Source: Eurostat

Jobless rate falls slightly from record level

Unemployment has slowly begun to fall from a record level. The latest monthly figure was 11.8 per cent, down from a peak of 12.0 per cent in February-September 2013. In all GIPS countries, the jobless rate has now stabilised (in Greece at about 27 per cent) or begun to fall (Ireland, Portugal and Spain). More worrisome is that unemployment in Italy and France continues to rise. In March 2014, it reached 12.7 per cent in Italy (highest for decades) and 10.4 per cent in France (highest since 1999). Meanwhile the German labour market continues to perform strongly; the jobless rate has more than halved in the past decade and is now just above 5 per cent.

Because of weak growth in various countries, unemployment will remain at disturbingly high levels. At the end of 2014, unemployment will stand at 11.7 per cent. Measured as annual average, **unemployment will be 11.7 and 11.5 per cent respectively in 2014 and 2015**. Equilibrium unemployment has probably increased in recent years and is now estimated at around 9 per cent, but labour force participation has actually risen during the crisis: a trend that clearly diverges from the US.

Growth gaps creating political challenges

Different growth rates and increasingly divergent labour market conditions are creating tensions in the largest euro zone economies. The **German** current account surplus remains high, at around 7 per cent of GDP; combined with low inflation, this increases international pressure on Germany to adopt a more expansionary economic policy. With unemployment at its lowest in decades, room for cyclical expansion appears limited. Germany's relatively high government debt, 78 per cent of GDP, can also be cited as an argument against large stimulus measures, although the budget is in balance. Nor do we expect the CDU/CSU-SPD coalition to implement major changes in Germany's fiscal and EU policies. The reforms that the government has announced will be financed, and a small budget surplus will emerge during our forecast period.

The **French** economy seems to have rebounded slightly early in 2014, although President François Hollande is pressed by a weak economy and a shortage of reform ideas. However, there are signs of an **economic policy shift**. In January, ministers promised to cut public expenditures and household and business taxes. Since then the government has been reshuffled and a committee appointed by Hollande has recommended ways to improve the business climate. The ambition is to reduce the budget deficit from 4.3 per cent of GDP in 2013 to 3 per cent in 2015. The government has unveiled a cost-cutting package of EUR 50 billion, among other things by freezing social benefits and trimming health care and local government spending until 2017 to partly finance the proposed tax cuts. Hollande is thus trying to shift towards a more pragmatic policy, as President François Mitterrand did in the early 1980s after failed experiments early in his tenure at the Élysée Palace, but it is doubtful whether Hollande has enough authority to do this. His popularity is at record lows and local elections in March were a setback for his Socialist Party. Hollande is also squeezed between EU institutions that want lower deficits and elements of the Socialist Party that wish to stimulate the economy in order to drive up growth and public opinion figures.

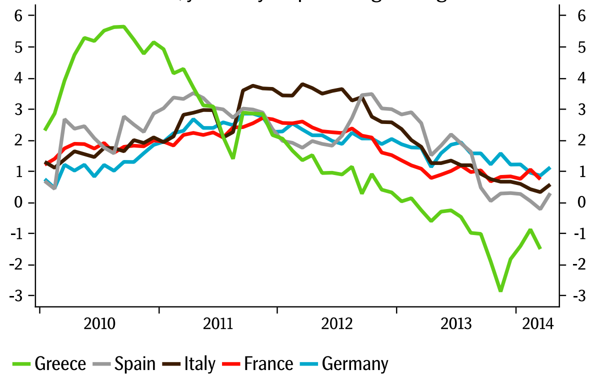
Late in 2013, **Italy** emerged from recession after nine quarters of negative GDP growth. The economy is slowly recovering; the PMI is above 50, and in April consumer confidence was at its highest since January 2010. Meanwhile there is a continued need for reforms, against a backdrop of rising unemployment and high government debt. The public sector deficit is just below 3 per cent of GDP and Prime Minister Matteo Renzi has signalled that the country will not seek relief from Brussels, but that reform efforts and deficit reduction will occur simultaneously. Renzi's reform agenda includes changes in the election system, more temporary employment openings, tax cuts for households and improved public sector efficiency. If the new government is to retain its public and parliamentary support, it is important that the country is moving in the right direction, especially in economic terms. In the short term, tax cuts may be popular, while structural changes in the labour market and public sector cutbacks may undermine support for the government.

The deflation risk has increased

Inflation is continuing to fall on a broad front in the euro zone. Deflation tendencies in several crisis-hit countries are keeping the average down, but inflation is also low and falling in countries like Germany and France. As a result, the regional average is well below the ECB's target. In the short term, there is some upside inflation risk due to rising food prices, but otherwise most factors suggest continued low inflation.

Inflation is falling on a broad front

HICP, year-on-year percentage change

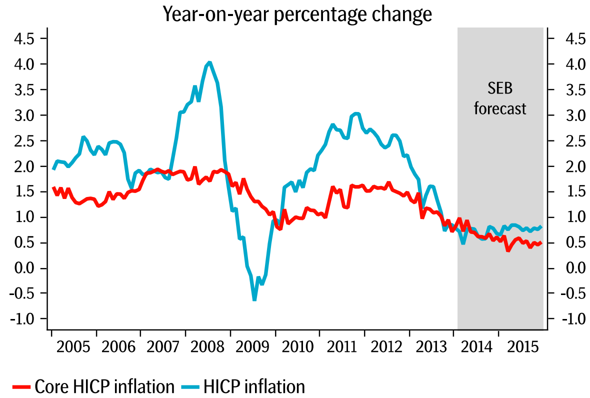


Source: Eurostat

Deflation risks have generally increased recently, illustrated by falling and worryingly low inflation expectations. Due to high unemployment, pay increases are slow. There is also a further need to improve competitiveness in many countries, although higher minimum wages in Germany are among factors pulling in the opposite direction. It is increasingly clear that an internal devaluation within the framework of the euro zone can hardly occur without broad deflationary tendencies when German inflation is as low as around one per cent.

Low inflation pressure

Year-on-year percentage change



Source: Eurostat, SEB

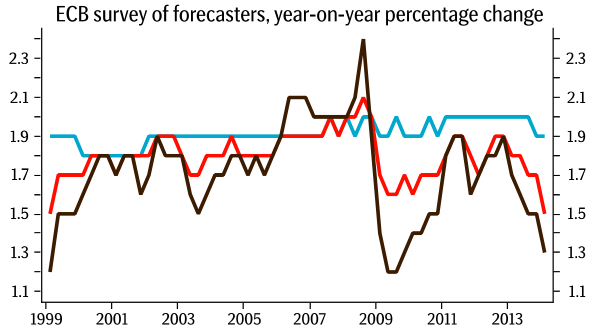
The ECB finally seems to be taking this problem more seriously and is calling attention to negative consequences of deflation. Aside from the depressionary spiral that may occur when consumption and capital spending are postponed, deflation reduces efficient resource allocation. It also increases the size of debts in real terms and undermines the effects of fiscal consolidation due to lower revenue. High real interest rates also worsen the outlook for a property market recovery. Assuming that the ECB undertakes the actions described below, we expect the region as a whole to avoid deflation, but inflation will end up well below the ECB's target in the near term. **HICP inflation will be 0.7 and 0.8 per cent in 2014 and 2015.**

ECB will be forced to take further steps

Recurring downside inflation surprises and falling inflation expectations have increased pressure on the ECB. Its repo rate cut in November has been followed by more words than deeds, but to avoid losing credibility the ECB will be forced into action.

Falling inflation expectations

ECB survey of forecasters, year-on-year percentage change



Source: ECB

Based on the policy speech held by ECB President Mario Draghi late in April, the challenges faced by the ECB can be divided up into three areas. Aside from the fundamental problem of maintaining confidence in the inflation target in a situation of large unutilised resources and strong disinflationary forces, Draghi highlighted the following areas:

Financial conditions in the euro zone risk becoming tighter. Falling surplus liquidity, due to the banks' LTRO loan repayments, have put upward pressure on short money market rates. The euro has meanwhile appreciated. The net effect is difficult to assess, since euro appreciation also reflects an increased appetite for assets in former crisis countries, which has meant an easing of financial conditions (lower spreads between countries, higher corporate bond and share prices).

A fragmented banking system is hampering the impact of the ECB's interest rate policy. Lending to non-financial companies is falling. The gaps between lending rates in different parts of the region remain wide, and small companies that are dependent on functioning bank financing dominate the business sector. The ECB's hope is that lower borrowing costs, combined with asset quality reviews (AQRs) and stress tests, will pave the way for stronger banks (see the theme article).

Given the existence of a bank-, rather than market-financed, economy, the ECB has so far chosen other mechanisms than the Fed and the BoE to stimulate the economy. Its conventional toolkit is now becoming exhausted. According to Draghi there is little room for action based on interest rates and our main scenario is that the ECB is finished cutting rates. A final step to 0.1 per cent, combined with a slightly negative deposit rate, cannot be excluded, for instance to counter an unwelcome strengthening of the exchange rate or, on the margin, put some further downward pressure on short-term market rates.

New liquidity injections (LTROs) are also conceivable, but due to reduced bank interest, the path towards powerful stimulus via loans to the banking sector is probably closed. The ECB is also investigating measures aimed at improving credit supply. One path is cheap loans to the banking sector connected to particular types of lending ("funding for lending"). Another is steps to stimulate increased market financing for companies by re-creating a market for asset-backed securities (ABSs).

However, the foremost tool to stimulate the economy and to counter a lower inflation outlook is, according to Draghi, quantitative easing (QE) in the form of unsterilised asset purchases. The ECB seems to prefer buying private assets (ABSs) to more directly influence corporate funding, but the volume of these securities is too small to make up more than a marginal portion of a QE programme. We thus believe that the ECB will mainly buy sovereign bonds, but it may express a readiness to buy ABSs once such a market has come into being.

We expect a decision in June in connection with new inflation forecasts from the ECB staff. According to unconfirmed reports in German media, the ECB has modelled effects of **EUR 1 trillion asset purchases** and estimated that such purchases could **boost inflation by 0.2-0.8 percentage points**. This EUR 1 trillion volume should be seen as a sample calculation, corresponding to nearly 10 per cent of euro zone GDP. It is less than half of the asset purchases made by the Fed and the BoE but enough to bring the ECB's balance sheet back to the same size as before LTRO repayments began and restore earlier levels of surplus liquidity. We believe the ECB may initially choose a more cautious path and to present a programme of monthly purchases EUR 40-50 billion for 12 months.

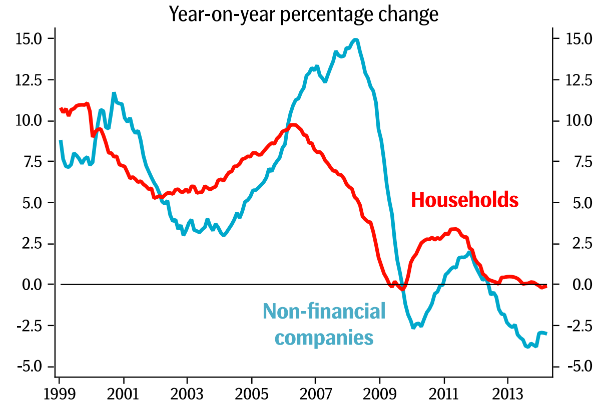
To avoid accusations of debt financing or the risk of removing incentives for consolidation, we believe that the ECB will buy **bonds according to each country's share of ECB equity**. This means that around a fourth of purchases will consist of German bonds. Although Germany does not need lower bond yields, a reduced supply of German sovereign bonds should also help lower yields and spreads on bonds in peripheral countries as well as generally boost demand for risky assets. **The effects on the euro currency are difficult to assess**: the ECB's actions may, for example, strengthen confidence in crisis-hit countries and thereby encourage further inflows into the euro via purchases of risk assets in the periphery. If the QE program is credible enough, it will most likely stabilise falling long yields and inflation expectations, and eventually put some upward pressure on German long yields as inflation expectations start to recover.

- **Euro zone credit cycle remains a major obstacle to economic recovery**
- **ECB supervisory responsibility and tests offer hope of increased banking stability**

A stable, well-functioning banking system is a **critical factor** in achieving a sustainable economy recovery in Europe. Today banks supply about **85-90 per cent** of lending in the European Union. Looking ahead, we expect this percentage – and thus also EU dependence on banks – to decrease as the corporate bond market evolves and deepens in terms of liquidity. But this is a process that will take time to complete.

Euro zone: Bank lending continues to shrink

Year-on-year percentage change



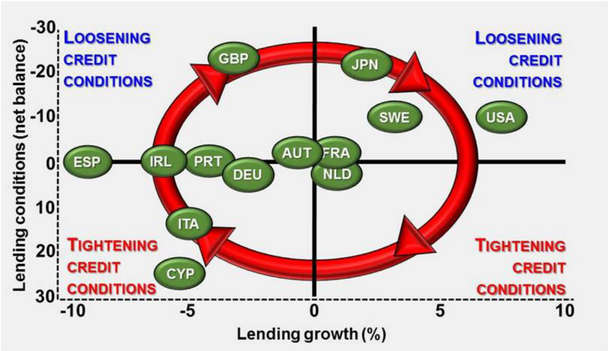
Source: ECB

Two factors have stood in the way of achieving the stability objective for the European financial system and eliminating the negative link between the balance sheets of banks and governments in crisis situations: ❶ partly flawed, nationally based, **divergent banking supervision** and ❷ **weak banks** in terms of capital adequacy and balance sheets.

On **November 4, 2014, the European Central Bank (ECB) will assume overall responsibility** – in collaboration with national authorities – for supervising some 130 banks, whose assets are expected to be equivalent to some 85 per cent of all bank assets in the euro zone; the exact number and names of the banks covered by this system will be announced by the ECB and the European Banking Authority (EBA) in September. The new Single Supervisory Mechanism (**SSM**) will be entrusted with harmonising national regulations, improving the quality of bank supervision, making it more competition neutral and reducing the risk of improper political interference on matters related to financial stability. This will include harmonising risk models and risk weighting and well as ways of dealing with doubtful receivables and provisions for possible loan losses.

A number of European banking systems are still grappling with weaknesses and credibility problems, although the scope of these problems scope has diminished somewhat – illustrated, for example, by weak or even negative lending growth (see above chart). This trend is partly an expression of **unwillingness to lend money** due to ongoing necessary adjustments in the balance sheets of the banking system in response to new regulations and requirements, as well as a weak growth environment. But it also reflects **low demand for money** by businesses and households for capital spending and consumption. In a number of countries, the credit cycle has thus not yet reached a stage where it can help to sustain economic recovery and growth.

"The credit cycle": credit conditions & lending growth



Since the financial crisis began, the **20 largest European banks have bolstered their capital by about USD 300 billion**. Increased confidence in banks has been evident from their rising share prices and shrinking credit spreads. But the stock of doubtful loans has also continued to increase. Today it totals about **EUR 800 billion**, according to IMF estimates, or twice the pre-crisis figure. There is a high probability that these doubtful receivables **will continue to increase due to over-indebted companies in various countries and weak economic growth**. Doubtful loans are not synonymous with loan losses, but EUR 800 billion is a high figure compared to the public financial safety net (the existing European Stability Mechanism and the EUR 55 billion Single Resolution Fund to be built up in the future). The requisite capital contributions will come from the private sector, if the need arises.

The dilemma and challenge to the ECB, national supervisory authorities and political systems is to try to speed up the task of repairing bank balance sheets without adversely affecting the credit supply. Meanwhile stress testing – which has been carried out twice earlier but in simpler form – must be tough enough to win credibility. Even though the banks are already in the process of strengthening their balance sheets, there are many indications that **further measures to strengthen the financial situation of individual banking institutions are necessary**. This will become evident in the coming months. The process that the ECB and the European banking system have now initiated will **help strengthen confidence in the financial system and facilitate economic recovery**.

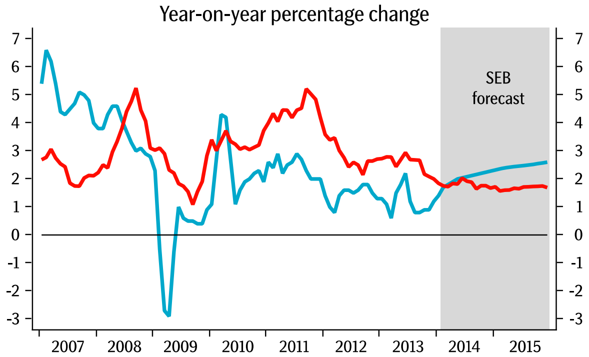
British economy ploughs ahead, firing on many cylinders

- **Favourable combination: high growth and lower inflation**
- **Unemployment down and wages up**
- **Home prices rise worryingly fast**

The British economy is continuing to move forward energetically. After another strong quarter, it is more than 3 per cent larger than a year earlier and the growth rate is the strongest since 2007. GDP remains 0.6 per cent below its 2008 peak but is likely to set a new record this quarter. **GDP will grow by 3.0 per cent this year and by 2.6 per cent in 2015**, a bit above consensus in both years. Meanwhile our inflation forecast is slightly below the average assessment. **Inflation**, which has fallen below the Bank of England (BoE) target for the first time since 2009, will continue downward to annual **averages of 1.8 in 2014 and 1.7 in 2015**. We are sticking to our prediction that the BoE will shadow the Fed and that **interest rate hikes will start in the summer of 2015**, around six months later than market pricing now indicates. By the end of 2015, the BoE's key rate will stand at 1 per cent.

Real wages growing again

Year-on-year percentage change



Source: ONS, SEB

Consumer confidence rose in April to a seven-year high. **Unemployment**, which has fallen below the BoE's 7 per cent threshold, **will continue down to 6.5 per cent in 2014 and 6.1 per cent in 2015, measured as annual averages**. Thanks to the increased number of self-employed people, there is rapid job growth; over the past year this group has accounted for nearly half the upturn and since 2008 a full three fourths. One reason why productivity growth is so weak might be that many of these entrepreneurs are under-employed, but **a tighter resource situation is gently pushing wages upward**. A combination of rising wages and falling inflation will lead to positive real wage growth for the first time since 2010. **The consumption upturn, averaging 2.3 per cent yearly in 2014-2015**, will thus rest on a more solid foundation.

The indicators also look promising in the business sector. The manufacturing PMI rose to 57.3 in April and seems headed towards a cyclical peak. In construction, the PMI looks even more cheerful at 60.8. **The composite index** – including construction, services and manufacturing – stands at 59.2. Combined with consumption indicators, this is **compatible with 4.5 per cent annualised GDP growth thus suggesting upside risks**. The broad economic recovery, driven by both consumption and capital spending, will thus continue. After last year's drop, **capital spending growth will average nearly 5 per cent** in 2014 and 2015, despite the stronger pound. One longer-term headache is the current account deficit, which grew to a high 5.5 per cent of GDP late in 2013.

While CPI inflation is slowing, home price inflation is high. Nationwide, home prices were 11 per cent higher than one year earlier – which is also helping to boost consumption because of wealth effects. The negative side is **mounting concern about a new home price bubble**, especially in London, where prices are at a record high and the year-on-year upturn is 18 per cent. The growing number of property-related IPOs, rapidly rising mortgage loan volume and the re-emergence of housing-related derivatives are signs that may justify raising a warning flag. However, it is unlikely that the frothy housing market will trigger earlier key interest rate hikes; a number of monetary **policy makers regard interest rates as a blunt instrument for keeping home prices in check**. Instead, various types of regulation may be imposed if the housing market threatens financial stability.

Yields on 10-year gilts (sovereign bonds) bottomed out at 1.50 per cent in 2012 but have since climbed to 2.66 per cent. We predict that they will keep rising to 3.20 by the end of our forecast period. This will also increase the interest expense on central **government debt, which will level off at just below 82 per cent of GDP in 2015**. The national budget deficit, which was 5.8 per cent of GDP last year, will fall to 4.1 per cent in 2015. Although the 2015 election is approaching, budget consolidation will thus continue. As for the referendum on Scottish independence on September 18, the winds are blowing in favour of the Yes side. Supporters of an independent Scotland are now 5 percentage points behind; last year they trailed by 20 points. **Our main scenario is that the No side will win the battle** but that Scotland will still be granted greater autonomy within the UK as a consolation prize.

Worsening Russia-Ukraine conflict will hurt growth

- **Continued gradual recovery in Central Europe despite geopolitical turmoil**
- **Ukraine: GDP slump in 2014 despite bail-out**
- **Russia: Stagnation this year**

Military and political tensions between Russia and Ukraine plus NATO and other Western countries have increased dramatically since Russia annexed Crimea in mid-March. Civil strife in Ukraine has escalated. This situation **looks set to last for a long time. The risk of trade war between Russia and the West (driven by the EU/US) has increased,** but the likelihood of a Russian military invasion of Ukraine or a cut-off of Russian energy deliveries remains relatively low. So far, EU/US sanctions – targeting key individuals in Ukrainian and Russian business and politics – have involved travel bans and freezing of bank assets; in late April, the US expanded these sanctions to certain companies connected to key individuals. Generally speaking, **both the West and Russia are highly reluctant to start a trade war**. The nascent euro zone recovery remains fragile and Russia is teetering on the brink of recession. There is also significant mutual dependence on Russian natural gas. About 30 per cent of this gas is sold to Europe, of which half is transported via Ukraine. Germany, for example, buys about a third of its natural gas from Russia; this dependence on Russia (though natural gas accounts for only some 20 per cent of Germany's energy supply) may partly explain why Berlin has so far kept a relatively low profile amid rhetorical threats of escalating sanctions. The US, which has little direct trade with Russia, has sounded more aggressive.

We expect **the Russia-Ukraine crisis to have a broadly negative economic impact across Eastern (including Central) Europe**. It is worth noting that both **Ukraine and Russia were performing weakly long before the conflict escalated**. In Ukraine, two years of zero growth and structural current account problems led to an acute crisis in late 2013. Russia has struggled with largely structurally driven deceleration in growth for some years. Growth is now slowing further due to military tensions and incidents that are hampering production and consumption in Ukraine, along with a decline in foreign demand and weaker investments in both countries. We also expect the geopolitical conflict and weakened Russian and Ukrainian growth to have **negative effects** on the rest of Eastern Europe, **especially nearby Baltic countries and parts of the south-east**. This adverse impact will occur not only via foreign trade but also via short-term setbacks in previously rising optimism and longer-lasting weakness in investment growth, especially in countries close to trouble spots. Eastern Europe's capital spending outlook was generally lukewarm even before the Russia-Ukraine conflict, partly due to modest capacity utilisation and still relatively tight credit conditions in some countries.

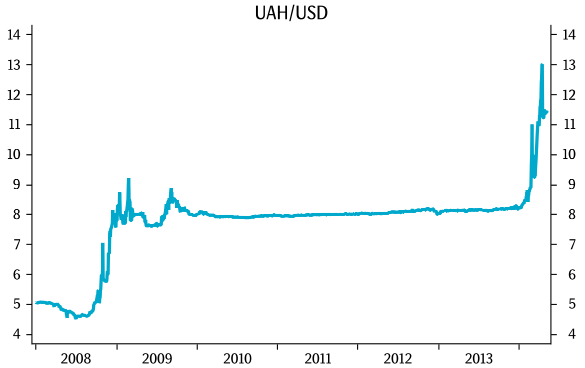
In our latest twice-yearly ***Eastern European Outlook* (*EEO*)** report, **published on March 26, 2014** – eight days after Russia's formal decision to annex Crimea – **we lowered our overall 2014-2015 growth forecasts for Eastern Europe, especially for 2014**. We made large downward adjustments for Ukraine, Russia and Estonia and pointed to a higher risk of short-term setbacks in individual countries because of geopolitical turmoil. Our *EEO* forecasts rested on three key assumptions: 1) the Russia-Ukraine conflict would not escalate militarily, 2) no large-scale trade sanctions would be imposed and 3) there would be no serious disruptions in Russian energy deliveries to Europe. Since then, military escalation has exceeded expectations, the conflict looks set to be more prolonged and the risk of trade war has clearly increased. We are thus **lowering our growth forecasts further for Ukraine and Russia, with minor effects on other countries too**, due to trade ties and even greater reluctance by foreign companies to invest in the two conflict countries and their surroundings.

In *EEO* we also argued that **the Russia-Ukraine conflict would not halt the economic upturn in Central Europe and in more southerly Eastern European countries**. We are sticking to this view. The gradual economic recovery that began in much of Eastern Europe during the second half of 2013 will continue. Individual countries have relatively minor direct trade ties to Russia and Ukraine – except for the Baltics, a number of former Soviet republics in Central Asia and Bulgaria, which receives a large share of its imports from Russia. A **continued economic upturn in Germany and Western Europe generally will partly offset lost exports** due to weak Russian demand. Eastern Europe's financial resilience has also improved as the euro zone economies and banking systems have stabilised over the past year. During the past two quarters, for example, Polish banks – which are mostly owned by Western parent banks – have begun to ease their earlier relatively tight credit terms. Meanwhile there are **good prospects of continued growth in private consumption**. Households will enjoy good real income increases, partly due to sharply depressed inflation but also thanks to labour market stabilisation. Interest rates will remain low. Some countries will loosen their fiscal policies. In the first quarter, GDP growth also improved in most Central European countries and several south-eastern countries. More notably, gradually rising domestic demand is increasingly connected to the nascent export-led economic upswing; this is especially true of Poland and is sustained by sound fundamentals.

Ukraine has ended up in an **acute crisis**, after two years of stagnation and accelerating current account deficits (to an unsustainable 9 per cent of GDP in 2013). Declining steel prices and weaker competitiveness have contributed to this imbalance, which in turn has drained the currency reserve. After repeated interventions in 2013 and an attempt at capital controls last winter, in February the central bank abandoned its USD peg and let the hryvnia float/fall freely; as early as autumn 2013 it allowed a very cautious "devaluation" from the previous UAH/USD 8.1 exchange rate. **The currency has fallen by nearly 30 per cent** to about UAH 11.50 per dollar (40 per cent at the worst). This is somewhat more than the nearly 25 per cent decline until the end of 2015 we assumed in *EEO*. We now believe that the currency will stabilise at around 11.50, but with a major risk of fluctuations also after the important May 25 presidential election.

Sharp depreciation in the hryvnia

UAH/USD



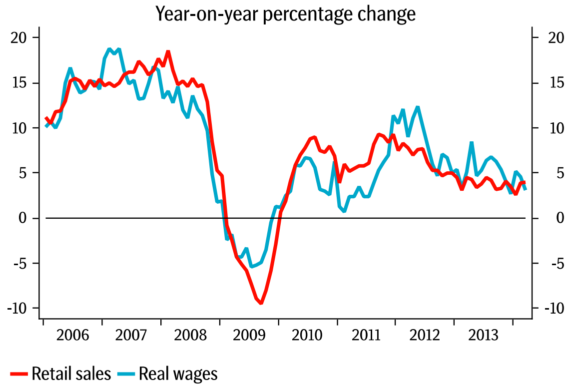
Source: Macrobond

This spring's decisions to grant Ukraine **bail-out loans** totalling USD 30 billion (mainly from the IMF and EU) **will help stabilise the currency, while removing the risk of a government default**. Meanwhile, **in exchange for the bail-out**, the IMF and EU are **imposing tough demands** in the form of reduced gas subsidies to households and businesses, smaller budget deficits and reforms in the energy and financial sectors. This will slow short-term growth but boost long-term potential. Hryvnia depreciation will also squeeze households in the short term via more expensive imports; inflation has climbed from zero at the end of 2013 to 3.5 per cent year-on-year in March. The banking sector is also affected; 35 per cent of private sector loans are in foreign currencies. Only over time will currency depreciation provide much-needed support to Ukraine's exports and thus its GDP growth. Nor is there any prospect of major upturns in steel prices this year. It **will take at least two years before the Ukrainian economy stabilises**. First quarter industrial production was down 5 per cent year-on-year. **We expect GDP to fall by 6 per cent this year and increase by 2 per cent in 2015.**

Russia's economic growth **continued to slow** in the first quarter to 0.8 per cent year-on-year and was down 0.5 per cent from the fourth quarter of 2013. But **developments in various economic sectors do not suggest any imminent growth collapse**, with the important exception of a continued decline in investments and accelerating capital outflows (to USD 60-70 billion in Q1 2014, as much as during all of 2013). There was a slight deceleration in the growth of industrial production from the fourth quarter, while retail sales growth was unchanged at 3.5 per cent. Rising real wages and a strong labour market, with unemployment somewhat below equilibrium, are sustaining private consumption. Looking ahead, however, real wage growth (6 per cent in March) is expected to slow because of slightly rising inflation in the wake of rouble depreciation (by nearly 10 per cent against the USD/EUR basket this year). Indicators suggest continued economic weakness but no slump. For example, manufacturing PMI remained stable at 48, a bit below the expansion threshold, in January-April.

Good real wage growth is sustaining consumption

Year-on-year percentage change



Source: Russian Federal State Statistics Service

We expect the **Russian economy to stagnate completely this year and grow by 1.2 per cent in 2015**, well below its 2-3 per cent potential. **The risks remain on the downside** due to the Ukraine conflict. Continued large capital outflows and even weaker investments may lead to recession this year. Inflation will be 6.5 per cent this year and 6.0 per cent in 2015, or 0.5 percentage points higher than in our *EEO* forecast in March. In the short term, growth will be hampered by the falling rouble and stock market, in the long term by a persistently weak investment trend. We expect the rouble to fall a bit further. **Crucial to our GDP forecast is that energy prices remain stable**, in line with our projections: we expect Brent crude oil to fall only slightly, from about USD 106 to USD 100/barrel next year. This will provide continued support to the economy – and thus to households and private consumption – even though a somewhat higher level, about USD 110/barrel, is needed to balance the budget. Three fourths of Russia's exports and half of tax revenues are energy-related. We also predict some fiscal stimulus measures, focusing on infrastructure investments. In the short term, low public debt and a strong currency reserve will protect the Russian economy, but within a couple of years the country will be heading towards twin deficits (budget and current account) due to downward pressure on energy prices as increased global shale gas and oil extraction affect commodity prices. If oil falls towards USD 80/barrel, Russia will end up in a very tight situation, with a clear recession and a budget deficit approaching 5 per cent of GDP.

Squeezed by nearby crisis via several channels

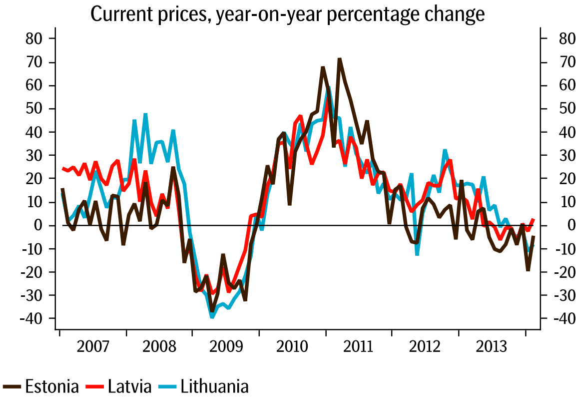
- **Weaker exports, transit trade, investments**
- **Resilient thanks to strong real wage growth**
- **Lithuania will get green light for euro**

The Russia-Ukraine conflict has led to further downward adjustments in our GDP forecasts for Eastern Europe (see page 27). We expect it to have a **relatively big impact on growth in the Baltic countries. It also risks having long-term negative effects on investments**. This is because of extensive Baltic-Russian trade and elevated geopolitical uncertainty in the region. Tourism, which is relatively important to the Baltic economies, is only expected to suffer minor setbacks. We are lowering our GDP forecasts for Lithuania and Latvia by 0.3 and 0.4 percentage points in 2014, respectively, and by 0.2 percentage points in 2015, compared to March's *Eastern European Outlook*. We are also lowering our 2015 forecast for Estonia - which is highly dependent on exports - by 0.2 points while leaving our already depressed 2014 forecast unchanged. **We expect Estonia's GDP to increase by 0.5 per cent in 2014 and 2.3 per cent in 2015. Latvia's growth will reach 2.5 and 3.2 per cent, respectively. Lithuania's GDP will grow by 2.7 per cent in 2014 and 3.8 per cent in 2015**. Potential growth is about 3-3.5 per cent. Our forecasts remain well below consensus. Lithuania will weather external weakness and uncertainty better, partly because it is well positioned for a clearer recovery in domestic demand, something that has been under way in the other Baltic countries for a few years. Its expected euro zone accession in 2015 is also likely to provide an extra impetus for investments; the country is also moving towards reducing its trade ties with Russia. Starting in 2015, a newly constructed gas terminal will allow Lithuania to eliminate its current 100 per cent dependence on Russian gas.

The Baltics will be squeezed by the Russia-Ukraine conflict via export and investment channels. The **export effect** will occur **via the countries' direct exports and large-scale transit trade with Russia**. The Baltics stand out in Eastern Europe for the large share of their exports going to Russia: Estonia 13 per cent, Latvia and Lithuania 18-19 per cent. For the latter two, Russia is their single biggest market. Trade with Ukraine is very small. Estonia also has extensive trade with Finland, the Western country with the biggest exposure to Russia. Since last summer, Baltic exports have shown a weaker trend. Although export growth has stabilised in the short term due to the upturn in the West, economic weakness in Russia and vicinity will hamper recovery this year. According to anecdotal information, several Estonian transit companies have noticed a clear slowdown in Russia goods transport traffic so far in 2014, partly because the weaker rouble has made imports more expensive for Russia. There are reports that Latvia has got more transit trade due to redirection from Ukraine. Baltic companies will also probably try to redirect part of their exports elswhere, as during earlier international crises.

Exports squeezed even before Ukraine conflict

Current prices, year-on-year percentage change



Source: National statistical offices

Investment growth faces the same headwinds. In Estonia, public investments were already pushed down to negative growth in 2013 due to lower EU funding. The geopolitical crisis will hamper investments, probably even after the acute crisis. Credit conditions will also probably tighten somewhat due to greater geopolitical uncertainty.

Meanwhile the Baltics have **buffers that support GDP growth** and make **the risk of recession small. Strong real wage growth** of about 4 per cent this year, and in Latvia and Lithuania even lower unemployment, **will help sustain continued stable growth in private consumption**. Nominal pay increases will remain relatively high, and prevailing near-zero inflation rates will transition to weak price increases in the next couple of years. Consumer optimism is historically high after rising in recent years. The EU confidence indicator in Estonia and Latvia rose in April, despite escalating turmoil in Ukraine. Additional strengths that provide **financial resilience** are small current account and public budget deficits; public sector debt is very low in Estonia and moderate in Latvia and Lithuania. Estonia's new coalition government has embarked on an expansionary fiscal policy that will help sustain consumption in 2014-2015. Exchange rate risk in **Lithuania** is also on its way to disappearing, since the country will probably **join the euro zone in 2015**, according to plan. It is expected to meet the convergence criteria by a wide margin in the upcoming EU/ECB evaluation report. A formal go-ahead from the EU on euro zone membership will then come this summer.

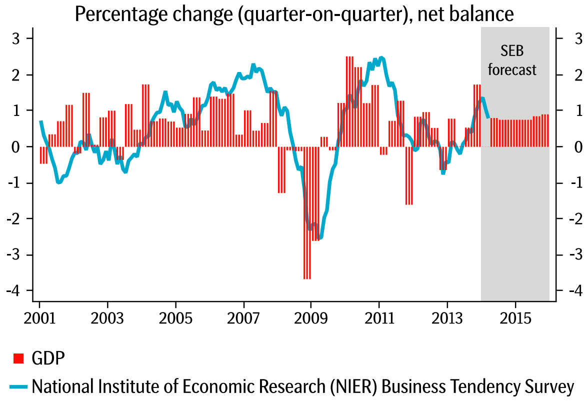
Low inflation is putting pressure on the Riksbank

- **Gradually stronger growth**
- **Weak export recovery**
- **Persistently low resource utilisation**
- **Inflation far below Riksbank target**
- **Riksbank will cut key rate to 0.25 per cent**

Economic signals have recently been mixed. The GDP figure for the fourth quarter of 2013 was unexpectedly strong, but meanwhile optimism has fallen among both businesses and households. Indicators suggest that the recovery will continue but that the fourth quarter upturn exaggerated the underlying trend. We believe that **GDP will grow by 2.7 per cent in 2014 and 3.1 per cent in 2015**: largely unchanged since our forecasts in February's *Nordic Outlook*. Growth will be driven primarily by rising consumption and residential construction, while the export outlook is more mixed.

Indicators point to decent growth

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



Source: Statistics Sweden, SEB

Job creation is relatively rapid, but an **increased labour supply has contributed to unexpectedly high unemployment** in recent months. Looking ahead, indicators point to continued job growth, while labour force participation will probably level out. Unemployment will then gradually fall from today's level of around **8 per cent to a little over 7 per cent by the end of 2015**. Resource utilisation will remain low. Combined with weak international price pressure, this will lead to very low inflation. CPIF (CPI excluding interest rates) will be far below 2 per cent both in 2014 and 2015.

The Riksbank has clearly signalled that the **inflation trend will become increasingly important to monetary policy** as deflation risks have grown and the main responsibility for macroprudential supervision now lies with the Financial Supervisory Authority (FSA). We predict that the Riksbank will **cut the repo rate to 0.5 per cent in July** due to downward revisions in its inflation forecasts. Falling inflation expectations will probably also force reassessments of the longer-term inflation outlook as the ECB's quantitative easing begins to have an impact. The Riksbank will thus remain under pressure. We believe that **a further key interest rate cut to 0.25 per cent will occur in October this year**.

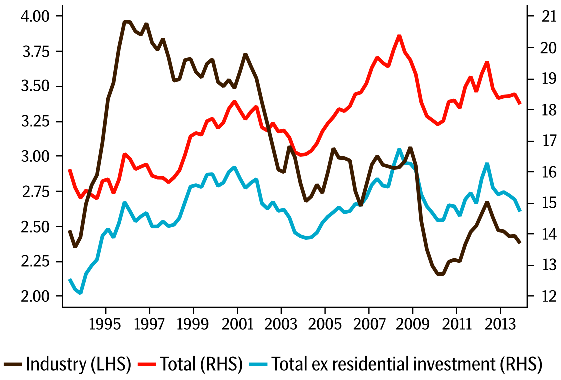
Weak export recovery

The recent pace of recovery in the manufacturing sector has again been disappointing, but a slight upturn in production and export data for early 2014 is discernible. Forward-looking indicators suggest that this upturn will gradually strengthen. A somewhat weaker krona and relatively robust demand in important export markets such as Denmark, Norway and Germany will help sustain this trend. Due to a weak recovery in the global economy, however, **export growth will reach only 3.7 per cent**: below the historical norm during recoveries. The Ukraine crisis is a risk factor. Although Swedish exports to Russia are less than 2 per cent of total exports, indirect effects via weaker demand in key markets may worsen the situation.

The manufacturing recovery rests on shaky ground, as confirmed by the cautious approach of many companies towards capital spending. We expect a **weak upturn in manufacturing sector investments** this year, although surveys actually suggest an unchanged level. In a longer perspective, investments by manufacturers have shown a declining trend relative to GDP. The level has fallen during slowdowns and has then only recovered partially during upturn phases in the economic cycle. Manufacturing investments thus show the same downward structural trend as manufacturing employment over the past 20 years (see theme article).

Total capital spending as a share of GDP, however, is at a relatively high level compared to the average for the past two decades. This is partly due to rising residential construction, although it has been low for a long time in an international perspective and is far from sufficient to meet rising demand. Housing policy thus faces major challenges. Yet the scale of today's construction is large compared to the extremely depressed level that has generally prevailed since the crisis of the early 1990s. The number of housing starts indicates that investment volume will increase by 15-20 per cent this year. In addition to increased new construction, repair and renovation activity has climbed, partly due to the extension of the tax deduction for such work a few years ago.

New homes boost total investment
Per cent of GDP



Source: Statistics Sweden

Continued consumption upturn is likely

Household consumption has held up relatively well in recent years, and several factors now suggest that **an acceleration is now on its way**. Good real income increases – driven by low inflation, tax cuts, rising employment and rising household wealth attributable to the upturn in home and share prices – are providing support. We anticipate that the **increase in consumption will gradually accelerate from 2.0 per cent in 2013 to 2.7 per cent this year and 3.0 per cent in 2015**. Certain trends towards higher consumption are already discernible in monthly consumer data, including new car registrations, but in recent months a reversal in consumer confidence has indicated that households are still not convinced the economic upturn will be strong. We thus believe that given continued uncertainty about international economic conditions, households will maintain a high level of saving.

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	2.8	3.4	1.9
Savings ratio, % of disp. income	12.2	12.2	12.6	11.6

Source: Statistics Sweden, SEB

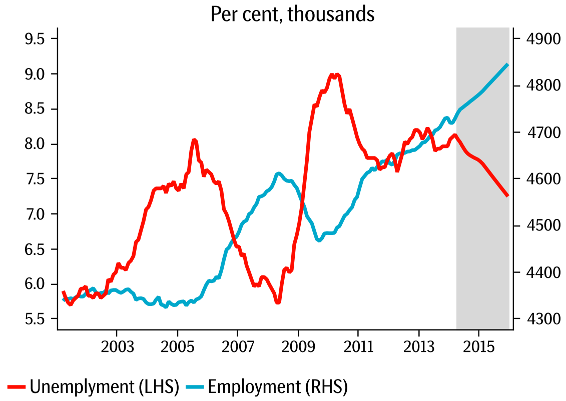
Home prices rose by nearly five per cent in 2013. According to certain price indices, the upturn has shown signs of **accelerating early in 2014**. Prices of cooperative flats in Sweden's three largest metropolitan areas have climbed by more than 10 per cent. SEB's home price indicator also suggests that these price increases will continue. Our assessment is that prices will increase by about 5 per cent this year and then level out in 2015. Recent trends suggest that the risks are on the upside.

Despite rising home prices and increased construction, **lending to households has risen more slowly than expected**; the year-on-year increase has only climbed from 4.5 per cent in mid-2013 to 5.1 per cent at present. The correlation between lending, on the one hand, and home prices and construction volume, on the other, thus seems to have changed compared to the pre-crisis situation. The introduction of loan-to-value ceilings and other rule changes, plus a sharp downturn in conversions from rental units to tenant-owned cooperatives, are probably major reasons behind this trend.

Stubborn unemployment will fall

Unemployment has shown continued upside surprises, and the predicted downturn may again have to be postponed. **Job creation continues at a healthy pace**, which means that unemployment is being sustained by a **sizeable influx of labour**. Looking ahead, there are many indications that job creation will actually accelerate somewhat, as the upturn in the labour supply slows. Immigration remains high, but the downturn in the number of people on long-term sick leave and with disability pensions is starting to level out. Due to changes in job creation and labour supply trends, we believe that unemployment will soon begin to fall. Also supporting this forecast is that the jobless rate according to Public Employment Service statistics began to show a downward trend late in 2013. **Towards the end of 2015, we foresee unemployment of 7.2 per cent**: an upward revision from our earlier forecasts due to a larger labour supply.

Labour market will continue to improve
Per cent, thousands



Source: Statistics Sweden, SEB

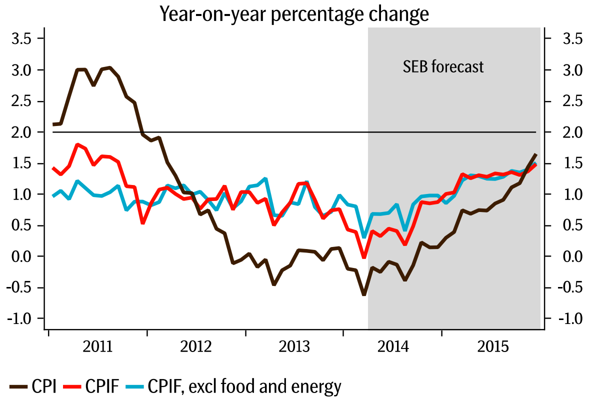
Unemployment will thus remain high throughout our forecast period. It is not easy to estimate how far the jobless rate can fall without the emergence of labour market bottlenecks and inflation pressure. The Riksbank shows a certain resignation on this issue by stating a very large uncertainty interval for equilibrium unemployment. A substantial part of the unemployed have weak ties to the labour market: for example immigrants with poor language skills, young people lacking secondary school qualifications and those previously on long-term sick leave. Partly as a result of this, the **equilibrium unemployment level may have increased somewhat**. But at present there are no signs of bottlenecks; instead most indications are that the resource situation is far below normal. Given the labour market policy ambition of the non-socialist Alliance government – to widen the gap between working income and social insurance benefits, thus creating incentives to work – equilibrium unemployment may have fallen. A more mobile labour market in Europe also makes early signs of bottleneck problems less likely, especially in light of generally high unemployment in the euro zone. For example, Norway (which is not even an EU member) has managed to maintain its job creation level over a very long period, with unemployment at around three percent, without any major resource utilisation or inflation problems, which shows the importance of this factor.

Inflation far below target

CPIF inflation fell to zero in March, and **core inflation** (CPIF excluding energy and food) fell to 0.2 per cent; both readings are on a par with **historical lows**. These figures confirmed a **long-term trend of downside surprises**, although it is also possible to single out temporary factors that pushed down the inflation level more than usual in March.

CPIF well below 2 per cent

Year-on-year percentage change



Source: Statistics Sweden, SEB

The inflation slowdown is broad and **is mainly attributable to domestic goods and services**. Downward pressure from international food and energy prices is also contributing to low inflation, but the decline in prices of imported goods is generally in line with the historical average. There is reason to believe that inflation has now bottomed out, although we expect continued very low inflation pressure both this year and next. Temporarily depressed prices for tourist services will probably boost inflation by a few tenths of a percentage point in April, but the seasonal pattern is difficult to estimate. Petrol prices have also been raised, partly due to a weaker krona.

Underlying inflation has probably also bottomed out, but it is difficult to predict the timing of any rebound. In the near future, exchange rate fluctuations will be the most important driver, as the effects of krona depreciation over the past 12 months increasingly take over following the earlier krona appreciation. We estimate that the exchange rate will boost inflation by 0.3-0.4 percentage points this year.

The outlook for wage-driven inflation is more unclear. We expect pay increases to accelerate gradually, but a recovery in productivity will have the opposite effect. The outlook for international prices is also mixed. Agricultural commodity prices have risen in recent months, and we expect them to affect Swedish CPI inflation by late 2014. International inflation on more processed goods is still showing a downward trend. Overall, we expect CPIF inflation to accelerate to nearly 1.5 per cent by the end of 2015. Given underlying resource utilisation, pay, productivity and inflation expectation trends, it is **difficult to find any strong reasons why CPIF inflation should climb to the Riksbank's 2 per cent target within the foreseeable future**. Since we expect the Riksbank to continue lowering its key interest rate, downward pressure on mortgage rates will squeeze CPI inflation to a somewhat greater extent than we had previously anticipated.

One upside risk is that the international economic upturn may lead to higher prices for energy and other commodities, but the risk picture is symmetric in this area. For example, forward prices for energy are currently somewhat lower than assumed in our forecast. One **domestic upside risk for CPI is the Social Democratic Party's ambition to restore full value-added tax (VAT) on restaurant bills and possibly also limit tax deductions on household-related services and home renovations** if elected in September. These tax changes would boost CPI inflation by more than half a percentage point. Because of uncertainty as to whether and when these proposals will be implemented, we have chosen not to include them in our CPI forecast for the time being.

Inflation increasingly important to repo rate

Inflation trends have become more and more important to Swedish monetary policy. In part, this is **a logical consequence of the shifted responsibility for macroprudential supervision to the FSA**. The Riksbank is only one of several bodies represented on the new Financial Stability Council, which held its first substantive meeting in May. Looking ahead, the Riksbank's responsibility for financial stability may also have some impact on interest rate policy, but in this new situation the Riksbank seems to be having difficulty clarifying in what way. For example, the sensitivity analysis presented in its Monetary Policy Report showed that **changes in the repo rate have only marginal effects on household borrowing**. Although the Executive Board has internally discussed the reliability of this analysis, it weakens the Riksbank's chances of justifying a more cautious interest rate policy out of concern about lending. Another way of bringing together the inflation target with financial stability has been to present risk scenarios in which rapid inflation upturn to target level may create overheating problems and threaten financial stability in a way that, in a later stage, may generate deflation. Our view is that this type of scenarios is a bit too speculative and has too little support in empirical experience from deflation spirals in other countries to play any role in justifying interest rate policy.

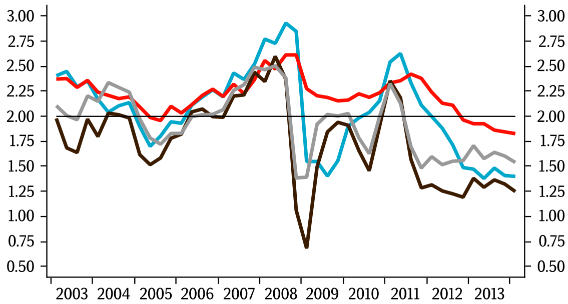
The continued inflation slowdown and the recurring need for downward revisions in the inflation path have naturally also contributed to an increased focus on inflation. The minutes of the Riksbank's April monetary policy meeting clearly shows that **long-term low inflation is at the top of the problem list for most Executive Board members**. Because of the low CPI figure for March, the **repo rate is very likely to be lowered to 0.50 per cent in July**.

But we do not believe that the Riksbank will stop there. In a number of ways, criticism of the central bank's unwillingness to cut its key rate and combat unemployment and deflation risks has been unfair and marked by exaggeration. Yet we are probably moving into an environment where there will be major re-appraisals of inflation forecasts and risk assessments.

If the ECB implements unconventional monetary policy measures, this will put pressure on the Riksbank and **worries about dangerously low inflation cannot be dismissed in Sweden** either. Assuming that CPIF inflation remains below one per cent and long-term inflation expectations gradually fall, **pressure for further key rate cuts will persist**.

Falling inflation expectations

Per cent



Source: The Riksbank, Bloomberg, SEB

The Riksbank's medium-term inflation forecasts will increasingly **be questioned** and compared to other forecasters. The Riksbank could previously maintain that stable inflation expectations provided a solid basis for forecasts that its inflation target would be met within 2-3 years. But falling inflation expectations undermine this argument. The Riksbank's projection of rising inflation rather one-sidedly assumes that businesses will be able to increase their margins as the economy improves, compensating themselves for earlier cost increases – implying significant downside risks to its forecast. This bias will probably be pointed out more and more clearly by the Executive Council's doves, and other members will find it difficult to defend their views. In order to maintain confidence in its inflation target, the Riksbank will probably need to adopt a more symmetrical approach to wage formation and the role of the exchange rate in the inflation process.

Overall, we believe that this will be **sufficient to bring about a further key rate cut to 0.25 per cent in October 2014**. If there is a downside surprise in economic conditions, the Riksbank may even consider unconventional monetary policy measures. The Riksbank will then keep the policy rate unchanged for a year until a cautious hiking cycle begins; in **October 2015 the key rate will be increased by 25 basis points**. We expect another 25 basis point hike in December bringing the repo rate to 0.75 per cent at the end of 2015.

Shrinking yield spread against Germany

The yield gap between Swedish and German sovereign bonds has narrowed since late 2013. The Riksbank's key rate cut in December, combined with expectations of a further rate cut, has been the dominant driving force. A rate cut in July will probably contribute to a continued narrowing of the spread against Germany, and if our forecast of another Riksbank rate cut by October proves correct, downward pressure on the spread will continue during the second half of 2014. During 2015, Swedish yields will rise more than their German counterparts, since expectations that the Riksbank will hike its key rate before the ECB does so will have a greater impact. Compared to our earlier assessment, however, we have adjusted our forecast downward for this time frame as well.

SEK will reach 9.25-9.30, then rebound

During the past year unexpectedly low inflation has led to looser monetary policy, contributing to a weakening of the krona against most other currencies. There are many indications that interest rate policy will remain the most important driver during the next six months. According to our forecast, there is a high probability that the Riksbank will carry out a further key rate cut, beyond the rate cut in July that has already been priced in. This would push down the krona further, since international market players would probably continue to be net sellers of the SEK. Our short-term equilibrium exchange rate models indicate that the EUR/SEK will weaken to 9.25-9.30.

The underlying flow situation is fundamentally rather positive, however, since Swedish exporters are expected to increase their krona purchases as the economy improves. In addition, net krona sales by international investors in the near future will be governed by short-term position-taking and will not reflect a need to reduce the krona-denominated portion of currency portfolios. We believe that the krona will bottom out during the third quarter of 2014. During the fourth quarter, the krona will begin a recovery. At the end of 2014, the EUR/SEK rate will stand at 9.00. In 2015 the krona will continue to be sustained by stronger economic conditions. Comparative monetary policy will also eventually contribute to krona appreciation, due to the ECB's quantitative easing and expectations that the Riksbank will begin hiking its key rate significantly earlier than the ECB. However, we have revised our long-term estimate somewhat and expect that the EUR/SEK rate will be 8.60 at the end of 2015. The USD/SEK rate will stand at around 6.70 at the end of 2014 and 2015. In terms of the KIX effective exchange rate index, the krona will stand at 101.6 at the end of 2015.

Public finances

Per cent of GDP

	2012	2013	2014	2015
Net lending	0.2	-1.4	-1.5	-0.5
Gen. gov't gross debt	38.2	41.5	41,7	40.6
Central gov't debt	32.3	35.3	35.9	34.7
Less onward lending	29.0	29.3	30.0	29.1
Borrowing req., SEK bn	25	131	65	20

Source: Statistics Sweden, SEB

Stable debt ratio, despite deficits

Sweden's public sector deficit was 1.4 per cent of GDP in 2013, mainly attributable to the central government. The deficit will remain unchanged this year, with a weakly expansionary fiscal policy including tax cuts of SEK 15 billion for households will be offset by stronger economic conditions. **The deficit will shrink to 0.5 per cent of GDP in 2015** as the economy strengthens further. Due to uncertainty about what economic policies the government will pursue after the election, there are certain risks to central government finances in the longer term. At the same time, it is **easy to underestimate the impact of stronger economic conditions on public finances**. Our forecast implies that **central government debt**, adjusted for temporary loans of nearly SEK 200 billion to the Riksbank's currency reserve, will remain **stable at around 30 per cent of GDP this year and next.**

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New political landscape after the election

Over the past 15 years, political changes in Sweden have not been a big issue for financial markets. Immunity to political uncertainty has gradually strengthened, due to stable inflation, strong government finances and sizeable current account surpluses. Broad support for today's official economic policy framework, including expenditure ceilings and budget surplus targets, has been a guarantee against overambitious reforms. **By most indications this stability will persist, but the political system will be sorely tested in the coming year**. As September's parliamentary election approaches, many changes are conceivable, such as a new government, untested governing coalitions, new party leaders, blurred lines between the political blocks, parties leaving or entering Parliament and a kingmaker party that no one else wants to work with.

There are also a number of concrete political challenges. The Alliance government – Moderates (M), Liberals (FP), Centre (C) and Christian Democrats (KD) – has pursued a labour market policy based on creating financial and other incentives to work. This has increased the labour force and job creation, but high unemployment will probably be the most important campaign issue. Various other issues have attracted renewed interest, such as **privatised social welfare services, taxes, housing, integration of immigrants, schools, defence and energy supply**. So far, the parties have been reluctant to unveil long-term plans in various fields. Minor policy details or budget quibbles have taken up a lot of space in public discourse, perhaps making it harder to achieve political breakthroughs on difficult issues after the election. But the campaign has just begun and the election is still four months away.

Alternative governments after the 2014 election

	S+MP	S+MP +V	S+MP +FP	Alliance +MP	S+M
Support,%	43.3	51.9	49.1	40.5	57.2
Probability	High	High	Medium	Low	Low

Source: Svensk väljaropinion (a poll of polls), SEB

Public opinion polls are clearly pointing to a change of government. At present, most voter surveys also indicate that the "red-green" parties – Social Democrats (S), Greens (MP) and Left (V) – will win a majority in Parliament, but the gap between the Alliance and red-green blocks normally narrow as the election approaches. Whether the populist anti-immigrant Sweden Democrats (SD) gain a kingmaker role will depend, among other things, on whether the Centre and/or Christian Democrats attract the 4 per cent of voters needed to retain seats in Parliament. At present, we believe that a Social Democratic-Green coalition is the most likely governing constellation, although a three-party government including the (ex-Communist) Left Party is not far behind.

A Social Democratic-led government would face new political challenges. The party's leading duo, Stefan Löfvén and finance spokesperson Magdalena Andersson, have neither served in a government nor in Parliament: a lack of experience that may affect the work of the government, at least initially. Ruling in a coalition with parties to their left will also be a completely new experience for the Social Democrats. If a red-green government should run into internal problems or have trouble functioning in a parliamentary situation where the Sweden Democrats have a kingmaker role, other combinations may be considered. The most natural might be a government that includes the Social Democrats and Liberals. **A grand coalition of both Social Democrats and Moderates or a coalition between the Alliance parties and Greens may also be considered**, but probably only after a new election.

The Social Democrats and Greens have presented policies that, compared to the Alliance, would channel more money into social welfare services and make large investments in infrastructure and the labour market. In addition, unemployment insurance and sick leave benefits would be raised. These reforms would be financed by higher income and excise taxes, removal of the rebate on employer-financed social insurance fees for young employees and removing the reduction in value-added tax on restaurant purchases. **Even looking at Alliance policies, we have apparently reached the end of the road in terms of new tax cuts for the foreseeable future**. Red-green policies may have more impact on short-term growth, but so far the Alliance's policies have had good effects on the supply side of the economy and thus on long-term growth capacity.

Looking ahead, broad public support for continued strong central government finances will continue to have a stabilising effect on the Swedish economy. This applies, for example, to the surplus target for public finances (1 per cent of GDP over an economic cycle). **But it is reasonable to believe that a discussion of the surplus target will be initiated after the election, in light of Sweden's low central government debt**. Regardless of where this discussion leads, it is important that official policy be designed in a way that provides predictability and ensures a broad parliamentary consensus on future economic policy rules of the game.

Theme: Swedish merchandise exports lag Germany

- **Manufacturing employment trending lower**
- **Hard to compete with German automakers**
- **Sharp rise in Swedish service exports**
- **Continued large foreign trade surplus**

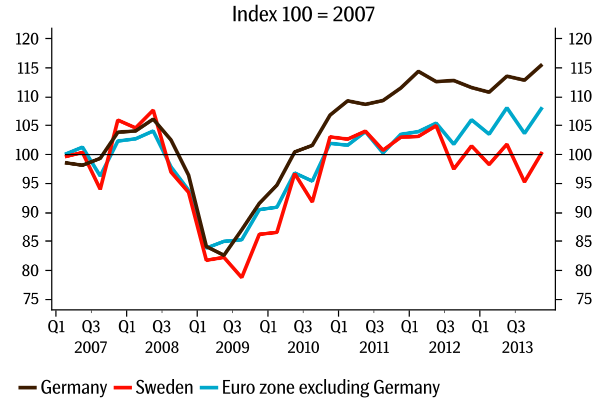
After recovering quickly from their decline during the financial crisis, Swedish exports have been fighting an uphill battle during the past 2-3 years. **This is in striking contrast with Germany**, whose merchandise exports have continued to grow in recent years. **It is also reflected in manufacturing sector employment**, which has only shrunk slightly in Germany over the past five years while it has fallen more than 15 per cent in Sweden; manufacturing employment and merchandise exports have instead more closely tracked the euro zone countries excluding Germany. **Weak merchandise exports are partly offset by a 15 per cent increase in service exports since 2007**. Although in percentage terms this is less than half of the upturn for Germany, Swedish service exports make up twice as large a share of the economy, so the contribution to GDP growth is of the same magnitude in the two countries.

Downward trend in manufacturing jobs

The pattern of a rapid decline in manufacturing employment during an acute crisis, followed by an inability to recover lost ground, also characterised the early 1990s and the IT (dotcom) crash at the turn of the century. During these periods, however, the pattern in Germany was similar to that in Sweden. Germany's better performance than Sweden's this time around is largely due to the continued expansion of the German automotive industry, even though nearly all other European automakers have been in dire straits. A strong Swedish currency has probably also played a role, but in that case the recent depreciation of the krona should create opportunities to shrink the gap with Germany.

Swedish merchandise exports lagging behind

Index 100 = 2007



Source: Eurostat

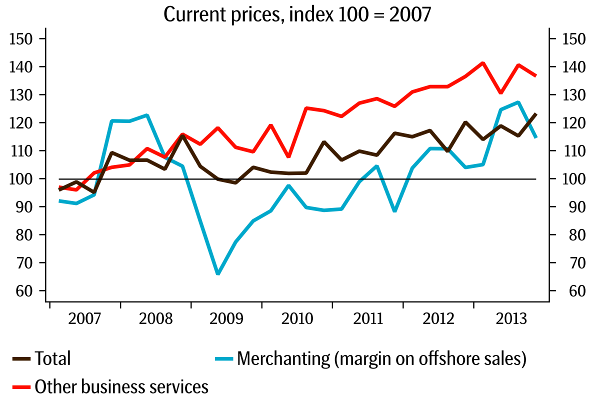
Despite the decline in manufacturing employment, it appears that **Sweden has succeeded in maintaining its competitiveness relatively well**. Merchandise exports and manufacturing employment has mainly kept pace with the euro zone excluding Germany, which is not as negative as it may sound. Weak GDP in these countries is mainly due to falling domestic demand. Merchandise exports from Sweden and from the euro zone excluding Germany are now at about the same level as in 2007. Due to a steady upturn in service exports, Sweden's total exports are now more than 5 per cent higher than in 2007.

Continued large trade surplus

Largely due to increased service exports, **Sweden continues to show a foreign trade surplus of 5-6 per cent of GDP**. This surplus is a bit lower than it was a decade ago, but it is still high in international terms. Not until early 2013 did Germany begin to show larger trade surpluses as a share of GDP.

Increasing service exports

Current prices, index 100 = 2007



Source: Statistics Sweden, SEB

Increased service exports are largely driven by business services, with significant increases in merchanting (i.e. merchandise trade that does not cross the borders of Sweden) and other business services. Many industrial companies with production around the world have head offices in Sweden that produce services in the form of research, development, administration and marketing. An increasing share of exports and the trade surplus consists of this type of services, which raises questions since it is uncertain to what extent they generate jobs and tax revenues in Sweden. They can also easily be moved abroad if economic conditions in Sweden are deemed unfavourable. But there is hardly any reason to believe that the situation would be more secure if a larger share of the surpluses were still due to merchandise exports. Experience shows that production can also be moved quickly from one country to another. To summarise, it is possible to feel somewhat concerned that Swedish manufacturers are losing ground against Germany, but the overall picture is still that **Sweden is not suffering either competitiveness problems or structural problems in its export sector as a whole**.

Recovery on track

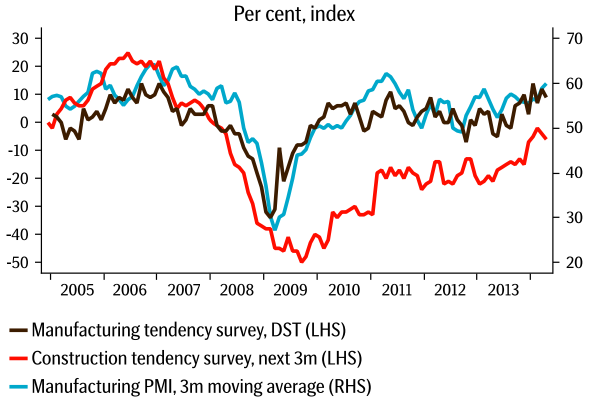
- **Weak Q4 numbers don't change outlook**
- **Central bank reacts to currency weakness**
- **Expiring interest-only mortgages no big risk**

We are sticking to *Nordic Outlook* February's forecast of **2 per cent growth for 2014** despite significant disappointments in the fourth quarter 2013 numbers, both for overall GDP and consumption. Most of the Q4 weakness is explained by the effects of big autumn storms and the way insurance payments are handled in the national accounts. Leaving out such effects, we see little to suggest that forecasts for 2014 should be at risk. We are also leaving our **GDP growth forecast for 2015 unrevised at 2.5 per cent**.

Recent developments in Denmark still support expectations of a strengthening recovery. Consumer sentiment is close to post-crisis highs, as unemployment falls and job creation gradually picks up. Anecdotal evidence from real estate businesses points to improving activity around Easter, lending support to forecasts of a continued home price recovery. In manufacturing as well as construction, confidence has been increasing in 2014. Distilling the message from a range of surveys, we see the strongest overall picture for some time.

Rising confidence in manufacturing and construction

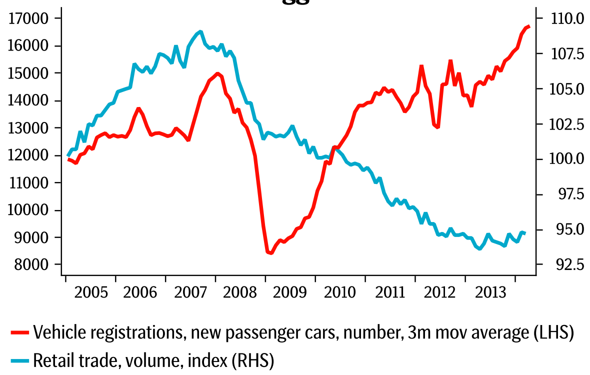
Per cent, index



Source: European Commission, Statistics Denmark

While the manufacturing sector is improving nicely, the tendencies are still mixed within retail trade. On the positive side a take-off in car registrations is sending a comforting signal of rising optimism, but retail sales remain stubbornly sluggish despite the relative high level of confidence expressed in surveys. We need to see improvement here for our expectations to come true.

Vehicle registrations have surged but retail trade is sluggish



Source: ACEA, Statistics Denmark

Inflation hovering around all-time lows

Inflation in Denmark is still very depressed, in line with the trend in the euro zone. The headline CPI inflation rate is again moving closer to zero, at 0.4 per cent in March, after hitting 1 per cent in December 2013. Core inflation showed the same pattern at a slightly higher level. We are still forecasting a moderate rise in inflation during the second half, but **the full-year average for 2014 should stay below 1 percent**. In **2015** we expect inflation to accelerate to a higher but still depressed rate of **1.3 per cent**, as a result of stronger global fundamentals and a firming of the Danish labour market.

If inflation fails to pick up and deflationary tendencies spill into already weak wage dynamics, this would constitute a risk for households due to their high debt/income ratio (more on this below). However, we think that such dynamics would show up in the euro zone before Denmark, since labour markets there are significantly weaker. In that case the European Central Bank would have to take aggressive action, leaving more room for manoeuvre for Danmarks Nationalbank.

Overblown concern about household debt

The state of Danish households is often debated. In April 2014, for example, *The Economist* wrote an article focusing quite one-sidedly on the risks associated with being the world champion in consumer indebtedness (Danish households have the largest share of debt relative to disposable income of any country in the world). A high debt/income ratio is obviously a risk if a big shock hits or interest rates rise significantly.

But the factors behind this high debt are important. Danish consumers are not currently engaged in a spending binge. As the above chart indicates, consumption is a good deal below its level of seven years ago. A few factors connected to household debt are worth noting. First, this high debt is mirrored by even larger assets, leaving Danish households with a high net asset position in an international comparison – even after a 25 percent home prices decline. An inflated balance sheet still entails risk, but the asset side cannot be completely ignored either. Additionally, most debt is financed via Danish mortgage bonds, which have not generated a loss to bond holders for 200 years. It is a highly efficient system that generates cheap mortgage financing for Danish households. And there is no sub-prime segment.

New record current account surplus

The current account is posting new records on an annualised 12-month rolling basis, at almost DKK 140 billion in February. As stated before, this observation is missing from the discussion of Danish competitiveness. Goods and services as well as income are contributing, but the income element is becoming more important after years of firming external surpluses. This part is also the most stable one.

Weak currency leads to rate hike

As anticipated in our Macro Update in March 2014, the central bank found it necessary to hike the deposit rate back to positive territory (by 15 basis points) in April. The reasoning was moderate capital outflow and, more importantly, a weak Danish krone, trading at the edge of its corridor vs the EUR. We still expect further accommodation from the ECB in coming months due to weak inflation. The krone did strengthen slightly after the rate hike, but is still at the weak end of the spectrum, so our main scenario is that Danmarks Nationalbank will not have to follow the ECB if it takes further action. Without ECB action, another independent Danish hike could come if the krone stays at current levels.

Risks related to interest-only mortgages

Worries related to the expiry of interest-only periods for many Danish mortgages do demand some consideration. The introduction of interest-only (I-O) mortgages in Denmark back in 2003 was, in retrospect, not the best decision. It added fuel to already bullish sentiment in Danish housing, further inflating house prices into bubble territory. I-O mortgages in Denmark are normally 30-year loans with a 10-year grace period before amortisation kicks in. Plenty of loans were issued in the years leading up to the crash in 2007-08, and in 2013 the first I-O loans to be issued started to be amortised. As borrowers may only fully refinance loans with loan-to-value ratios below 80 per cent, concern has been building about loans issued in the years leading up to the home price peak, as a large share of these have LTV ratios above 80 per cent and cannot be refinanced in full. This could potentially lead to stress in the housing/mortgage market.

Danish mortgage market (estimates)

value as of Q3/Q4 2013

	DKK billion	% of GDP
Total mortgage loans	2,700	145
I-O loans expiring in 2013-18	340	18
I-O loans expiring in 2013-18, LTV>80%	106	6
Annual cost of amortisation (when fully phased in, 2018)		
All I-O loans expiring in 2013-18	9.2	0.5
I-O loans with LTV>80%	2.9	0.2

Source: Realkredit Danmark, Nykredit, SEB Fixed Income estimates

Extrapolating public numbers from the two biggest mortgage lenders (Nykredit and Realkredit DK, with 70 per cent of the total market) we can get rough estimates of the size of the problem. Most importantly, we obtain an estimate of the total value of private loans with LTV>80% for which the I-O period is expiring in 2013-2018. This adds up to approximately DKK 105 billion, i.e. 6 per cent of GDP or roughly 4 percent of the total mortgage bond market. The table shows an estimate of the cost of amortising these loans. It creates a drag on income and potential consumption of less than 2 per cent annually: less in the early years and only taking full effect in 2018. This is too little to affect forecasts meaningfully.

A more pessimistic scenario would unfold if none of the loans with I-O expiry are refinanced for new I-O periods. If that were the case, the drag on consumption could be a significant 0.5 of GDP per year. A more likely downside scenario is probably that a certain share of borrowers who would have the option available would decide to start amortising (and some of those who start to amortise their mortgage might lower other saving or stop paying down other more expensive loans). In any case, we see this as more of a downside to our growth forecast than a systemic risk to the mortgage or housing market as such.

In recent weeks, there has been increasing public discussion about politically limiting access to I-O loans in order to make the housing market more resilient in the long term. It is still unclear where this debate will lead, but lower LTV on I-O loans is one possible outcome. If that were the case, it would be a further moderate downside risk.

Regaining some lost speed

- **Firmer but still below-trend growth**
- **Drag from stalling oil-sector investment, but firmer consumption and non-oil exports**
- **Core inflation at target but should moderate going forward**
- **Norges Bank to start hiking its key interest rate very cautiously from mid-2015**

The outlook for the Norwegian economy is marked by strong crosscurrents. Headwinds are coming from investment within oil and gas extraction where growth will downshift from 18 per cent in 2013 to 2.5 per cent in 2014, according to our forecast. Demand impulses to the rest of the economy will thus be very modest. In addition, we expect weaker residential investment.

However, private consumption should firm as already seen in solid momentum in households' domestic spending on goods. Moreover, continuing recovery abroad will provide a tailwind for accelerating exports of non-petroleum goods: survey-based indicators thus show a sharp upturn in foreign orders.

Growth in mainland GDP – excluding oil, gas and shipping – has recovered since mid-2013 and momentum has broadly stabilised in early 2014. The forecast is for **full-year growth in mainland GDP to firm only slightly to 2.1 per cent in 2014 and gain further speed to 2.4 per cent in 2015** (a minor downward revision relative to the February *Nordic Outlook*).

Meanwhile, **growth in overall GDP should accelerate from a sluggish 0.6 per cent in 2013 to 1.9 per cent this year and next**. Such a sharp acceleration seems at odds with sharply downshifting investment growth in the petroleum sector, but note that the import content of such investment is rather high. Moreover, the effect on growth should be more than made up for by stabilising petroleum exports after the plunge in 2013.

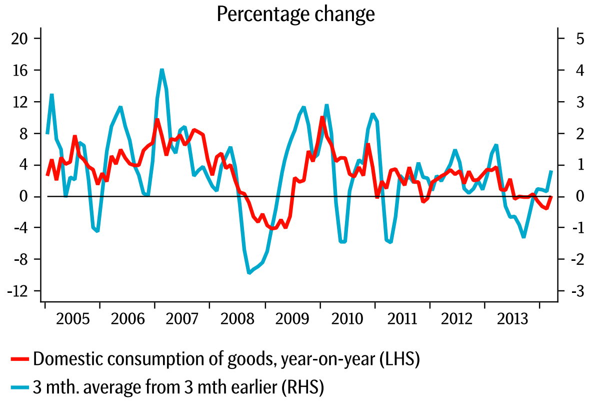
Consumption gaining speed again

Households' real disposable income showed solid growth in 2013 as well, yet momentum in private consumption slowed markedly and the 1.5 per cent year-on-year rate in the fourth quarter was the slowest in more than four years. In fact, consumption growth has trailed real income by 5 percentage points since early 2010. There are some structural reasons for the subsequent marked increase in the savings ratio in the past few years, but spending should be more aligned with growth in real disposable income going forward.

The first quarter brought evidence of recovering consumption as sequential growth in households' domestic spending on goods (almost half the total) gained speed. In fact, the underlying trend is even stronger as the gain was dented quite a bit by a weather-related drop in spending on electricity.

Consumption is re-accelerating

Percentage change



Source: Statistics Norway

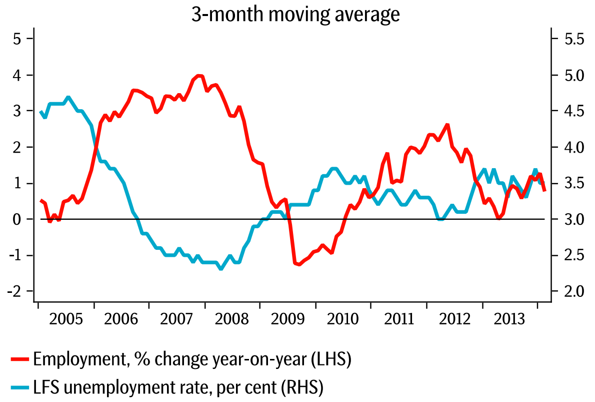
Growth in private consumption should pick up from last year's 2.1 per cent **to 2.5 per cent in 2014 and 3.2 per cent in 2015**. The gain should be in line with households' real disposable income in the current year but slightly lagging in 2015.

Unemployment has stabilised

Accelerating consumption growth is in line with various fundamentals, among them labour market developments.

Unemployment holding within a range

3-month moving average



Source: Statistics Norway

Registered unemployed increased rather markedly during 2013 in tandem with softer momentum in the economy, but has since declined slightly. Meanwhile, the Labour Force Survey has showed random monthly variations, though the 3.5 per cent unemployment rate in the first quarter of 2014 was the same as in the previous five quarters. The stabilisation masks a 0.5 percentage point decline in labour force participation over the past year to 70.8 per cent, a multi-year low, which is attributable to those aged 15-24 years since fewer are working part-time while studying. The decline is mirrored in softer momentum in job growth, which on the LFS measure eased a tad in the first quarter, the first decline since late 2012.

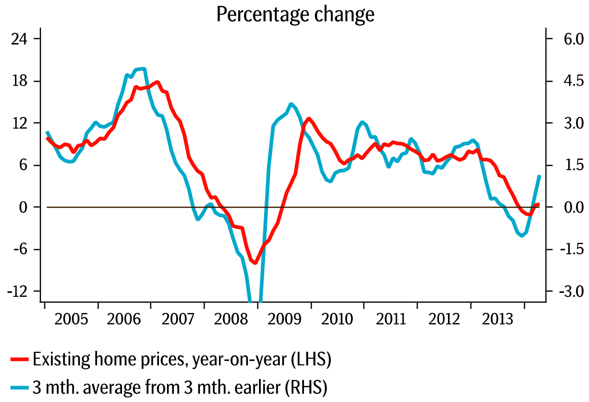
The decline should prove transitory and the 0.8 per cent year-on-year rate is more indicative of the trend, and the more comprehensive national account measure should have held up better. However, to the extent growth in the labour force accelerates a bit as well, the **LFS unemployment rate should average 3.6 per cent in 2014 and 2015**.

Home prices recovering fast

The recent firmer existing home prices should be a plus for confidence and consumption going forward. Existing home prices started turning south a year ago, and the decline until last autumn fuelled fears of a deep plunge with wider repercussions. It is interesting to note that the primary cause of lower prices was not a sudden drop in demand, which actually held up pretty well. Instead, the supply of homes for sale saw a sharp increase, presumably as potential buyers wanted to sell first due to widespread expectations of a sharp drop in prices.

Existing home prices have turned the corner

Percentage change



Source: Eiendom Norge

The first few months of 2014 have seen existing home prices recovering more than the entire decline from 2013 while sales are only marginally lower year-to-date. The demand side has been helped by banks easing lending standards while the previous tightening had an adverse effect on the market. At the same time, mortgage rates are slightly lower. The recent lending survey also saw banks reporting a marked turn in households' credit demand in the first quarter, with a further rise expected in the current one. Supply-side dynamics have turned favourable as well. After a jump in home completions by almost a third in 2012 and a further increase in 2013, new home sales have plunged. Unsurprisingly, approved housing starts are sharply lower and completions should wane with a certain lag. As such, lower supply of new homes should affect the existing home market as well.

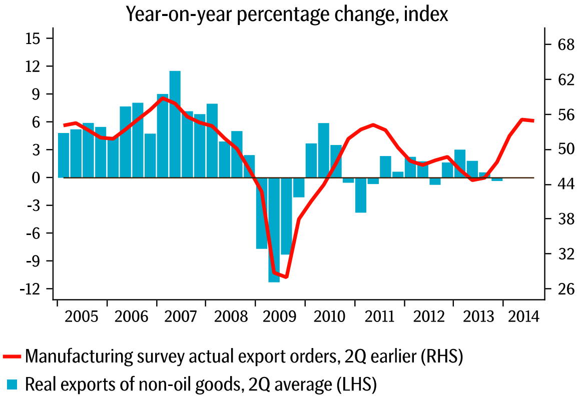
Healthy fundamentals explain the better part of rising existing home prices in recent years, but we still think the *level* is somewhat inflated relative to the historic trend (but not overly so). Nonetheless, as **existing home prices** in January-April were a marginal 0.1 per cent below the full-year average in 2013, **our previous forecast for a 3-4 per cent decline in 2014 seem too pessimistic: prices might instead rise slightly**.

Exports about to revive

Non-petroleum exports of goods looks set to accelerate over the course of 2014, fuelled by the general recovery in the main markets in Europe and the boost from the marked depreciation of the NOK on a trade-weighted basis since early 2013.

Solid foreign orders suggest rising exports

Year-on-year percentage change, index



Source: Statistics Norway

According to the just-released Business Tendency Survey, manufacturers reported a further increase in export orders in the early part of the year at broadly the same rate as in the final quarter of 2013 (and thus at the strongest rate in seven years as measured by the survey). Moreover, foreign demand is expected to show ongoing growth in the near term. Even if the correlation is far from perfect, and less so in recent years, the trend strongly suggest that exports of non-petroleum manufactured goods is in for a solid acceleration.

Capital spending within oil and gas extraction has been growing briskly in the past three years, but should downshift sharply from 18.0 per cent growth in volume terms in 2013 to a modest 2.5 per cent in 2014 and might decline marginally next year. The forecast is on the downside of Statistics Norway's most recent survey (compiled in mid-February) which showed operators expecting nominal investment to increase 7.0 per cent from the estimated 2013 outcome to a new record high.

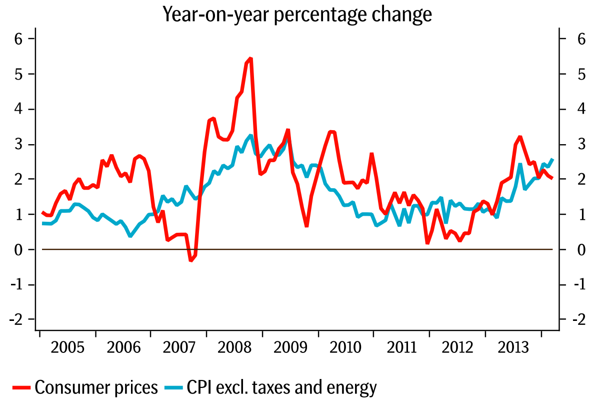
There is no denying that the downshift will lend much smaller demand impulses to the rest of the economy in 2014, but one should not overstate the negative effect either. The economy weathered a similar downshift from 2005 to 2006 (though momentum at that time was much stronger).

A marked lift in inflation

The year-on-year rate of increase in core consumer prices has shifted upward a sharp 1.5 percentage points since the first quarter of 2013 to 2.5 per cent on average in January-April 2014 according to the CPI-ATE index (CPI excluding taxes and energy). As such, core inflation was at the Norges Bank medium-term target for the first time since mid-2009. Meanwhile, overall CPI inflation peaked slightly above 3 per cent late last summer and has since slowed by more than a full percentage point owing to electricity prices.

Core inflation accelerating fast over the past year

Year-on-year percentage change

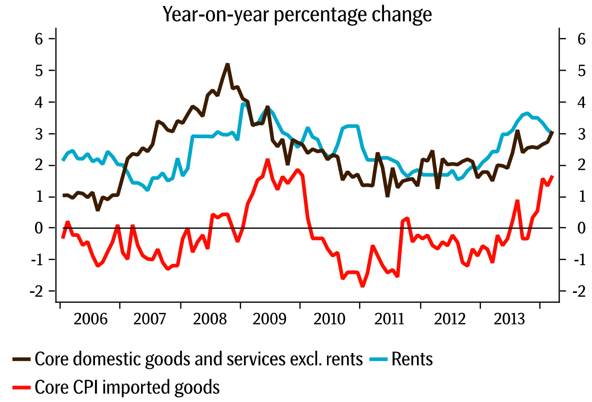


Source: Statistics Norway

The spurt in core inflation was initially home-made as rents (about one fifth of the core CPI basket) started accelerating in late 2012 while prices for domestically-produced goods followed suit. Overall core domestic inflation was running near 3 per cent in the first quarter. The lift in domestic inflation has been checked by services, whose prices amid monthly volatility have been broadly stable over the past year. At the same time, the weaker NOK since late last spring has lifted imported inflation with a certain lag, as normal. While prices for imported goods declined on a full-year basis in 9 of the past 10 years, they were up 1.5 per cent in the year to the first quarter.

Broad-based upward shift

Year-on-year percentage change



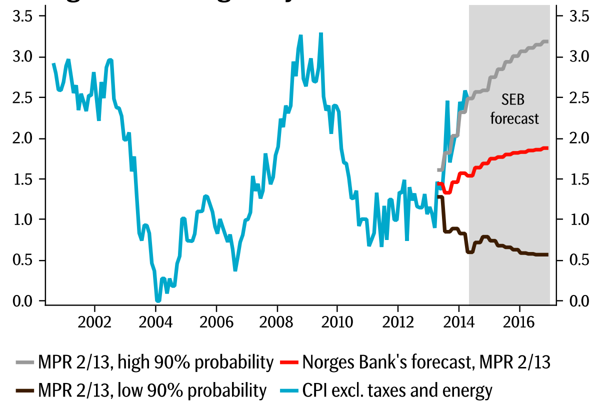
Source: Statistics Norway

The effect from the exchange rate might still exert some upward pressure in the very near term, though it should wane by late summer. Meanwhile, the trend in rents has already eased, and some correction is likely for domestically produced goods, which have seen the sharpest gain. Some moderation is thus likely going forward, and **core inflation should average 2.2 per cent in 2014 and 2.1 per cent in 2015**.

Norges Bank parting from peers

While Norges Bank stated in March that the driving forces behind inflation are moderate, it has grossly underestimated the upturn in core inflation since mid-2013. This underscores that Norges Bank's cautious rate approach is due to still soft, though stabilising, momentum in the domestic economy. Hence, for Norges Bank to start mulling rate hikes, an improvement in the real economic is necessary.

Norges Bank has grossly underestimated inflation



Source: Statistic Norway, Norges Bank

Surprisingly to us, Norges Bank lowered its forecast for mainland GDP growth to 1¾ per cent in the March *Monetary Policy Report*. The data since then have been reassuring, suggesting that momentum in the economy has stabilised if not firmed a bit in early 2014. However, the bank's communication may still be dovish as it continues to emphasise monetary policy abroad. Any looser monetary policy from the ECB and the Riksbank will thus first and foremost affect the timing of an initial rate hike in Norway. Our forecast for global central banks suggests that rate expectations abroad will decline in the near-term, neutralising the effect of our expectations that Norges Bank will revise its mainland GDP forecast higher for 2014. We thus now expect the **rate hiking cycle to begin in mid-2015**, slightly later than previously assumed. Since we expect both the Fed and BoE to deliver hikes in the second half of next year, and the domestic economy to expand close to trend, we still forecast that the Norwegian key rate will be 50 basis points higher by year-end 2015.

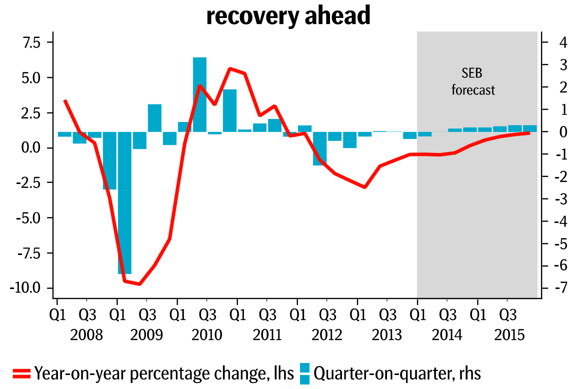
The **outlook for the krone has improved** and we are expecting a gradual appreciation against the euro throughout this year. Speculative accounts have become more comfortable in holding long NOK positions after fears of dovish monetary policy surprises were markedly reduced. The long-term flow outlook is also positive, but weak competitiveness will still prevent an overly rapid appreciation of the krone. We forecast a EUR/NOK exchange rate of 8.05 by the end of 2014. The 10-year government bond should perform better against Germany towards year-end as the supply hurdle eases. We expect a 10-year spread vs. Germany of 80 bps by end-2014.

Slow sailing, and no big improvement in sight

- **Structural and cyclical problems**
- **Recession in early 2014, weak recovery**
- **Unemployment close to its 2009/2010 peak**
- **Continued fiscal austerity**

Structural and cyclical problems are continuing to create a weak growth environment. The Finnish economy recently suffered a new recession: its third since 2008, although GDP has now stopped falling. The outlook ahead is weak. Virtually all parts of the economy are performing sluggishly. As an annual average, GDP will also fall in 2014. Problems in the forest product industry and the telecom sector have worsened growth prospects. On top of this are the effects of Finland's relatively extensive trade ties with Russia. Given this backdrop, the S&P rating agency downgraded the country's outlook to negative earlier this spring, which implies a risk that its AAA sovereign debt rating may be lowered within two years. Idle capacity and weak exports, due among other things to a strong euro and the economic deceleration in Russia – which buys about 10 per cent of Finnish exports – are making businesses reluctant to invest. Meanwhile households are squeezed by rising unemployment and fiscal austerity. **GDP will fall by 0.3 per cent in 2014 and increase by 0.8 per cent in 2015**; in a Nordic comparison, the economy is thus losing further ground.

New recession in late 2013 and early 2014, weak recovery ahead

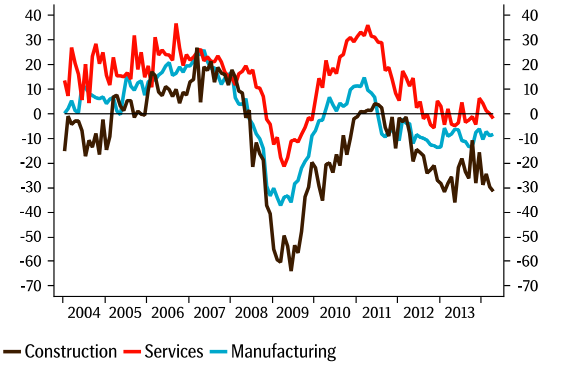


Source: Eurostat, SEB

Indicators are not signalling a quick turnaround. The European Commission's indicator for the service and construction sectors fell in April; the manufacturing sector showed a slight improvement but remains at a low level.

Indicators are not signalling any rapid recovery

Net balance

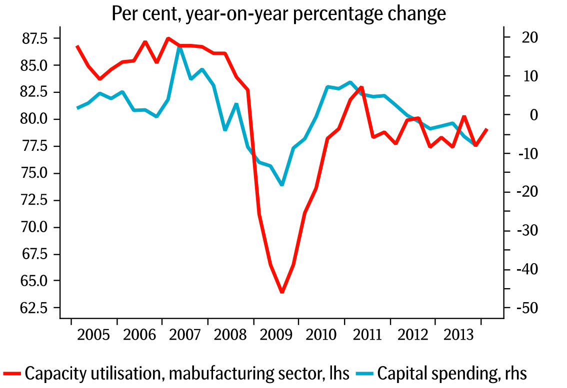


Source: European Commission

Exports recorded an upswing late in 2013, with a clear surge in optimism among businesses. These hopes have now been quickly disappointed, and **so far this year both production and exports have fallen, measured year-on-year**. The downturn in the information and communications technology (ICT) sector played a major role in the nearly 10 percentage point decline in exports as a share of GDP compared to 2008. ICT production now seems to have levelled out but will hardly contribute to a recovery in the next couple of years. A sharp deterioration in the current account balance indicates that the strong euro is causing some problems, but Finland's competitiveness – measured as real effective exchange rate – has not worsened especially much in the past decade. Unfavourable world market price trends related to Finnish exports and imports have probably played a larger role.

Idle capacity is hampering capital spending

Per cent, year-on-year percentage change



Source: OECD, Statistics Finland

Overall, we believe that exports will rise by 1.5 per cent in 2014 and by 3 per cent in 2015, which implies continued losses of global market share. Because of weak domestic demand, the trend of imports will also be sluggish. The current account improved slightly to a deficit of 1.1 per cent of GDP in 2013 and is expected to stay at about the same level in 2014 and 2015.

Capacity utilisation in manufacturing remains low, even though capital spending has fallen for two years in a row. An uncertain housing market has resulted in weak growth in the number of building permits. This indicates that residential investments will remain low, in any case during 2014. All in all, investments will fall by 1.2 per cent in 2014 followed by a slight increase in 2015.

Household squeezed from many directions

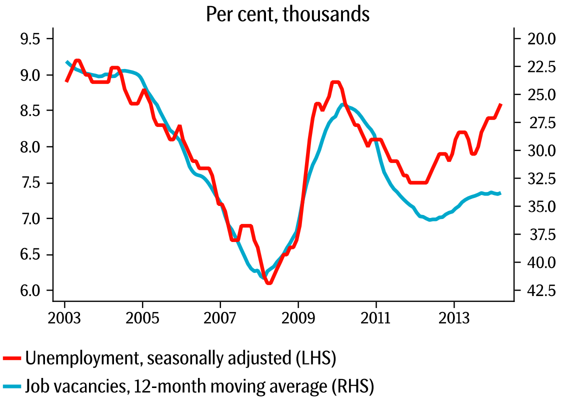
Consumer confidence also fell early in 2014 in the wake of rising unemployment, fiscal austerity, low pay increases and a shaky labour market. Uncertainty will contribute to a higher household savings ratio. Falling inflation, which improves real incomes, and continued low interest rates are positive counter-forces. **Consumption will keep falling in 2014 (by 0.4 per cent), then increase slightly in 2015 (by 0.5 per cent)**. Our main forecast is that the home price downturn will be very moderate. In a Nordic comparison (see *Nordic Outlook*, February 2014), certain factors make a large price decline unlikely, including weaker price increases since 2006, stable prices in relation to incomes and the household debt ratio. If economic growth should turn out worse than expected, there is a **risk of a major home price decline**, which could trigger a further wave of falling demand in the Finnish economy.

Unemployment close to record levels

Weak economic growth is having an impact on the labour market, and unemployment rose to 8.6 per cent in March 2014. Meanwhile the number of job vacancies has remained rather high. The end to the strong correlation between unemployment and job vacancies (see chart) can be regarded as a sign that due to restructuring, there is an increasing mismatch between job seekers and job openings.

Unemployment is close to its 2009 peak

Per cent, thousands



Source: Statistics Finland

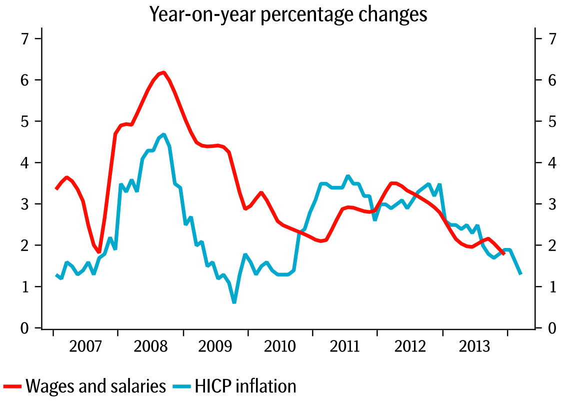
Labour force participation is falling and is well below that of other Nordic countries. This downturn is largely driven by demographic factors, but the weak economy and high unemployment are also having an impact. The government has signalled that it wants people to work longer, but the retirement age has not been raised. One bright spot is that employment, as measured by the Labour Force Survey, has stopped falling. This is a bit contradictory, since labour force participation is falling and unemployment is rising. As growth is weak, unemployment will continue to rise and level out at 9 per cent late this summer/early fall before slowly falling. Measured as annual average, **unemployment will be 8.8 and 8.6, respectively, in 2014 and 2015**.

Weak price and pay increases

The rate of pay increases slowed due to the collective labour agreements signed in 2013. On the one hand, this puts more economic pressure on households. On the other hand, it benefits Finland's competitiveness. Wages and salaries will increase by about 2 per cent annually in 2014-2015; due to low inflation, real wages are actually rising. HICP inflation fell to 1.3 per cent in April and will remain low despite tax hikes. In the prevailing environment of low demand and restrained incomes, companies are finding it hard to raise prices. **HICP inflation will average 1.5 and 1.7 per cent in 2014 and 2015**.

Decelerating price and wage increases

Year-on-year percentage changes



Source: Statistics Finland

Weak economy creating need for austerity

Public finances are in good shape compared to most other euro zone countries. Despite consolidation programmes, the public deficit remained at 2.5 per cent of GDP in 2013, since continuous downgrading of the economic outlook put pressure on the budget. **Fiscal policy** will maintain a focus on bringing down the deficit and remain **contractionary in both 2014 and 2015**. Yet because of weak growth, the deficit will persist, totalling some 2 per cent of GDP in 2015. Public sector debt will stabilise at 60 per cent of GDP in 2014-2015, well below the euro zone average of 95 per cent.

Weak demand and low interest rates might suggest a need for somewhat looser fiscal policy, but the government has invested political prestige in bringing down the deficit. It was thus a shock when S&P gave the country's AAA credit rating a negative outlook earlier this spring. Prime Minister Jyrki Katainen has announced plans to step down and is aiming at a new EU job. This creates some concerns about the future of the governing coalition.

GLOBAL KEY INDICATORS

Yearly change in per cent

	2012	2013	2014	2015
GDP OECD	1.3	1.2	2.1	2.7
GDP world (PPP)	3.3	3.2	3.6	3.9
CPI OECD	2.3	1.6	1.8	1.7
Export market OECD	2.5	3.7	5.7	6.8
Oil price, Brent (USD/barrel)	111.7	108.7	106.0	100.0

US

Yearly change in per cent

	2013 level USD bn	2012	2013	2014	2015
Gross domestic product	17,090	2.8	1.9	2.6	3.7
Private consumption	11,662	2.2	2.0	3.2	3.2
Public consumption	3,118	-1.0	-2.2	-1.5	-0.4
Gross fixed investment	2,386	8.3	4.5	4.7	10.7
Stock building (change as % of GDP)		0.2	0.2	0.0	0.0
Exports	2,321	3.5	2.7	2.7	6.0
Imports	2,778	2.2	1.4	2.8	5.7
Unemployment (%)		8.1	7.4	6.3	5.5
Consumer prices		2.1	1.5	1.9	1.9
Household savings ratio (%)		5.6	4.5	4.0	3.6

EURO ZONE

Yearly change in per cent

	2013 level EUR bn	2012	2013	2014	2015
Gross domestic product	9,577	-0.7	-0.4	1.0	1.6
Private consumption	5,480	-1.4	-0.7	0.8	1.3
Public consumption	2,061	-0.6	0.1	0.1	0.8
Gross fixed investment	1,691	-4.0	-3.1	1.7	2.8
Stock building (change as % of GDP)		-0.6	-0.1	0.0	0.0
Exports	4,392	2.5	1.3	3.8	4.0
Imports	4,050	-0.9	-0.1	3.8	3.9
Unemployment (%)		11.3	12.0	11.7	11.5
Consumer prices		2.5	1.4	0.7	0.8
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	0.3	1.7	3.0	2.6
Japan	1.4	1.5	1.0	1.3
Germany	0.7	0.4	1.8	2.1
France	0.0	0.3	0.8	1.4
Italy	-2.4	-1.9	0.3	1.0
China	7.7	7.7	7.2	7.0
India	5.1	4.7	5.0	5.4
Inflation				
United Kingdom	2.8	2.6	1.8	1.7
Japan	0.0	0.4	2.7	1.9
Germany	2.0	1.2	1.6	2.0
France	1.5	0.8	1.5	1.8
Italy	3.3	1.3	0.9	1.1
China	2.6	2.6	2.8	2.9
India	9.7	10.1	8.0	7.6
Unemployment (%)				
United Kingdom	8.0	7.6	6.5	6.1
Japan	4.4	4.0	3.6	3.6
Germany	5.5	5.5	5.5	5.4
France	10.3	10.2	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	0.8	0.5	2.3
Latvia	5.5	4.1	2.5	3.2
Lithuania	3.5	3.3	2.7	3.8
Poland	1.9	1.6	2.9	3.3
Russia	3.4	1.3	0.0	1.2
Ukraine	0.2	0.0	-6.0	2.0
Inflation, yearly change in per cent				
Estonia	3.9	3.2	0.6	2.6
Latvia	2.3	0.0	1.4	3.3
Lithuania	3.2	1.2	0.8	1.2
Poland	3.7	0.8	1.4	2.4
Russia	5.1	6.7	6.5	5.8
Ukraine	0.6	-0.3	6.0	6.0

FINANCIAL FORECASTS

		May 7th	Sep 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	2.59	2.65	2.90	3.10	3.20
Japan	10 years	0.59	0.70	0.90	1.10	1.20
Germany	10 years	1.47	1.50	1.70	2.00	2.10
United Kingdom	10 years	2.66	2.80	3.00	3.10	3.20
Exchange rates						
USD/JPY		102	101	104	109	115
EUR/USD		1.39	1.36	1.34	1.31	1.28
EUR/JPY		142	137	139	143	147
GBP/USD		1.70	1.66	1.65	1.64	1.62
EUR/GBP		0.82	0.82	0.81	0.80	0.79

SWEDEN

Yearly change in per cent

	2013 level SEK bn	2012	2013	2014	2015
Gross domestic product	3,634	0.9	1.5	2.7	3.1
Gross domestic product, working day adjustment		1.3	1.5	2.7	2.9
Private consumption	1,764	1.6	2.0	2.7	3.0
Public consumption	998	0.3	2.0	0.8	0.8
Gross fixed investment	667	3.3	-1.3	3.0	5.5
Stock building (change as % of GDP)	2	-1.3	0.2	0.3	0.0
Exports	1,659	0.7	-0.9	3.7	6.2
Imports	1,455	-0.6	-1.2	3.5	6.1

	2012	2013	2014	2015
Unemployment (%)	8.0	8.0	7.9	7.5
Employment	0.6	1.1	1.1	1.3
Industrial production	-4.3	-3.5	2.5	4.5
CPI	0.9	0.0	-0.1	0.9
CPIF	1.0	0.9	0.5	1.3
Hourly wage increases	3.0	2.5	2.7	2.8
Household savings ratio (%)	12.2	12.2	12.6	11.6
Real disposable income	3.5	2.8	3.4	1.9
Trade balance, % of GDP	2.4	2.2	2.5	2.7
Current account, % of GDP	6.5	6.6	6.2	6.0
Central government borrowing, SEK bn	25	131	65	20
Public sector financial balance, % of GDP	0.2	-1.4	-1.5	-0.5
Public sector debt, % of GDP	38.2	41.5	41.7	40.6

FINANCIAL FORECASTS	May 7th	Sep 14	Dec 14	Jun 15	Dec 15
Repo rate	0.75	0.50	0.25	0.25	0.75
3-month interest rate, STIBOR	0.91	0.65	0.45	0.50	1.05
10-year bond yield	1.93	1.90	2.05	2.25	2.55
10-year spread to Germany, bp	46	40	35	25	45
USD/SEK	6.49	6.80	6.72	6.72	6.72
EUR/SEK	9.04	9.25	9.00	8.80	8.60
TCW	121.7	125.3	122.2	119.9	117.5
KIX	105.3	108.3	105.6	103.7	101.6

NORWAY

Yearly change in per cent

	2013 level NOK bn	2012	2013	2014	2015
Gross domestic product	2,848	2.9	0.6	1.9	1.9
Gross domestic product (mainland)	2,188	3.4	2.0	2.1	2.4
Private consumption	1,188	3.0	2.1	2.5	3.2
Public consumption	612	1.8	1.6	2.1	2.3
Gross fixed investment	635	8.3	8.7	1.7	1.9
Stock building (change as % of GDP)		-0.1	0.0	-0.1	0.0
Exports	1,121	1.1	-3.9	1.8	1.9
Imports	816	2.3	2.5	2.2	3.5
Unemployment (%)		3.2	3.5	3.6	3.6
CPI		0.8	2.1	2.0	2.2
CPI-ATE		1.2	1.6	2.2	2.1
Annual wage increases		4.3	3.5	3.6	3.6

FINANCIAL FORECASTS	**May 7th**	**Dec 13**	**Sep 14**	**Dec 14**	**Jun 15**	**Dec 15**
Deposit rate	1.50	1.50	1.50	1.50	1.75	2.00
10-year bond yield	2.64	2.55	2.40	2.50	2.90	3.05
10-year spread to Germany, bp	117	100	90	80	90	95
USD/NOK	5.91	6.16	5.96	6.01	6.11	6.25
EUR/NOK	8.22	8.25	8.10	8.05	8.00	8.00

DENMARK

Yearly change in per cent

	2013 level DKK bn	2012	2013	2014	2015
GDP	1,858	-0.4	0.4	2.0	2.5
Private consumption	905	-0.1	0.0	1.2	2.4
Public consumption	525	0.4	0.9	2.1	0.6
Gross fixed investment	322	0.8	0.8	2.4	5.6
Stock building (change as % of GDP)		-0.2	0.2	0.1	-0.1
Exports	1,021	0.4	1.0	3.8	4.9
Imports	916	0.9	1.5	3.6	5.1
Unemployment (%)		4.6	4.3	4.1	3.8
Consumer prices, harmonised		2.4	0.7	0.9	1.3
Hourly wage increases		1.5	1.3	1.5	2.0
Current account, % of GDP		6.0	6.8	7.0	6.5
Public sector financial balance, % of GDP		-4.1	-0.8	0.0	-0.5
Public sector debt, % of GDP		45.5	44.5	43.5	42.0

FINANCIAL FORECASTS	**May 7th**	**Dec 13**	**Sep 14**	**Dec 14**	**Jun 15**	**Dec 15**
Lending rate	0.20	0.20	0.20	0.20	0.20	0.20
10-year bond yield	1.52	1.60	1.60	1.80	2.15	2.25
10-year spread to Germany, bp	5	5	10	10	15	15
USD/DKK	5.36	5.57	5.49	5.57	5.69	5.83
EUR/DKK	7.47	7.46	7.46	7.46	7.46	7.46

FINLAND

Yearly change in per cent

	2013 level EUR bn	2012	2013	2014	2015
GDP	193	-1.0	-1.4	-0.3	0.8
Private consumption	109	0.3	-0.8	-0.4	0.5
Public consumption	50	0.5	0.8	0.4	0.5
Gross fixed investment	37	-0.8	-4.6	-1.2	1.4
Stock building (change as % of GDP)		-1.3	-1.1	0.0	0.0
Exports	78	-0.2	0.3	1.5	3.2
Imports	78	-0.7	-1.8	1.5	3.2
Unemployment (%)		7.7	8.2	8.8	8.6
Consumer prices, harmonised		3.2	2.2	1.5	1.7
Hourly wage increases		3.2	2.1	2.0	2.0
Current account, % of GDP		-1.4	-1.1	-1.4	-1.5
Public sector financial balance, % of GDP		-2.2	-2.3	-2.5	-2.2
Public sector debt, % of GDP		53.6	57.0	60.0	60.0

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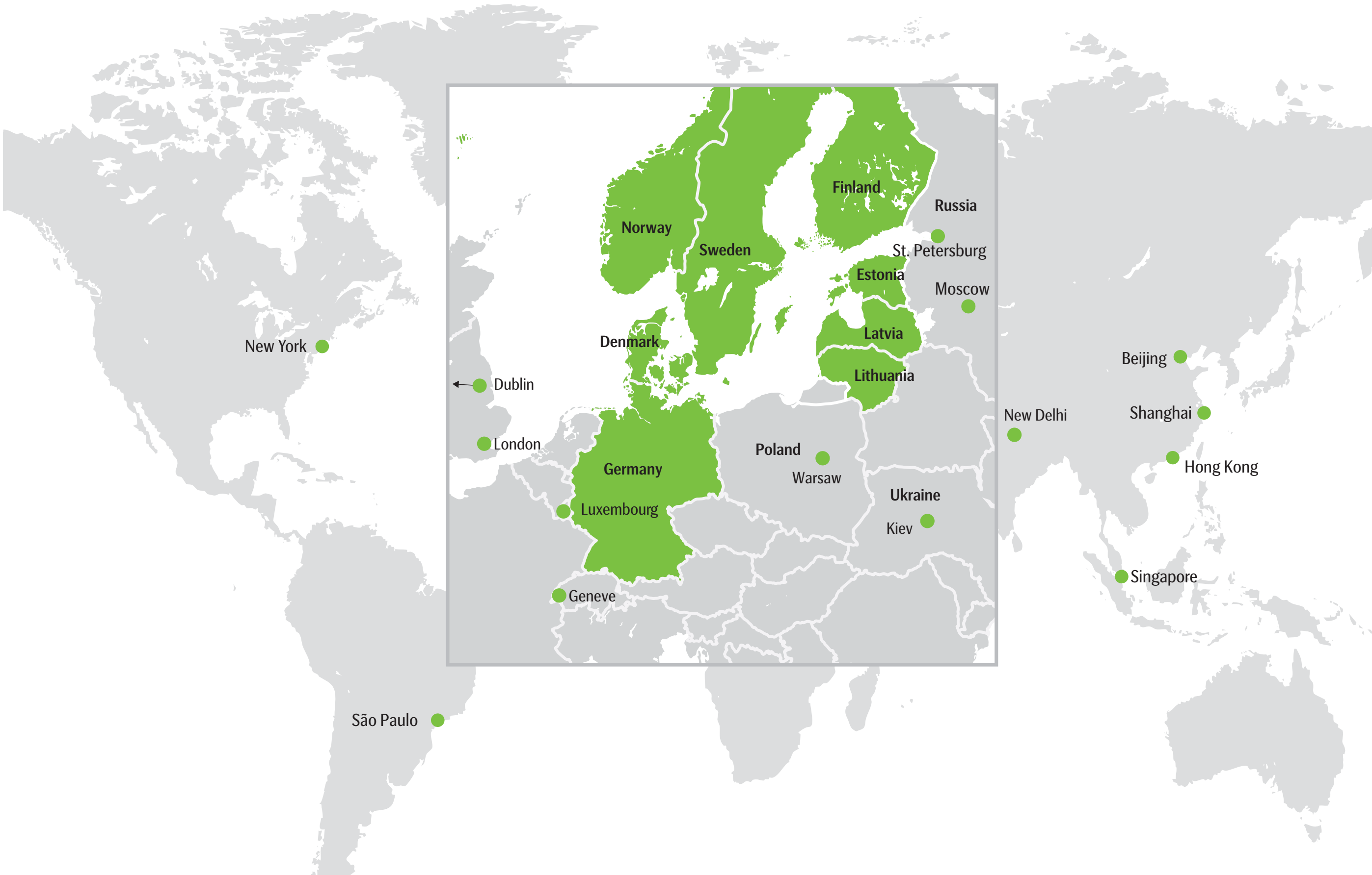

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