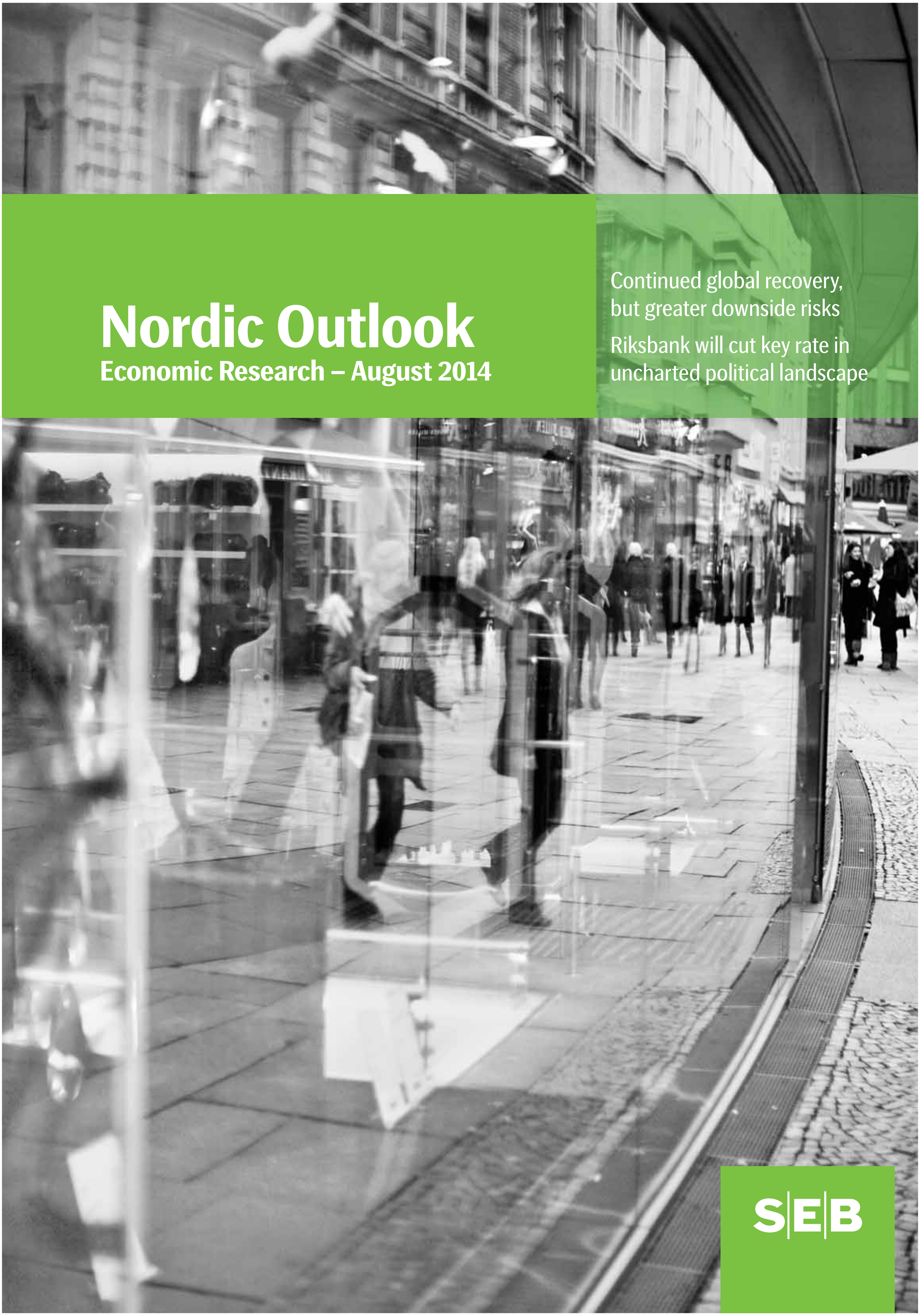
Nordic Outlook

Economic Research – August 2014

Continued global recovery, but greater downside risks

Riksbank will cut key rate in uncharted political landscape



SEB

Contents

This report was published on August 26, 2014.

Cut-off date for calculations and forecasts was August 21, 2014.

Robert Bergqvist
Chief Economist
+ 46 8 506 230 16

Elisabet Kopelman
Head of Economic Research
Japan
+ 46 8 506 230 17

Håkan Frisén
Head of Economic Forecasting
Sweden
+ 46 8 763 80 67

Daniel Bergvall
Economist
The euro zone & Finland
+46 8 763 85 94

Mattias Bruér
Economist
US & United Kingdom
+ 46 8 763 85 06

Ann Enshagen Lavebrink
Editorial Assistant
+ 46 8 763 80 77

Mikael Johansson
Economist
The Baltics, Poland & Eastern Europe
+ 46 8 763 80 93

Andreas Johnson
Economist
China, India, Ukraine & Russia
+46 8 763 80 32

Frederik Engholm-Hansen
SEB Copenhagen
Denmark
+45 3328 1469

Erica Blomgren
SEB Oslo
Norway
+47 2282 7277

Thomas Thygesen
SEB Copenhagen
Denmark
+45 3328 1008

Stein Bruun
SEB Oslo
Norway
+47 2100 8534

Olle Holmgren
Trading Strategy Stockholm
Sweden
+46 8 763 80 79

SEB Economic Research, K-A3, SE-106 40 Stockholm

Continued recovery, but downside risks have increased

- **Central bank support and spare resources will help fuel continued economic recovery**
- **US growth over 3 per cent in 2015 and 2016**
- **Rising EM growth, despite structural flaws**
- **Euro zone: Intensified deflation risks**
- **ECB launching QE in March, Fed hike in April**
- **Slow yield upturn, wider US-German spread**
- **Gradual US dollar appreciation against euro**

The world economy continues to be marked by a fragile recovery of varying strength. In the **United States**, the trend became clearer after a slump early in 2014. GDP growth rebounded sharply in the second quarter and the labour market is showing gradual improvement. The **British** economy has also shown strength. In **China**, first half growth was higher than expected despite a real estate market downturn. In **Japan**, however, hopes of a clear export upturn have been dashed. Negative signals are even more predominant in the **euro zone**, where GDP stagnated completely in the second quarter. This weakness also applies to **Germany**, where industrial production and optimism have fallen. To a minor extent, the trade conflict with Russia has probably played a role, at least psychologically.

We foresee a continued tug-of-war between different forces. **Monetary policy will remain very expansionary**. We expect further stimulus programmes from various central banks, especially the European Central Bank (ECB) and the Bank of Japan (BoJ), but also from Sweden's Riksbank. The US and UK central banks will begin normalising key interest rates in the spring of 2015 but will probably carry out their rate hikes very cautiously. In general, there is lingering **fundamental uncertainty about the effectiveness of monetary policy**, in an environment where balance sheets remain in great need of repair. **Fiscal policy is now moving into a rather neutral phase after earlier budget-tightening**. Due to high public debt, there is very limited room for stimulus. **Instead, the focus is on measures that do not weigh down budgets so much**. This applies, for example, to tax reforms that benefit lower-income households and opportunities to bring about capital spending by using various methods to initiate partnerships between public institutions and the business sector. **Geopolitical uncertainty will probably continue** during the foreseeable future, as various regional conflicts unfold. This is apparently not having a big impact on oil prices, but trade disruptions and more cautious investment behaviour are likely to dampen future growth to some extent.

Global GDP growth

Year-on-year percentage change

	2013	2014	2015	2016
United States	2.2	2.2	3.4	3.1
Japan	1.5	1.1	1.2	0.8
Germany	0.1	1.2	1.4	1.8
China	7.7	7.5	7.3	6.9
United Kingdom	1.7	3.1	2.8	2.6
Euro zone	-0.4	0.7	1.1	1.5
Nordic countries	0.6	1.5	2.0	2.2
Baltic countries	2.9	2.1	2.7	3.6
OECD	1.4	1.9	2.5	2.4
Emerging markets	4.8	4.6	5.0	5.1
World, PPP*	**3.3**	**3.4**	**3.9**	**4.0**

Source: OECD, SEB * Purchasing power parities

We arrive at the conclusion that **accelerating growth in 2015 is the most probable world economic scenario**. In an environment of low resource utilisation, there is ample room for continued powerful monetary stimulus. Historically speaking, it has been very unusual for an economic downturn to occur before the central bank normalisation process has even begun. Heightened geopolitical uncertainty and continued sluggishness due to balance sheet adjustments will diminish the power of the upturn and delay a clear capital spending upturn. But given a rising US economy, it is unlikely that this will end the global recovery. Overall, **we expect GDP growth in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) to be 2.5 per cent in 2015 and a tenth of a percentage point lower in 2016**. We have thus revised both our 2014 and 2015 OECD forecasts downward by two tenths.

In emerging market (EM) economies, we also expect growth to speed up somewhat in 2015 and 2016. Most such countries have shown resilience amid the prevailing geopolitical turbulence. We also believe they are generally well equipped to deal with the impact of the US Federal Reserve's cautious rate hikes. Overall, EM growth will climb from 4.6 per cent in 2014 to some 5 per cent in 2015 and 2016.

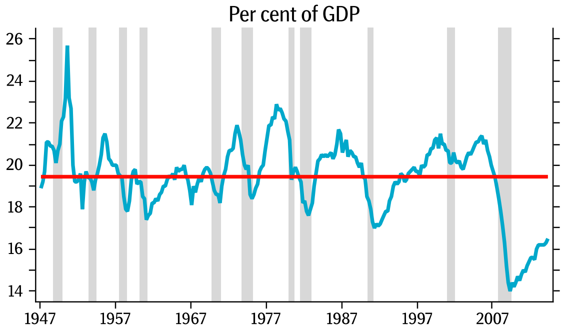
In an environment where major central banks are moving in different directions and growth is accelerating somewhat, but where large downside risks persist, financial market trends will be less clear. Looking ahead, US and UK central bank rate hikes are likely to **lead to a moderate upturn in bond yields**. Due to ever-widening interest rate gaps between the Fed and the ECB, the spread between US and German 10-year sovereign yields will increase further from today's already high level. Bond yields will thus remain historically low in Europe; the German 10-year yield will not exceed 2 per cent during our forecast period. **Stock market volatility will probably increase** as the Fed's rate hikes approach. If our forecast of continued low interest rates and a degree of acceleration in global growth proves correct, there is potential for rising share prices further ahead. **Exchange rates will also be largely influenced by differences in monetary policy**. Among other things, this implies a gradual appreciation of the US dollar. We expect the EUR/USD rate to continue down to 1.20 by the end of 2016. Scandinavian currencies will eventually appreciate against the euro, but cautious central banks will help limit that potential. This autumn the Swedish krona will also be weighed down by further Riksbank stimulus measures and by political uncertainty related to the September parliamentary election.

US: Growth engine of unruly world economy

Most indications are now that the US economic slump early in 2014 was due to temporary factors such as severe winter weather, de-stocking in the automotive industry and the temporary effects of economic policy measures (see the box in the US section of this issue). GDP growth rebounded to an annualised 4.0 per cent in the second quarter. More and more factors suggest a continued upturn, with GDP growth above 3 per cent in both 2015 and 2016. Confidence indicators are at high levels and the labour market has shifted to higher gear. Rising wealth and good incomes will benefit consumption. At present, fiscal policy is less strict and less uncertain than for a long time. Even if the Fed begins hiking its key interest rate next spring, monetary policy will provide continued support. In such an environment, we see good prospects for cyclical sectors to expand from today's depressed levels. By the end of our forecast period, unemployment will fall below its equilibrium level, but we do not expect general resource problems to stop the recovery.

US: Big upside in the most cyclical sectors

Per cent of GDP



Source: BEA, SEB

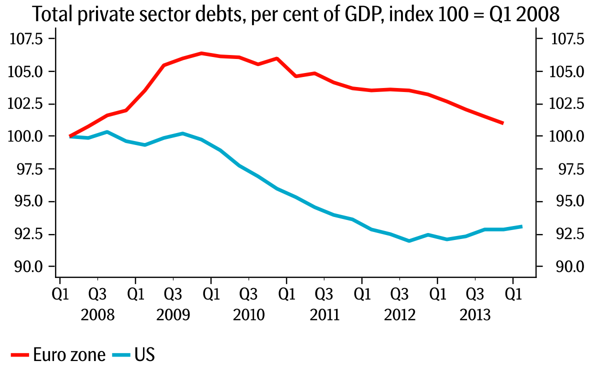
Renewed euro zone weakness

In the euro zone, disappointments have predominated in recent months. Even the German economy has weakened, which is partly connected to the direct and indirect consequences of trade disruption with Russia. The euro zone economy is generally vulnerable, in a situation where balance sheet adjustment has a long way to go. In addition, the credit market is not yet working satisfactorily, though risk premiums for government securities have greatly decreased. Because of weak real growth, combined with very low inflation, nominal GDP is stagnating. This worsens the debt dynamic in many countries, since the budget-tightening they have implemented has not been enough to bring down their debt as a percentage of GDP. We have revised our **2014 and 2015 growth forecasts rather clearly downward to 0.7 and 1.1 per cent**, respectively (previously 1.0 and 1.6). In **2016**, growth will be **1.5 per cent**.

This somewhat stronger growth will be largely driven by ECB stimulus programmes. The measures the bank approved in early June have not yet begun to have much effect, and also we expect further stimulus programmes ahead. Other countries will also provide some help. Several crisis-hit countries, especially Spain, are entering a more robust growth phase after their previous deep downturns. France and Italy are showing worrisome stagnation tendencies, however. The process of increasing European Union political and economic integration is moving sluggishly. The election to the European Parliament last spring was a success for parties that oppose expanded supranational powers. In the near term, the process of creating a common EU banking union will continue, but otherwise not much is likely to happen. The euro zone thus has quite far to go before it has laid the groundwork for a stable, well-functioning currency union. The ECB's efforts remain vital in order to keep the euro zone together.

Continued need to pay down private debts in the euro zone

Total private sector debts, per cent of GDP, index 100 = Q1 2008



Source: Banque de France

EM economies are showing resilience

In recent months, emerging market (EM) economies have shown resilience to increased geopolitical uncertainty. Overall, we anticipate some acceleration in growth this coming year, among other things because there is room for continued loose monetary policies. Although EM countries are struggling with various types of structural problems, we still believe they are rather well equipped to meet the challenges that the Fed's coming interest rate hikes will bring. In particular, generally strong external balances and robust exchange rate systems are in contrast to the situation in the late 1990s when the Asian financial crisis broke out.

The **Chinese economy** seems to be holding up well against the ongoing downturn in the construction sector. We have revised our GDP growth forecast a bit upward to 7.5 per cent. After that we foresee a controlled and cautious slowdown to 6.9 per cent in 2016. There are high hopes for the economic policies of the **new Indian** government (BJP). We foresee a certain risk of disappointments on the reform front but still believe that growth will accelerate from 5.0 per cent this year to around 6 per cent in 2015 and 2016. Structural factors have contributed to the sharp deceleration in **Brazilian** growth over the past few years. During 2000-2010, annual growth averaged 3.7 per cent. Our GDP forecast for 2014 is 1 per cent. Far-reaching structural reforms are needed to get the economy moving. Capital spending will need to take over from private consumption as the main driver of growth. The presidential election in October could serve as a catalyst for change, but none of the main candidates has shown an impressive reform agenda. Weak growth will continue during our forecast period, with GDP rising by 2-2.5 per cent in 2015 and 2016.

Downside risks have increased somewhat

Because of greater geopolitical risks, for example connected to risks of escalation in the Russia-Ukraine crisis combined with renewed stagnation tendencies mainly in the euro zone, downside risks have increased somewhat in recent months. Looking ahead a bit, we also see a certain risk that US interest rate hikes may come at such an early stage that they will have negative international consequences. **We have thus raised the probability of our low-growth scenario to 30 per cent from 25 per cent in the May 2014 issue of *Nordic Outlook***.

As in recent issues of *Nordic Outlook*, we estimate the probability of a faster-growth scenario at **20 per cent**. Our main scenario implies that secondary effects from the American economic upturn will be weaker than usual. Yet one potential upside for our global forecast is that the positive international impact of the US upturn will be more in line with historical patterns.

Permanently higher geopolitical risk level

In recent months, geopolitical uncertainty has escalated. The main focus has been on Russia-Ukraine, the Islamic State (IS) offensive in Iraq and the Israel-Palestine conflict. Apart from these, there are a number of other conflicts in which no solution is in sight, for example the civil war in Syria, the ongoing disintegration of Libya and increased tensions between various groups in other African countries. Behind the scenes, we are also seeing how China's increasing strength and growing long-term power ambitions are creating tensions in East Asia, especially in relations to Japan and Vietnam.

The EU has entered the toughest phase (No. 3) of its sanctions plan against the Russian economy. Russia has responded with trade barriers in the aviation, agriculture and food sectors. Western sanctions are intensifying the structurally weak trend in the Russian economy, and the conflict has in itself already pushed Ukraine into a deep recession. **Yet in our assessment, the direct effects on the EU will be rather small**. Hardest hit will be Finland and the Baltic countries, which are the most dependent on trade with Russia. Looking ahead, we believe that the EU countries will not be inclined to escalate trade sanctions further, partly due to their vulnerable domestic economic situation. However, the likelihood of a Russian invasion in parts of eastern Ukraine has recently increased, and thus also the risks of serious secondary economic effects.

Oil prices have not been driven up by the trouble spots in the Middle East and North Africa. Instead they have tended to fall. Perhaps the most important link between geopolitical turmoil and global economic activity seems to have been broken, making the impact of such turmoil more unclear. Greater geopolitical tensions presumably have a negative psychological effect, primarily on the investment climate. But sometimes the massive new flow from crisis flashpoints seems to lead to an initial tendency to exaggerate the global economic and financial effects of emerging crises.

In a long-term perspective, however, we can still foresee the beginnings of a negative trend. **The relaxation of tensions following the fall of the Soviet Union and the end of the Cold War stimulated the world economy**. The shift towards greater democracy and economic liberalisation helped drive demand and trade for a long time. The US was able to transfer resources from military to civilian use, but still maintain its role as an unchallenged superpower that guaranteed stable international trade conditions.

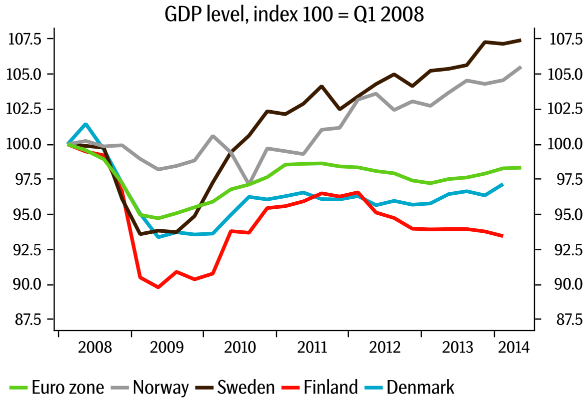
There are many indications that we are now entering a phase of weakened US authority, for both political and economic reasons. The conflict of interests between the West and Russia is likely to persist, especially in light of the prevailing political trends in Russia. Meanwhile the rivalry between China and the US is likely to grow as Southeast Asia becomes an increasingly important world economic engine. These developments represent both threats and opportunities. **But the stimulative effect on global trade created by the relaxation of tensions in previous decades is unlikely to return**. Instead the geopolitical situation will probably become more uncertain ahead. Regional conflicts are likely to become more common. This will probably also mean that the global community must prepare to deal with larger flows of refugees.

Finland lagging other Nordic countries

The Nordic countries continue to show divergent growth trends. The **Swedish** economy is showing decent growth, primarily due to strong consumption that is benefiting from rising real incomes and asset prices. Yet industrial production and exports are not taking off and they will also continue to show subdued growth. Employment is rising, but because of the rapidly increasing labour supply the jobless rate is falling very slowly. Fiscal policy will probably be neutral over the next couple of years, although there is great uncertainty about the shape of economic policy after September's parliamentary election. Low inflation and falling inflation expectations continue to pressure the Riksbank, which will deliver further monetary stimulus measures this autumn.

Divergent performance in the Nordic countries

GDP level, index 100 = Q1 2008



Source: Eurostat

The **Finnish** economy is fighting an uphill battle. Structural problems in the forest product and information and communications technology (ICT) sectors have hampered growth for a long time. Now the country is also being hit relatively hard by slow Russian growth and Russian import restrictions. Most parts of the Finnish economy are under pressure; exports are weak, unemployment is high and household incomes are growing at a slow pace, while businesses are hesitant to invest. GDP will fall by 0.6 per cent in 2014 and then increase weakly in 2015 and 2016. The **Danish** economy is showing stronger growth dynamics after several weak years. Rising employment and home prices as well as looser fiscal policy will support households. Improved international economic conditions will benefit the corporate sector. We believe initial resource utilisation is relatively low, which will help GDP grow above trend throughout our forecast period. The **Norwegian** economy is dominated by forces that are pulling in different directions. The headwind is coming from lower capital spending in the oil and gas sector as well as weak residential investments. But the labour market has stabilised, along with the housing market, and good real income increases are providing support to consumption. We expect Norway's GDP growth to accelerate from 1.6 per cent this year to 1.7 per cent in 2015 and 2.1 per cent in 2016. This is somewhat below trend.

Nordics and Baltics, GDP growth

Year-on-year percentage change

	2013	2014	2015	2016
Sweden	1.6	2.1	2.9	2.7
Norway	0.6	1.6	1.7	2.1
Denmark	0.4	1.8	2.3	2.5
Finland	-1.2	-0.6	0.5	0.9
Estonia	0.8	0.5	1.8	3.0
Latvia	4.1	2.5	2.7	3.4
Lithuania	3.3	2.7	3.2	4.0

Source: OECD, SEB

Baltics weighed down by effects of Russia

The Baltic countries are being hit relatively hard by the Russia-Ukraine conflict due to their large volume of trade with Russia. Exports and capital spending are being hampered by Russian economic stagnation and increased regional uncertainty. Russian food import restrictions are impacting Lithuania the hardest, but Estonia is generally the most vulnerable of the Baltics due to its higher export level relative to GDP and its strong connections to the shaky Finnish economy.

Meanwhile there are positive growth forces in the Baltics. Private consumption remains relatively robust, sustained by continued high real wage increases. Looking at capital spending, construction is continuing to grow while infrastructure projects will receive increased support from EU funds after a decline in recent years. Direct investments in Lithuania will also receive an extra push when the country joins the euro zone on January 1, 2015. Overall, we predict some acceleration in Baltic growth in 2015-2016, although we have revised our 2015 forecasts for all three countries by about 0.5 percentage points compared to the May *Nordic Outlook*.

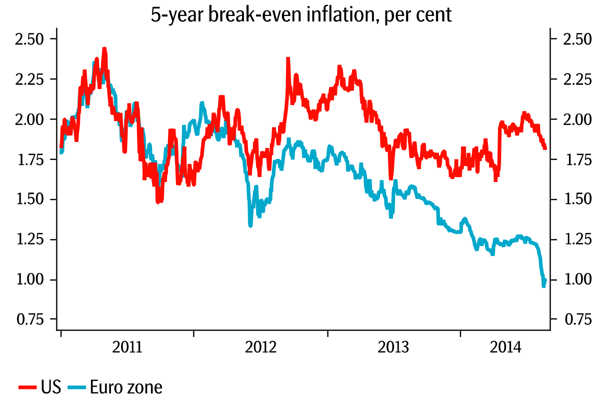
Ever more divergent inflation environments

During the first half of 2014, tax hikes in Japan and rising core inflation in the US were instrumental in raising Consumer Price Index (CPI) inflation in the OECD countries from 1.5 to about 2 per cent. Generally, however, inflation pressure in the developed economies remains low. They share many of the forces that are driving this trend; for example, **low resource utilisation is continuing to hold back wages and profit margins**. International producer prices for consumer goods are also continuing to fall. Falling commodity prices, especially for energy and food, have recently led to further downward pressure on inflation. Looking ahead, we expect oil prices to remain rather stable at around USD 100/barrel. Rising oil production in the US and Saudi Arabia and somewhat lower international demand, for example because of lower prices for other types of energy, are offsetting production disruptions in crisis-hit regions. Oil price risks are on the downside.

The differences between the inflation environments of various regions are meanwhile becoming increasingly evident. In the US, CPI inflation climbed from 0.9 per cent in October 2013 to 2.0 per cent in July. So far, unit labour costs have been pushed somewhat higher by falling productivity growth, but wages and salaries are likely to take over as a driving force when unemployment approaches its equilibrium. Inflation expectations in the US are at fairly comfortable levels from a central bank perspective, and the Federal Reserve has consequently toned down deflation risks. Our forecasts indicate that CPI will increase by 1.9 per cent in 2015 and by 2.2 per cent in 2016. The Fed's favourite measure, the personal consumption expenditure (PCE) deflator, will end up a bit lower. The risks are on the upside, however.

Divergent inflation expectations

5-year break-even inflation, per cent

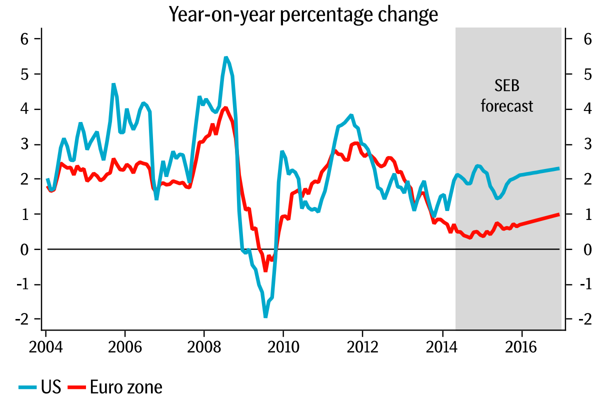


Source: Bloomberg, SEB

In the euro zone, the deflation threat nevertheless remains a focus of attention. Inflation has continued to deliver downside surprises, and the downturn in inflation expectations has actually speeded up since the European Central Bank (ECB) presented its broad stimulus package in early June. Wage and price adjustments in crisis-hit euro zone countries are continuing; both Greece and Spain showed falling prices in July. But even in Germany, inflation is below 1 per cent, which also makes it harder for crisis-hit countries to solve their competitiveness problems. We believe that the euro zone as a whole can avoid deflation, partly because further ECB stimulus measures will improve the credit market situation and help weaken the euro. Measured as annual averages**, inflation** according to the Harmonised Index of Consumer Prices (HICP) **will be 0.5 per cent in 2014, 0.6 per cent in 2015 and 0.9 per cent in 2016**. Core inflation in 2015 will be somewhat below HICP inflation.

CPI inflation

Year-on-year percentage change



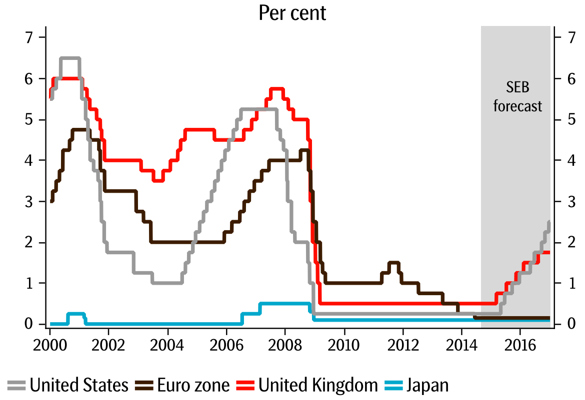
Source: Eurostat, BLS, SEB

Central banks face widely different choices

The world's central banks are facing many challenges and dilemmas. Today's systems assign heavy responsibility to them for stabilisation policy, but it is not self-evident that the instruments available to them are sufficiently effective. The prevailing low interest rate environment both stimulates and compels greater financial risk-taking, but it is far from certain that it generates productive investments. Meanwhile the risks of financial imbalances will increase the longer this exceptionally low interest rate environment persists. Nor, at present, is there much agreement on how responsibilities should be allocated in the future when it comes to safeguarding financial stability and countering financial imbalances. The interplay between interest rate policy, tax policy and macroprudential supervision is especially complicated and hard to assess in such an environment.

Key interest rate

Per cent



Source: Macrobond, SEB

On the whole, monetary policy will remain expansionary during our forecast period, but the leading central banks in the OECD countries face different sets of choices. We expect the BoE and the Fed to take their first cautious steps towards normalisation during the first half of 2015. Our forecast is that the BoE will be the first, raising its key interest rate in February, and that the Fed will follow suit in April. Then they will carry out cautious rate hiking cycles, with the US federal funds rate reaching 2.5 per cent and the British base rate 1.75 per cent by the end of 2016. In two theme articles (*What should central banks aim for?* and *Is low potential GDP growth in the US here to stay?*) we discuss the reasons why we believe that rate hikes will occur at a slower pace than has been historically normal and why we believe that a neutral key interest rate is now around 3 per cent: far lower than previously. No active changes in US and British central bank securities portfolios will probably be carried out during our forecast period.

Meanwhile we expect the ECB and the BoJ to expand their stimulus programmes. The BoJ will enlarge its balance sheet this autumn beyond the level announced so far. Because of sluggish economic growth and falling inflation expectations, during the spring of 2015 the ECB will initiate a traditional quantitative easing (QE) policy, including weighted purchases of government bonds. The ECB and BoJ will leave their key interest rates at close to zero throughout our forecast period.

Due to low inflation and falling inflation expectations, Sweden's Riksbank will lower its key interest rate further to 0.15 per cent this autumn. We also expect the central bank's Governing Council to reach consensus on guidance based on the conditions that must be met before raising the repo rate. Decisions on new tightening measures will probably also be made this autumn within the macroprudential supervisory system, thereby increasing monetary policy manoeuvring room. The Riksbank will not begin its rate hikes until early 2016, and by year-end the repo rate will stand at 1.0 per cent.

Fiscal policy makers seek new mechanisms

After the budget-tightening of recent years, fiscal policy looks set to provide a relatively neutral growth impulse over the next couple of years. Deficits have fallen to a level that is stabilising government debt, although GDP stagnation is making debt problems more difficult in the crisis-hit countries of the euro zone. Debt levels are nevertheless so high in most developed economies that unfunded projects are difficult to implement.

Fiscal policy makers still have an important role to play. There are lingering risks of long-term (secular) stagnation connected to the weakened effectiveness of interest rate policy in the prevailing environment of balance sheet adjustment, which the recent period of economic weakening in the euro zone has further accentuated. In the last *Nordic Outlook*, we discussed the potential for tax policy in a box entitled "Tax policy – a key that can unlock growth?" The main argument, for example in International Monetary Fund (IMF) analyses and proposals, is that tax reforms with a favourable redistribution profile will provide an injection of economic stimulus. **This is because they supply lower-income households with resources, and these households normally have a higher marginal inclination to consume**.

The international economic policy discourse is now beginning to focus increasingly on the potential for setting private investments in motion more rapidly. There may be various reasons for sluggishness in investment activity, for example global overcapacity or increased political uncertainty at national and global levels. Another explanation is that return requirements are still too high, creating financial short-termism and hampering investments aimed at increasing production capacity. There are many justifications for large infrastructure investments in such sectors as transport, energy, water and communications. Aside from their cyclical growth stimulus, they can also improve long-term growth potential. For developing countries, infrastructure investments help boost growth, reduce poverty and promote environmental and climate-related efforts.

Right now the use of government resources to try to kick-start private investments is a consistent theme in such debate forums as the G20, the EU and the BRICS group of countries. To avoid increased public debt, one strategy is for such bodies as the European Investment Bank, the World Bank, the IMF or the BRICS countries' new development bank to mobilise resources for concrete investments. Through partnerships, long-term investors such as pension funds will also find attractive investment alternatives.

The exact mechanisms for this kind of collaboration are being worked out. But if infrastructure projects partially based on private funding are to become possible, this will require a long-term approach and broad parliamentary support. Partnerships also require a high degree of certainty in the wording of legal contracts that regulate allocation of responsibilities among the parties involved. The ambition is that the G20 countries will take the first concrete steps at their summit in Brisbane later this year. This will put pressure on all 19 countries plus the EU to deliver decisions: the G20's target is for these measures to help boost global growth by 2 per cent over the next five years.

Continued decoupling of bond yields

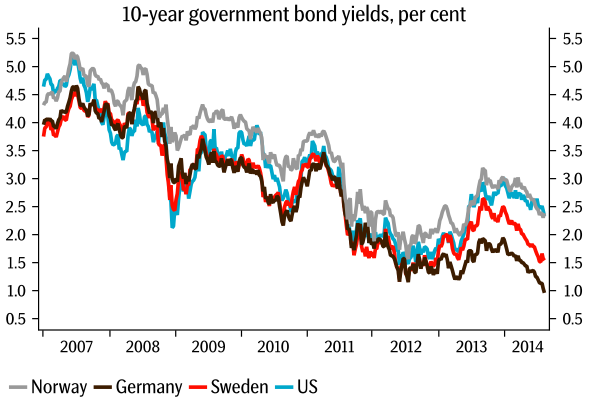
After a temporary US-driven upturn last autumn, this year long-term yields have been in a downward trend. Since January 1, yields on 10-year US Treasuries have fallen by 60 basis points, while yields on German 10-year bonds have nearly halved to record lows of less than 1 per cent. This downturn in yields has been driven by several factors. The economy has repeatedly shown signs of weakness, and inflation has shown downside surprises, especially in the euro zone. New monetary easing by the ECB is also expected, and the Fed has sent soothing signals regarding the pace of its interest rate hikes. Geopolitical worries have also contributed to a greater appetite for liquid American and German government securities.

The trend of international bond yields will continue to be dominated by historically expansionary monetary policies. In the US, long-term yields are rising in anticipation of the start of key interest rate hikes next spring. Looking ahead, however, the upturn may be limited because the Fed may be expected to proceed substantially more slowly than during previous rate hiking cycles, although we see an upside risk in relation to cautious market pricing. Yields on 10-year US Treasuries will be 3.20 per cent at the end of next year and 3.60 per cent at the end of 2016.

Falling inflation expectations, and expectations of further easing by the ECB, will exert downward pressure on long-term German yields this autumn. But if the ECB succeeds in stabilising and raising inflation expectations, we believe that long-term German yields may begin moving upward in line with the American pattern during the QE programme. At the end of 2015, German 10-year government bond yields will be 1.50 per cent, and at the end of 2016 they will be 1.90 per cent. This means that the US-German yield spread will widen further from today's 140 points to 170. The US-German spread has not been this wide since the 1980s. **The decoupling between US and euro zone economic cycles and inflation will also show up in the fixed income market.**

Long-term yields have again trended downward

10-year government bond yields, per cent



Source: Macrobond

In Sweden, the spread against German long-term yields has narrowed since the Riksbank cut its key interest rate by 50 basis points in July. New Riksbank actions in the form of a rate cut during the fourth quarter plus clearer guidance on what will be required before the Riksbank will again begin to hike the repo rate will narrow the spread to a low of 40 points, compared to 60 points today. As rate hikes approach again in 2016, the spread will widen to around 60 points by the end of 2016, which is close to the peak levels of the past 20 years. Because of low international yields, the **yield on a 10-year Swedish government bond will still remain at low levels, around 2.60 per cent at the end of 2016**.

Due to rising activity during the summer and inflation that is stuck at high levels, Norwegian bond yields have not been pulled down by the German yield decline. This autumn we also believe that better liquidity in the Norwegian fixed income market will also help narrow the spread. **The 10-year spread against Germany will thus shrink from today's record levels at 130-140 basis points to 120 points at the end of this year and 90 points at the end of 2015**.

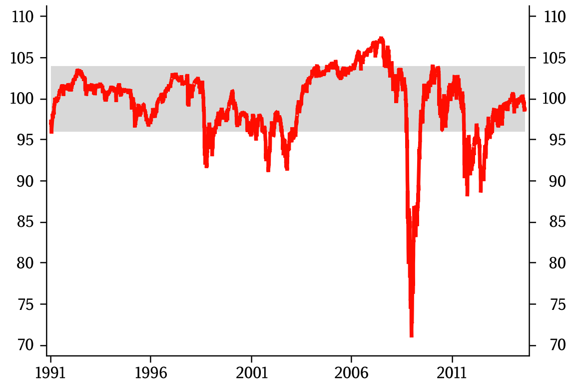
Higher stock market volatility on the way

During the past six months, stock markets have faced a number of challenges. Macroeconomic signals have not been persuasive and geopolitical trouble spots have flared up in rapid succession. SEB's index of global risk appetite has also gradually fallen. But despite macro disappointments in several major markets, a majority of corporate interim reports for the second quarter ended up close to or above earnings and sales expectations. We also believe that the need for downward revisions in the earnings outlook has decreased or even ended. The prospect of further monetary stimulation – for example, by the ECB and Bo J – has also confirmed the picture of persistently low interest rates and bond yields. **Low interest rates serve as a shock absorber** in an uncertain situation where share valuations are beginning to reach higher levels.

Looking ahead, we foresee various forces that will influence the stock market climate. Monetary policy impulses will be mixed, but as the US and British central banks move closer to interest rate hikes, we expect volatility to increase. Persistent geopolitical uncertainty also suggests volatile stock market performance during the next six months. At the same time, our forecast of continued low interest rates means that current valuations imply a rather high risk premium on equities. If the global economy performs in line with our forecasts, equities appear to be an increasingly attractive alternative to investments in government securities and corporate bonds.

SEB risk appetite index

Index 96-104 neutral zone



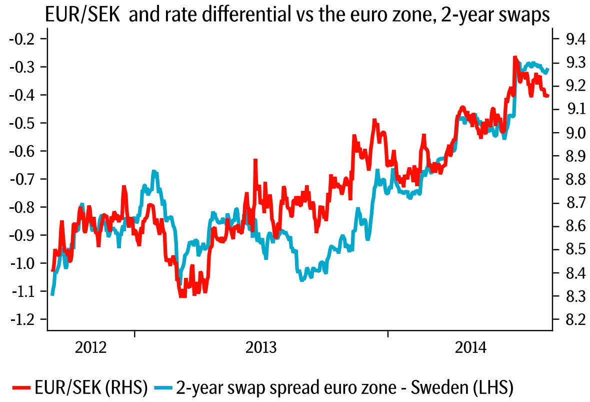
Source: SEB

Interest rate policy will dominate FX market

The foreign exchange (FX) market continues to show high volatility and range trading. So far in 2014, high interest rate currencies – often commodity currencies – have performed best. Looking ahead, the driving forces that have characterised the past year are likely to persist. Speculative market players are acting mainly in response to signals from central banks about monetary policy changes, with moves towards tighter policies unavoidably seeming to lead to a stronger currency.

Rate expectations steer SEK

EUR/SEK and rate differential vs the euro zone, 2-year swaps



Source: Macrobond

Given this dominant driving force, it is natural to stick to our forecast that the US dollar will trend higher, since the Fed will be raising its key interest rate long before the ECB. Over the past year, the euro has remained firm because investors have had a great inclination to increase their European portfolio holdings as the ECB has successfully stabilised the euro zone. This factor is now fading in strength, which will later lead to a continued weakening of the euro against the USD. We expect a EUR/USD exchange rate of 1.30 at the end of 2014; then the rate will move towards 1.20 at the end of our forecast period.

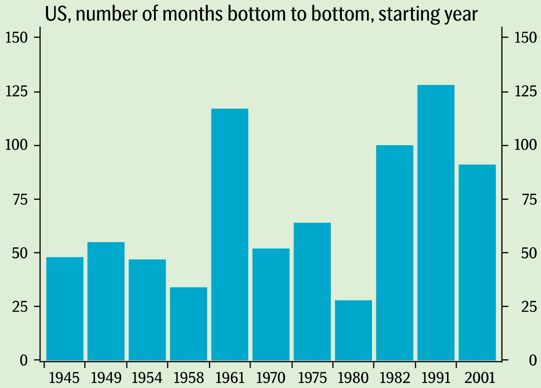
How long will the recovery last?

The economic recovery has now been under way for a rather long period. Share prices, industrial production and GDP generally bottomed out in 2009 and have trended upward since then in most countries. Now that we are extending our forecast horizon to the end of 2016 – eight years after the Lehman Brothers crash – there is reason to ask how long the recovery can last. There are several conceivable approaches for assessing this:

Historical patterns. For decades after the Second World War, a certain regularity was discernible in economic cycles, which lasted about 5 years (including both upturn and downturn). These cycles were often driven by labour market, investment and inventory cycles. Given this mechanical way of thinking, a new cyclical downturn might come soon. But after financial markets were deregulated in the early 1980s, the pattern seems to have changed. Upturn phases have become longer. Normally, various forms of bubble-like imbalances have gradually built up. When these have become unsustainable, relatively deep downturns have followed. Our conclusion is that at present, it is hardly meaningful to estimate the duration of the recovery by citing historical regularity.

The economic cycle has become longer

US, number of months bottom to bottom, starting year



Source: NBER

Output and labour market gaps. Resource gap analysis is a natural tool for trying to estimate the duration of an expansion. Growing international economic integration, especially via greater labour mobility, means that output gaps are increasingly becoming a global matter. However, country-by-country gap analyses are important in shaping economic policy, since it presumably provides guidance about future inflation and overheating risks. During our forecast period, there will be clear differences between regions. In the US, we expect unemployment to fall below its equilibrium level during 2016, yet depressed productivity and labour supply levels still suggest there is some spare capacity in the economy. A similar situation applies in the UK. Low German unemployment indicates that the economy is close to normal capacity utilisation, whereas there is plenty of spare capacity elsewhere in the euro zone. To summarise, we believe that we will be rather close to equilibrium at the end of 2016, but that even then there will be some spare capacity in the OECD countries as a whole. Our gap calculations thus suggest that the upturn may continue for another while.

Output gaps in selected countries

Per cent of GDP *

	Q2 2014	Q4 2016
United States	3.5	1.0
Japan	1.5	0.5
Euro zone	4.0	2.0
Germany	1.5	0.5
United Kingdom	2.0	0.5
Sweden	3.0	1.0
OECD	3.2	1.0

* Positive figures mean spare capacity
Source: OECD, SEB

Imbalances and financial bubbles. Gap analysis has, however, been insufficient in recent years to predict the major shifts in financial and economic performance. For a long period (the Great Moderation), inflation was almost improbably low and stable in many countries. Central banks with inflation targets thus had both legitimacy problems and analytical difficulties in deciding when to impose monetary tightening in order to prevent imbalances from growing to unsustainable size. The dramatic financial and economic crisis thus led to a discussion of the need to change the economic policy framework. The development of new macroprudential supervision policies is precisely intended to relieve central banks of the dual tasks of simultaneously meeting inflation targets and preserving financial stability. How effectively the various branches of the political system can work together to avoid the build-up of unsustainable financial imbalances in the future is nevertheless uncertain.

To summarise, it is difficult to **draw any clear conclusions on the length of the current recovery based on historical patterns or regularities**. However, developments over the past five years have confirmed experiences from earlier balance sheet crises; the recovery will be lacklustre and lengthy, among other things because balance sheet adjustment weakens the effects of interest rate stimulus measures. This has contributed to speculation that growth has been damaged in the long term (secular stagnation). Although such uncertainty makes the task of central banks more difficult, it is still **unlikely that resource shortages will halt the upturn during our forecast period**. The duration of the recovery will instead probably be determined by the shape of economic policies. The big challenge will be to formulate an exit strategy that avoids both an abrupt cyclical downturn and new financial bubbles. According to our forecasts, this question will not come to a head in the next couple of years. Our conclusion is that the cautious upturn can continue for another while.

The Japanese yen has stabilised following the earlier BoJ-induced depreciation. We believe that a bit further ahead the JPY will continue to weaken, among other things due to new central bank stimulus measures. The USD/JPY rate will move to around 115 by the end of 2015.

Because of the Riksbank's key rate cuts from 1.0 per cent in December to its current level of 0.25 per cent, the SEK has showed the weakest performance among G10 currencies. In the recent calmer environment the krona has nevertheless regained some ground, supported by krona-positive flows. Uncertainty about the parliamentary election, combined with further stimulus measures by the Riksbank, will probably weigh down the krona in the short term. The downside for the krona is limited, though. Towards year-end the EUR/SEK exchange rate will be 9.25. During 2015 and 2016, we will then see a gradual krona appreciation as stronger Swedish growth persuades the Riksbank to begin rate hikes long before the ECB. At the end of 2015, the EUR/SEK rate will be 8.90. At the end of 2016 it will be 8.70. Our forecast of gradual US dollar appreciation against the euro will lead to a slow upturn in the USD/SEK rate to 7.25 at the end of our forecast period.

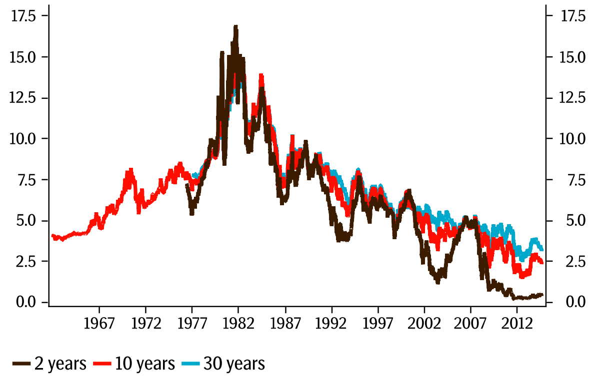
Given our forecast that Norges Bank will not deliver the key rate cut that the market has partly discounted, the outlook for the Norwegian krone is cautiously positive. Yet an excessively strong currency runs a risk of triggering a rate cut. We believe that Norges Bank will again warn the market if the NOK moves too high. A EUR/NOK exchange rate of around 8.00 thus seems to be a benchmark, looking ahead a year or so.

- **Central banks at an important crossroads**
- **Bond portfolios in standby mode – automatic adjustment most likely**
- **New normal key rate around 3 per cent**
- **Greater financial volatility after rate hikes**

Global monetary policy has now been **exceptionally expansionary for six years**. Both nominal and real key interest rates have been close to zero or negative. Meanwhile central banks have expanded their balance sheets by USD 14.65 trillion: up 83 per cent to USD 22.65 trillion by our calculation. This increase is equivalent to 20 per cent of both global GDP and stock market capitalisation (July 2014). The economic outlook indicates a continued need for monetary policy support, but various countries are approaching the date when they will **begin a normalisation process, including slimmed balance sheets and higher key interest rates**.

US: 30-year interest rate also near record low

Per cent



Source: Macrobond

Central bank assurances that exceptional policies will last until the recovery is on firm ground have helped to keep volatility in financial markets very low in recent years. The normalisation process is thus likely to result in **greater financial volatility**. For example, the economic recovery may well suffer temporary setbacks ahead, creating uncertainty about the sustainability of normalisation policies. The need to adjust large financial global portfolios to a new risk environment will also have an impact.

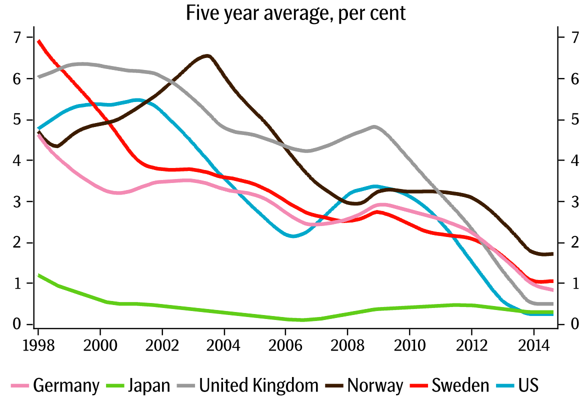
No rapid slimming of balance sheets

We believe that **upward adjustments in key interest rates will be the next step in normalisation policy** and that active changes in bond portfolios will be delayed. By raising interest rates, central banks probably want to **create manoeuvring room** that will enable them to deal with any new setbacks. In case there are new periods of economic weakness, a reduction in central bank portfolios in a situation where recovery is not completely ensured may create **communication challenges and renewed monetary policy uncertainty**. A reduction of bond portfolios at the beginning of normalisation also risks being interpreted by the market as meaning that rate hikes may be accelerated, which on the whole would result in an **excessively large monetary tightening**.

Our main scenario is thus that central bank **bond holdings will be adjusted gradually** by not reinvesting loans as they mature. If the quantity of liquidity in the system is considered too large, there are alternative instruments that can reduce its impact on the economy. New IMF estimates indicate that the Federal Reserve, by not reinvesting the proceeds of maturing bond loans, will achieve a portfolio that may be regarded as optimal from the standpoint of promoting efficient markets in about eight years. For the Bank of England (BoE), the situation is different: not until 2060 will the expanded government securities portfolio reach its equilibrium level after the GBP 375 billion expansion that has occurred in recent years.

Key interest rates: Falling trend

Five year average, per cent



Source: Macrobond

Interest rate hikes in small steps

Our main forecast (see *International overview*) is that **interest rate hikes will be carried out cautiously and that key interest rates will remain historically low**. This is also consistent with what the BoE and the Fed are communicating. For example, BoE Governor Mark Carney has emphasised that **2.5 per cent**, not 5 per cent, **is the "new normal"** for the British base rate and that this level can be achieved by early 2017. In itself, it is worth noting that central banks are often inclined to signal a cautious strategy at the beginning of a hiking cycle, when they are not yet sure that the recovery is firmly established. In the current situation, however, we see several reasons why the low interest rate scenario will stick:

1. Sluggish cyclical growth. Healing processes following the global recession/financial crisis are continuing, but debt levels remain dangerously high in some countries. This will impede growth for years to come, due to deleveraging, higher emergency saving and more cautious capital spending. A lengthy period of lower average growth is compatible with lower real interest rates.

2. Slower long-term growth. An ageing population and in all likelihood slower productivity growth point in the direction of slower real potential growth, compared to recent decades. Credit-driven growth before the crisis broke out in 2008 probably helped mask an underlying trend towards falling productivity growth in developed economies. This signals a new environment of lower real equilibrium interest rates.

3. Continued downward pressure on inflation. Expanded production resources in the commodity, energy and food industries as well as more efficient resource utilisation are expected to push down their prices in the future. Meanwhile globalisation implies further integration of production capacity – in Asia/Africa – and downward pressure on wages and salaries. Today inflation is, in many respects, a global phenomenon – with national output gaps gradually diminishing in monetary policy importance.

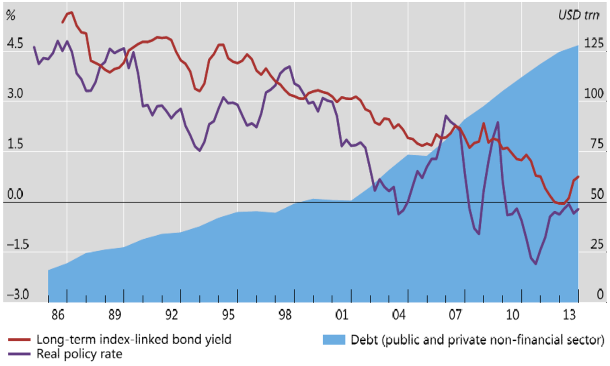
4. The new role of macroprudential supervision policies. The development and launching of new tools that regulate credit volumes will ease the burden on monetary policy makers and thereby make lower key interest rates possible.

Not too quickly ...

The economic recovery of recent years has been generally lacklustre in most large industrialised countries. Debt deleveraging needs have weakened the effectiveness of monetary policy and made their economies less interest rate-sensitive. But this is not symmetric. Because **private debt remains at record-high levels**, future rate hikes – after a long period of low interest rates – may have a powerful impact on the economy despite continued low interest rates.

Global private debt and interest rate trend

USD trillion and per cent



Sourcer: BIS

A number of factors will play a role in how future interest rate hikes are planned and implemented:

1. Aggregate financial conditions increasingly important. Recent communications from central banks indicate a greater interest in the aggregate effect of monetary policy on currency rates, credit spreads and stock markets. If interest rate hikes result in unexpectedly tight financial conditions due to falling share prices, rising long-term yields and appreciating currency, it is thus likely that central bank actions will be more cautious.

2. Political pressure on central banks. Due to a lack of fiscal policy manoeuvring room, central banks will remain under pressure to help sustain economic growth. An increased focus by economic policy makers on capital spending as the most important growth force will also accentuate the need for continued low interest rates.

3. Target symmetry will lead to increased acceptance for rising inflation. In recent years inflation has been well below central bank targets, while resource utilisation has been low. For reasons of symmetry, central banks will thus probably be less sensitive to inflation and inflation expectations being above their targets for a time. Lingering risks of setbacks and stagnation also point to such increased acceptance.

4. Global considerations will have a certain influence. During the crisis, monetary policy cooperation was easier because countries faced similar economic and financial challenges. Now that we are moving towards greater inflation and growth divergence, the tensions in global monetary policy cooperation will probably increase. Taking global factors into account is not part of central bank mandates. Yet it is likely that the Fed, the BoE and others will be subjected to pressure to take into account the effects on global capital streams and exchange rates when they shape their normalisation strategies.

... and not too slowly

Acting too slowly also entails risks. Low interest rates and generous access to money boost risk-taking, but it is far from certain that this leads to productive investments. In an environment where investors are searching for returns, there are obvious risks of **financial imbalances and poor real investments**. Although macroprudential supervision policies are gaining in importance, there is not yet a broad consensus on what role interest rates should play in regulating credit growth or countering asset price bubbles. Delaying interest rate hikes for too long also decreases pressure on political systems to implement structural reforms, while postponing necessary balance sheet adjustments in the private sector.

We arrive at the following overall conclusions:

- Weak demographic and productivity trends indicate that potential future GDP growth will be lower than in recent decades.
- Structural reasons point to a lower real equilibium interest rate. Central banks will regard a level of around 3 per cent as the new benchmark for a neutral key interest rate.
- High debt levels and a long period of exceptionally low interest rates will imply high interest rate sensitivity in many economies. This will probably make central banks extra cautious in the medium term.
- A lower neutral key interest rate will mean that asset prices will generally be at a higher level than before the crisis.

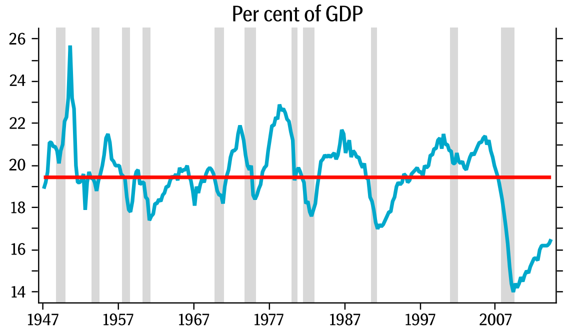
Interest rate hikes looming ahead

- **Incomes and consumption growing faster**
- **Home price increases decelerating**
- **Vigorous labour market**
- **Wage inflation rebounding from low level**

After a very weak first quarter, the American economy has regained its energy. GDP growth in the second quarter was 4.0 per cent on an annualised basis, and **indicators are exuding optimism**. The recovery is thus continuing as planned, with households as the growth engine. Business investments are also gaining momentum, while residential investments are falling short of our earlier forecasts. Overall, **we predict that GDP growth will reach 2.2 per cent this year, 3.4 per cent in 2015 and 3.1 per cent in 2016** – above potential and consensus in all three years. Cyclical sectors remain depressed, an indication that the recovery will continue for several more years, especially since the Federal Reserve is proceeding cautiously with interest rate normalisation. **The first key interest rate hike will come in April 2015**, and by the end of our forecast period, the key rate will stand at 2.50 per cent: in line with the Fed's estimate, but well above futures pricing.

Big upside in the most cyclical sectors

Per cent of GDP



Historical average
Durable goods consumption, residential and equipment investments

Source: BEA, SEB

During the past six months, employment growth has been the strongest in 17 years. **Unemployment, which will amount to 5.9 per cent at the end of 2014**, will continue falling to 5.0 per cent at the end of 2016 according to our forecasts: somewhat below the Fed's latest estimate. Inflation curves are pointing upward, and **the deflation threat feels distant**, but our main scenario is that inflation will remain low during the next couple of years. Food and commodity prices will be restrained in the short term, but the resource situation points to a normalisation of wage-driven inflation.

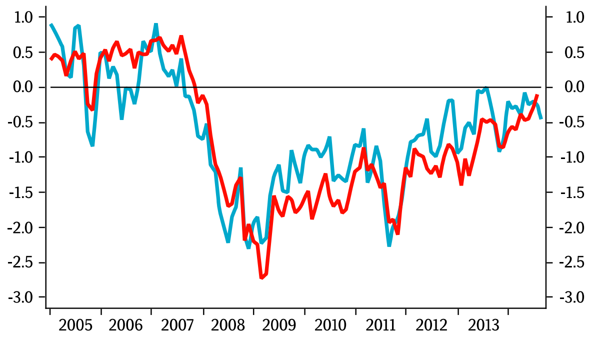
Temporary factors have lowered 2014 GDP

American GDP fell by 2.1 per cent during the first three months of this year. This is of **great importance to full-year 2014 growth, and we have sharply lowered our forecast to 2.2 per cent**. Various temporary factors – severe winter weather, the phase-out of a programme for the chronically unemployed, de-stocking in the automotive industry, tougher new lending requirements and regulations introduced on January 1 plus acceleration of business investments for accounting reasons – explain the downturn.

GDP growth bounced back vigorously in the second quarter, and despite the dip early in 2014, GDP growth has averaged 2.5 per cent viewed over the past four quarters. The strong outlook is likely to persist: business and consumer surveys point to continued **good underlying economic dynamism**.

Consumer confidence close to pre-crisis levels

Index



Conference Board — University of Michigan

Source: Bloomberg, Conference Board, SEB

Incomes are driving consumption higher

We see several reasons for consumer optimism. Household debt has decreased by about USD 1 trillion since its peak, and **the credit bubble** that built up in 2003-2007 **has definitely been punctured**. The debt service ratio (interest and principal costs as a percentage of income) is at record lows. Credit quality has also greatly improved, while the percentage of borrowers who are delinquent and in danger of default has also fallen to low levels. Loans to businesses and for commercial construction are already growing rapidly, but in the past six months various forms of consumer credit have also expanded. One indication that **confidence has returned to**

the household sector is the strong light vehicle sales earlier this summer.

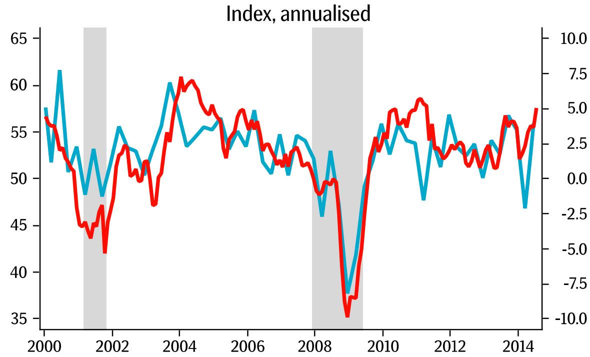
Lagging wealth effects from rising share and home prices also indicate that consumption growth is now accelerating. **Incomes are already showing robust rates of increase** and the latest six-month period has been the strongest in eight years. Real disposable incomes rose at a 3.5 per cent rate in the first quarter and 3.8 per cent in the second, driving up the household savings ratio to 5.3 per cent. **The conditions are thus in place for stronger consumption growth. Private consumption will increase by an average of 2.7 per cent in 2014-2016**, compared to 2.1 per cent in 2010-2013.

Business investments gaining momentum

We see several reasons for stronger capital spending growth after last year's dip. The average age of factories and machinery is 22 years: the highest figure since the 1950s. Capacity utilisation has normalised to levels that have historically been compatible with capital spending growth of 7-10 per cent. Meanwhile fiscal policy uncertainty has diminished, due to the two-year federal budget now in place. A combination of easier bank lending terms and strong corporate earnings and cash reserves also means that **financing will not be an obstacle**. Optimistic companies – **our composite ISM purchasing managers' index is compatible with real GDP growth of 5 per cent** – also point to growth-promoting investments. Such a robust GDP increase is not in our forecast, but stronger demand still justifies a **capital spending upswing averaging 7.5 per cent in 2014-2016**.

ISMs point to 5 per cent GDP growth

Index, annualised



Source: ISM, BEA, SEB

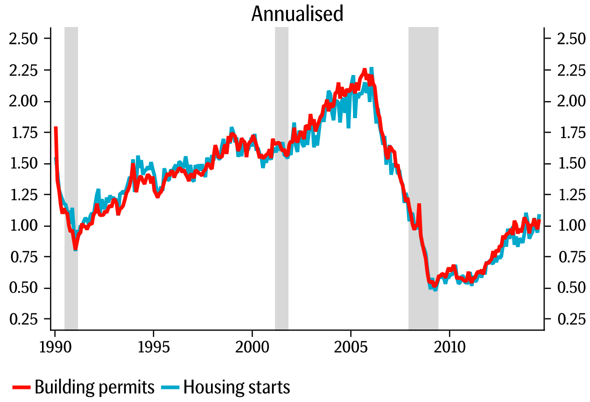
Downshift in home price increases

Since residential construction bottomed out in 2009, its recovery has been relatively weak in a historical perspective; for example, housing starts are still at a level consistent with the lows in previous economic cycles. Lingering crisis effects, combined with a major decline in labour mobility, are two reasons behind the sluggish recovery. Early in the year, residential investments and construction sector confidence were also hampered by severe winter weather and by the introduction of tougher regulations and credit standards – **banks are still considerably more restrictive with home loans** – compared to other types of consumer credits.

As earlier, we believe that residential investments and housing starts will continue to climb, **but the upturn will be more lacklustre** than we previously forecasted. The stronger labour market is continuing to improve conditions for first-time home buyers, an important group. Over the past year, employment among people aged 25-34 has increased by 700,000 jobs. Meanwhile residential construction has fallen about one million units per year short of demographic demand since 2008. There is thus a pent-up need for housing, and we predict **1.8 million housing starts annually by the end of our forecast period**.

Housing starts: room to grow

Annualised



Source: BEA, SEB

Fewer households are moving

The percentage of the population who move each year has trended downward from just below 20 per cent in the early 1990s to less than 12 per cent today. Several factors explain the downturn. Until the middle of the last decade, US home ownership increased at the expense of renting, causing a lock-in effect and resulting in fewer moves. In the wake of the economic crisis, home prices then fell steeply; selling and moving in that situation would have resulted in capital losses for many households. Additional factors that slow housing market mobility are an ageing population and the fact that more and more households now have two breadwinners. **Falling mobility is one reason why the housing market recovery has been weak so far by historical standards**.

Looking ahead, however, the prospects are brighter. The percentage of households who own their homes has fallen sharply in recent years, and more people are renting instead. This is highly important, because **renters have four-five times higher mobility than home owners**. Home prices are also approaching their earlier peaks. This means that fewer people are trapped in their homes by negative equity. But demographics will continue to hamper mobility, since older people are less likely to move house than younger people.

After a 12 per cent increase last year, home prices according to the Case-Shiller 20-City Index are currently rising at a year-on-year rate of 9 per cent. This deceleration is in line with our forecasts of **slower price increases of 8 per cent in 2014**

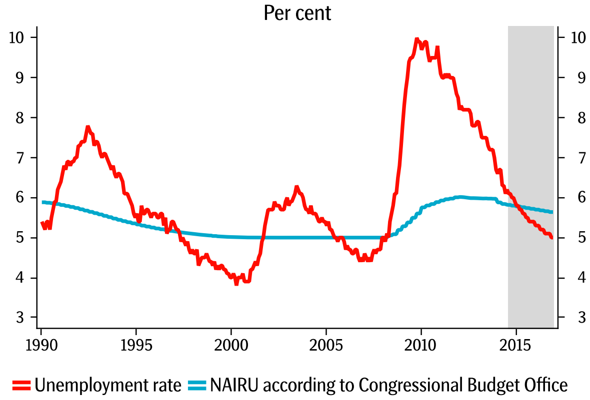
and 6 per cent in 2015. In 2016, home prices will increase by 3 per cent.

Unemployment will continue to fall

The American labour market is enjoying a tailwind. For the first time since 1997, job growth has exceeded 200,000 for six months in a row. Current levels of newly registered job seekers indicate that this favourable trend will continue. The four-week average was recently below 300,000 for the first time since February 2006 – a level historically **compatible with at least 4 per cent real GDP growth**. So far in 2014, employment has increased by an average of 230,000 jobs per month, which means that our earlier job growth forecasts were on the cautious side. **We are now predicting that employment will climb by an average of 220,000 per month in 2014-2016**.

Unemployment will fall below equilibrium

Per cent



Source: BLS, CBO, SEB

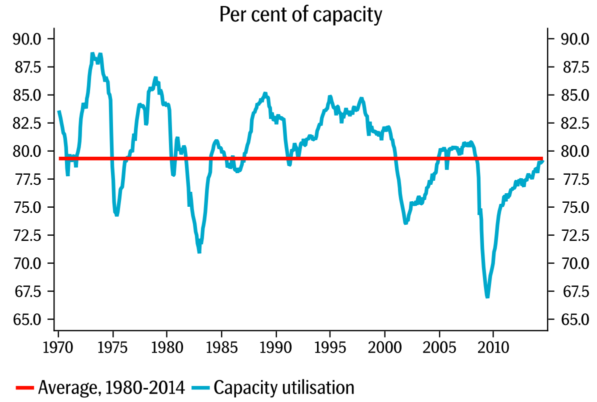
Most indications are that unemployment will continue to fall. Job growth is considerably faster than the long-term trend. The Chicago Fed estimates a trend level of 80,000 new jobs per month, while other analyses end up a bit higher. Businesses are also beginning to have difficulty recruiting new employees; even now, 33 per cent of small businesses believe they cannot find qualified workers, and these problems are likely to increase over time. The trend of labour market participation will be a key issue ahead. For example, the IMF estimates that one third of the downturn in recent years is cyclical. We also expect a slight recovery in participation over the next couple of years, although for demographic reasons the long-term trend is downward. Overall, we predict that **unemployment will gradually fall to 5.0 per cent by the end of 2016**. This is a bit below non-accelerating inflation rate unemployment (NAIRU) – or equilibrium unemployment – which is 5.6 per cent according to the Congressional Budget Office and 5.4 per cent according to the Fed. The level is also relatively low in a historical perspective; unemployment bottomed out at 3.8 and 4.4 per cent, respectively during the two previous economic cycles.

Pay hikes will boost inflation somewhat

The resource situation points to somewhat higher inflation during the next couple of years. Capacity utilisation in manufacturing is approaching its historical average, while labour market gaps are closing: an estimated 50 million people are already working in sectors that have full employment. In light of this, the Fed toned down deflation risk when announcing its latest key interest rate decision.

Capacity utilisation is normal again

Per cent of capacity

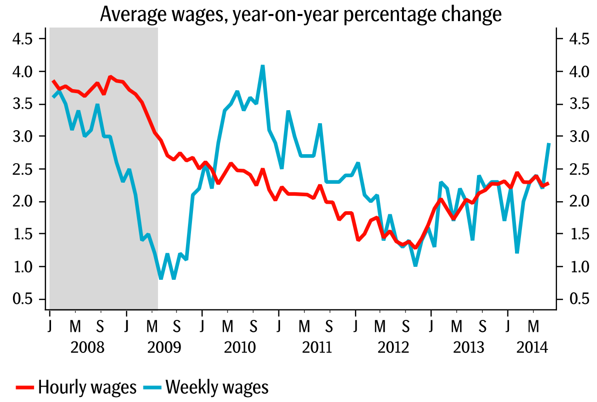


Source: Federal Reserve, SEB

In some respects, today's wage formation is following the pattern from the three previous economic cycles. Wage inflation did not bottom out until five years into the recovery both in the 1980s and the 1990s. During the latest economic upturn, wage increases bottomed out in 2005 – three years after the recovery began. This time around, average hourly wage increases bottomed out at 1.3 per cent in October 2012 and have risen by about one percentage point since then. **Wage inflation remains low but is trending upward**, and small business planning for wage increases is consistent with continued upturns. **Average hourly wages will increase at a 3.5 per cent rate by the end of 2015 according to our forecasts**. The rate of increase in average weekly pay has already reached the 3 per cent mark.

Wage curves pointing cautiously upward

Average wages, year-on-year percentage change



Source: BLS, SEB

Inflation increased from 0.9 per cent in October 2013 to 2.0 per cent in July. Prices are rising faster in the service sector, while the inflation trend in the goods sector is pointing downward. **CPI inflation will be 1.9 per cent both this year and next**: unchanged from our earlier forecasts. In 2016, prices will increase by 2.2 per cent. The risk picture is nicely balanced: food and energy prices may lead to lower inflation figures, while inflation may also end up higher if wages and salaries accelerate faster. Core inflation, which has climbed since the turn of the year, will continue its weak upward trend, especially since the upturn in housing costs appears likely to persist.

Budget deficit is shrinking steadily

Federal revenue is increasing twice as fast as expenditures, and the budget deficit is continuing to decrease. According to the latest figures, the cumulative deficit was USD 460 billion – a major improvement compared to July 2013, when the corresponding figure was USD 607 billion, not to mention July 2009 when the deficit was three times as large. Since this improvement is taking place concurrently with the "tapering" process, this means that the Fed is still buying about an equally large share of government bonds. In July, the central bank purchased 44 per cent of all Treasury securities issued. **The Fed thus still dominates the sovereign bond market**, which has probably helped keep long-term yields down.

The budget deficit, estimated at 6.4 per cent of GDP this year, will fall to 5.5 per cent next year. **Fiscal consolidation will continue** and in 2016 the deficit will be just below 5 per cent of GDP.

Fed will hike its key rate in April 2015

When the Fed ends its stimulative bond purchases in October this year, its balance sheet will be equivalent to 25 per cent of GDP, around USD 4.5 trillion – nearly six times larger than before the crisis. The market's focus will thus soon shift to when the central bank will again raise its key interest rate. It has been a long time; the last rate hike occurred in June 2006.

In practice, it looks as if the Fed has a "wage target" for its monetary policy. The bank explicitly wishes to see average hourly wages increasing by 3-4 per cent year-on-year before beginning its rate hikes. Because wages are lagging behind unemployment, which in turn is lagging behind the real economy, the central bank has room and arguments to continue pursuing its zero interest rate policy for another while. To ensure that interest rate hikes do not derail the recovery prematurely, it is **important that households are sustained by rising income curves**; otherwise high interest on debt will threaten to sink the recovery. After the debt deleveraging of recent years, household balance sheets are also in good shape, which banks have already taken advantage of. Apart from home mortgage loans, **lending is increasing on a broad front**.

Pay increases in line with the Fed's target interval will occur in mid-2015, according to our forecasts. Our forecast that unemployment will continue to fall relatively fast nevertheless **indicates that the first rate hike may occur a bit earlier**. One important question is whether a continued zero interest rate will create credibility problems for monetary policy as unemployment creeps closer to 6 per cent and eventually lower. Viewed over the last five rate hiking cycles from 1988 onward, **unemployment has averaged 5.8 per cent when Fed rate hikes began**. Average capacity utilisation in manufacturing has been 81 when interest rate hikes began, compared to 79 per cent today.

Our forecast is that the first rate hike to 0.25-0.50 will occur in April 2015. At the end of next year, the key rate will stand at 1.25 per cent and at the end of 2016 at 2.5 per cent according to our forecasts, which also closely match the Fed's forecasts. **The market still believes that rate hikes will be substantially slower**. The futures market is pricing in a key rate of 0.67 per cent at the end of 2015 and 1.62 per cent at the end of 2016.

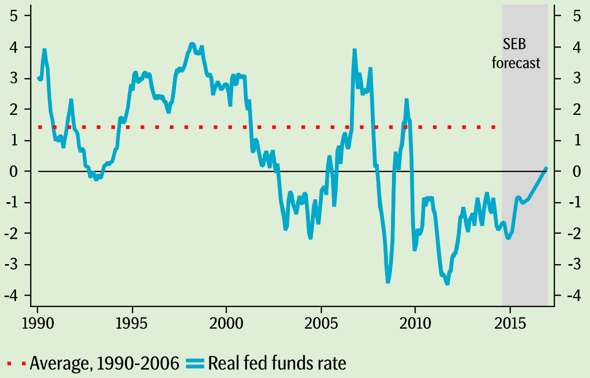
Neutral interest rate is lower today

A neutral or equilibrium interest rate is a key interest rate that will keep GDP growth at its potential level, while maintaining full employment and a trend of inflation in line with central bank targets. A neutral interest rate is often analysed in real terms, that is, key interest rate corrected for inflation.

According to the Fed's forecasts, the real neutral interest rate is 1.75 per cent today. Before the financial crisis, it was often generally assumed that the real neutral interest rate was around 2 per cent – which is a bit remarkable since the average from 1990 to 2006 was 1.4 per cent. Since there are many indications that potential GDP growth and expected real return on assets have fallen since the crisis, the real interest rate should also be lower today. Since capital adequacy requirements are also stricter, this means in practice that for any given key interest rate, the long-term interest rates at which banks lend to households and businesses will be higher. The Fed's quantitative easing has flattened the yield curve, though, which has the opposite effect. **Our overall assessment is that the real neutral interest rate is closer to 1 per cent**, clearly below the Fed's official view.

Real key interest rate is still negative

Per cent



Source: Macrobond, SEB

If inflation ends up close to the Fed's 2 per cent target, this will result in a nominal neutral key interest rate of 3 per cent, rather than 3.75 per cent as the Fed's own forecasts show. This, in turn, indicates that the central bank will proceed cautiously with its key rate hikes, and that the peak key interest rate – once it occurs – will be well below earlier levels. Not until the end of 2016 will the real key interest rate exceed zero, according to our forecasts.

Theme: Is low potential growth in the US here to stay?

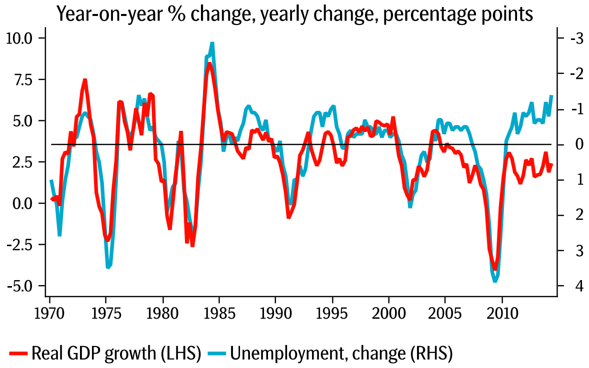
- **Okun's law: Potential GDP growth has been close to zero since 2009**
- **Our estimate: Around 2 per cent**
- **New technology will determine whether the slowdown will be temporary**
- **Neutral interest rates are lower today**

In recent years, the relationship between GDP growth and labour market developments has diverged greatly from the historical pattern. Since the recovery began in 2009, GDP growth has averaged 2.2 per cent – very low in historical terms. Yet unemployment has fallen sharply from its peak of 10 per cent in October 2009 to 6.2 per cent today. "Okun's law" can illustrate how exceptional this development is. According to this law, unemployment falls by half a percentage point for each percentage point that GDP growth exceeds the potential rate. **Okun's law indicates that potential GDP growth has been as low as 0.3 per cent so far during the recovery.**

Such a negative view of potential growth seems greatly exaggerated, however. Changes in labour supply and productivity have probably been exceptional during the recovery. It is also possible that actual GDP growth will be adjusted upward later. Still, this development is worrisome and the question of whether lower potential GDP growth will be temporary or lasting will be very important in the future.

Low growth + unemployment decline = low potential GDP growth

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



Source: BEA, BLS, SEB

According to the textbooks, long-term GDP growth is created by **labour** (more hours worked), **capital** (investments in infrastructure, machinery and factories) and **new technology**.

Since the economic recovery began, US population growth has been the weakest since the days of the 1930s depression. Meanwhile the population is ageing and the upward trend in women's labour force participation has probably levelled out permanently. **Our estimate of the long-term annual growth trend in labour supply is thus around 0.5 per cent**, but it is difficult to estimate the effect of migration flows on the labour supply. By all indications, the US labour market will remain internationally attractive; in a stronger economic situation, this may potentially mean somewhat faster labour supply growth.

Labour productivity growth has slowed in the past decade. Both in a five- and ten-year perspective, average yearly growth is around 1.5 per cent: far lower than in the 1980s and 90s. In the past three years, however, the average has dropped to 1.0 per cent. Low capital spending has also **greatly undermined US capital stock**. In recent years, the growth in capital stock has been the weakest since measurements began. This has presumably had an impact in the form of lower productivity.

In the long term, future technology will determine the growth outlook. The pessimistic way of viewing this matter is that technological progress will continue **but new discoveries will weigh more lightly than earlier giant leaps such as the combustion engine and the light bulb**. Although computers are becoming more powerful, this does not deliver a higher living standard to most people. The IT boom of the 1990s led to higher productivity, but the effect was rather short-term. Optimists, on the other hand, look ahead at how computerisation will change the playing field even in such knowledge-based sectors as economics, law and health care. Freeing up a large quantity of labour even in typical knowledge-based sectors will greatly boost productivity figures. Robot technology is also still in its infancy, from an optimist's point of view.

To summarise, our estimate of potential real GDP growth today is around 2 per cent annually. While the impact of new technology is hard to judge, we know with great certainty that the population structure will continue to push down potential GDP growth. Even if the dip in potential growth is temporary and the post-war trend of 3 per cent resumes at some point, this is not likely to occur any time soon. As a result, the **neutral key interest rate will probably be lower in this cycle and, consequently, the Fed's coming peak interest rate as well**.

Further stimulus needed while waiting for reforms

- **Disappointing exports and industrial output**
- **Structural reforms key to higher wages**

April's consumption tax hike has resulted in choppy growth so far this year. GDP surged in the first quarter due to accelerated consumption and capital spending, followed by a setback in the second quarter. The recovery will regain momentum this autumn and **the economy will continue to grow above trend: by 1.1 per cent in 2014 and 1.2 per cent in 2015**, followed by a deceleration to **0.8 per cent in 2016**.

This summer's developments are raising questions about the underlying strength of the economy, thus providing support for our relatively cautious forecast. Yen depreciation has not yet boosted exports. One interpretation is that relocating production elsewhere in Asia has weakened the currency rate sensitivity of Japan's foreign trade. But it is also likely that the economic slowdown in the US and China early in 2014 spilled over into the rest of Asia. We thus foresee an export rebound, sustained by growing international demand, during our forecast period. The positive effects on the trade balance will be limited by continued large energy imports while awaiting the gradual restarting of domestic nuclear power plants.

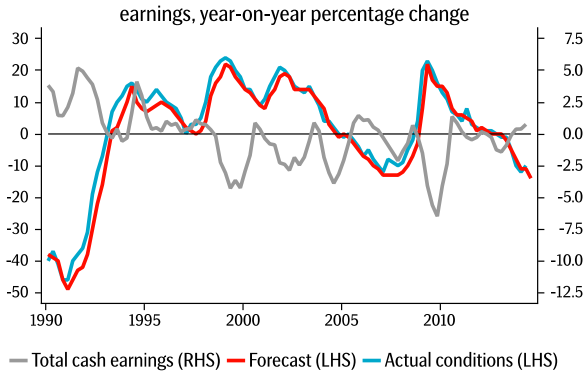
Industrial production has trended downward all year, and machinery orders have dropped sharply but **sentiment indicators paint a brighter picture** of the situation in both manufacturing and the business sector as a whole. The quarterly Bank of Japan (BoJ) Tankan survey shows sentiment at historically high levels, and companies have again raised their capital spending outlook. The most expansionary investment plans as well as the greatest optimism are found in the construction industry, which will enjoy an added surge ahead of the 2020 Tokyo Olympic Games.

Consumer confidence has recovered after dipping in April, sustained by the labour market. Unemployment has now fallen to levels that the BoJ and others believe will push up wages and salaries. According to Tankan, the labour market has not been tighter since the early 1990s. Pay is now rising year-on-year, but far from enough to keep up with the inflation upturn. **Household purchasing power is thus being squeezed**.

CPI inflation rose to 3.6 per cent in June, but excluding the effects of the tax hike, inflation remains below 2 per cent. The BoJ's target variable (CPI excluding fresh food) is at about 1.25 per cent excluding tax effects. The inflation impulse from the earlier yen depreciation is now gradually fading – an indication that the **BoJ will find it difficult to achieve its target of stabilising inflation at around 2 per cent**. This is reflected in the pricing of expected inflation in 10-year CPI swaps, which has levelled out at a bit above 1 per cent. Our forecast is that inflation will rise from 0.4 per cent in 2013 year to 2.7 per cent this year, then 1.7 per cent in 2015 and 2.0 per cent in 2016, including the effects of 2014 and 2015 consumption tax hikes. Excluding the tax hike, inflation will remain around today's levels of somewhat above 1 percent and the upturn expected by the BoJ from the end of 2014 will fail to materialise.

Earnings are rising as labour market tightens

Employment conditions, % (excessive minus insufficient); earnings, year-on-year percentage change



Source: Bank of Japan

The key to sustainably higher inflation is wages and salaries, but **the low rate of pay increases is only partly due to cyclical factors**. In recent decades, real wages have steadily lagged behind productivity improvements. Meanwhile the Japanese labour market has become increasingly divided, with a sizeable increase in the share of part-timers and employees not covered by centralised pay agreements, who have a harder time negotiating higher wages. In order to speed up the rate of pay hikes, a reform of the labour market will thus be required.

This summer, Prime Minister Shinzo Abe launched the third "arrow" of his economic plan: a list of reforms to improve wage formation and to sustainably boost both productivity and the labour supply, thereby raising **potential GDP growth from today's 0.5 per cent or so**. But concrete details are still missing in several key areas. Meanwhile it will take time before such reforms affect the economy. At the same time, the government remains under pressure to bring down its deficits – for example by making a decision this autumn on the next consumption tax hike to 10 per cent in October 2015 – especially if it carries out the planned corporate tax cut.

Low inflation and another consumption tax hike means the BoJ must stimulate the economy further. During fall, we expect the BoJ to increase its bond purchase programme to JPY 100 trn annually from today's JPY 60-70 trn. This will also contribute to a renewed depreciation in the yen to 125 per USD late in 2016.

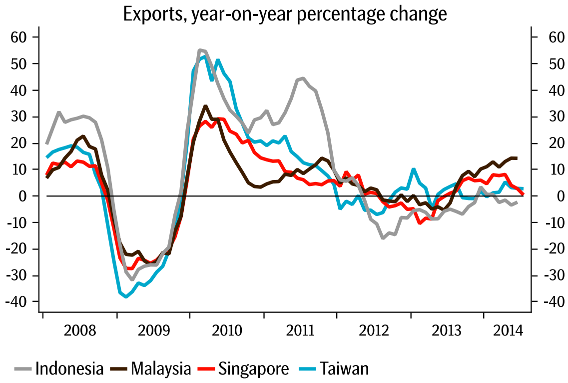
Modest growth acceleration, but China will slow down

- **Gradual GDP acceleration, followed by levelling out in 2016**
- **China: External demand and targeted stimuli offsetting weak real estate sector**
- **India: Election outcome will benefit growth**

We expect growth to strengthen gradually in Asia's emerging economies during the next few quarters. Exports to OECD countries will gain strength as the recovery progresses and will be the main driver of growth. Meanwhile continued soft monetary policies and strong labour markets will help to sustain domestic demand in most economies.

Asia: Potential for continued export growth

Exports, year-on-year percentage change



Source: National statistical offices

Yet due in part to other forces, **GDP acceleration in the region as a whole will be moderate, levelling out in 2016**. China's expected slowdown will restrain economic activity in the region over the next few years. Credit growth is also unsustainably high in some economies. So far this discussion has focused on China, but countries like Thailand and Singapore also have a very high credit growth. When lending must be slowed in the future, the impact on domestic demand may be significant in individual countries. However, there is little likelihood of a broad, deep downturn similar to the Asian financial crisis of the late 1990s, among other things because of today's more robust system of floating exchange rates as well as improved external balances. Beyond our forecast horizon, various economies including China and South Korea will also be hampered by worsening demographics. Escalating geopolitical tensions in the region, driven by China's increasing influence, also risk hampering long-term investment appetite.

Inflation pressure generally remains low in the region, although India and Indonesia are major exceptions. Yet even in these countries, inflation has begun to ease. There is thus room for continued soft monetary policies in the region for a while longer; we expect a more general tightening only during 2015. One upside inflation risk is a scenario of rising oil prices. Most Asian economies are net oil importers. Indonesia, for example, is especially sensitive due to its sizeable current account deficit.

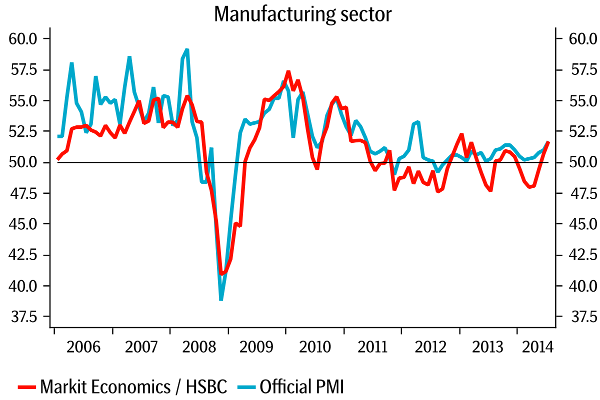
Asian stock markets, and to some extent currencies, have continued to strengthen in recent months. Worries related to the Ukraine conflict have not had an impact. Hopes of increased reform measures in India and Indonesia following the recent elections have helped sustain their local stock markets, but financial developments have also been positive in most other economies. The impact of the US Federal Reserve's coming monetary policy tightening remains a source of uncertainty, however, although financial market turbulence similar to that of summer 2013 is not expected to recur.

China: Growth target within reach

Chinese economic growth during the first half of 2014 was somewhat better than expected. **In the second quarter, GDP growth accelerated marginally to 7.5 per cent** year-on-year, compared to 7.4 per cent in Q1. The quarter ended strongly. Most final statistics from recent months, both indicators and hard data, have shown improvements or stabilisation. Both China's official purchasing managers' index and the Markit PMI have risen in recent months, and other leading indicators have risen cautiously.

Purchasing managers' indices (PMIs) rebounding

Manufacturing sector



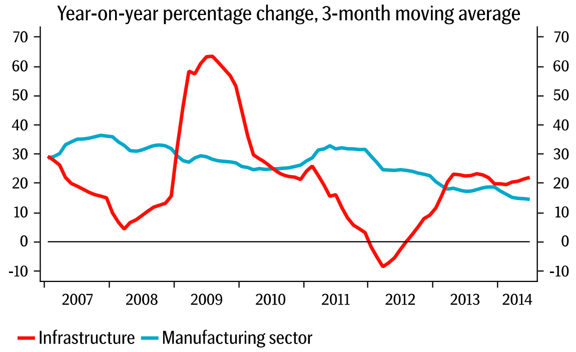
Source: China Federation of Logistics & Purchasing, Markit Economics

The performance of the **real estate sector** remains very weak and is **the most serious downside risk today**. The main problem is that construction has expanded much faster than demand. There has been a sharp cutback in construction volume although there are some indications of recovery. The construction sector will be a restraining factor for economic growth for a long time ahead. Home prices have fallen month-on-month for three consecutive months, but in itself this is not necessarily anything negative since a downward price adjustment improves the situation of households in the residential market and reduces the risk of price bubbles.

So far in 2014, construction sector weakness has been offset by improved external demand as well as by the **targeted measures** the authorities carried out in the spring and summer. Measures to counter weakness in the real estate sector have nevertheless consisted of fine-tuning rather than large-scale stimulus. Just as in 2012, increased infrastructure investments have also been used in order to speed up activity.

Government infrastructure investments to stabilise growth

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



Source: National Bureau of Statistics of China

Exports have gained strength in recent months. The picture has also become clearer, since over-invoicing for tax reasons – which previously made trade statistics difficult to interpret – has now vanished from monthly figures. The recent export upturn is due to stronger US and EU demand. There is, moreover, good potential for continued decent performance, since economic growth will gradually speed up in 2014 and 2015. Imports are far more sluggish than exports and declined year-on-year in July. One important reason is lower demand for commodities, in turn driven by the weak performance of the real estate sector. The trade surplus is again at record highs, pushing the yuan higher and causing China's foreign currency reserve to reach new record levels. Industrial production has accelerated cautiously in recent months, yet the rate of increase is still well below that of early 2014.

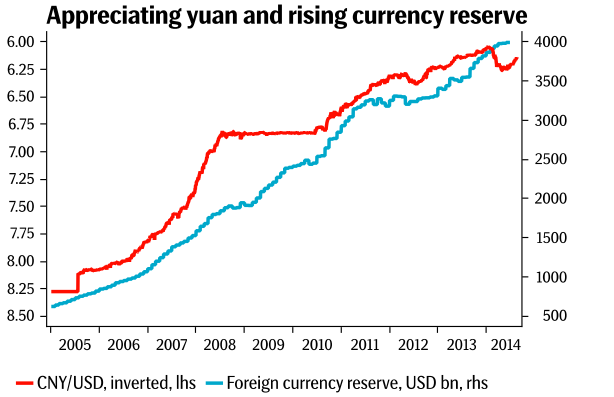
Overall conditions are favourable for the Chinese economy to achieve or come close to the official 2014 growth target of 7.5 per cent. Based on somewhat faster first half expansion than expected, we are raising our GDP forecast somewhat, but we believe that **the deceleration trend will continue** during our forecast period, driven by a slowdown in credit growth and capital spending. **We expect GDP to increase by 7.5 per cent in 2014, followed by a slowing in the growth rate to 7.3 per cent in 2015 and 6.9 per cent in 2016.**

The weak real estate market will remain a key issue for economic policy. Tight housing market regulations have been cautiously eased, and banks have been ordered to increase their lending for home purchases. There are also efforts to improve borrowing opportunities for small and medium-sized businesses. Last spring, authorities eased reserve requirements at certain banks. These policy measures have recently helped to slow the deceleration in total lending. But looking ahead, the authorities must keep limiting credit growth to mitigate the imbalances in the economy caused by inefficient lending.

If China's economy should weaken more severely, there is plenty of room for both monetary and fiscal stimulus. Although monetary policy has already been softened, borrowing costs – especially for small and medium-sized businesses – remain high. Yet we believe that no extensive stimulus measures will be needed. As long as the growth target is not perceived as being in danger, we instead expect a focus on structural reforms. China has also undertaken further reform measures in recent months. For example, local authorities in some provinces will be allowed to issue their own bonds. This reform is a step in the right direction and will increase transparency.

The inflation rate was 2.3 per cent in July. Although we expect inflation to accelerate a bit during the rest of 2014 – driven by rising food prices – it will remain below 3 per cent. Producer prices are still falling year-on-year, but a rebound has begun. These price declines mainly reflect weak commodity price trends rather than businesses being forced to cut prices. Core inflation remains below 2 per cent. The overall picture is one of low inflation pressure; the risk of rising prices is thus no constraint on policy makers. **We expect full-year 2014 inflation of 2.5 per cent and foresee inflation of 2.7 per cent in 2015 and 3.0 per cent in 2016.**

Appreciating yuan and rising currency reserve



Source: China State Administration of Foreign Exchange, Macrobond

In recent months, the yuan has begun to appreciate against the USD, after weakening sharply in February and March because China's central bank wanted to counter capital inflows. Yuan depreciation attracted great attention. The central bank is probably pleased about having shown financial markets that the currency can also weaken for long periods. But the fundamental factors driving appreciation remain in place. Record-sized trade surpluses are creating clear upward pressure and large-scale capital inflows are also contributing to this. We thus believe that **long-term yuan appreciation will continue**, but this process will move at a leisurely pace. We expect volatility to increase as China continues its move towards a freely floating currency. **We expect a USD/CNY exchange rate of 5.90 at the end of 2014, 5.80 at the end of 2015 and 5.70 at the end of 2016.**

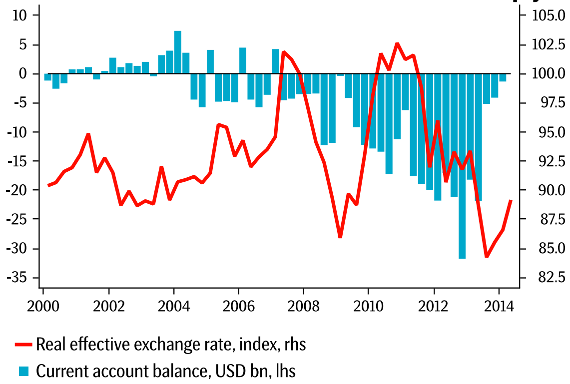
India: New government raises reform hopes

The victory of the opposition **Bharatiya Janata Party (BJP)** in last May's parliamentary election was anticipated, but the party unexpectedly won its **own majority** in the Lok Sabha (lower house): 282 out of 543 seats. Led by Narendra Modi, the BJP campaigned on a business-friendly programme including extensive reforms. Its majority **will create far better potential to push through reforms than if the election outcome had been a coalition government**. Key elements of these reforms will be to speed up capital spending and infrastructure projects and try to loosen restrictive labour market laws. Despite its lower house majority, the BJP still faces obstacles to its reforms. The BJP and its allies have no upper house majority, and the party will also be forced to work together with local parties in India's states, which often oppose reforms.

So far, the government has not released very many details about how it will meet reform expectations. Although the budget unveiled in July was tighter than predicted, with an ambitious target of reducing the deficit to 4.1 per cent of GDP this fiscal year, it included no large-scale reform package as many had hoped. Nor were there any indications of how the government will be able to reduce large subsidy expenses. The budget presented only minor reforms: deregulation of foreign investments in the defence and insurance sectors and a pledge to review tax disputes. **There is a risk that high expectations of the Modi government will be disappointed unless it soon presents more concrete reform proposals**, thereby showing in what ways it differs from the previous government.

There will be a time lag before reforms are implemented and have positive growth effects. During the next few quarters, there is little chance of a clear GDP acceleration. First quarter GDP grew by 4.6 per cent year-on-year, and we do not believe that second quarter growth was much faster. There are **some bright spots**, however. Purchasing managers' indices in both the manufacturing and service sector have improved, although levels remain low. Industrial production has recovered somewhat in recent months, but it is too early to say whether there will be a sustained recovery. Accelerating exports have helped to push down the trade deficit, which during the first quarter of 2014 was the smallest since early 2009.

The current account deficit has narrowed sharply



Source: BIS, Reserve Bank of India

One key factor hampering vigorous growth recovery is heavy debt among Indian companies. Combined with continued tight monetary policy, this is holding back capital spending. Overall, we are thus making **a relatively cautious upward revision of our May growth forecast** in *Nordic Outlook*, based on the improved potential for economic reforms, but if reform efforts begin in earnest there is good chance of even higher growth. **In 2014 we expect GDP to increase by 5.0 per cent, accelerating to 5.8 per cent in 2015 and 6.2 per cent in 2016.**

Inflation has decelerated somewhat since the beginning of the year but CPI inflation accelerated to 8.0 per cent in July and is thus at the target that the Reserve Bank of India has set for the beginning of 2015. The RBI's long-term target is inflation of 4 per cent, but the large role of food in the CPI basket creates sensitivity to food price fluctuations. For example, a weak monsoon risks leading to rising vegetables prices – an upside risk for inflation. The RBI has nevertheless shown a clear desire to bring down inflation, despite potentially negative growth consequences. We believe that inflation pressure will ease during our forecast period. **In 2014 we expect CPI inflation to end up at 8.0 per cent, and in 2015 at 7.3 per cent. In 2016, inflation will slow further to 6.7 per cent.**

Because of the recent inflation slowdown and the RBI's belief that it will achieve its inflation target for early 2015, the key interest rate can remain at today's 8.0 per cent during the rest of 2014. In 2015 we expect that the RBI can begin easing monetary policy as inflation pressure softens.

The rupee has weakened against the USD since last spring, but the currency remains well above its September 2013 lows. **At the end of 2014 we expect the rupee to stand at 57.0. However, with the Fed expected to start hiking interest rates the rupee will likely weaken in 2015 to 60.0 by year end. In 2016 the rupee will strengthen again to 55.0 by year-end.**

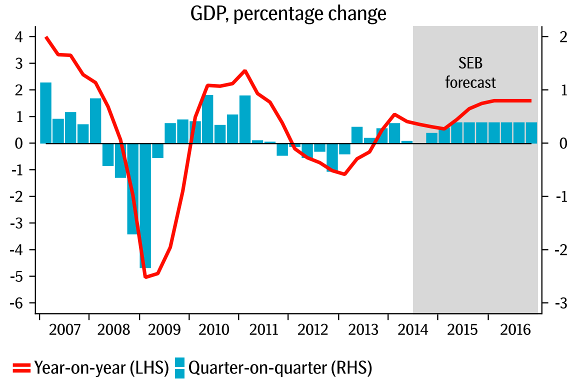
Weak growth with deflationary tendencies

- **Italy and France losing ground**
- **Trade sanctions increasing downside risks**
- **Falling inflation expectations creating sustained deflation risks**
- **More ECB support coming, no QE until 2015**

The economic situation remains weak, and the second quarter brought new disappointments. Indicators point to somewhat faster expansion ahead, and stimulus measures from the European Central Bank (ECB) will provide support. Fiscal policies will be largely neutral in 2015 and 2016 after earlier austerity; if anything, lacklustre growth may lead to acceptance of weakly expansionary fiscal policies despite high debt levels. Consumption and capital spending are slowly rebounding from depressed levels, and a weaker euro is helping exports a bit. Our forecast is that **GDP growth will gradually rise from 0.7 per cent in 2014 to 1.1 per cent in 2015 and 1.5 per cent in 2016**. Partly because of continued balance sheet adjustments, growth will be fragile and uneven. Competitiveness has not been completely restored in some countries, and unemployment levels remain very high.

The growth rate is slowly increasing

GDP, percentage change



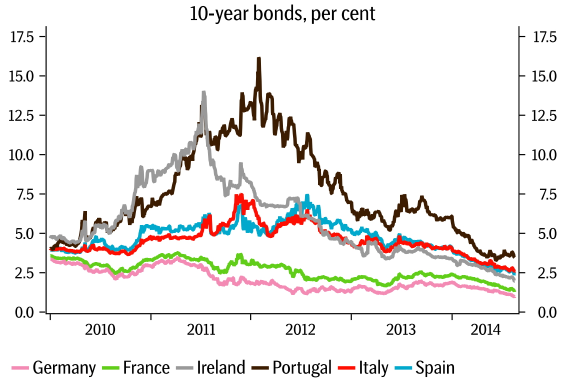
Source: Eurostat, SEB

Risks to economic growth are on the downside. Since May's *Nordic Outlook*, relations with Russia have worsened and sanctions have intensified in both directions. We believe the current sanctions will have a certain impact on the euro zone as a whole, partly via psychological channels. The direct effect on exports will be relatively marginal for the overall region, but noticeable in some countries – especially Finland and the Baltics. Sanctions create a downside risk for our forecast. Renewed financial market turmoil, for example when the results of the ECB's stress tests and asset quality review (AQR) of euro zone bank assets are published in October, may contribute to weaker economic performance, though we regard these risks as small. First half 2014 growth was weaker than expected, also accentuating the issue of whether balance sheet adjustment will be a bigger obstacle to underlying growth than we assume.

The ECB's broad action package in June – including interest rate cuts, conditional loans to banks and preparations to buy asset-backed securities (ABSs) – was well received, leading to lower long-term bond yields and a weaker euro. Yet inflation and especially inflation expectations have continued to fall. The risk of a damaging deflation process has actually risen. **The ECB will leave interest rates unchanged but launch a broad bond purchasing programme** (quantitative easing or QE, including weighted purchases of government bonds). We believe that the central bank wants more time to evaluate the measures presented/implemented in June and will consequently not launch its new QE package until the first quarter of 2015.

Sovereign bond yields historically low

10-year bonds, per cent



Source: Macrobond

Euro zone economic and political integration remains sluggish. In the European Parliament election, parties opposed to expanded supranational powers gained ground. The new European Commission is not yet in place. Among more EU-friendly forces, there is meanwhile a tug-of-war between more enthusiastic supporters of greater integration and pragmatists who wish to hurry slowly. The EU election shows the need to seek more public support and to explain why more centralised power is needed, in order to avoid further fuelling the popularity of anti-EU parties. What will probably happen is that processes that have already started, such as the banking union, will continue but the economic and political integration roadmap unveiled in the summer of 2012 will largely be shelved. Looking ahead, there is a risk that the slow integration process may lead to a new crisis of confidence in the euro.

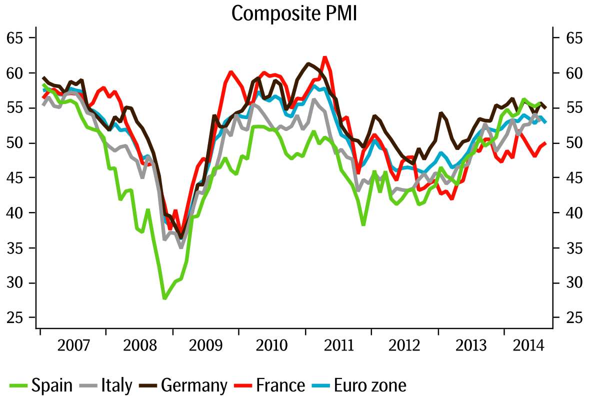
Economic indicators are diverging again

After converging last spring, **indicators** in major euro zone countries have again begun diverging. Purchasing managers' indices (PMIs) in Germany, Italy and Spain are at around 55, while in the past three months France has slipped below the growth threshold of 50. In the euro zone as a whole, composite PMI stood at 52.8 in August, roughly the same as in January.

Readings for manufacturing are slightly below the composite index, indicating that exports are performing more weakly than domestically oriented sectors. There are also divergences among crisis-hit countries. PMIs in Greece (just below 50) and Italy (just above 50) look worse than in Spain and Ireland. The overall euro zone manufacturing PMI points to quarter-on-quarter growth of 0.2-0.3 per cent in the near term.

Divergent sentiment indicators

Composite PMI



Source: Markit

As for short-term GDP trends, Germany – despite some second quarter weakness – and Spain are performing more strongly while France and Italy lag behind. This diverges from the pattern in the first post-crisis years, when France was the country that most successfully latched on to the German recovery. We believe major euro zone countries will continue to follow different paths in terms of 2015-2016 growth. German and Spanish GDP will increase by about 1.5-2.0 per cent annually, while France and Italy will end up with growth below 1 per cent.

Exports will take off slowly

So far this year export growth has cooled, failing to provide the push that the euro zone needs in order to break out of its crisis. In addition, industrial production weakened early in the summer, falling in such countries as France and Italy in May (year-on-year). Improved international economic conditions and stronger competitiveness due to pay cuts and a weaker euro will eventually help drive growth. Our calculations indicate that a 10 per cent weakening of the euro against the US dollar will raise aggregate GDP by one per cent in the space of a few years. Overall, **exports will increase by 2.5 per cent in 2014, 3.3 per cent in 2015 and 4.2 per cent in 2016**.

The current account has improved in recent years, showing a surplus of 1.5 per cent of GDP in 2013. In most cases, crisis-hit countries have moved from deficit to balance or surplus, largely due to falling domestic demand. We expect the surplus to remain at the same level. Exports will improve, while imports will climb as consumption and capital spending grow.

GDP

Year-on-year percentage change

	2013	2014	2015	2016
Germany	0.1	1.2	1.4	1.8
France	0.4	0.1	0.7	1.1
Italy	-1.9	-0.2	0.5	0.8
Spain	-0.1	1.3	1.9	2.1
Greece	-3.9	0.1	1.5	2.2
Portugal	-1.4	1.2	1.2	1.7
Ireland	0.2	1.7	2.3	2.3
GIPS countries	-0.7	1.2	1.8	2.1
Euro zone	**-0.4**	**0.7**	**1.1**	**1.5**

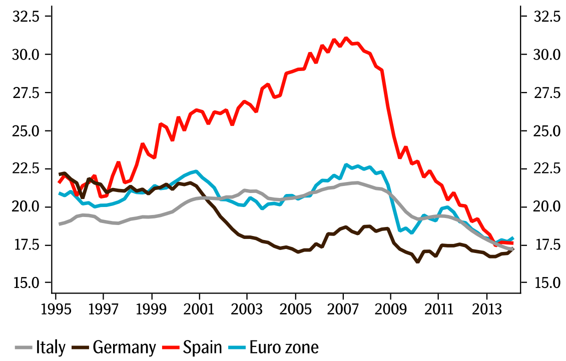
Source: Eurostat, SEB

Capital spending is slowly reviving

The level of capital spending has fallen sharply in recent years, especially in crisis countries, but now seems to have bottomed out. Capacity utilisation, which is low, has remained largely unchanged in the past three years. Problems in the banking sector are another restraint; lending to both households and businesses continues to shrink. We believe that the credit situation will ease late in 2014 once ECB stress test and AQR results are published and shortcomings have started to be dealt with.

Converging investment ratios

Per cent of GDP



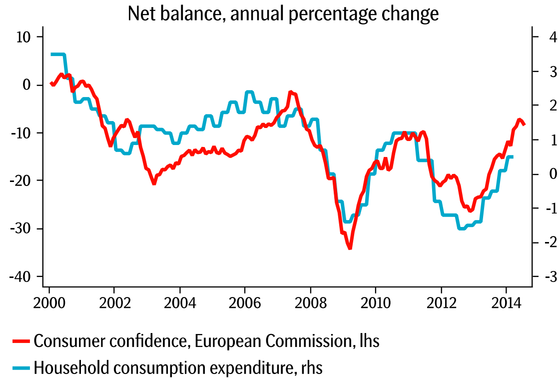
Source: Eurostat

Due to a certain increase in capacity utilisation, combined with a better-functioning credit market, capital spending will slowly rebound from today's depressed levels. Lingering uncertainty about the underlying strength of the economy and the effects of disruptions in trade with Russia will hamper capital spending, but we expect a shift in economic policy priorities towards fixed investments in order to provide some help. This will occur because of both EU-level projects and targeted loans that the ECB will provide to banks that boost their lending. Although the economy is now growing again, partly because of continued low capacity utilisation, capital spending will rise very slowly. **Capital spending will increase by 1.2 per cent in 2014, 1.6 per cent in 2015 and 2.3 per cent in 2016**.

Consumers not yet ready to spend

Consumer confidence is showing an upward trend, although it lost some ground in June and July. Households generally view the economic situation more positively, but still indicate that they will be saving more. Despite cautious households, several factors point to rising consumption in 2015 and 2016. Unemployment will fall somewhat, while looser fiscal policies and low interest rates will provide stimulus. Low inflation will also contribute to purchasing power, which will increase by about 1 per cent in 2015, although continued cost adjustment needs in southern Europe will push down wages. Overall, we anticipate that **consumption will climb by 0.5 per cent in 2014, 0.8 per cent in 2015 and 1.2 per cent in 2016**.

Private consumption is increasing
Net balance, annual percentage change

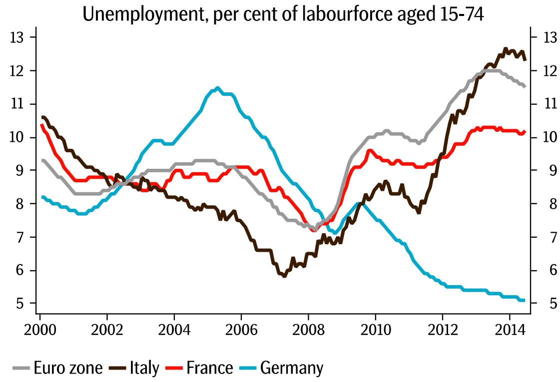


Source: Eurostat

Slowly falling unemployment

Unemployment is slowly creeping lower. In May 2014 it stood at 11.5 per cent. Jobless rates now seem to have peaked in most countries but remain alarmingly high (Spain 24.5 per cent, Portugal 14.1 per cent, Greece 27.3 per cent). In France and Italy, too, unemployment is historically high. In Germany it has fallen towards 5 per cent, the lowest since reunification.

Weak but gradual downturn in unemployment
Unemployment, per cent of labourforce aged 15-74



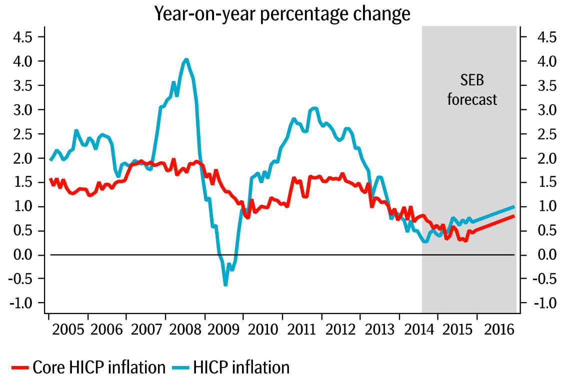
Source: Eurostat

One reason why euro zone unemployment is now falling is lower labour force participation, **but there has also been a positive employment trend in 2014**. The upturn is the first since the third quarter of 2011. Job creation continues to rise, but at such a weak rate that the downturn in unemployment will be very moderate over the next couple of years. Much of the upturn in joblessness can be viewed as cyclical, but it risks becoming permanent if growth fails to take off. We estimate that equilibrium unemployment is now around 9 per cent. The IMF believes that economic weakness affects the jobless rate for young people twice as much as that of people over age 25. This underlines the importance of focusing policy on measures that prevent exclusion of the young from the labour market.

Lower inflation and inflation expectations

Inflation continues to fall on a broad front in the euro zone. The July preliminary figure according to the Harmonised Index of Consumer Prices (HICP) was 0.4 per cent – well below the ECB's target. Wage and price adjustments in crisis-hit countries are holding down the average: both Greece and Spain showed falling prices in July. But inflation in Germany and France is also below 1 per cent. Falling food and energy prices will push down inflation further this autumn. Generally low inflation in the euro zone deepens the debt problems of crisis countries and makes it harder to solve competitiveness problems with the help of internal devaluations.

Low inflation pressure
Year-on-year percentage change



Source: Eurostat, SEB

The ECB's June action programme has eased deflation pressure somewhat, for example via a weaker euro, but exchange rates will probably have rather little impact on inflation. Due to the continued need to restore competitiveness in crisis-hit countries, as well as high unemployment and moderate growth, deflation risks remain. If anything, they have increased in recent months. Inflation expectations continue to fall, making the situation even more serious. We believe the region as a whole will avoid deflation, but the margins are not wide. Annual average **HICP inflation will be 0.5 per cent in 2014, rising to 0.6 per cent in 2015 and 0.9 per cent in 2016**. Core inflation in 2015-2016 will be somewhat below HICP.

ECB will wait and see, but more to come

Weak economic performance, low inflation and falling inflation expectations prompted the ECB to act late last spring. On June 5, it approved various measures to increase monetary policy stimulus and improve lending:

1) **It cut the refi rate** by 10 basis points to 0.15 per cent.
2) **It cut the deposit rate** equally much to -0.10 per cent.
3) **It discontinued sterilisation in the Securities Markets Programme (SMP)**, thus adding about EUR 156 billion in new

liquidity to the banking system.

4) It is offering banks up to four-year **targeted long-term refinancing operation** (TLTRO) loans for onward lending to the corporate sector. The offer applies on eight occasions starting in September at the prevailing refi rate. The loans may not exceed 7 per cent of total lending (excluding home loans) and fall due in September 2018.

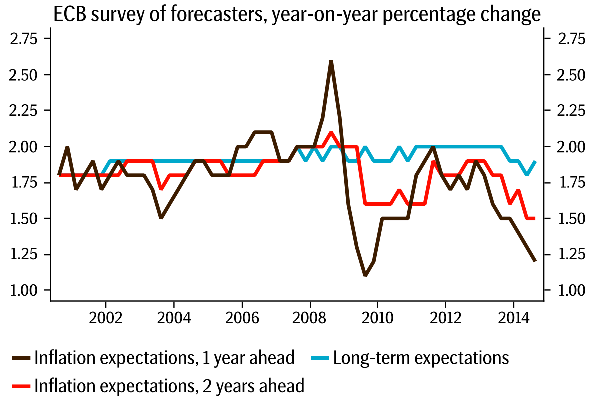
5) It is keeping main refinancing operations (MROs) as **fixed rate tender procedures with full allotment** as long as there is a need and at least until December 2016.

6) It is prolonging its expansion of the range of instruments that may serve as **collateral for loans** in the ECB system until September 2018.

7) It will intensify preparations to begin direct purchases of **Asset-Backed Securities** (ABSs).

Falling inflation expectations

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



Source: ECB

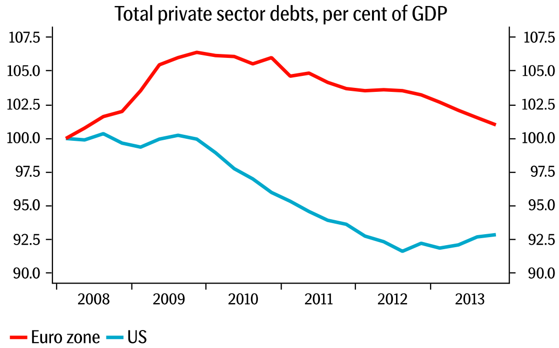
This package is powerful and has considerable signalling value. It has already had an impact by helping create more expansionary financial conditions, mainly due to the weaker euro. Ten-year government bond yields have generally fallen compared to the days before the ECB policy meeting, although the spread against German bond yields – which hit record lows – has widened. This has decreased the need for further interest rate cuts and/or government bond purchases (QE) in the near term. The ECB needs time to evaluate the effects of the measures it has implemented. In addition, two measures (TLTRO and ABS purchases) have not yet been launched.

Yet lingering deflation risks and falling inflation expectations will put continued pressure on the ECB to act. We believe that the **ECB will leave its key rate untouched** since negative rates risk causing unnecessary uncertainty and worsening the functionality of the interbank market. The ECB is more likely to try strengthening its guidance on refi rate developments, for example by linking future changes to inflation variables. Early in 2015, once its latest actions have been evaluated, the ECB will probably carry out **large-scale asset purchases**. Using only ABS purchases will hardly be sufficient; instead it will probably also implement government bond purchases.

One factor weighing down euro zone economic performance is that households and businesses have not yet sufficiently decreased their balance sheets. A study by the Bank for International Settlements (BIS) shows that lingering **pressure to correct balance sheets** (to reduce debt levels) **makes economies less interest rate-sensitive** and that only when balance sheets have been adjusted can low key interest rates support a recovery. At present, there is a clear divergence between the US and the euro zone. In the US, households and businesses have carried out sizeable deleveraging, while in the euro zone the same process has just begun. This further strengthens the arguments for unconventional ECB measures as a complement to low interest rates.

Continued need to pay down private debts in the euro zone

Total private sector debts, per cent of GDP



Source: Banque de France

ECB rotation, minutes, fewer meetings

Various ECB rules and procedures will soon change. Some changes are governed by treaties; others are the ECB's own reforms in its methods and communication.

When Lithuania joins the euro zone on January 1, 2015, the number of member countries will reach 19. According to treaty, **voting rights in the Governing Council will begin to rotate**. Thus "one country, one vote" will not apply at all meetings. The 21 votes in the Council will be allocated as follows: 1) The six Executive Board members have permanent voting rights. 2) The five largest countries (weighted 5/6 for GDP and 1/6 for size of financial sector) get 4 votes. 3) Other countries must share 11 votes, with a monthly rotation. Overall, this change means that the Executive Board and the five largest countries enjoy more power due to higher voting frequency. This is likely to result in a tougher battle for seats on the Executive Council, even though its members do not formally represent their home countries.

Starting on January 1, 2015, the ECB will also publish **minutes of monetary policy meetings**. Published minutes mean greater openness and transparency, but there is also a risk that it will lead members to become more cautious during their discussions.

The frequency of monetary policy meetings will change to every six weeks, also starting on January 1, 2015. The ECB Governing Council will also have more general meetings at least once a month.

- **Smaller deficits and neutral fiscal policy**
- **Higher interest expenses despite low rates**
- **Tax relief may be considered once again if stagnation tendencies persist**

The era of major budget-tightening is over. Euro zone public finances are moving in the right direction. Measured as change in structural saving, **fiscal policy will be largely neutral in 2014-2016**. This may be regarded as a well-balanced policy, given both the continued need for saving and the need to avoid sabotaging the recovery. **Public sector deficits will shrink to 2.3 per cent of GDP in 2016, and public debt is expected to peak at 96.3 per cent of GDP that year**. Future economic policies will largely focus on stimulating growth, for example through tax cuts and infrastructure investments, but we believe these measures will generally be funded, since many countries still have sizeable deficits.

Net lending and gross debt

Public sector, per cent of GDP

	2013	2014	2015	2016	Debt 2016
France	-4.3	-3.9	-3.5	-3.5	96.0
Ireland	-7.0	-4.8	-4.0	-4.0	119.0
Portugal	-5.0	-4.0	-2.5	-2.5	125.0
Italy	-2.8	-2.6	-2.5	-2.4	133.0
Spain	-7.1	-6.2	-5.3	-5.0	103.0
Euro zone	-3.0	-2.7	-2.3	-2.3	96.3

Source: Eurostat, SEB

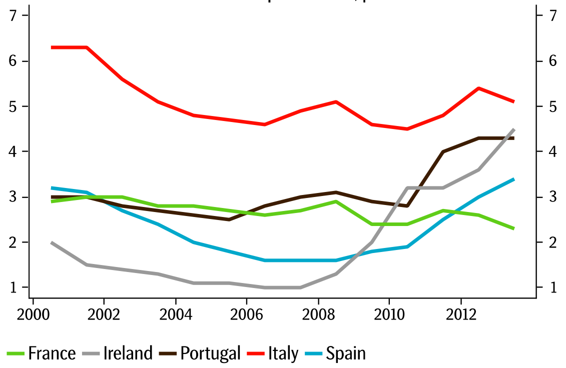
Hard to reduce debt levels without growth

This summer, bond yields on government debt in a number of euro zone countries reached record lows. It is clear that at the moment, the market fully trusts the ECB to continue sustaining the region. But even though budget deficits are now falling, the long-term problems of high debt levels will persist.

Low bond yields make funding easier for euro zone countries, but their impact on interest outlays occurs gradually since only a small proportion of their debt is refinanced each year. In crisis-hit countries, public sector interest outlays account for a substantially higher proportion of GDP today than before the crisis. The biggest difference is in Ireland, where these outlays have quadrupled to the equivalent of 4.5 per cent of GDP in 2013. In Spain and Portugal they have doubled to 3.4 and 4.5 per cent of GDP, respectively. In France and Germany, interest outlays as a percentage of GDP have instead decreased.

Low interest rates but rising interest outlays

Public sector interest expenditures, per cent of GDP

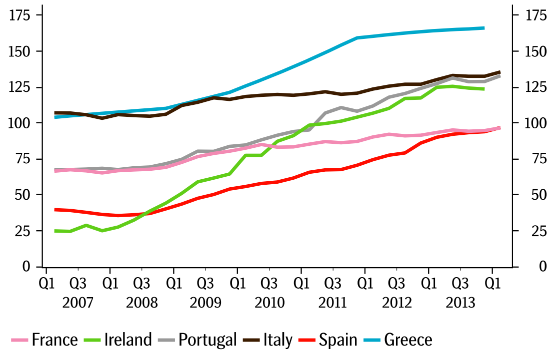


Source: Eurostat

Because of low real economic growth and low inflation (or deflation), nominal GDP is growing very slowly. This is one reason why public debt, as a percentage of GDP, continues to increase at an almost unchanged pace despite falling budget deficits. Italy is a clear example of this problem. Although its deficit is low by southern European standards, about 3 per cent of GDP in 2013, its debt is climbing as a percentage of GDP. Nominal GDP growth was just above zero, and the debt level early in 2014 was clearly higher than in 2012 and 2013.

Public sector debt continues to climb

Per cent of GDP



Source: Eurostat

It is quite possible to get by with a high level of debt, but this entails disadvantages and risks. It reduces fiscal manoeuvring room and increases the likelihood of adverse effects on confidence in troubled times. Today's low bond yield spreads are highly dependent on ECB support. In the short and medium term, there is no indication that this support will decrease, but in the long term there is still a risk that yield spreads may widen. Nor – given continued tendencies towards stagnation of nominal growth – can we rule out the potential for further debt write-offs or renegotiation of bail-out loans for the most indebted countries in the euro zone.

Unemployment will fall below equilibrium level

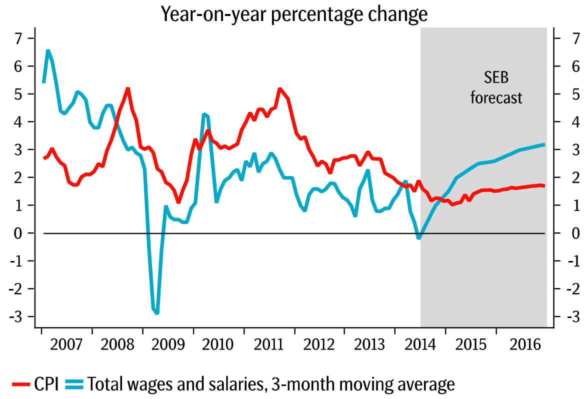
- **Households and companies exude optimism**
- **Low inflation will slow interest rate hikes**
- **Scotland will stay in the United Kingdom**

The British economy has wind in its sails. GDP has now regained its entire loss during the financial crisis. The UK will report the highest 2014 growth among G7 countries. The economy will continue upward, **with GDP growth at a robust 2.8 per cent in 2015 and 2.6 per cent in 2016**: a bit above consensus. The labour market is strong but is not causing pay increases to speed up. **At the end of 2016, unemployment will be at 5 per cent**, somewhat below equilibrium. Meanwhile we **predict that inflation will fall below target throughout our forecast period**. This indicates that the Bank of England (BoE) will hike its key interest rate slowly, starting in the first quarter of 2015. By the end of 2015 the key rate will be at 1.25 per cent, and by the end of 2016 at 1.75 per cent.

Job creation is rapid today. Employment is at its highest level in 23 years. Meanwhile unemployment is falling. Yet wage and salary growth remains subdued, a sign that there is still spare capacity in the British labour market. The BoE also lowered its estimate of **equilibrium unemployment to 5.5 per cent** in its recent inflation report. Structural factors may also explain the pressure on pay: job growth has been especially strong among the self-employed, who are often under-employed, which is another reason why productivity growth is so weak.

Stronger wage growth next year

Year-on-year percentage change



Source: ONS, SEB

The strong labour and housing markets have lifted consumer confidence above historical averages, and household consumption is showing high growth figures. The future outlook also seems bright, and **households will remain the engine** of the recovery, especially as wages and salaries accelerate in 2015. Pay indicators as well as the planned minimum wage hike this autumn point in the same direction. **The risk of overheating in the housing market seems to have decreased a bit**: macroprudential supervisory measures such as linking the maximum size of a mortgage loan to income have already had a certain cooling effect. The housing supply is also increasing, which also indicates that the price upturn will soon decelerate. Overall, household consumption will **grow by an annual average of 2.5 per cent in 2015-2016**, in line with this year's rate of increase.

Business sector indicators are also exuding optimism. Service, manufacturing and construction PMIs are at robust levels in the 55 to 62 range. **Capital spending will grow by 7 per cent this year and by an average of 4 per cent in 2015 and 2016**. The upside risks in our forecast are the biggest in capital spending: overall indicators are compatible with quarterly GDP growth of 6 per cent on an annualised basis. Yet hopes of export-driven growth continue to fall short. For the third year in a row, foreign trade will contribute negatively to GDP in 2014. Sentiment indicators for export orders are nevertheless at high levels. Combined with gradually stronger demand in important export markets, this suggests a **positive net contribution to GDP from foreign trade in 2015-2016**.

Having exceeded the BoE's 2 per cent target in 2005-2013, **inflation will be low in the next couple of years**. Energy and food prices have recently fallen, and the CPI upturn of 1.9 per cent in June is temporary; early next year, 12-month figures will bottom out at 1.0 per cent. **As annual averages, inflation will be 1.5 per cent in 2014, 1.3 per cent in 2015 and 1.7 per cent in 2016**. Lagging effects of the past year's pound appreciation – more than 10 per cent in effective terms – will hold down imported inflation. Primarily driven by expected interest rate spreads, the pound will appreciate somewhat against the euro, while weakening against the US dollar. At the end of 2015, the GBP/USD rate will be at 1.63 and the EUR/GBP rate at 0.76 according to our forecasts.

Despite good momentum in the real economy, the wage and inflation picture justifies a cautious **normalisation of monetary policy**. The first key interest rate hike, to 0.75 per cent, will occur in February 2015. Rate hikes will continue at a slow pace to 1.25 per cent at the end of 2015 and 1.75 per cent at the end of 2016. As for the September 18 referendum on Scottish independence, **the No side currently has a clear lead**. There is every indication that Scotland will remain in the union. The UK's future relations with the EU will probably dominate the next parliamentary election. Voters' choices will be important and will affect, not least, the Nordic countries.

Tougher sanctions are having little direct impact on growth

- **Structurally weak Russia will stagnate**
- **Central Europe: Continued gradual recovery**
- **High inflation in Russia and Ukraine**

The downing of a Malaysian passenger plane over Ukraine in mid-July led to a rekindling of the Ukraine crisis, following a trend in May and June towards easing military and diplomatic tensions between Russia and Ukraine, and between Russia and Western powers. This event underscores our May forecast in *Nordic Outlook* that **the geopolitical conflict in eastern Ukraine, including domestic discord, will last a long time**.

The US and EU have responded with tougher sanctions to pressure Russia to work towards demilitarising the conflict region. The US quickly seized the initiative, banning some major Russian companies and banks from long-term USD loans. One reason why the US was a step ahead of the EU is probably that it has far smaller trade with Russia and that major EU countries are divided for selfish national reasons. Italy is the only large EU country with marginal foreign trade links to Russia. Other interests are in the background. Germany imports a lot of Russian natural gas. France is selling two warships to Russia. Not until late July did the EU reach accord on an expanded three-part sanctions package: Russian state-owned banks and some large non-financial companies will be denied access to long-term financing in EU capital markets; there will be embargoes on arms trade and certain energy sector technology exports to Russia. The US imposed similar embargoes. Japan and Switzerland followed up with financial sanctions to block possible evasion of US and EU sanctions.

By expanding its sanctions, the EU entered the toughest phase (No. 3) of the action plan it launched last spring after Russia's annexation of Crimea, aimed at hurting the Russian finance, energy and defence sectors. **Yet the sanctions imposed so far have had fairly little direct effect, at least in the short term**. Russian banks have a modest need to refinance foreign loans in the next nine months. The central bank has a strong currency reserve, and the government is in a strong financial position if funding must be provided. Russia's arms exports are also small in relation to total production. The freeze on Western technology input to the energy sector will affect performance and production only long-term. But escalated sanctions are expected to cause **greater uncertainty about general developments in Russia** and lead to speculation that sanctions will be further tightened or broadened, making **foreign companies more restrictive about investing** in Russia and also hampering short-term growth.

Russia responded in August by imposing trade barriers in the aviation, agriculture and food sectors. **About 10 per cent of food imports are being halted for one year, but the effect** of this ban **is mostly symbolic**. It will have little economic impact on any affected countries, except Lithuania, which has relatively large food exports to Russia. Instead, one effect of these measures may be to drive up Russian inflation. Further targeted sanction measures by the Russians are rather likely. But in that case they will be relatively cautious. Note the words of President Vladimir Putin in his decree to the authorities concerning agricultural and food products: *"with the goal of guaranteeing the security of the Russian Federation."*

We are sticking to the fundamental economic assumptions we have maintained since the Russia-Ukraine conflict broke out in February-March: There will be **no large-scale trade sanctions and no serious disruptions in Russian energy deliveries to Europe**. Western powers and Russia are both highly reluctant to start a full-scale trade war, since the early recovery of the euro zone is fragile and Russia's economy is both cyclically and structurally weak. There is also a sizeable mutual dependence on Russian natural gas exports, which cover 30 per cent of Europe's natural gas needs.

The consequences of the conflict – especially via accentuated weakness in Russian and Ukrainian growth – caused modest downward adjustments in our general growth forecasts for Eastern (including Central) Europe last spring. **Our latest downgrade of the 2015 Russian outlook and the 2014-2015 German outlook and any new sanctions** justify only a **small further lowering of GDP forecasts for the region**. Given the limited impact of sanctions, we are maintaining our forecast that the **gradual recovery** which began in the second half of **2013, mainly in the central portion of Eastern Europe but also further south in the region, will continue** over the next couple of years. Growing private consumption in Germany/Western Europe will offset lost exports to Russia and short-term investment downturns in countries near the conflict area. It is worth noting that the larger countries of Central Europe send a relatively small share of their exports to Russia.

During the second quarter, GDP year-on-year growth in the Czech Republic, Hungary, Poland and Slovakia was largely unchanged at decent levels compared to the development in the first quarter. Retail sales remained good. Although manufacturing indicators have lost some ground generally, a similar pattern is also apparent in Western Europe. We view this as a temporary correction.

Private consumption will remain a key driver of economic growth in many countries. Households are benefiting from

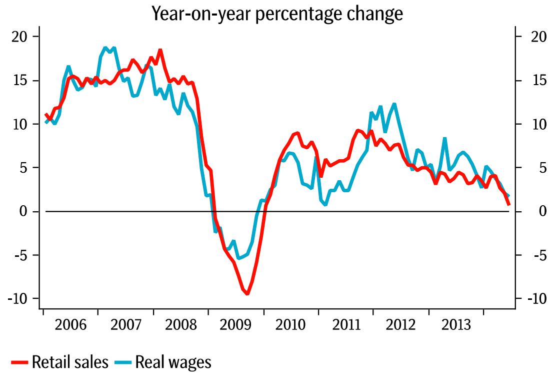
good real income increases via labour market stabilisation and **especially via low inflation**. Purchasing power has strengthened further in recent few months, because weak price pressures in countries like Hungary, Poland and Slovakia have turned into deflation. Downward pressure on inflation in Central Europe will continue during the coming year, since there are sizeable idle economic resources. In the near future, inflation will remain low due to falling food prices, partly a global trend. This may open the way for further cuts in already low key interest rates, thereby boosting household demand for loans and helping lead to higher consumption.

Stagflation problems in Russia

There is little risk of Russian economic collapse over the next couple of years. Stable energy prices and a strong labour market will help sustain the economy. The country also shows financial strength in the form of low sovereign debt (11 per cent of GDP), a balanced federal budget and a strong currency reserve. Note that extra 2014 expenditures for Crimea and Sevastopol are covered by funds, not the budget. The government's forecast that its 2014 surplus will be 0.5 per cent of GDP this year (after a 0.5 per cent deficit in 2013) is also based on a realistic +0.5 per cent growth assumption. But **years of anaemic growth lie ahead, as well as high short-term inflation**. These problems are not only due to the Russia-Ukraine conflict but **largely stem from structural problems**.

Weaker real wages are squeezing consumption

Year-on-year percentage change



Source: Russian Federal State Statistics Service

Russia's GDP will increase by 0.5 per cent this year. The economy will almost stagnate in 2015 and then expand by 1.5 per cent in 2016 – below potential growth of 2-3 per cent. We have raised our 2014 forecast from zero in May's *Nordic Outlook*, following unexpectedly good second quarter growth (+0.8 per cent year-on-year, compared to +0.9 in Q1). Industrial production was surprising, and the manufacturing sector purchasing managers' index has gradually risen since spring; it reached 51 in July – above the expansion threshold of 50. Sustained by unchanged oil prices of USD 105-110/barrel for the rest of 2014 and decent net exports, Russia can avoid recession despite a rapid fall in domestic demand. **We have cut our 2015 GDP growth forecast from 1.2 per cent to 0.3 per cent** due to lower household purchasing power (via higher-than-expected inflation), new regional extra sale taxes of up to 3 per cent and weaker capital spending because of the Ukraine conflict and the impact of new sanctions. A sharp upturn in long-term bond yields will help push down capital spending, but this summer's government grants for infrastructure investments will have the opposite effect. The government will possibly also try to offset economic weakness by means of higher wages and pensions in 2015.

The economy is being squeezed on other fronts as well. Demographic trends are unfavourable; despite weaker growth in recent years there are **supply-side restrictions** in the labour market. Unemployment has fallen from 5.5 per cent early in 2014 to just under 5 per cent (lowest since the mid-1990s) and has been below its equilibrium level of 6-7 per cent since 2011. Capital spending has also lagged for many years; the investment ratio is low compared to other EM economies.

Inflation has surged from 6 per cent early in 2014 to 7.5 per cent, well above the central bank's year-end target of 6.5 per cent (raised since the spring) and the medium-term target of 4 per cent. The upturn has been driven by several periods of rouble depreciation. But inflation is also largely due to the tight labour market. The central bank raised its key interest rate in late July in order to slow inflation and try to halt the renewed trend towards **accelerating** capital outflows. **We expect new interest rate hikes, but inflation will remain high** due to further weakening of the rouble, driven by geopolitical turmoil and economic weakness. The rouble will weaken from today's 36 per USD to 38.5 a year from now. Food import restrictions will also help drive up inflation despite a government directive ordering a price freeze. The new sales tax will also have an impact next year. **We predict 6.5 per cent inflation in 2015.**

A long way back for Ukraine

Ukraine entered a deep recession after the severe domestic political unrest that began late in 2013 and has gradually worsened. The current state of war has severely hurt production and consumption and nearly paralysed capital spending activity. The plunging value of the hryvnia after Ukraine abandoned its USD peg in February **helped drive inflation** from close to zero early in 2014 to 12.5 per cent in July. There have also been major price increases for natural gas because of cuts in subsidies, partly due to IMF/EU bail-out loan requirements. This has further hampered consumption. As earlier, we believe that the international bail-out loans (which began to be disbursed in May) eliminate the default risk and stabilise the currency reserve and the hryvnia. But Ukraine still has a long way back. The **positive effect of the currency depreciation on exports will occur only after a delay. Meanwhile the government must implement budget-tightening** in order to keep receiving its bail-out loan payments. The pace of GDP decline accelerated from 1.1 per cent year-on-year during the first quarter to 4.7 per cent in Q2. **We expect GDP to fall by 6 per cent this year, followed by zero growth in 2015. Only in 2016 will Ukraine again see weak growth of 3 per cent**. Inflation will remain high but will fall within 1-2 years as the effects of this year's currency rate depreciation fade.

Russian weakness/sanctions are slowing recovery

- **Estonia hardest hit by Russian weakness**
- **Resilience because of strong real incomes**
- **Unexpectedly low inflation bottoming soon**

Unlike most countries in Europe, the Baltics are being relatively hard hit by the Russia-Ukraine conflict via accentuated Russian economic weakness, expanded sanctions and increased regional uncertainty. The main reason is that **a large share of their exports go to Russia** (in 2013, 12-20 per cent), partly due to sizeable transit trade. The transport sector is thus also affected by falling Russian foreign trade, although the effects on this sector are not entirely negative; to date, Latvia has benefited from extra transit business that used to go through Ukraine. Capital spending is also hampered by greater political uncertainty in the surrounding region. Tourism, which is relatively important to the Baltic economies, is expected to fall only a bit due to the conflict. Statistic available so far from last spring showed that total tourist flows increased somewhat in those months compared to the corresponding period of 2013, although the number of Russian visitors fell significantly.

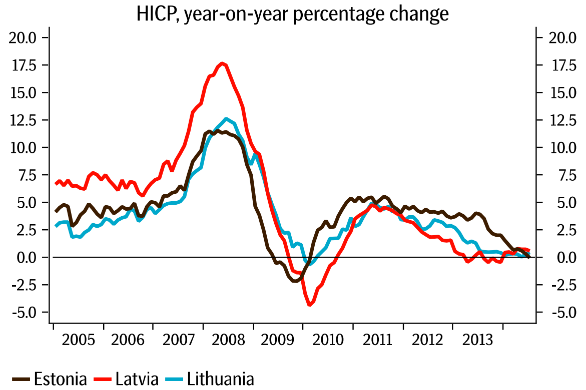
Estonia – which already entered a major slowdown last year – will be **squeezed the most** as Russia moves towards stagnation. This is because exports make up a larger share of the economy (equivalent to 80 per cent of GDP, compared to 65 per cent in Lithuania and 45 per cent in Latvia) and that it also has large exports to recession-plagued Finland. **Lithuania will weather the Russia-Ukraine conflict best** of the Baltics. Negative effects on GDP will be offset by domestic demand, which is entering a more robust recovery; the domestic recovery in Lithuania, in particular the property market, has lagged behind the other Baltic states. Lithuania can also benefit from a new gas terminal next year, markedly reducing its 100 per cent dependence on Russian natural gas. However, Lithuania will be clearly harder hit than Estonia and Latvia by Russia's food import restrictions; the effect of the one-year sanctions is equivalent to nearly 1 per cent of GDP.

Meanwhile **positive growth dynamics** in the Baltics will partly offset the negative impact of the Russia-Ukraine conflict. **Private consumption will remain the most important driver** in 2015, mainly due to continued **high real wage increases**. Consumer confidence is historically high; in Estonia and Latvia, optimism has climbed since the Crimea crisis last March, while it has fallen somewhat in Lithuania. Good economic fundamentals in the three countries are probably contributing to household confidence; public sector finances are in good shape and current account balances are showing only small deficits. Looking at capital spending, construction continues to grow and infrastructure projects will receive larger support from EU funds, following a decrease in recent years. Direct investments in Lithuania will get an extra push when the country joins the euro zone on January 1, 2015. During 2015-2016, Baltics exports will also gradually recover.

Overall Baltic growth will accelerate somewhat after a slump in all three countries in 2013-2014. Estonia's GDP will grow 0.5 per cent this year, 1.8 per cent in 2015 and 3.0 per cent in 2016. Latvia's growth will be 2.5 per cent this year, 2.7 per cent in 2015 and 3.4 per cent in 2016. Lithuania's GDP will increase by 2.7, 3.2 and 4.0 per cent, respectively. **These forecasts are still well below consensus. Our GDP forecasts for 2014 are unchanged** from *Nordic Outlook* in May, since second quarter figures were in line with our expectations. **We have lowered our 2015 forecasts** by about 0.5 percentage points in each case, mainly due to Russia's poorer growth outlook and food sanctions, and marginally due to lower growth in Western Europe.

Very weak consumer price pressure

HICP, year-on-year percentage change



Source: National statistical offices

Inflation is now extremely low in the Baltics. Even in the once high-inflation Estonian economy, the rate has slowed significantly; year-on-year HICP inflation was zero in July, after an almost uninterrupted slide from 3.9 per cent in July 2013. Inflation has provided downside surprises in the Baltics for years, mainly because of subdued energy prices and lower food price increases. We have now sharply lowered both our 2014 and 2015 inflation forecasts. Meanwhile the bottom is near. We expect **a gradual upturn to the 1.0-2.5 per cent range in 2015-2016**. The fundamental reason is **rising wage costs due to increasingly scarce labour market resources**. There have already been localised labour shortages for a couple of years. In Estonia, unemployment fell to 7 per cent in the second quarter, which is below its equilibrium of about 8 per cent.

Decent growth, but the election will create political risks

- **Recovery but no real economic dynamism**
- **Slowly falling unemployment**
- **Inflation will continue to pressure Riksbank**
- **Election outcome will push down krona**

The Swedish economy continues to show higher growth than most European countries, but the data have again turned weaker than expected and we have adjusted our forecasts for both 2014 and 2015 downward. **We now believe that GDP will increase by 2.1 per cent this year and by 2.9 per cent in 2015**. Growth will slow to 2.7 per cent in 2016. GDP will exceed its long-term trend throughout our forecast period, leading to a gradual decline in unemployment. Yet resource utilisation will remain below normal. Growth is being driven by strong consumption, which is benefiting from rising real incomes and asset prices. Accelerating home prices and household lending are increasing the risk of a downward correction further ahead. We are thus expecting new macroprudential supervision measures, including a decision on stricter mortgage principal repayment requirements, during autumn 2014. This will help increase the chances of a soft landing in the housing market.

In the run-up to the general election on September 14, a coalition between the Social Democrats and the Green Party is our main scenario. The unclear parliamentary situation creates uncertainty about economic policy and the political system faces major challenges over the next few years. Taken together the result is **heightened political uncertainty**. But the likelihood of an irresponsibly expansionary fiscal policy or major changes in the economic policy framework is small.

The Riksbank will remain under pressure due to worryingly low inflation. We expect the **central bank to cut its repo rate to 0.15 per cent**, probably this October, and leave the rate unchanged throughout 2015. We also believe that the Riksbank wants to achieve further stimulus effects by signalling more cautious rate hikes a bit further ahead. It will probably also strengthen its monetary stimulus by means of guidance: for example, by having the entire Governing Board support a requirement that inflation must reach 1.5 per cent before any interest rate hike is considered. Only in 2016, once the US and British central banks have made some headway in their hiking cycles, do we expect cautious Riksbank key rate hikes. **By the end of 2016, the repo rate will stand at 1.0 per cent.**

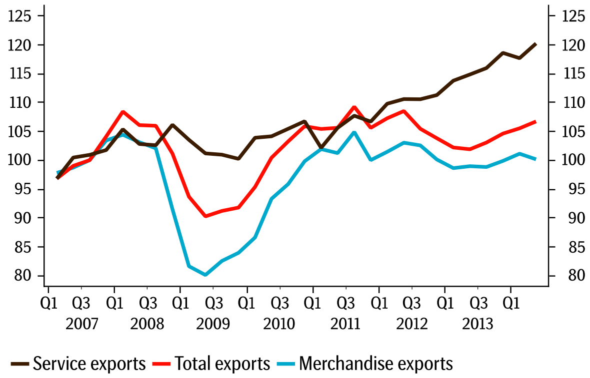
Slow upturn in exports, industrial output

During the first half of 2014, industrial production was weaker than expected. Merchandise exports were also sluggish, showing a weak and uneven upturn. Forward-looking sentiment indicators rose early in the year but then fell somewhat. Their levels are low compared to earlier recoveries but point towards decent growth. We should, however, bear in mind that actual export and production figures in recent years have been lower than the indicators have signalled.

Shaky world market demand is reflected in falling Swedish manufacturing sector investments, and companies are signalling that they will also cut back their capital spending during the second half of 2014. The weakening of the krona over this past year has helped improve profitability but has thus not been enough to maintain the capital spending level.

Service exports take the lead

Index 2007 = 100



Source: Statistics Sweden

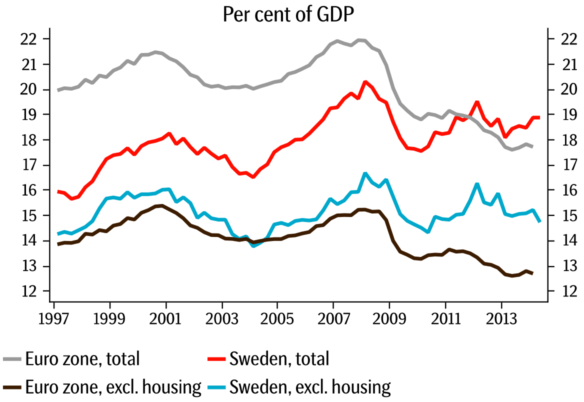
Despite their disappointing first half performance, there is reason to believe that merchandise exports will now gradually recover. One is the relatively good economic conditions in key export markets: 35 per cent of all exports go to Norway, Germany, the United Kingdom and the US, for example. Exports will also benefit from the krona depreciation of the past year. According to our estimates, the 5 per cent weakening of the currency in the past year will push up exports by a total of 2 percentage points. A continued steady upward trend for service exports will also help boost total export growth. Because of low final figures and weaker international growth, we have nevertheless lowered our forecast somewhat compared to May. We believe that exports will increase by 2.4 per cent this year and climb by 5.2 per cent in 2015 and 2016: a slow upturn viewed in a historical perspective.

Potential for higher residential construction

Total capital spending rose by nearly five per cent during the first half of 2014, mainly because residential construction increased by more than 20 per cent year-on-year. The overall investment ratio in Sweden is somewhat above the euro zone average, but the level of residential investments is still low in an international perspective. In Sweden such investments are equivalent to around 4 per cent of GDP, which remains lower than the euro zone average and well below the 5-6 per cent historical average in most countries. We thus believe **there is sizeable potential for a continued increase in residential investments**. Rapidly rising population also points to large demand for housing. So far, economic policy makers have not been so successful in their ambition to initiate broad-based new residential construction. But we expect these efforts to intensify this autumn, regardless of the governing constellation. We expect the increase in overall residential construction to a total of 70 per cent in the period 2014-2016.

Flat trend for gross fixed investments

Per cent of GDP



Source: Statistics Sweden, Eurostat

On the whole, business investments will benefit somewhat from low interest rates, but these investments are primarily dependent on the demand situation and capacity utilisation. The cyclical pattern indicates that the service sectors will lead the recovery, but manufacturing sector investments will also rebound with a certain lag. After a 1.3 per cent downturn in 2013, total capital spending will increase by 3.0 per cent in 2014. After that the recovery will continue, with an increase of 4.5 per cent in 2015 and 5.5 per cent in 2016. As in the case of exports, this is a slow rate of increase in historical terms.

Household incomes and consumption

Year-on-year percentage change

	2013	2014	2015	2016
Consumption	2.0	2.7	3.0	2.5
Incomes	2.6	3.0	2.2	2.3
Savings ratio, % of disposable income	13.0	13.3	12.5	12.3

Source: Statistics Sweden, SEB

Cautious households start opening wallets

Household consumption has held up well during the economic slumps of recent years, but it has increased at a slower pace than incomes. This has meant that households have continued to increase their saving from an already high level. We are now seeing clear signs that the rate of consumption is about to accelerate. We expect consumption growth of about 3 per cent next year, mainly driven by wealth effects from rising asset prices. While tax hikes and somewhat higher inflation will probably contribute to slower income growth, this will be partly offset by higher benefit levels in social insurance systems: measures that will also help households with a relatively high marginal inclination to consume.

Neutral fiscal policy after the election

During 2014, fiscal policy is having an expansionary effect on the economy equivalent to 0.5 per cent of GDP, or about the same magnitude as in 2013. This will help increase the public sector deficit to 1.8 per cent of GDP. To some extent, reforms that worsen the fiscal balance will be offset by improved economic conditions, but at the same time they will be kept up by such items as higher refugee reception costs. Because of pre-election uncertainty, we are cautious about our fiscal policy assumptions. A red-green government, which we regard as the most likely outcome (see "New political landscape after the election" in this issue of *Nordic Outlook*), is expected to pursue a more demand-oriented fiscal policy, implying higher levels of both expenditures and revenue. We believe government measures will be largely financed from revenue and that fiscal stimulus will be largely neutral.

Given a neutral fiscal policy stance over the next couple of years, **stronger economic conditions in 2015-2016 will gradually improve the public financial balance**. The deficit will decrease to 0.4 per cent of GDP in 2016, when general government debt will again fall below 40 per cent of GDP. Our overall assessment is that public finances are in good shape. The deficit is under control and public debt is low, both in a historical and international perspective. In our judgement, further stimulus would be possible given low interest rates, good confidence levels and a large quantity of idle resources.

Public finances

Per cent of GDP

	2013	2014	2015	2016
Net lending	-1.2	-1.8	-1.0	-0.4
Gen. gov't gross debt	40.6	41.5	41.0	39.8
Central gov't debt (unconsolidated)	35.3	36.0	35.5	35.0
Borrowing req., SEK bn	131	60	30	20

Source: Statistics Sweden, SEB

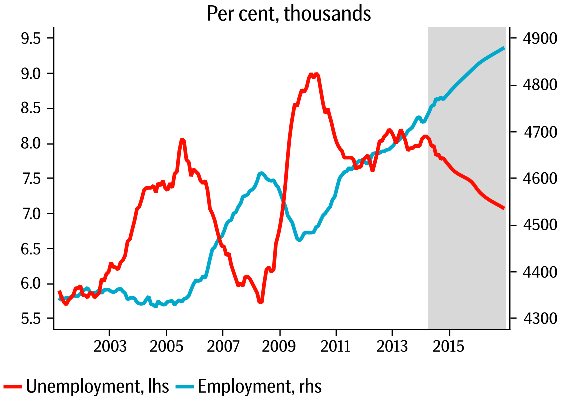
Slow decline in unemployment

Employment has continued to climb. Forward-looking indicators, such as lay-off figures and hiring plans according to the Business Tendency Survey of the National Institute of

Economic Research (NIER), signal that the upturn will intensify. Despite faster job creation, unemployment according to the Labour Force Survey (LFS) has continued to increase due to an expanding labour supply. The downturn in the number of people on long-term sick leave and disability pensions now seems to have levelled out. This will help slow the increase in labour supply.

The labour market will improve

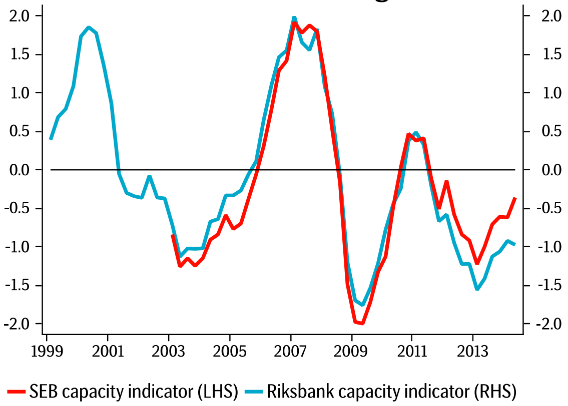
Per cent, thousands



Source: Statistics Sweden, SEB

We thus expect the jobless rate to start falling soon, which is also being signalled by declining unemployment according to Public Employment Service statistics. We believe that **joblessness will continue its gradual decline in 2015 and 2016**, but because of a strong increase in the working-age population due to increased immigration in the next couple of years, the downturn is likely to be slow. By the end of 2016, unemployment will remain a bit above 7 per cent. The employment ratio will increase but at a slow pace.

Resource utilisation rebounding from low level



Source: The Riksbank, SEB

A growing percentage of the unemployed are people with little formal education and/or poor language skills and weak ties to Swedish society. This increases uncertainty about how far unemployment can fall without leading to wage-driving bottlenecks. Resource utilisation indicators are rising (though

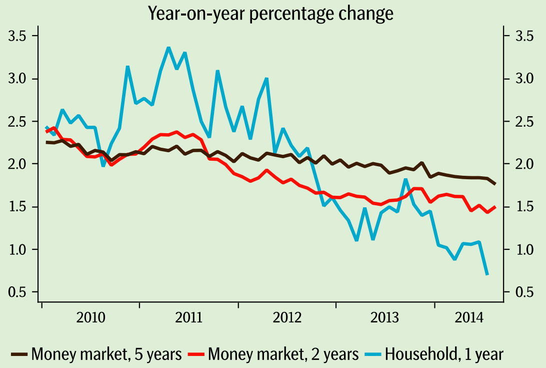
Low pay hikes a threat to inflation target?

The three-year collective pay agreements signed early in 2013 are now in their second year, and it still appears as if wage and salary increases will end up well below the average for the past 20 years. The next wage round will not begin until early 2016, when lower unemployment is likely to trigger higher contractual pay increases than the 2+ per cent that the previous wage round resulted in.

The relationship between the Riksbank and the two sides in the labour market faces new challenges ahead. Last spring, representatives of both trade unions and employers expressed displeasure with low inflation and the Riksbank's poor record in meeting its inflation target. If union and employer inflation expectations continue to fall below the 2 per cent target, we may end up in a **downward spiral where low wage agreements make it more difficult to meet the inflation target**. As one element of its efforts to restore the credibility of its inflation target, we expect the Riksbank to abstain from warnings that excessively high pay increases may lead to interest rate hikes.

Depressed inflation expectations

Year-on-year percentage change



Source: Prospera

Such a development already appears to be on its way, but the question is whether the Riksbank wants to go so far as to explicitly advise the two sides to sign high pay agreements that make it easier to meet the inflation target. Germany's Bundesbank has changed its signals and has urged the parties to conclude higher pay agreements in Germany as a way of pushing up inflation in the euro zone, which shows that such actions are not unreasonable. Such a signal may, however, challenge the conceptual framework that connects inflation to resource utilisation. Riksbank Deputy Governor Martin Flodén's speech on May 14 indicates that he is willing to reduce the bank's ties to this conceptual framework. In his speech, Flodén emphasises that monetary policy transmission channels such as exchange rates and expectations may influence inflation without necessarily having such a big impact on real variables such as GDP and unemployment. Although it is too early to draw major conclusions from this, it seems reasonable that the Riksbank may need to use new, unconventional methods to reverse the trend towards falling inflation expectations.

the Riksbank measure showed a slight downturn in the second quarter) but remain at low levels. Today there are also few signs that companies are having problems finding suitable labour. NIER surveys indicate that recruitment problems are bigger in the public sector than in the business sector. In a number of public sector areas, this probably reflects uncompetitive wages and salaries. Meanwhile there is **little risk of wage-driving bottlenecks arising during our forecast period**.

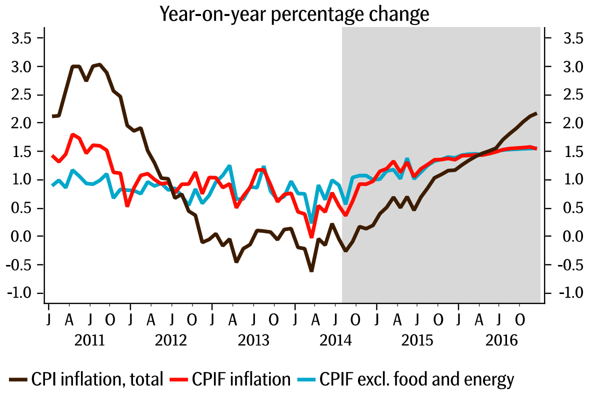
Higher inflation, but far below target

Inflation pressure will remain low throughout our forecast period. In the short term, however, there are many indications that CPIF inflation bottomed out at zero in March and that the year-on-year rate will be higher ahead. The most important short-term factor is the weakening of the krona during the past year. Other factors contributing to somewhat higher inflation will be higher energy prices and food prices once the effects of the current downturn disappear from the 12-month figures. During 2016 there will also be a faster rate of pay increases. With international prices of both commodities and more processed goods trending flat, Swedish CPIF will still have a hard time reaching 2 per cent during our forecast years. International food prices, partly driven by the Russian import restrictions, are again starting to fall. This is a downside inflation risk to our forecast during the coming year.

During 2016, when the Riksbank begins to raise its repo rate, **we expect CPI to climb above 2 per cent** due to higher interest expenses for home owners.

Price increases well below inflation target

Year-on-year percentage change



Source: Statistics Sweden, SEB

Upside inflation risks will come mainly from the indirect taxes proposed by the red-green parties. Due to the uncertain political situation and the lack of clarity about the exact shape of government tax policy, we are making a cautious forecast of tax effects on CPI. The table below shows tax hikes discussed by various parties in the current red-green opposition (Social Democrats, Greens and Left Party) and a rough estimate of their CPI effect. In our forecast, we have assumed that indirect taxes will boost inflation by 0.2 percentage points per year in 2015 and 2016. Even a continued Alliance government would be quite likely to raise certain indirect taxes, for example on energy, alcoholic beverages and tobacco.

Indirect taxes that may be raised by a new government

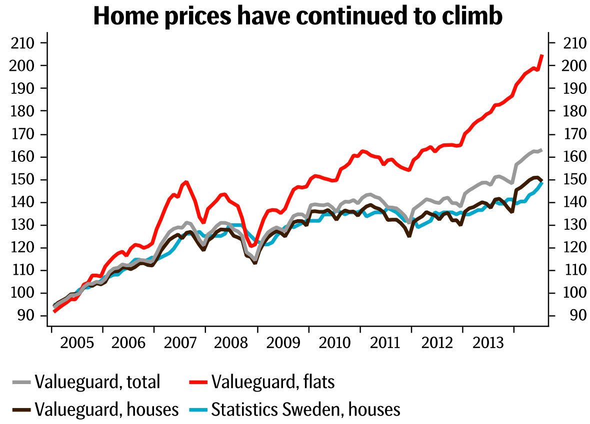
	CPI effect*
Restoring 25% restaurant VAT	0.2-0.3
Reduced home care/repair deduction	0.1-0.2
Air travel tax	0.1-0.2
Energy taxes (per year)	0.1-0.2
Property tax	0.1-0.2

* Percentage points. Source: SEB

Home prices increases have accelerated

Home prices have continued to rise. Continued low interest rates and growing imbalances in the housing market indicate that **home prices will continue to rise by 5-10 per cent by the end of 2015**. A renewed acceleration in home prices from already high levels will increase the risk of a sizeable future correction. The tone of discourse has become more urgent, and further measures will be introduced as part of macroprudential supervision when the Financial Stability Council holds its next meeting in November. We are mainly expecting the Financial Supervisory Authority to introduce new principal payment requirements on home mortgages before the end of 2014. Other measures may also be considered, for example restrictions on the ability of households to borrow at floating interest rates and restrictions on bank funding in foreign currencies. Our forecast is that these measures will help bring about a soft landing in the housing market and that prices will fall somewhat during 2016.

Home prices have continued to climb



Source: Valueguard, Statistics Sweden

Further monetary policy stimulus

The minutes of the July monetary policy meeting of the Riksbank shows that inflation is again back in focus in interest rate policy. By cutting its repo rate by a full 50 basis points, the bank is also clearly signalling that macroprudential supervision and not interest rate policy bears the main responsibility for financial risks connected to imbalances in the housing market and household borrowing.

During the summer, inflation figures came in somewhat higher than expected. Our inflation path is now in line with the Riksbank's for the next six months. The pressure for further immediate actions thus appears to have eased somewhat. This is why we believe that the Riksbank will make no changes in September but will then **lower the repo rate to 0.15 per cent** when it publishes its Monetary Policy Report **in October**. Not much will be needed to persuade the Riksbank to carry out a further rate cut. Even today, the Riksbank needs to lower its GDP forecasts. A CPIF figure a few tenths of a per cent lower than expected – or a continued decline in long-term inflation expectations – will probably be enough to trigger an interest rate cut of 10 basis points. The built-in signalling at three points in the rate path published in July also shows a clear readiness to act in this direction. Low inflation during much of next year, a weak recovery in historical terms and a continued zero interest rate policy by the ECB indicate that the Riksbank will **not raise its repo rate in 2015. During 2016 we expect three rate hikes to 1.00 per cent.**

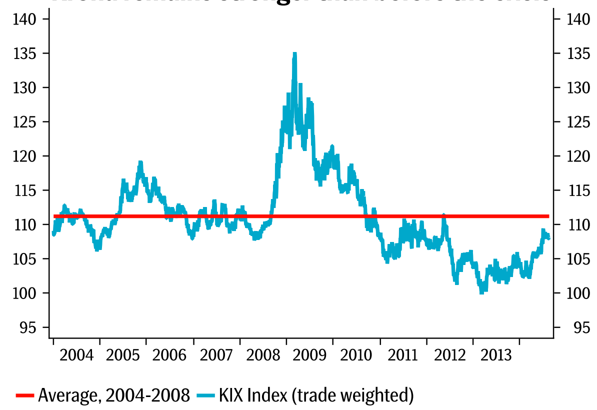
Further stimulus will come primarily via stronger monetary policy guidance. During the autumn, the rate path will probably signal more cautious rate hikes in a slightly longer perspective. Governing Board members also seem prepared to offer future guidance with the help of economic variables in line with what the Fed and BoE have previously done. Among the members, Per Jansson has made the clearest "promise" not to vote for a repo rate hike before CPIF reaches 1.5 per cent. The Governing Board will probably reach a consensus during the autumn on conditions for deciding when to consider rate hikes, for example a requirement that CPIF inflation must reach at least 1.5 per cent. Governor Stefan Ingves has also pointed out that the Riksbank should hold off on any rate hikes until the Fed and BoE have made some headway in their rate hiking cycles.

Although German 10-year government bond yields are now at record lows, the Riksbank's rate cut has helped narrow the spread between Germany and Sweden in recent weeks. Our estimates indicate that the margin may shrink somewhat further in the near future, partly depending on new measures by the Riksbank. We also expect German bond yields to rise somewhat when the ECB begins buying government bonds next year. The mechanism goes via rising inflation expectations and capital flows to other euro countries. The spread between Germany and Sweden will then bottom out at 40 basis points. As rate hikes move closer in 2016, however, the spread will widen again and approach its peak level of the past 20 years, around 70 basis points. Given continued low international bond yields, this still means that the **yield on a 10-year government bond will be 2.60 per cent at the end of 2016**.

Krona will remain weak in the near future

The key interest rate cut in July helped weaken the trade-weighted krona to its lowest level in two years. Despite the depreciation of the past year, today's exchange rate is higher than the average during the period 2004-2008 (before the financial crisis broke out). On the other hand, today's exchange rate is lower than we and other observers (for example the IMF) view as a reasonable long-term equilibrium rate.

Krona remains stronger than before the crisis



Source: NIER

But although the krona is undervalued at present, it is difficult to find forces that will drive a rapid reversal of the past year's depreciation. The foreign exchange market today is largely based on relative monetary policies. This autumn, the Riksbank's monetary policy easing – including a further key interest rate cut – is expected to be more prominent than the actions of the ECB. Also likely to hold down the krona is uncertainty about the formation of a government after the September parliamentary election, especially if neither the red-green opposition nor the Alliance wins a majority of seats.

Our conclusion is that the krona will continue to weaken in the near term, and the **EUR/SEK** exchange rate will **peak at around 9.40 this autumn**. Towards **year-end the rate will be 9.25**. During 2015 and 2016 we will then see a **gradual appreciation of the krona** as stronger Swedish growth helps persuade the Riksbank to begin rate hikes well before the ECB. However, we have adjusted our long-term forecasts towards a less vigorous krona, among other things because we foresee very cautious interest rate hikes by the Riksbank. In addition, the krona usually has difficulty holding its own in periods when the USD is appreciating against other major currencies. **At the end of 2015, the EUR/SEK rate will be 8.90 and at the end of 2016 it will stand at 8.70.** Our forecast of a gradual strengthening of the US dollar will lead to a slow upturn in the USD/SEK exchange rate to a level of 7.25 at the end of our forecast period.

- **S-MP minority coalition is most likely**
- **Gradually increased difficulties in governing unless there is cross-bloc cooperation**
- **Higher tax and fee levels**
- **Changes in existing economic policy framework are unlikely**

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 an independent Riksbank, expenditure ceilings and budget surplus targets – has been a guarantee against imprudent policies. **By most indications this stability will persist, but the political system will be sorely tested in the coming year**. As the parliamentary election approaches, many changes are conceivable: a new government, untested governing coalitions, new party leaders, blurred lines between the two political blocs, parties leaving or entering Parliament and a kingmaker party that no one else wants to work with.

With only a few weeks left before the election, the government formation process is a major focus. Opinion polls show a clear lead for the "red-green" opposition – Social Democrats (S), Greens (MP) and Left (V) – against the governing Alliance bloc of Moderates (M), Liberals (FP), Centre (C) and Christian Democrats (KD). According to some polls, the red-green bloc will win its own majority, while other polls indicate that the populist anti-immigrant Sweden Democrats (SD) will achieve a kingmaker role in Parliament. One key question affecting the majority situation is whether C and/or KD will attract the 4 per cent needed to stay in Parliament, but parties teetering on this threshold often attract sympathy votes. Historical experience also indicates that wide gaps between blocs tend to shrink as elections draw closer, though we have not yet seen any such trend. **Today we still believe that a more likely outcome is that the red-green bloc will fail to win its own majority**.

Proven leadership skills were a decisive trump card for the Alliance in the 2010 election, especially after the S, MP and V finally formed a three-party governing alternative. In the 2014 campaign, the Social Democrats have changed strategy and avoided showing their cards on the government formation issue. In recent weeks, the Alliance has tried to raise this issue and show what difficulties a red-green government may face. Yet after lively debate, the Alliance seems willing to let an S-led government take over in a situation where the red-green parties have more seats than the Alliance but lack their own majority. Instead the Alliance is focusing on the difficulties that may arise during this autumn's budget process.

Because the parliamentary situation seems unclear, the formal timetable for the formation of a government may be of interest. The key innovation this time around is that Parliament must choose a prime minister (PM) no later than 14 days after opening. This means that all parties will be explicitly forced to show their cards on the government formation issue. However, a majority that actively votes No is still required in order to reject a PM candidate. It thus remains possible for parties to passively allow a government to take office by abstaining.

Important dates in the political process

Sep 14: Incumbent PM has the option to choose resignation
Sep 29: New Speaker of Parliament appointed – a no-confidence vote may be proposed
Sep 29-Oct 13: Speaker may ask a PM candidate to form a government
Sep 30: Parliament opens; a PM may be proposed
Oct 3: Statement of Government Policy if Alliance stays in office
Oct 3: Possible Statement of Government Policy from a new PM (but no later than three weeks after the PM is chosen)
Oct 10: Deadline for choosing a PM; an extra parliamentary election will be held if the Speaker fails after four attempts
Oct 14: Deadline to submit Budget Bill if Alliance stays in office
Oct 24: Earliest date for a new government to submit Budget Bill
Nov 17: Deadline for a new government to submit Budget Bill
Dec 30: A formal decision on the 2015 budget must be made

We now believe that t**he most probable outcome is a Social Democratic-Greens minority government**. The Left Party (ex-Communist) likely to vote with an S-MP government, whether the red-green bloc wins its own majority or not. The Left will agree to stay out of government, among other things because it can thereby avoid major compromises that some of its party factions would have a hard time accepting.

The ability of the next government to actually push through its political programme will largely depend on how much voter support it has attracted. To enable an S-MP government to be formed relatively painlessly and act with sufficient authority, it is important that the red-green parties receive a clear voter mandate. If the gap between the blocs shrinks towards 5 percentage points, we believe that forming a government may be complicated. For the Social Democrats, it will be of great value to exceed the 30.7 per cent of votes they received in 2010, which was viewed as almost disastrous. If their 2014 election outcome is the worst in modern times, it will weaken the party's authority and self-confidence. In such a situation, the leadership's more pragmatic economic policy strategy might be challenged by V and MP as well as the party's own left wing. The Social Democrats are also very unaccustomed to sharing power; their most recent experience is a coalition government with the Center (then Farmers') Party in the 1950s.

If the red-green parties have only a small lead in Parliament and/or the Social Democrats are weakened, other governing constellations besides **S+MP** may be considered. We foresee the following alternatives, in descending order of probability: a) a three-party **S+MP+V** government; b) a minority **S+MP+FP** government; c) a pure **S** government; d) a minority of **non-socialist parties (Alliance)**; e) formation of an **S+M** grand coalition with a parliamentary majority; f) a majority government of **MP plus** the **non-socialist (Alliance) parties**.

But political uncertainty is not limited to the formation of a government. **At least equally important is how effective any minority government will be**. During the past four years, the Alliance has governed as a minority without any organised cooperation with the opposition. Several factors have made this possible: 1) the government has nearly commanded its own majority (with 173 seats out of 175 needed), which has strengthened its authority; 2) the Sweden Democrats have mainly voted with the government; 3) the leftist (red-green) opposition has been unwilling to team up with SD to defeat government bills; 4) the government has squeezed as many proposals as possible into its Budget Bills, making it easier to win since the opposition must join forces and submit a single bill to defeat a Budget Bill. **The price of this parliamentary situation has been that the government has pursued substantially more passive policies than during its 2006-2010 majority period**. The lack of cross-bloc cooperation has also led to passivity on various policy issues, such as private contractors in social services and health care, taxes, housing, integration of immigrants, schools, defence and energy supply.

The question is how big the problems will be for a leftist minority government with no organised cross-bloc cooperation. The Alliance has declared that it intends to submit a joint budget bill, regardless of the election outcome. This would reinforce SD's kingmaker role and force the government to compromise in different directions. But we can also raise more fundamental questions about the practices employed in 2010-2014. The Alliance's way of using Budget Bills, for example, seems dubious in principle. The idea behind the Budget Act is to make the budget process more transparent and reduce the risk of uncontrolled spending expansion in various fields, not to make it easier for a minority government to rule. We believe that the difficulties facing a minority government **will grow as the parliamentary term progresses**, increasing the pressure for cross-bloc cooperation. A cross-bloc government may be formed during the coming term, but a government crisis and snap election might be required before the parties are ready for this. Leadership changes in Alliance parties may eventually ease the way for new coalition alternatives.

One crucial question is what differences in economic policy the various governing constellations represent. Right now it is very difficult to see the big picture, since new proposals are continuously being unveiled. Below we are thus presenting some overall conclusions in key areas. We generally believe that the **fiscal policy** will be rather neutral or weakly expansionary, regardless of government. It may be tempting for a government to try to make a flying start in the labour market by increasing fiscal stimulus programmes, especially in light of the shaky economic situation. But this is difficult because the Social Democrats have long criticised the Alliance government for being fiscally irresponsible. Instead the likely outcome is that a red-green government will raise certain taxes, such as income and excise taxes, and remove the rebate on employer-financed social insurance fees for young employees. Meanwhile a red-green government will raise fees to a greater extent, for example by boosting unemployment insurance benefits. This implies a policy mix that provides an **extra short-term dose of stimulus, while a higher tax burden will risk worsening long-term growth potential**.

During the next government's four-year term, tax reforms will be considered. The table below presents our view regarding the probability of changes in various tax areas.

Tax area	Higher/lower	Probability
Direct taxes on labour (incomes, home care/repair)	↗	High
Indirect taxes on labour	↗	High
Capital incomes (interest/deductions/dividends)	↗↘	Medium
Assets (real estate, wealth, inheritance, gift)	↗	High
Corporate tax	↗↘	Medium
VAT, indirect taxes/fees	↗	High

There has been lively debate, especially within the red-green opposition, on reforming the **economic policy framework**. This includes giving the Riksbank greater responsibility for the labour market and resource utilisation. But when the dust settles, we do not believe there will be any changes in the central bank's mandate. The government and other political leaders have little long-term interest in further expanding or complicating the task of the Riksbank. Also under discussion is adding unemployment and capital spending targets to the current public surplus target. We do not believe there will be any changes in this area either. The government may very well formulate visions and goals related to economic variables, for example in line with the Social Democrats' unemployment target in the 1990s. But we believe that political leaders will preserve the distinction between such visions and the actual framework, whose purpose is to clarify overall fiscal policy rules of the game. In light of Sweden's low central government debt, a minor reform transforming the surplus target for general government finances (1 per cent of GDP over an economic cycle) into a zero balance target is not unlikely.

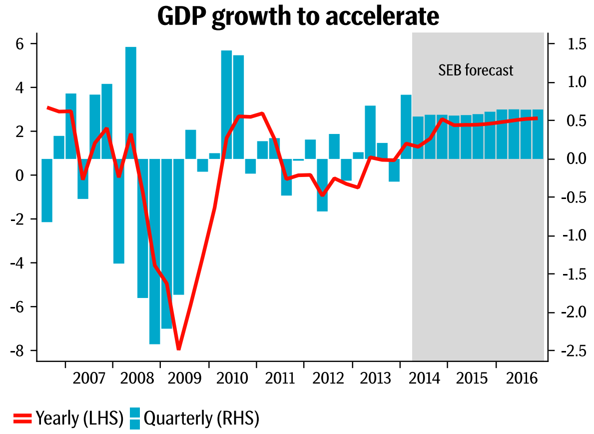
Generally speaking, the Swedish political system faces major challenges over the next few years. In the short term **we see risks that the formation of a government may be complicated**, resulting in heightened political uncertainty. There is also some uncertainty about how economic policy will be formulated, especially if a red-green government is headed by a greatly weakened Social Democratic Party. **But the likelihood of an irresponsibly expansionary fiscal policy or major changes in the economic policy framework is small.**

Room for above-trend growth

- **Lower growth forecast for 2014-2015 due to foreign weakness**
- **2016 growth will be 2.5 per cent**
- **Labour market slack under-estimated**

Weak GDP numbers in the fourth quarter of 2013 led to worries about the recovery. As noted earlier, however, technical and temporary factors drove much of this Q4 weakness (see *Nordic Outlook,* May 2014), and the Q1 number released at the end of May seemed to confirm this notion. Most domestic indicators still look solid, but lower growth expectations for Denmark's key trading partners in the euro zone and for Sweden have led us to **trim Danish GDP growth in 2014 and 2015 by a quarter of a per cent to 1.8 and 2.3, respectively**. A slightly higher sequential growth rate should put **2016** growth at **2.5 per cent**. In 2016, we foresee tighter fiscal policy countering improvements in private demand.

GDP growth to accelerate



Source: Statistics Denmark, SEB

Recovering consumers face a more dynamic labour market as well as improving balance sheets; housing prices are rising despite high household debt levels. Along with fading cautiousness among firms, a loosening fiscal stance, the ongoing global recovery and super-easy monetary policy, this will feed into the Danish upturn. One major current risk to this outlook stems from a more significant escalation of the Russia-Ukraine conflict, which would affect European forecasts more materially. A small open economy like Denmark is highly dependent on the external environment.

Little has changed in the outlook for the consumer. Employment is still picking up nicely, growing at an annual rate of close to 1 per cent. Wage growth is sluggish but is expected to slowly speed up as the recovery matures and unemployment continues its downward trend (more on this below). Unemployment is expected to be 4.1 per cent in 2014 and to average 3.5 per cent in 2016. We expect wages and salaries to accelerate by slightly below 2 per cent in 2015 and slightly above 2 per cent in 2016.

The **recovery in the housing market continues**, supported by mortgage rates that have stayed at historical lows. Single-family houses are only seeing slight price increases, whereas flats are appreciating by close to 10 per cent annually, and even more in Copenhagen. The ongoing improvement in household fundamentals is visible in consumer sentiment, which during the summer reached levels only seen at the peak of the 1990s and 2000s expansions. The volatility of consumer spending in recent GDP releases makes it hard to track the underlying strength, so our consumption growth forecast is based more on the fundamental backdrop outlined above than on an extrapolation of the current trend.

On the business side, things are more mixed. The tendency survey for the manufacturing sector has declined throughout the late spring and summer and is now at a lower level than in the past couple of years. This is somewhat disturbing, but also confusing. We see little to suggest such a dramatic change of the situation among manufacturers. Other business indicators do not signal the same dramatic change. Fear of an escalation of the Russia-Ukraine conflict might be part of the reason for the summer blues. Concerns among business leaders could lead to postponement of capital spending, leading to a downside risk to our investment forecasts and thereby also to our GDP forecast.

The external balance is still looking very healthy. On a 12-month rolling basis, the goods and services balance of the current account has come off the peak reached early in the year, but it is still looking very solid at around 4-5 per cent of GDP. The total current account surplus is running at around 6 per cent of GDP. We still see this as an indication of solid competitiveness among the parts of the economy that compete internationally. An expected weakening of the euro implies that the Danish krone will also weaken in real effective terms.

Danish inflation to outpace euro zone

Inflation dynamics are still extremely weak, with domestic demand still far from pre-crisis levels, held back by sluggish income growth. However, accelerating growth and employment combined with moderately faster wage increases and a firming residential property market should feed into **gradually increasing inflation**. Specifically, we expect Danish inflation to run ahead of euro zone inflation during our forecast period.

This is due to a more advanced position in the expansion curve, slightly higher growth expectations and significantly milder deflationary pressure from structural adjustment and depressed labour markets than in southern Europe. This means that Danish HICP inflation should outpace that of the euro zone in the next couple of years. **We expect inflation of 0.6 per cent in 2014. In 2015, inflation will accelerate to 1.1 percent and in 2016 to 1.5 per cent.** Nonetheless, we see little need for monetary policy action in our main scenario. The key interest rate hike by Danmarks Nationalbank in May and the bank's passiveness when the ECB lowered rates in June have reinstated a positive spread to Germany and strengthened the krone just as intended. Although we expect the ECB to do more, this will not change the conditions for Danmarks Nationalbank.

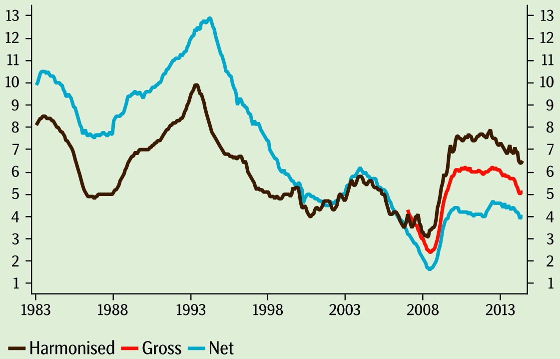
Is Denmark overheating?

In June, Nationalbank Governor Lars Rohde publicly advised a tightening of economic policy in 2015 due to fear of bottlenecks and overheating. The government seems to agree. Earlier this summer, the prime minister raised similar concerns and the government has repeatedly warned about the risk that Denmark may lose competitiveness.

We find little to support this case right now. The labour market seems to have plenty of slack if the proper measure is used. Official Danish publications have historically referred to Net Unemployment, excluding people in public employment programmes, or since 2010 Gross Unemployment, which includes this group of people. But both figures are *register-based*, i.e. includes only people listed in public files as receivers of state unemployment benefits or social transfers. People who are not eligible for such benefits are not registered as being part of the labour force and thus not counted as unemployed.

Harmonised unemployment indicates plentiful slack

Per cent



Source: Statistics Denmark, OECD

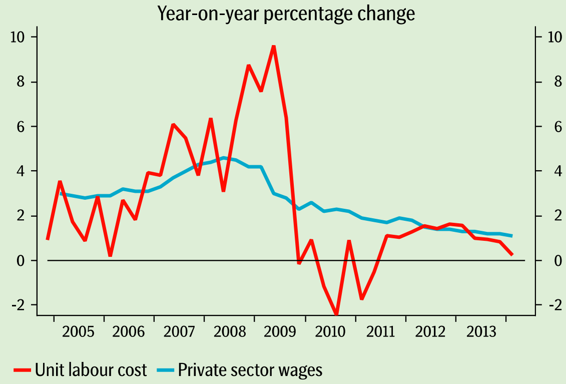
With recent changes to Danish unemployment insurance rules reducing the maximum benefit period from four to two years, going forward it is likely that more people will be unemployed but ineligible for public support.

We believe slack is better analysed using survey-based unemployment rates, such the one the OECD uses in its harmonised measures. As indicated in the chart above this number (black curve) points to plenty of slack, with the survey- based unemployment rate remaining above the levels seen from late 1990s through the start of the financial crisis. The latest figure of 6.5 per cent still stands 3.5 percentage points above the low point of the previous cycle, which admittedly looks somewhat extreme.

Are there other indications of overheating? Bottlenecks can lead to overheating even at elevated unemployment rates if skill-matching between firms and jobseekers is insufficient. This would lead to wage pressures. But as indicated by the chart below, wage growth does not seem worrisome from that perspective and neither does growth in unit labour cost. We believe the risk that wage and inflation expectations will settle at inappropriately low levels is bigger than the risk of overheating at present.

No signs of overheating

Year-on-year percentage change



Source: Statistics Denmark, ECB

This also relates to the discussion on competitiveness. Is the Danish economy at a stage where it is appropriate to warn about lost competitiveness and a need for restraint in wage negotiations? Sluggish ULC is not only the result of moderate wage dynamics but also of solid productivity. Productivity for the total economy in a boom-bust period with a big correction in the construction sector is hard to measure accurately. But manufacturing productivity can more meaningfully be measured – and it has shown a much stronger improvement than most observers acknowledge, reaching the highest growth level in the past 20 years (when current records started).

Measuring problems aside, if this was such a pressing issue how could Denmark maintain such strong external surpluses? Going forward, we expect wage growth to pick up as the labour market tightens, but given plentiful slack we see this as a gradual process. It is difficult to forecast wages and salaries because they seem less responsive to the drop in unemployment than normally. The current unemployment rate has historically led to wage growth of above 2 per cent, but today it is close to 1. This downward shift is hard to explain, but the downshift in overall inflation expectations could be part of the reason.

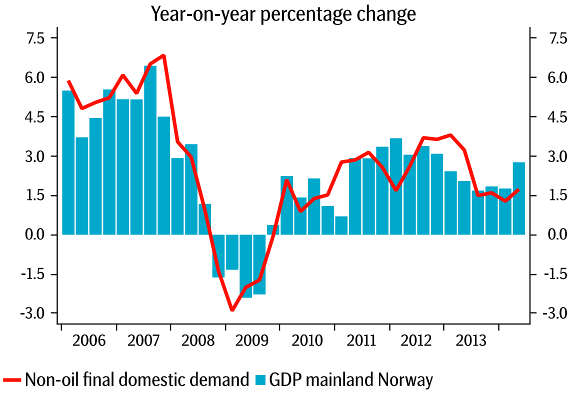
Weathering the storm

- **Growth picking up to trend-like pace**
- **Drag from stalling oil-sector investment, but firm consumption and non-oil exports**
- **Surprisingly persistent core inflation**
- **Norges Bank on hold until higher key rates abroad ease appreciation pressure on NOK**

Economic momentum has risen markedly over the past year. Mid-2013 saw signs of stagnation, and declining prices of existing homes raised fears that consumption was about to falter. However, 2014 has so far been stronger, fuelled by revitalised private consumption on reviving home prices, high employment and still-healthy income despite higher inflation. Moreover, exports of non-petroleum goods have recovered on robust foreign orders, in part helped by previous NOK weakness. In fact, mainland GDP – excluding oil/gas and shipping – jumped 1.2 per cent from the first to the second quarter and by an above-trend 2.8 per cent year-on-year. While declining capital spending in the petroleum sector will be a drag, it is very hard (to say the least) for Norges Bank to argue that the economic outlook has undergone "further weakening", which it in June saw as a potential trigger for lower key rates.

Growth running above trend in mid-2014

Year-on-year percentage change



Source:Statistics Norway

Mainland GDP should gain 2.4 per cent in 2014 and 2.5 per cent in 2015. Growth in **overall GDP will be 1.6 and 1.7 per cent** in 2014 and 2015, respectively, slightly less than assumed in the May *Nordic Outlook* due to weaker investment.

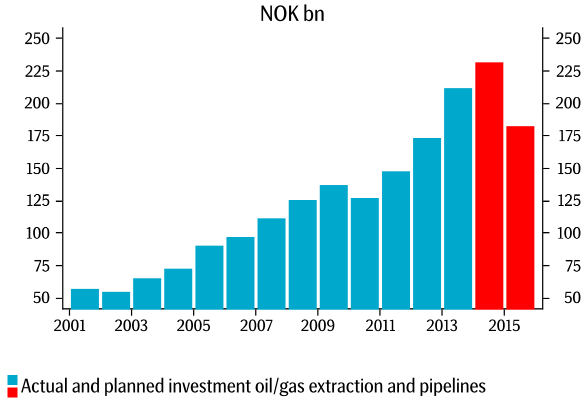
Headwinds from capital spending

The capital spending cycle within oil and gas extraction is downshifting sharply. Such investments gained an average of more than 14 per cent in volume terms in 2011-13, providing the rest of the economy with important demand impulses, though its average direct contribution of 0.9 percentage points to annual GDP growth during this period exaggerates the net effect (for example, due to high import content).

Statistics Norway's oil-sector investment survey in June suggested a much steeper-than-expected downshift. Projections by operators on the Norwegian continental shelf put nominal investment in oil and gas extraction and pipeline transportation at record-high levels in 2014, but the first estimate for 2015 was 16 per cent lower than assumed for 2014 a year earlier and fully 22 per cent below the current prediction for 2014.

Petroleum-sector investment to drop in 2015

NOK bn



Source: Statistics Norway

Planned investment for any year, as measured in the survey, has historically tended to be revised upward over time, especially because the survey only covers projects approved by authorities: the vast Johan Sverdrup field will thus not be included until mid-2015. Moreover, some details in the June survey looked too dire. In particular, operators expected purchases of goods and services at fields on stream (roughly half the total) to drop by almost a third in 2015, which is very hard to square with the general notion of broadly stable production.

Part of the downshift is due to companies trying to rebuild profits/margins, with a renewed focus on cost-cutting measures and improving efficiency after years of runaway cost inflation. Hence, the looming decline should be more accentuated in nominal terms than measured in real activity, which is what counts towards GDP. While such **investments will probably be up only marginally in 2014, they will probably decline by 9 per cent in 2015**, slicing ½ percentage point from overall GDP. The next oil-sector investment survey, due September 3, will be very important to watch.

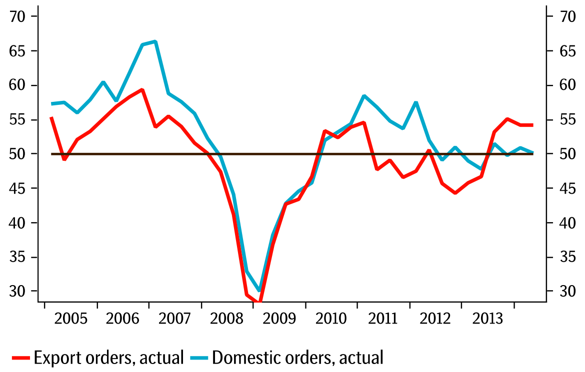
The investment cycle in the petroleum sector has already turned markedly weaker. Measured in volume terms, capital spending in oil and gas extraction was 3 per cent lower in the first half of 2014 compared to the second half of 2013, when it was up 19.0 per cent year-on-year. In other words, so far the relative shift in such investment and related demand impulses is as large as expected for 2015.

Weathering the storm so far

Yet developments suggest that the economy has weathered the headwind, at least so far. **Other demand components should take up at least part of the slack**. There are prospects for improving exports of non-petroleum goods, which in the second quarter were up more than 3 per cent from the previous quarter and year-on-year. The recent manufacturing Business Tendency Survey suggests more is in store, since respondents reported growth in foreign orders for the fourth consecutive quarter in Q2 (the survey was compiled in late June/early July). Part of the improvement over the past year reflects the weaker NOK exchange rate, but we believe the upturn will be sustained. We expect **exports of non-petroleum goods to be up 3.2 per cent in 2014 and a further 4.0 per cent in 2015.**

Manufacturers report healthy foreign orders

Index



Source: Statistics Norway

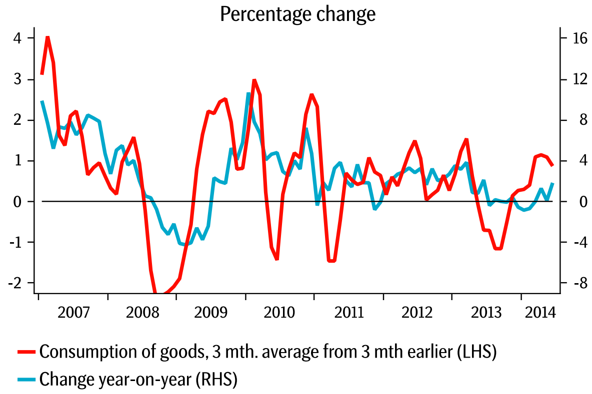
Improving foreign demand helped lift the manufacturing sentiment indicator from 6.6 in the first quarter to 7.5 in the second, slightly above the long-term trend. Meanwhile, stagnating domestic orders reflect downshifting investment in the oil sector. It is thus unsurprising that expectations are the weakest within the investment goods sector, but the Business Tendency Survey nonetheless suggests that manufacturing is coping well with these waning demand impulses. Hence, production in the sector – excluding energy and mining – was up a solid 1.3 per cent from the first to the second quarter, although the year-on-year rate slowed to 2.4 per cent.

Firm consumption

We have long been relatively optimistic regarding the outlook for private consumption: our May forecast of 2.5 per cent growth in 2014 was thus more than ½ percentage point above consensus at the time. In fact, the monthly indicator for household domestic consumption of goods – non-auto retail sales plus spending on electricity and autos – has been even stronger than expected. The sequential gain of 0.9 per cent in the second quarter almost matched growth in the first quarter. While annual growth remains modest, momentum has rebounded markedly from the weakness of summer and autumn 2013. In all, **private consumption should grow by 2.6 per cent in 2014 and a further 3.2 per cent in 2015**.

Private consumption has recovered

Percentage change

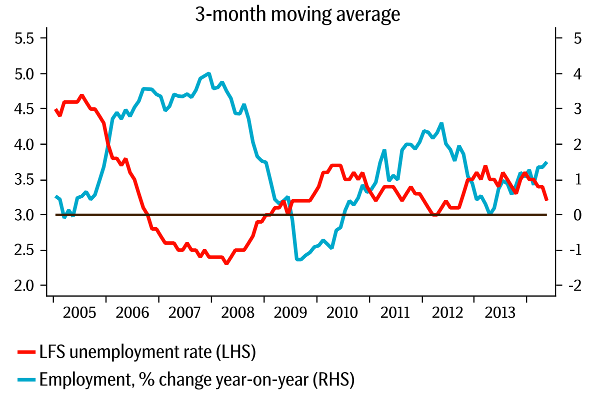


Source: Statistics Norway

The underlying trend is thus quite strong. This is despite the fact that higher inflation is dampening household purchasing power, which nonetheless shows healthy year-on-year growth. One reason is the resilient labour market. The Labour Force Survey (LFS) employment figure rose by a surprising 0.7 per cent from the first to second quarter. The 0.4 per cent average sequential growth rate in the first two quarters of 2014 is more representative of the trend, which still signifies a healthy pace.

Labour market surprisingly healthy

3-month moving average



Source: Statistics Norway

Meanwhile, although registered unemployment is up marginally on net so far in 2014, a marked decline in the number on people in labour market programmes has left the overall level lower and reversed half the 2013 increase. Meanwhile, the LFS unemployment rate declined to a seasonally adjusted 3.2 per cent in the second quarter, after staying at 3.5 per cent for six consecutive quarters. Here, the drop looks a bit too deep due to inflated employment growth, and **unemployment should average 3.4 per cent in 2014 and 3.6 per cent in 2015.**

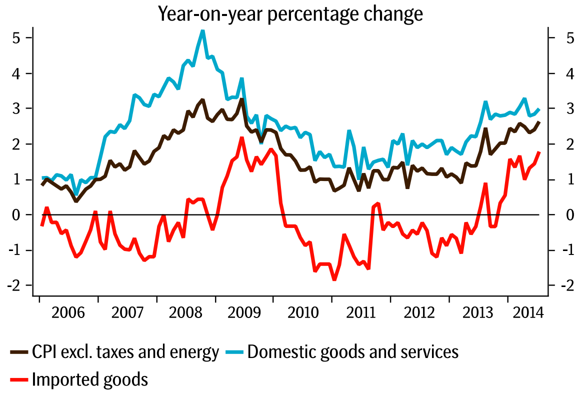
An upturn in existing home prices has probably helped fuel private consumption through its effect on consumer sentiment. A year ago, falling home prices created fears of a deep slump, but demand has held up and prices have risen in seasonally adjusted terms in each of the first seven months of 2014. While they are up a modest 0.7 per cent year-to-date from the full-year average, the six-month annualised change was running at a strong 7.2 per cent as of July. We expect a stabilisation going forward, but the low number of building permits and housing completions and still-low interest rate puts a floor under the market.

Still waiting for core inflation to move lower

In the May issue of *Nordic Outlook*, we noted the marked pickup in core inflation since mid-2013 but expected a slowing in the near term. Although year-on-year rate CPI-ATE inflation (CPI excluding taxes and energy) initially eased slightly, July saw a surprising re-acceleration to 2.6 per cent, matching the near five-year high in March. Meanwhile, the annual rate of increase in overall consumer prices picked up to 2.2 per cent.

Core inflation remains sticky

Year-on-year percentage change



Source: Statistics Norway, SEB

Core CPI inflation has averaged 2.5 per cent so far in 2014, bang in line with the medium-term target and a material upward shift from the 1.3 per cent average rate over the first seven months of 2013. Slightly less than half the acceleration is due to food prices, while the rest has been more diverse, including a marked upturn for imported goods generally. At least part of this reflects earlier NOK depreciation, which filters through with a certain lag, an effect that is about to moderate. In addition, rent inflation (affecting almost one fifth of the core CPI basket), which initiated the surge in domestic inflation, has slowed quite a bit.

Part of the recent upside surprise is probably explained by shifts in seasonal patterns, suggesting a reversal in the very near term (strong base effects will also be at work). However, the relatively high core inflation rate also seems to be more persistent than expected, although it is hard to identify a general cost-push in prices (other than the currency effect). Despite recent upside surprises, we have nudged our forecasts only slightly higher. **Core CPI inflation should average 2.4 per cent in 2014 and 2.1 per cent in 2015**.

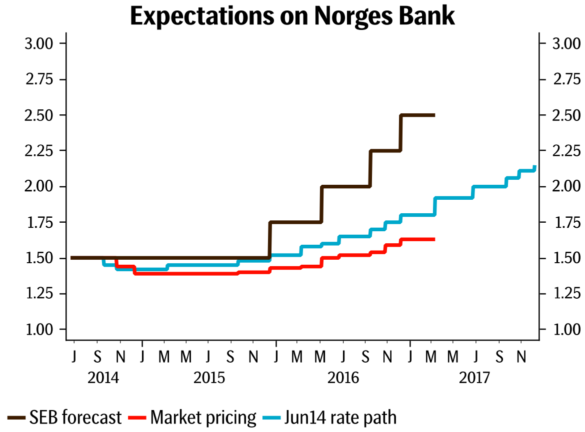
Norges Bank constrained by peers

At its June monetary policy meeting, Norges Bank revised its rate path markedly lower and re-opened the door to a possible rate cut. The extent of the downward revision was questionable, since the growth and inflation outlook was broadly unchanged. However, it underscores the bank's dovish bias. Furthermore, the bank has downplayed the relatively more hawkish rate path in favour of a more dovish statement, also proving that it is favouring a more "gut feeling" approach, factoring in more input from exchange rate movements and monetary policy abroad.

The rate path from June pencilled in a 30 per cent likelihood of a rate cut, conditional on a further deterioration in the domestic growth outlook. Considering surprisingly strong data since the June Monetary Policy Report, uncertainty about the growth outlook has if anything receded. A rate cut is thus off the table, and we expect a more balanced statement at Norges Bank's upcoming September 18 rate announcement.

Improved growth momentum, marked rebound in existing home prices and surprisingly persistent high inflation suggest that a rate hike may come earlier than we have previously assumed. However, the bank's subjective approach to setting interest rates suggest it will remain on hold until higher key rates abroad ease the otherwise large appreciation pressure on the NOK from higher Norwegian rates. Our expectations that the BoE and Fed will hike their rates next year thus opens the way for Norges Bank to start lifting its key rate in late 2015. However, still-low key rates in the euro zone and in Sweden will constrain the pace of rate hikes in Norway. **We expect a key interest rate of 1.75 per cent by end-2015 and 2.50 per cent by end-2016**.

Expectations on Norges Bank



Source: Norges Bank, SEB

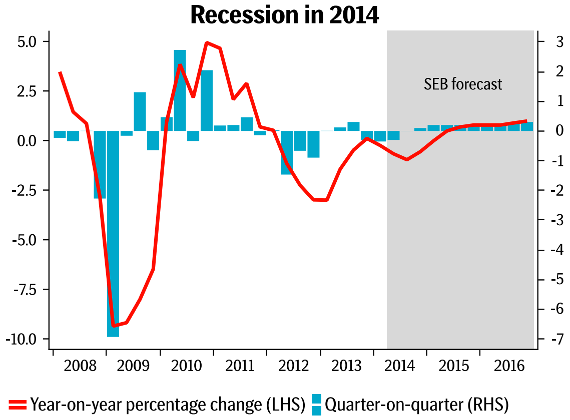
Following surprisingly strong economic data, the market has re-priced its expectations about Norges Bank, which has strengthened the NOK. Speculative accounts are thus likely to increase their NOK exposure, supporting the krone in the near-term. The long-term positive flow outlook and our expectations about Norges Bank imply a gradual appreciation of the NOK. We forecast a **EUR/NOK exchange rate of 8.00 by mid-2015 and 7.90 by end-2015**. Ten-year government bond yields are likely to receive support from the continued low key rate and the improved NOK outlook, since foreigners currently hold a historically low share of outstanding sovereign debt. **We expect a 10-year yield spread vs. Germany of 90 bps by end-2015**.

The recession is continuing

- **Weakness in Russia and trade sanctions put further pressure on economic growth**
- **Unemployment will stabilise at a high level**
- **Continued contractionary fiscal policy**

The Finnish economy has shown falling GDP during half of all quarters since 2008. The economy entered a recession in the first quarter (two consecutive quarters of negative growth) for the fourth time since the financial crisis started. This negative trend is continuing. On top of the **structural and cyclical problems** the country has grappled with, there are also **trade sanctions with Russia**. From a Western European standpoint, Finland is hard hit by these sanctions. Most parts of the Finnish economy are under pressure. Exports are weak and households are squeezed by high unemployment, while low capacity utilisation and weak business optimism are holding down capital spending. The recession will end only late this year. As an annual average, **GDP will fall by 0.6 per cent in 2014**. A weaker euro will provide help to exports, but in 2015 and 2016 growth will be modest: 0.5 and 0.9 per cent, respectively. Short-term risks are on the downside and mainly related to whether Russian import restrictions have a larger impact than we have assumed.

Recession in 2014



Source: Eurostat, SEB

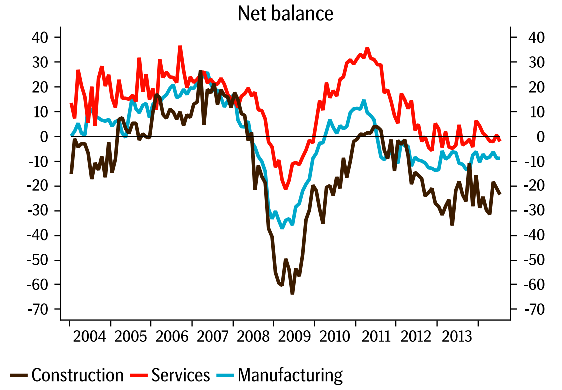
No turnaround in sight

Indicators are not signalling any quick turnaround. Last autumn's improved sentiment has vanished and all sectors view the situation negatively, according to the European Commission's indicator. The service sector is the least negative, although the indicator level is weak here as well.

For years, structural problems in the forest products and information and communications technology (ICT) sectors have hampered the economy, contributing to weak or falling growth. In the short term, Russian import restrictions have now effectively sabotaged export-driven growth. Finland's exports total less than 40 per cent of GDP. Russia is the country's third largest trade partner (after Sweden and Germany). Nearly 10 per cent of exports go to Russia. EU-Russian trade sanctions thus have a relatively big impact on the Finnish economy; for example, Russia buys nearly 20 per cent of Finnish food exports. Also hurting this trade is the fact that for some time, the Russian economy has shown structural weaknesses.

Indicators are not signalling any rapid recovery

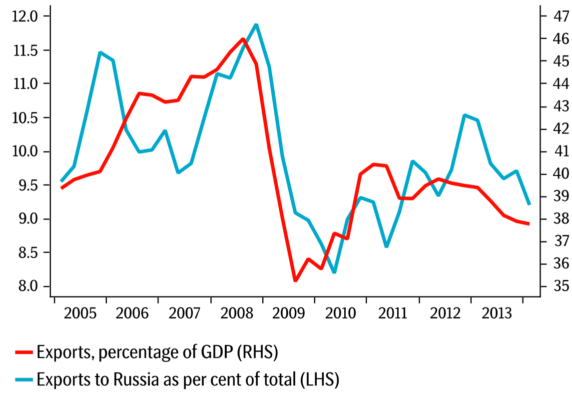
Net balance



Source: European Commission

It is hard to quantify the impact of Russia's import restrictions, but a 25 per cent downturn in total exports would lower GDP by more than 1 per cent. In addition there are negative spill-over effects, but in practice these are usually offset as exports find new markets. The Bank of Finland has estimated the final effect of such a scenario to 0.5-1.0 per cent lower GDP.

Continued decline in trade with Russia



Source: Statistics Finland

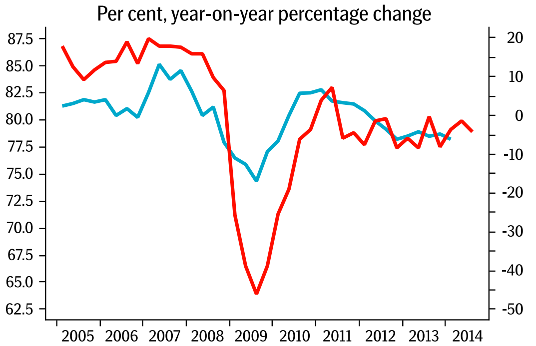
Prime Minister Alexander Stubb has declared that Finland may seek compensation from the EU, since EU-wide sanction decisions have a relatively large impact on Finland. So far the EU's response has been cautious. Compensation will depend on the extent to which new markets can replace exports to Russia. Even if the EU should pay compensation, its help to the Finnish economy would be marginal. Overall, we forecast **unchanged Finnish exports in 2014, followed by a weak increase of 1.5 per cent in 2015 and 3.7 per cent in 2016**.

Capital spending will keep falling in 2014

Idle manufacturing capacity suggests a continued decline in business investments. Falling home prices will also help keep construction activity weak, although the number of building permits has increased. Borrowing statistics also show that households and businesses are being cautious. Lending to households is rising by less than 2 per cent and to businesses by 5 per cent year-on-year. For households, borrowing is at its lowest level in at least two decades. Total capital spending will fall by 1.7 per cent in 2014, followed by a certain improvement.

Idle capacity is hampering capital spending

Per cent, year-on-year percentage change



Capacity utilisation, manufacturing sector (LHS) — Capital spending (RHS)

Source: OECD, Statistics Finland

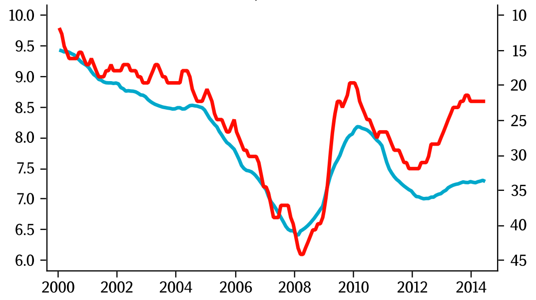
Continued high unemployment

Despite continued recession, unemployment has levelled out and has remained stable at 8.6 per cent so far this year – a high level that is still relatively close to the average in recent decades. We estimate equilibrium unemployment at around 7.5 per cent. Demographics and prolonged economic weakness are contributing to a decline in labour force participation, which is holding back an upturn in joblessness. Despite weak economic growth and high unemployment, the number of job vacancies is surprisingly high. This may be a signal of mismatching and may indicate that economic restructuring will require a redoubling of labour market training, for example. **Unemployment will remain at its current level for the rest of 2014** and then fall slowly to 8.4 per cent in 2015 and 8.2 per cent in 2016.

Due to low pay increases, along with high unemployment that will fall only slowly in 2015-2016, household incomes will show weak growth during our forecast period. Listless retail sales show that **households are being cautious. Consumption will fall by 0.4 per cent this year**. In 2015-2016, it will again increase, but slowly (by 0.4 and 0.5 per cent, respectively).

Unemployment is close to its 2009 peak

Per cent, thousands



Unemployment, seasonally adjusted (LHS)

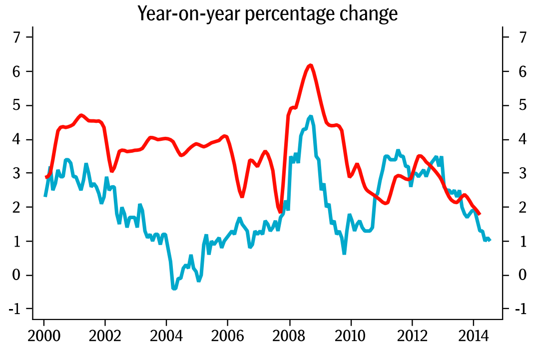
Job vacancies, 12-month moving average (RHS)

Source: Statistics Finland

The rate of pay increases has slowed and is now in line with inflation. Competitiveness has worsened, due to a long period of relatively high pay hikes, but that trend has now ended. Along with a falling euro, this will weaken the real effective exchange rate and benefit exports. Households are squeezed, although thanks to low inflation they are receiving unchanged or marginally rising real wages. Inflation slowed to 1.0 per cent in July and will remain low in 2015-2016, in line with euro zone price trends. Due to weak domestic and international demand, it is difficult for companies to raise prices. **HICP inflation will be 1.2 per cent in 2014 and 1.0 per cent in 2015 and 2016**.

Decelerating price and wage increases

Year-on-year percentage change



Wages and salaries — HICP inflation

Source: Statistics Finland

Continued consolidation policy

Finland continues to pursue a cost-cutting fiscal policy, but due to weak growth there is still a public sector deficit. Decisions in March 2014 will place limitations on central government outlays. Meanwhile the government is creating some room for growth stimulus, using proceeds of asset sales. **Fiscal policy will be contractionary in 2014-2016.** The deficit will fall from 2.7 per cent of GDP in 2014 to less than 2 per cent in 2016. Public sector debt will continue to rise, reaching 62 per cent of GDP in 2016. The sovereign bond yield spread to Germany is very narrow and public finances are in decent shape in a euro zone perspective, which might suggest a somewhat looser fiscal policy. Yet it is unlikely that the government will implement any policy shift, having investing a lot of political prestige in bringing down the deficit and stabilising debt.

Economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2013	2014	2015	2016
GDP OECD	1.4	1.9	2.5	2.4
GDP world (PPP)	3.3	3.4	3.9	4.0
CPI OECD	1.6	1.8	1.6	1.9
Export market OECD	2.7	3.6	5.4	4.8
Oil price, Brent (USD/barrel)	108.7	108.0	100.0	100.0

US

Yearly change in per cent

	2013 level, USD bn	2013	2014	2015	2016
Gross domestic product	17,078	2.2	2.2	3.4	3.1
Private consumption	11,653	2.4	2.4	3.0	2.6
Public consumption	3,143	-2.0	-0.7	-0.1	0.0
Gross fixed investment	2,395	4.7	5.3	8.9	8.5
Stock building (change as % of GDP)		0.0	0.1	0.1	0.0
Exports	2,325	3.0	3.1	6.2	6.1
Imports	2,788	1.1	4.6	6.1	5.7
Unemployment (%)		7.4	6.2	5.6	5.2
Consumer prices		1.5	1.9	1.9	2.2
Household savings ratio (%)		4.9	5.1	5.0	5.4

EURO ZONE

Yearly change in per cent

	2013 level, EUR bn	2013	2014	2015	2016
Gross domestic product	9,579	-0.4	0.7	1.1	1.5
Private consumption	5,482	-0.7	0.5	0.8	1.2
Public consumption	2,066	0.1	0.3	0.3	0.5
Gross fixed investment	1,694	-2.9	1.2	1.6	2.3
Stock building (change as % of GDP)		-0.1	0.0	0.0	0.0
Exports	4,396	1.4	2.5	3.3	4.2
Imports	4,065	0.4	2.5	3.0	4.0
Unemployment (%)		12.0	11.5	11.2	11.0
Consumer prices		1.4	0.5	0.6	0.9
Household savings ratio (%)		7.8	7.9	8.0	7.8

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2013	2014	2015	2016
GDP				
United Kingdom	1.7	3.1	2.8	2.6
Japan	1.5	1.1	1.2	0.8
Germany	0.1	1.2	1.4	1.8
France	0.4	0.1	0.7	1.1
Italy	-1.9	-0.2	0.5	0.8
China	7.7	7.5	7.3	6.9
India	4.7	5.0	5.8	6.2
Inflation				
United Kingdom	2.6	1.5	1.3	1.7
Japan	0.4	2.7	1.7	2.0
Germany	1.2	0.9	1.5	2.2
France	0.8	0.7	0.2	0.2
Italy	1.3	0.2	0.0	0.2
China	2.6	2.5	2.7	3.0
India	10.1	8.0	7.3	6.7
Unemployment (%)				
United Kingdom	7.9	6.5	5.8	5.3
Japan	4.0	3.6	3.5	3.4
Germany	5.5	5.5	5.4	5.4
France	10.2	10.5	11.0	10.9
Italy	12.2	12.5	12.4	12.2

EASTERN EUROPE

	2013	2014	2015	2016
GDP, yearly change in per cent				
Estonia	0.8	0.5	1.8	3.0
Latvia	4.1	2.5	2.7	3.4
Lithuania	3.3	2.7	3.2	4.0
Poland	1.6	2.7	3.0	3.5
Russia	1.3	0.5	0.3	1.5
Ukraine	0.0	-6.0	0.0	3.0
Inflation, yearly change in per cent				
Estonia	3.2	0.1	1.6	1.9
Latvia	0,0	0.8	2.2	2.6
Lithuania	1.2	0.1	0.7	1.0
Poland	0.8	0.3	1.6	2.2
Russia	6.7	7.3	6.5	5.5
Ukraine	-0.3	10.0	7.5	6.0

FINANCIAL FORECASTS

		Aug 21st	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
Official interest rates							
US	Fed funds	0.25	0.25	0.50	1.25	1.75	2.50
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.15	0.15	0.15	0.15	0.15	0.15
United Kingdom	Repo rate	0.50	0.50	0.75	1.25	1.50	1.75
Bond yields							
US	10 years	2.39	2.50	2.80	3.20	3.40	3.60
Japan	10 years	0.53	0.60	0.65	0.70	0.75	0.80
Germany	10 years	0.99	1.10	1.40	1.50	1.70	1.90
United Kingdom	10 years	2.51	2.60	2.90	3.20	3.50	3.80
Exchange rates							
USD/JPY		104	105	110	115	120	125
EUR/USD		1.33	1.30	1.27	1.24	1.22	1.20
EUR/JPY		138	137	140	143	146	150
GBP/USD		1.66	1.69	1.67	1.63	1.63	1.62
EUR/GBP		0.80	0.77	0.76	0.76	0.75	0.74

SWEDEN

Yearly change in per cent

	2013 level, SEK bn	2013	2014	2015	2016
Gross domestic product	3,640	1.6	2.1	2.9	2.7
Gross domestic product, working day adjustment		1.6	2.1	2.7	2.5
Private consumption	1,765	2.0	2.7	3.0	2.5
Public consumption	998	2.0	0.8	0.8	0.8
Gross fixed investment	668	-1.3	3.0	4.5	5.5
Stock building (change as % of GDP)	2	0.2	0.3	0.1	0.1
Exports	1,668	-0.9	2.4	5.2	5.2
Imports	1,461	-1.2	3.5	4.9	5.2
Unemployment (%)		8.0	7.9	7.5	7.2
Employment		1.1	1.2	1.2	1.0
Industrial production		-4.0	0.5	3.5	4.0
CPI		0.0	-0.1	0.8	1.7
CPIF		0.9	0.6	1.3	1.5
Hourly wage increases		2.5	2.8	2.8	3.5
Household savings ratio (%)		13.0	13.3	12.5	12.3
Real disposable income		2.6	3.0	2.2	2.3
Trade balance, % of GDP		2.2	2.5	2.6	2.4
Current account, % av GDP		6.8	6.3	6.0	5.8
Central government borrowing, SEK bn		131	60	30	20
Public sector financial balance, % of GDP		-1.2	-1.8	-1.0	-0.4
Public sector debt, % of GDP		40.6	41.5	41.0	39.8

FINANCIAL FORECASTS	Aug 21st	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
Repo rate	0.25	0.15	0.15	0.15	0.50	1.00
3-month interest rate, STIBOR	0.52	0.55	0.55	0.55	0.85	1.35
10-year bond yield	1.56	1.55	1.80	2.00	2.30	2.60
10-year spread to Germany, bp	57	45	40	50	60	70
USD/SEK	6.89	7.12	7.17	7.18	7.21	7.25
EUR/SEK	9.16	9.25	9.10	8.90	8.80	8.70
TCW	124.3	126.4	124.9	122.5	121.4	120.2
KIX	108.1	110.0	108.7	106.6	105.6	104.6

NORWAY

Yearly change in per cent

	2013 level, NOK bn	2013	2014	2015	2016
Gross domestic product	2,848	0.6	1.6	1.7	2.1
Gross domestic product (Mainland)	2,188	2.0	2.4	2.5	2.6
Private consumption	1,188	2.1	2.6	3.2	3.2
Public consumption	612	1.8	2.2	2.0	2.0
Gross fixed investment	635	8.4	-0.3	-0.5	2.9
Stock building (change as % of GDP)		-0.2	0.2	0.0	0.0
Exports	1,121	-3.3	0.7	2.8	1.8
Imports	816	2.9	1.2	3.9	3.6
Unemployment (%)		3.5	3.4	3.6	3.6
CPI		2.1	2.1	2.1	2.3
CPI-ATE		1.6	2.4	2.1	2.3
Annual wage increases		3.9	3.6	3.6	3.8

FINANCIAL FORECASTS	Aug 21st	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
Deposit rate	1.50	1.50	1.50	1.75	2.00	2.50
10-year bond yield	2.37	2.30	2.40	2.40	2.65	2.85
10-year spread to Germany, bp	138	120	100	90	95	95
USD/NOK	6.15	6.27	6.30	6.37	6.48	6.67
EUR/NOK	8.17	8.15	8.00	7.90	7.90	8.00

DENMARK

Yearly change in per cent

	2013 level DKK bn	2013	2014	2015	2016
Gross domestic product	1,858	0.4	1.8	2.3	2.5
Private consumption	905	0.0	1.6	2.2	2.4
Public consumption	524	0.8	1.0	0.8	0.0
Gross fixed investment	322	0.7	2.1	2.1	3.2
Stock building (change as % of GDP)		0.2	0.0	-0.1	0.0
Exports	1,021	1.2	3.8	4.0	4.6
Imports	916	1.7	3.8	3.0	3.6
Unemployment (%)		4.4	4.1	3.8	3.5
Unemployment, OECD harmonised (%)		7.0	6.5	5.7	5.0
CPI, harmonised		0.8	0.6	1.1	1.5
Hourly wage increases		1.3	1.3	1.7	2.2
Current account, % of GDP		6.8	6.8	6.5	6.0
Public sector financial balance, % av GDP		-0.8	0.0	-0.5	0.5
Public sector debt, % av GDP		44.5	43.5	42.0	40.0

FINANCIAL FORECASTS	Aug 21st	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
Lending rate	0.20	0.20	0.20	0.20	0.20	0.20
10-year bond yield	1.04	1.15	1.45	1.55	1.75	1.95
10-year spread to Germany, bp	5	5	5	5	5	5
USD/DKK	5.61	5.73	5.87	6.01	6.11	6.21
EUR/DKK	7.46	7.45	7.45	7.45	7.45	7.45

FINLAND

Yearly change in per cent

	2013 level, EUR bn	2013	2014	2015	2016
Gross domestic product	201	-1.2	-0.6	0.5	0.9
Private consumption	111	-0.7	-0.4	0.4	0.5
Public consumption	50	1.5	0.3	0.3	0.5
Gross fixed investment	37	-4.9	-1.7	0.6	2.0
Stock building (change as % of GDP)		-0.4	0.0	0.0	0.0
Exports	77	-1.7	0.0	1.5	3.7
Imports	79	-2.5	0.2	1.3	3.5
Unemployment (%)		8.5	8.6	8.4	8.2
CPI, harmonised		2.2	1.2	1.0	1.0
Hourly wage increases		2.1	1.2	1.5	1.8
Current account, % of GDP		-1.0	-1.4	-1.2	-1.0
Public sector financial balance, % av GDP		-2.3	-2.7	-2.0	-1.8
Public sector debt, % av GDP		57.0	60.0	61.5	62.0

Economic Research available on Internet.
Nordic Outlook published by SEB Economic Research is available on the Internet at: www.seb.se. This page is open to all.

To get access to all other research and trading recommendations for Merchant Banking's customers on the Internet at www.mb.se, a password is needed that is exclusive to these clients. If you wish to get access to this web site, please contact Merchant Banking to receive the password.

SEB is a leading Nordic financial services group. As a relationship bank, SEB in Sweden and the Baltic countries offers financial advice and a wide range of financial services. In Denmark, Finland, Norway and Germany the bank's operations have a strong focus on corporate and investment banking based on a full-service offering to corporate and institutional clients. The international nature of SEB's business is reflected in its presence in some 20 countries worldwide. At 30 June 2014, the Group's total assets amounted to SEK 2,654 billion while its assets under management totalled SEK 1,605 billion. The Group has around 16,000 employees. Read more about SEB at www.sebgroup.com.

With capital, knowledge and experience, we generate value for our customers – a task in which our research activities are highly beneficial.

Macroeconomic assessments are provided by our Economic Research unit. Based on current conditions, official policies and the long-term performance of the financial market, the Bank presents its views on the economic situation – locally, regionally and globally.

One of the key publications from the Economic Research unit is the quarterly Nordic Outlook, which presents analyses covering the economic situation in the world as well as Europe and Sweden. Another publication is Eastern European Outlook, which deals with the Baltics, Poland, Russia and Ukraine and appears twice a year.

SEGR0071 2014.08