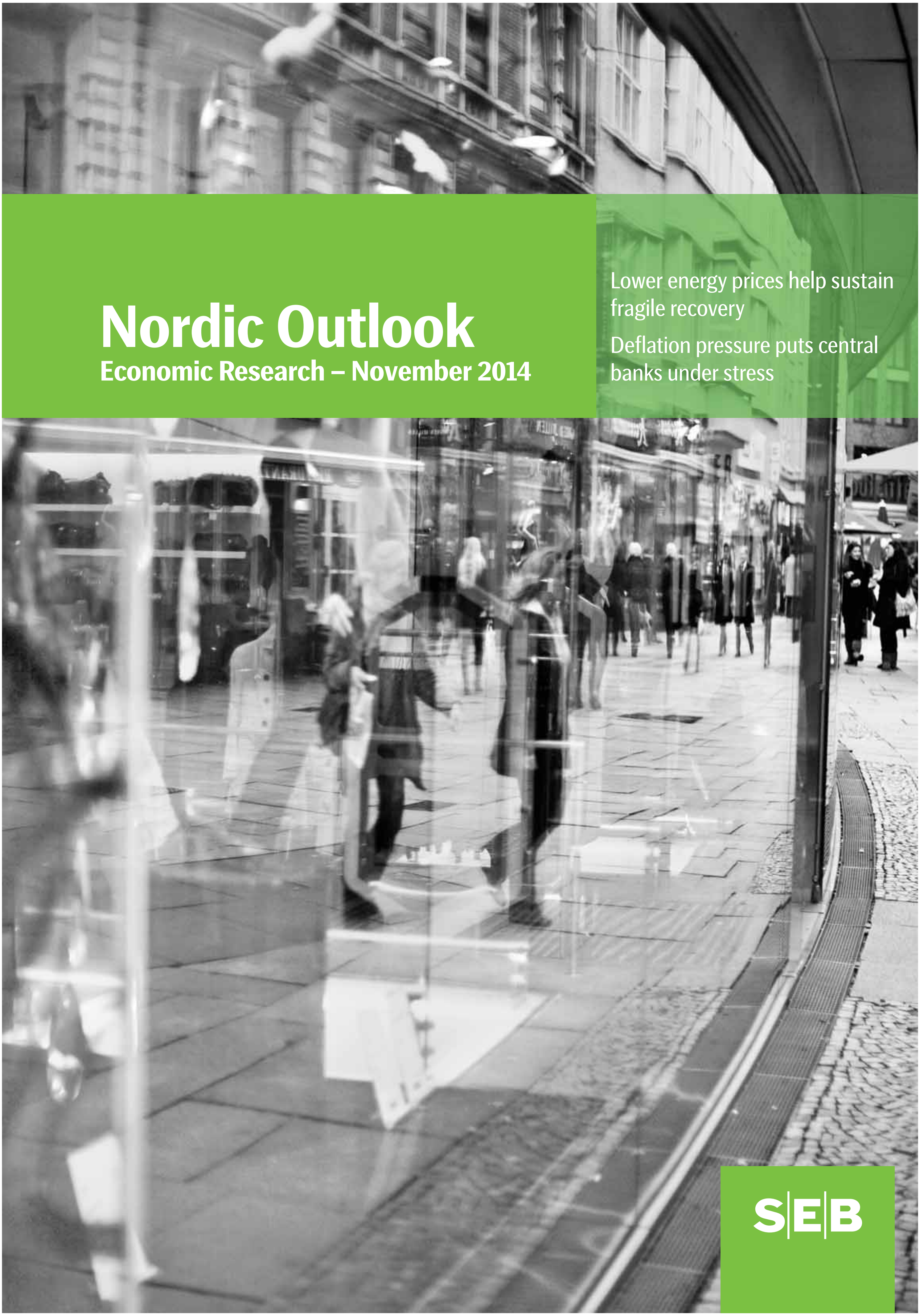

Nordic Outlook

Economic Research – November 2014

Lower energy prices help sustain fragile recovery

Deflation pressure puts central banks under stress

SEB

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Lower energy prices help sustain fragile recovery

- **US recovery can weather global shakiness**
- **Stronger deflation pressure in euro zone**
- **Increasing global pleas for German stimulus**
- **Oil prices at persistently low levels**
- **Fed will hike key rate in September 2015**
- **Sweden's Riksbank will abstain from unconventional measures**
- **EUR/USD will fall gradually towards 1.13**

The world economy has been increasingly volatile over the past six months. Because of rising geopolitical uncertainty and growing doubts about the effectiveness of monetary policy, there was a broad-based decline in optimism during the spring and summer. This impacted financial markets, for example via several periods of share price downturns. The decline in risk appetite was clearest in September and early October. In recent weeks, we have seen a **stock market rebound, while interest rates and bond yields have continued downward**. This reflects a stabilisation of economic signals. Meanwhile falling commodity prices have lowered the inflation outlook, leading to expectations of additional monetary policy easing.

This trend is consistent with our forecast of a fragile global recovery that will remain dependent on economic policy support. Structural problems, excess supply in many sectors and regions as well as continued balance sheet adjustment needs are weakening the growth dynamic and making economies sensitive to temporary disruptions. Meanwhile we see that economic policymakers are still in a position to take action to help sustain growth when confidence fades. In a situation of low resource utilisation and weak or non-existent inflation pressure, **the battle against deflation tops the agenda of central banks** while the risks of new financial imbalances receive lower priority. We are also seeing clear ambitions to supplement monetary policy with other growth-promotion measures, for example acceptance of a more expansionary fiscal policy or various initiatives to stimulate capital spending activity, especially for infrastructure.

We are sticking to our forecast that global growth will accelerate somewhat in 2015. Lower energy prices will provide a certain growth impulse in most countries, but we believe this will be rather small in a world that is hampered by geopolitical and structural problems. **GDP growth in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) will increase from 1.9 per cent this year to 2.4 per cent in 2015**. This will essentially be due to a relatively powerful average yearly acceleration in the US economy; growth in other countries will be flatter. Emerging economies will also see some increase in GDP growth, even though the Chinese economy will decelerate a bit as planned. We have adjusted our total percentage forecast for the world economy for 2015 downward by one tenth since August's *Nordic Outlook*.

Global GDP growth

Year-on-year percentage change

	2013	2014	2015	2016
United States	2.2	2.3	3.4	3.1
Japan	1.5	0.4	0.9	1.1
Germany	0.1	1.3	1.2	1.6
China	7.7	7.4	7.0	6.7
United Kingdom	1.7	3.1	2.8	2.5
Euro zone	-0.5	0.9	0.9	1.3
Nordic countries	0,6	1.5	1.8	2.1
Baltic countries	3.1	2.4	2.6	3.3
OECD	1.4	1.9	2.4	2.4
Emerging markets	4.8	4.7	4.8	4.9
World, PPP*	**3.3**	**3.5**	**3.8**	**3.9**

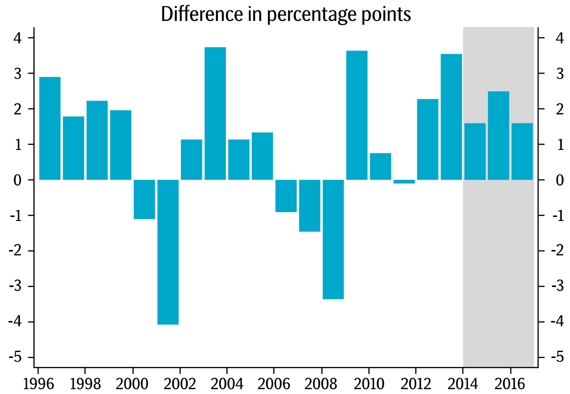
Source: OECD, SEB * Purchasing power parities

Financial market performance will be greatly influenced by central bank actions. We expect new stimulus measures from the European Central Bank (ECB) and the Bank of Japan (BoJ). Meanwhile we have postponed the expected start of key interest rate hikes by the US Federal Reserve (Fed) and the Bank of England (BoE). **Because of loose central bank policies, bond yields will remain very low for another while** before they slowly begin to climb. The spread between German and US sovereign bond yields will remain historically wide for the next couple of years. **In this environment, the US dollar will continue to appreciate against the euro, with the EUR/USD exchange rate gradually falling towards 1.13**. Persistently low interest rates and yields as well as lower oil prices will also benefit stock markets, but in the short term we do not expect high earnings expectations to be met. This will slow the upturn and lead to a largely flat share price trend. As the economy gains a little more strength, there is room for a cautious stock market upturn a bit further ahead.

US recovery will weather global weakness

The US recovery has continued in line with our expectations. Domestic factors suggest continued strong growth during the next couple of years. **The economy has entered a positive spiral, with a stronger labour market and rising wealth benefiting household consumption**. The most cyclical parts of the economy are still depressed, indicating that there is room for a rather long period of above-trend GDP growth.

GDP growth in the US and the euro zone
Difference in percentage points



Source: BLS, Eurostat, SEB

One important question is to what extent the upturn will be hampered by international weaknesses. Historical experience indicates that the US economy is insensitive to economic weakening in other countries. The deep recessions the world has gone through in recent decades have been initiated by imbalances in the US economy. The global recovery dynamic has then been largely determined by how the US has acted in terms of economic policy and how quickly its domestic imbalances have been remedied. Because the US economy is relatively closed, with low exports as a percentage of GDP, it is also relatively insensitive to external changes. **It is thus unlikely that international factors will cause the American recovery to derail**. Nor are the differences in GDP growth between the US and the euro zone that we foresee during the next couple of years alarmingly high in a historical perspective, although the period of wide divergence will become lengthy.

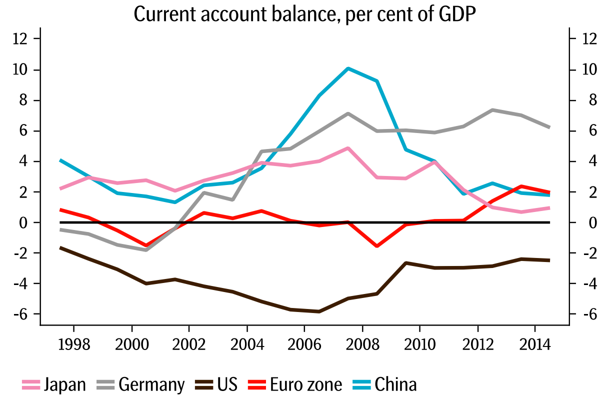
Increased pressure for German stimulus

After a period of weakened optimism, indicators in the euro zone have recently stabilised. ECB stimulus programmes, a weaker euro and lower energy prices will help the region avoid a recession. **Our forecast implies that the euro zone will be trapped in stagnation, with GDP growth of an anaemic 0.9 per cent in both 2014 and 2015**: a bit below trend. Continued lack of clarity and battles about future economic policy choices will create uncertainty that hampers capital spending and consumption. At present, economic developments in France and Italy are the most worrisome, with GDP growth close to zero. Spain, in contrast, has recently provided upside surprises and will see 2015 growth of a decent 2 per cent.

The German economy has also lost momentum during 2014. This has had an impact on all of Europe, impeding industrial production in Eastern Europe, the Nordic countries and elsewhere. Rising uncertainty connected to greater tensions between Russia and the West has apparently proved more important than expected. **Although direct trade is small, capital spending has been noticeably affected**. Our assessment is that German GDP will grow by a mere 1.2 per cent in 2015 and then climb to 1.6 per cent in 2016.

Future developments in Germany will be important in several ways. The weaker euro will help make German industry even more strongly competitive against the US, the UK and other countries. This will provide a stable growth platform. If we analyse global imbalances from a current account perspective, we see that the picture has changed since the financial crisis. At that time, a large current account surplus in China and a sizeable deficit in the US dominated the picture. **Today the main thing that stands out is Germany's gigantic surplus**. A German stimulus policy that boosts domestic demand would thus reduce global imbalances. For the euro zone, increased German import demand combined with a faster rate of wage and price increases are even more important. We thus believe that international pressure for a more expansionary economic policy in Germany will intensify, although we have not factored any dramatic change of policy into our main forecast.

New patterns of global imbalances
Current account balance, per cent of GDP



Source: IMF

China slowing down while India accelerates

We predict weakly accelerating growth in emerging economies, despite geopolitical worries and a slight deceleration in China. Oversupply in the Chinese housing market is now leading to falling prices and reduced construction, but we believe that policy measures in the form of lower mortgage rates and looser credit conditions will allow a soft landing in the housing market. This is one reason why Chinese growth will decrease very slowly. **GDP growth in China will fall from 7.4 per cent this year to 7.0 per cent in 2015 and 6.7 per cent in 2016.** In India, we see prospects for some acceleration in GDP growth. So far the government's reform policies have proceeded more sluggishly than expected, but the success of the ruling BJP party in recent state elections will increase its chances of implementing more vigorous deregulation. India is also benefiting greatly from falling oil prices. **Overall, growth will gradually climb from 5.4 per cent this year to 6.2 per cent in 2016.**

The Russian economy is weakening more and more, as effects related to the Ukraine crisis are combined with underlying structural weaknesses. Falling oil prices are squeezing the energy sector and leaving less room for expansionary fiscal policy. While a sharply declining currency is helping push oil revenues higher in rouble terms, inflation problems are worsening. We believe this will compel the central bank to continue tightening its monetary policy, following a 150 basis point hike in the key interest rate in October. Assuming that the trade conflict with the West does not escalate, we believe that **Russian GDP growth will end up around zero both in 2014 and 2015, while we foresee weak growth of 1 per cent in 2016**.

Risk picture more symmetrical

In recent months, the risk picture has changed to some extent. This is mainly related to the consequences of lower energy prices. Traditional sensitivity analyses indicate that the stimulus effect in the OECD countries may be significantly larger than we have assumed in our main forecast. This indicates a potential for faster growth. As earlier, there is also a chance that the secondary effects of the American economic upturn will be larger than in our main forecast, where we have made cautious assumptions in light of structural weaknesses, especially in the euro zone. **Our overall assessment is that the probability of a faster growth scenario has increased to 25 per cent**; in the August issue of *Nordic Outlook*, our estimate was 20 per cent.

The downside risks in our forecast are mainly connected to larger economic effects from increased tensions between Russia and other countries. We believe that these risks have increased somewhat. Falling oil prices will strain the weak Russian economy, and recent financial market trends including a weakened currency and falling share prices indicate that the situation has become more volatile. Looking ahead a bit, we also see some risk that US interest rate hikes may come at such an early stage that they will have negative international consequences. Yet on the whole, we still believe that **the probability of our low-growth scenario will be 30 per cent**.

Inflation outlook revised downward

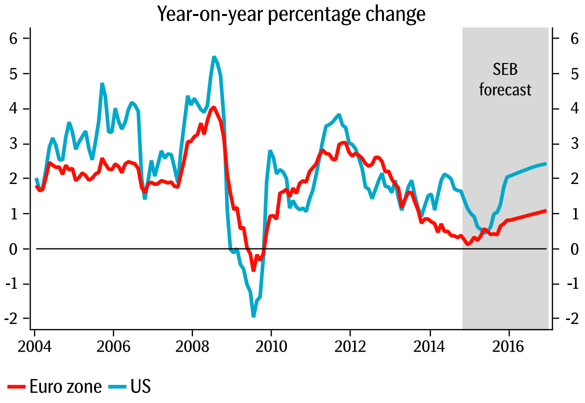
During the first half of 2014, tax hikes in Japan and rising core inflation in the US were instrumental in raising Consumer Price Index (CPI) inflation in the OECD countries from 1.5 to about 2 per cent. Since then, inflation has fallen again. Because of the recent decline in commodity prices, **we have adjusted our inflation forecasts for 2015 significantly downward**. The direct effect of the oil price decline on inflation is greatest in the US. Consumer fuel prices react quickly and their weight in the consumption basket is relatively large. In addition, the upturn in the US dollar has slowed the oil price decline in the national currencies of most other countries.

The impact of falling commodity prices on core inflation is not unequivocal, however. In a weak economic situation, secondary effects may cause broader price downturns and squeeze inflation expectations further. Yet lower energy prices represent a significant stimulus effect that boosts household purchasing power, among other things eventually leading to a higher level of economic activity and thus higher underlying price increases. Overall, we believe that the impact of the oil price downturn on core inflation will be small. **But the risks of a deflation spiral have increased somewhat**, especially in the euro zone, since actual inflation in many countries will now be exceptionally low for an extended period.

Yet our main forecast is that a bit further ahead, inflation will slowly turn higher as the economy gains some strength. Although we have adjusted our inflation forecasts downward on a broad front, differences in inflation rates and in the risk picture will persist. In the US and the UK, rising resource utilisation will lead to some underlying inflation pressure, while the euro zone will remain dependent on massive ECB support to reverse the falling inflation trend.

CPI inflation

Year-on-year percentage change



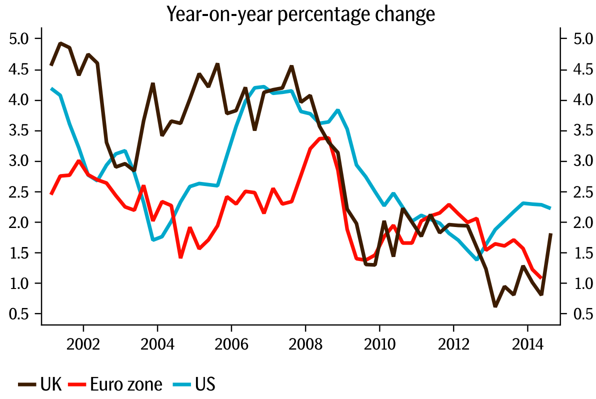
Source: Eurostat, BLS, SEB

Wages crucial to inflation in the long term

The trend of wages and salaries will determine whether industrialised countries eventually achieve a more stable inflation environment and avoid widespread deflationary tendencies. Globalisation and rising educational levels in emerging economies have helped push down the rate of pay increases in the OECD countries. A large proportion of the new jobs created since the financial crisis has also been in low-wage sectors, squeezing the average pay level. **These forces will continue to hold down wage and salary increases**. We believe that by the end of our forecast period, the US and the UK will have unemployment below equilibrium and that pay increases will thus rise to a level that will make cautious key interest rate hikes possible. But structural forces that have wage-lowering effects make this forecast uncertain.

Falling wage and salary trend

Year-on-year percentage change



Source: Macrobond

Tentative economic policy experiments are now under way to try to boost the rate of pay increases. In Japan, the government has clearly declared that it is desirable for the business sector to allow higher pay increases. This is a way of ensuring that currency depreciation will lead to lasting higher inflation. Raising the minimum wages in large countries such as the US, the UK and Germany is another way. **The most important channel for generally influencing wage formation is via inflation expectations**. In countries where negotiations between employer and employee organisations play a major role in wage formation, central bank signals may be important. For example, the Bundesbank has declared that higher pay increases in Germany can help reduce imbalances in the euro zone. In Sweden it is still unclear whether the Riksbank is prepared to change its signals to labour market organisations as part of its efforts to counter falling inflation expectations.

Global monetary policy out of synch

A number of new challenges and dilemmas will affect future central bank decisions. One important question is how the banks should **factor in the effects of lower oil prices**, which have a positive impact on growth but at the same time threaten to push down already low inflation expectations. **Achieving the right relationship with macroprudential supervisors** will be another challenge. This applies especially to explaining pedagogically the extent to which new tools will replace or supplement monetary policy in order to achieve financial stability. The Fed will also face a difficult balancing act in order to shape its policy **normalisation process** in ways that do not generate excessive financial market volatility or capital flows that may harm world economic growth.

The dominant role of stagnation and deflation risks is one reason we believe that central banks have an **asymmetrical reaction function**. This means that they will act forcefully if growth and inflation are unexpectedly low, yet will be cautious about tightening if the data provide upside surprises. Such behaviour would confirm that **inflation targets are symmetrical** and that central banks have no problems accepting inflation that is a bit above 2 per cent after a long period of below-target inflation. In this way, inflation targeting policies can eventually achieve greater credibility, creating additional manoeuvring room in the future.

Key rates

Per cent

	Nov 2014	Dec 2015	Dec 2016
Federal Reserve	0-0.25	1.00	2.25
ECB	0.05	0.05	0.05
Bank of England	0.50	0.50	1.25
Bank of Japan	0.10	0.10	0.10
Riksbank	0.00	0.00	0.50
Norges Bank	1.50	1.50	2.00

Source: Central banks and SEB

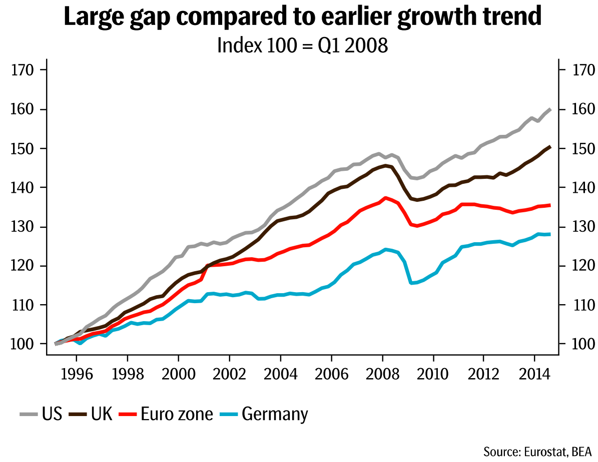
Leading central banks are now moving in different directions, although we have changed our forecasts of the starting dates for key rate hikes in the US and the UK. **The Fed will raise its key rate in September 2015**; it will reach 2.25 per cent at the end of our forecast period. **The BoE will raise its refi rate, too**, but not until early 2016. Due to low inflation and weak pay increases, both banks can hold off so as not to jeopardise the recovery. Neither the Fed nor the BoE is expected to reduce its securities portfolio during our forecast period. **We believe that the ECB and BoJ will keep their "zero interest rates" throughout our forecast period**, while their balance sheets keep growing. We expect the ECB to start buying government bonds in the first quarter of 2015. To achieve the objective of increasing its balance sheet by EUR 1 trillion to EUR 3 trillion, the ECB will need to include government securities. We believe that the BoJ will launch broad financial asset purchases, with the aim of increasing total purchases and balance sheet expansion from the current JPY 80 trillion per year to JPY 100 trillion.

Our forecast is that Sweden's Riksbank will keep its repo rate unchanged at 0.00 per cent until summer 2016, then raise it to 0.5 per cent by year-end. The central bank will also reinforce the stimulus effect of this zero rate by lowering its interest rate path further and by issuing an explicit "pledge" not to raise the repo rate until CPIF inflation (CPI with a fixed mortgage rate) exceeds 1.5 per cent for at least six months. **Our main forecast is that the Riksbank will not carry out unconventional measures**, even though the market will probably begin pricing in such actions in the near future. If inflation should continue providing major downside surprises and force the Riksbank to act, we believe that purchases of government bonds are the action that will enjoy top priority (See the theme article "The Riksbank's next step").

Fiscal policy will assume a larger role

Because growth remains fragile and lacklustre in much of the world economy, this is fuelling discussion on **the effectiveness of monetary policy and the risks that we are facing a lengthy ("secular") stagnation**. The weak capital spending response can be partly explained by low inflation expectations. Despite nominally low interest rates, real rates are higher than the equilibrium level that provides a balance between saving and capital spending. One fundamental problem which the International Monetary Fund (IMF) and others have pointed out in various contexts is that growing **wealth gaps are helping to hold down demand**. This is because the wealthiest households have a relatively low inclination to consume. Unrealistically high return requirements and greater short-termism in corporate investment decisions are other likely factors behind weak capital spending activity.

In various theme articles and boxes in the last three issues of *Nordic Outlook*, we have discussed these risks and their economic policy consequences (See, for example, "Tax policy – a key that can unlock growth?" in the May 2014 issue). Our general conclusion, which is gaining greater support in international discourse, is that fiscal policy has a major role to play in the current situation. However, sizeable budget deficits and high levels of government debt are limiting room for manoeuvre and to some extent making it necessary to look for new mechanisms. For example, the IMF has pointed to the possibility of using tax policies to boost growth **by redistributing income to households that have low incomes and a high marginal inclination to consume**.



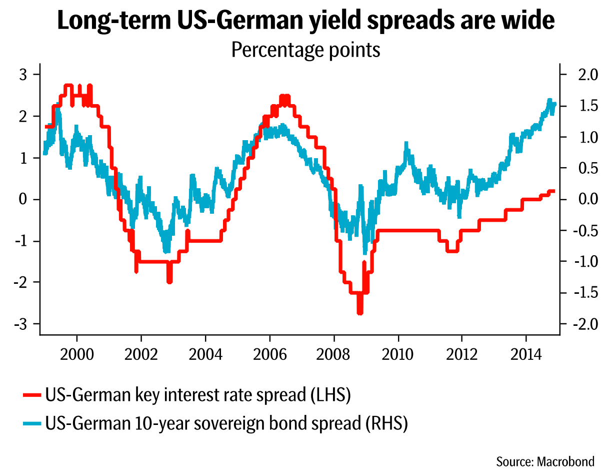
We are also seeing tendencies towards general fiscal policy easing in the short term, with a **shift of emphasis from fiscal discipline to fiscal expansion**. Japan will postpone the second stage of its consumption tax hike, and major euro zone countries such as Italy and France are being given more time to comply with budget deficit ceilings. There is also increasing international pressure on Germany to use fiscal policy in a significantly more active way to help sustain euro zone growth.

Various ways of potentially stimulating investment activity are another recurrent theme of policy recommendations, for example from such organisations as the G20, BRICS, IMF and EU. The focus of attention is on infrastructure projects in such sectors as transport, energy, water and communications. **The G20 has begun taking steps aimed at achieving its target of boosting GDP growth by 2 per cent no later than 2018**.

After several decades of policy recommendations based on classic market liberalism and strong reliance on the ability of central banks to handle both stabilisation policy and financial stabilisation with the help of inflation targets, we are now seeing a shift. It remains to be seen whether financial market regulation in such areas as macroprudential supervision, combined with more active fiscal policy and increased public investments, are the right medicine. In any case, a new look at such old recipes is assuming a bigger role in international discourse on how to resolve the problems related to weak growth, widening gaps and future financial imbalances.

Long-term yields close to historical lows

This autumn, international bond yields have been pushed down by growth worries. Strong euro zone disinflationary forces and declining US inflation expectations, driven by falling oil prices, have also contributed. Looking ahead, developments will continue to be dominated by diverging growth outlooks and central bank policies in English-speaking countries and in the euro zone/Japan. This implies that the **spread between 10-year government bond yields in the US and Germany will remain historically wide** and even increase somewhat.



In the US, long-term yields will rise as the Fed approaches its first rate hike, but the upturn will be moderate in historical terms, reflecting great uncertainty about what interest rate the Fed is aiming at and how fast it can hike its rates. The search for returns, driven by a continued surplus of cheap central bank money in other countries, is expected to help keep down long-term yields in the US. **At end-2016, 10-year US bond yields will be 3.20 per cent**: a level last seen in mid-2011.

In the euro zone, long-term yields have approached Japanese levels and the fixed-income market is thus discounting a lengthy period of key interest rates around zero. Expectations that the ECB will also start buying government bonds may push down long-term yields a bit further in the near term. We are nevertheless sticking to our assessment that an ECB quantitative easing (QE) programme may lead to a slight upturn in 10-year German yields if it succeeds in stabilising and turning around inflation expectations. **At the end of 2016, 10-year German government bond yields will be 1.50 per cent, or 170 basis points below their US counterparts**.

This autumn, Swedish yields have followed euro zone rather than US yields, even though developments in the real economy have greater similarities with English-speaking countries. Due to speculation that low inflation may also persuade the Riksbank to try unconventional measures, the spread between Swedish and German long-term yields may shrink somewhat further early in 2015. Further ahead, however, we believe that Swedish bonds will be traded at somewhere between US and German long-term yields, since the Riksbank is expected to hike its key interest rate before the ECB but after the US and the UK. **At the end of 2016, Swedish 10-year yields will be 2.20 per cent, 70 basis points above corresponding German yields but 100 bp below US yields**.

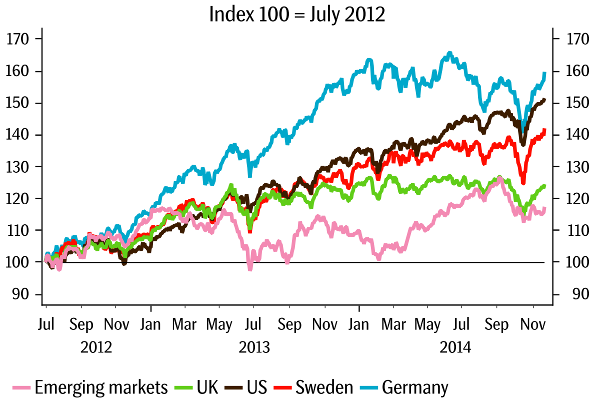
Speculation that Norges Bank is about to cut its key interest rate has led to narrower spreads between Norwegian and German government bond yields. We see room for the spread to shrink further from today's historically high levels, helped by a decreased supply of bonds. During 2016 the yield spread will again widen somewhat, as Norges Bank cautiously begins to hike its key rate. At the end of 2016, Norwegian 10-year government bonds will trade at 2.35 per cent, 85 bp above their German counterparts.

Central banks continue to support equities

Stock market performance has been volatile, dominated by concerns about a renewed economic downturn in the euro zone, doubts about the effectiveness of economic policies and rising geopolitical risks. Greater uncertainty about US monetary policy, now that the Fed has ended its bond purchases, may also have contributed to stock market instability. After slumping sharply during September and October, stock markets have rebounded and reached new record highs in the US, while the trend in emerging markets has been more hesitant. Recent stabilisation in leading indicators has helped to calm markets. Other factors included receding expectations of immediate Fed tightening, due to falling oil prices and lower inflation forecasts. Dovish signals from the ECB and expanded monetary stimulus are also confirming the perception that monetary policymakers will provide continued support to stock markets even once the Fed begins tightening. The Nordic stock markets also received support from third quarter corporate reports which generally surpassed expectations and were driven, among other things, by favourable currency rate effects and acquisitions.

Stock markets back at high levels

Index 100 = July 2012



Source: Macrobond

We expect the stock market to remain conflicted between uncertain growth prospects and greater geopolitical tensions, on the one hand, and continued low interest rates on the other hand – but with a risk of increased volatility as US interest rate hikes approach. The risk premium is high because the stock market has prepared itself for both a degree of disappointment with company earnings in 2015 and somewhat higher interest rates ahead. Although earnings estimates are relatively cautious in a historical comparison, the picture is not as bright if we also factor in the effects of low inflation. In real terms, earnings expectations are thus more consistent with their earlier trend. If global economic conditions improve in line with our forecasts, share prices should rise somewhat during 2015. The stock market will thus remain an attractive alternative to other investments throughout our forecast period.

Fed rate hikes will strengthen the US dollar

We are maintaining our outlook on major world currencies in 2015-2016. There are still good reasons to believe that the US dollar will strengthen, while the euro and the yen weaken. We expect major differences in monetary policy. We believe that the Fed, having ended its QE3 bond purchases at the end of October 2014, will begin hiking its key interest rate in September 2015. The ECB and the BoJ will keep their key rates close to zero, and both of these central banks will expand their purchases of financial assets. Another circumstance that points to a falling JPY is the recent decision by Japan's Government Pension Investment Fund (GPIF) to reduce the share of Japanese bonds in its portfolio from 60 to 35 per cent and increase the share of Japanese and foreign equities. **The JPY will continue to fall; we have increased our final USD/JPY target exchange rate to 140 at the end of 2016. As for the EUR/USD rate, we expect a gradual decline to 1.13**.

The performance of the British pound has been affected by shifting messages from the Bank of England. Earlier signals that the BoE might raise its key interest rate by early 2015 have gradually changed. Partly due to downward revisions in the BoE's November inflation forecasts, we now believe the first rate hike will occur in early 2016. We have thus lowered our pound forecast a bit, **but we still expect the pound to appreciate against the euro, with the EUR/GBP exchange rate moving towards 0.75**.

The Swedish krona weakened sharply when the Riksbank lowered its key interest rate to zero in October. In keeping with developments after the unexpectedly large rate cut in July, however, the krona recovered relatively fast. In the short term the krona will remain under pressure, but given our forecast that the Riksbank will abstain from unconventional monetary policy, the upside potential for the EUR/SEK exchange rate is limited. We expect it to peak at around 9.35 and then slowly move downward towards 8.80 by the end of our forecast period. **The krona will continue its weakening trend against the dollar, moving towards a USD/SEK exchange rate of around 7.80**.

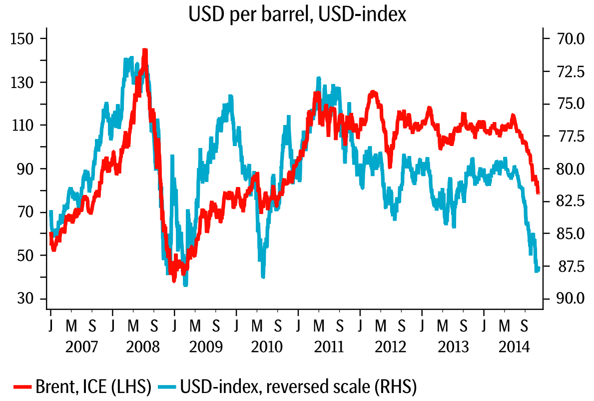
The Norwegian krone has weakened due to the rapid oil price downturn this autumn. Further easing by Sweden's Riksbank and the ECB have also fuelled expectations that Norges Bank will follow suit and cut its key interest rate in 2015. While falling oil prices risk leading to a decline in oil industry investments, Norway's economy is still fundamentally strong – with rising consumption and employment as well as inflation close to the central bank's target. Unless the currency appreciates to a significantly greater degree than we foresee, we thus do not believe that Norges Bank will cut its key rate. We expect the first rate hike to occur only in the second quarter of 2016. In this environment, we anticipate a cautious appreciation of the Norwegian krone to 8.15 per euro at the end of 2015. As the central bank tightens monetary policy during 2016, it will tolerate a somewhat stronger currency and the **EUR/NOK exchange rate will fall to 7.95 towards the end of 2016.**

- **More supply = lower oil prices in long term**
- **OPEC will accept lower price level**
- **Uncertainty will reduce stimulus effect**

Oil prices have shown a downward trend since early summer, falling by a total of about 25 per cent. Weak demand from China, Europe and elsewhere has contributed to the downturn. The International Energy Agency (IEA) has lowered its forecast of oil demand several times and now expects an increase of 0.9 per cent this year and 1.3 per cent in 2015. In addition, structural forces are causing consumers to switch from oil to cheaper or renewable energy sources. For example, oil costs six times more than coal per unit of energy. Oil is twice as expensive as natural gas in Europe and four times as expensive in the US. Looking ahead, these differences will become even more important as technical advances erode oil's exclusive position as a road transport fuel. A stronger USD has also helped push down price levels; **historically, there is a clear connection between dollar exchange rate movements and oil prices measured in USD/barrel**.

Fall in oil price boosted by USD strength

USD per barrel, USD-index



Source: ICE, Macrobond

There are also important supply side forces behind the downturn. The emergence of new production – especially shale oil from the US – has reduced the ability of the Organisation of the Petroleum Exporting Countries (OPEC) to control oil prices. Due to new sources of production combined with rather weak growth in demand, the OPEC countries must reduce their production in order to keep oil prices at around USD 100/barrel. **In our assessment, the OPEC countries will not sacrifice their market shares in order to prop up prices**, although the outcome of the OPEC meeting on November 27 may change this conclusion. Since there are no country-by-country production quotas, the burden falls heavily on Saudi Arabia – OPEC's dominant oil producer – to keep production down. Yet the signals we have seen so far indicate that Saudi Arabia will accept lower prices, among other things as a way of slowing investments in new extraction, especially in the US. **We thus believe that oil prices will remain low, and we expect an average price of USD 85/barrel during 2015 and 2016.**

A long-lasting, highly supply-driven downturn in oil prices represents a new element in our forecast. Worth noting is that the IMF's *World Economic Outlook*, published as recently as October, contained sensitivity analyses of a supply-driven **oil price upturn of 20 per cent**, i.e. a change in the opposite direction of roughly the same magnitude as we are seeing. The IMF analysis estimated a direct global GDP effect of ½ per cent accumulated over 2 years. In a scenario where this price upturn was also combined with an **accompanying decline** in investor, household and business confidence, the equivalent effect was as much as 1½ per cent. Of major economies, China and Japan are the most sensitive to changes in oil prices, while the impact is smaller in the US and the euro zone.

The question now will instead be how large a positive GDP effect we can expect in consumer countries. The IMF analysis is one of a number of sensitivity analyses that have been made using different modelling approaches. The effects vary, for example depending on what policy responses we assume and various kinds of secondary effects. Our assessment is that at present, we can expect a **relatively limited effect in the ½ per cent range over a two-year period**. Experience from earlier oil price changes indicates that the results of modelling tend to overestimate the effects. In the prevailing situation of geopolitical worries, continued balance sheet adjustment needs and deflation risks in important parts of the world economy, the impact on optimism will probably be rather small. In the US, the stimulus effect will also be limited because oil production has increased and thus also exposure to lower prices. The negative impact on producer countries that are highly dependent on oil revenues may also affect world economic stability. Russia is the most important example, but the situation in Venezuela, many Middle Eastern countries and elsewhere will also be affected.

The GDP effect in model simulations is often intensified because in the short term, lower inflation allows more room for monetary policy stimulus. **In the prevailing situation, we believe that the policy response will be marginal**. In the US the impact will be significantly larger than in other countries, at most pushing down CPI by nearly 1 percentage point (see the discussion in our *International overview*). But we do not expect any secondary effects on core inflation that the Fed will need to take into account. In Japan and the euro zone, the positive stimulus effect is welcome, although it only worsens the problem of falling inflation expectations. This will probably lead to marginally more powerful quantitative easing programmes.

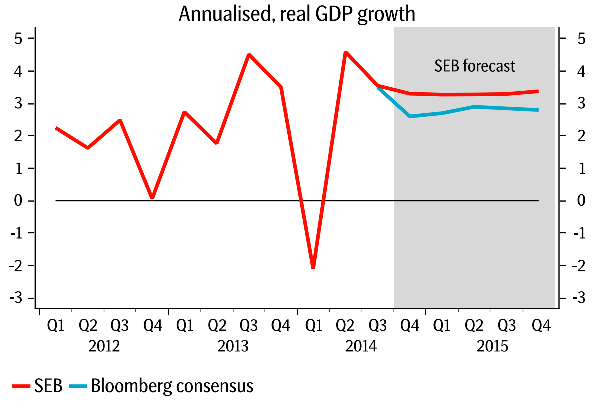
Tighter resource situation opens the door for rate hikes

- **Households taking over as growth engine**
- **Labour market is enjoying a tail-wind**
- **Fed will hike key rate in September 2015...**
- **...despite slower inflation**

The recovery in the American economy is continuing in line with our forecasts. Lower oil prices and interest rates are offsetting the negative growth impact of a stronger US dollar and weak economic performance in the euro zone and elsewhere. Both the labour market and household confidence indicators suggest that consumption growth will soon accelerate. Unemployment, which has already fallen to 5.8 per cent, will continue down to 4.7 per cent at the end of our forecast period. After real GDP growth of 2.3 per cent this year, **the economy will grow by 3.4 per cent in 2015 and 3.1 per cent in 2016**, which is above consensus. Growth will thus be the strongest since 2005, when the full-year figure last surpassed 3 per cent.

Good growth outlook

Annualised, real GDP growth



Source: BEA, Bloomberg, SEB

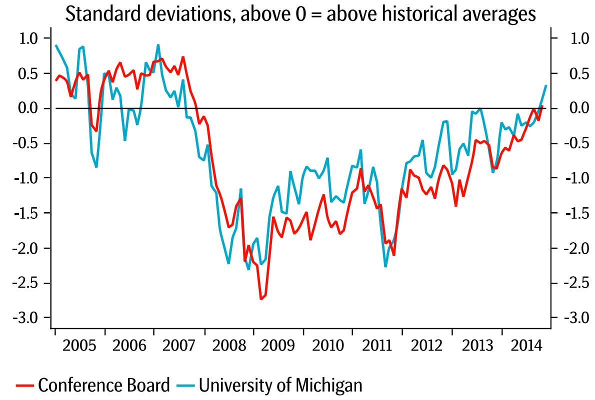
At the same time as the growth picture has remained bright, **projected inflation has fallen dramatically**: a combination of the stronger dollar and lower oil prices will push inflation in 2015 nine tenths of a percentage point below our August forecast. Some measures of inflation expectations have fallen, but not enough to cause concerns about deflation to regain a foothold. **Key interest rate normalisation will be delayed until September 2015**. By the end of 2015, the federal funds rate will be 1.00 per cent and by the end of 2016 it will be 2.25 per cent, well above market pricing.

Household consumption will accelerate

After average annual growth of more than 2 per cent since 2011, the conditions are in place for an **acceleration in consumption growth, with incomes as the driving force**. Lagging wealth effects and looser credit conditions will also contribute – American households have left behind their debt deleveraging, and bank lending is increasing at its fastest pace since 2008. Meanwhile the upswing in hours worked has led to robust income growth, even though average hourly wages have only risen slightly. According to our forecasts, hourly wages will climb faster too, further stimulating the trend.

Consumer confidence back to normal

Standard deviations, above 0 = above historical averages



Source: Bloomberg, Conference Board, SEB

A combination of cheaper petrol (gasoline) and falling unemployment has **helped household confidence indicators to regain the ground they lost during the recession** Lower petrol prices leave more money in people's wallets. With petrol prices down 80 cents since summer and the country consuming around 135 billion gallons a year, this generates an annualised saving of around USD 110 billion – or about 0.9 per cent of total consumer spending. This will help boost consumption in time for Christmas shopping, since the price drop will probably affect consumer behaviour quickly: nearly half of households have no savings at all but live from hand to mouth, while energy costs have gradually expanded to a larger share of household budgets among low income earners. **Overall household consumption will increase by 3.0 per cent in 2015 and 2.6 per cent in 2016**. The household savings ratio, which has climbed by a full 0.7 percentage points so far this year, will continue upward to 6.5 per cent of disposable income in 2016 from today's 5.6 per cent. One upside risk for our consumption forecast is if the savings ratio remains near its current level.

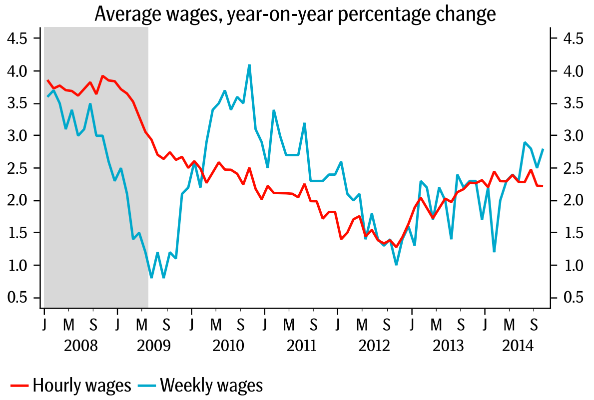
Labour market enjoying a tail-wind

The labour market is continuing to show strength, with robust job growth and falling unemployment. **Indicators are exuding optimism**. New applications for unemployment benefits are at their lowest since 2000 and the number of job vacancies is at a 13-year high. Overtime hours and the average work week have climbed to record-high levels, an indication that even stronger employment growth is in the cards. We predict that in 2014, **job growth** will average 230,000 per month, becoming **even stronger in 2015 with average monthly increases of 240,000**. Unemployment, which measured 5.8 per cent in October, will gradually fall to 4.7 per cent by the end of 2016.

The resource situation remains a controversial issue. Our view is unchanged: **the decline in labour force participation is largely structural, and unemployment is thus a good indicator of the resource situation in the economy**. Average hourly wage increases remain stubbornly within a narrow range, perhaps because hourly wages held up during the economic crisis years and this is creating sluggishness today. But when unemployment falls below non-accelerating inflation rate unemployment (NAIRU) – or equilibrium unemployment – which the Congressional Budget Office estimates at 5.6 per cent, hourly wages will probably begin moving upward more clearly. Ambitious hiring plans, combined with difficulties in recruiting qualified staff (according to the NFIB small business index) also indicate that employees will gain a better negotiating position. There are currently two job seekers per vacancy, compared to seven in 2009. **Average annual hourly wages will climb by 2.7 per cent in 2015 and 3.5 per cent in 2016**, according to our forecasts. Quarter-on-quarter measures such as the official Employment Cost Index are meanwhile already showing faster pay increases. According to the ECI, wages and salaries rose by a robust 0.6 per cent in the second quarter of 2014 and 0.8 per cent in Q3. So far this year, average weekly wages have also accelerated. Faster pay increases are a key element of our optimistic economic outlook and of the coming monetary policy normalisation.

Wage curves pointing cautiously upward

Average wages, year-on-year percentage change



Source: BLS, SEB

Home price increases are slowing

The upturn in home prices has slowed noticeably, and price increases according to the Case-Shiller 20-City Index are now somewhat below their peak of a few months ago. This deceleration is quite consistent with our forecasts of **slower price increases: 8 per cent in 2014 and 6 per cent in 2015**. Meanwhile construction industry confidence has bounced back to robust levels, suggesting that home price increases will stabilise and also rebound on a month-to-month basis. As earlier, our assessment is that both residential investments and housing starts will continue to increase as the stronger labour market improves conditions for first-time buyers in particular. After a weak trend in 2014**, residential investments will grow by a yearly average of 8.5 per cent in 2015-2016**.

Capital spending upswing is coming

Business confidence indicators are pointing towards high growth. In October the ISM purchasing managers' index for manufacturing showed a level of optimism **compatible with GDP growth of around 5 per cent**. Our composite ISM indicator, which has a shorter history, is pointing in the same direction. Small businesses have still not jumped on the recovery train, which will restrain overall business investment, and our forecasts do not assume such strong growth figures as the indicators suggest. Yet household demand is gaining strength, paving the way for a capital spending upswing. **Business investments will increase by an average of 7.5 per cent in 2014-2016**. High capacity utilisation in manufacturing, easier lending terms, strong company earnings and cash reserves as well as ageing production equipment are other reasons for optimism, although the latest order statistics fail to support this upbeat assessment in the short term.

We believe that the sharply positive GDP contribution from foreign trade during the third quarter was temporary; USD appreciation and stronger domestic than international demand suggest a **growing trade deficit in the next couple of years**. Rising US energy production and a downward trend in the petroleum product trade deficit will partly offset this.

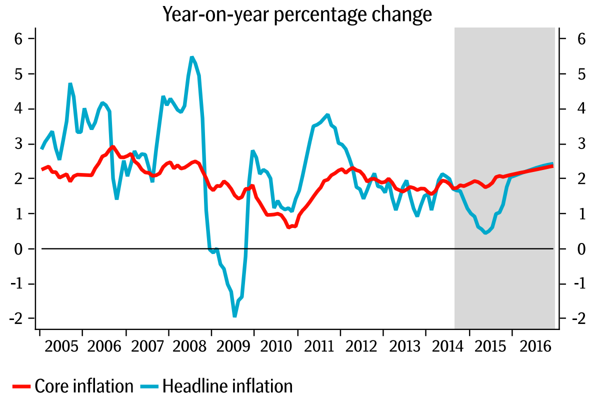
Overall, however, the **USD appreciation since summer will have little impact on growth**. US export goods will indeed become more expensive and less competitive, while imported goods will become cheaper and imported inflation lower. But exports are a low 13 per cent of GDP, compared to 32 per cent in Canada and 46 per cent in Germany. Since exchange rates are relative prices, **a stronger dollar will also help balance global growth**; German exports to the US, for example, are three times larger than American exports to Germany.

Inflation will slow sharply in 2015

The biggest change in outlook compared to our forecasts in the August issue of *Nordic Outlook* concerns inflation. After peaking in May, inflation has slowed, but the biggest declines still lie ahead of us. According to our forecast, **CPI inflation will bottom out at a low 0.8 per cent in May 2015**. Falling energy prices, but also lower food prices, are the main reasons for the downturn. As annual averages, inflation will be 1.0 per cent in 2015 and 2.3 per cent in 2016 – well below consensus for 2015. **As long as inflation expectations do not collapse, the Federal Reserve can be relaxed about the dip in inflation** and begin its interest rate normalisation as planned. Inflation expectations in financial markets have fallen this autumn but are not at worryingly low levels. The Fed's own measures of inflation expectations as well as household expectations have not changed significantly.

Lower headline inflation in 2015

Year-on-year percentage change



Source: BLS, SEB

The secondary effects of falling food and energy prices will be small, and core inflation will accelerate slightly in 2015 and 2016 according to our forecasts. Although wage inflation remains low for now, given a tighter resource situation it is reasonable to expect faster wage and salary increases ahead. Small businesses are planning for pay hikes, and we are maintaining our forecast that hourly wages will increase at a 3.5 per cent rate by the end of 2015. **We predict core inflation of 1.9 per cent in 2015 and 2.3 per cent in 2016**.

Republicans have gained further ground

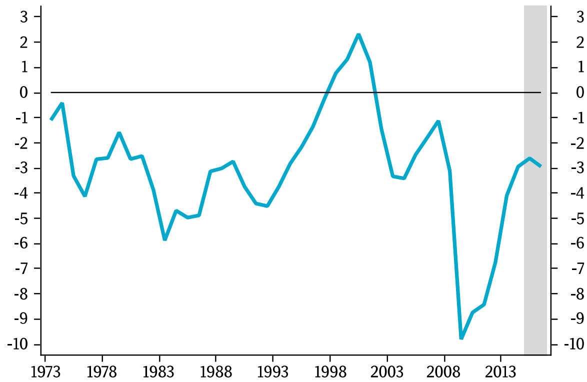
The improvement in public finances since 2010 – when federal deficits were in double digits as a percentage of GDP – has been **the fastest in nearly 50 years**. In fiscal 2014, which ended September 30, the deficit was 2.8 per cent of GDP or below the 40-year average of 3.1 per cent. During 2015-2016, we expect the budget deficit to remain at current levels and **fiscal policy will make a neutral contribution to growth**.

Stronger federal finances helped to diminish the influence of the Tea Party movement in the November 4 mid-term elections. Instead, more moderate Republicans scored numerous successes as their party captured majorities in both houses of Congress. Because Barack Obama's public approval ratings are very low, we believe that the president will be cautious about using his veto power to kill Republican proposals. In this way, Obama can improve his legacy and boost Democratic chances in the 2016 elections. We thus see potential for **federal policy makers to embrace cooperation instead of confrontation**. One successful example of cooperation under similar circumstances is President Bill Clinton's last two years in office. Ronald Reagan, too, faced a Congress dominated by the other party during his final years as president.

Several important policy areas will be in the spotlight. A free trade agreement with the European Union needs to be put in place, as do investments in America's neglected infrastructure. Corporate taxation and immigration reform are other controversial fields where broad agreements are needed. The sweeping defence cuts that were implemented in response to the 2011 debt ceiling crisis will probably be reversed, benefiting the defence industry. We also believe that the federal government **can avoid a new crisis when the debt ceiling issue comes up again next spring**. "Obamacare" also appears safe: any Republican attempts to scrap the president's signature health care reform will face a certain veto.

Public finances have rapidly improved

Per cent of GDP



Source: Congressional Budget Office, Macrobond

Interest rate normalisation will begin

Now that the Fed has ended its stimulative bond purchasing programme as planned, attention will shift to its most important key interest rate and the approaching normalisation of monetary policy. **Our forecast is that the first rate hike, to 0.25-0.50 per cent, will occur in September 2015** and that the federal funds rate will be 1.00 per cent at the end of 2015 and 2.25 per cent at the end of 2016. This is well above the current market consensus of 0.53 per cent in 2015 and 1.45 per cent in 2016. Meanwhile the Fed's own forecasts are considerably higher: the median year-end forecast by Federal Open Market Committee members was 1.375 per cent in 2015 and 2.875 per cent in 2016. Experience from the 1984, 1994 and 2005 rate hiking cycles suggests that the first 200 basis points of rate hikes will have relatively small macroeconomic effects. On the other hand, because of the long period of extremely low interest rates there is greater uncertainty today about the interest rate sensitivity of the economy.

If anything, the resource situation might justify earlier hikes. Viewed over the last five rate hiking cycles from 1988 onward, unemployment has averaged 5.8 per cent when Fed rate hikes began. However, the Fed's new focus on a broad spectrum of labour market variables gives the central bank flexibility and arguments to wait longer before it starts to normalise interest rates. Low inflation also increases the Fed's manoeuvring room. With the European Central Bank and Bank of Japan also continuing to expand stimulus measures, there are many signs that the US dollar will be strong. This, in turn, indicates that the Fed may normalise more slowly than according to historical patterns.

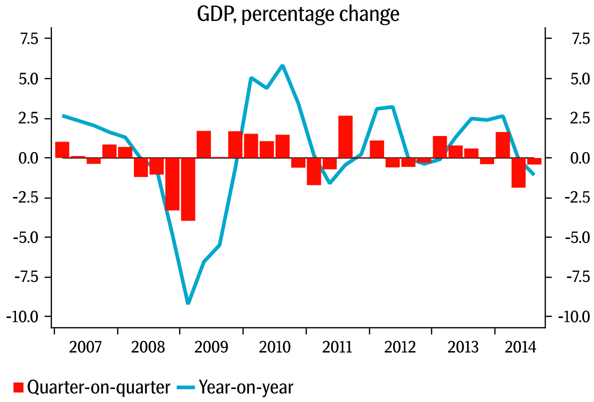
Setbacks for Abenomics leading to new stimulus efforts

- **Japan is in new recession after tax hike**
- **Prime Minister Abe has called snap election**
- **Steps to boost labour supply more urgent**

Japan's economic recovery has derailed. Due to fiscal tightening and sluggish international demand, **GDP growth will slow from 1.5 per cent in 2013 to only 0.4 per cent this year. In 2015 the economy will grow by 0.9 per cent and in 2016 by 1.1 per cent**, supported by new economic stimulus measures. Especially regarding 2014, this is a sharp downward revision compared to the August issue of *Nordic Outlook*.

Four recessions in six years

GDP, percentage change



Source: Cabinet Office

Due to lingering weaknesses from the second quarter's decline in growth, and the adjustment to the consumption tax hike in April, GDP unexpectedly shrank again during the third quarter. This means that technically, Japan has entered its fourth recession since the 2008 global crisis. Behind the Q3 downturn was major de-stocking, which led to weak performance in manufacturing, plus a continued downturn in residential construction. Although the economy is expected to grow again late this year, it is hard to find any strong driving forces in the short term. Exports are hampered by international weaknesses, offsetting the effect of a weaker currency. Both business and household optimism have been muted during 2014. Growing employment and weak wage and salary increases will help sustain household incomes, but pay hikes will not be able to keep pace with inflation and the effects of the tax hike. This will hold back consumption, but indicators suggest that private investments may regain momentum further ahead.

Prime Minister Shinzo Abe has called a **snap election in mid-December to strengthen the public mandate for his "Abenomics" economic reform policies** after the latest growth reversals. The second tax hike, which the government had planned for October 2015, will now probably be shelved until 2017. Instead, new fiscal stimulus measures are likely. This will benefit short-term growth but will not strengthen the credibility of Japanese public finances in a situation where tax revenues are not enough to finance current social expenditures for an ageing population and where public sector debt totals 240 per cent of GDP.

According to the government's long-term forecast, the primary deficit in public finances will be halved from 6.6 per cent of GDP in 2010 to 3.3 per cent in 2015, then approach 1 per cent by 2023. The projection is based on very ambitious growth assumptions, including real GDP growth averaging 2 per cent over the next two decades. This can be compared to potential GDP growth of 0.5 per cent or lower today, according to the Bank of Japan (BoJ). Japan's ambition to leave deflation behind and boost long-term growth imposes major demands for structural reforms. Since the growth upturn of recent years has led to an increased labour shortage, **measures to both increase the labour supply and take more efficient advantage of the existing labour force are becoming more urgent**. A cautious upturn in the share of women and older people in the labour force has helped keep employment increasing. This can be interpreted as meaning that the reforms have begun to bear fruit. However, dealing with a 20 percentage point gap in labour market participation between women and men will require major changes in women's labour market position and their ability to combine children with work. As for productivity-raising reforms, the government has also unveiled ambitious targets whose effects remain hard to assess. These include measures to increase competition in the agricultural and health care sectors.

The BoJ expanded its stimulus measures in late October. The central bank will now expand its balance sheet by no less than JPY 80 trillion or nearly 20 per cent of GDP per year. Meanwhile, authorities unveiled new guidelines for managing the Government Pension Investment Fund (GPIF) that will reduce domestic bond holdings in the fund's portfolio while increasing the role of domestic and foreign equities. We believe that **further monetary easing will be introduced during the first half of 2015** and are sticking to our forecast of a new JPY 100 trillion target for annual asset purchases. This will help weaken the yen to 140 per USD by the end of 2016. Inflation has again turned downward, and once the effects of last spring's tax hike disappear from the 12-month figures, we believe that inflation will fall below 1.0 per cent. Despite increased stimulus measures and renewed yen depreciation, we do not expect Japan to achieve the 2 per cent inflation target during our forecast period.

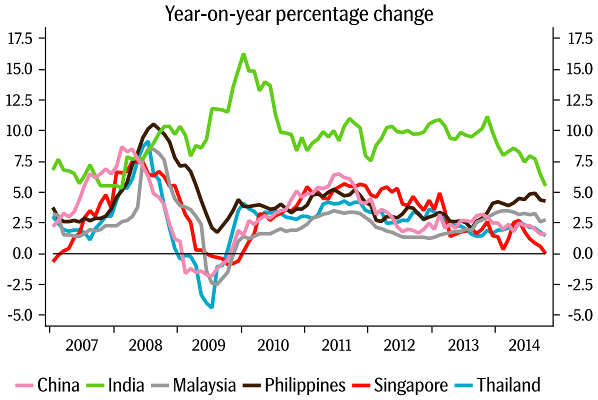
Cautious acceleration despite China's slowdown

- **Low inflation will help emerging Asia region**
- **China: Labour market can handle slowdown**
- **India: Lower inflation will allow easing of monetary policy**

Growth appears to have levelled out or decelerated slightly in most Asian emerging economies in the third quarter, compared to earlier quarters. There is potential for gradually accelerating growth rate with China as a key exception. Strong labour markets will help sustain domestic demand, and somewhat stronger global economic conditions will stimulate external demand. Open economies like South Korea, Singapore and Taiwan will benefit the most from greater export demand, though China's slowdown will dampen exports throughout the region. Several economies are also approaching their capacity ceiling – one reason why activity will increase only gradually. The decline in commodity prices has pushed down inflation in the region, since most countries are net energy importers. Inflation pressure will remain low in 2015-2016, making continued expansionary monetary policies possible.

Asia: Inflation pressure is easing

Year-on-year percentage change



Source: National statistical offices

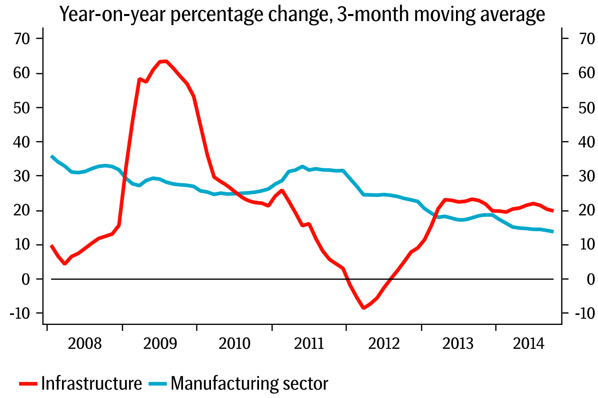
We do not expect tighter US monetary policy to result in major financial turbulence of the kind that prevailed in the summer of 2013. The Fed's rate hikes are announced well in advance and most Asian economies are showing more stability, but it is too early to declare all danger past. Economies with large current account deficits are the most vulnerable. In Asia, Indonesia shows especially troubling weakness in its external balance.

China: Continued slowdown in growth

Weak domestic demand, pulled down by a slumping real estate sector, has not been entirely offset by decent external demand and gradual monetary and fiscal policy easing. As expected, growth decelerated slightly in Q3 to 7.3 per cent year-on-year. During Q1-Q3, GDP rose by 7.4 per cent. The government can probably achieve its 2014 growth ambition of **around 7.5 per cent**, helped by continued targeted measures and good external demand in late 2014. Purchasing managers' indices for manufacturing are not pointing to any clear rebound. This outlook is reinforced by sluggish industrial production and a continued slowdown in capital spending growth. Retail sales are also lacklustre. Good exports are partly offsetting weak domestic demand. **We expect full-year average GDP to increase by 7.4 per cent in 2014, followed by a slowdown in growth to 7.0 per cent in 2015 and 6.7 per cent in 2016.**

Capital spending growth is decelerating

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



Source: National Bureau of Statistics of China

Chinese authorities will need to continue taking steps to keep growth at levels that are sustainable in the long term, while maintaining the pace of reform efforts. Labour market stability is fundamentally more important than GDP increases. An excessively rapid slowdown in growth may lead to rising unemployment, which in turn may run the risk of triggering social unrest. GDP growth has decelerated significantly in recent years, but there are no clear signs that the labour market has weakened, although comprehensive labour market statistics are lacking. If we look further ahead, the labour market will be sustained by demographic changes and the growing, labour-intensive service sector. **The labour market can thus cope with a gradual decline in GDP growth without weakening.** We believe that the **government's 2015 growth target will be lowered to 7.0 per cent**, which is compatible with labour market stability. An overly ambitious growth target risks thwarting reform efforts if this target is achieved by means of increased stimulus measures and capital spending. Another less likely possibility is that the official growth target will be entirely abolished.

Home prices have fallen month-on-month (as measured in 70 major cities) for six straight months but the downturn has been relatively moderate; in October, they fell 2.5 per cent year-on-year. The main problem is the large oversupply of homes. Demand for new homes is fundamentally strong, but it will take time before supply has decreased. Until then, construction will remain subdued. An easing of housing market policies will help avoid a more severe downturn.

This autumn, a **gradual policy softening has become increasingly evident**. In November the **central bank cut the key rate by 40 basis points** to 5.60 per cent; the first rate adjustment since July 2012. The "targeted measures" strategy is continuing in various areas. Authorities have greatly loosened restrictive housing market policies by cutting mortgage interest rates and easing restrictive lending criteria. In September and October, the central bank carried out two rounds of liquidity injections into the banking system, helping bring about lower interest rates. Meanwhile the government has pursued a more expansionary fiscal policy – cutting taxes and providing aid to small and medium-sized businesses. We expect policy softening to continue in 2015.

Inflation pressure remains very low; in October, CPI inflation was 1.6 per cent. Falling food and commodity prices have lowered inflation further, but wages and salaries continue to climb by nearly double-digit figures year-on-year, making deflation risks seem remote. We expect full-year **2014 inflation of 2.5 per cent** and foresee inflation of **2.0 per cent in 2015**, followed by an upturn to **2.5 per cent** in **2016.** Continued yuan appreciation will help keep price pressures low but also offset the easing of monetary policy. Chinese officials have expressed concern that expanded stimulus measures by the Bank of Japan may lead to a troublesomely weak yen. We expect a **USD/CNY exchange rate of 5.80 at the end of 2015 and 5.70 at the end of 2016.**

Reform efforts are continuing at a healthy pace. A major piece of the puzzle is the **budget law revision** adopted in late August, which takes effect in January 2015. One of its aims is to increase transparency and prevent local governments from further borrowing through special financing arrangements. Local governments will instead become entitled to issue bonds, though subject to restrictive legislation. This revision is a step in the right direction and **will substantially reduce the risk that local debt will jeopardise the financial system**.

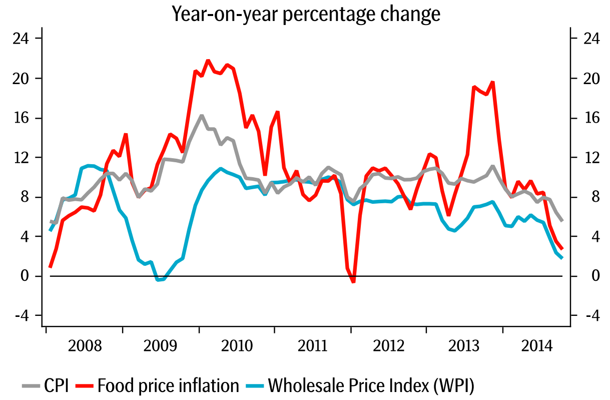
India: Potential for more reforms

Year-on-year GDP growth rose to 5.7 per cent in the second quarter, compared to 4.6 per cent in Q1, but this acceleration was temporary. The latest figures show a weak trend in the manufacturing sector; the export recovery has also faded. Car sales, which serve as an indication of consumer demand in the absence of retail sales statistics, have also slowed and the purchasing managers' index has weakened. On the whole, it is hard to see how economic growth can accelerate further from the pace of the second quarter.

Since June, global energy prices have fallen sharply, clearly benefiting India with its large-scale energy imports and subsidies. The decline in energy prices certainly contributed to the government's **decision** in October to **deregulate diesel prices** and raise domestic natural gas prices, since the global price decline minimises the impact on consumers. Since the victory of his Bharatiya Janata Party (BJP) in May, Prime Minister Narendra Modi's government has found it difficult to satisfy expectations that it would speed up reform efforts to resolve structural problems in the economy. Since only minor reforms had been made earlier, the deregulation of diesel prices has been the most important reform so far. **BJP's success in state elections has weakened local parties** that often oppose reforms. Overall, **the basic conditions are now in place for more far-reaching reforms** to counter the structural problems that are the main reason behind weak growth. **In 2014 we expect GDP to increase by 5.4 per cent and in 2015 by 5.8 per cent. In 2016, growth will accelerate a bit further to 6.2 per cent.** Since the BJP's victory, growth acceleration has been built into our forecast, but if reform efforts take off in earnest and the Reserve Bank of India eases monetary policy faster, growth may be even higher.

In September and October, **CPI inflation fell unexpectedly fast**, driven by slower food price increases. It is now 5.5 per cent. The Reserve Bank's inflation target of no more than 8 per cent at the beginning of 2015 is well within reach, but since food makes up 50 per cent of the CPI basket, inflation figures are volatile. This increases the risk of reversals, but we believe that the RBI can more permanently push down inflation. **We expect CPI inflation to average 7.3 per cent in 2014 and 6.5 per cent in 2015. In 2016, it will slow to 6.0 per cent.** The key interest rate has stood at 8 per cent since the RBI hiked it in January 2014, but slower inflation reinforces our view that a softening of monetary policy is approaching. We expect the RBI to begin cutting its key rate in the first quarter of 2015; by year-end the rate will stand at 7.25 per cent.

Inflation slowed greatly in September and October



Source Ministry of Commerce and Industry

After falling since last spring, the rupee has rebounded nearly to the levels against the USD prevailing in early 2014. We do not expect a repeat of its sharp decline in the summer of 2013. Uncertainty about the Fed's monetary policy has diminished, and India's higher key interest rate and far smaller current account deficit are providing better protection. **At the end of 2015 we expect an INR/USD exchange rate of 55.0 and at the end of 2016 a rate of 50.0.**

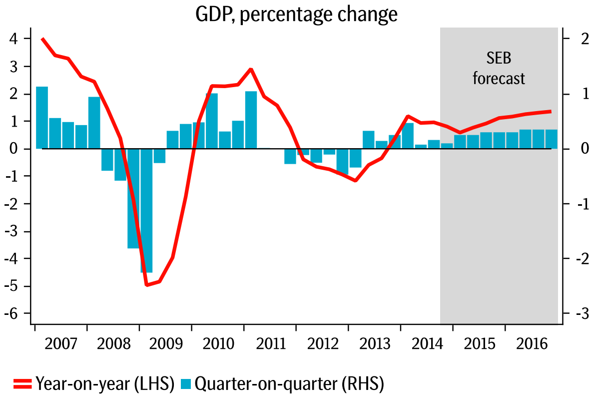
Lacklustre growth, low inflation despite stimulus efforts

- **Weak growth, but stabilisation after mid-2014 reversal**
- **France and Italy are losing ground**
- **Fiscal policy and investments will provide some growth stimulus**
- **Lower inflation expectations pressure ECB to buy government securities in early 2015**

The euro zone is stuck in a lacklustre growth environment. A number of countries are struggling with low demand and structural problems. Even Germany has slowed and cannot provide enough growth impulse to the euro zone, but Spain has proved an exception from this gloomy picture by showing unexpectedly strong expansion. After disappointments and falling indicators last spring and summer, we now foresee some stabilisation in the euro zone as a whole, but no clear upturn. **GDP grew by a 0.2 per cent in the third quarter compared to Q2**, and 2014 will end on a weak note.

The growth rate is slowly increasing

GDP, percentage change



Source: Eurostat, SEB

Due to stagnation and the risk of a new recession, various **actors will take steps to help sustain growth**. The European Central Bank's targeted long-term refinancing operation (TLTRO) loans and its stress tests of the euro zone banking system **are laying the groundwork for improved lending**. The broadening of ECB asset purchases that we foresee, combined with the US Federal Reserve's key interest rate hikes, will lead to **a continued decline in the euro** and thereby stimulate both inflation and demand. As a result of pressure from international organisations such as the IMF, which maintains that **fiscal policy must be loosened**, Italy and France are among the countries being granted more time to bring down their budget deficits. Germany is reluctant to bend the rules but is cautiously expanding its public sector capital spending. European Commission President Jean-Claude **Juncker's plan** to create an infrastructure investment fund will take time to put in place, but may eventually have a positive impact on demand. Aside from economic policy measures, **falling energy prices** will boost household purchasing power and lower costs for the corporate sector, which has long found it difficult to raise prices to offset its cost increases.

Even if these factors together help avoid a new recession, the euro zone continues to lag behind other major global economic regions. One reason is that it is the region most susceptible to heightened geopolitical insecurity caused by the Russia-Ukraine conflict. Meanwhile there is still a **great need for balance sheet consolidation**. Also hampering performance is lingering uncertainty about future economic policy choices. The euro zone has taken steps towards greater oversight and cooperation, but **much more is needed to enable the region to function as a currency union**. There are divergent views on crisis management mechanisms between important actors, especially France and Germany. Because of similar disagreements, earlier remedial actions have come too late and have exhibited a certain sense of desperation. For example, the ECB has been slow to take action compared to other major central banks and must now struggle against headwinds.

Overall, we expect GDP to increase by only 0.9 per cent yearly in 2014 and 2015. Growth will then rise to 1.3 per cent in 2016, equivalent to the trend rate and not high enough to greatly reduce unemployment or debt ratios. We also believe that the risks remain on the downside.

GDP

Year-on-year percentage change

	2013	**2014**	**2015**	**2016**
Germany	0.1	1.3	1.2	1.6
France	0.4	0.4	0.5	0.9
Italy	-1.9	-0.3	0.3	0.8
Spain	-0.1	1.4	2.0	2.2
Greece	-3.9	1.0	1.5	2.5
Portugal	-1.6	1.0	1.2	1.7
Ireland	0.2	3.0	2.5	2.5
GIPS countries	-0.7	1.5	1.9	2.2
Euro zone	**-0.5**	**0.9**	**0.9**	**1.3**

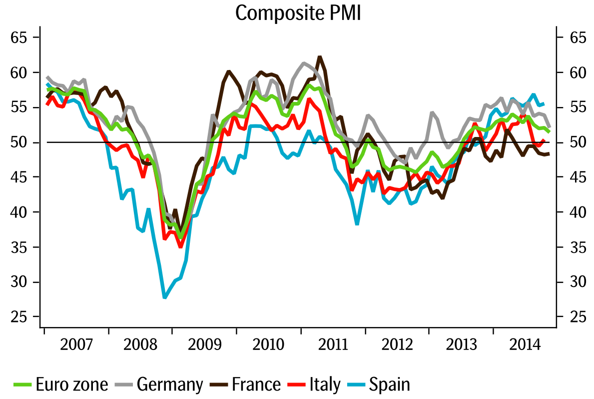
Source: Eurostat, SEB

Indicators stabilising but divergent

Falling indicators last spring and summer contributed to uncertainty about short-term economic trends. The clearest downturn was in purchasing managers' indices (PMIs) for manufacturing, which fell between April and September. Manufacturing is the sector most exposed to disruptions from the Russia-Ukraine crisis, not least via slumping capital spending. Especially worrisome was the decline in the German manufacturing PMI from 56.5 in January to 49.9 in September. In recent months the trend has been flat, with a slight upturn in October and downturn in November according to preliminary data.

Divergent indicators

Composite PMI



Source: Markit

Broader measures are at somewhat better levels but the trend is weak. Composite PMI (including non-manufacturing) is at a higher level than manufacturing PMI but has fallen in recent months. The October upturn to 52.1 was followed by a downturn according to preliminary November figures, pointing to a continued weak quarter-on-quarter growth rate. Composite PMI diverges between countries. In Germany and Spain, it stands above the euro zone average, while in France and Italy it is now at or below the expansion threshold of 50. We expect this divergence to continue and to be reflected in our growth forecasts. German and Spanish economic growth is above the euro zone average, while Italy and France are losing ground.

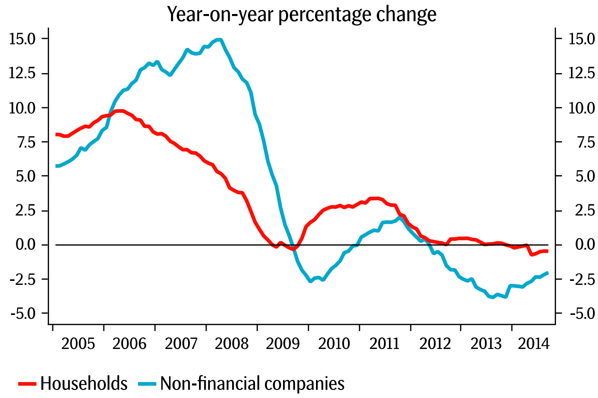
Euro zone exports remain weak and are not providing much growth impetus, although the situation has stabilised in recent months. Looking ahead, a weaker euro and improved competitiveness will help sustain exports, but in several countries – including France and Italy – the trend is moving in the wrong direction as regards the cost situation. **Exports will grow by 2.8 per cent in 2014, 3.0 per cent in 2015 and 4.2 per cent in 2016**. Imports will increase somewhat more slowly, and the current account will continue to show a surplus of about 2 per cent of GDP.

Domestic demand will remain weak

Continued low demand, combined with political and economic uncertainty, is continuing to hamper capital spending. Capacity utilisation also remains below the historical average, which is one reason why the capital spending upturn is occurring slowly from a depressed level. The stress tests conducted by the ECB will probably lead to **a certain strengthening of confidence in the euro zone banking system and a loosening of bank lending**. But even if the supply side situation in the credit market improves, lending will be hampered by a continued weak inclination to invest. Public sector projects may provide a certain positive effect. This applies both to Juncker's investment initiative and **Germany's plan to boost public capital spending**. The EUR 10 billion programme recently unveiled in Germany will nevertheless have only a marginal impact. **Euro zone capital spending will increase by 1.2 per cent in 2015, 1.4 per cent in 2015 and 2.0 per cent in 2016**.

Weak bank lending, but the decline is shrinking

Year-on-year percentage change



Source: ECB

Consumer confidence has fallen in recent months, but the level remains relatively high considering the generally weak economic situation. Unemployment is still very high, while households have a continued need to deleverage their debts. We expect consumers to be cautious, but a number of factors suggest increased consumption. The jobless rate is falling, albeit slowly, while employment is increasing. Continued cost adjustment is pushing down wage increases, but because of low inflation and less austere fiscal policies, real incomes are rising. **Consumption will climb by 0.5 per cent in 2014 and 2015, then increase by 1.0 per cent in 2016**.

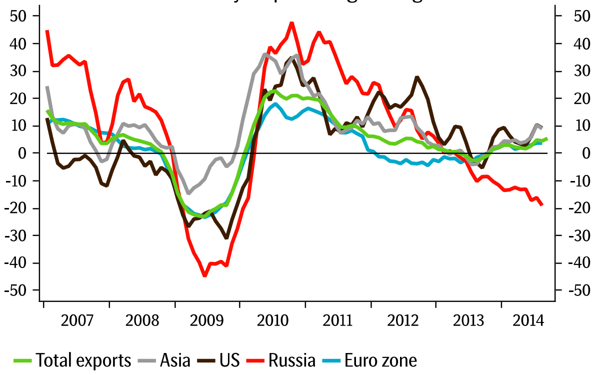
Trade barriers are hampering Germany

The weak second quarter and falling indicators raise questions about the **resilience of the German economy**. Although its trade with Russia is small (2-3 per cent of total exports), Germany seems to have been clearly affected by the Russia-Ukraine conflict and its consequences. Exports to Russia have slowed for a rather long time as the underlying weakness of the Russian economy has emerged, but capital spending activity has also recently been hampered by greater uncertainty about geopolitical and trade conditions. The German economy has been held back by weakness elsewhere in the euro zone too.

In our judgement, however, the risks of a major economic slowdown are rather small, as evidenced by the latest slight upturn in economic indicators. With its large current account surpluses and a strong labour market, the German economy has an underlying strength. The government could respond to any renewed weakness with broader fiscal stimulus measures than the investment projects promised so far: something that various international organisations are already calling for. In addition, the further weakening of the euro that we foresee will strengthen the global competitiveness of German industry. Low unemployment indicates that supply side restrictions may eventually emerge, but the imbalances in the euro zone open the way for a significant influx of labour from southern Europe.

Rising German exports despite weakness in Russia

Year-on-year percentage change



Source: Eurostat

Neutral fiscal policy but high debt

We expect euro zone fiscal policy to be largely neutral in 2014-2016, while public deficits will shrink slowly to 2.2 per cent of GDP in 2016. But although deficits are shrinking and the ECB's actions have pushed down sovereign bond yields, the public debt situation remains worrisome. Because of low inflation and weak growth, debt ratios – already record-high in some countries – will continue to climb. In the euro zone as a whole, public debt will level out in 2016 at 95 per cent of GDP. Given heavy public debt, especially in Greece and Portugal, further restructuring rounds cannot be ruled out, though not in the near term. In this situation, it does not take much to trigger renewed turbulence, for example worries that disagreements within the euro zone might prevent the ECB from implementing powerful new expansionary measures. One indication that the situation is volatile was Greece's attempt to end its bail-out programme and shift to borrowing in the market, which led to sharply rising bond yields.

High unemployment will fall slowly

In September, unemployment remained at 11.5 per cent for the fourth straight month. Jobless rates are still by far the highest in the most crisis-hit countries (Greece over 26 per cent, Spain 24.0 per cent), but the trends in Italy (12.6 per cent) and France (10.5 per cent) are also quite worrying. German unemployment keeps falling to new lows (5.0 per cent) despite shaky growth.

Although employment is now rising, because of weak growth and structural problems in a number of countries this will occur slowly. Persistently high unemployment creates social and political problems, and it risks shutting certain age categories out of the labour market. Meanwhile divergent labour market conditions will lead to increased migration, reducing the risk of labour shortages in countries like Germany.

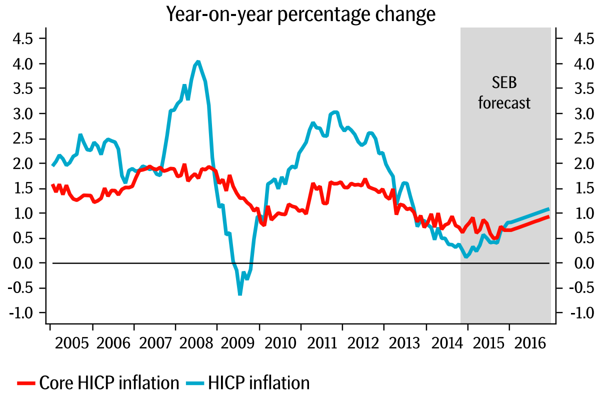
Inflation: Below target, slow upturn

The euro zone continues to teeter on the brink of deflation. Price and wage adjustments are pushing down inflation in the most crisis-hit countries. Prices are falling year-on-year in Greece (-1.1 per cent), Spain (-0.3) and Italy (-0.1), among others. But even in Germany (0.8 per cent) and France (0.4), inflation is far below the ECB target of close to 2 per cent.

Low oil and food prices will squeeze inflation further in the near term. Low pay hikes will also help keep price increases low. A weaker euro will help push up inflation, but how much is uncertain. In a low demand environment, companies find it hard to raise prices when their input goods become more expensive. Deflation risks remain, but our main scenario is that ECB actions will contribute to a weak upturn in inflation. **Average inflation measured by the Harmonised Index of Consumer Prices (HICP) will be 0.5 per cent in 2014 and 2015, rising to 1.0 per cent in 2016**. Core HICP will be just below 1 per cent throughout our forecast period.

Low inflation pressure

Year-on-year percentage change



Source: Eurostat, SEB

ECB will buy government bonds in Q1 2015

The monetary action package that the ECB unveiled in June is now being implemented. In October, the bank made its first covered bond purchases. Before year-end, it will start buying asset-backed securities (ABSs). These measures are in addition to the latest key rate cuts to 0.05 per cent and targeted long-term refinancing operation (TLTRO) loans to banks.

The ECB may also possibly expand its purchases to include corporate bonds, but their volume is not enough to enable the bank to expand its balance sheet at the pace it has signalled. Thus our main scenario is that **the ECB will add government bonds to its quantitative easing (QE) programme in the first quarter of 2015**. This is necessary because the ECB intends to increase its balance sheet by EUR 1 trillion, reaching earlier peaks. There is still opposition to such government bond purchases, for example from Germany, but we expect it to weaken as the alternatives become fewer and fewer.

We also expect the ECB to expand its guidance connected to the repo rate path, although this will have little impact given today's market expectations. No changes in the refi rate are likely during our forecast period. This means that the interest rate gap against the US will grow to 220 basis points, close to earlier peaks in 2000 and 2006 of 250 points.

Low inflation helping to push up real wages

- **Households will increasingly drive growth**
- **Unemployment below equilibrium in 2015**
- **Bank of England will hike rates only in 2016**

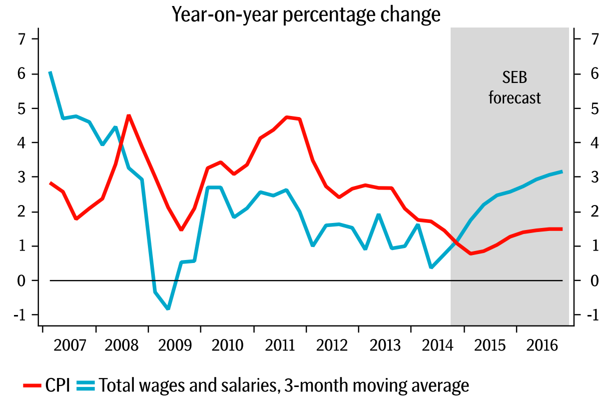
Despite recent declines in business indicators, British growth in 2014 will be the highest since 2006 and the fastest among G7 countries. The recovery will continue in 2015 and 2016, with **GDP growth of 2.8 and 2.5 per cent, respectively**: slightly above consensus. **We are greatly lowering our inflation forecast** to an average of 1.2 per cent in 2015-2016. Meanwhile unemployment is falling and will eventually end up below its equilibrium level, contributing to good real wage increases. This will boost purchasing power for the first time in years, thus accelerating household consumption and helping the British economy stay resilient to weak euro zone economic performance. Low inflation will give the Bank of England (BoE) room to hold off on hiking key interest rate hikes. The key rate will be raised only in February 2016, much later than our earlier forecast, and will be a low 1.25 per cent at the end of 2016.

As in many other countries, the inflation picture is the biggest change since the August *Nordic Outlook*. **Inflation**, already at a five-year low, **will fall further**. Partly because of downward price pressures due to fierce competition between major retailers, combined with the lagging effects of this autumn's oil price decline, we predict that inflation will drop below 1 per cent during the next few months. Under the British system, the governor of the BoE will thus have to submit a written explanation to the chancellor (finance minister). Inflation will remain stuck at low levels; **we predict averages of 1.0 per cent in 2015 and 1.5 per cent in 2016**. Not even in 2017 will inflation hit the 2 per cent target, according to BoE forecasts.

After six years of falling real wages, **lower inflation is good news for households**. Average hourly wages rose clearly in September, while indicators point to continued upturns. Recent productivity improvements, combined with shrinking idle labour market resources, suggest upward wage and salary curves. A year ago unemployment was 7.7 per cent; now it is 6 per cent. Employment will keep growing. **By the end of 2016 the jobless rate will stand at 5 per cent**, our forecasts show: below the BoE's estimated equilibrium unemployment (NAIRU). This autumn's 3 per cent minimum wage hike will also contribute to **a predicted 2.1 per cent increase in nominal pay in 2015 and 2.8 per cent in 2016** – but this is below the pre-crisis trend of 4-5 per cent. Consumer confidence, which has rebounded to pre-crisis levels, is compatible with strong retail sales expansion. Macroprudential measures have cooled housing price hikes since the summer. Home prices will increase in line with incomes during the coming year, reducing the risk of overheating. **Overall household consumption growth will average 2.4 per cent in 2015-2016**.

Stronger wage growth next year

Year-on-year percentage change



Source: ONS, SEB

Business sector indicators have fallen from excessive levels, especially in services, which account for three fourths of the economy. October's purchasing managers' index (PMI) in services was the lowest since May 2013. Greater geopolitical uncertainty, weak euro zone demand and the strong pound will hamper exports this year and next. Lagging effects of the past year's pound appreciation will dampen exports and hold down imported inflation. Looking ahead, the pound will weaken against the dollar but appreciate against the euro, mainly driven by expected key interest rate differentials. **At the end of 2016, the GBP/USD exchange rate will be 1.51 and the EUR/GBP rate at 0.75**, according to our forecasts.

A combination of good momentum in the real economy and low inflation will justify a cautious monetary normalisation, as also signalled in the BoE's latest inflation report. The first rate hike will come in February 2016, once a tight resource situation has led to clear real wage increases. **At the end of 2016, the key rate will be 1.25 per cent**, according to our forecasts. The recovery is not yet being reflected in success for the current Tory (Conservative)-led government. Labour is still ahead in the opinion polls, with a **parliamentary election set for May 2015**. If the Tories stay in power after that, they have promised a referendum in 2017 on future British membership of the EU – a choice that will impact the Nordic countries in particular.

Central Europe rising despite weak Russia and Ukraine

- **Lengthy conflict – sanctions in 2015 as well**
- **Ukraine: Acute need for more bail-outs**
- **Russia: Stagnation, rouble stabilisation**

Gradual economic recovery will continue in much of Central and South-Eastern Europe in 2015-2016. This is in spite of the Russia-Ukraine conflict, which will lead to stagnation in Russia and continued decline in Ukraine in 2015 after this year's plunging GDP. **Private consumption and in 2016 also slightly improved demand from Germany and the euro zone will provide support.** The decline in oil prices is also positive, since these countries are relatively large energy importers – Poland to a lesser extent. **But GDP growth will be moderate**: SEB's forecasts for 2015 are somewhat below consensus for most countries.

In our judgement, the **Russia-Ukraine conflict** will be **long-lasting**. **Our growth forecasts are based on key assumptions**: battles will continue in eastern Ukraine but the conflict will not escalate into a Russian invasion and/or heightened military tension between Russia and NATO. We also assume that there will be no serious disruptions in Russian energy deliveries to Europe and that trade sanctions between the West and Russia will not intensify. There is large mutual dependence on Russian gas, and both sides will probably do everything they can do avoid igniting a full-scale trade war, given their shared economic weakness. The October 30 gas agreement between Ukraine, Russia and the EU (as co-financier) will secure Ukraine's gas supply this winter and also clearly diminish the risk that Russia will shut off gas supplies to Western Europe as well. We assume that current sanctions – whose direct adverse effects are expected to be relatively small – will remain largely unchanged during most of 2015. Russia's import ban on food and other agricultural products from the EU and other Western countries that had introduced sanctions will apply for one year, starting in early August 2014.

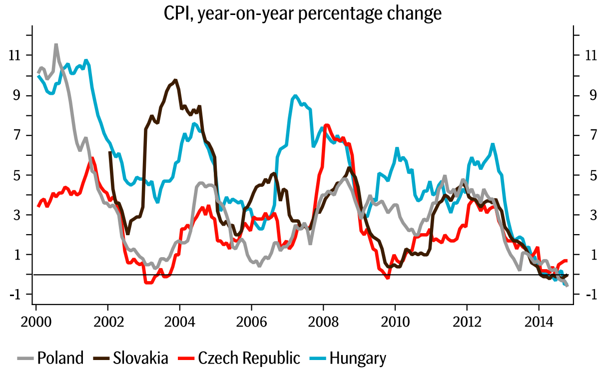
In light of this, we are sticking to our assessment last spring that the Russia-Ukraine conflict will have little direct impact on global growth. The main reason is that individual countries have relatively little export exposure to Russia, except for the Baltics, Finland and former Soviet republics in Central Asia. But due to heightened geopolitical uncertainty, investment appetite has diminished not only close to the crisis area, but also across much of Europe. The conflict has already contributed to less optimistic sentiment in both Eastern and Western Europe, but this negative effect seems to be fading, judging from stabilisation of indicators in recent months.

Growth in Central and South-Eastern Europe remained healthy during the second quarter – driven by domestic demand – and **slowed a bit in the third quarter**. This had only a slight connection to anaemic Russian and Ukrainian demand. **The main reason for the slowdown was weak demand in Germany and the euro zone.** Germany is far more important as a market for Central European exports. For example 5 per cent of Poland's exports went to Russia in 2013, but 26 per cent to Germany. The situation is similar in Slovakia, the Czech Republic, Hungary and elsewhere. A large proportion of Polish industry is integrated with German industry. Lower capital spending activity was another factor behind slower growth.

We expect growth to remain subdued in the fourth quarter, due to sluggish economic expansion in the West, but **in the first half of 2015 the region will benefit from somewhat better euro zone growth**. A continued climb in private consumption and stronger exports to the West during 2015-2016 will offset lost exports to Russia and Ukraine. **Households will enjoy good real incomes**, low interest rates and looser credit conditions. Unemployment will slowly fall. Manufacturing sector investments will remain slow because of geopolitical worries, but increased construction and more EU structural funds will enable overall capital spending to grow moderately.

Historically low inflation in Central Europe

CPI, year-on-year percentage change



Source: National statistical offices

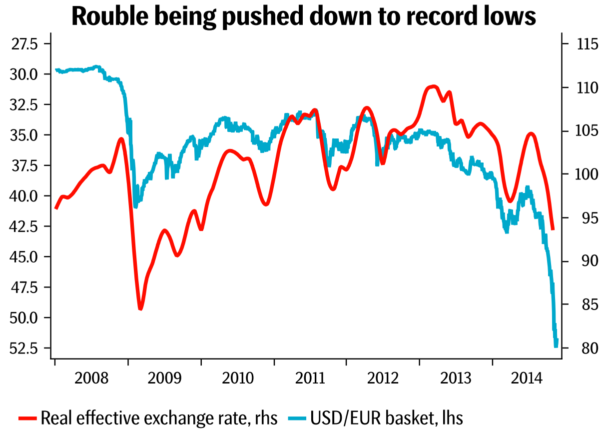
Since last spring, deflation pressure and slightly falling prices year-on-year have prevailed in Slovakia and Hungary, and since the summer also in Poland. In the Czech Republic, prices have begun to climb a bit. **In the short term, inflation will remain strongly depressed**, squeezed by global commodities and weak price impulses from the euro zone. In recent months Russian sanctions have also created an oversupply of certain foods. **There is little risk of long-lasting deflation.** Continued growth in domestic demand and pay increases will lead to weakly rising inflation over the next year.

Economic policymakers in major Central European countries **are not doing much to help sustain growth**. Czech fiscal policy is shifting towards slight stimulus, while Hungary is tightening its budget. Poland's fiscal policy will be neutral to mildly tightening, but with potential for a shift to looser policy before next autumn's parliamentary election. All governments have in common that they are being careful to keep their budget deficits below the EU's maximum: 3 per cent of GDP. There is also limited manoeuvring room for monetary policy. Poland may perhaps make another 50 basis point rate cut this winter (after a cut in October) from a record-low 2 per cent. **We expect major Central European currencies to appreciate** over the next year or two, partly because the weak economic situation in the euro zone will push down the euro. But these movements will be small.

Falling rouble worsens Russian stagflation

Russia's GDP growth slowed a bit further to 0.7 per cent in the third quarter. Lower oil prices are squeezing the energy sector and ruling out expansionary fiscal policy. Household consumption is subdued because of weaker real wages. Western sanctions and high interest rates are hurting investment appetite and capital spending, which has been weak for a long time due to underlying structural problems, but the decline in capital spending will probably ease in 2015 as the current more acute conflict gradually fade. Helped by a weak rouble and rising external demand, cautious recovery is expected in 2016. **GDP will grow by 0.7 per cent in 2014, shrink by 0.2 per cent in 2015 and then climb by 1 per cent in 2016.**

Rouble being pushed down to record lows



Source: BIS, Macrobond

In October, rouble depreciation accelerated, driven by falling oil prices. The downturn was also intensified by speculative currency trading and was sharper than during the 2009 global financial crisis. In early November, the central bank ended its attempts to stop the rouble from tumbling by using market intervention. The "rouble corridor" was abandoned. The shrinking currency reserve was probably one reason behind this decision; during October the central bank used USD 30 billion (more than 5 per cent of the reserve). **In practice, the rouble is now floating freely**, even though the central bank intends to intervene if financial market stability is threatened. The transition to a new monetary policy with a freely floating currency early in 2015 has thus happened earlier. We expect the rouble to remain volatile for another while before finding an equilibrium level. **At the end of 2015 we expect a rouble exchange rate of 43.0 per USD and at the end of 2016 a rate of 45.0.** The weaker rouble will provide budget support, since government oil revenues will be higher measured in local currency, but this effect is not enough to offset the weakening of the budget caused by lower oil prices. However, we expect Russia to cover its budget deficit during the next couple of years by using money from the Reserve Fund; the deficit is projected at around 1 per cent of GDP. Lower oil prices also mean a faster transition to current account deficits, but large-scale currency reserves will enable Russia to cope with a weaker current account without risking an acute crisis.

In October, inflation reached 8.3 per cent, up about two percentage points so far this year. We believe it will continue accelerating, driven by rouble depreciation. **Annual average inflation will be 7.7 per cent in 2014, slowing to 6.7 per cent next year and 5.7 per cent in 2016.** The 4 per cent target has been postponed from 2016 to 2017, but the central bank is clear about wanting to bring down inflation. We expect more key interest rate hikes after the 150 bp hike in October.

Acute need for more Ukrainian bail-outs

The economic situation in Ukraine has recently deteriorated greatly and **the risk of default has risen sharply**. From late September to early November the central bank kept the hryvnia steady against the USD, but it was forced to give up attempts to defend the currency due to its rapidly shrinking reserve. The hryvnia fell sharply and is now far below the levels assumed by the IMF when it approved a bail-out loan package last spring. This depreciation puts heavy pressure on banks that have large foreign-currency loans. Meanwhile the treasury has fallen to a critical level due to greatly increased military expenditures and payment of a gas debt to Russia. Ukraine thus faces another acute current account crisis. **Our main scenario is that Ukraine will shortly receive expanded bail-out loans from the IMF and the EU and can thus avoid default.**

GDP fell sharply in the third quarter yet was much better than expected, probably due to strong agricultural production and higher defence expenditures. Due to this outcome, we are revising our forecast upward for **2014, when we expect GDP to fall by 5.0 per cent. In 2015 GDP will decline by 2.0 per cent. In 2016 a cautious recovery will begin and GDP will increase by 2.0 per cent.** The recovery will be export-driven. We expect the **hryvnia** to bounce back from its current depressed level, reaching **17.0 per USD at the end of 2015 and 19.0 at the end of 2016**.

The political situation remains complicated. The October 26 **parliamentary election** resulted in a **clear majority for greater integration with the EU**. Reform chances have improved. Meanwhile the conflict in eastern Ukraine has intensified and the cease-fire agreed in early September is fragile. The local elections in separatist-controlled areas reinforce our forecast that the conflict with Russia will be lengthy.

Domestic demand offsetting negative Russian effects

- **Good real incomes = robust consumption**
- **Geopolitical worries hurt capital spending**
- **Exports will rebound soon, but weakly**

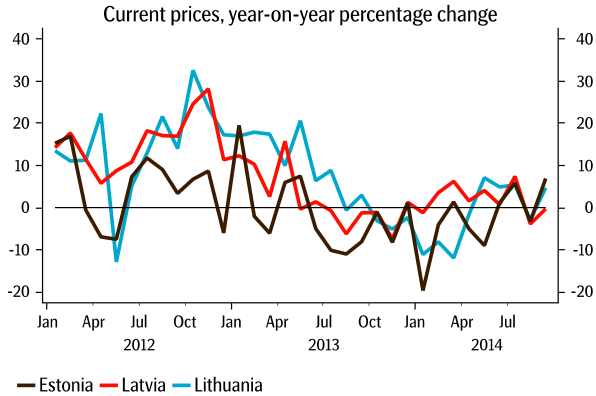
In line with SEB's forecasts, **Baltic growth has slowed moderately since the Russia-Ukraine conflict broke out** in February 2014, though Estonia has been more resilient than expected. Estonia's year-on-year growth recovered from 0.3 per cent in the first quarter to 2.4 per cent in Q2, then fell slightly to 2.1 per cent in Q3. Latvia's growth gradually slowed from 2.8 per cent in Q1 to 2.1 per cent in Q3. Lithuania's growth slipped to 2.7 per cent in Q3 after 3.3-3.4 per cent in Q1-Q2.

Economic forces have pulled in different directions. Exports began a sharp weakening trend as early as the second half of 2013, caused by falling Russia growth and anaemic Western demand. This year exports have continued downward, mainly due to the Russian slowdown and euro zone stagnation (Estonia especially hampered by Finnish weakness). Russia's ban on food imports from countries that had imposed sanctions – introduced in August and running one year – has played a part. This ban hits Lithuania the hardest. The Baltics are generally more affected than most countries by Russian weakness, since their export exposure to Russia is high: 12-20 per cent of total exports (2013), including a sizeable transit trade. Meanwhile there are more and more reports that Baltic companies are successfully reducing their dependence on Russia by turning to other markets. For example, Latvia is now doing more business with the UK, Sweden and Central Europe; Latvian dairy firms are making inroads in China. **Capital spending**, which was weak even before the Russia-Ukraine confrontation, has remained weak this year, especially in Estonia and Latvia, except for a construction upswing in all countries and some temporary public investments in Estonia. Geopolitical uncertainty has probably begun to have some impact, with companies postponing or cancelling planned projects. Construction investments have been fuelled by rising home prices; during Q1 and Q2, Estonia showed the fastest price upturn in the EU. During 2014, **private consumption** has continued to chug along at a healthy pace, especially in Estonia and Lithuania, without adverse effects from the Ukraine crisis. Strong real incomes (including real wage growth of 5-6 per cent due to inflation well below 1 per cent) are driving retail sales including autos. In 2014, month-to-month consumer confidence surveys have shown a levelling-out trend in Estonia and Latvia, with optimism at relatively high levels historically. But in Lithuania, confidence has fallen noticeably since last winter – without affecting consumption.

Conflicting forces continue to influence GDP growth, which will become more balanced only in 2016. **The Ukraine crisis and Russia's zero growth will cast shadows** on capital spending plans and exports **in 2015 as well**, but a partial recovery in these areas is expected. Capital spending will benefit from increased construction and more EU grants. Slightly better Western European demand and the declining euro will help stimulate exports. **Early signs of stabilisation in exports** have been visible since the summer.

Baltic exports bottoming out

Current prices, year-on-year percentage change



Source: National statistical offices

Private consumption will continue to drive economic growth, with households still enjoying favourable conditions. We expect real wage growth of 4-5 per cent. Unemployment in Lithuania and Latvia remains relatively high, but will gradually fall further. Estonian unemployment – which has dropped just below the equilibrium rate of 8 per cent – will also fall slightly. In the short term, inflation will be kept low by the global commodity price squeeze and Russian sanction effects but inflation will rise cautiously over time as labour costs increase. Continued emigration will contribute to a persistently growing labour shortage.

Overall, Baltic growth will accelerate somewhat after its 2013-2014 slump: in Estonia's case this was relatively deep. But we foresee **moderate growth**, even if Lithuania and Latvia regain their position among the fastest-growing EU economies. In 2016 only Lithuania will surpass potential growth, which is 3-3.5 per cent in all three countries. Its GDP will increase by 3.2 per cent in 2015 and 4.0 per cent in 2016. Latvia's growth will reach 2.7 and 3.4 per cent, respectively. Estonia's GDP will grow by 1.8 per cent next year and 2.8 per cent in 2016. All of our **forecasts for 2015 remain below consensus**.

Weak exports are slowing recovery

- **Consumption and residential construction are boosting economic growth**
- **Weak recovery for manufacturing sector**
- **High unemployment despite many new jobs**
- **Low inflation, with downside risks**
- **Riksbank under continued pressure**

The **Swedish economy remains divided** between robust domestic demand, driven by household consumption and housing construction, and a weak export sector. We expect overall **GDP to grow by 2.1 per cent this year, then accelerate to 2.7 per cent in 2015 and 2016**, when a moderate international recovery will lead to somewhat faster export growth. We have adjusted our forecast for 2015 slightly downward. Employment is rising, but due to a rapidly increasing labour supply the jobless rate is falling very slowly.

We expect the new government to **win approval for its budget in Parliament**. This will result in weakly expansionary fiscal policy during 2015. Further ahead, the red-green minority government will have greater difficulty achieving parliamentary majorities for its policies. Without broader cross-bloc agreements, **there is a risk of political paralysis**.

Although the repo rate has now been cut to zero, we expect **low inflation and falling inflation expectations to put pressure on the Riksbank to do more**, but in our view the threshold is high for implementing unconventional monetary policy measures. The central bank will probably settle for trying to hold down expectations of future key interest rate hikes by further lowering its key rate path. We also expect the Riksbank to explicitly try to guide the market by linking future rate hikes to the inflation trend and the actions of major central banks.

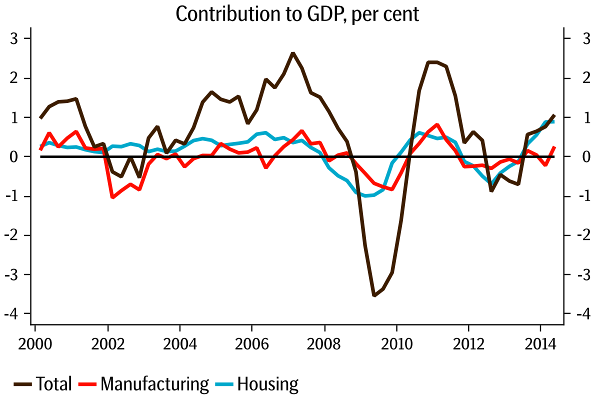
Manufacturing sector is stuck in a rut

Despite some support from a weaker krona, **merchandise exports have continued to stagnate**; their level has been relatively unchanged since 2011. Forward-looking indicators are signalling somewhat stronger performance towards the end of this year, but **euro zone weakness poses a risk of reversals**. A continued increase in service exports and eventually stronger international economic conditions still point to an upturn in exports during the next two years, but compared to historical patterns the recovery will be very weak.

The anaemic industrial outlook is confirmed in company surveys, where manufacturers report falling investments this year, followed by a small increase in 2015. Yet total capital spending is increasing at a decent pace. **The main driving force is rising residential construction**, but growing public sector investments are also contributing. We expect residential investments to continue increasing, though at a slowing pace, and will total 5.1 per cent to GDP in 2016. This is relatively high in a historical and international perspective, but still a couple of percentage points lower than, for example, in Denmark before the financial crisis. Housing construction will contribute around 1.0 percentage point per year to GDP in 2014 and 2015.

Rising housing investments

Contribution to GDP, per cent



Source: Statistics Sweden

Strong households increasing consumption

Helped by rising real incomes, higher asset prices and a stronger labour market, **household consumption has gradually increased**. The rate of increase during the first half of 2014 was the highest since 2011. A downturn in consumer confidence since the summer nevertheless reflects a certain hesitation, presumably due to international turmoil and uncertainty about Sweden's economic policies. The government's budget for next year includes various tax hikes, especially for high income earners. Stimulative measures include proposals to cut taxes for pensioners and boost unemployment benefits. Overall, we believe that fiscal policy will be largely neutral for household incomes next year.

Household incomes and consumption

Year-on-year percentage change

	2013	2014	2015	2016
Consumption	2.1	2.7	3.0	2.7
Incomes	2.1	3.0	2.8	1.9
Savings ratio*	15.3	15.6	15.3	14.4

* % of disposable income. Source: Statistics Sweden, SEB

Because of rising asset values in the national pension funds over the next couple of years, we expect pensions to increase at a faster pace. Combined with strong real wages, this will enable household disposable income to increase rapidly in both 2015 and 2016. Overall private consumption will grow by nearly 3 per cent annually during 2014-2016.

Home prices will level out

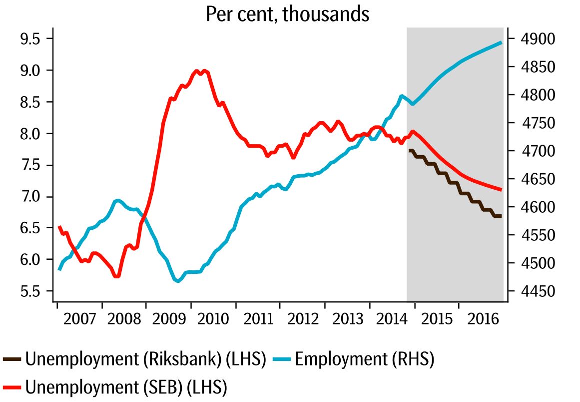
In recent years, home prices have accelerated upward, especially for tenant-owned cooperative units. This trend has been driven by such factors as a housing shortage, lower mortgage interest rates and rising wealth. Macroprudential supervisory measures, mainly the 85 per cent residential loan-to-value ceiling introduced in 2010, have marginally slowed the price upturn. We expect the recent proposal requiring **larger principal payments on home mortgages to have a relatively limited effect**. Since only new loans are affected, the impact on total loan amortisations will be only about SEK 2 billion during the first year. For new home buyers, the principal payment requirement will be equivalent to an interest rate hike of several percentage points, which will affect their willingness to take out a new loan. Rising household debt in recent years has increased sensitivity to rate hikes. When the Riksbank cautiously begins adjusting its key rate upward in 2016, we thus expect home prices to level out. **There is a sizeable risk that home prices will fall once interest rates start climbing** – suggesting that rates will be raised very cautiously.

Rapid job growth but high unemployment

The labour market improvement remains strong, in light of moderate GDP growth. During the third quarter, employment rose 2 per cent year-on-year. Although the underlying trend is not equally robust, **employment will probably continue to increase rapidly**. For example, the number of newly listed job openings rose to record levels this autumn. Even though employment has been significantly stronger than expected, unemployment has been somewhat above projections. The reason is a strong increase in the number of people in the labour force, driven by rapidly population growth as well as increased labour force participation.

The labour market continues to improve

Per cent, thousands



Source: Statistics Sweden, Riksbank, SEB

The downward trend in the number of people on long-term sick leave and disability pensions is now coming to an end. This will help slow the upturn in the labour supply and enable the jobless rate to slowly begin falling. Yet high immigration will continue to increase the labour force at a historically very rapid pace. **The jobless rate will thus fall only very slowly**, and we believe it will remain at nearly 7 per cent at the end of 2016.

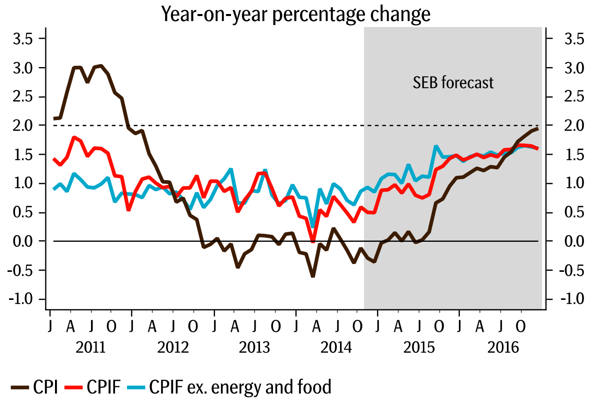
A growing percentage of the unemployed are non-European immigrants who have a hard time finding jobs. This is because of poor Swedish language skills and/or low levels of formal education, as well as slow administrative processes, for example in order to recognise foreign qualifications in the health care field. **This suggests that "equilibrium" unemployment is on its way up**. Yet because of the EU single labour market and otherwise liberal rules for labour immigration, companies will still largely be able to find suitable employees. **The risk of wage-driven inflation is thus low.**

Low inflation with growing downside risks

Forecasts of rebounding inflation have again proved incorrect, partly due to falling oil and food prices. Core inflation (CPIF excluding energy and food) has also **been surprisingly low**, remaining largely unchanged at below one per cent; both SEB and the Riksbank had predicted a slightly rising trend. Prices of services have been unexpectedly low, while goods prices have increased roughly as expected, driven by a weaker krona.

Inflation increasing but far below target

Year-on-year percentage change



Source: Statistics Sweden, SEB

Due to further inflation impulses from earlier krona depreciation, somewhat higher pay increases and an eventual normalisation of energy and food prices, we still **expect inflation to gradually rise in 2015 and 2016**. We have adjusted our 2015-forecast significantly downward and expect the CPIF upturn to reach only an annual average of 1.0 per cent: just above half the upturn expected in our August forecast. **CPIF inflation will remain well below the Riksbank's 2 per cent target throughout our forecast period.**

Unconventional monetary policy unlikely

Due to low inflation the Riksbank remains under pressure, even though it has lowered the repo rate to zero. **It is relatively likely that the Riksbank will have to adjust its inflation forecast downward again**, triggering expectations of further action. The increasingly loose monetary policies of the European Central Bank will also help increase this pressure.

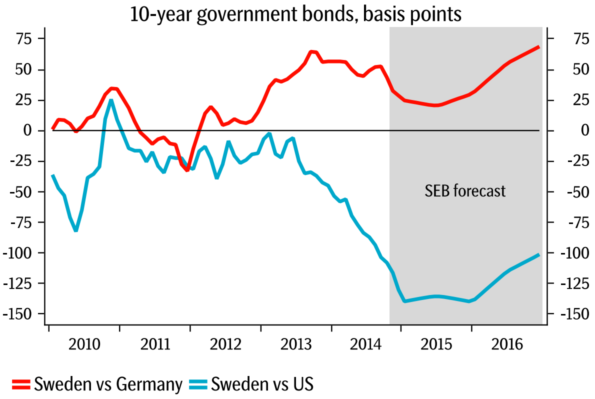
Our theme article "The Riksbank's next step" discusses the potential for unconventional monetary policy in Sweden. Our main conclusion is that given the smoothly functioning credit market, with low yield spreads and a probably undervalued currency, **there is a high threshold for Riksbank actions of this type**. Our main scenario is that the Executive Board will be content to try to hold down expectations of key rate hikes by lowering its rate path. We also expect the Board to reach a consensus on a pledge to link rate hikes to specific inflation conditions, such as requiring that CPIF inflation must be above 1.5 per cent for a certain period. Rate hikes will also probably be linked to the actions of the world's major central banks.

Given our forecast that the Federal Reserve will begin hiking its key rate in the second half of 2015 and the Bank of England in early 2016, the **Riksbank is still likely to follow suit and raise its repo rate in mid-2016**. The GDP and employment trends in Sweden are more in line with the US and the UK than with the lengthy stagnation that appears likely in the euro zone. This also implies that the risk of a deflationary spiral, with falling wages and prices, is smaller than in the euro zone.

Partly because the Riksbank has cut its key rate by a total of 75 basis points since July, yields on Swedish government bonds have fallen more than on equivalent German yields. In the near term, **we foresee room for yield spreads against Germany to narrow further**, since the market will probably begin to price in a certain likelihood of unconventional monetary policy in Sweden. Although we expect the ECB to expand its bond purchases early next year to also include government bonds, we believe this will create some upward pressure on German yields, driven by a stabilisation of inflation expectations.

Falling and increasing 10-year spreads

10-year government bonds, basis points



Source: Macrobond, SEB

Since we forecast that the Riksbank will hike its key rate before the ECB, it is reasonable for the yield gap against Germany to widen a bit further ahead. Starting in mid-2015, we thus expect Swedish bond yields to rise faster than German yields; by the end of 2016, we expect a gap of no less than 70 basis points. The **yield on 10-year bonds will nevertheless not exceed 2.20 per cent two years from now**. Our forecast also implies that the spread against the US and the UK will narrow over time. In light of macroeconomic conditions, it is reasonable for Swedish 10-year yields to move towards a level somewhere in between those in Germany and the US.

Further krona depreciation in the near term

Since the first half of 2013, the krona has weakened in competitor-weighted terms. The main driving force has been larger monetary policy easing in Sweden than elsewhere. Due to somewhat more dovish signals about future monetary policy and uncertainty about the parliamentary situation and the shape of fiscal policy, the krona will probably weaken over **the next six months, with the EUR/SEK exchange rate reaching around 9.35-9.40**. But further ahead, the gap between Swedish and euro zone growth rates, reflected in monetary policy, should lead to a krona recovery. The **EUR/SEK rate is expected to reach 8.80 by the end of 2016**. The krona will probably be somewhat weaker than today against the dollar at the end of our forecast period, but due to the large weight of the euro in the exchange rate index, in competitor-weighted terms the krona will still be 3 per cent stronger than today.

Political deadlock = neutral fiscal policy

The red-green (Social Democratic-Green Party) minority government will probably get its budget through Parliament, supported by the Left Party, **but adjustments will probably be pushed through by the opposition in committees**. The government is shifting the direction of economic policy, for example by raising taxes and increased social insurance benefits. **Further along during the current four-year Parliament**, once the parties in the former Alliance non-socialist government have had time to re-assess their political strategies, **broader parliamentary agreements may be considered**. A government re-shuffle at some point cannot be ruled out, and political uncertainty will be greater than normal in an environment where the traditional non-socialist and red-green blocs both refuse to work together with the right-wing populist Sweden Democrats, who hold the balance of power.

Public finances

Per cent of GDP

	2013	2014	2015	2016
Net lending	-1.2	-1.5	-0.9	-0.2
Gen. gov't gross debt	38.6	39.7	39.0	37.7
Central gov't debt*	33.8	34.9	34.3	33.0
Borrowing req., SEK bn	131	45	20	-15

* Unconsolidated Source: Statistics Sweden, SEB

Public finances have recently been better than expected. When growth is driven by highly taxed parts of the economy, such as employment and consumption, upside surprises are not unusual. Yet the finance minister has announced that the government has **no ambition to achieve the official target of a fiscal surplus of 1 per cent of GDP by the end of its current term in 2018**. Such an easing of fiscal policy seems reasonable in light of relatively low resource utilisation and because conventional monetary policy has reached its limit, but the disappearance of this budget policy anchor may eventually create problems for the finance minister. Spending pressures are likely to increase in a number of policy areas, such as migration, sick pay, schools, health care and defence.

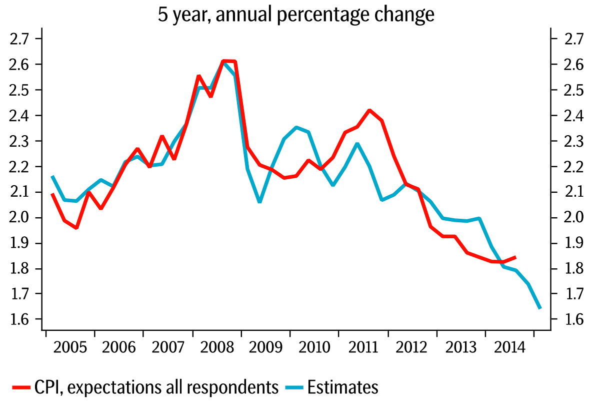
Theme: Inflation expectations will fall further

- **5-year expectations remain close to target...**
- **But our model indicates a further decline**
- **A long period of low inflation will increase the risk of behavioural changes**

Low inflation in recent years has gradually pushed down inflation expectations, especially short-term ones. October's household CPI expectations 12 months ahead, for example, were 0.4 per cent – after record lows several months earlier. According to a Riksbank study conducted by Prospera, money markets show falling 1- to 2-year CPI expectations, now on a par with the lowest figures around the year 2000. **But 5-year expectations were unchanged at 1.8 per cent**.

Falling inflation expectations

5 year, annual percentage change



Source: Prospera, SEB

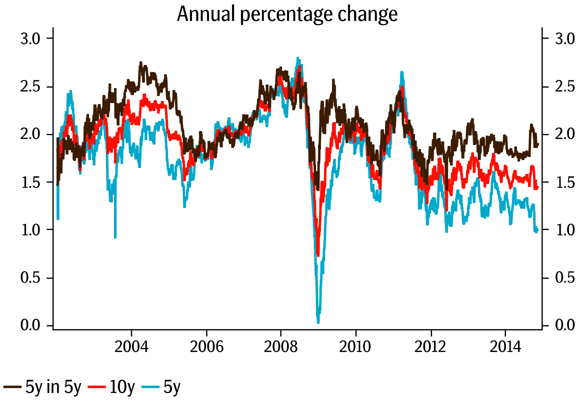
To the Riksbank, the most important thing is stable long-term confidence in its 2 per cent inflation target, since it is possible to argue that short-term expectations are strongly influenced by current inflation. We have produced model estimates for inflation expectations, which indicate that 5-year expectations are also falling and that the Riksbank's December measurement **will show a decline towards 1.6 per cent**.

Other indications are also interesting. "Break-even" inflation – the difference between yield on nominal and index-linked bonds – shows that the market expects CPI to rise by an annual average of 1.0 per cent in the next five years and 1.5 per cent in the next 10 years. Yet implicit expected inflation during the period 5-10 years ahead, which the US Federal Reserve sees as an important indication, is still 1.9 per cent. It is possible to argue that this measure should be a bit higher than 2 per cent, taking into account that those who buy protection against inflation should reasonably pay a risk premium.

Another aspect of credibility is that public sector forecasters, such as the government and the National Institute of Economic Research (NIER), now estimate that inflation will reach the Riksbank's target only in 2018. **The question is how, in the wage formation process, employer and employee organisations will act in such a situation**. Will they reach collective agreements at a lower level, taking into account that real wage and salary increases will remain high based on price forecasts issued by the government and NIER, or will they instead proclaim their full confidence in the Riksbank's inflation target, despite the long period of low inflation?

Break-even inflation

Annual percentage change

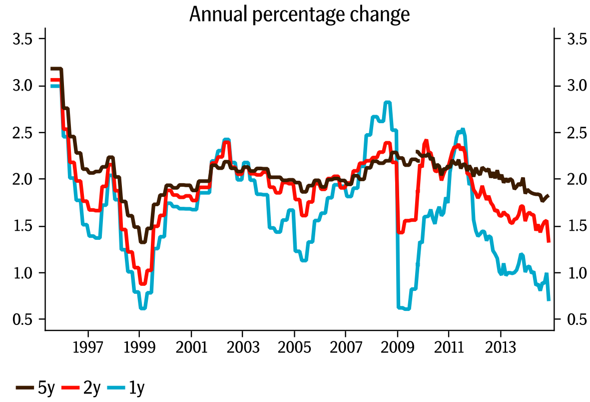


Source: Bloomberg, SEB

Today's situation is not unique; historically, we have seen periods when expectations diverged even more from the target. But with short-term expectations having unilaterally remained below target for years and a continued downward trend, there is a risk that the decisions of economic actors will begin to be affected. The IMF has also shown that during the 1990s the Bank of Japan relied excessively on stable 5-year expectations and underestimated the damage from persistently low short-term expectations. Martin Flodén is one member of the Riksbank's Executive Board who has picked up that thread, emphasising that short-term expectations may be just as important as long-term ones. Our estimates that 5-year expectations are also falling indicate that **the Executive Board's worries will grow larger in the next few months**.

Money market inflation expectations

Annual percentage change



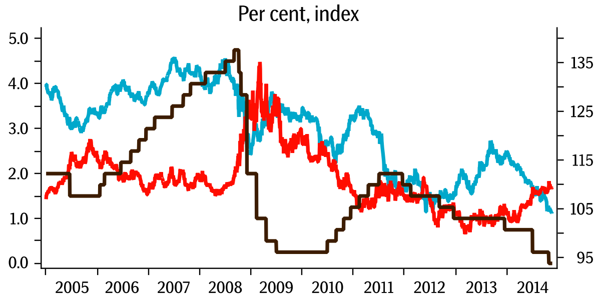
Source: Prospera

- **Focus on inflation expectations and krona**
- **Heightened preparedness for new tools**
- **Government securities purchases after lowering rate path**
- **Currency interventions very unlikely**

In a short time, the Riksbank has cut its key rate from an already low 0.75 per cent to a **record-low 0.00 per cent**. The real repo rate has also fallen, since inflation expectations (according to Prospera and others) have not fallen as fast as the bank has cut its key rate. These cuts have occurred despite **faster household credit growth** (5.7 per cent year-on-year in September), **rising home prices** and **strong job growth**.

More dovish Riksbank policy means weaker krona

Per cent, index



Source: Macrobond

Riksbank defends its inflation target

The Riksbank's actions confirm that its 2 per cent inflation target is now the main focus of its monetary policy. Several interrelated factors have helped exhaust the Riksbank's conventional monetary policy toolkit (the key interest rate):

- Inflation has repeatedly provided downside surprises, **increasing the risk of falling inflation expectations**.
- **Growth risks** have risen, due to weak performance in Europe and Asia plus increased nearby geopolitical risks.
- **New ECB stimulus measures**, including low and negative key rates and renewed balance sheet expansion, risk pushing up the krona exchange rate against the euro.
- **Macroprudential supervision** has become more well-defined since 2013, although the Riksbank is not entirely satsfied with the situation.
- **Criticism** of the Riksbank has become increasingly vocal, not only in Sweden but also in international contexts.

The Riksbank's **Executive Board was unanimous** in late October when it voted to cut the repo rate to 0 per cent. This means that Governor Stefan Ingves and First Deputy Governor Kerstin af Jochnick supported this decision, after having advocated a more cautious interest rate strategy due to the risk of driving up home prices and household debt.

Change in allocation of responsibility

According to the Riksbank Act, the Riksbank shall use its monetary policy instruments not only to **ensure a safe and efficient payment mechanism** but also **maintain price stability**, which the Riksbank has operationally defined as meaning consumer price index (CPI) inflation of 2 per cent. These policies are to be applied in such a way as to "*support the objectives of general economic policy with a view to achieving sustainable growth and high employment*".

For years, Swedish interest rates have hardly been an obstacle to economic growth and higher employment. Various studies (such as the Deloitte/SEB CFO Survey) indicate that business investments are mainly hampered by weak international demand, global overcapacity and heightened geopolitical uncertainty. Yet the Riksbank's **zero interest rate accentuates the question of how responsibility for economic policy is allocated**. It will now be primarily the government's task to stimulate growth and employment via fiscal policy. According to decisions made in 2013, the main responsibility for the new macroprudential system will rest with the government and its Financial Supervisory Authority. This has largely relieved monetary policy makers from responsibility for imbalances connected to excessively high home prices and household debt. Although the Riksbank is still responsible for financial stability, it is clear that in the coming years the bank will focus its monetary policy mainly on defending the credibility of its inflation target, instead trying to persuade other actors to take steps to reduce threats to financial stability as part of macroprudential and fiscal policy.

Unconventional monetary policy choices

The Riksbank faces a rather difficult task, now that it must ensure the credibility of its inflation target. Low inflation is a largely global phenomenon. Greater competition and mobility are squeezing both wages and the ability of companies to raise prices. In this environment, the Riksbank mainly seems to prefer acting via two channels to eventually push up inflation:

1. Ensure **well-founded inflation expectations** at the 2 per cent target rate, thereby preventing expectations from reaching such low levels that they affect wage formation and hamper consumption and capital spending;

2. Pursue a policy that helps **keep the krona weak** compared to other currencies, thereby stimulating exports and ensuring that imported inflation will not fall.

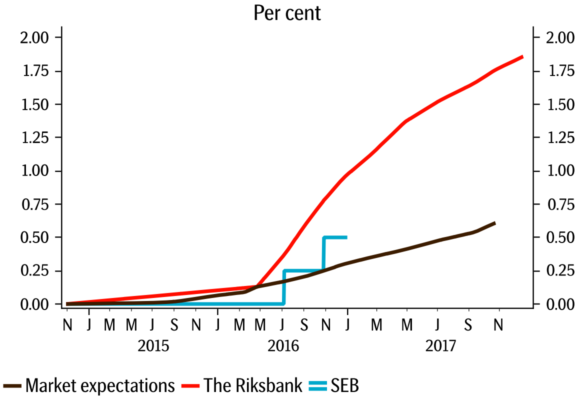
These ambitions will determine the **choice of tools** if the Riksbank proceeds with unconventional monetary policy measures. Here are various policy tools and their objectives:

Instrument	Expected/desired effect
Direct lending	**Liquidity effect** and better **credit supply**.
Negative interest rate	Help bring about greater **bank lending** to the private sector as well as **weaken the currency**.
Purchases of domestic securities (government, mortgage-backed or corporate debt securities)	Create a **re-allocation** of private sector securities portfolios that boosts lending capacity and/or has an impact on prices of securities (lower yields and generally rising asset prices). This measure also has a signalling value, i.e. that interest rates will remain low for a long time, which may also affect the currency and inflation expectations. These purchases are expected to be **unsterilised** (newly created liquidity is not tied up in the central bank's balance sheet through various "draining operations").
Purchases of foreign securities	I.e. **currency interventions** whose main purpose is to influence the exchange rate. Purchases are expected to be **unsterilised** (see above).

Unlike the euro zone, Sweden has no problem with **credit fragmentation between countries and sectors**; both household and business lending works satisfactorily. The **liquidity** supply is also very good and the "smoothness" of the financial system is illustrated, for example, by the M3 money supply, which is growing by nearly 6 per cent (September). Unlike the euro zone, and the UK and US earlier, there is no need to relieve the private sector of interest rate or credit risk in order to push down **interest rates** for households and businesses.

Repo rate expectations

Per cent



Source: Riksbank, Bloomberg, SEB

Government bonds – if the need arises...

But before the Riksbank takes steps to let its balance sheet grow, the bank will probably **lower its repo rate forecast**. Today the Riksbank says it will begin raising the repo rate in mid-2016 and that by the autumn of 2017 this rate will be nearly 2 per cent. Lowering this rate path, if perceived as credible, may push the krona down to weaker levels and raise inflation expectations somewhat, but in practice a lowering of the rate path merely implies that the Riksbank is adjusting its forecast to what the market is already expecting. Its signalling value would be stronger if the Riksbank, more explicitly than so far, issues a **"pledge" not to raise its key rate until inflation reliably exceeds 1.5 per cent**, as Deputy Governor Per Jansson has suggested. This would link the bank's key rate more closely to inflation and the 2 per cent target.

If the Riksbank takes further unconventional monetary policy steps, it is likely to **choose purchases of government bonds with 3-5 year maturities**; shorter maturities allow an easier phase-out process when the need arises. We estimate that the volume may be around **SEK 50 billion**. This is equivalent to a 10 per cent expansion of the Riksbank's balance sheet and 8.5 per cent of the outstanding total of government bonds. Such purchases would probably occur in several rounds. As needed, if there is too large a shortage of bonds, it is **possible for the National Debt Office to increase the supply of bonds** beyond the actual central government borrowing requirement and to deposit any liquidity surplus in the banking system. Since the government bond market is the backbone of the fixed income market, yields on both mortgage-backed and corporate bonds would probably be pushed down. The supply of mortgage-backed bonds is larger than the sum of government bonds outstanding, but any purchases by the Riksbank would create difficult pedagogical challenges if the bank is meanwhile propagating for macroprudential action to reduce household debt and slow the increase in home prices.

FX purchases presuppose a severe crisis

If successful, purchases of foreign securities – **currency interventions** aimed at weakening the krona – stimulate exports and lead to higher imported inflation (if Swedish importers choose to pass the cost onward to consumers). It is a highly effective tool, but there is a low probability that the Riksbank will resort to such action, for the following reasons:

1. Today the krona is about 10 per cent **undervalued** against the euro. Given a current account surplus of 6 per cent of GDP, it will be **difficult to gain international support for such action**, especially in a situation where future Swedish growth is likely to be relatively high (according to consensus forecasts), while employment is increasing rather fast.
2. Sweden is **not facing a structural influx** of capital in the way that "safe haven" Switzerland did during the euro crisis. There is thus not the same need for the Riksbank to respond to capital inflows and increase its currency reserve.
3. Introducing an exchange rate floor as Switzerland did increases the risk that **questions will begin to be raised about Sweden's monetary policy regime, with an inflation target and a floating exchange rate**.

A negative key rate is another effective tool for weakening a currency, but earlier Riksbank experiences show that it may cause problems in the interbank system. This offsets any benefits that may arise from a weaker krona.

Overall, our review shows that the Riksbank still has some room to **make its monetary policy more expansionary** by **lowering its rate path** by up to two percentage points. After that, **government bond purchases** appear to be the best signalling instrument for bringing inflation expectations as close to the 2 per cent target as possible and ensuring that the krona will remain undervalued.

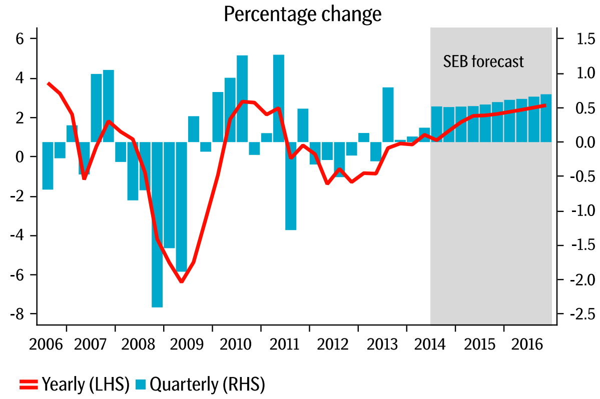
Europe the wild card for growth

- **Growth on track but risks are increasing**
- **Fiscal stance easier in 2015**
- **Strong krone like to trigger key rate cut**

Weak second quarter **GDP growth** has led us to lower our estimated increases to **1 per cent in 2014** and **2 per cent in 2015** since the last *Nordic Outlook*, with **2016** unchanged at **2.5 per cent**. Growth has been on a smoothly but slowly rising trajectory in the past three quarters. While we still expect growth to reach 2.5 per cent by the end of our forecast period, divergent trends in domestic and external sectors pose both upside and downside risks, especially for this and next year. Should the effects of geopolitics more quickly than expected lose their grip on European manufacturing, stronger internal drivers could push Danish growth above current expectations. If the Russia-Ukraine conflict instead escalates, sanctions are tightened or the weakness resulting from uncertainty spreads to service sectors in the euro zone and/or Denmark, we would need to moderate our forecasts.

Growth expected to firm

Percentage change



Source: Statistics Denmark, SEB

Our euro zone forecast sees sluggish growth, with risks mostly on the downside. In the past 6 months, there has been a visible slowdown in German industrial production and manufacturing confidence. When Denmark's most important trading partner slows down, this normally impacts the country's manufacturers. We also saw a steep drop in the Danish Industrial Tendency Survey, now at its lowest since 2009.

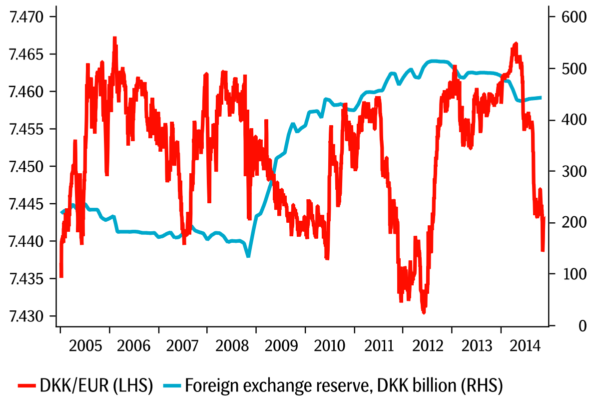
But the latest couple of observations show a firming trend for the total service sector survey, reaching a three-year high. Industrial worries so far have not spilled into the broader economy, so consumer confidence is still close to the summer's multi-year peak and unemployment was flat over the summer. We expect optimism, firming home prices, and improving employment to drive stronger consumption, but for now the economy seems to be in a holding pattern, awaiting a clearer direction for European growth. Weak wage increases and stubbornly low inflation, although partly due to positive supply shocks, also constitute risks for consumption.

A final positive driver is fiscal policy. Negotiations on the budget have just been finalised. With an election scheduled for next year, the ruling parties are using their last chance to offer the electorate a bone. Denmark's fiscal stance in 2015 is going to be looser than in recent years. In its own view, the government will exploit the flexibility in the EU Stability and Growth Pact almost to its limits. This includes prolonging into 2015 a temporary offer to reduce pension taxes if they are paid up front, thereby generating fiscal manoeuvring room. Overall, this could deliver a moderate boost to growth.

The ECB's aggressive stimulus plans create an interesting situation for the normally staid Danish krone. The EUR/DKK rate dipped below 7.44 in early November, and although it has recovered a little it remains at the strong end of its range.

If the krone continues to strengthen, pressure will eventually build for a key interest rate cut to narrow the spread between Danmarks Nationalbank (DNB) and the ECB. However, at first we think the DNB will accommodate currency inflows by expanding the foreign exchange reserve, which has been edging higher since spring. Part of the reason is that euro covered bond spreads have been reduced by the prospect of ECB purchases, while the DNB has no plans to buy Danish mortgage bonds. Spreads thus have not moved so much. This could lead to a period of capital inflows until spreads have aligned. An accommodative stance could be the DNB's easiest way to adjust to ECB quantitative easing.

Krone demand raises FX reserve



Source: Macrobond

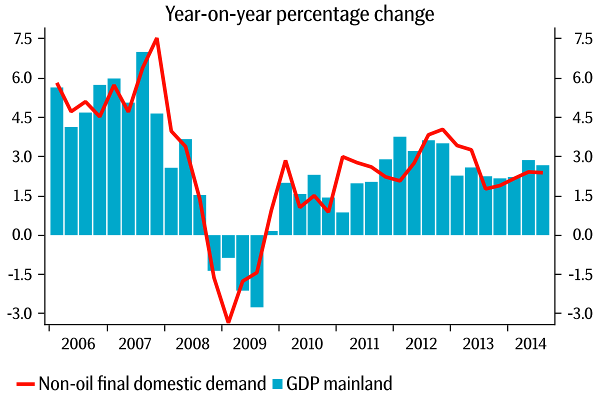
Growth set to slow below trend in 2015

- **A marked drag from lower oil sector investment will slow the economy in 2015**
- **Core inflation has continued to run at target**
- **Norges Bank on hold well into 2016**

Momentum in the Norwegian economy held up during the summer, although various indicators have been a bit mixed. Sequential growth in mainland GDP – excluding oil/gas and shipping – slowed in the third quarter after a very strong spurt in Q2, but the year-on-year rate was still an above-trend 2.7 per cent. Yet the Labour Force Survey showed employment growth stalling in Q3. While private consumption growth came to an abrupt halt in Q3, existing home prices continued to trend higher, suggesting that consumers remain comfortable.

Mainland GDP running at an above-trend rate

Year-on-year percentage change



Source:Statistics Norway

Mainland GDP should gain 2.6 per cent in 2014 but **slow to 2.1 per cent in 2015 before picking up to 2.4 per cent in 2016**. **Overall GDP growth will be 1.2 per cent next year but accelerate to 1.9 per cent in 2016**. Our forecasts for the next couple of years have been revised lower from August.

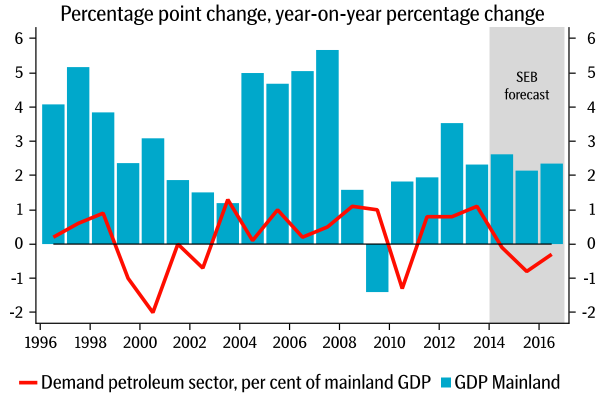
Adjusting to the new normal

The extent of the downshifting capital spending cycle in the oil sector is a key uncertainty in our outlook. On top of cutbacks already announced, which are partly cyclical and partly based on cost savings to improve cash flow, sharply lower oil prices might negatively impact the outlook from 2016 onward. We have cut our forecasts further, expecting **such investment to drop 12.1 per cent in 2015 and a further 3.5 per cent in 2016**.

For next year, our calculation suggests that the decline will slow annual growth in mainland GDP by ¾ of a percentage point. The effect might be slightly more, since investment with a lower import share should see the sharpest drop, while the estimate is uncertain due to potential secondary effects. But factors working in the other direction include a weaker NOK exchange rate helping exports on non-petroleum goods.

Oil sector investment to dent, not crunch growth

Percentage point change, year-on-year percentage change



Source: Statistics Norway, SEB

It should be emphasised that investments on the Norwegian continental shelf will remain substantial for years. First, capital spending at fields on stream (half the total) is necessary just to maintain output and increase recovery rates as fields mature. Second, fields sanctioned by partners and under development will be finalised despite the drop in oil prices. The largest one is the vast Johan Sverdrup field, with investments estimated at NOK 100-120 bn in the first phase from 2015 until production starts in late 2019. Moreover, developments at a number of smaller projects, each with investments in the NOK 10-20 bn range, might start in 2015-18. However, marginal fields and discoveries not yet sanctioned could be put on hold if persistent low oil prices make them unattractive to develop.

Manufacturing might slow in the near term

Manufacturing output held up surprisingly well over summer despite downshifting investment in the petroleum sector. Production thus increased 1.1 per cent in the third quarter, almost the same as in the two previous ones, to be up a solid 3.3 per cent year-on-year. However, a steep drop in September, while tentative, suggests weakness ahead.

Such a development would be in line with the most recent manufacturing Business Tendency Survey, showing confidence in the sector sliding to its lowest since spring 2012 and the level consistent with stalling production year-on-year. In particular, incoming orders reportedly turned softer and dragged production expectations to a five-year low.

Unsurprisingly, most of the reported weakness centres on the investment goods sector – where confidence has nose-dived to a level not seen since 2010, the last time oil sector investment was declining. In contrast, sentiment eased only modestly in the intermediate goods and consumer goods sectors, reflecting still-healthy actual demand and orders expectations holding above historical averages.

Unemployment to creep higher in 2015

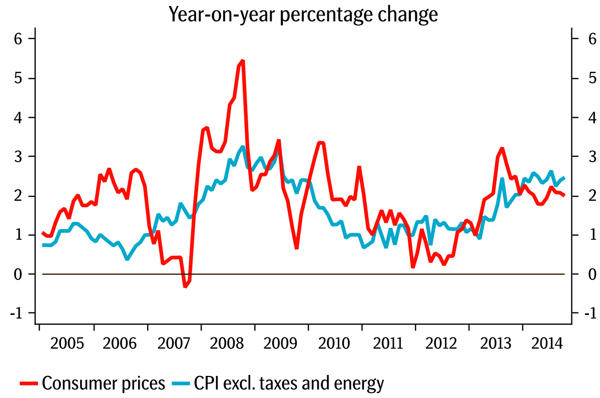
The Labour Force Survey turned weaker in Q3 as employment stalled and the jobless rate rose from 3.2 per cent in Q2 to 3.5 per cent. The extent of the deterioration looks exaggerated, as the survey is sometimes erratic. The 0.6 per cent upturn in LFS employment over the past two quarters is more indicative of the trend: hence, employment using the National Accounts measure has held up better (with sustained growth in the private sector). Registered unemployment – a more reliable gauge – has also risen only moderately so far in 2014 and has actually declined if we include those in labour market programmes. That said, assuming increasing lay-offs in oil and related sectors, **we expect average LFS unemployment to increase from 3.5 per cent in 2014 to 3.8 per cent in 2015.**

Core inflation stays surprisingly firm

Core CPI excluding energy and taxes has been choppy since last winter. In line with this pattern, the annual rate lifted from 2.2 per cent in August to 2.5 per cent in October, while the year-to-date average of 2.4 per cent is right at the medium-term target. Overall CPI inflation eased to 2.0 per cent in October, pushed down by lower energy prices.

Core inflation running at target

Year-on-year percentage change



Source: Statistics Norway

Core domestic inflation has been rather steady in recent months as slower rent inflation and some moderation for domestically-produced goods has been countered by slightly higher services inflation. Part of the latter reflects volatile airfares which might moderate going forward. At the same time, it is questionable whether the 1.3 percentage point downshift in annual rent inflation (a fifth of the core CPI basket) over the past year has much further to run. Meanwhile, inflation on imported goods (almost a third of core CPI) might slow in the short term. However, with the normal lag, the recent marked depreciation of the NOK on an import-weighted basis might keep such prices higher than previously expected. Annual core inflation should **slow from 2.4 per cent in 2014 to 2.0 per cent in 2015 and pick up to 2.2 per cent in 2016**.

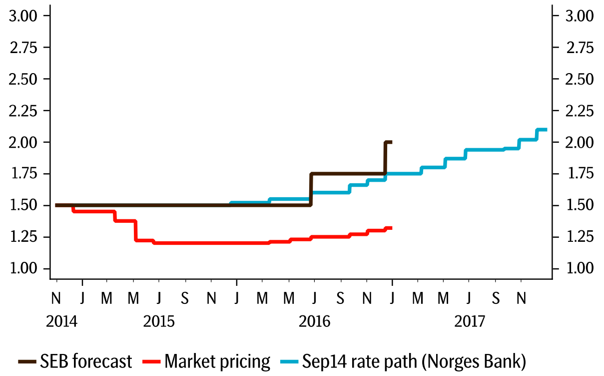
Norges Bank retakes a dovish bias

Norges Bank's September Monetary Report *de facto* closed the door for a rate cut, but the recent plunge in oil prices and lower interest rates abroad have fuelled expectations of more stimulus. We regard expectations for a rate cut before year-end as too aggressive. Uncertainty has increased but is hardly sufficient to justify aggressive action when, as recently as September, the bank expected mainland GDP and core CPI to be up 2¼ per cent in 2015. Instead, the bank's rate path is expected to be lowered at the December 11 policy meeting.

While acknowledging greater uncertainty, we still think Norges Bank will refrain from lowering rates. Existing home prices have reaccelerated and inflation is projected to hold close to target, despite somewhat higher unemployment next year. Such an environment does not call for more monetary stimulus. Nonetheless, it suggests Norges Bank will stay put for longer than previously assumed. We now expect a **first rate hike in June 2016 and a key rate of 2.00 per cent by end-2016.**

Expectations for Norges Bank

Per cent



Source: Norges Bank, SEB

However, since Norges Bank has historically been cautious in periods of heightened uncertainty, we expect it to **retake a dovish bias, signalling a willingness to cut the key rate if downside risks to growth materialise**. In that case, the rate is likely to be lowered sooner rather than later next year.

Increased market expectations of a rate cut from Norges Bank early next year and the sharp drop in oil prices have weighed on the NOK. We see little near-term support for the krone but remain positive on the long-term outlook as we expect Norges Bank to remain on hold, oil prices to stabilise and the flow outlook to be positive. **We forecast a EUR/NOK exchange rate of 8.30 and 7.95 by mid-2015 and end-2016, respectively**. We regard Norwegian government bonds as attractive vs. Germany, despite recent outperformance. Gradually higher yields abroad, a still-low key rate and less gross supply should support a gradual **tightening of the 10-year yield spread vs. Germany to 80 bp by end-2015**.

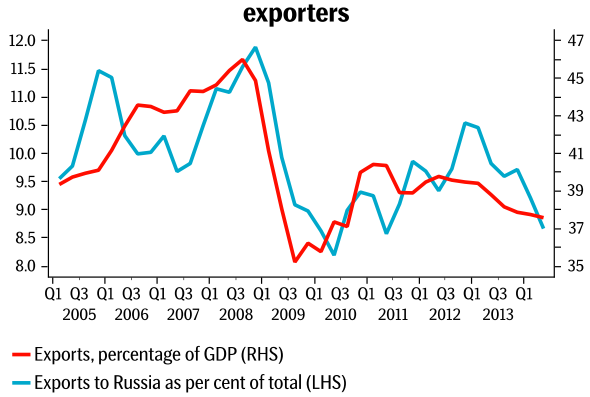
A third consecutive year of falling GDP

- **Broad-based economic weaknesses**
- **Households are cautious, but exports are benefiting from the weaker euro**
- **Continued contractionary fiscal policy**

The Finnish economy is grappling with various weaknesses. GDP is falling for the third straight year and is about 7 per cent below pre-crisis levels. Indicators point to a weak year-end. Looking a bit further ahead, Finland's prospects remain bleak. Structural problems in forest products and information and communications technology (ICT), a large trade exposure to Russia and public austerity are hampering growth. **We expect GDP to fall by 0.3 per cent in 2014 and then rise by only 0.5 per cent in 2015 and 0.9 per cent in 2016**. The risks are also on the downside: the effects of restrictions on trade with Russia may be larger than we expect, while a more marked decline in home prices can greatly impact domestic demand.

Indicators point to a weak outlook. The European Commission's sentiment indicator has recently trended downward, though it showed a slight upturn in October. The manufacturing indicator remains low but has not weakened further. The clearest downturn is instead affecting domestic sectors: service producers have become more negative, while optimism in the construction sector has fallen sharply.

Continued decline in trade with Russia is squeezing exporters



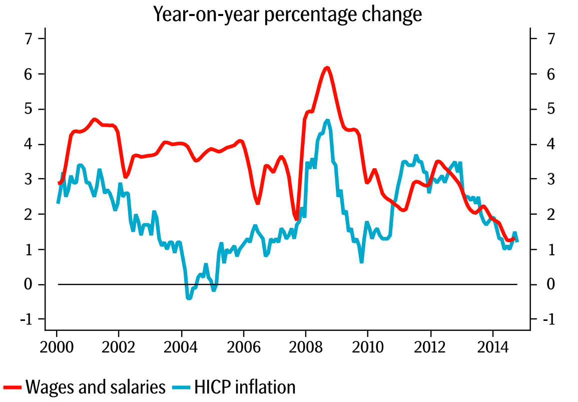
Source: Statistics Finland

Exports have stabilised and are increasing slightly, partly due to the weaker euro. But it is clear that **because of reduced trade with Russia, strong export-driven growth will be delayed**. The downturn in exports to Russia is now being reinforced by Russian import restrictions but has been under way for years, due to slow growth in Russia. For example, Finland's food exports fell 17 per cent year-on-year in August: a clear consequence of import restrictions on agricultural products, which Russia introduced early that month.

Due to low demand and idle manufacturing capacity, **capital spending remains weak**. Uncertainty about the housing market, combined with weak household income growth, is leading to a decline in residential investments. Total capital spending will fall in 2014 for the third straight year and then increase slowly in 2015 and 2016.

Unchanged real wages

Year-on-year percentage change



Source: Statistics Finland

Despite falling GDP, the jobless rate has declined during 2014. Employment has fallen, but demographic factors have contributed to a shrinking labour supply. Next year, slowly improving growth will stabilise employment. The number of job vacancies is high, given high unemployment. This may indicate matching problems in the labour market. **Inflation is above the euro zone average** but will fall as lower pay increases and recent international declines in food and energy prices impact Finland. Household confidence has deteriorated sharply, as evidenced by falling consumption. The rate of pay increases has decelerated and is now in line with inflation, meaning that real wages are largely unchanged. Consumption will increase only slightly, and the household savings ratio will fall in 2014-2016.

Because of the 2015 parliamentary election, no changes in fiscal policy are likely in the near term. Fiscal tightening will continue, despite stimulus needs. Due to weak economic growth, **government net lending will only improve marginally in spite of cost-cutting; the deficit will shrink from 2.2 per cent of GDP to 1.8 per cent in 2016**. Citing worries about the financial position of the public sector, Standard & Poor's lowered Finland's credit rating earlier this year. Yet investors remain confident in the economy, and the sovereign yield spread to Germany has narrowed during 2014.

GLOBAL KEY INDICATORS

Yearly change in per cent

	2013	2014	2015	2016
GDP OECD	1.4	1.9	2.4	2.4
GDP world (PPP)	3.3	3.5	3.8	3.9
CPI OECD	1.6	1.7	1.1	1.7
Export market OECD	2.7	3.6	5.1	4.8
Oil price. Brent (USD/barrel)	108.7	101.0	85.0	85.0

USA

Yearly change in per cent

	2013 level, USD bn	2013	2014	2015	2016
Gross domestic product	17,078	2.2	2.3	3.4	3.1
Private consumption	11,653	2.4	2.3	3.0	2.6
Public consumption	3,143	-2.0	-0.1	0.5	0.0
Gross fixed investment	2,395	4.7	5.2	8.0	8.4
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	2,325	3.0	3.7	6.1	6.1
Imports	2,788	1.1	3.6	5.2	5.7
Unemployment (%)		7.4	6.2	5.4	4.9
Consumer prices		1.5	1.7	1.0	2.3
Household savings ratio (%)		4.9	5.3	5.9	6.3

EURO ZONE

Yearly change in per cent

	2013 level, EUR bn	2013	2014	2015	2016
Gross domestic product	9,881	-0.5	0.9	0.9	1.3
Private consumption	5,537	-0.7	0.5	0.6	1.0
Public consumption	2,086	0.2	0.3	0.3	0.4
Gross fixed investment	1,936	-2.4	1.2	1.4	2.0
Stock building (change as % of GDP)		-0.1	0.0	0.0	0.0
Exports	4,312	2.0	2.8	3.0	4.2
Imports	3,971	1.2	2.3	2.8	4.0
Unemployment (%)		12.0	11.6	11.3	11.1
Consumer prices		1.4	0.5	0.5	1.0
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	2.5
Japan	1.5	0.4	0.9	1.1
Germany	0.1	1.3	1.2	1.6
France	0.4	0.4	0.5	0.9
Italy	-1.9	-0.3	0.3	0.8
China	7.7	7.4	7.0	6.7
India	4.7	5.4	5.8	6.2
Inflation				
United Kingdom	2.6	1.5	1.0	1.5
Japan	0.4	2.8	1.2	0.8
Germany	1.2	0.9	1.4	1.7
France	0.8	0.7	0.2	0.2
Italy	1.3	0.2	0.0	0.0
China	2.6	2.5	2.0	2.5
India	10.1	7.3	6.5	6.0
Unemployment, (%)				
United Kingdom	7.8	6.4	5.8	5.3
Japan	4.0	3.6	3.5	3.4
Germany	5.3	5.1	5.0	4.9
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	1.6	1.7	1.8	2.8
Latvia	4.2	2.5	2.7	3.4
Lithuania	3.1	2.7	3.2	4.0
Poland	1.6	3.1	3.2	3.5
Russia	1.3	0.7	-0.2	1.0
Ukraine	0.0	-5.0	-2.0	2.0
Inflation, yearly change in per cent				
Estonia	2.8	0.1	1.6	1.9
Latvia	0.0	0.7	2.1	2.1
Lithuania	1.2	0.2	1.0	1.5
Poland	0.8	0.0	1.3	2.0
Russia	6.8	7.7	6.7	5.7
Ukraine	-0.3	11.5	10.5	7.0

FINANCIAL FORECASTS

		Nov 20th	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
Official interest rates							
US	Fed funds	0.25	0.25	0.25	1.00	1.75	2.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.05	0.05	0.05	0.05	0.05	0.05
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.75	1.25
Bond yields							
US	10 years	2.34	2.35	2.45	2.90	3.05	3.20
Japan	10 years	0.47	0.50	0.50	0.55	0.60	0.65
Germany	10 years	0.80	0.70	0.90	1.20	1.35	1.50
United Kingdom	10 years	2.11	2.00	2.30	2.80	3.05	3.30
Exchange rate							
USD/JPY		116	118	125	130	135	140
EUR/USD		1.25	1.23	1.18	1.16	1.14	1.13
EUR/JPY		145	145	148	151	154	158
GBP/USD		1.56	1.52	1.49	1.51	1.50	1.51
EUR/GBP		0.80	0.81	0.79	0.77	0.76	0.75

SWEDEN

Yearly change in per cent

	2013 level, SEK bn	2013	2014	2015	2016
Gross domestic product	3,776	1.5	2.1	2.7	2.7
Gross domestic product, working day adjustment		1.5	2.2	2.5	2.5
Private consumption	1,764	2.1	2.7	3.0	2.7
Public consumption	990	2.0	0.8	0.8	0.8
Gross fixed investment	836	-0.1	4.5	4.5	5.5
Stock building (change as % of GDP)		0.0	0.1	0.1	0.1
Exports	1,653	-0.5	2.1	3.4	4.9
Imports	1,461	-0.8	3.5	3.7	5.4
Unemployment (%)		8.0	8.0	7.6	7.2
Employment		1.1	1.4	1.3	1.0
Industrial production		-4.0	-2.0	2.5	3.0
CPI		0.0	-0.2	0.3	1.5
CPIF		0.9	0.5	1.0	1.5
Hourly wage increases		2.6	2.7	2.8	3.5
Household savings ratio (%)		15.3	15.6	15.3	14.4
Real disposable income		2.1	3.0	2.8	1.9
Trade balance, % of GDP		1.4	1.0	0.5	0.7
Current account, % av GDP		6.6	6.0	5.5	5.3
Central government borrowing, SEK bn		131	45	20	-15
Public sector financial balance, % of GDP		-1.2	-1.5	-0.9	-0.2
Public sector debt, % of GDP		38.6	39.7	39.0	37.7

FINANCIAL FORECASTS	Nov 20th	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
Repo rate	0.00	0.00	0.00	0.00	0.00	0.50
3-month interest rate, STIBOR	0.27	0.30	0.35	0.35	0.35	0.85
10-year bond yield	1.13	0.95	1.10	1.50	1.90	2.20
10-year spread to Germany, bp	33	25	20	30	55	70
USD/SEK	7.43	7.60	7.80	7.76	7.81	7.79
EUR/SEK	9.25	9.35	9.20	9.00	8.90	8.80
TCW	125.7	127.0	126.0	123.9	122.9	121.8
KIX	109.3	110.4	109.6	107.8	106.9	105.9

NORWAY

Yearly change in per cent

	2013 level, NOK bn	2013	2014	2015	2016
Gross domestic product	2,987	0.7	2.1	1.2	1.9
Gross domestic product (Mainland)	2,347	2.3	2.6	2.1	2.4
Private consumption	1,201	2.1	2.1	2.7	3.0
Public consumption	629	1.7	3.2	2.1	2.0
Gross fixed investment	705	6.8	1.1	-1.8	2.2
Stock building (change as % of GDP)		0.4	0.4	0.0	0.0
Exports	1,169	-3.0	0.4	2.6	2.2
Imports	857	4.3	1.1	3.4	3.8
Unemployment (%)		3.5	3.5	3.8	3.6
CPI		2.1	2.0	1.9	2.1
CPI-ATE		1.6	2.4	2.0	2.2
Annual wage increases		3.9	3.5	3.3	3.5

FINANCIAL FORECASTS	**Nov 20th**	**Dec-14**	**Jun-15**	**Dec-15**	**Jun-16**	**Dec-16**
Deposit rate	1.50	1.50	1.50	1.50	1.75	2.00
10-year bond yield	1.98	1.80	1.90	2.00	2.20	2.35
10-year spread to Germany, bp	118	110	100	80	85	85
USD/NOK	6.78	6.91	7.03	7.03	7.11	7.04
EUR/NOK	8.45	8.50	8.30	8.15	8.10	7.95

DENMARK

Yearly change in per cent

	2013 level, DKK bn	2013	2014	2015	2016
Gross domestic product	1,891	-0.1	1.0	2.0	2.5
Private consumption	894	0.2	0.9	2.3	2.7
Public consumption	524	0.7	1.3	0.9	0.0
Gross fixed investment	321	0.5	2.4	2.4	3.5
Stock building (change as % of GDP)		0.2	-0.1	0.1	0.1
Exports	1,019	1.0	2.4	3.0	4.7
Imports	914	1.4	3.9	3.2	4.2
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	0.8	1.4
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	-1.5	0.0
Public sector debt, % av GDP		44.5	43.5	43.0	41.0

FINANCIAL FORECASTS	**Nov 20th**	**Dec-14**	**Jun-15**	**Dec-15**	**Jun-16**	**Dec-16**
Lending rate	0.20	0.20	0.10	0.10	0.10	0.10
10-year bond yield	0.85	0.75	0.95	1.25	1.40	1.55
10-year spread to Germany, bp	5	5	5	5	5	5
USD/DKK	5.98	6.05	6.31	6.41	6.53	6.58
EUR/DKK	7.44	7.44	7.44	7.44	7.44	7.44

FINLAND

Yearly change in per cent

	2013 level, EUR bn	2013	2014	2015	2016
Gross domestic product	201	-1.2	-0.3	0.5	0.9
Private consumption	111	-0.7	-0.4	0.3	0.5
Public consumption	50	1.5	0.3	0.3	0.5
Gross fixed investment	43	-4.8	-1.2	0.7	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	-0.3	1.3	3.5
Unemployment (%)		8.5	8.5	8.3	8.0
CPI, harmonised		2.2	1.3	1.1	1.1
Hourly wage increases		2.1	1.5	1.5	1.8
Current account, % of GDP		-1.3	-1.4	-1.2	-1.0
Public sector financial balance, % av GDP		-2.4	-2.2	-2.0	-1.8
Public sector debt, % av GDP		57.0	60.0	61.5	62.0

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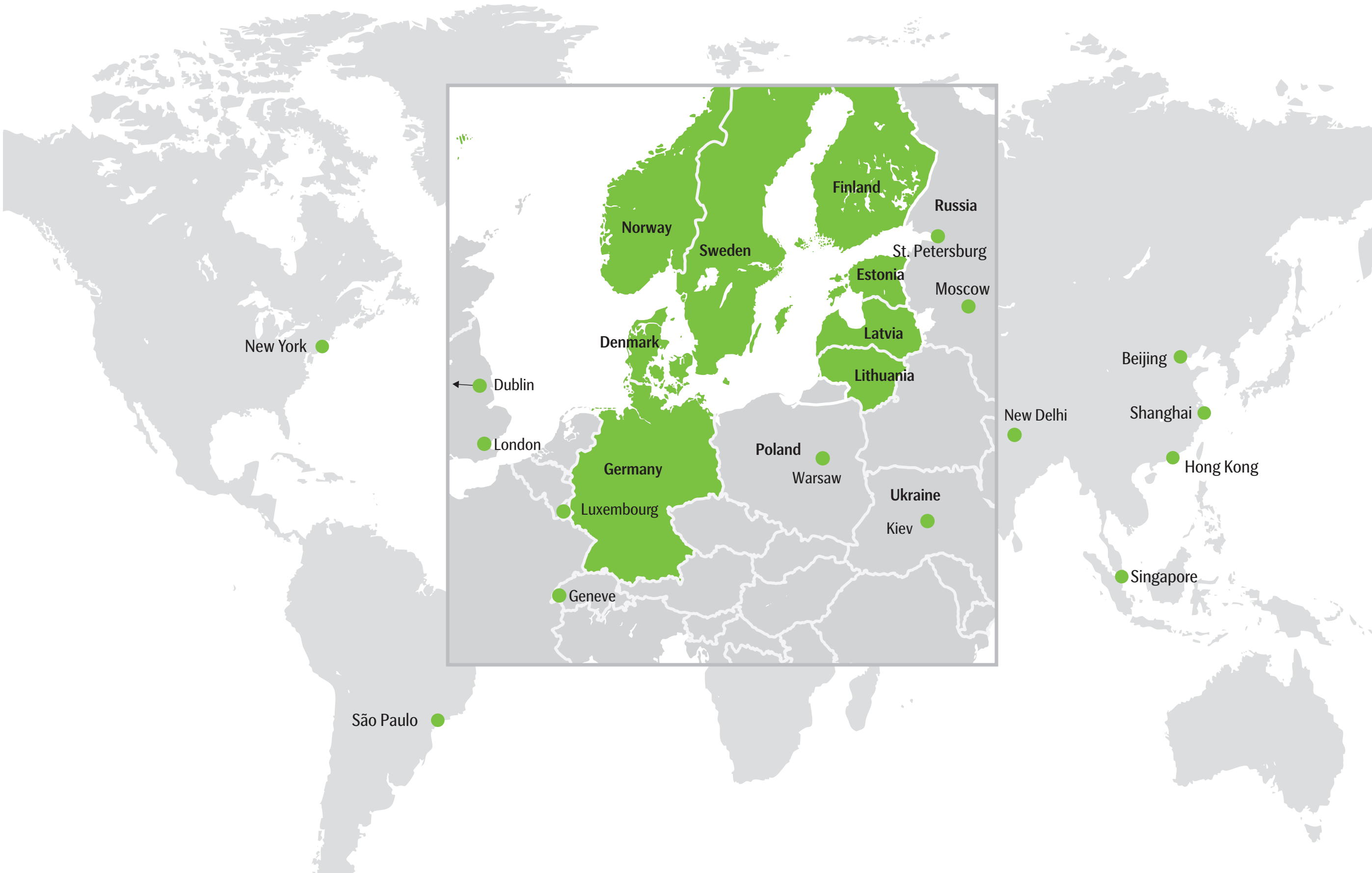

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