

## Press release

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# Nordic Outlook: Increased stress squeezing global growth Riksbank looking inside its unconventional toolkit

**The world economy's big headache is the shortage of optimism. Economic policy instruments are becoming fewer and fewer, as well as less effective, but the toolkit is not yet empty. Global growth in 2015-2016 will enjoy support from continued monetary expansion and an increasingly solid recovery in the United States. Sweden's economic growth is being lifted by households and construction, but will be impeded by heightened political uncertainty. The Riksbank will lower its key interest rate path and open the door to government bond purchases, while the issue of financial stability has ended up as a task for the government alone, writes SEB Economic Research in the latest issue of its quarterly report *Nordic Outlook*.**

**The recovery will be sluggish.** Lower energy prices – with Brent crude oil expected to cost about USD 85 per barrel during 2015 – have the potential to stimulate household purchasing power and business investment appetite, thereby boosting the overall GDP level in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) by 0.5 percentage points over a few years. But the **world economy is being both stressed and squeezed** by continued balance sheet weaknesses, difficult rebalancing processes in emerging economies, low investment appetite, wide wealth gaps and heightened geopolitical uncertainty. **GDP growth in the OECD countries will reach 1.9 per cent this year, up from 1.4 per cent in 2013. Next year, GDP growth will climb to 2.4 per cent, with the same growth rate again in 2016.** Taken together, these factors represents a **significant risk** of an extended period of **weak demand and lingering deflation risks**.

“In many ways, this situation is completely unique,” says Robert Bergqvist, Chief Economist at SEB. “Six years after the Lehman Brothers collapse, and despite exceptional monetary policies, the world is still characterised by a lack of stability. This is manifested in an unclear economic pattern,” Bergqvist continues. “Countries show divergent growth, putting a strain on international cooperation. This is forcing re-assessments of economic policies and testing their limits. While lower energy prices have a positive impact in most countries, they also represent major challenges for oil producers in a new geopolitical energy landscape,” Bergqvist maintains.

**Inflation has provided downside surprises and is troublingly low in many countries.** In 2015-2016 inflation is expected to remain low, though rising cautiously. Global overcapacity is squeezing prices, and so are structural changes in the labour market; increasingly well-educated labour force reserves in Asia – and eventually Africa – will be integrated into the world economy, while new jobs in the Western world tend to show up in low-wage sectors. This will hold down the rate of wage and salary increases, contributing to continued weak inflation pressure and low demand. Various commodity markets will also probably show a long-term downward price trend, as previously completed production capacity pushes down prices.

**The zero interest rate environment makes the allocation of economic policy responsibility more clear.** For example, stagnation and deflation risks mean that fiscal expansion – not fiscal discipline – is enjoying renewed political support and acceptance among economists. Japan's next consumption tax hike is being delayed, and countries such as Italy and France are being granted greater budget flexibility. Meanwhile there is increasing pressure on Germany to pursue a more expansionary fiscal policy, since its economy and export sector are benefiting from extra support due to the weak euro and deeply depressed interest rates and bond yields.

“The risk picture generally forces central banks to have an asymmetrical reaction function,” says Håkan Frisén, Head of Economic Forecasting at SEB and Editor-in-Chief of *Nordic Outlook*. “This means that monetary policymakers react forcefully if inflation expectations surprise them on the downside, but meanwhile they show an acceptance when inflation exceeds 2 per cent. In this environment, macroprudential policymakers are assigned responsibility for preventing the emergence of new financial imbalances. Governments and their regulatory authorities are thus being forced to assume greater responsibility for financial stability,” Frisén says.

The **European Central Bank** and the **Bank of Japan** will keep their key interest rates unchanged at 0.05 and 0.10 per cent, respectively, throughout our forecast period and will expand their balance sheets; the ECB will begin buying government securities. The US **Federal Reserve** and the **Bank of England** are moving towards rate hikes: the US central bank after the summer of 2015 and its British counterpart early in 2016. By the end of 2016 their key rates will be 2.25 and 1.25 per cent, respectively. **Overall global monetary policy will thus remain strongly expansionary throughout our forecast period.** Long-term bond yields will fall further in the near term, then begin cautiously moving upward only in 2015. Loose central bank monetary policies, low interest rates and bond yields and low oil prices will help sustain share prices.

**We expect the US economy to grow by 3.4 per cent in 2015**, up from 2.3 per cent this year, and by **3.1 per cent in 2016**. Because of earlier household debt deleveraging, the effectiveness of the Fed’s monetary policy will now increase. Substantially lower energy prices, record household wealth and unemployment that will continue falling to 4.7 per cent in 2016 will give the US the economic strength to weather a fragile international situation and a stronger dollar (with the EUR/USD exchange rate expected to be 1.13 by the end of 2016). Absent major imbalances of its own, the US economy has historically proved to be fairly insensitive to international weaknesses.

**The most important of the BRICS countries** (Brazil, Russia, India, China and South Africa) **show divergent prospects**. Growth engine **China** is decelerating due to increased uncertainty in the real estate sector and the credit market, but we expect Beijing’s sound grasp of these problems and financial capacity to enable China to continue experiencing good growth. We expect GDP to increase by 7.0 per cent in 2015 (down 0.4 percentage points from 2014) and by 6.7 per cent in 2016. In **India**, we foresee an acceleration of GDP growth from 5.4 per cent in 2014 to 6.2 per cent in 2016 thanks to reforms. The **Russian economy** looks gloomy, however. Its problems are connected to geopolitics and reduced production capacity, due to many years of under-investment and an ageing population. The sharp decline in the rouble confirms Russia’s economic and financial instability, which also boosts geopolitical risk. We expect GDP to shrink by 0.2 per cent in 2015 and grow by 1.0 per cent in 2016.

**The euro zone is the world’s economic problem child.** Healing processes are moving slowly, and the political trend towards an increased desire for national economic policy independence and departures from shared rules of the game is still making the future of the euro uncertain. But now that the ECB has carried out its assessment of the banking system, growth is expected to stabilise with the help of lower energy prices, a weaker euro and – despite high public debt – looser fiscal policies. The economic curves are pointing in the wrong direction for Italy and France, however, while Spain’s growth has rebounded. **We expect euro zone GDP growth of 0.9 per cent in 2015 and 1.3 per cent in 2016.**

“Germany’s willingness to accept a more expansionary fiscal policy will be vital to both the euro zone growth outlook and the long-term stability of the common currency,” says Robert Bergqvist. “The euro project needs more integration, not less. Today the winds of independence are blowing in several euro zone countries, while political populism is gaining ground. The euro zone as a whole may avoid outright deflation, but falling inflation expectations will force the ECB to begin buying government bonds after the end of this year in order to expand its balance sheet to a sufficient extent,” according to Bergqvist.

The **Swedish economy remains divided** between robust domestic demand, driven by household consumption and increased residential construction, and a weak export sector. New principal repayment requirements for mortgage loans will have a limited impact on private consumption, but the upturn in home prices will slow. Public

sector debt will remain stable at less than 40 per cent of GDP. The underlying labour market trend is strong, but because of increased labour supply, unemployment will fall only slowly to a bit below 7 per cent at the end of 2016. Increased immigration and weak integration policy will help push up the equilibrium unemployment rate. **We expect GDP to grow by 2.1 per cent this year and 2.7 per cent in both 2015 and 2016.**

“Sweden’s national balance sheet and income statement are strong, but the challenges are growing,” according to Håkan Frisén. Economic policy is surrounded by uncertainties connected to the parliamentary situation; without broad cross-bloc agreements, there is a great risk of political paralysis. We expect the new minority red-green (Social Democratic-Green Party) budget to receive parliamentary approval, and fiscal policy will be mildly expansionary in 2015,” says Frisén.

As expected, the Riksbank lowered its key interest rate in October, but the 0.00 per cent level was a surprise. The bank’s decisive action – cutting its key rate by 0.75 percentage points within a few months – shows that a unanimous Executive Board supports the central bank’s main task of bringing inflation higher. **But inflation will climb only slowly;** underlying CPIF inflation will not reach a steady 1.5 per cent rate until late spring 2016. Because of loose monetary policy, the Swedish krona will weaken to 9.35 per euro during the winter and then strengthen to 8.80 by the end of 2016. The krona will weaken to 7.80 per US dollar at the end of 2016.

“Low inflation and – especially – downward pressure on inflation expectations will force the Riksbank to adjust its inflation forecasts further downward,” Robert Bergqvist says. “This opens the way for a lower key rate path and a zero interest rate tied to the inflation trend (CPIF) and to the monetary policies of other central banks. But there is a high threshold for unconventional monetary policies – expansion of the balance sheet, currency interventions or negative interest rates. We still believe that the first rate hike will occur in the summer of 2016,” Bergqvist says.

“Higher principal payment requirements will slow credit growth and the home price upturn a bit,” according to Håkan Frisén. “In an environment of low interest rates, rapid population growth, a strong labour market and a housing shortage, home prices and household debt will still continue to increase somewhat in the coming year. Disagreements in the Financial Stability Council have already become apparent, and the Riksbank seems to be alone in worrying about the growth in debt. The government and its Financial Supervisory Authority and National Debt Office want to proceed cautiously in order to avoid a sudden deceleration. But given a monetary policy that is entirely focused on pushing up inflation expectations, in practice the responsibility for avoiding future debt-related setbacks rests entirely with the government,” Frisén says.

The **Finnish economy** is grappling with structural problems in the forest product and information and communications technology (ICT) sectors, a large trade exposure to Russia and public sector austerity that is hampering growth. A weaker euro will provide some support to Finland’s exports, but the slowdown in other sectors is broad-based. GDP growth will be 0.5 per cent in 2015 (after this year’s decline of 0.3 per cent). In 2016, growth will accelerate to a still-weak 0.9 per cent. The **Danish economy** is facing both upside and downside risks. Geopolitics will play a large role. Fiscal policy will be supportive before the 2015 election. Denmark’s GDP growth will be 1.0 per cent this year and twice as high in 2015; in 2016, growth will reach 2.5 per cent. The **Norwegian economy** is characterised by forces that are pulling in different directions. Negative factors include a capital spending slowdown in the oil and gas sector and weak residential investments. But the labour market has stabilised, along with the housing market, and good real income increases will help sustain consumption. We expect Norway’s mainland GDP to decelerate from 2.6 per cent this year to 2.1 per cent in 2015 and reach 2.4 per cent in 2016, which is somewhat below trend growth. We believe that the underlying strength in the economy is sufficient to enable Norges Bank to abstain from key interest rate cuts in the near future, but the first rate hike will not come until the second quarter of 2016. In this environment, the Norwegian krone will strengthen cautiously, and we expect the EUR/NOK exchange rate to be somewhat below 8.00 at the end of our forecast period.

**Conflicting forces will again dominate the Baltic economies during 2015.** Not until 2016 will growth become more balanced. Consumption will remain the growth engine, as strong increases in households’ real wages slow

down only marginally and unemployment falls somewhat further. Exports and capital spending will recover slowly, however, since the Ukraine crisis, Russian zero growth and food import sanctions will continue to cast shadows over the Baltic countries during 2015. We expect some acceleration in growth after the 2013-2014 slump, which was deep in Estonia's case. Lithuania and Latvia will regain their position among the fastest-growing EU economies, yet their growth will be moderate in relation to the 3-3.5 per cent potential rate in the Baltics. Estonia will lag behind, not quite reaching 3 per cent growth in 2016, while Lithuania will grow the fastest with 4 per cent in 2016.

**Key figures: International & Swedish economy** (figures in brackets are forecasts from the August 2014 issue of *Nordic Outlook*)

<b>International economy. GDP, year-on-year changes, %</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
United States	2.2	2.3 (2.2)	3.4 (3.4)	3.1 (3.1)
Eurozone	-0.5	0.9 (0.7)	0.9 (1.1)	1.3 (1.5)
Japan	1.5	0.4 (1.1)	0.9 (1.2)	1.1 (0.8)
OECD	1.4	1.9 (1.9)	2.4 (2.5)	2.4 (2.4)
China	7.7	7.4 (7.5)	7.0 (7.3)	6.7 (6.9)
Nordic countries	0.6	1.5 (1.5)	1.8 (2.0)	2.1 (2.2)
Baltic countries	3.1	2.4 (2.1)	2.6 (2.7)	3.3 (3.6)
The world (purchasing power parities, PPP)	3.3	3.5 (3.4)	3.8 (3.9)	3.9 (4.0)
<b>Swedish economy. Year-on-year changes, %</b>				
GDP, actual	1.5	2.1(2.1)	2.7(2.9)	2.7(2.7)
GDP, working day corrected	1.5	2.2(2.1)	2.5(2.7)	2.5(2.5)
Unemployment, % (EU definition)	8.0	8.0(7.9)	7.6(7.5)	7.2(7.2)
Consumer Price Index (CPI) inflation	0.0	-0.2(-0.1)	0.3(0.8)	1.5(1.7)
Government net lending (% of GDP)	-1.2	-1.5(-1.8)	-0.9(-1.0)	-0.2(-0.4)
Repo rate (December)	0.75	0.00(0.15)	0.00(0.15)	0.50(1.00)
Exchange rate, EUR/SEK (December)	8.86	9.35(9.25)	9.00(8.90)	8.80(8.70)

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