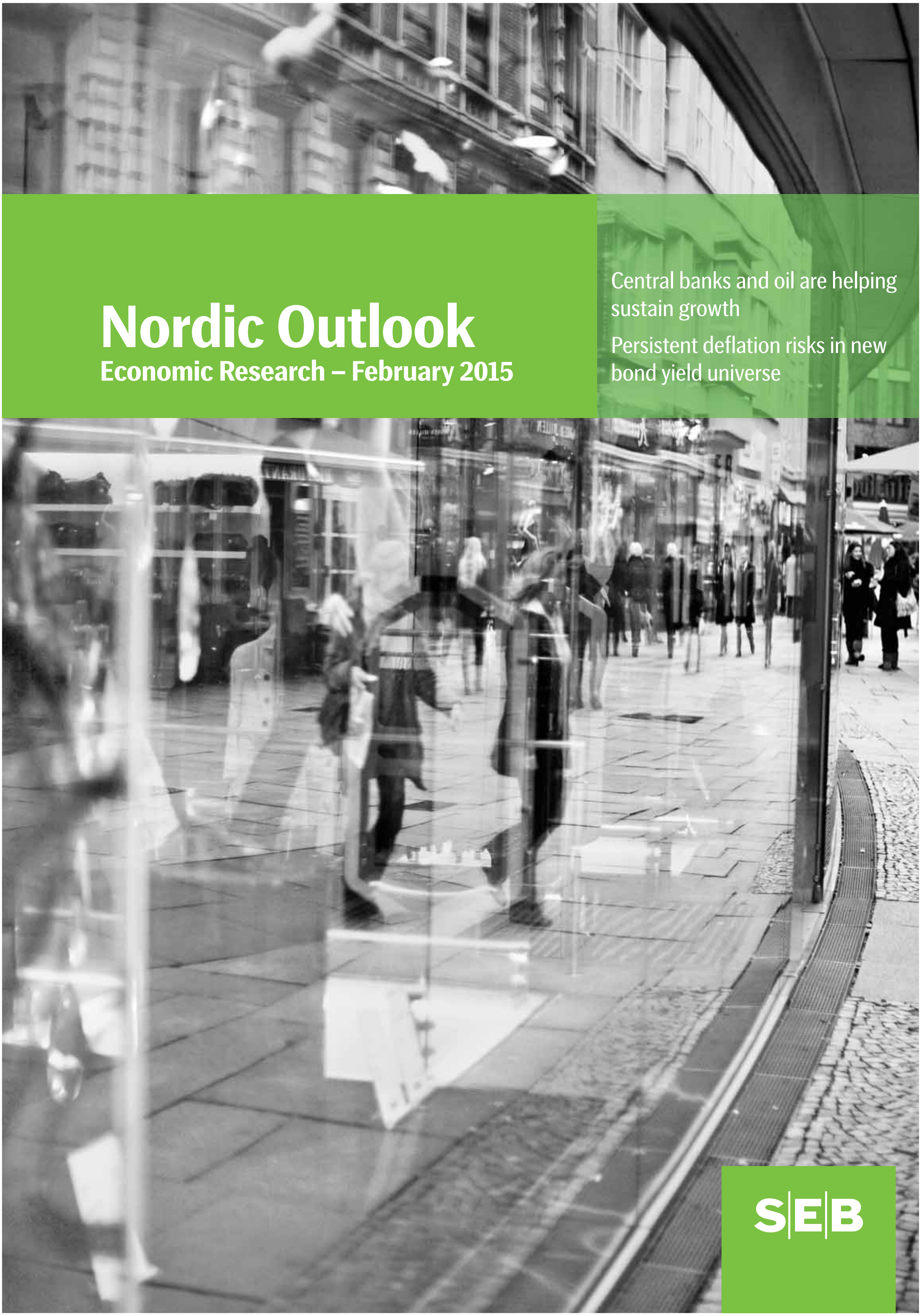

Nordic Outlook

Economic Research – February 2015

Central banks and oil are helping sustain growth

Persistent deflation risks in new bond yield universe

SEB

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Boxes

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Brighter growth outlook, but deflation risks persist

- **Strong US growth a global driving force**
- **Brighter euro zone growth prospects, but increased political tensions**
- **New equilibrium oil price of USD 70/barrel**
- **Fed rate hike in September despite low CPI**
- **EUR/USD will fall gradually towards parity**
- **Negative key rate from Sweden's Riksbank**

In recent months, world economic performance has been mixed. In the **United States**, the recovery has become increasingly apparent even though Gross Domestic Product (GDP) in the fourth quarter of 2014 was a little lower than expected. In **Japan**, there are signs that the US upturn is stimulating exports, but the country's long-term challenges remain unresolved. In Western Europe, the **British** economic upturn has continued, while the situation in the **euro zone** has stabilised. Signals from emerging market (EM) economies have varied a bit. In China, a soft landing is under way roughly as expected; the fourth quarter GDP figure provided an upside surprise. Because of the oil price decline and economic sanctions, the **Russian** economy is headed for a deep recession, and the outlook has also deteriorated in **Brazil**.

Looking ahead, it is clear that global conditions have recently changed in ways that pose new challenges for forecasters. **The slide in crude oil prices has continued**, and although we anticipate a slight rebound in the second half of 2015, prices will remain lower that we have been accustomed to. **The European Central Bank (ECB) has now delivered its long-expected asset purchase (quantitative easing, QE) programme**, which is somewhat more forceful than expected. For example, the ECB pledges to continue purchases until inflation actually rises as it desires. The ECB's QE programme and US economic strength have now led to **significant US dollar appreciation**. There are many indications that this will be **more far-reaching than we previously thought**. The potential for global economic recovery will improve if the US can sustain a stronger dollar without needing to escalate the currency wars that many countries are now fighting.

Altogether, these factors have contributed to a slight upward revision in our growth forecast for the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD). **We now expect GDP to increase by around 2.6 per cent both in 2015 and 2016**, compared to 2.4 per cent annually in our November forecast. But due to deteriorating prospects in Russia and Brazil especially, our downward revision for the EM economies is even larger. We have thus adjusted our global growth forecast a bit lower. We now expect a moderate acceleration **from 3.5 per cent in 2014 to 3.7 per cent in 2015 and 3.9 per cent in 2016**.

Global GDP growth
Year-on-year percentage change

	2013	2014	2015	2016
United States	2.2	2.4	3.5	3.2
Japan	1.6	0.2	1.1	1.1
Germany	0.1	1.5	1.6	2.0
China	7.7	7.4	7.0	6.7
United Kingdom	1.7	2.6	2.8	2.5
Euro zone	-0.5	1.0	1.2	1.7
Nordic countries	0.4	1.6	1.9	2.2
Baltic countries	3.2	2.5	2.4	3.2
OECD	1.4	1.9	2.6	2.6
Emerging markets	4.7	4.8	4.4	5.0
World, PPP*	**3.1**	**3.5**	**3.7**	**3.9**

Source: OECD, SEB * Purchasing power parities

This forecast represents a cautious assessment of the consequences of more expansionary conditions. **The impact of lower oil prices** will be muted, because higher real household incomes in many countries will go towards greater saving and debt consolidation (see theme article). **The effectiveness of exceptional monetary policy stimulus is also still uncertain**, and the debate on whether developed economies are in the midst of long-term (secular) stagnation is still undecided.

The oil price decline is having a clear impact on inflation forecasts and **CPI-inflation in many countries will be negative during 2015**. The effects on core inflation and consequences for the longer-term inflation process are double-edged, however, since a higher level of economic activity also leads to upside inflation impulses. Yet falling inflation expectations indicate risks that deflation pressure will intensify, especially in the euro zone and Japan. We believe that a paralysing deflation process can be avoided, but underlying inflation will remain well below central bank targets, thereby **forcing monetary policy makers to continue prioritising their battle to preserve the credibility of their inflation targets**. Falling inflation expectations and downward revisions in inflation forecasts have contributed to greater uncertainty about whether the US Federal Reserve can deliver the key interest rate hikes it has signalled. But in our assessment, due to rapidly rising resource utilisation in the US economy, the Fed will have good arguments for an eventual inflation upturn. **We thus expect the Fed bank to begin cautious rate hikes after this summer**.

Monetary policy developments will continue to have a decisive impact on various financial markets during 2015 and 2016. We expect bond yields to continue falling a bit before bottoming out in mid-2015. **The US dollar will continue to appreciate against both the euro and the yen in this environment**. Because of somewhat stronger economic growth, combined with a continued exceptionally low interest rate environment, **the medium-term stock market outlook is relatively good**.

While it is reasonable to believe that more expansionary global economic conditions will have an effect on the real economy, various sources of concern remain. The potential threats that are usually discussed can be roughly divided into three categories, which to some extent are interconnected: 1) **Heightened geopolitical uncertainty** in a world where US dominance is no longer self-evident and where various actors, especially Russia and China, are seeking new roles. 2) Continued **long-term uncertainty about the future of the euro project**, in a situation where the integration process seems to have ground to a halt and where political forces that do not accept the prevailing principles for crisis management are growing in strength. 3) **General uncertainty about how the massive central bank stimulus measures** that have been highly instrumental in driving the world economy **can be reversed** without jeopardising financial stability.

Public discourse often focuses on the first two areas, since they have a more obvious impact on political and economic news reporting, but the question is whether the third area is not the most crucial to medium-term developments. Monetary stimulus policies are capable of pumping up asset prices, as we have seen constantly confirmed in recent years, but their secondary effects on the real economy have been **hampered because their wealth effects are unevenly allocated** and end up largely in households with a low inclination to consume. In investment markets, the question marks are even larger, among other things because **high return requirements make it hard for many new investments to yield the desired returns**. Further stimulus measures and additional years of a continued low interest rate/bond yield environment risk widening wealth gaps and increasing the likelihood that new asset price bubbles will build up.

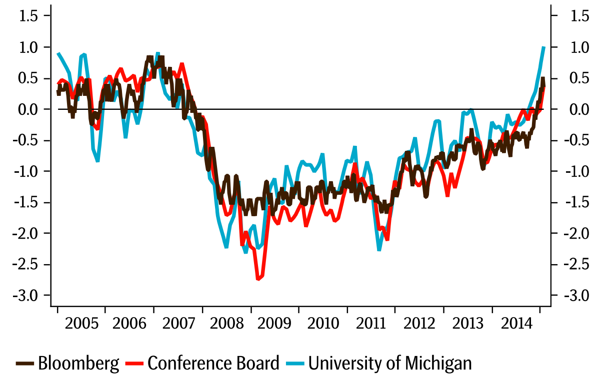
The willingness of investors to buy financial instruments with negative yields over a rather long period of time indicates a clear scepticism about the success of reflation policy (see the theme article on "A new bond yield universe"). Central banks, headed by the Bank for International Settlements (BIS) also warn that there is latent high volatility in the financial system, currently concealed by the expansion of central bank balance sheets – so far by about USD 15 trillion. For example, this stress became visible on October 15, 2014, when US 10-year Treasury yields fell by 40 basis points in just a few hours. The low yield environment and continued high return requirements are probably behind this volatility, and the stress is probably also due to reduced risk absorption and buffer capacity because of new regulations and tighter requirements in banking systems.

US recovery on increasingly firm ground

Over the past 3-4 years, global growth has been characterised by listless recovery. Expectations early each year of a clearer recovery have repeatedly been crushed. Debt crises flaring up in the euro zone, Japanese natural disasters and US budget disputes or extreme weather have been disruptions that analysts have cited as the reasons behind downward revisions of their forecasts. But in most cases, it is a bit hard to understand why such events should lead to a permanently lower production level; normally there should be subsequent rebounds that eventually provide extra growth impulses. **It is thus reasonable to believe that underlying growth conditions have not been in place** to ensure a sustainable recovery. This is also quite consistent with historical experiences from earlier balance sheet crises, in which healing processes often require 6-8 years.

Will 2015 be the year of the American consumer?

Standard deviations

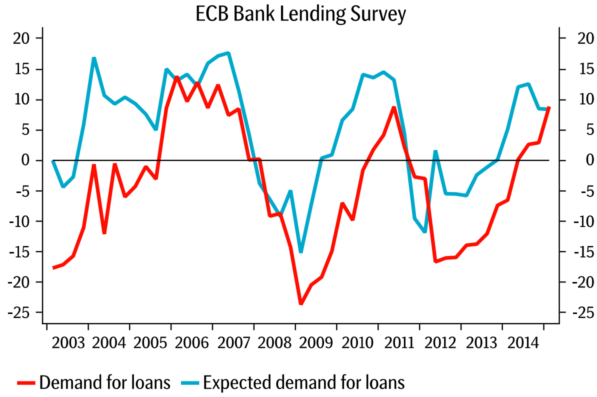


Source: Bloomberg, Conference Board, SEB

As we now move into 2015, our assessment is that the situation has changed and that the US economy will grow at a faster pace than for years. A strong labour market and rising real incomes – driven by low oil prices and such factors as growing wealth due to higher share and home prices – are creating strong fundamentals for consumer-driven growth. We also see a good chance that such growth will expand into a broader upturn in capital spending, in light of increasingly tight resource utilisation and the strong financial situation of the corporate sector. **Altogether, we expect GDP growth of 3.5 per cent in 2015 and 3.2 per cent in 2016: well above trend**.

Increasing demand for loans

ECB Bank Lending Survey



Source: ECB

Euro zone has bottomed out

If we are correct in forecasting that the EUR/USD exchange rate may move towards parity while the US economy continues to grow well above trend, Western Europe will benefit more from US demand than we had expected earlier. In particular, German manufacturers will become far more competitive, also increasing their chances of taking over as a growth engine in a later stage of the recovery. **As a major net importer of crude oil, the euro zone benefits greatly from lower oil prices**. Higher household incomes will however go largely to increased saving, in a situation of continued debt consolidation needs and an uncertain political outlook in many countries.

The impact of the ECB's quantitative easing programme will depend on various factors. Compared to the experience of the US, there are indications that the **stimulus effect via the exchange rate channel will be larger**. Yet the effects on nominal interest rates and yields will probably be less than in the US and the UK, at least in core euro zone countries where rates and yields are already very depressed from the outset. But the loosening effect on the credit market will be stronger, because euro zone banks have already undergone stress tests and many banks have strengthened their capital base. Inflation expectations will be vital to the general success of the QE programme, since they affect both real interest rates/bond yields and confidence among households and businesses. Early signals indicate an initial upturn in inflation expectations, but it is too early to draw any strong conclusions from this. Overall, we are still cautious in our assessment of the effects of stronger growth forces. We have revised our GDP growth forecast for the euro zone upward by 0.3 percentage points for the next couple of years and now predict that **GDP will increase by 1.2 per cent in 2015 and by 1.7 per cent in 2016**.

Economic integration efforts have largely come to a halt, and euro zone cooperation efforts are facing pressures that hamper consumption and capital spending. Because large countries like France and Italy are struggling with major structural problems, euro zone growth will have difficulty in taking off, but Spain has continued to deliver upside surprises recently and will see decent 2 per cent growth in 2015.

Greece shakes up the euro zone – again

Recent political developments in Greece have again thrown the spotlight on regional crisis management. So far the main recipe has been bail-out loans from European institutions and the IMF, linked to demands for cost-cutting and structural reforms. Experience from recent years indicates that this strategy has had **bigger negative effects on growth than expected**.

The euro zone crisis is now entering a new phase, in which austerity policies are being challenged by new political forces around the EU that are not as willing to compromise as their predecessors. Today Greece is the first such example; dissatisfaction with several years of austerity set the stage for the radical leftist Syriza party's election victory in January. Similar movements exist in other countries, for example in Spain where Podemos is ahead in public opinion polls before the general election later this year. We are once again seeing a kind of **chicken race between the new Greek government on one side and the "troika" (euro zone/ECB/IMF) on the other**. Important positions on matters of principle are coming into conflict with each other as countries like Germany, Finland and the Netherlands oppose a debt write-down and demand that Greece should adhere to its reform programme. This puts the Greek government in a difficult position. It won the election based on its promises to demand significant debt relief, but it is partly handicapped in the negotiations because the Greek people want to keep the euro, according to opinion polls.

At present it is difficult to judge how much room there is for negotiations among the players, resulting in heightened insecurity. Since the snap election was called in December, Greek bond yields have climbed and the stock market has fallen. We are also seeing capital outflows from Greek banks that are dependent on central bank liquidity. Meanwhile it is clear that the contagious effects on other crisis-hit countries are much smaller than previously; the ECB's actions, support mechanisms such as its earlier Outright Monetary Transactions (OMT) programme and the budget cutbacks implemented in a number of euro zone countries have obviously had an effect.

There are **three main paths that Greece and the euro zone can take from here**. Which path they choose is important in principle, since it will show how the region can resolve similar conflicts in the future. **Our main scenario is that a negotiated solution will be reached, giving Greece substantial relief** in the form of lower interest rates and longer loan maturities. It may also include a moratorium allowing the country to skip interest payments during a given period (5-10 years) or until its economic growth reaches a certain level**. Alternative two is that Greece receives an actual debt write-down**, probably to a level of around 120 per cent of GDP, so that the country's public sector debt will still be the highest among crisis-hit countries. This would be connected to continued cooperation with the euro zone, ECB and IMF, which may dissuade other crisis-hit countries that have already left behind/want to leave behind the troika's oversight. The **third alternative**, which no one seems to want, is that **Greece unilaterally defaults on its loan payments and withdraws from the euro zone**. There is a risk that tough rhetoric, German unwillingness to compromise and Syriza's difficulties in handling domestic accusations of selling out will **lead Greece "involuntarily" into such a situation**.

Our main scenario implies a compromise that will ease current financial market worries. But it is an open question whether this solution will lead Greece and the region on the right long-term path. The risk is that they will postpone a solution and that compromises reached in various phases of the Greek crisis will be described by future historians as the reason for 5-10 lost years of economic progress. The situation illustrates that dilemma that arises when various actors are bound by **domestic political calculations** that make it hard to **achieve a solution that is good for the whole region**.

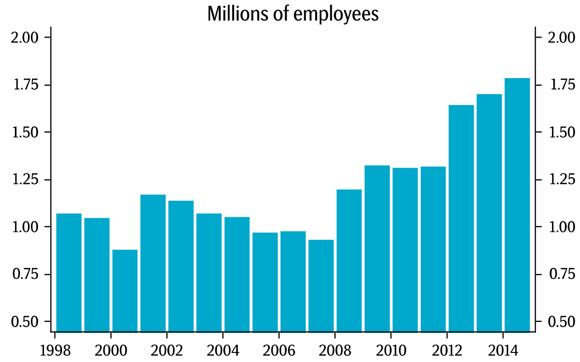
In the German economy, confidence is again on the way up after a dip in 2014 that was largely due to trade disruptions connected to the conflict with Russia. Because of heavy dependence on exports, the economy is now benefiting greatly from the weak euro. With the EUR/USD exchange rate moving towards parity, Germany's current account surplus will increase further from already record-high levels. **Germany will thus be a focus of attention when it comes to imbalances both at global and euro zone level**. There will probably be mounting international criticism of Germany for not stimulating its economy in order to ease the problems of trade imbalances and deflation pressures in the euro zone. The enormous build-up of wealth generated by its current account surpluses will also be cited as a reason why the country should adopt a gentler approach in discussions about debt write-downs in Greece (see the box on page 7). But we do not believe that Germany will launch any large stimulus package, among other things in light of its high resource utilisation. German political leaders are also under pressure from domestic public opinion, and the ECB's QE programme will probably lead to increased opposition to any further European Union policy concessions.

Mixed outlook for EM economies

The role of EM countries in the global economy is increasingly important, especially in the economic policy field, where the BRICS countries (Brazil, Russia, India, China and South Africa) are expanding their cooperation. China also hopes to build new alliances that sometimes compete with traditional OECD- and US-dominated institutions. This is particularly true of its relations with various African countries, but China's offer of financial aid to Russia in its current crisis situation is another important example.

Increase in urban employment for each percentage point of GDP growth

Millions of employees



Source: IMF, National Bureau of Statistics of China, SEB

The short-term economic prospects are mixed, however. We expect GDP to accelerate cautiously in 2015 and 2016 in most Asian emerging economies. The effects of lower oil prices will generally be rather small, but lower inflation will enable central banks in the region to continue their loose monetary policies. **China** will remain the exception; we expect its **GDP growth** to continue slowing from **7.4 per cent in 2014 to 7.0 per cent in 2015 and 6.7 per cent in 2016**, but the labour market will be resilient to falling GDP growth. One reason is that rapid expansion in the labour-intensive service sector means that **more jobs than before are being created by a given level of GDP growth**. The risk of a serious housing market downturn has decreased, but an oversupply of homes will continue to hamper construction and thus growth for many years. The authorities are now giving higher priority to growth-sustaining policies, but as in 2014 there is a need to balance increased stimulus and the risk that credit growth will rebound.

Upside risks outweigh downside risks

For some time, our high-growth scenario has been based on a development in which secondary effects of the US economic recovery spread to elsewhere in the world, especially Western Europe, more powerfully than expected and more in line with historical experience. **The probability that such a scenario will materialise has recently increased**. The upturn in the dollar is an important ingredient of this, since a stronger currency will test the ability of the American economy to serve as a global growth engine. If we are correct in forecasting that the EUR/USD exchange rate may move towards parity, while the US economy keeps growing above trend, this will provide substantial help to Europe. In particular, it will improve the potential for German manufacturers to act as an economic engine in a later stage of the recovery. The effects of the oil price downturn also have potential to speed up growth, since our main forecast is based on the assumption that its effects will be less than traditional sensitivity analyses indicate. **We estimate that the probability of our high-growth scenario is 30 per cent**, compared to 25 in November's *Nordic Outlook*.

Meanwhile there are various downside risks in our forecast. **Tensions between Russia and the West may escalate and have major economic effects**. In particular, there are risks of an economic collapse in Russia. Although the EU countries are eager to avoid such a development, experience shows that it may be difficult to resolve foreign and security policy impasses.

Heightened tensions in the euro project, as discussed earlier, may also lead to uncertainty that hampers growth. A bit further ahead, we also foresee risks that the shift towards more normal monetary policy conditions may trigger market turbulence. An initial test will be how the world economy reacts to US key rate hikes, but we believe this is rather unlikely to disrupt the global recovery, especially given the Fed's sizeable manoeuvring room. **Our overall assessment is that the risks of poorer performance in 2015-2016 have decreased to 20 per cent (compared to 30 per cent in November)**. Yet several of the downside risks discussed above may become more critical in a slightly longer time perspective.

In **India** a sharp slowdown in inflation will enable the central bank to loosen its monetary policy, thereby providing some stimulus to boost sluggish growth. The governing BJP party is continuing its reform efforts despite strong resistance from the opposition and special interests. Progress has been made, but really major reforms are still conspicuously absent. We expect **GDP growth** in India to accelerate cautiously to **7.3 per cent in 2015 and to 7.6 per cent in 2016**. Beyond our forecast horizon there is potential for further high growth, driven by looser monetary policy and continued reform efforts.

In **Brazil**, growth remains sluggish. We expect GDP growth to accelerate from 0 per cent in 2014 to 2.5 per cent in 2016, but this is still well below earlier level. Despite reform initiatives from President Dilma Rousseff, Brazil needs more far-reaching structural reforms to get the economy moving. In the short term, growth will be hampered by a cost-cutting programme aimed at reducing government budget deficits. Nor has the central bank been able to tame inflation, which is expected to exceed the 6.5 per cent upper threshold of the inflation target.

Russia faces a deep recession in the wake of collapsing oil prices and the rouble crash of late 2014. We expect GDP to fall by 5.5 per cent in 2015, **as budget austerity, economic sanctions and a rouble collapse squeeze the economy**. Among other things, the rouble's slide will contribute to an inflation shock, dramatically weakening household purchasing power. The rouble will remain under pressure, although an oil price recovery provides some support. The decline in GDP will slow in 2016 to 1.0 per cent, but risks will be on the downside, especially since the Ukraine crisis is threatening to escalate into a clearer conflict between NATO and Russia. Despite these economic and financial strains, Russia has enough financial muscle to avoid a fiscal crisis during the next couple of years.

Nordic economies resilient to stresses

The Nordic economies have recently been exposed to various types of stresses. Weaker growth in the euro zone, especially in Germany, hampered exports during much of 2014. The Russian crisis also had an especially large impact on Finland, while Norway's economy is being squeezed by falling oil prices. Denmark's 33-year-old currency peg is under pressure from massive currency inflows, due to the ECB's QE programme and Switzerland's change of currency policy. Sweden has experienced some economic policy drama because of its government crisis late in 2014 and the Riksbank's drastic measures to preserve the credibility of its inflation target.

We still see good reasons to stick to a rather optimistic view. Slightly better growth prospects in the euro zone, especially Germany, will provide support. Scandinavian currencies will follow the euro downward against leading currencies. Swedish growth will also be sustained by a rapid upturn in residential construction, helping GDP grow by 2.7 per cent both in 2015 and 2016. Although we have adjusted our Norwegian growth forecast lower due to the oil price downturn, growth will rebound in 2016 as oil prices climb. Fiscal policy will assume a key role if the oil price slide should have a larger impact on growth than we expect. The Danish economy will also enjoy support from more expansionary fiscal policy, while ECB stimulus measures will also have an impact on Danish monetary conditions. Further interest rate cuts may be needed to defend the DKK/EUR peg. The Finnish economy will remain weak, but the recovery elsewhere in the euro zone and a weaker currency will offset further weakening in Russia.

Nordics and Baltics, GDP growth

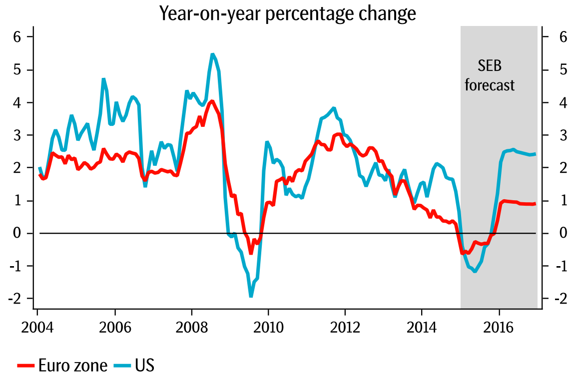
Year-on-year percentage change

	2013	2014	2015	2016
Sweden	1.3	2.0	2.7	2.7
Norway	0.7	2.1	1.0	1.8
Denmark	-0.5	1.0	2.0	2.5
Finland	-1.3	0.0	0.7	1.0
Estonia	1.6	1.8	1.8	2.6
Latvia	4.2	2.4	2.5	3.0
Lithuania	3.3	3.0	2.6	3.5

Source: OECD, SEB

CPI inflation

Year-on-year percentage change



Source: Eurostat, BLS, SEB

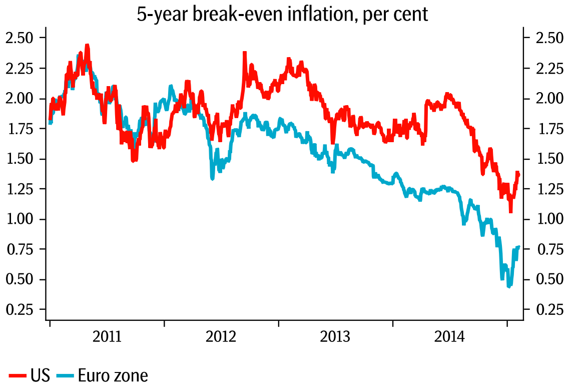
Oil prices pushing down inflation further

The continued decline in oil prices contributed to our broad-based downward adjustments of inflation forecasts for 2015. Its biggest impact on CPI inflation has been in the US. **Compared to the euro zone and Sweden, the effect of a given oil price change there is more than twice as much.** In Sweden and the euro zone, a sizeable volume-based tax component makes the total price of petrol less dependent on crude oil price changes. These differences in inflation impacts are further accentuated because lower oil prices often coincide with a rising dollar trend, which in turn decreases the price movement in European currencies compared to the US. We expect total US inflation to average about -½ per cent in 2015. In the euro zone, too, we foresee a negative inflation rate as oil effects reinforce strong underlying deflationary forces.

A rebound in oil prices late in 2015 is one factor behind our forecast that total inflation will rise in 2016. But with even long-term inflation expectations now falling, the question is what secondary effects the oil price slide will have. An impact on core inflation occurs almost automatically in sectors where oil is an important input item, for example transport services and travel. Various components in the consumer basket theoretically add up to an indirect inflation effect of about the same size as the direct effect. In practice, however, it is uncertain to what extent companies actually implement price changes at the consumer level and, if so, after how long a lag this occurs. Our analyses indicate that **the impact of the oil price decline we have seen so far on US core inflation is around 0.2-0.3 percentage point per year during a three-year period**. The impact is not larger because the direct effects are offset by the positive inflation impulse caused by a higher activity level.

Stabilising inflation expectations?

5-year break-even inflation, per cent



Source: Bloomberg, SEB

Wage and salary changes will be crucial to the inflation environment in a slightly longer perspective. In recent years, globalisation and rising educational levels have helped push down the rate of pay increases in the OECD countries. If falling inflation expectations after the oil price shock result in further general downward pressure on the rate of pay increases, this deflationary environment risks becoming permanent. Only then will the argument that lower inflation increases the debt burden of households actually become relevant.

However, the supply side-driven downturn in inflation that we are now seeing also has the potential to push wages upward, since **lower input costs at companies increase their wage-paying capacity, while a higher level of economic activity helps increase employment**. This mechanism has a bigger chance of making itself felt in a situation of relatively high resource utilisation. We believe that pay increases are on their way up in the US and the UK, while high unemployment and continued cost adjustment needs in many euro zone countries suggest a continued squeeze on wages.

In countries where centralised labour agreements are highly important to wage formation, there is a risk that a depressed inflation rate will be cited as justifying depressed pay agreements. In Germany, such tendencies are difficult to discern, partly because both the Bundesbank and leading politicians have declared that higher pay increases can help reduce imbalances in the euro zone. In Sweden, however, there are signs that **the temporary downturn in inflation risks impacting the expectations of labour market organisations**.

We can also see modest attempts to speed up the rate of pay increases through political decisions and recommendations. In Japan, the government has clearly declared that it is desirable for the business sector to allow higher pay increases. Raising the minimum wage in such countries as the US, the UK and Germany is another way. Overall, wages are likely to continue increasing at a slow pace in the OECD countries, **but there is little probability that falling wages will drive these economies into a paralysing deflationary spiral**.

Continued expansionary monetary policy

So far, monetary policy has been effective in driving up asset prices but its impact on consumption and capital spending has not been persuasive, especially in the absence of structural reforms. Its impact on inflation seems to occur mainly through the exchange rate channel, implying that **monetary policy is serving as a weapon in ongoing currency wars but that its effects on global inflation as a whole are more doubtful**.

This year also began with dramatic central bank decisions: new key interest rate cuts, sharply negative key rates, a currency shock in Switzerland and a large government bond purchasing programme launched by the ECB. Overall, global monetary conditions will continue to move in a more expansionary direction during 2015 with the help of the ECB, the Bank of Japan and other central banks – even though the Fed will begin a cautious hiking cycle this autumn. **Global monetary policy will also remain sharply expansionary in 2016**.

Swiss monetary policy – including a key interest rate of -0.75 per cent – have opened up new, uncharted monetary policy terrain. For Switzerland, as well as Denmark, the purpose of strongly negative deposit rates has been to combat capital inflows. But for most central banks, it is still **likely that a zero rate, or slightly lower, is an interest rate floor**. We thus believe that further monetary stimulus will occur via central bank balance sheets.

Falling long-term inflation expectations, combined with weak economic growth, compelled the ECB to launch its forceful QE programme, including asset purchases equivalent to EUR 60 billion per month. To enable the bank to genuinely influence inflation expectations, it was also **important to signal directly that the programme is open-ended and can be extended beyond September 2016** if inflation does not react in the desired way. The Japanese central bank will also need to respond to risks of renewed deflationary tendencies and launch additional QE programmes that will gradually propel its balance sheet towards a breath-taking 80-85 per cent of GDP.

Central bank key interest rates

Per cent

	Feb 2015	Dec 2015	Dec 2016
Federal Reserve	0-0.25	0.75	1.75
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	-0.10	0.50
Norges Bank	1.25	1.00	1.25

Source: Central banks and SEB

The US is also now seeing a decline in long-term inflation expectations. But because of the rapid improvement in the US labour market, the Fed is attaching importance to the positive growth effects of oil prices and can plausibly maintain that any CPI deflation is temporary. Low inflation also creates communications challenges, but we expect the Fed's first rate hike to occur after this summer. **By the end of 2015, the key rate will be 0.75 per cent and by the end of 2016 1.75 per cent**: still below neutral interest rates. The Fed's securities portfolio will remain unchanged. However, it is clear that the outlook for the dollar will play a role in how Fed monetary policy will be shaped in relation to other countries.

In Sweden, the paradoxes of inflation targeting policy will be especially clear. Due to broadly falling inflation expectations, we predict that the Riksbank will **cut its repo rate to -0.10 per cent in February and launch a small QE programme in 2015**, among other things to combat krona appreciation due to the ECB's QE programme. But this will occur in an environment of rather healthy economic growth, a smoothly functioning credit market and overheating risks in the housing market. Because of relatively strong economic growth, it will be time to consider rate hikes during the second half of 2016.

Norges Bank seems to have temporarily abandoned its inflation target in favour of further support to the real economy and has indicated a high probability of a further interest rate cut. Since its last Monetary Policy Report at the December meeting, oil prices have fallen further and other central banks have eased their monetary policies even more. We thus believe that **Norges Bank will deliver a further cut of 25 basis points in March**. The economic outlook will probably have to deteriorate further if the market's aggressive rate cut expectations are to materialise.

Central bank policy in countries like China, India and Singapore – and in Canada, a commodity exporter – indicate that **global monetary policy will keep on converging towards lower key interest rates** in response to falling inflation rates, structural reforms and the need to stimulate growth. But it will be a difficult balancing act. On the one hand, lower EM interest rates may reduce the attractiveness of EM assets and generate capital outflows. On the other hand, tighter US monetary policy and a stronger dollar may lead to more expensive global dollar financing; the BIS estimate the extra costs at about USD 9 trillion. This risk will decrease if the US economy shows strength that leads to good demand for EM exports.

Long-term yields near new historical lows

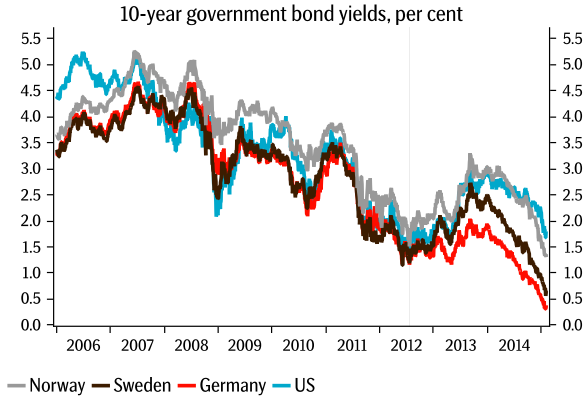
Falling oil prices and inflation expectations together with a new wave of central bank easing have pushed international 10-year bond yields to levels close to, and in some cases even below, zero (see theme article "A new bond yield universe").

In the short term, German government bond yields will continue to be pushed downward by strong forces. Because the ECB's QE programme uses GDP weighting as the basis for purchases, a large percentage of its purchases will consist of German government bonds. This is in a situation where Germany's net borrowing is close to zero, since the country is aiming at budget balance. Meanwhile, the financial crisis in Greece may increase uncertainty about the future of the euro. In the short term, this has boosted the market's appetite for German bonds, which could potentially become D-mark-denominated. German yields have thus probably not reached their floor. But if the ECB's QE programme succeeds in its ambition of making inflation expectations rebound, we see eventual prospects of rising yields, in line with what happened earlier in the US. A more stable economic outlook in the euro zone, especially in Germany, will also help German 10-year bond yields gradually begin moving upward to **0.50 per cent at the end of 2015 and 0.90 per cent at the end of 2016**.

The Fed's rate hike this coming September should be reflected in a widening yield spread to Germany. The global search for returns, with relatively attractive yields in the US and prospects of a rising dollar exchange rate, may nevertheless push down US bond yields compared to European ones in the short term. The same factors suggest a flattening of the yield curve (10-year yield minus key interest rate) once the Fed begins its rate hikes. **Ten-year US Treasury yields will be 2.00 per cent at the end of 2015 and 2.50 per cent at the end of 2016**.

Accelerating decline in long-term yields

10-year government bond yields, per cent



Source Macrobond

The yield spread between Sweden and Germany will be squeezed further in the short term by the Riksbank's actions. Swedish 10-year bond yields will fall to new historical lows during the spring. Looking ahead, however, differences in relative economic growth and monetary policy between Sweden and the euro zone suggest a faster upturn in Swedish yields. During 2016 the yield spread will widen from 15 to 50 basis points. **Swedish 10-year yields will be 0.65 per cent at the end of 2015 and 1.40 per cent at the end of 2016**.

The yield on Norwegian government bonds has declined since last autumn, driven by supply/demand factors and lower oil prices. We expect the 10-year spread vs. Germany to shrink further as the bond supply drops to only NOK 50 billion this year. **By the end of 2015, the Norwegian 10-year bond spread against Germany will be 70 basis points.**

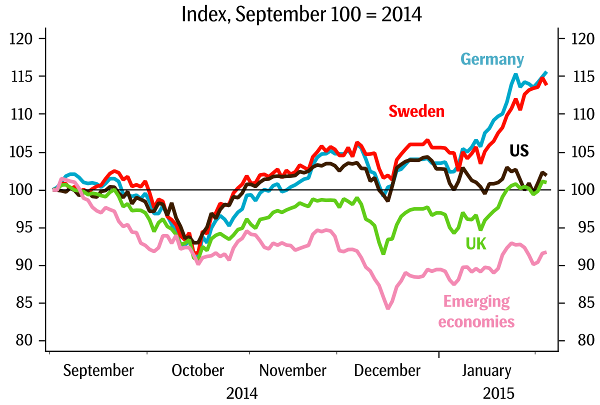
Central bank stimulus lifts European shares

Low interest rates and bond yields, monetary policy easing and the prospect of a cautious recovery are creating a favourable stock market climate. This is especially true in Western Europe including the Nordic countries, where 2015 began strongly partly driven by ECB's bond purchases and weaker currencies.

Fed rate hikes may temporarily dampen the US stock market mood, but if these hikes are justified by a stronger economy the stock market will instead enjoy support from rising earnings. Political risks, for example in Russia and Latin America – and the varying effects of the oil price decline on importing and exporting countries – create a mixed picture for EM equities. Stronger foreign trade due to weaker currencies and rising global demand will benefit many EM countries, however. Despite a generally bright outlook for equities, new setbacks cannot be ruled out in a still fragile global economy.

European stock exchanges outperforming

Index, September 100 = 2014



Source: Macrobond

The biggest threat to this relatively bright stock market scenario is that valuations of future earnings – measured, for example, by forward-looking price/earnings ratios – are high. The Nordic stock markets are now trading at 25 per cent above average valuations over the past ten years and higher than at any time since 2002. Compared to historically low risk-free returns (long-term government bond yields), however, equities still pay good returns. Even if today's extremely low interest rates and bond yields do not last for a long time, lower interest rates than the average prevailing in the past 10-20 years should lead to higher share valuations than previously for each krona of earnings. Because companies have adjusted their operations to the prevailing macro environment, earnings can grow even when there is weak demand, while cautious capital spending allows room for high dividends and good dividend yields compared to interest rates and bond yields. For example, dividend yields on the OMX Stockholm exchange are just below 4 per cent, compared to long-term bond yields of well below 1 per cent. But looking further ahead, the combination of high dividends and low capital spending represents a threat to long-term growth and thus to future corporate earnings potential.

USD exchange rate in the hands of the Fed

For some time, monetary policy has played a crucial role in currency movements. Now the reverse dependence will be increasingly clear as **monetary policy becomes a key weapon in the type of currency wars that are now under way**. The decline in commodity prices has further intensified the need of many countries to generate inflation with the help of a weaker currency. This behaviour also seems to contribute to increased volatility in the foreign exchange (FX) market.

Growing economic and monetary policy divergence between the US and the euro zone has paved the way for a significantly weaker euro. The EUR/USD exchange rate fell by 12 per cent during 2014, while euro depreciation in trade-weighted terms was more modest. In a situation of near-zero interest rates and weak bank lending, a depreciating currency will be a key factor in enabling the euro zone to combat economic stagnation and deflation risks. The ECB's bond purchases will now push down the euro further. We predict that the **EUR/USD exchange rate will reach parity in 2016**. But continued dollar appreciation on this scale will be highly dependent on the Fed's actions. In a situation of exceptionally low inflation and moderate wage growth, the Fed has a lot of room to manoeuvre. A scenario in which the Fed postpones its rate hikes in order to slow the upturn in the dollar poses a risk to our currency forecast.

Given EUR/USD movement from 1.40 to parity in only a few years, the weakness of the euro and the strength of the dollar will create tensions in the global currency system. In Europe, we have seen how capital inflows forced Switzerland to remove its temporary currency cap against the euro. Today the more than 30-year-old Danish currency peg against the euro is being subjected to pressures. **Conversely, countries with US dollar pegs in Latin America and Asia will have problems with currency outflows and competitiveness**. Costa Rica is an example of a small country that recently had to give up its dollar peg, but such tensions also affect big economies. China's situation, for example, is being changed by the "super dollar". We predict a movement in the JPY/USD rate up to 140 as a consequence of divergent Japanese and US monetary policies. Even assuming a rather cautious appreciation in the Chinese yuan against the USD, China's competitiveness will deteriorate dramatically against that of Japan.

The British pound has weakened against the US dollar but has strengthened against the euro since mid-2014. A comparison of central bank policies suggest that the pound's recent trend will continue. Because of low inflation pressure, the Bank of England will postpone rate hikes until early 2016. The EUR/GBP exchange rate will gradually move down towards 0.70.

The currency drama in Switzerland and Denmark may spread elsewhere, generating capital inflows to Sweden and Norway as well. The currency effects are likely to be small, however; these economies are now not strong enough to be perceived as safe havens, in the way they were a few years ago. The Riksbank's next step will instead be crucial for the performance of the Swedish krona. Given our forecast that the Riksbank will introduce a negative repo rate and announce a QE programme, the **EUR/SEK rate will move upward towards 9.60 during the next few months**. But in light of the situation in the Swedish economy, it is unreasonable to assume that the Riksbank will match the ECB's subsequent balance sheet expansion. We thus expect the krona to rebound after bottoming out in trade-weighted terms during the first quarter. We believe that the EUR/SEK rate will reach 9.00 by the end of 2015. The USD/SEK exchange rate, however, will continue gradually upward and will reach 8.90 towards the end of 2016. In the short term, **the Norwegian krone will be weighed down by depressed oil prices and monetary policy easing**, but because Norges Bank has increased its krone purchases to NOK 700 million per day to regulate Government Pension Fund – Global flows, the pressure will ease. We expect the EUR/NOK exchange rate to climb above 9.00 later this spring. After that the upturn in oil prices during the second half of 2015 and rate hikes by Norges Bank will help bring about a shift in the EUR/NOK rate back to 8.50 in December 2015.

- **Strong short-term forces push down prices**
- **Rebound this autumn due to better balance**
- **Small but significant growth stimulus**

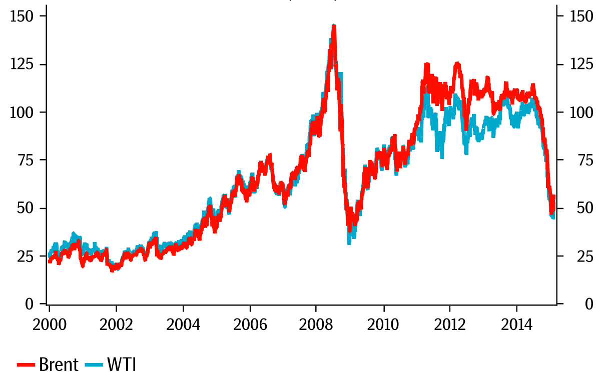
Oil prices have kept falling at a dramatic pace. In just over six months, they more than halved from USD 110-115/barrel to levels around USD 50. In the theme article "Energy prices and macro implications" (*Nordic Outlook*, November 2014), we discussed causes and consequences of this slide and forecast an average Brent crude price of USD 85/barrel during 2015-2016. The continued downturn gives us a reason to re-assess both oil prices as such and their stimulus effects.

One starting point is to examine what factors have driven the latest price slide. Historically, there has been a strong link between US dollar movements and oil prices measured in USD/barrel. **Further dollar appreciation thus helps push down prices further**. In addition, **the Organisation of the Petroleum Exporting Countries (OPEC) has been unexpectedly unwilling to adjust production**, even in response to seasonal fluctuations in demand. Since demand is normally lower in the first half, the result is **growing oil stockpiles that push down oil prices in the short term**. Finally, **US shale oil production has been unexpectedly resilient**. Estimates of price levels at which it pays to extract US shale oil are uncertain but end up in the USD 60-70/barrel interval for West Texas Intermediate (WTI). The cost of drilling new wells within the limits of existing infrastructure is only half as much, though. US shale oil producers can thus continue drilling new wells for another year before new infrastructure must be added. This will maintain production in the short term. Looking a bit further ahead, there is reason to expect a gradual improvement in the supply/demand balance. Our forecast of a continued – though subdued – US-driven growth acceleration in the world economy implies that future oil prices will be **sustained to some extent by growing demand**. The US Energy Information Administration (EIA), for example, bases its demand forecast on US growth of 2.5 per cent in 2015, about one percentage point lower than SEB. Today's low oil prices also help limit the non-OPEC oil supply, causing upward pressure on future oil prices. The Bank of Canada estimates that one third of current production is unprofitable at less than USD 60/barrel. There are signs that US investments have already begun to be cut back, suggesting that oil prices are now below sustainable long-term levels. **Our forecast for 2015 as a whole is an average of USD 60/barrel, levelling out at around USD 70**, just above futures market pricing.

Our new oil price forecast implies a larger dose of stimulus than our November estimates. At that time, we assumed a relatively limited GDP effect of around ½ per cent during the first two years; similar rules of thumb now point towards a stimulus around ¾ per cent. An oil price downturn generally leads to a transfer of resources from exporting to importing countries. Since the inclination to consume is normally higher in the latter, oil price downturns are usually positive for the world economy. The most important channels are stronger household purchasing power, lower costs for input goods and manufacturing, improved terms of trade and possible monetary policy easing due to lower inflation.

Oil market in search of new equilibrium

Crude oil, USD/barrel



Source: Macrobond

As earlier, we currently see **reasons for caution regarding the positive impact of cheaper oil**. Because of higher post-crisis indebtedness, consumers in importing countries are largely using their increased room for consumption to pay off debts and increase their saving. Some emerging market countries are expected to respond to falling prices by cutting fuel subsidies and consolidating their budgets. In Japan, the euro zone and elsewhere, the price slide is also partly offset by a weaker currency. The reaction functions of central banks are another important factor, and interest rates around zero limit their room for monetary easing in the wake of lower oil prices. **Now that the European Central Bank has initiated a full-scale quantitative easing programme, there is reason for a more positive view of the effects of the oil price slide on the euro zone than in November**. The net effect of lower prices in the US is positive, but the expansion of the country's oil industry – which means that the US now produces more than half of oil consumed there – nevertheless suggests that the stimulus to the US economy will be smaller than before. For producer countries, the dramatic price slide means that in many places, oil prices are below the level required to achieve a balanced budget. **This increases the risk of financial market disruption, currency depreciation and inflation**, especially in countries with limited fiscal policy manoeuvring room. Shaky economies are also a source of (geo)political risks and negative effects on sentiment related to Russia and parts of the Middle East. This is especially risky for Europe.

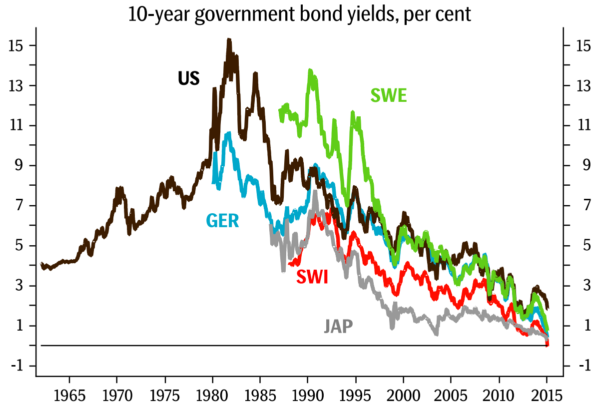
Theme: A new bond yield universe

- **Reasonable logic behind negative yields**
- **Still room for further decline in yields**
- **Negative yields create desired debt relief**

A box in *Nordic Outlook*, August 2010 was entitled ***Moving towards Japanese yields?*** To be honest, at the time we could never believe that yields on various countries' long-term government bonds – in Switzerland even exceeding 10-year maturities – would move below zero and **be traded at negative yields**. Now that 2015 has begun, we have clearly entered a new bond yield universe.

A 30-year trend towards falling long-term yields

10-year government bond yields, per cent



Source: Macrobond

The trend towards falling yields is stable and has been under way for 30 years. When yields plunged in 2008-2009, this reflected severe, exceptional growth and financial worries – a flight to safe securities. When the euro crisis later flared up, there was a similar flight to safety, due to heightened risk of a euro collapse. **The trend has continued and periodically accelerated, indicating other driving forces besides fear**.

What is driving long-term yields down?

A long-term yield trend is determined mainly by three factors: (1) expected short-term *[real] interest*, (2) expected inflation and (3) a term premium. **Key interest rates** will remain low for quite a while, due to low inflation, new tools (macroprudential supervision policy) that ease pressure on monetary policy, lower long-term growth due to ageing populations and slower productivity growth. There are even expectations of negative key interest rates, especially in countries that must fight large capital inflows (Switzerland and Denmark). Historically low **expected inflation** is reinforced not only by the oil price drop, but also by expanded production resources, low pay hikes and more efficient resource use (such as automation).

The term premium – compensation for the extra risk of holding an investment for a certain period – helps give the yield curve its characteristic positive slope (along with normal expectations of rising key rates). The premium should be positive in light of future uncertainty, proximity to the "zero point" and greater risk of capital losses in case of rising yields, for example caused by unexpected inflation or poorer credit-worthiness. But if yields are expected to be low for a long time, this reduces the need for risk compensation. Finally, long-term yields are affected by today's global savings surplus and low investment appetite, as well as safe investment regulations or requirements that contribute to downward pressure on yields.

But who wants to earn a sure capital loss?

Buying an investment with a negative yield (or a value of 100 that, for example, pays 95 at maturity) means a sure capital loss. Under what exceptional conditions does an investor accept this outcome, especially over a long time period?

1. Deflation expectations. Even if nominal return is negative during the term of the investment, **long-term deflation** may still make the investment **profitable – in real terms**. This assumes mistrust of central banks' monetary policies and their ability to achieve higher long-term inflation. It also assumes that deflation expectations occur in the way they have in countries like Japan. Today, market-priced 5-10 year inflation expectations are still positive, but they are falling.
2. Expectations of currency appreciation. A fixed income investment with a negative yield may ultimately result in a positive return if it is associated with **currency risk**. Swiss fixed income investments, including long-term ones, may be profitable if the Swiss franc appreciates. A Danish fixed income investment may also be profitable if the Nationalbank fails to defend its currency peg between the krone and the euro.
3. Central bank purchases (QE). A strong belief in new, unexpected securities purchases by central banks may cause a fixed income investment that today has a negative return (at maturity) to still pay a positive capital gain if **long-term yields fall further** and if the investment is sold before maturity.
4. Mandatory rules. Even if an investment is unattractive from a return standpoint, official regulations may require banks, for example, to **hold certain securities as collateral**.
5. Fear. The Lehman Brothers collapse of 2008 and the euro zone crisies of recent years are examples of situations where investors have moved their money into safe securities that at best may **minimise an investor's losses**.

Positive and negative effects of low yields

The prevailing low yield situation allows very affordable financing of long-term public sector investments, such as **infrastructure projects**. This is good for short- and medium-term growth and a country's long-term production capacity. It also means that **room for fiscal stimulus** can gradually emerge, due to falling interest payments on government debt. In the private sector, too, low yields allow **capital spending** and facilitate restructuring of sectors, eventually leading to

improved competitiveness. Better conditions for servicing both private and public sector debt, which is record-high in some countries, reduce credit risk in the economy and facilitate **credit supply**. In addition, a situation of permanently lower yields implies that **asset prices will rise** (a discounting effect for assets like equities, real estate and bond portfolios), also reducing systemic credit risk and boosting the growth dynamic.

But both the forces behind extreme yields – such as low investment appetite, uncertainty and deflation risks – and historically low yield levels represent **new and uncharted economic and financial landscapes, which risk adding new uncertainty**. If investors are willing to own bonds that pay negative returns, this shows that they believe there are **alternatives that are worse than earning a negative return**. Low yields may also lead to **bad investments**, which under other financial circumstances would/should never have occurred. But downward adjustments in return requirements are sluggish. This implies greater **risk-taking** – on both a voluntary and involuntary basis; market players are forced to look for returns further and further out on the yield curve and buy investments that carry higher risk. This is an environment in which pension systems encounter growing challenges, due to lower returns and rapidly ageing populations.

What do central banks really want?

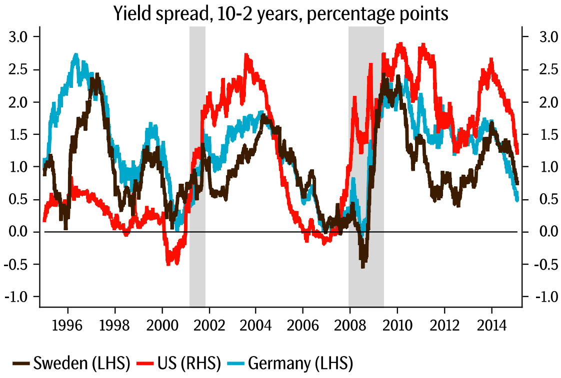
There are many indications that **0 per cent key interest rates**, or slightly lower, still represent **an absolute minimum**. The interbank market may function poorly, and there is an increased risk that households will rush into bank notes and coins if the key rate turns too negative for long periods. The main argument by Switzerland and Denmark for their deposit rates of -0.75 and -0.50 per cent, respectively, is connected to capital inflows and overly strong currencies; in countries with floating currencies, supply and demand are always expected to be cleared at a market rate, which is not the case when countries are trying to defend a certain currency exchange rate. It is a **conscious, and clear, central bank strategy** to drive down long-term yields by cutting key interest rates, guide markets lower and implement large purchases of various assets. The aim has been to ease the **burden of interest payments** on households and businesses in a difficult economic situation, boost **asset prices** in order to accelerate balance sheet repairs, help sustain economic recovery and influence **exchange rates**. In the euro zone, for example, a shift from fiscal discipline to demand-generating fiscal expansion is easier if a growing share of national government debts is moved into the balance sheets of central banks.

The yield curve is changing its shape

Central bank actions are thus also having a major effect on the shape of yield curves. In most countries, the curve still has a positive slope (10-year minus 2-year yields). Among other things, this is because 2-year government yields are negative compared to key interest rates. The slope of the curve raises three questions: **Is it possible to have a negative slope? Can the entire yield curve lie below zero? And does the slope of the curve say anything about future economic performance?** A bond portfolio may need cheap(er) short-term funding, which is difficult if the slope is negative, but as mentioned above, a negative nominal return may ultimately be profitable in a deflationary situation, since **real return is positive**. Historically, of course, the slope of the curve has been negative on various occasions, but often during short (1-2 year) periods. Nor, as we see it, is there anything to prevent large portions of the yield curve from lying below zero, even though this may cause major systemic technical challenges.

Flatter and flatter yield curves

Yield spread, 10-2 years, percentage points



Source: Macrobond

History and Fed research show that the slope of the yield curve has a certain **predictive power**: a negative or inverted curve usually means a recession within 1-2 years. As indicated above, many countries still have positive-sloping curves, though further flattening can be expected. Using the earlier rule of thumb, this would indicate a **new recession in perhaps 3-4 years**, but our conclusion is that unconventional central bank policies will **eliminate the predictive ability** of the curve.

Debt reduction by means of negative yields

It is difficult to determine whether we are in an unusually long period of low resource utilisation and deflationary pressures or whether low yields confirm adjustment processes connected to **secular stagnation:** a prolonged period of low economic growth. If saving is too large and investment appetite too low – for structural reasons – lower (real-term) yields are still needed in order to regain balance. Meanwhile, when inflation is low and in some cases negative (deflation), nominal yields must be pushed down so much that a new equilibrium occurs, in order to achieve a balance between saving and investments.

Another way of viewing today's negative bond yields is that they confirm an ongoing **balance sheet reduction** (lower liabilities *and* assets). Negative yields can be viewed as a gentle way of reducing debt. Global debt as a share of GDP has kept on rising since the financial crisis broke out in 2008, reaching unsustainable levels in many countries. Debts can be reduced to sustainable levels through principal payments, economic growth and inflation (all difficult to hope for in a disinflationary, low-growth world). Another alternative is straightforward, hard write-downs of debt. **But negative yields achieve similar but slower and gentler debt relief: both lenders and investors will see lower debt and shrinking assets at maturity**. This moves the world towards a more sustainable and stable situation, but shrinking asset supplies obviously create other challenges, for example in our pension systems.

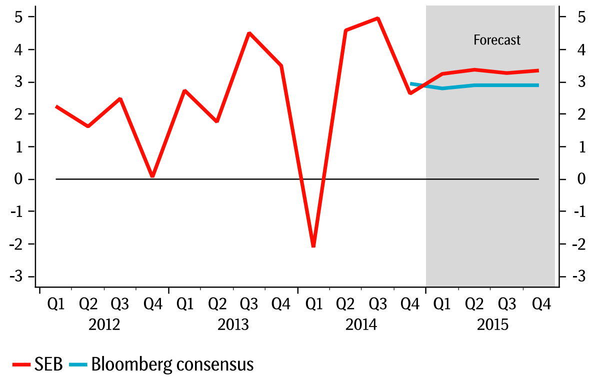
American households are waking up in earnest

- **Lower oil prices mainly help the economy**
- **Unemployment is falling below equilibrium**
- **Energy prices will push inflation below zero**
- **Fed is setting the stage for key rate hikes**

Conditions are right for the US economic recovery to shift into high gear. With households as the economic engine, **we predict GDP growth of 3.5 per cent this year and 3.2 per cent in 2016**. The decline in oil prices is lifting household purchasing power and confidence indicators – outweighing the effect of the stronger dollar, which is pulling in the other direction. The labour market was strong last year and will continue to improve. **Unemployment**, already close to equilibrium, **will fall to a low 4.4 per cent by the end of 2016**. Meanwhile alternative measures of resource utilisation still indicate plenty of slack in the labour market, supporting our optimistic view that 2015-2016 economic growth will be above trend.

Real GDP growth: Robust

Annualised



Source: BEA, Bloomberg, SEB

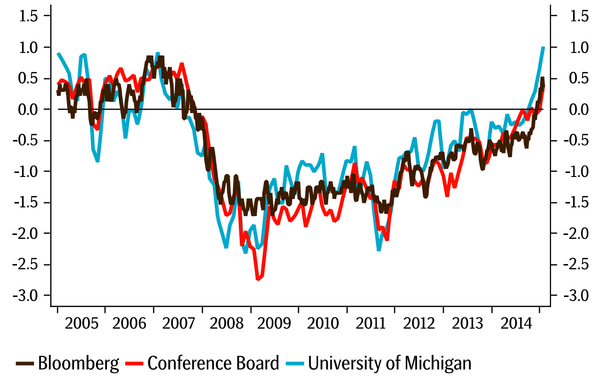
Headline inflation will plummet in the first half of 2015, with **annual averages of -0.4 per cent this year and 2.4 per cent in 2016**. Core inflation will also fall somewhat. In spite of this, we expect that due to the increasingly tight resource situation, the Federal Reserve will fulfil its intention to begin hiking the key interest rate. **The first step towards normalisation will occur in September 2015**, although the consensus among economists is that this hike will take place as early as June. By the end of 2015, the federal funds rate will stand at 0.75 per cent and by the end of 2016 at 1.75 per cent. While our key rate forecast is well above market pricing, it is lower than the Fed's own forecasts. The pace of rate hikes is also slower than both the historical pattern and our earlier forecasts.

Households are shifting into high gear

The conditions are in place for stronger household consumption. Although hourly earnings are stuck at a slow growth rate, the labour market tail-wind is pushing up incomes rapidly and purchasing power is soaring due to lower oil prices. Car sales are at a nine-year high and petrol (gasoline) prices at a six-year low, while **household confidence indicators are surging**; in particular, the University of Michigan's consumer sentiment index has climbed to its highest level since 2004.

Will 2015 be the year of the American consumer?

Standard deviations



Source: Bloomberg, Conference Board, SEB

Annual average **household consumption will grow by 3.3 per cent this year and 2.8 per cent in 2016**. This would make 2015 the strongest consumption year since 2004. Because we have factored in a clear upturn in the ratio of household savings to disposable income, the risk in our consumption forecast is probably on the upside. One model that explains the savings ratio as a function of wealth, the credit situation and the labour market is actually pointing towards lower household saving in the next couple of years.

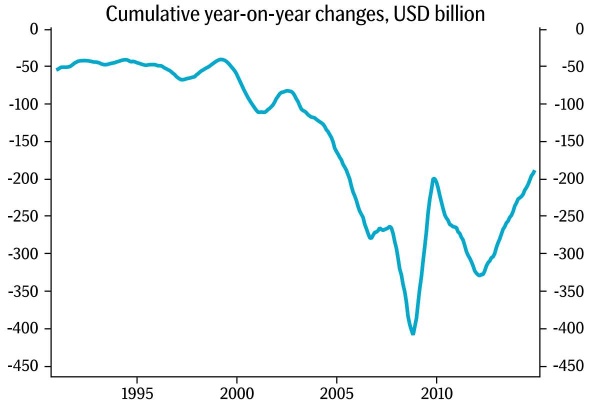
Increasingly optimistic small businesses

While household confidence indicators have been climbing steadily, the Institute for Supply Management (ISM) purchasing managers' index has fallen from last year's peak and is now compatible with GDP growth of around 3 per cent. One reason why the ISM index currently indicates lower growth figures than our forecast may be that it reflects confidence among large companies, which are already being affected by weak international demand and the strong US dollar, while the surge in domestic demand has not yet entirely materialised.

It is especially clear from the NFIB small business index that **domestic demand is about to surge, leaving behind its weak trend of recent years**. This confidence index, covering nearly 600 companies both inside and outside the energy sector, has recently climbed steeply. The upturn in the NFIB index also indicates that **on a net basis, the oil price decline is positive for the US economy**. Hard data point to the same conclusion; the deficit in US oil trading totalled about USD 200 billion last year. **Oil consumption exceeds exports, an indication that the oil price decline is beneficial to the economy**. Furthermore the Federal Reserve's macroeconomic models indicate that lower oil prices will boost both GDP and employment.

Large trade deficit in petroleum products

Cumulative year-on-year changes, USD billion



Source: Census Bureau

In a relatively closed economy like the US it is very likely that after a certain lag, rising household demand will lead to higher capital spending. Another reason to be optimistic about business investments is that companies are taking advantage of low interest rates and have extended the average maturity of their outstanding bond loans to 16 years. Some companies are even issuing 50-year bonds. Credit-worthiness will thus probably not worsen when the Fed eventually begins pushing up the yield curve. High capacity utilisation in manufacturing and strong corporate earnings and cash reserves will also contribute to good capital spending, along with the need to update ageing production equipment. Overall, **we expect business investments to accelerate from a growth rate of 5 per cent in 2014 to an average of 8 per cent in 2015-2016**.

Stronger dollar creating headwinds

The dollar has gained some 11 per cent in trade-weighted terms since mid-2014 and is expected to continue upward for the next couple of years. Several factors have contributed to USD strength. The American economy has delivered upside surprises and while the Fed is preparing the ground for key rate hikes, other central banks are easing their monetary policies. Lower oil prices and weak international demand may also have contributed. **The strength of the dollar is decreasing the positive effect of lower oil prices**, but one financial index that includes not only the dollar but also the stock market and fixed income assets is showing that overall financial conditions are looser today than six months or a year ago. For example, the Fed's own research indicates that a 50 basis point decline in long-term yields may be regarded as equivalent to a 200 point key interest rate cut – **lower long-term yields thus serve as an important counterweight to USD appreciation**. Yet export order bookings have worsened and we have lowered our export forecast. **Foreign trade will contribute negatively to US growth in 2015-2016**. The current account deficit, estimated at 2.5 per cent of GDP last year, will grow to 3.1 per cent of GDP in 2016.

Housing market will gain strength

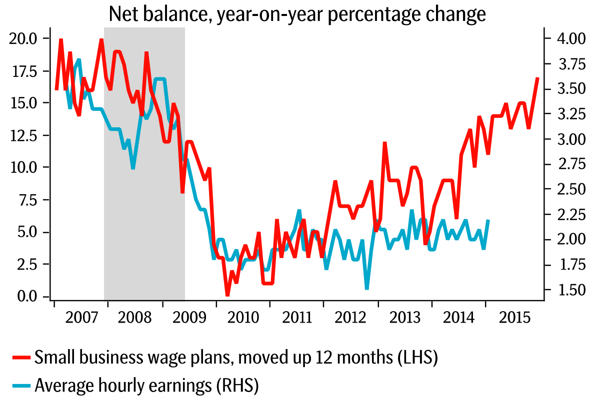
After last year's sluggish trend, the housing market is turning brighter. **The market has finally worked its way through the large excess supply of homes**; available homes as a percentage of total housing stock are now close to historical averages. Employment has also increased strongly among first-time buyers, an important category, while the number of households is expected to increase by more than 1.2 million yearly. Thus, housing starts will increase robustly in 2015-2016.

Employment is going like gangbusters

Employment growth in 2014 was the strongest in 15 years. The US economy created 2.9 million jobs last year, of which 2.7 million were full-time – the highest figure since 1984. Last year's drop in unemployment was also the second largest over the past thirty years. **The jobless rate now stands close to a level that the Congressional Budget Office defines as equilibrium unemployment**. Job growth in 2015 will match that of last year, with an average monthly increase of 260,000, according to our forecast. Unemployment will fall to 4.4 per cent by the end of 2016.

Average hourly earnings and indicator

Net balance, year-on-year percentage change



Source: BLS, NFIB, SEB

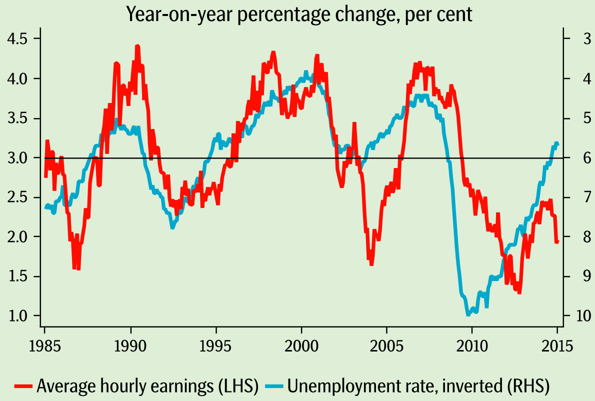
Despite unexpectedly weak figures last year, a tighter resource situation suggests that **hourly earnings will rise faster in 2015**. Demand for labour is climbing steadily: job vacancies are at a 14-year peak, and the ratio between job vacancies and new hires is record-high. The negotiating position of employees should thus improve, which suggests higher real wage increases. Wage expectations of small businesses have already climbed and are currently compatible with hourly earnings increases of about 3.5 per cent. Overall, **we predict that average hourly earnings will rise by 2.7 per cent in 2015 and 3.5 per cent in 2016**. But if, despite our forecasts, hourly wages continue to lag, the **normalisation of Fed monetary policy may be delayed**.

Why aren't hourly earnings growing faster?

With unemployment already close to the equilibrium level (NAIRU), wage growth should be accelerating. **According to the official quarter-on-quarter Employment Cost Index (ECI), wages are already increasing in line with the previous recovery**, and the trend of average weekly earnings is also pointing upward. But the market focus is on average hourly earnings growth, which has instead slowed this winter.

Unemployment and hourly earnings growth

Year-on-year percentage change, per cent



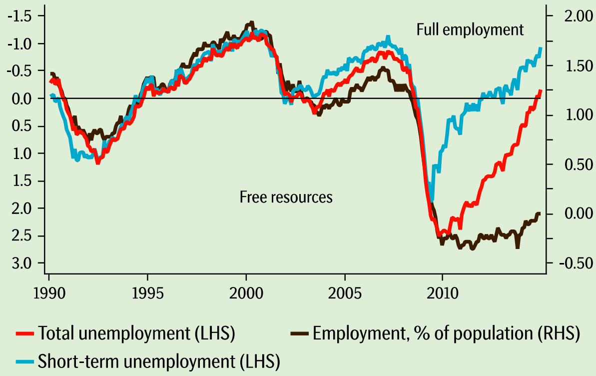
Source: BLS, SEB

Earnings rigidity during the deep recession of 2008-2009 is one reason that has been cited to explain why hourly earnings are stuck at slow rates of increase. Even though joblessness rose to double-digit levels, earnings continued upward during the years of economic crisis. These postponed wage cuts are probably now having an impact in the form of unexpectedly slow pay increases. Historically, today's **unemployment level should be compatible with average hourly earnings increases of more than 3 per cent**.

Lags between given resource situations and wage formation may be long and varied. During the recession of the early 2000s, it also took a long time for earnings growth to rebound. Looking back even further in history, there are indications that **the link between the labour market resource situation and wage inflation has weakened** in recent decades; before former Fed Chairman Paul Volcker's aggressive action in the 1980s to combat inflation, the link was stronger. At that time, the Fed's credibility as an inflation-fighter was lower and inflation expectations were less anchored. In the past, it was also more common for wages and salaries to be inflation-indexed. Since the 1990s, globalisation has also had a growing influence on wages and prices, probably weakening these links.

How far from full employment?

Standardised indicators



Source: BLS, SEB

A further explanation is that the resource situation is substantially less tight than unemployment figures indicate. While various standardised measures of unemployment indicate that the economy already enjoys full employment, labour force participation has hardly risen at all during the recovery – and demographic factors cannot fully explain this. If there are indeed still plenty of idle resources in the economy, it is **good news for the recovery**. In that case, we can look forward to several years of above-trend GDP growth before the economy hits its capacity ceiling.

Fiscal policy cooperation or confrontation?

The improvement in public finances since 2010 has been the fastest in 50 years. In fiscal 2014, which ended September 30, the federal deficit was 2.8 per cent of GDP – below the 30-year average of just over 3 per cent. During 2015-2016, the budget deficit will remain close to current levels and **fiscal policy will make a neutral contribution to growth**.

Strong federal finances are reducing incentives to tackle difficult medium- and long-term fiscal challenges. The new Congress, with Republican majorities in both the Senate and House of Representatives, otherwise has good potential to introduce significantly more bills than earlier Congresses. Meanwhile it remains to be seen whether Barack Obama will use his veto power regularly to kill Republican proposals. The president's decision late in 2014 to push through an immigration policy reform without Congressional approval annoyed Republicans and increases the risk of confrontation. Yet we **remain optimists about the climate of political cooperation at the federal level**: by using his veto power sparingly, the president can improve both his legacy and Democratic chances in the 2016 elections.

We thus believe that **most deadlines will be met in time**. But considering the autumn 2013 political deadlock, when Washington was temporarily forced to shut down various government services, there is a natural concern about the debt ceiling issue. The debt ceiling, which sets a limit on how much the federal government may borrow, will formally come up in mid-March but this restriction will not become binding until after the summer.

Inflation will fall sharply

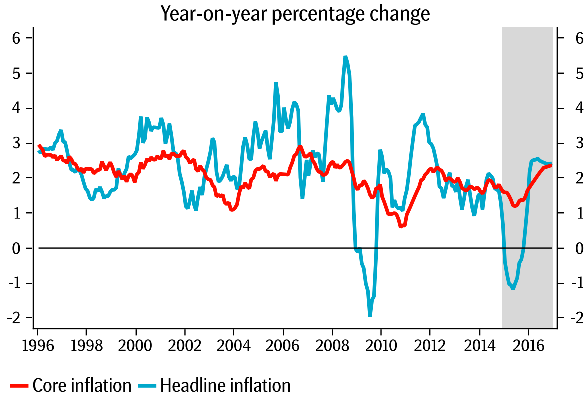
The oil price decline will have dramatic effects this year. CPI inflation will drop to a low of -1.20 per cent this spring. Although this downturn will probably be temporary, annual average inflation in 2015 will also be negative; **we predict inflation of -0.4 per cent this year and 2.4 per cent in 2016**. The sharp decline in inflation during 2015 will trigger a surge in real incomes, stimulating consumption. **The oil price decline will thus have a two-edged effect on the Fed's decision making situation**. Its impact on long-term inflation expectations will probably be important. So far, it appears that the inflation expectations of the financial market have fallen, while expectations remain stable among households. According to the University of Michigan sentiment survey, only one per cent of households foresee deflation over the next five years, and long-term inflation expectations are set at 2.8 per cent.

Aside from CPI inflation expectations, core inflation is being carefully watched by the Fed. We believe that **core inflation**, excluding food and energy, will **slow by 3 tenths of a per cent during 2015**. USD appreciation since last summer will make imported goods cheaper, while secondary effects of oil prices will occur via such channels as air fares, which fell sharply in December. Our overall assessment is that **core inflation will reach 1.4 per cent in 2015 and 2.1 per cent in 2016**, close to market consensus.

The risks in our inflation forecast are probably on the downside. Yet we believe that **there is little likelihood of a broad deflation spiral**. The sizeable decline in CPI inflation to date is fully explained by the downturn in the energy index – excluding energy, consumer prices are rising by 1.9 per cent according to the latest figure, which is four tenths of a per cent higher than in January last year. According to alternative measures such as the Cleveland Fed's median-weighted CPI, prices are climbing by 2.1 per cent, and looking at the service sector the annual rate of inflation is currently 2.4 per cent.

Plummeting inflation in 2015

Year-on-year percentage change



Source: BLS, SEB

Fed is setting the stage for key rate hikes

Judging from what is being communicated today by US central bankers, **decision makers seem to feel that June will be a good time to begin normalising** monetary policy. As a group, economists have also focused on this date, with 60 per cent of them viewing June as the most likely starting point for key rate hikes. Our forecast of the real economy, with strong GDP growth and falling unemployment, also suggests relatively early rate hikes. Meanwhile, a cocktail consisting of inflation expectations, the dollar and core inflation suggest that the Fed will wait longer. The Fed's decision-making situation has become more difficult in terms of balancing low inflation pressure against the risks of an excessively tight resource situation and the emergence of financial bubbles.

Our forecast is that the **first interest rate hike will take place in September**. Once the Fed has begun its hiking cycle, the historical pattern is that interest rate normalisation occurs stepwise at each monetary policy meeting – that was the pattern during the last such cycle in 2004-2006. This also provides the greatest monetary policy transparency. Meanwhile the pace of tightening depends on how financial conditions react and is not carved in stone. Our forecast is that **the Fed will hike its key rate to 0.75 per cent by the end of 2015 and 1.75 per cent by the end of 2016**. This implies that the central bank will choose to raise its key rate at every second monetary policy meeting this time around. Such a procedure would also lead to much faster rate hikes than indicated by today's market pricing, but a gentler rate path than the Fed itself is signalling.

The risk that interest rate normalisation will be postponed for even longer is greater than the risk of faster rate hikes. If average hourly earnings continue their slow pace of increase and household inflation expectations also begin to lose ground, there is reason for the Fed to abstain from rocking the boat for a longer period. And if core inflation falls as low as one per cent, we believe that the first rate hike will probably not occur until 2016.

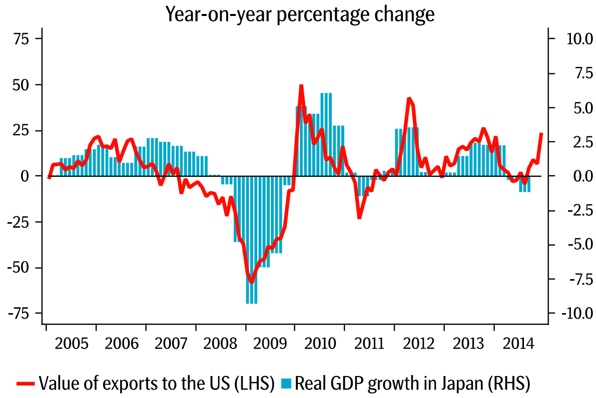
Brighter export outlook – sluggish structural reforms

- **Looser fiscal and monetary policies**
- **Stronger demand in US lifting exports**
- **Bond market relaxed about monetarisation**

Last year Japan's economy entered its fourth recession in six years. Growth in 2014 as a whole looks set to reach only 0.2 per cent, a major disappointment compared with expectations early in the year. **We forecast growth of 1.1 per cent in both 2015 and 2016**. This is above the long-term trend of around 0.5 per cent, but below the optimistic projections made when the government's new economic policy – Abenomics – was launched some two years ago. Our forecast represents a slight upward revision for 2015 compared to November's *Nordic Outlook*. The main reasons for this more positive estimate are increased **economic policy stimulus and stronger US demand** which together with improved competitiveness are **beginning to have an impact on foreign trade**. The weak response to the currency depreciation from exports has been one of the big disappointments of Japan's economic reforms, but now there are signs that export growth is starting to accelerate, driven by a fourth quarter upswing in deliveries to the US as well as newly industrialised Asian countries and to some extent China. Meanwhile falling oil prices – and a reduced future need for imported energy as Japan restarts its nuclear power production – may slow the growth of imports.

Increased US demand for Japanese exports

Year-on-year percentage change



Source: Statistics Bureau of Japan, Cabinet Office

During the final quarter of 2014, other economic activity also increased as private consumption and industrial production gradually began to recover from their sharp declines earlier in the year. Business and household sentiment is showing signs of at least stabilising, while unemployment is levelling out at a low 3.5 per cent or so. Looking ahead, one important question is to what extent the tight labour market will affect wage formation. Large companies, which have benefited most from the weaker yen, are being pressured by the government to boost wages and salaries in this spring's round of pay negotiations. But the divided labour market, with its growing share of people employed on looser contracts, suggests that it may be **difficult to bring about broad-based pay increases in the economy**. Inflation has been lifted by rising import prices and especially by the consumption tax hike, but is now falling rapidly, partly as a consequence of low energy prices. We expect **inflation of 1.0 per cent in 2015 and 0.7 in 2016, still below the 2 per cent Bank of Japan (BoJ) target**.

Short-term economic policy will provide greater support for growth. The first "arrow" of Abenomics – powerful monetary policy stimulus – intensified in October when the BoJ decided to expand its asset purchases to JPY 80 trillion a year. We believe that due to low inflation, in April the BoJ will boost its quantitative easing to JPY 100 trillion per year. The second arrow – short-term fiscal policy stimulus followed by steps to steer public finances into a more sustainable long-term path – has been re-launched as well. The next step in the planned consumption tax hike has been postponed until 2017. After the December 2014 election, the government also approved a new stimulus package totalling about 0.7 per cent of GDP and aimed at households and infrastructure projects, while the corporate tax will be lowered by 2.5 percentage points in April.

The third arrow – structural reforms to boost long-term growth – remains sluggish, although the government is taking steps to increase labour force participation among women and ease the recruitment of foreign workers. The re-election has strengthened Abe's reform mandate but the pace of reform is too slow to make any difference in underlying growth potential during our forecast period. Meanwhile demographic challenges, including a rapidly ageing population, are a growing obstacle in a situation where spare resources are now largely gone and the output gap has closed. Public sector fiscal deficits are now being fully financed by "printing money", since **the BoJ is buying more government bonds than are being issued**. In the long run this is not sustainable, but it is no threat to short-term stability. Ten-year bond yields have continued falling, touching new record lows of only 0.20 per cent. This shows that **the fixed income market is not yet worried about inflation risks from government debt**, but instead is discounting excessively low inflation. As for the exchange rate, in trade-weighted terms the yen has recovered its entire earlier appreciation during the crisis. We expect BoJ stimulus measures to continue weakening the yen to **USD/JPY 140** by the end of our forecast period.

Lower inflation pressure allows easier monetary policy

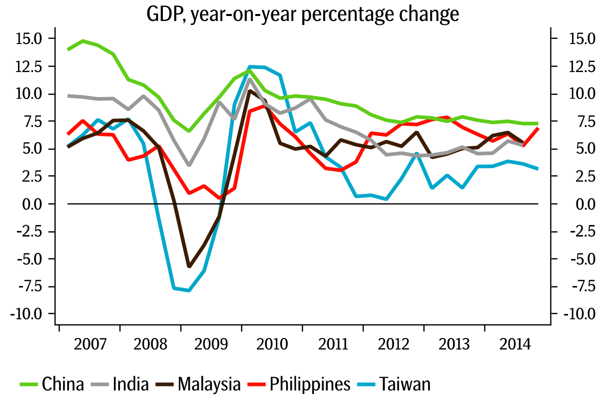
- **Cautiously accelerating economic expansion in most of emerging Asia**
- **China: Continued slowdown in growth**
- **India: Lower inflation, higher GDP growth**

GDP growth is expected to accelerate during 2015 and 2016 in most emerging economies in Asia, but China will be a key exception. Because of its slowdown, acceleration elsewhere in the region will be moderate despite stimulus from the strong US economy. Credit-driven domestic demand will also cool off in many economies. Including China, growth will stagnate at about 6 per cent in both 2015 and 2016.

Most Asian emerging economies are net energy importers and therefore benefit from the sharp oil price decline. Combined with low underlying inflation pressure, this means that inflation will occasionally be negative during 2015, but we expect deflationary tendencies to be short-lived and prices to climb again in 2016. The **positive growth effects from lower inflation** will vary between economies but will generally be **limited**. The channels through which these effects occur will also vary. In economies with energy subsidies, such as Indonesia, central government finances will benefit rather than households. In other countries, households will see significant real income increases. But leakage in the form of higher imports and saving will limit the impact on GDP. Another consequence of downward pressure on inflation is that **central banks can continue their loose monetary policies**. In some economies like India, South Korea and Thailand, slower inflation will contribute to further key interest rate cuts.

Cautious GDP acceleration expected

GDP, year-on-year percentage change



Source: National statistical offices

The consequences of the Fed's expected key rate hikes are a risk factor, but our main forecast is that financial market turbulence on the scale that arose in the summer of 2013 can be avoided. The Fed's rate hikes will most likely be communicated well in advance, while most Asian emerging economies have boosted their resilience, primarily because of improved current account balances. We thus expect most currencies in the region to strengthen against the USD during 2015. Indonesia is still the economy that looks the most vulnerable.

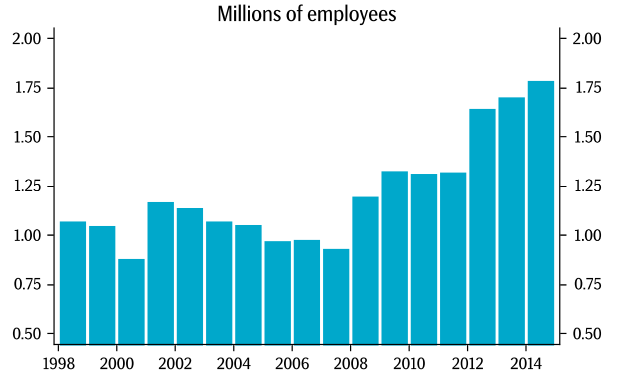
China: Economic policies will continue to ease in response to the slowdown

Fourth quarter GDP growth ended up at 7.3 per cent year-on-year, which was somewhat higher than expected, but on a **full-year** basis the country's economic deceleration continued and growth was **7.4 per cent**. China can thus be viewed as having achieved its 2014 growth target of "about 7.5 per cent". The official target for 2015 will probably be lowered to 7.0 per cent. A **gradual growth slowdown** to sustainable growth rates is a **benign scenario for China**.

Chinese policymakers consider labour market developments very important. As we have emphasised in earlier analyses, the labour market can probably handle slower economic expansion without serious consequences (see, for example, *Economic Insights*, "China's labour market can cope with a decline in GDP growth without weakening", January 2015). This is due to a **shrinking labour supply** and because rapid expansion in the labour-intensive service sector means that **more jobs than previously are being created by a given level of GDP growth**.

Increase in urban employment for each percentage point of GDP growth

Millions of employees



Source: IMF, National Bureau of Statistics of China, SEB

Despite lower ambitions, it will be a challenge to achieve the new official growth target. Economic policy will face trade-offs between the need to stimulate growth and the government's desire to reduce the risks of unsustainably rapid credit growth. Rapid reform efforts are making this balancing act even more difficult, but it has become increasingly clear that Chinese authorities have assigned higher priority to growth-sustaining policies and have shown a readiness to abandon their goal of a clear deceleration in credit growth. We thus expect both monetary and fiscal policy to become more expansionary. We believe that the **key rate cut in November** 2014 to 5.6 per cent **will be followed up by a further cut to 5.20 per cent**. Bank reserve requirements were lowered early in February and more cuts are expected, while the central bank will continue to inject liquidity into the banking system. **We also expect somewhat looser fiscal policy**, with the budget deficit climbing from its current 2 per cent of GDP towards 3 per cent during our forecast period.

We expect ambitious reform efforts to continue. The budget law revision adopted last year has now gone into effect, reducing the risk that local government debt will pose a threat to the financial system. Late in November, the government unveiled a plan for a bank **deposit guarantee** system of a type similar to that found in most developed countries. The guarantee amount will top out at half a million yuan and is one step along China's path towards deregulating deposit interest rates. Reforms in the financial sector are moving quickly, but other projects are also being implemented. For example, the **pension system** will be reformed to make conditions for public and private sector employees more similar.

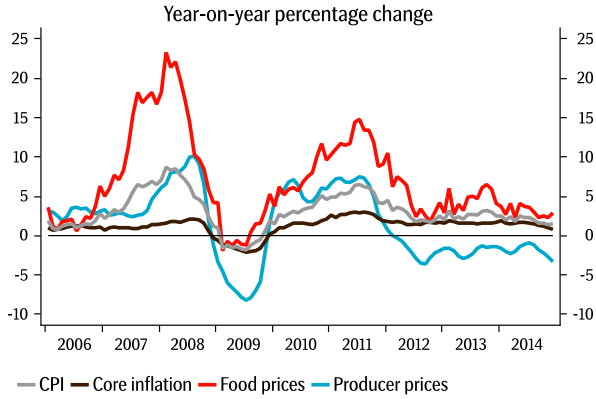
The question now is to what extent more expansionary economic policies can interrupt the downward trend in growth. Both **indicators and hard data showed weakness late in 2014**. Purchasing managers' indices in manufacturing have fallen. In January, both official PMI and the HSBC/Markit index were just below the growth-neutral 50 mark. Most hard data also weakened late in 2014 as industrial production, capital spending and retail sales slowed. One bright spot is exports, which are sustained, but year-on-year import growth has fallen in recent months. We expect imports to remain weak, largely due to weak demand for commodities. This trend will continue, since neither a clear upturn in the housing market nor a stimulus-driven investment boom appears likely.

As in 2014, we do not believe that stronger external demand and increased stimulus measures can fully offset weak underlying domestic demand in China. Looking ahead, the housing market situation will be crucial to domestic growth. Month-on-month, home prices (measured in 70 major cities) fell during the whole of the second half of 2014, but the decline has slowed while the number of home sales has started to recover. Our overall assessment is thus that **the risk of a severe correction in the housing market has clearly decreased** in recent months, partly due to a softening of strict housing market policy. Yet the housing market **will continue to hamper growth**, since the large oversupply of homes will mean less construction. The problems in the housing market are one important reason behind the slowdown in overall capital spending, especially since activity in various related sectors is falling. Another side effect of the weak housing market is a decline in land sales, which leads to lower local government revenue and makes it harder to finance infrastructure and other investments. Our overall estimate is that **GDP growth will cool to 7.0 per cent in 2015 and to 6.7 per cent in 2016**.

Full-year CPI inflation in 2014 ended up at 2.0 per cent, after slowing to 1.5 per cent late in the year. Already low core inflation has also moderated in recent months. The drop in oil prices – combined with price declines for other commodities – has further pushed down producer price inflation, which has been negative for some time. CPI inflation is less sensitive to oil price changes than in other countries, however. Although China is a large net importer of oil, price controls mean that the oil price downturn has only a limited impact. Meanwhile energy represents a small percentage of the CPI basket. Food prices account for around one third of the basket and were the main factor pushing down CPI inflation in the second half of 2014. Lower oil prices, combined with price declines for various agricultural commodities, will lead to a continued short-term slowdown in overall inflation. **We expect full-year 2015 inflation to be 1.7 per cent**: a downward revision of 0.3 percentage points since our forecast in November's *Nordic Outlook*. In **2016**, inflation will accelerate to **2.0 per cent**.

Continued low inflation pressure

Year-on-year percentage change

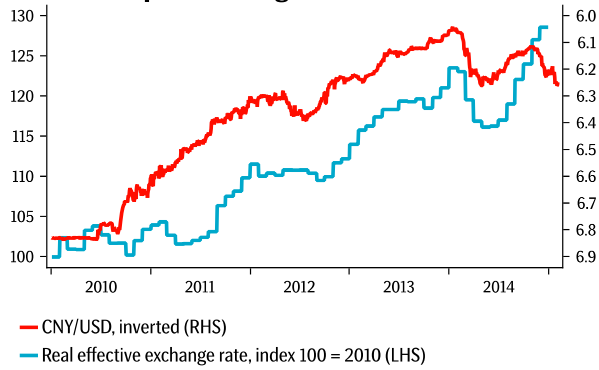


Source: National Bureau of Statistics of China

Low inflation pressure has created concern about deflationary tendencies, and there is undoubtedly a risk that inflation pressure will be lower than in our forecast. **Yet we believe that there is little likelihood that China will get stuck in a dangerous deflationary spiral.** Downward pressure on inflation is being driven by commodity and food prices, while wages continue to rise at a healthy pace and companies do not appear to be under pressure to cut the prices of their products.

During 2014 the **yuan** weakened by about 2.5 per cent against the USD, but measured in trade-weighted terms, the currency appreciated. Even if exports would benefit from continued depreciation against the dollar, we believe that Chinese authorities want to avoid such a development due to the hazard of US trade sanctions. A weaker currency also risks leading to capital outflows that can destabilise the financial system and also undermining the official goal of eventually making the yuan a globally important currency. **We expect an USD/CNY exchange rate of 6.00 at the end of 2015 and 2016.**

Stronger real effective exchange rate in 2014 but depreciation against the US dollar



Source: BIS, Macrobond

India: Brighter picture after sizeable upward revision of GDP figures

In late January, India's Central Statistics Office published GDP figures incorporating big upward revisions. **The CSO revised GDP growth for the fiscal year ended in March 2014 from 4.7 per cent to 6.9 per cent**. Growth in the preceding fiscal year was also revised higher, but not as much. These revisions were due to major changes in calculation methods. The base year is later, while GDP is now calculated using market prices instead of factor cost. GDP is also more broad-based than before. We believe this will improve GDP data quality, making it more consistent with internationally accepted principles.

Although this **revision** is a step in the right direction, it **makes assessing economic conditions harder**, creating uncertainty about growth forecasts. The far brighter picture provided by the revised figures is difficult to reconcile with indicators and hard data. For example, industrial production points to weak performance during the same period that GDP accelerated rapidly, although a sizeable share of the revision originates in the manufacturing sector. A revision of production data would thus probably also result in a brighter picture.

Regardless of the revision, we are sticking to our scenario of **relatively cautious growth acceleration ahead**. Heavy corporate sector debt is holding back an upturn in capital spending, despite key interest rate cuts. The Narendra Modi government's reforms are moving in the right direction, but tough resistance is expected to far-reaching, important reforms such as loosening labour market legislation. It will also take some time before already implemented reform measures have an impact on growth. The GDP revisions may also adversely affect reform potential, since the ruling BJP party used sluggish growth under the previous government as a key argument for reforms in its campaign before the May 2014 parliamentary election. Substantially higher historical growth may thus further harden opposition to reforms.

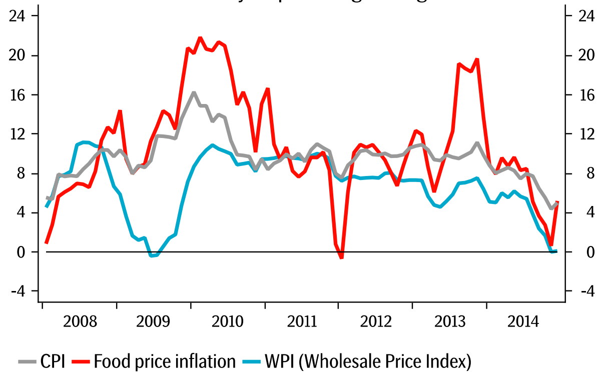
Aside from its efforts to reduce the budget deficit, the Modi-led government has presented a number of reform initiatives. For example, it appears likely that a **national sales tax** can be implemented despite opposition. It will replace a patchwork of different state taxes, thereby making it easier for companies to operate in more than one state. But really major reforms are still conspicuously absent.

Overall, the revisions mean our GDP forecast will be far higher than in November's *Nordic Outlook*. **The growth rate will rise cautiously from 7.0 per cent in 2014 to 7.3 per cent in 2015 and 7.6 per cent in 2016**. Assuming continued reform efforts and looser monetary policy, there is **potential for further growth acceleration after 2016**.

In mid-January, the Reserve Bank of India (RBI) cut its key interest rate from 8 per cent to 7.75 per cent at an extra policy meeting. Although this cut happened a bit earlier than expected, it was in line with our forecast of a rate reduction in the first quarter of 2015. The central bank explained the cut by saying that slower inflation has now "provided headroom for a shift in the monetary policy stance", aimed at speeding up weak economic growth. **Inflation has slowed markedly** in recent months. CPI inflation, the RBI's target variable, was at 5 per cent in December 2014, compared to nearly 10 per cent early in the year. A drop in oil and food prices drove the downturn. Inflation expectations have also fallen sharply. The RBI left the key rate unchanged at its regular February meeting. According to its press release, the upward revision in GDP growth may affect the RBI's own forecasts in the future. However, we believe that the sharp slowdown in inflation has made room for further rate cuts. **We expect the RBI to cut its repo rate by a further 75 basis points. The key rate** will thus stand at **7.0 per cent at the end of 2015**. The central bank's long-term target is inflation of 6 per cent at the beginning of 2016: a target that is now clearly within reach. Annual average CPI inflation ended up at 7.2 per cent in 2014. **It will slow to 5.7 per cent in 2015 and 5.4 per cent in 2016**.

Sharp decline in CPI inflation

Year-on-year percentage change



Source: Ministry of Commerce and Industry

The rupee ended 2014 close to the levels against the USD that prevailed early in the year. Nor do we foresee any dramatic shifts in the exchange rate ahead; **at the end of 2015 and 2016, we expect an INR/USD exchange rate of 60.0**. Lower oil prices will support the currency by strengthening India's trade balance. The rupee is now more resilient to foreign exchange market turbulence.

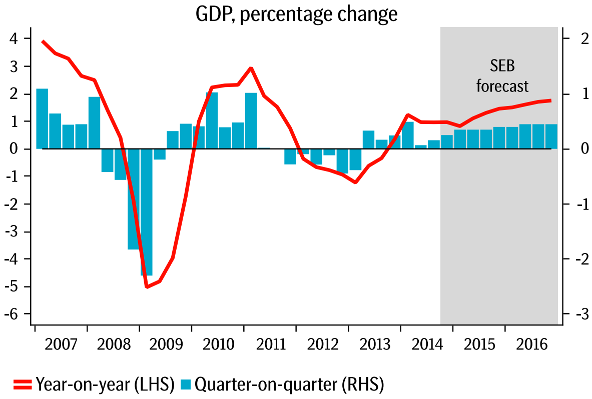
ECB and low oil prices will help boost growth

- **Heavy debt and political uncertainty are hampering economic expansion**
- **Consumer prices will fall in 2015, but broad deflation can be avoided**
- **Greek crises illustrates euro zone internal tensions**

Despite gradually improving growth prospects, the euro zone is lagging the international recovery. Lower oil prices, combined with a weak euro and a more expansionary interest rate environment due to forceful measures by the European Central Bank (ECB), are providing a rather powerful **dose of economic stimulus**. But at the same time there are strong counterforces: heavy debt, fragmented credit markets and political uncertainty both at home and in relation to Russia. This means that economic growth will remain too weak to make a dent in the problems of widespread unemployment and high debt.

The growth rate is slowly increasing

GDP, percentage change



Source: Eurostat, SEB

The German economy will show 1.5-2 per cent annual growth in 2015-2016 while recovery continues in Spain, but France and Italy will continue to lag behind the region as a whole (the four largest countries account for about 75 per cent of euro zone GDP). Altogether, we believe that **GDP growth will climb from 1.0 per cent in 2014 to 1.2 per cent in 2015 and 1.7 per cent in 2016**. This represents an upward revision of three tenths in both 2015 and 2016, as well as a **more balanced risk picture**, compared to the last *Nordic Outlook*. The increase in real incomes due to lower oil prices is the main reason behind our revision.

Unemployment fell early in 2014 but has been stuck at around 11.5 per cent for the past six months. Low resource utilisation, continued cost adjustment in various countries and low oil prices are intensifying deflation pressure in the euro zone, but we believe that **the ECB's actions are enough to prevent a long-term and paralysing deflation process**. Inflation according to the Harmonised Index of Consumer Prices (HICP) will be negative during most of 2015 and then rebound to less than 1 per cent during 2016. Core inflation will be around ½ per cent in both years.

GDP

Year-on-year percentage change

	2013	**2014**	**2015**	**2016**
Germany	0.1	1.5	1.6	2.0
France	0.4	0.4	0.8	1.1
Italy	-1.9	-0.4	0.3	1.0
Spain	-0.1	1.6	2.2	3.0
Greece	-3.9	1.0	1.7	2.6
Portugal	-1.4	1.0	1.2	2.0
Ireland	0.2	3.0	2.5	2.7
GIPS countries	-0.7	1.6	2.1	2.8
Euro zone	**-0.5**	**1.0**	**1.2**	**1.7**

Source: Eurostat. SEB

The ECB's decision in January to supplement its zero interest rate policy with a large-scale **government bond purchasing programme will have an impact in many areas**. The programme will help partly decouple euro zone bond yields from the US upturn following expected Fed key rate hikes. Meanwhile it will help slow the trend towards falling inflation expectations. The ECB's stimulus measures will also weaken the euro, thus benefiting exports, but we should not expect too great an impact. One reason for this is that trade sanctions and recession in Russia will have an adverse impact, both directly via exports and indirectly via lower confidence and hesitation about new capital spending.

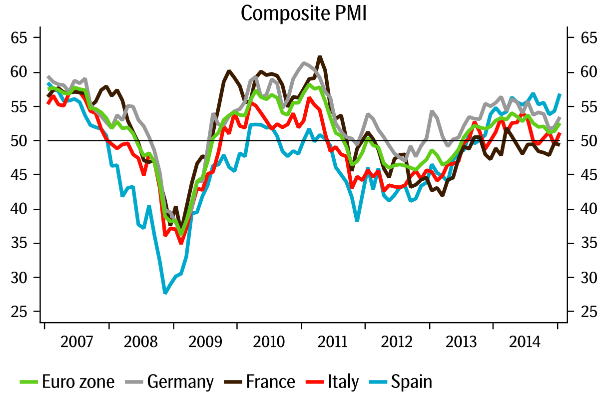
Political factors are also continuing to hamper expansion. Weak and divergent economic expansion is making euro zone cooperation more difficult. For example, there is growing support for populist parties that are critical to euro zone austerity policies and/or generally opposed to greater economic integration. Time-consuming reform and consolidation efforts tax public patience, and structural reform efforts now seem to be losing momentum. The lack of progress in structural policy will hamper growth potential, especially long term, but it may also dampen household and business optimism, thus holding back short-term growth as well. Deeper economic integration is also important in order to improve the region's resilience to major economic strains and shocks.

Indicators remain subdued

Indicators have recently converged to some extent, although differences remain between countries. **Last autumn's broad-based downturn in purchasing managers' indices (PMIs)** ended in December 2014 and has since turned to the better. The PMI for the euro zone as a whole was in January a bit above the neutral 50 mark (52.6). This level indicates a quarter-on-quarter growth rate of 0.1-0.2 per cent early in 2015. Meanwhile the EU's Economic Sentiment Indicator (ESI) has remained flat. The divergence between countries in the region has narrowed somewhat. **Domestically oriented service sectors are showing stronger performance than manufacturing**, partly because manufacturing is more affected by the uncertainty connected to the Russia-Ukraine crisis. Although direct export exposure to Russia is small (2-3 per cent), confidence and capital spending are being affected.

Some convergence, but gaps persist

Composite PMI



Source: Markit

International conditions will help exports

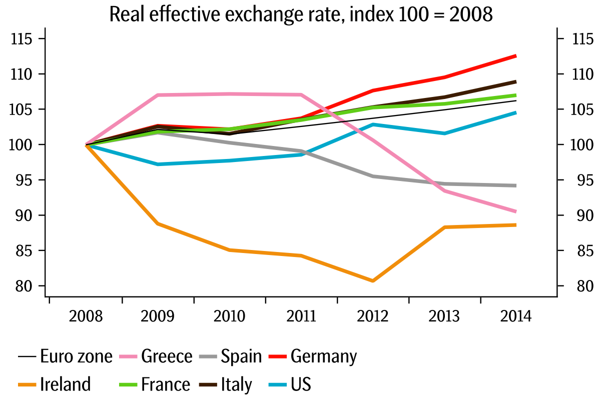
The rate of increase in industrial production slowed gradually last year. An improvement now appears to be under way; for example, German indicators are pointing to somewhat brighter expectations. Slowly improving world economic conditions and a weaker euro will **help boost both production and exports**.

Various euro zone countries have improved their competitiveness compared to the situation in 2008. Measured as real effective exchange rates, this applies especially to Greece and Spain. The question now is how big an impact the weaker euro will have on competitiveness and exports. Our analysis indicates that a 10 per cent euro depreciation boosts exports by 3-4 per cent. However, exchange rate variations explain only a small part of export changes – shifts in global demand are more important. So far, the trade-weighted weakening has not been as large as the shifts in the EUR/USD exchange rate indicate. While the euro has fallen by 16 per cent against the dollar since February 2014, the trade-weighted change has only been 8-9 per cent. Looking ahead, the gap will be narrower; we expect an additional 10 per cent EUR depreciation against the USD and a 6-7 per cent improvement in trade-weighted terms.

Our overall assessment of euro zone export growth in the next couple of years is relatively cautious. We expect an upturn of **3.2 per cent in 2015 and 4.4 per cent in 2016**. Imports will grow somewhat more slowly, and the current account surplus will remain at around today's level: some 2 per cent of GDP.

Improving competitiveness - for some

Real effective exchange rate, index 100 = 2008



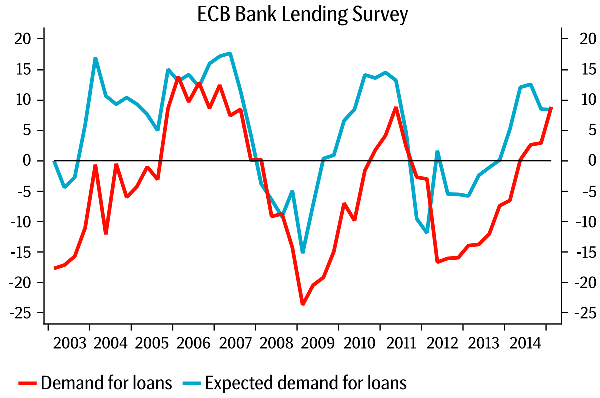
Source: OECD

Domestic demand will gradually improve

Continued uncertainty about economic trends and generally low demand **is continuing to hamper capital spending**. Capacity utilisation remains below the historical average. Industrial production is also weak and confidence is shaky, but recently a slight recovery has been noted. In Germany, for example, the ZEW financial sector and Ifo business confidence indices have bounced back in recent months.

Increasing demand for loans

ECB Bank Lending Survey

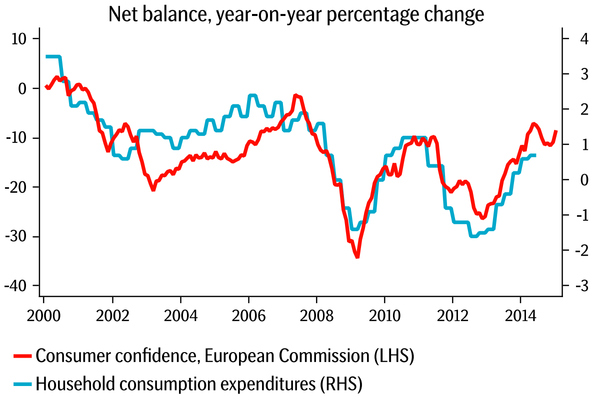


Source: ECB

Demand for loans remains weak, but a slight improvement is discernible in the ECB's research. One contributing factor is that euro zone banks have now been stress-tested and some have raised more capital. ECB asset purchases are also providing liquidity and pushing down interest rates, benefiting credit supply and demand. Despite this more favourable credit environment, we believe that the upturn in capital spending will be only **1.5 per cent in 2015 and 2.2 per cent in 2016**.

Consumer confidence has fallen somewhat since last summer but remains **at a level that suggests higher consumption**. Looking ahead, consumption will be sustained by rising incomes due to low inflation and some job creation. We expect real income to increase by more than 1 per cent in both 2015 and 2016, but because of heavy debt and a lack of optimism, part of this income increase will be eaten up by larger precautionary saving. **Consumption will thus increase by only 1.0 per cent this year and 1.4 per cent in 2016**.

Private consumption is increasing
Net balance, year-on-year percentage change



Source: Eurostat

Looser fiscal policy

The era of major belt-tightening is over, and economic policy-makers will focus on **using the available room for stimulus**. In the long term the challenge is still to bring down debt levels so they can deal with an ageing population. But with today's stagnation tendencies, the focus is now on easing the economic and social effects of the crisis. **Protest parties are gaining ground**, causing political leaders at the national and euro zone levels to **re-assess their crisis responses and accept more expansionary policies**. This process has been under way for some time but is being accentuated now after the election victory of the leftist Syriza party in Greece and strong support in opinion polls for Podemos in Spain, which will hold a general election later this year. Both parties were established during the crisis and have grown due to dissatisfaction with government austerity policies, high unemployment and social injustices. This trend reflects challenges that the euro zone faces. To be sustainable long term, a currency union requires strong fiscal policy integration. But if this is accompanied by rigid rules that are not effective in a crises, it will hardly be possible to win political support for more cooperation.

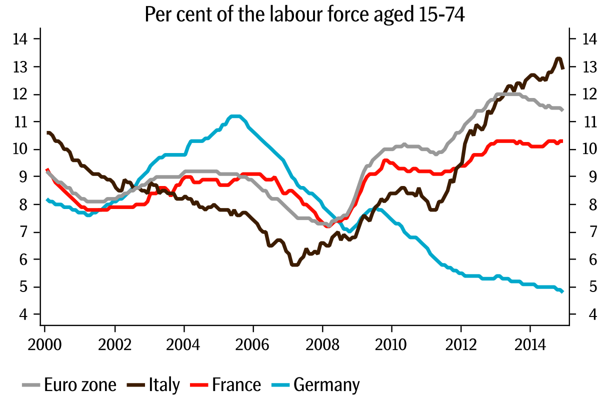
With a euro zone budget deficit of more than 2 per cent and government debt of around 95 per cent of GDP, there is very limited room for fiscal expansion, especially in light of slow growth and falling prices, which are boosting the debt burden as a share of GDP. We thus largely expect **relatively neutral fiscal policy in 2015-2016**, which means that deficits and debt levels in the euro zone as a whole will remain largely unchanged compared to the current situation. This limited room for traditional fiscal policy will create a need for supplementary measures. European Commission President Jean-Claude Juncker's plan for increased capital spending is one example of such measures. We also expect a large element of redistribution policy, with tax hikes being combined with higher expenditures in areas where the impact on consumption and capital spending will be maximised. But these measures will probably not be extensive enough to have any large direct effect. They will nevertheless be an important piece of the puzzle by improving confidence in the region.

Germany will play an increasingly vital role when it comes to fuelling demand in the euro zone. Because of its large exports as a percentage of GDP, the country will benefit from the weak euro. Its current account surplus will increase further from already record-high levels. It is thus likely that international criticism of Germany for doing too little to stimulate its domestic economy will become louder, but we do not believe that the country will launch any major stimulus packages. German political leaders are also under pressure from domestic critics who oppose making concessions in EU policy. For a long time, Germany tried to block the ECB's quantitative easing (QE) programme and won concessions. The lion's share of the risk associated with bonds bought will be on the balance sheets of national central banks. As for developments in Greece, we expect Germany to oppose any further debt write-offs but believe it will be forced to accept lower interest rates on Greek bail-out loans, possibly combined with a moratorium on interest and principal payments for a number of years.

Unemployment is stuck at a high level

Since the spring of 2014, euro zone unemployment has been relatively stable at 11.5 per cent. The differences between countries clearly reflect their divergent situations during the economic crisis. Germany's jobless rate is historically low, while Spain and Greece are still stuck at around 25 per cent. But in some crisis-hit countries, the trend towards rising unemployment has reversed. By the end of 2014, the levels in Spain and Greece were 2.0-2.5 per cent lower than at their peak in 2013. But it is worrying that unemployment in Italy is continuing to climb, while it has remained relatively unchanged at a high level in France for the past year.

Weak but gradual downturn in unemployment
Per cent of the labour force aged 15-74

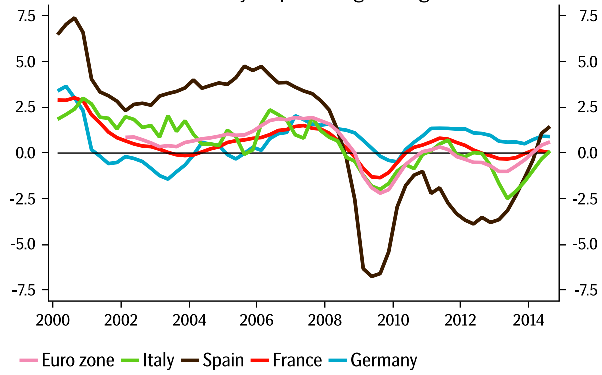


Source: Eurostat

There is relatively broad job creation in the region, even in France and Italy, thus providing a slightly brighter picture of the labour market. The reason why unemployment remains high in spite of this is that labour force participation has risen in the past year: the opposite of the US trend. On the other hand, emigration from heavily crisis-hit countries has climbed. Looking ahead, rising employment and a levelling out of labour market participation will cause the jobless rate to fall, albeit slowly. **Measured as annual averages, unemployment will be 11.2 per cent in 2015 and 11.0 per cent in 2016**.

Employment is increasing

Year-on-year percentage change



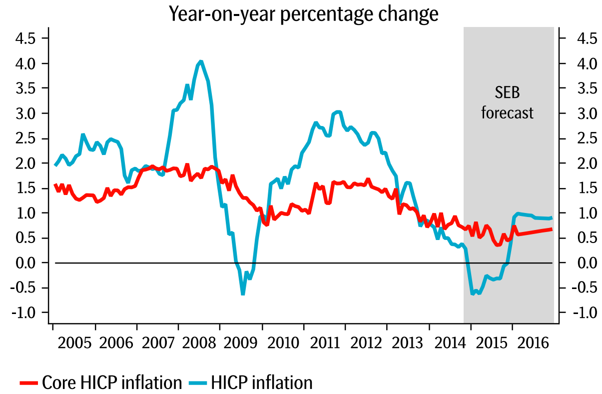
Source: Eurostat

Falling prices during 2015

In January 2015, the oil price decline pushed already low euro zone inflation down to -0.6 per cent. We are forecasting that **HICP inflation will remain below zero during most of 2015**. Low inflation is being driven mainly by low oil prices, but secondary effects on other areas will be apparent, for example in such fields as travel and transport. Meanwhile there is **general disinflationary pressure due to low pay increases and weak demand**, making it hard for companies to raise their prices. The deflationary environment is also strengthened by the need to restore competitiveness in southern Europe – in an environment of very low German price and wage inflation.

Low inflation pressure - deflation in 2015

Year-on-year percentage change



Source: Eurostat, SEB

Our forecast implies **that a broad deflation process in the euro zone will be avoided and that the downturn in inflation expectations will reverse**. The ECB's measures will contribute to this, among other things by weakening the euro. Euro depreciation will drive inflation to some extent, although historical data show a relatively low correlation between the exchange rate and the price trend.

QE programme will change the playing field

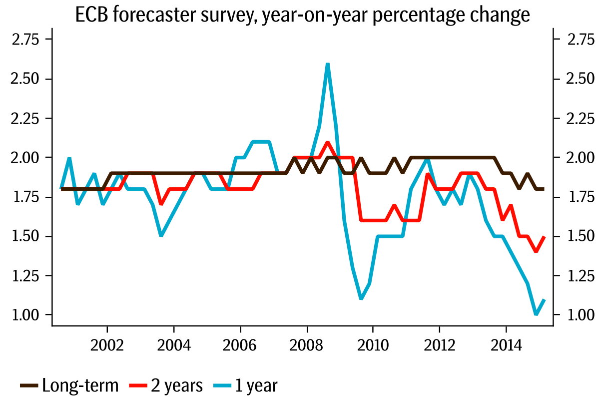
At its January policy meeting, the ECB kept the refi and deposit rates unchanged at 0.05 and -0.20 per cent, respectively. As expected, the bank also announced that it will begin buying government bonds in March. The quantity of asset-backed securities and covered bonds was simply not enough to enable the ECB to increase its balance sheet to the desired extent. The bank will also buy bonds issued by EU institutions. In all, it will **purchase EUR 60 billion worth of assets per month from March 2015 to September 2016**. The programme can then be extended until inflation sustainably reached its target of close to 2 per cent. The ECB is also lowering the interest on its remaining LTRO loans to euro zone banks to the same level as the refi rate (previously 10 basis points above the refi rate).

ECB **bond purchases will be based on countries' share of the bank's equity** (GDP-weighted) and will occur through coordination between the ECB and the national central banks. This means that the **risk of losses** (beyond 20 per cent of risk, which the ECB will accept) **will largely end up at national level**. In liquidity terms, it should not matter, but it is difficult to interpret in any way other than as a concession to countries that have been – and still are – sceptical to QE. This may be viewed negatively in terms of euro zone cohesiveness and solidarity; the currency union needs to be more cohesive and supportive to crisis-hit countries.

During the past year, the ECB has approved various stimulus measures. Inflation expectations are low but rebounded a bit before and after the bank's QE decision. Expectations about QE and falling inflation have pushed down government bond yields. QE is expected to further shrink yield spreads in the euro zone, since confidence in the region will increase and the ECB's actions will reduce country-specific risk. German yields have fallen since the ECB's announcement and we expect some additional near term downward pressure before yields starts to rise slowly. In the near term, we foresee no further policy announcements from the ECB. The QE programme shows that the key rate has bottomed out, and QE has to be given time before that decision is retested. The policy of buying government bonds is an open mandate and purchases may continue until inflation reaches the bank's target, so there is room to expand these purchases in the future if needed. What was psychologically difficult was to start the programme. Now that has happened.

Low inflation expectations, but weak upturn

ECB forecaster survey, year-on-year percentage change



Source: ECB

Rising excitement as parliamentary election approaches

- **Inflation will average below zero in 2015**
- **Unemployment will fall below equilibrium and pay is set to rise**
- **Tight resource situation will justify a Bank of England rate hike in 2016**

The British economy achieved an impressive GDP growth rate of 2.6 per cent during 2014. **This year and in 2016, the economy will expand by 2.8 and 2.5 per cent, respectively**: an unchanged growth forecast compared to our last *Nordic Outlook* and second only to the United States among G7 countries. Heightened political uncertainty due to the parliamentary election will not derail the recovery. Falling oil prices are also helping fuel the upswing. **We have sharply cut our inflation forecasts** to 0.2 per cent in 2015 and 1.4 per cent in 2016. Unemployment, which fell steeply last year, will continue downward towards equilibrium level and eventually below it, helping push wages and salaries higher. Meanwhile low inflation means that the Bank of England (BoE) can hold off on its key rate hikes for a long time: **the first step in interest rate normalisation will occur only a year from now**. By the end of 2016, the key rate will be 1.25 per cent.

Excitement is mounting as the May 7 election approaches. The Labour Party, which has been ahead in the opinion polls for a long time, has lost its lead and the latest surveys show almost identical support between the Labour Party and the ruling Tories (Conservatives). Neither Labour nor the Tories appear likely to win their own majority. Instead, our scenario is a **new coalition government**. But the Tories' current coalition partner, the Liberal Democrats, appears weak. The right-wing populist UK Independence Party (UKIP) is meanwhile gaining support. This means that the process of forming a government may be tricky. If it fails, the UK may hold its first snap election since 1974. Prime Minister **David Cameron has promised a referendum on continued EU membership** if the Tories remain in power. This is contributing to political uncertainty, which risks hurting both household and business confidence. A coalition that includes UKIP may also decide to hold the referendum earlier than 2017, the year most market players currently expect. Fiscal policy, which is expected to contribute a bit negatively to GDP growth this year, will be tighter in 2016. Another reasonable scenario is a **centre-left coalition between Labour and the Scottish Nationalists (SNP).** In that case, less fiscal tightening can be assumed.

Despite the political storms, there are **good reasons for continued optimism about the economy**; the halving of oil prices since last summer is benefiting both households and businesses. Household purchasing power will surge eve more as inflation falls to an annual average below zero in 2015. **Pay increases are also speeding up and credit conditions are easier**, suggesting that households will play an ever-larger role in driving growth. We expect nominal wages and salaries to rise by 2.1 per cent this year and 2.8 per cent in 2016. **Overall household consumption will grow by a yearly average of 2.6 per cent in 2015-2016**. Unlike earlier years, consumption will be based on solid incomes and the household savings ratio will rise from its current record-low level, according to our forecast.

Meanwhile business confidence indicators have fallen and are currently not compatible with our rather optimistic forecasts. In the last three months of 2014, GDP also grew by a moderate 0.5 per cent quarter-on-quarter and it was less broad-based; services and agriculture advanced strongly while manufacturing and construction lagged. **Indicators are thus raising questions about the duration of the recovery** and about the productivity declines of recent years. But we are cautiously optimistic about productivity: today's low interest rates and rising real wages should create strong incentives for capital spending that can boost the efficiency of employees.

The labour market will continue to improve, but job creation as strong as in 2014 – when employment growth reached a 25-year high – is not expected in 2015-2016. The UK's low unemployment is close to matching the 10-year pre-crisis average, indicating that there is **less and less slack in the economy**. Despite higher immigration, employment thus cannot continue rising at the same pace. **Unemployment**, which fell to 6 per cent in late 2014, **will be 5 per cent at the end of our forecast period**. With oil prices driving inflation lower, the resource situation will instead be the factor that eventually gives the BoE a justification to raise its key interest rate. We expect the Fed to hike its key rate this autumn, while the ECB will eases monetary policy. This suggests that the British pound will weaken against the US dollar but appreciate against the euro. **By the end of 2016, the GBP/USD exchange rate will be at 1.43 and the EUR/GBP rate will be at 0.70, according to our forecasts**.

Deep recession in Russia, bail-out for Ukraine

- **Russia has a 1-2 year reserves buffer**
- **Debt write-downs for Ukraine on the way**
- **Domestic demand driving Central Europe**

In mid-December last year, SEB drastically lowered its Russian growth forecast for 2015 from -0.2 to -4.0 per cent. This was after the rouble lost 37 per cent against the USD between late November and mid-December due to an unexpected further oil price collapse. We predicted an average Brent crude price of USD 70 per barrel in 2015 (compared to our forecast of USD 85 in November's *Nordic Outlook*) and assumed that this would generally slow Russia's strongly energy-dependent economy.

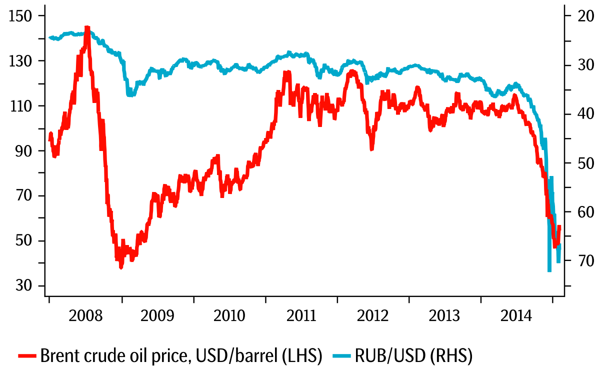
We are now forecasting a bigger GDP decline in 2015: 5.5 per cent. This is mainly because of a **downward revision in our 2015 oil price** forecast to USD 60/barrel, but also **new and extended Western sanctions** and the government's proposed 10 per cent **budget cuts**, except in defence and other "protected" fields. Sensitivity analyses by the IMF and others indicate that a permanent oil price downturn of USD 10/barrel for a year would have a negative GDP effect of 1-1.5 per cent in Russia. The weaker rouble is expected to have a big short-term impact on the economy by dealing a powerful blow to household consumption and squeezing the banking system. Competitive export advantages due to such large currency depreciations usually take time to materialise. Lower confidence in the Russian economy and sharply higher interest rates are expected to trigger a further downturn in capital spending; for some years, **weak investments have been one of the biggest structural problems in the economy**.

A large-scale emergency plan that the government launched late in January 2015 is expected to have a small positive impact on short-term growth. The 60-point plan, totalling about RUB 2.3 trillion (around 1.5 per cent of GDP), focuses mainly on aid to banks. The business and agricultural sectors will also receive subsidies and tax relief. The money will be taken from Russia's large reserve fund.

GDP will keep shrinking in 2016, by 1.0 per cent. This will be softened by a recovery in average oil price to USD 70 and better export conditions via depreciation effects and higher global demand. The decline in domestic demand will ease.

The rouble will remain vulnerable and weak during the next few months at somewhat above RUB 70 per USD – the same historically weak rate fix (72) at which it bottomed out in December 2014. It will then gradually appreciate. Sustained by an increase in oil prices during the second half of 2015, the RUB/USD exchange rate will reach 55 late in the year, still well below the Russian currency's estimated equilibrium level of 45.

Oil price collapse has now pushed down the rouble far more than in 2008



Source: Macrobond

Inflation accelerated to 15 per cent year-on-year in January. It will continue rising rapidly as a direct result of the rouble collapse, but also of supply-side effects from Russia's restrictions on food imports from countries that have enacted sanctions against the country. **We expect the inflation rate to culminate close to 20 per cent during the first half of 2015** and then gradually slow. This year inflation will average 16.5 per cent, and in 2016 it will average 9.5 per cent.

In December 2014 Russia's central bank raised its key rate sharply to 17 per cent and made huge currency interventions, but this only temporarily stabilised the rouble. In late January it cut the key rate to 15 per cent. **It will probably cut the rate cautious during the first half** out of concern for the rouble and inflation. Excessively large rate cuts risk triggering large-scale capital flight. Late this year, the bank will cut the key rate to below 10 per cent to support depressed domestic demand.

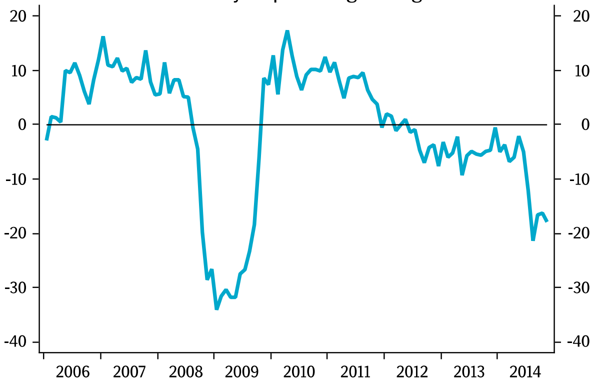
Despite this year's deep recession and continued short-term stress on currency and interest rates as well as in the banking sector, **Russia has enough financial muscle to avoid a fiscal crisis**. Its currency reserve of RUB 385 billion at the end of 2014 – which had admittedly shrunk from RUB 510 billion in December 2013 – low government debt and two large reserve funds will serve as a **protective buffer for 1.5-2 years**. The banking system can thus meet its refinancing needs even though Western sanctions have practically shut Russia off from the international USD loan market. A currency swap programme with China also provides support. If the predicted oil price recovery later this year fails to occur and/or Western sanctions are escalated sharply – for example by beginning to target the oil and gas sector – there is a heightened risk of a severe financial and economic crisis.

Ukraine on its way to debt restructuring

The Ukrainian economy is close to collapse. **Fighting in the eastern part of the country**, where most industry is located, has recently intensified and **is having a broad, powerful impact**. Production, exports, tax revenue and energy supply are hard-hit. For example, industrial production fell nearly 18 per cent year-on-year in November 2014. Exports are also down sharply, driven by the fighting and by economic problems in Russia, which is Ukraine's biggest export market. This is despite a huge slide in the hryvnia, which has driven up inflation to nearly 25 per cent. The weakened currency hurts household consumption and also affects the banking system, due to its large-scale loans in foreign currencies. Lending is adversely affected and thus also the economy as a whole.

Industrial production is plunging

Year-on-year percentage change



Source: State Statistics Service of Ukraine

Sharply declining economic activity, combined with rising military expenditures, is wreaking havoc with government finances. The public budget deficit is increasing. Ukraine's currency reserve is continuing to shrink rapidly. At the end of 2014 it was equivalent to only about one month's imports. The risk of default has risen dramatically. The current bail-out loans from the IMF and EU, totalling USD 27 billion (of which USD 17 billion from the IMF), have proved insufficient since they were based on excessively optimistic assumptions. In 2015 Ukraine will need another USD 15-20 billion to ensure its loan payments while implementing recapitalisations in the banking system as needed. **The government has asked the IMF to replace its current two-year bail-out loan with a four-year Extended Fund Facility (EFF).** The government has also announced that it intends to **initiate discussions on debt write-downs** with private lenders. No decisions have yet been made on these two issues, although the IMF appears prepared to reach an accommodation with the government. Both the EU and the US have also pledged small bail-out amounts. A credit facility, combined with a soft debt write-down in the form of an extension of the maturity of Ukraine's foreign loans, would probably be enough to cover the country's medium-term financing needs. This would also allow more time for the country to implement vital reforms.

The conflict with Russia is expected to be lengthy. There is also a risk that Ukraine will develop into an area of conflict between Russia and the US/NATO.

In 2014, Ukraine's GDP fell by an estimated 6.5 per cent. In 2015 the downturn will continue, reaching 5.0 per cent. With support from an upcoming bail-out and competitive advantages for the export sector from the currency depreciation, there is potential for a stabilisation in **2016**, with **GDP growth around zero**.

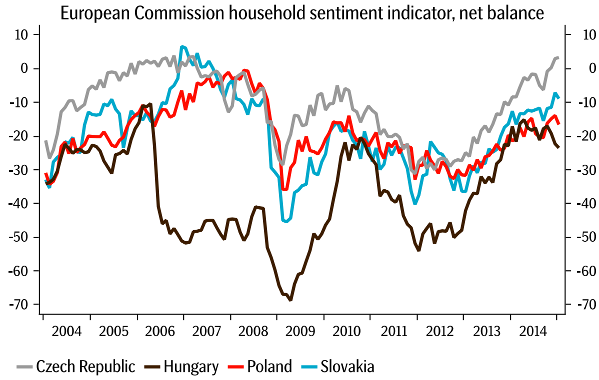
Central Europe will remain resilient

As we expected, growth in Central Europe and in south-eastern portions of Eastern Europe have been resilient to the Ukraine crisis and weak Russian demand. The main reason is **good domestic demand**, with consumption fuelled by relatively strong real household incomes. Generally speaking, most of these countries recorded mild slowdowns in GDP growth during the second half of 2014. For example, during the fourth quarter the year-on-year growth rate in Poland, the Czech Republic and Hungary stood at around 2.5-3 per cent. For the year as a whole, Poland's GDP increased by 3.3 per cent, which represented a clear improvement from 1.7 per cent in 2013.

We are revising our **2015-2016 growth forecasts for Central Europe** only slightly downward, despite a clear deterioration in the outlook in Russia. Central Europe's exports to Russia are relatively small. Far more important are Germany and the euro zone generally, where we are now adjusting our forecasts a bit higher. The **main driver of economic growth is households**, not the export sector. **In Poland and Hungary, consumption increases will decelerate a bit due to the sharp appreciation in the Swiss franc**, since a large share of mortgage loans (half in Poland) are CHF-denominated. Meanwhile there is decent job growth, while interest rates and inflation remain strongly depressed. Lower oil prices will support purchasing power. Russian food import sanctions are also creating an oversupply that is keeping food prices down. However, we expect **capital spending** to **remain modest** in Central Europe and increase only slowly. This is largely because of uncertainty about economic conditions in Western Europe and about how the Russia-Ukraine conflict will unfold. **The risk of lower capital spending growth is the main risk in our overall Central European scenario.**

Consumer confidence in Central Europe historically good

European Commission household sentiment indicator, net balance



Source: European Commission

Decent growth despite negative pressure from Russia

- **Downward revisions for Latvia, Lithuania**
- **Good real incomes = robust consumption**
- **2016 unemployment at or below equilibrium**

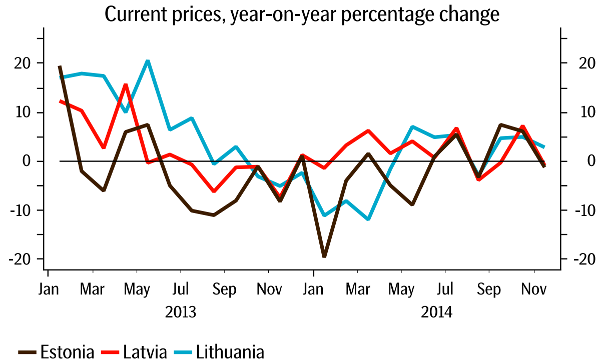
Baltic growth slowed moderately last year, though in Estonia it appears to have risen a bit. This is **despite weak demand in key export markets** like Russia (all three Baltic states) and Finland-Sweden (Estonia) as well as **negative sanction and confidence effects from the Russia-Ukraine conflict that broke out last winter**. Continued solid domestic demand, mainly driven by private consumption, supported growth. Statistics indicate that Latvia's GDP grew by 2.4 per cent and Lithuania's by 3.0 per cent in 2014, in line with SEB's forecasts last autumn and slightly stronger, respectively. Estonia's GDP is believed to have increased by 1.8 per cent. If so, Estonia showed the weakest growth for the second straight year, largely due to its heavy dependence on exports and weaker public sector investments.

External challenges recently worsened after **Russia's growth outlook fell steeply**. We now expect its GDP to decline by 5.5 per cent this year and shrink in 2016 as well. There is also a greater risk that Russia may extend its food import sanctions. Offsetting this are slightly better euro zone prospects and much lower oil prices and inflation assumptions, which will boost already strong real household incomes. Energy is a relatively large element of CPI in the Baltics (as elsewhere in Eastern Europe). Overall, **we are adjusting our Latvian and Lithuanian growth forecasts for 2015-2016 by 0.25-0.50 percentage points per year**, mainly in Lithuania which has the largest trade with Russia. **Latvia's GDP will grow by 2.5 and 3.0 per cent; Lithuania's by 2.6 and 3.5 per cent**. We are **keeping our 2015 forecast for Estonia at 1.8 per cent and trimming our 2016 forecast marginally to 2.6 per cent**. This is because of signs that Estonian economic momentum is a bit better than expected, due to rising Swedish demand and Russia's smaller impact on its exports than in the other Baltic countries. SEB's forecasts are all below consensus.

Conflicting forces will continue to dominate Baltic GDP performance, which will become more balanced only in 2016 when exports rebound. This year we expect continued weak export increases, weighed down by Russia's deep recession. The agricultural import ban in August 2014 (scheduled to expire after one year) will be a negative factor. Of the three Baltic countries, and among all EU countries, Lithuania is the most vulnerable to this; about 4 per cent of its total exports are affected. Due to their large transit trade, the Baltics have the EU's highest exposure to Russia (12-20 per cent of total exports). In current prices, Estonia's and Latvia's exports to Russia fell sharply year-on-year in January-November 2014, while Lithuania's unexpectedly rose by 7 per cent. This was due to large machinery and equipment re-exports, offsetting a sharp decline for agricultural and food products. Meanwhile there were reports that **Baltic companies have made themselves less dependent on Russia by turning to other markets**: in the case of Lithuania mainly Belarus, while Latvian companies did more business with the UK, Sweden and Central Europe. **Russian tourism to the Baltics decreased greatly** last year following the decline in the rouble, but this loss was slightly outweighed by increased tourism from other countries.

Baltic exports bottoming out, but Russia's recession will prevent a quick rebound in 2015

Current prices, year-on-year percentage change



Source: National statistical offices

Capital spending – sluggish even before the Russia-Ukraine confrontation – remained weak last year mainly in Estonia and Latvia. The exception was strong construction. **Investment growth will recover only gradually** in 2015-2016, sustained by EU structural funds and construction. Nearby geopolitical uncertainty and doubts about the upturn in Western Europe will have an inhibiting effect on capital spending. **Private consumption will remain the economic engine**, with households still enjoying favourable conditions. **Strong real incomes** will drive retail and car sales. Unemployment will gradually continue downward to 6-10 per cent (lowest in Estonia, highest in Lithuania) in 2016, partly a result of falling labour supply due to emigration. The jobless rate will be at or below equilibrium. This will lead to nominal pay increases of 5-7 per cent in 2015. In the short term, low energy and other commodity prices will keep inflation very low, although deregulation in Latvia will push up household electricity prices somewhat. Russian sanction effects will also help slow inflation effect via an increased food supply. Over time, inflation will climb cautiously as a result of higher wage and salary costs.

Improved export outlook helps ensure broader growth

- **Consumption, construction driving growth**
- **Weaker krona will accelerate export upturn**
- **Rising resource utilisation points to higher equilibrium unemployment**
- **Inflation is close to bottoming out**
- **Riksbank will introduce negative repo rate and launch modest QE programme**

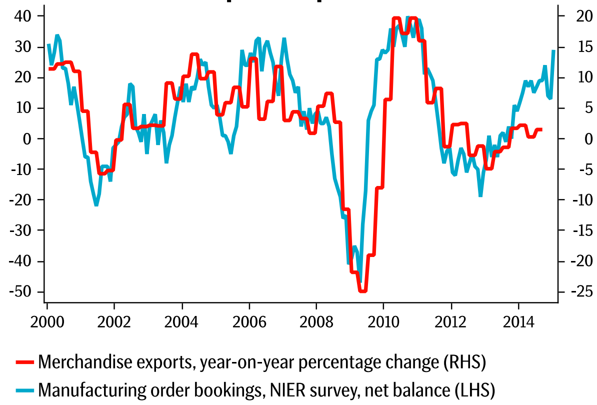
Despite headwinds from a weak Western Europe, this year the Swedish economy looks set for above-trend growth, something that has not happened since 2011. The upturn will continue to be driven by residential investments and household consumption, but unlike 2014 the manufacturing sector is now expected to make a positive contribution to growth. **We anticipate GDP growth by 2.7 per cent both in 2015 and 2016**: unchanged from *Nordic Outlook* in November 2014.

Employment increased strongly in late 2014, and there are many indications that the upturn will accelerate during the first half of 2015. The unemployment rate is now also beginning to fall, although rapid population growth will blunt the downturn. There are signs that some companies are finding it harder to recruit suitable employees, but capacity utilisation remains a bit below the levels where wage-driving bottlenecks usually occur. Yet because of low inflation – partly driven by low oil prices – we still believe that the Riksbank will launch unconventional policy measures. We expect the central bank to lower the repo rate to -0.10 at its February meeting. We believe that the Executive Board will also unveil a concrete plan for asset purchases and loans to the banking sector that can be implemented if extra stimulus measures are needed. Our forecast is that the Riksbank will expand its balance sheet later this year, but on a far smaller scale than in the euro zone.

Export outlook will be a little brighter

The manufacturing sector had a weak year in 2014. Hopes that were apparent in both the purchasing managers' index and the Economic Tendency Survey from the National Institute of Economic Research (NIER) were crushed when industrial production fell and merchandise exports remained flat. But since late 2014, sentiment indicators have started to rebound. This time, we believe that improved sentiment will be confirmed by hard data. In the euro zone, the period of falling GDP is over. **Swedish manufacturers are benefiting from a weaker krona**. According to our estimates, this currency depreciation will stimulate exports by an extra 3 per cent or so. Compared to historical upturns, the recovery will still be weak. The total export upturn, which is also driven mainly by higher service exports, will not exceed about 4 per cent this year.

Merchandise exports expected to rise in 2015



Source: National Institute of Economic Research, Statistics Sweden

Manufacturing sector investments will also climb in 2015, after a slight downward trend for the past three years. But a sharp upturn in residential investments resulted in an increase in overall capital spending in 2014. Residential investments rose by more than 25 per cent last year, and a continued upturn in the number of housing starts indicates that the increase will continue this year. A long period of insufficient construction – combined with rapid population growth – suggests another continued upturn in 2016, although at a gradually slower pace. In 2016, residential investments will account for approximately 5 per cent of GDP, which is relatively high in a historical and international perspective. But this is well below the levels reached in countries like Denmark and Spain before the financial crisis. **Residential construction is expected to contribute almost one percentage point to GDP this year and 0.5 points in 2016**. Excluding housing, we expect a moderate upturn in business investments during 2015 and 2016.

Strong households will keep spending more

Because of falling oil prices, real household incomes will increase slightly faster than we predicted earlier. Rising asset values in the National Pension Funds will make it possible to increase pensions faster in 2015-2016 than in 2013-2014. This is especially true of 2016. Consumption will also be sustained by higher asset prices and a stronger labour market. **In 2014, private consumption rose by 2.6 per cent. We believe that this year's increase will be somewhat stronger**. Yet consumer confidence declined in the second half of 2014, reflecting a degree of hesitation that can probably be explained by the shaky international outlook as well as uncertainty about the domestic political situation. This uncertainty has now diminished, at least temporarily, although it is still unclear what proposals the government can push through in its spring budget. We are nevertheless assuming that 2015 fiscal policy will be largely neutral in terms of household incomes.

Household incomes and consumption

Year-on-year percentage change

	2013	2014	2015	2016
Consumption	1.9	2.6	2.8	2.7
Incomes	1.8	2.4	2.7	1.6
Savings ratio*	15.4	15.4	15.2	14.3

* % of disposable income Source: Statistics Sweden, SEB

Continued strong housing market

During the past year, prices of single-family homes have begun to climb at an increasing pace after having stood still for nearly five years. Prices of tenant-owned cooperative units have climbed by 57 per cent since 2009, and the upturn for these units has also accelerated in the past year. These upturns are driven by rapidly increasing population, lower mortgage interest rates and rising share prices. The Financial Supervisory Authority's attempts to counter this trend, mainly by introducing an 85 per cent residential loan-to-value ceiling and proposing tighter rules on principal repayments, do not seem to have been enough to slow the upward trend so far. We also believe that the minister for financial markets will not attract broad support for any proposals to limit or abolish the existing tax deductions on interest payments.

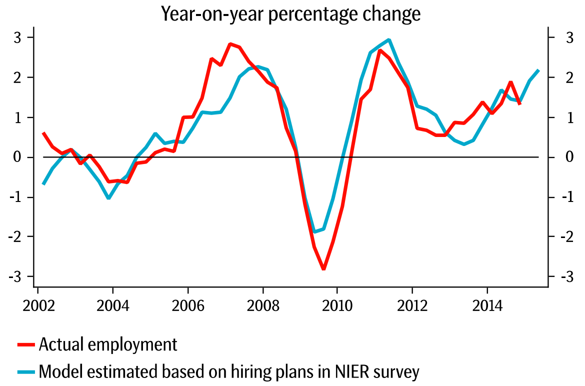
We expect the new principal repayment requirement to slow home prices increases in 2015. Since only new loans are affected by the proposal, the impact on total amortisations will be only about SEK 2 billion during the first year. For new home buyers, however, the requirement will be equivalent to an interest rate hike of several percentage points. Rising home prices and household debt in recent years have increased sensitivity to rate hikes. When the Riksbank eventually begins a cautious upward adjustment in its key rate in 2016, we expect home prices to level out. **There is a significant risk that home prices will fall once interest rates start climbing**, which suggests that key rates will be raised very gradually.

Strong job growth, lower unemployment

Despite weaker GDP growth, employment grew more strongly than expected in 2014 and the upturn also accelerated late in the year. Indicators for the next few quarters suggest that the upturn may speed up further. We now expect job growth of 1.5 per cent in 2015, which is equivalent to 72,000 new jobs.

Job growth is accelerating

Year-on-year percentage change



Source: SEB, Statistics Sweden, NIER

Despite strong job growth, unemployment will shrink very slowly because the labour force will continue to expand. The downturn in the number of people on long-term sick leave seems to be slowing, but the working age population keeps increasing rapidly while the number of people over 65 who are working is continuing to climb. Unemployment fell more than expected late in 2014, so we are lowering our unemployment forecast in any event. But the risks are on the upside; signals from the state employment offices are indicating that the number of job seekers has started to increase again.

2014 about as expected, despite everything

Economic news headlines in 2014 were dominated by disappointments, euro zone crisis and the need for increasingly aggressive monetary policy stimulus. Yet Swedish economic performance does not appear to have ended up very different from the forecasts we made late in 2013. With GDP for three out of four quarters already published, growth admittedly looks about half a percentage point lower than we had expected, mainly due to somewhat lower exports. But domestic demand increased more strongly than expected, with solid consumption growth in line with our forecast and capital spending that climbed much faster than expected, thanks to increasing residential investments. This picture of a relatively strong economy is confirmed by labour market data; although unemployment did not fall as much as expected, job growth surpassed expectations by a wide margin. High unemployment is explained by the continuing growth, instead of a levelling out, of the labour supply.

Although real economic performance was thus not much weaker than expected, inflation was substantially lower. Our forecasts in late 2013 assumed an average CPIF increase of 1.1 per cent, compared to a final figure of 0.5 per cent.

Two forecasts for 2014 on different dates

	Nov 2013	Feb 2015
GDP	2.5	2.0
Private consumption	2.7	2.6
Public consumption	0.8	1.3
Capital spending	3	5
Stock building	0.1	0.4
Exports	3.7	2.3
Imports	3.5	5.2
Unemployment	7.8	7.9
Employment	0.9	1.4
CPIF	1.1	0.5

Source: SEB

The labour market

Per cent and year-on-year percentage growth

	2013	2014	2015	2016
Unemployment, %	8.0	7.9	7.4	7.0
Employment	1.1	1.4	1.5	1.1
Labour force	1.1	1.3	1.0	0.6
Population, 16-64 year	0.1	0.3	0.7	0.5
Productivity	1.0	0.9	1.1	1.4

Source: Statistics Sweden, SEB

The percentage of job seekers with low levels of formal education and in many cases with poor Swedish language skills is continuing to rise. There is great uncertainty about what matching problems may occur in the next few years. **This probably means that equilibrium unemployment has risen**. Today there is no indication that the government will be able to achieve its long-term goal of the lowest unemployment in the EU. We are already beginning to approach labour market equilibrium, as confirmed by the rising percentage of companies stating that they are finding it difficult to recruit suitable employees, especially in the construction sector. Sizeable labour immigration from other EU countries will nevertheless reduce the risks of wage-driving bottlenecks.

Tighter resource situation

Labour shortage according to NIER survey

Source: National Institute of Economic Research

Early start to the next wage round

The next major round of pay negotiations will take place in 2016, which means we cannot expect concrete proposals before late 2015. Yet the battle lines are starting to emerge, with representatives of employer organisations pointing to exceptionally low inflation and weak productivity as reasons why room for pay increases is small (or non-existent). Even if this is a negotiating gambit, it is still a sign that fulfilling the Riksbank's inflation target of 2 per cent is not a self-evident point of departure for the two sides in the labour market. This is also underscored by their wage expectations, which are well below the levels prevailing when the current three-year collective agreements were reached in early 2013.

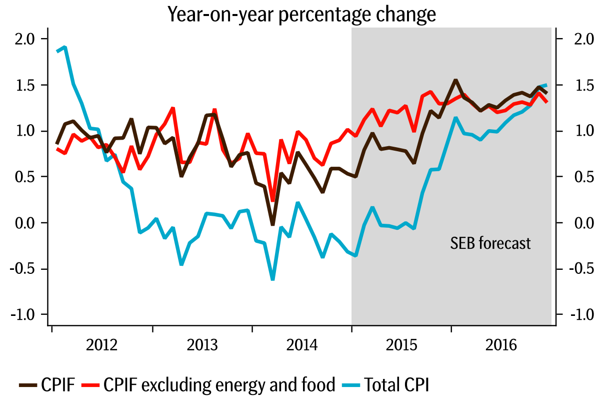
Yet a stronger labour market situation is likely to partly offset low price and pay expectations. There are also clear signs that calls for more equitable pay between women and men will cause pay hike demands in many service sectors, especially local government operations, to be higher than in manufacturing. Overall, we expect collective agreements in the coming wage round to provide pay hikes roughly in line with the last round: a bit above two per cent. It is also likely that these agreements will cover a three-year period. **We foresee pay increases of 3 per cent in 2016, including wage drift: marginally higher than the 2.8 per cent we expect in 2015**.

Further downward pressure on inflation

The inflation picture for 2015 is a little more fragmented in Sweden than in most other countries, but inflation will remain low and CPIF (CPI excluding interest rate changes) will probably stay at around a half per cent during most of the year. Low oil prices will make a negative contribution to CPI of about 0.5 percentage points this year, despite a petrol tax hike equivalent to 0.1 percentage points on January 1. The effect of oil prices on CPI is less in Sweden than in most other European countries, however. CPIF excluding energy is expected to show a slight upward trend, mainly driven by the krona depreciation of the past two years. This currency rate effect will push up inflation by 0.6-0.7 percentage points in 2015. We also expect food prices to climb somewhat faster than they did in 2014.

Inflation still below target

Year-on-year percentage change

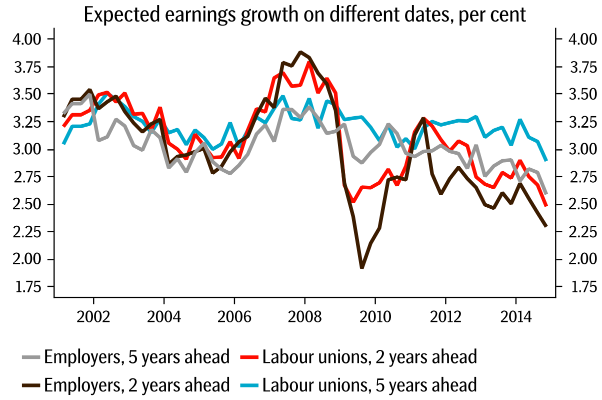


Source: SEB, Statistics Sweden

Yet much of the inflation pressure from the weak krona is being offset by falling international prices. There are also indirect effects of the oil price decline equivalent to 0.2-0.3 points per year in 2015 and 2016 via lower input goods prices in other sectors. Partly because pay increases will be less than three per cent throughout our forecast period, **CPIF will remain below target throughout the period**.

Falling wage and salary expectations by both sides

Expected earnings growth on different dates, per cent



Source: Prospera

CPI inflation will remain significantly lower than CPIF this year due to continued declines in mortgage interest rates, mostly as a consequence of the Riksbank's key rate cuts last year. During 2016, CPI inflation will gradually move closer to CPIF because of base effects. By the end of our forecast period, CPI will be somewhat higher as the Riksbank hikes its key rate.

Negative key rate and asset purchases

Due to continued low inflation, as well as inflation expectations that will continue falling in the long term, the Riksbank is now focusing on preserving the credibility of its inflation target. Thus, at least for now, it has been forced to abandon its ambition of using monetary policy as an instrument for limiting household debts. We thus believe **that the bank will cut the repo rate to -0.10 per cent**, probably as early as its February policy meeting. We believe that it will then leave the key rate unchanged, although there is a risk of further repo rate cuts.

Because the current low CPIF is largely due to the big oil price decline and is thus not connected to domestic factors, the policy response is not self-evident. This is further underscored by the positive impact of the oil price decline on Sweden's growth outlook. But we still believe that the trend towards falling inflation expectations and the tendency of average actual inflation to fall short of target over a long period will put pressure on the Riksbank to adopt a more expansionary monetary policy. The European Central Bank's quantitative easing programme, announced in January, will increase this pressure because the krona will probably appreciate unless the Riksbank matches the ECB, at least partly. Our main forecast is that the bank will carry out some expansion of its balance sheet in 2015 but must sort out various technical problems (discussed in the theme article "The Riksbank and unconventional monetary policy"). Our conclusion is that partly due to these factors, the Riksbank's QE programme will be modest. **We expect balance sheet expansion of about SEK 50 billion**: equivalent to only 1-2 per cent of GDP, compared to the ECB's expansion by some ten per cent of euro zone GDP in the next 20 months. The Riksbank would consider a more extensive programme only if the economic trend were much worse than in our main forecast.

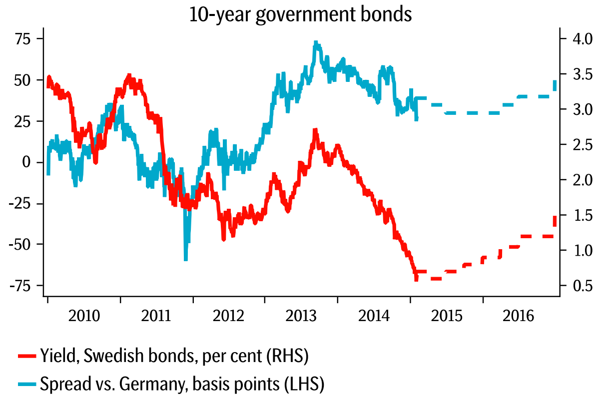
The timing of future rate hikes is very uncertain. Central banks in the OECD countries currently seem to be divided into two camps. Most central banks, led by the ECB, are in the process of making their monetary policies more expansionary, whereas the US Federal Reserve aims at hiking its key rate this year and the Bank of England will probably follow suit early in 2016. Because of very low inflation, in recent years the Riksbank has pursued a monetary policy that has shadowed the ECB. But in terms of growth and the labour market, Sweden looks more like the US and the UK. Although we believe that it will be a long time before inflation moves close to the Riksbank's target, we believe that the risk of very low inflation or deflation is less in Sweden than elsewhere in Europe. We thus assume that with a certain lag, the Riksbank will follow the Fed and the BoE and begin cautious rate hikes late in our forecast period, with the **repo rate reaching 0.50 per cent by the end of 2016**.

Bond yields have not yet bottomed out

The Riksbank has cut its repo rate by a total of 75 basis points since July. This is one reason why yields on Swedish government bonds have fallen more than equivalent German yields. In the short term, **we foresee further room for narrower spreads against Germany**, since the Riksbank's purchases of government bonds will push down yields. Given our forecast of German yields, we predict that 10-year Swedish bond yields will fall to 0.35 per cent by mid-2015.

Falling and increasing yield spreads

10-year government bonds



Source: Macrobond, SEB

Given our forecast that the Riksbank will hike its key rate before the ECB, it is reasonable for the yield spread vs. Germany to widen 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 50 basis points. **The yield on 10-year bonds will nevertheless not exceed 1.40 per cent two years from now**.

Further krona depreciation in the near term

After having appreciated in 2010-2012, when the krona attracted a certain amount of capital that was searching for a safe haven in troubled times, the currency has fallen by more than 10 per cent in trade-weighted terms since mid-2013. This has occurred even though Swedish economic growth has been relatively strong compared to most countries in Western Europe. After the ECB unveiled its QE programme, the krona gained some ground against the euro. However, we believe that the market will underestimate the monetary stimulus that the Riksbank will unveil in February and that the krona will again weaken to about 9.60 in the short run. Given our forecast of somewhat stronger Swedish growth and inflation that will eventually be a little higher than in the euro zone, the Riksbank will find it increasingly hard to match the ECB's aggressive easing. Combined with gradually stronger global economic conditions, which historically have almost always benefited the krona, **we expect the EUR/SEK rate to rebound to 9.00 by the end of 2015 and further to 8.90 by the end of 2016**. However, the krona will continue to weaken against the US dollar during most of our forecast period, though towards the end of 2016 it will strengthen slightly as the euro stabilises against the dollar. **At the end of 2016 we expect a USD/SEK exchange rate of 8.90**.

Expansionary but uncertain fiscal policy

One result of the political drama late in 2014 was that the red-green (Social Democratic-Green Party) minority government must now run the country based on the opposition Alliance parties' budget, which won a majority thanks to the right-wing populist Sweden Democrats. Certain adjustments can be made in the spring budget bill, but the options are limited since most tax hikes cannot go into effect until January 1, 2016 at the earliest. Looking ahead, there are also many indications that we will see a rather passive fiscal policy. So far the government has not announced any overall plan on how it wants to change economic policy. Although the December Agreement (see box) ensures the government's ability to pass its budget, the fragile parliamentary situation will probably hamper its decisiveness.

Finance Minister Magdalena Andersson has declared that she will not prioritise the official budget target of a surplus of one per cent of GDP if this requires austerity measures that curb economic growth. The financial principle that has emerged in the past year is also having an influence. Active decisions that burden the budget must be fully financed by tax hikes or spending cuts. But Andersson has said that budget shortfalls due to general economic events need not be financed. We believe that the government will broadly interpret what should be classified as automatic budget shortfalls, including volume-driven spending increases related to transfer systems and migration policy. But it is difficult to imagine higher spending pressure in fields like defence policy not requiring financing.

Public finances

Per cent of GDP

	2013	2014	2015	2016
Net lending	-1.4	-2.0	-1.2	-0.6
Gen. gov't gross debt	38.6	39.9	40.2	39.7
Central gov't debt*	33.8	35.1	35.5	35.0
Borrowing req., SEK bn	131	67	60	20

* Unconsolidated Source: Statistics Sweden, SEB

We believe that overall fiscal policy will be weakly expansionary. The more demand-oriented policy that the government wants to pursue, compared to the previous Alliance government's more supply side-oriented policy, may also include some extra short-term stimulus. We have long maintained that there is room for a more expansionary policy and that Sweden's low government debt justifies abandoning the official surplus target in favour of a balanced budget target. But the policy principles now emerging could make it harder to actively use this increased fiscal room for an aggressive policy aimed at improving long-term economic growth potential.

The public sector fiscal deficit will gradually shrink during 2015 and 2016. Since economic growth is largely driven by rising employment and consumption, this will strengthen public finances. On the other hand, low inflation and relatively low pay increases are holding down tax revenue.

New post-agreement playing field

The "December Agreement" reached just before New Year between the government and the four Alliance parties has created a new situation in Swedish politics. Under the agreement, which runs until 2022, the parties undertake to allow the candidate from the largest "party constellation" to win the parliamentary vote for prime minister. The opposition also agrees to allow the budget of the incumbent government to win parliamentary approval and not to vote down parts of the budget. The aim is to strengthen the position of minority governments, thereby supporting the principle of "negative parliamentarism", which means that the government does not need active support, but must be accepted by a majority of Parliament. This implies a partial change in practices, since **previous minority governments had normally sought cooperation with others to achieve a majority for their budget policies**. After the 2010 election, the Alliance departed from this practice by not actively seeking a majority for its budget but instead seeking other forms of cooperation.

One frequently cited advantage of the Agreement is that various government alternatives are made clear. Meanwhile **constant competition to demonstrate suitability to govern may weaken incentives for constructive opposition policies**. Even if the opposition can achieve major successes in policy terms, agreements in important fields may be interpreted as a sign of the incumbent government's suitability. There is thus a risk that bloc-based politics will become permanent and polarisation will increase if broad politically centrist agreements are no longer possible. **There will also be recurrent conflicts about what is reasonable to put in the budget**. Since most political decisions have economic consequences, it will be difficult to establish clear principles.

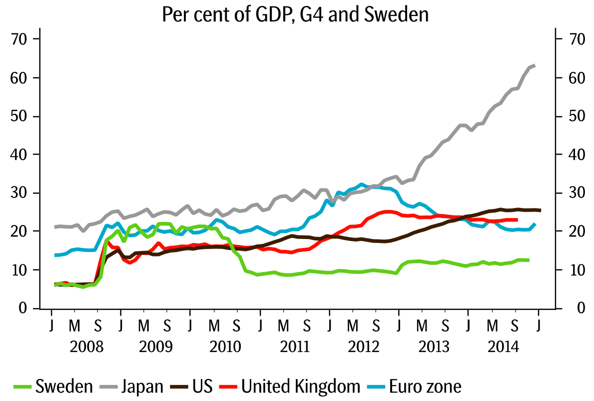
The December Agreement was reached under great time pressure. It was an alternative that many parties saw as less bad than calling a snap election. It remains to be seen how stable it is. The Social Democrats look like the winners, since they were able to stay in power, but in the long run they are probably the party that will have the most to lose from rigid bloc-based politics. Criticism of the Agreement has been loudest in the Alliance parties, but political scientists and other parliamentarians have also pointed out its questionable features from a democratic perspective. Obviously such criticism will remain strong, especially if the populist Sweden Democrats continue to gain support in opinion polls. It is an open question whether or not the Agreement will last. The Alliance parties are now moving towards a renewal process, including a thorough evaluation of the policies they pursued while in power. In particular, far-reaching liberalisation policies in various fields are being challenged by more cautious, conservative forces. Before these identity crises are resolved, they have no motive for an offensive aimed at re-capturing power, but changes in the profile of individual parties will also determine how intimate future Alliance partnerships will be.

- **Growth dynamic makes QE double-edged**
- **Low public debt may create bond shortage**
- **Hard for Sweden to reshape inflation target**

The Riksbank's repo rate, now zero, is soon expected to enter negative territory. Yet inflation is stuck far below target, while inflation expectations have shown a downward trend. One relevant question is how far the Riksbank is willing to pursue unconventional policy if the trends of recent years continue.

Central bank balance sheets

Per cent of GDP, G4 and Sweden



Source: Cental banks, national statistics offices,SEB

Many central banks have gone much further than the Riksbank. In some cases their balance sheets have risen by 20-30 per cent of GDP. The balance sheet of Japan's central bank now seems likely to reach 100 per cent of GDP by late 2015. Yet central banks that have expanded their balance sheet this sharply have not only done so as a reaction to uncomfortably low inflation, but also to **very weak economic growth**. Risks of financial instability, often caused by dramatic asset price declines, have sometimes also been part of the picture.

Resource utilisation in Sweden is relatively low, but the economy generally looks strong, especially compared to other countries at the time QE programmes have been launched. **Nor does the financial system need any support**, given a smoothly functioning credit market and overheating in the housing market. Yet inflation has been further below target for longer than in most comparable countries, partly because the krona appreciated during 2011 and 2012, a trend that has now been reversed. The deviation from the inflation target in 2015 now appears likely to be smaller in Sweden.

All four alternatives that the Riksbank has proposed to increase economic stimulus – given its zero interest rate – risk triggering adverse consequences. For example, many interest rate contracts may run into legal problems in case of negative rates. If the key rate moves too far into negative territory, banks may introduce negative deposit rates, which could lead customers to withdraw their money (of course free of charge). It is hard to assess how negative the key rate can be without undesired effects. Central banks are watching Switzerland and Denmark. Today their deposit rates are -0.75 and 0.50 per cent, respectively, for financial institutions. The main reason for such negative rates has been to stop undesired capital inflows. For central banks not at risk of destabilising inflows and a strong currency, including the Riksbank, **today's bottom interest rate will probably be just below zero**.

Asset purchases are not unproblematic either, especially in a country with central low government debt. A very large proportion of the SEK 700 billion or so in Swedish government bonds outstanding is held by banks, insurance companies and mutual funds – for desired or compulsory reasons. **Even small QE purchases of such bonds would have a significant impact on yields**. The supply of mortgage-backed securities is far bigger, but buying these would further fuel an already hot housing market. Such action would be especially remarkable, since the Riksbank has so clearly advocated further measures to cool off the housing market as part of macroprudential supervision. Collateralised loans to banks could be more targeted to the corporate sector, but banks would probably be reluctant to borrow from the Riksbank, even on very favourable terms. **Absent a more severe economic crisis, we thus believe that any asset purchases will occur on a small scale** and we thus expect the Riksbank to expand its balance sheet by about SEK 50 billion. This is equivalent to only 1-2 per cent of GDP, compared to the ECB's expansion of around 10 per cent of euro zone GDP in the next 20 months.

Another interesting question is to what extent unconventional policy will be effective in nudging inflation back up to target. QE policies in other countries have helped stabilise financial markets and weaken currencies, but their impact on inflation has been very limited. The moderate inflation upturns that are discernible also seem largely linked to currency depreciation, which means that some of the inflation effect **becomes part of a zero sum game rather than a solution to the global inflation problem**. Changes in inflation targeting policy have been discussed on occasion, but the trend to date has clearly been for the world's central banks to become more inventive, embracing larger, broader asset purchases and more negative interest rates instead of easing their inflation targets.

Because of Sweden' economic situation – decent growth, overheating risks in the housing market and a well-functioning credit market from the outset – QE policy may seem more paradoxical and hard to explain to the broad general public than in other countries. This might open the way to a broader discussion on the consequences of the inflation target. Yet it is **hard to believe that a small country like Sweden will have enough clout to march in the forefront of a process of re-assessing central bank inflation targeting policies**.

Currency peg under pressure

- **Swiss FX move is no Danish blueprint**
- **Changing oil balance means Denmark gains**
- **Economic policy supportive**
- **Recovery likely to outpace Europe's**

Last year, Denmark saw improving but disappointing GDP growth, with the average likely to end up at around 1 per cent. We remain optimistic that **GDP growth** in **2015 and 2016** will come in higher – at **2.0 and 2.5 per cent**, respectively – as we saw much of the headwinds as temporary while the backdrop remained positive. Then came the oil price slide. With other forecasts being revised upward we are sticking to our expectation of accelerating growth, but with greater conviction.

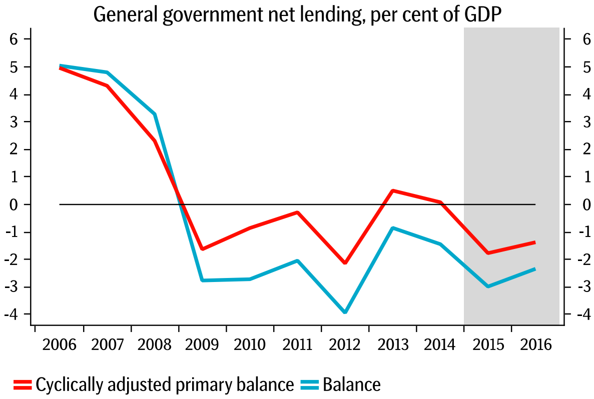
Overall, short-term negative effects are offset by medium-term positives. Weaker manufacturing sentiment reflects disappointing growth in Europe, but real wages, employment and home prices are rising, suggesting domestic demand will keep GDP growth rising. There is still a lot of labour market slack, so wages are only likely to rise slowly.

Economic policy delivers positive effects

This year still holds challenges: both the uncertain nature of the ECB policy experiment as well as uncertainty and risk of significant adjustments in energy-related sectors after the collapse in oil prices. But we foresee a range of positive drivers kicking in as the year progresses. The two most obvious are the result of policy changes. As we explained in November, fiscal policy should become strongly expansionary after having been mostly a contractionary factor for several years.

Fiscal policy highly expansionary in 2015

General government net lending, per cent of GDP



Source: IMF Fiscal Monitor, SEB

Whether or not the upcoming election is behind its change of policy, the government has decided (based on its own growth estimates) not only to fully use its fiscal room for manoeuvre (according to the EU's Stability and Growth Pact), but also to stretch it by extending pension taxation rules that deliver temporary revenues. We have long argued that fiscal policy was too tight, given fundamentally sound public balances and a stagnating Danish economy facing a crisis among its key trading partners – so this change in fiscal stance is welcome. Monetary policy has also eased, but as we explain in the box below, this is not a Danish decision but the result of the country's commitment to its DKK/EUR exchange rate peg combined with ECB policy changes (see box on next page).

During the second half of 2014 and in January this year, the ECB eased its monetary policy in several steps: using various instruments, such as rates cuts, easier liquidity provisions to euro zone banks and both private and public quantitative easing. The latest move into full-blown sovereign QE was expected by markets months in advance, with rates and currencies already reacting to the future abundance of liquidity. Although not a deliberate policy decision it leaves Denmark, which via the peg adopts euro zone policies, with easier financial conditions. This should further stimulate growth. If ECB policies are successful, a stronger European recovery might have even bigger effects on Danish growth. Further unilateral rate cuts are likely if appreciation pressure continues.

Oil a plus, despite virtual self-sufficiency

While most European countries rely heavily on oil imports, since the late 1990s Denmark's production of oil has been higher than domestic consumption. In the early 70s, dependence on foreign energy was almost 100 per cent, but growing North Sea oil and gas production combined with a policy of promoting alternative energy have led to significant changes over four decades. However, oil production peaked 10 years ago and new oil is becoming harder and costlier to extract, so today's production is some 50 percent below peak. This gradual decline means that Denmark moved from net exports to a small oil deficit by the end of 2014.

Denmark's nearly neutral oil balance might suggest that its economy would not see positive growth effects from lower oil prices. Although the mechanics are more complicated and the effects milder than in most of Europe, this is not the case. Obviously as an oil producer we are likely to see negative effects in mining and extraction spilling into investment and employment. However, this sector is neither very large nor labour-intensive, accounting for less than 1 percent of total employment. Such effects should thus not be exaggerated.

The impact of lower oil prices comes via the boost in disposable incomes from falling inflation. Manufacturers outside the energy sector also see a positive effect from falling oil prices – especially the shipping industry, which accounts for a sizeable share of oil imports. Denmark's high degree of openness to trade means that higher growth in other countries due to oil affects GDP rather strongly. Denmark mainly trades with countries that have benefited greatly from oil price developments – Norway, the country's fifth largest export market, is the main exception.

Taken together, the effects of looser economic policies and oil prices offset the short-term negatives mentioned above, if anything leaving an upside risk to growth. However, as we only saw moderate acceleration in 2014 it seems excessive to materially adjust our forecasts upward. There is also great uncertainty about oil price forecasts as long as the current aggressive price war is ongoing.

Public sector finances will be adversely affected by oil prices. Taxes and other charges on oil production will drop sharply, adding to the fiscal deficit. On the other hand, we think the government's growth estimate is too low, and its projected deficit for 2015 too high. The fiscal deficit is likely to be some DKK 5-10 billion lower than in a situation without the drop in oil prices – after taking into account positive growth effects. **We still do not believe that the deficit will exceed the limit of 3 per cent of GDP set by the Stability and Growth Pact.** Negative effects on fiscal revenue could lead to tighter policy in coming years, but at least in 2015 we do not consider this likely. In fact, revenue from taxes on oil extraction has been 'directly' linked to a public rail fund, set up to lower travel time between Danish cities. However, politicians are already confirming that they do not intend to change their plans for infrastructure, showing the complete irrelevance of directing specific public revenues to a specific expenditure area.

EUR/DKK peg and monetary policy dynamics

Following the Swiss National Bank's decision to end its CHF/EUR cap (it was never a peg), we have seen a lot of speculation that Denmark could end up deciding to abandon its currency peg. A brief look at the Danish monetary policy framework indicates that any comparison to Switzerland is unreasonable.

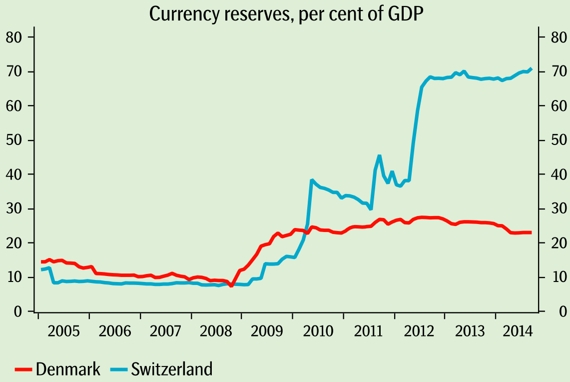
First, one needs to look at policy goals. The Swiss cap was a temporary policy introduced at the height of the European debt crisis to avoid CHF appreciation. It was created to achieve the objective of Swiss monetary policy: price stability. Denmark, however, has no other monetary policy goal than the DKK/EUR peg. A policy change is not up to the Nationalbank – the government is responsible (after consulting the Nationalbank). The peg has been the anchor of Danish policy for almost 35 years, whereas the Swiss used their cap – not as goal but as a tool – for only three.

Swiss GDP is some 8 percent above its pre-crisis peak, Danish GDP 3 percent below – in line with the euro zone. Such numbers indicate that Denmark will not view further policy easing, given its link to ECB policies, as an issue.

Denmark cut its interest rates few days after Switzerland's surprise move in mid-January, but this is also standard mechanics. Whenever appreciation pressure intensifies the Nationalbank normally intervenes, leading to increases in foreign exchange reserves. If the flow is too strong the Nationalbank may become unwilling to allow the resulting growth in reserves and at some point will lower rates to stop inflows. We estimate that DKK 35 billion was used for interventions on January 19, before rates were cut at the end of the day. Putting this in perspective, in the months after the Lehman Brothers collapse in 2008, monthly FX reserve increases were around DKK 40 billion. Intervention and rate cuts have continued after ECB announced its sovereign QE programme. It is standard that the Nationalbank eases when the ECB eases to uphold the peg, but the speculative pressure on DKK was unusually large by end January. At the end of the day, the question is how far the central bank is willing to let FX reserves grow or how low it will cut rates. **We think there is significant resistance to any debate about the peg after 33 years of successful stabilisation.**

Already huge Swiss reserves are rising

Currency reserves, per cent of GDP



Source: Statistics Denmark, SEB

The mechanics of Danish monetary policy:

- As part of ERM2, Denmark has a bilateral agreement with the ECB on unlimited intervention support
- DKK's has a special agreement under ERM2 allowing fluctuations in the DKK/EUR rate of ±2.25 per cent around the parity rate (±15 per cent is standard)
- The Nationalbank has a narrower band of ±0.5 per cent
- One key point is that the pressure now on the DKK is on the upside, which means ECB support has no relevance
- The Nationalbank can always defend the peg on that side if it agrees to boost its FX reserve (print money)
- The policy framework has been in place for more than 30 years, so willingness to defend it is very substantial
- The only serious downside test was in the early 1990s, when Denmark temporarily expanded its band to (a normal) ±15 per cent

Oil price fall shifts focus from inflation to activity

- **Further drop in oil prices to put additional pressure on oil sector investment**
- **Less vibrant private consumption main factor behind lower growth forecast**
- **Weaker currency will keep core CPI at target**
- **Norges Bank to cut key rate again in March**

Growth in mainland GDP – excluding oil, gas and shipping – picked up to a trend-like average pace in 2014 but looks set to slow more in the current year than previously expected. First, the further and sharper drop in oil prices in late 2014 will add more downside to investment in the petroleum sector. Second, private consumption should be less vibrant as growth in households' real disposable income slows due to softer employment gains, a tad slower wage growth and higher inflation than previously expected, reflecting the sharp depreciation of the Norwegian currency. The exchange rate should boost exports of non-petroleum goods and lessen the impact from the aforementioned factors.

We now expect **growth in mainland GDP to slow from an estimated 2.6 per cent in 2014 to 1.7 per cent in 2015**, or 0.4 percentage point below our November forecast, but **pick up to 2.2 per cent in 2016**. Growth in **overall GDP should be 1.0 per cent and 1.8 per cent this year and next**. (Note that the 2014 growth rate is a forecast, since full-year national accounts will be published just after this report.)

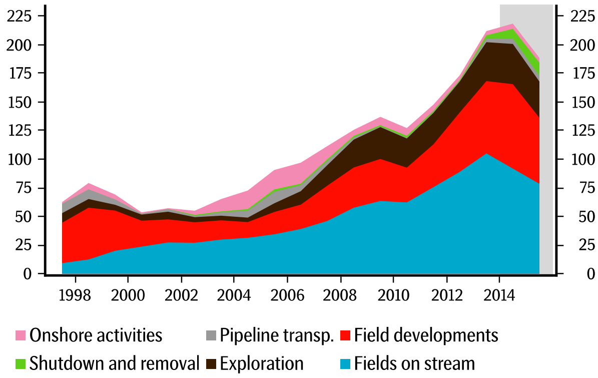
Oil investment a drag, not a full blow

In the November *Nordic Outlook*, investment in the petroleum sector was expected to drop 12 per cent in volume terms in 2015 and by a further 3.5 per cent in 2016. At the time, we expected the drop in overall demand from the sector to slow annual growth in mainland GDP by some ¾ of a percentage point in 2015. Part of the drop in such investment is cyclical, but more of it reflects operators' efforts to rebuild profits after years of runaway cost inflation: in fact, capital spending plans were cut back sharply before prices started to drop in earnest.

Statistics Norway's investment survey among oil and gas operators, published early last December, appeared reassuring: while still implying a marked drop in investment, estimated spending in 2015 was actually slightly higher. However, the survey was mainly based on budgets as of early October. Since then, oil prices have almost halved, which will probably lead to further cost-savings measures, first and foremost for fields that are on stream – purchases of goods and services and production drilling, potentially including less incentive for investments to increase recovery rates – and for exploration. Hence, downside risks prevail, but probably more starting next year although some effect is likely in 2015.

Oil sector cuts back on spending

NOK bn



Source: 2014-15 Statistics Norway investment survey, Dec 2014

Models suggest that sustained oil prices at current levels will result in substantially lower capital spending, causing a drag worth ½-¾ percentage point of mainland GDP in 2016 and a similar amount in 2017. However, the model doesn't take into account that operators started cutting spending prior to the drop in oil prices. Moreover, while development of some new fields not yet started will be put on hold, capital spending at the vast Johan Sverdrup field will go on from late 2015 and put a floor under the aggregate, since investments on this project will total some NOK 100-120 billion in the first phase to 2019.

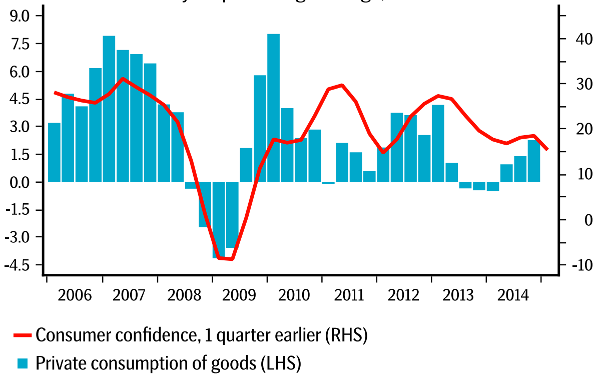
The next oil investment survey, due in early March, should show any additional depressing effect from lower oil prices. However, SEB's forecast is for Brent oil to average USD 60/barrel in 2015 and USD 70/barrel by the fourth quarter. For now, we are making only modest adjustments to the forecast, expecting **investment in the petroleum sector to drop 14 per cent in 2015 and 5 per cent next year**.

Consumption picking up less than expected

Growth in private consumption failed to live up to the expected acceleration in 2014, despite still-solid growth of slightly more than 3 per cent in households' real disposable income (running ahead of spending for the fourth consecutive year). Consumption of goods revived towards year-end. However, the risk is clearly for a weak start to 2015, amid all the gloomy predictions for the Norwegian economic outlook due to plunging oil prices. Hence, the quarterly consumer confidence survey took a hit late last year, dropping to its lowest level since end-2011, and appears compatible with sub-par growth in private consumption.

Weaker confidence suggests softer spending

Year-on-year percentage change, net balance



source: Statistics Norway, Finance Norway

Developments in consumer sentiment are uncertain going forward, in particular if labour markets start deteriorating more than the modest weakening seen so far. At the same time, sentiment should be supported by the still-solid housing market, especially the uptrend in existing home prices (2.3 per cent on average in 2014 but a stronger 6.7 per cent year-on-year in the fourth quarter). Aside from very low mortgage rates, one key factor underpinning the market is the still-subdued trend in housing starts, which suggests that completions should continue to lag demand.

On the other hand, there are reasons to expect slower growth in households' real disposable income in 2015. First, annual wage growth looks set to slow to marginally above 3 per cent due to the moderation in the broader economy and sharply downshifting activity in the petroleum sector, where wage inflation has been highest. In addition, real wage growth will be hit by higher inflation as the marked currency depreciation lifts import prices. **We are thus cutting our forecast for growth in private consumption in 2015 from 2.7 per cent to 2.0 per cent**. It will then pick up **to 2.5 per cent in 2016**.

Unemployment inching higher

In one important respect, the outlook for consumption looks a little less dire than a few months ago. Employment growth stalled over the summer, and negative short-term momentum late in the autumn seemed to imply more of a negative effect from the weaker economic outlook. However, the Labour Force Survey report for the fourth quarter was reassuring. Employment recovered 0.6 per cent from the previous quarter and was up 1.2 per cent year-on-year.

Meanwhile, LFS unemployment stayed at 3.7 per cent in the third and the fourth quarter, with average 2014 unemployment unchanged from 2013 at 3.5 per cent. One interesting feature of last year was the difference between the youngest and oldest groups. Employment among people aged 24 and younger dropped quite sharply, but the unemployment rate was nonetheless lower because labour force participation declined as well. Employment growth for others accelerated to 1.6 per cent last year, the strongest gain since 2008, but since the labour force expanded faster, the unemployment rate increased from 2.6 per cent in 2013 to 2.9 per cent as participation rose even more. In fact, higher participation among those 55 and older accounted for more than 60 per cent of the net increase in the labour force in 2014. Part of this reflects a decrease in elderly people retiring completely, which is just what the pension reform aimed at.

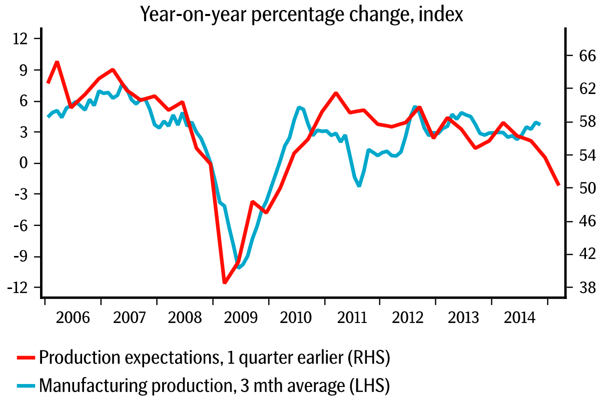
Employment growth should decelerate in tandem with slower economic momentum, but the labour force might continue increasing somewhat faster. Hence, **the LFS unemployment rate should average 4.0 per cent in 2015 and 2016**.

Manufacturing slower but exports strong

Short-term momentum in manufacturing production – excluding energy and mining – was solid until the third quarter of 2014 but has since slowed. SEB has long expected output growth to slow this winter as the sharply downshifting investment cycle in the petroleum sector has more of a negative impact. However, the recent manufacturing Business Tendency Survey (compiled from mid-December to late January) suggests a much sharper slowing.

Production expectations have turned negative

Year-on-year percentage change, index



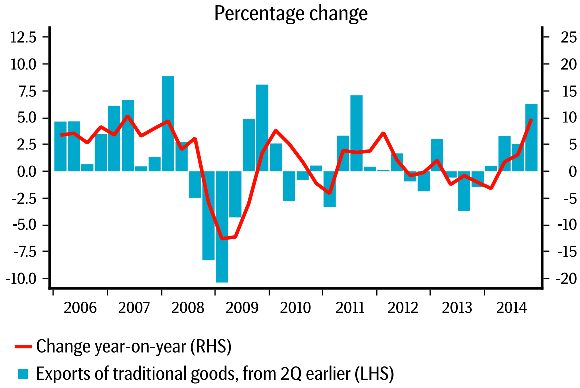
Source: Statistics Norway

The aggregate sentiment indicator declined to a five-year low of -1.5, a bit below the long-term average. Unsurprisingly, the deterioration was led by the investment goods sector, but sentiment among producers of intermediate goods soured as well, while the mood in the consumer goods sector lifted to its most positive since early 2012.

According to respondents, incoming orders have showed a broad-based slowdown. Production expectations fell further and seem to suggest negative year-on-year change in output. There is no mistaking the general direction, and output of investment goods should be hit the hardest, but some of the findings in the survey were too negative. In particular, the indicator measuring foreign orders has slowed over the past year to the lowest level since spring 2013, which contrasts sharply with actual developments. According to foreign trade statistics, real exports of traditional goods – excluding oil/gas, ships and platforms – accelerated markedly in 2014 and was up almost 10 per cent year-on-year in the fourth quarter.

Strong rebound for non-petroleum exports

Percentage change



Source: Statistics Norway, foreign trade statistics

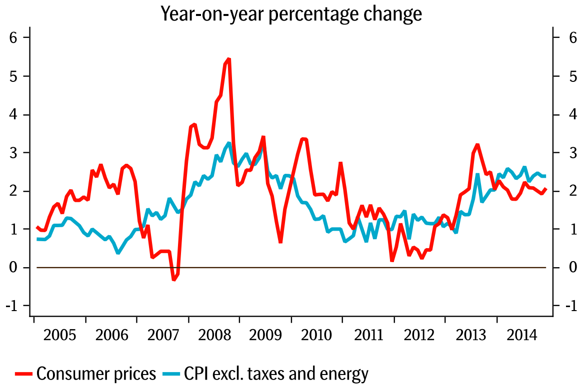
The Business Tendency Survey showed firmer expectations for foreign orders, though still at a below-average level, which seems too modest. In addition to improving demand, such exports should benefit from the sharp depreciation in the NOK exchange rate, which has gained speed in recent months. Annual growth in **exports of traditional goods should be up 3.9 per cent in 2015**, building on the improvement in 2014.

Weak currency to keep inflation at target

Inflation measured as CPI-ATE (excluding taxes and energy) is running broadly in line with Norges Bank's 2.5 per cent medium-term target. The full-year average increased quite markedly from 1.6 per cent in 2013 to 2.4 per cent in 2014, the highest in five years. Meanwhile, CPI inflation slowed a bit to 2.0 per cent on average in 2014.

Weaker currency boosts inflation

Year-on-year percentage change



Source: Statistics Norway

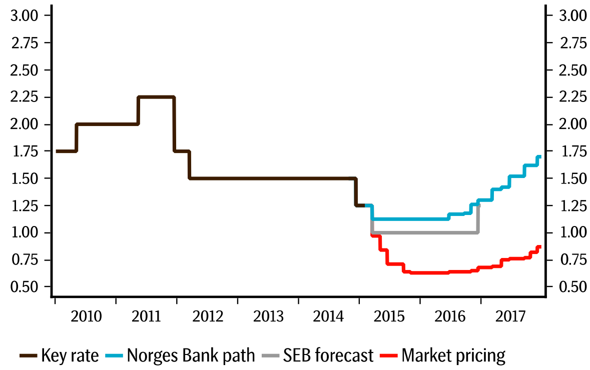
The initial lift to core inflation was fuelled by rents, while prices for other domestic goods and services followed suit, but core domestic inflation has since stabilised. As the NOK exchange rate turned weaker during 2013, imported inflation has pushed higher, averaging 1.4 per cent in 2014, the most since 2009 and only the second full-year increase in ten years. Going forward, domestic inflation might ease. However, the renewed and sharp depreciation of the NOK since mid-2014 in tandem with plunging oil prices should fuel imported inflation with the usual lag. As such prices make up almost one third of the core CPI basket, core inflation could pick up later in the year. **We have revised our core CPI forecast for 2015 upward to 2.5 per cent** (from 2.0 per cent last November), while we expect a full-year average of **2.3 per cent in 2016**.

One more key interest rate cut is likely

Norges Bank's 25 basis point rate cut in December showed the central bank focusing on downside risks to growth. The reduction was an insurance against an adverse outcome as economic indicators had yet to confirm a broad and severe economic slowing. At the same time, the *Monetary Policy Report* contained an upward revision to the inflation forecast, showing core CPI rising toward the 3 per cent mark by late 2015 and staying above the 2.5 per cent target throughout our forecast period. In effect, Norges Bank has temporarily suspended the inflation target in favour of stimulating the real economy and its rate path includes a high probability for another rate cut.

Expectations for Norges Bank

Per cent



Source: Norges Bank, SEB

Since the December meeting, oil prices have dropped further and several central banks have loosened monetary policy further. Considering still-high uncertainty on potential spillover effects from the downshifting activity in the petroleum sector we expect Norges Bank to remain in the forefront delivering another 25 bp reduction in March. For Norges Bank to act more aggressively in line with market's expectations, the economic outlook must deteriorate markedly.

Lower oil prices pressure NOK and rates

Since the start of the year, EUR/NOK has decoupled from the trend in oil prices and the 2y rate spread. This partly reflects the broad-based euro weakness, but Norges Bank's purchases of NOK 500-700mn/day is likely also helping to stabilise the NOK exchange rate. However, we still see pressure on the EUR/NOK rate in the very short-term. Thereafter, an improving flow outlook, recovery in oil prices and less rate cuts than what is priced by markets will gradually strengthen the NOK vs. EUR to 8.50 and 8.25 by the end of 2015 and 2016, respectively.

Norwegian government bonds have performed solidly since last autumn driven by an improving supply outlook, lower oil prices and Norges Bank's policy. We expect the 10y spread vs. Germany to tighten further as gross supply falls to NOK 50bn in 2015 and ECB's balance sheet expansion drives investors to look for yield pick-up elsewhere. Moreover, FX-related demand should recover as the outlook for the NOK exchange rate improves. We expect a 10-year yield spread vs. Germany at the end of this year of 70 bp.

- **No immediate need for "crisis measures"**
- **Authorities have ample room for massive stimulus if economy deteriorates**
- **Fiscal policy should be favoured as too strong monetary response carries risks**

Developments thus far do not suggest that the economy is in acute need of massive stimulus from fiscal and/or monetary policy. But authorities have a quite a lot of ammunition if needed. First, Norges Bank's key interest rate is currently at 1.25 per cent. Second, Norway's enviable fiscal position and the way fiscal policy works is potentially even more important.

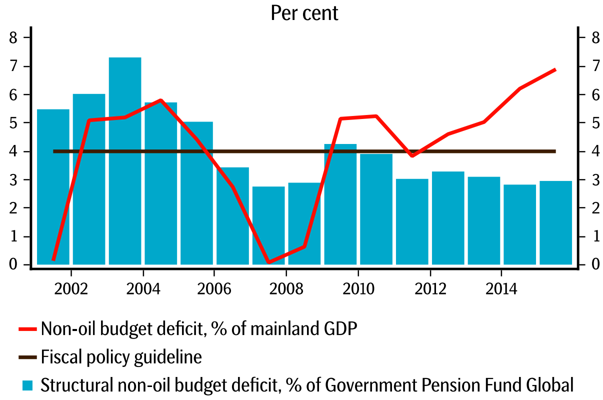
The "fiscal policy rule" links the non-oil budget deficit to the size of the Government Pension Fund Global, Norway's sovereign wealth fund – with assets now exceeding 200 per cent of GDP. Budget spending is thus shielded from volatile petroleum revenues, even such a sharp drop as seen at present. In addition, the fact that the rule is tied to the cyclically-adjusted budget balance lets automatic stabilisers work.

Potentially very powerful stimulus

In the 2015 budget, the structural non-oil deficit was estimated as corresponding to 3.0 per cent of the Fund at the start of the current year, well below the 4 per cent limit over a full cycle (and thus no absolute limit for any single year).

Ample room to use fiscal policy

Per cent



Source: National Budget 2015

In other words, should the government opt to expand the non-oil budget deficit all the way up to the 4 per cent mark – unlikely and probably not necessary – it would mean a fiscal stimulus worth almost two per cent of overall GDP and ½ percentage point more of mainland GDP. The potential is actually quite a bit higher, since the assets of the GPFG (in NOK) at the start of 2015 were far above the level assumed in the budget.

To us, a dose of fiscal stimulus would be preferable to deep rate cuts beyond the 25 basis points we expect Norges Bank to deliver in March. Any steeper rate cuts thus risk fuelling even more leveraging by the household sector – gross debt is slightly more than two times disposable income – and pushing what many already regard as inflated home prices higher.

Moreover, monetary conditions have eased considerably already. Admittedly, Norges Bank has only made one 25 bp cut in policy rates (last December), but mortgage rates and other market-based lending rates have declined more over the past year. Moreover, the sharply weaker NOK exchange rate provides a powerful de facto monetary stimulus.

Measures should be targeted

Concerning stimulus from fiscal policy, one might argue that part of the downshift in the petroleum sector is a necessary adjustment after many "fat" years with runaway cost inflation and that the adjustment should be allowed to play out by itself. Operators on the Norwegian continental shelf actually announced cutbacks before oil prices started to plunge.

While this is a valid argument, new fiscal measures might in part target the petroleum sector directly, since activity in the sector has important implications for the rest of the economy. Among other things, the government could reverse the effective tax hike introduced by its predecessor in May 2013, when an additional deduction in the tax base for the special petroleum tax was reduced. It could increase the tax deduction for exploration costs to put a floor under activity. For the rest of the economy, the government might bring forward some infrastructure spending, but more general tax cuts should be avoided unless the situation deteriorates sharply.

Using fiscal policy to lessen or avoid an economic slump would actually be consistent with the reformulation of the economic policy mix in 2001, when Norway introduced the fiscal policy rule and an inflation target for monetary policy. At the time, fiscal policy was assigned the main responsibility for stabilising economic performance. Since then, however, key interest rates have in reality become the first line of defence.

Concerning the timing of any fiscal policy measures, the government is unlikely to suddenly pull the trigger as its predecessor did in January 2009. Absent a sudden and sharp change for the worse, further fiscal stimulus measures should wait until the spring budget due in early May.

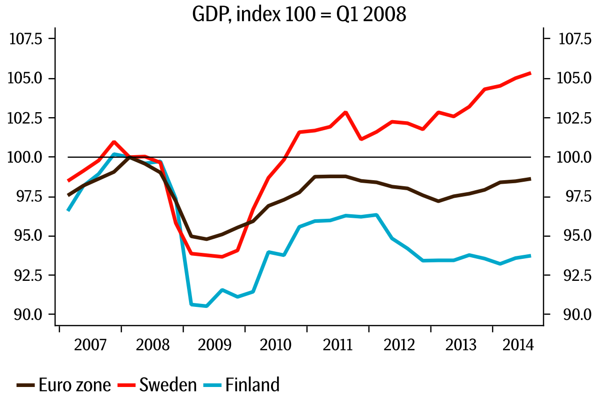
Tug-of-war between Russian weakness and oil stimulus

- **Weak exports, but weaker imports**
- **Low inflation means higher real incomes**
- **Continued tight fiscal policy**

The Finnish economy has now gone through four recessions since 2008, and GDP is still more than 5 per cent below its level in early 2008. Yet 2014 growth appears set to end up not quite as weak as predicted, after a positive surprise in the third quarter and upward revisions in second quarter figures. **Finland's outlook does not look promising, however**. The economy continues to be hampered by structural and cyclical problems and by Russia's recession as well as sanctions and trade restrictions. Exports are weak but imports are falling more, which means that net exports are contributing positively to growth. Households are squeezed by a weak labour market and tight fiscal policy, although **low oil prices and falling inflation are leading to higher real incomes**. We expect a continued tight fiscal policy after the April 2015 parliamentary election, **but the growth outlook has improved somewhat** compared to November's *Nordic Outlook*. We have revised our forecast slightly upward and predict that **GDP will increase by 0.7 per cent in 2015 and 1.0 per cent in 2016**.

Much worse GDP trend than Sweden and euro zone

GDP, index 100 = Q1 2008



Source: Eurostat

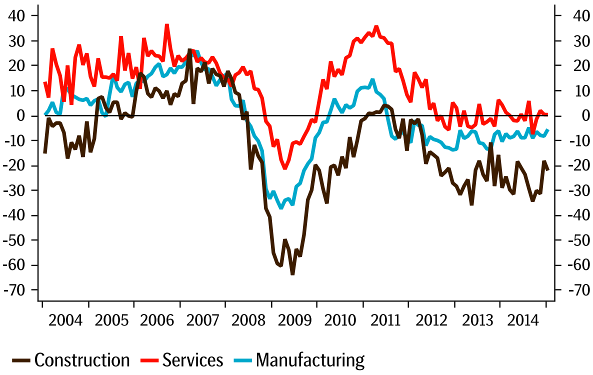
Weak indicators and no signs of turnaround

Rising unemployment and a weak Russian economy are contributing to a weaker outlook in Finland. As earlier, confidence is lowest among exporters and in construction.

Much of Finland's weak economic performance since 2008 can be explained by various factors that hamper exports. Structural problems and downturns in the forest product and information and communications technology (ICT) sectors are major factors. Production in the electronics industry has declined by nearly half since it peaked in 2008. Weaker competitiveness and terms of trade have also squeezed export revenue.

Indicators are not signalling any rapid recovery

Net balance

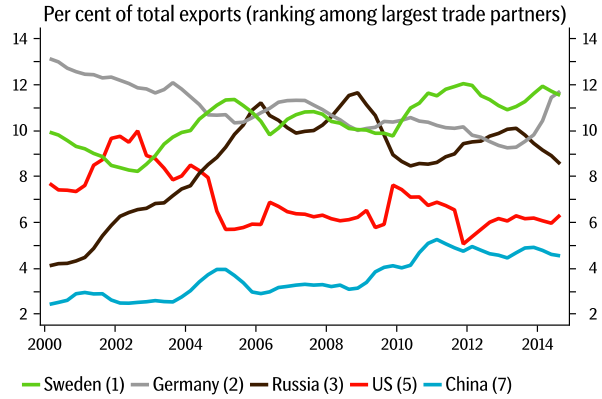


Source: European Commission

Recession in Russia, EU sanctions and Russia's trade restrictions are having a relatively strong impact on Finland, since Russia is the country's third most important export market. Weak exports to Russia have been partly offset by rising exports to other countries, such as Germany and China. When Russia introduced import restrictions in August 2014, there was a sharp decline in exports of dairy products, for example. These exports later recovered, indicating that Finland was able to redirect some of its export deliveries. **A weaker euro and decent growth in Sweden and Germany during 2015-2016 years will help stimulate the economy**: exports will climb by 2.5 per cent in 2015 and 3.7 per cent in 2016.

Trade with Russia is declining

Per cent of total exports (ranking among largest trade partners)



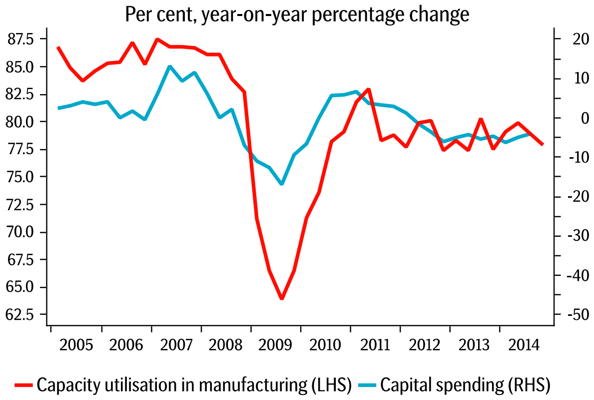
Source: IMF

Weak capital spending, high unemployment

Due to falling production, **the need for capital spending is low**. Such investments fell by an estimated 3 per cent in 2014. Capacity utilisation remains below the historical average. Because of low household income increases and uncertainty about home prices, residential construction will continue to be weak, but a long period of low capital spending means that there is an increasing need for investments in some parts of the economy. **Capital spending will increase marginally, by 0.5 per cent in 2015 and 2 per cent in 2016**.

Idle capacity is hampering capital spending

Per cent, year-on-year percentage change

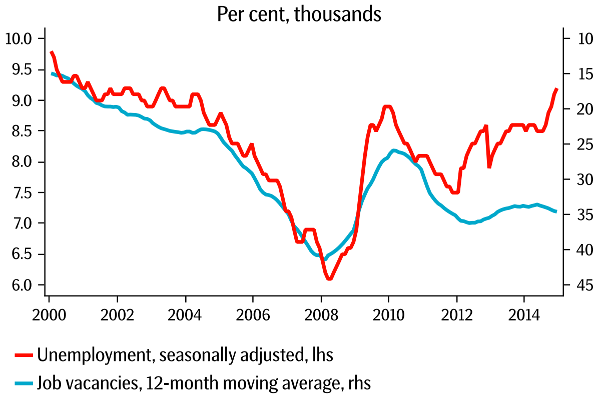


Source: OECD, Statistics Finland

Unemployment has provided upside surprises in recent months and reached 9.2 per cent in December 2014: the highest level since before the crisis. The jobless rate will fall in 2015 and 2016, but with a time lag; continued efficiency-raising measures in the manufacturing sector and efforts to improve productivity will precede new hiring. Considering the structural problems in the forest product and ICT sectors, labour market matching problems may also arise.

Surprisingly sharp upturn in unemployment

Per cent, thousands



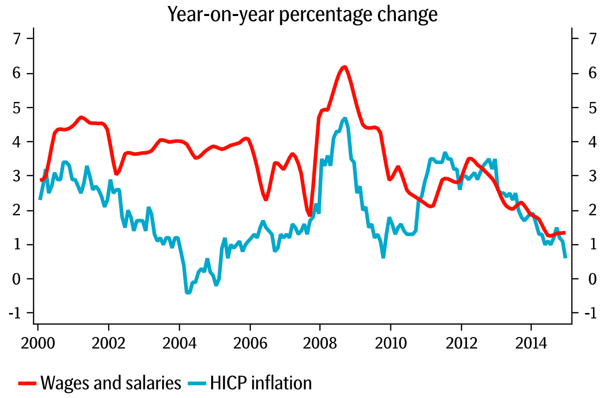
Source: Statistics Finland

The labour market is also affected by demographics: Finland's population aged 15-64 will decrease by 0.3-0.4 per cent yearly in 2015-2016, a process that will also continue in the future. Because of this trend, growth potential will worsen, although high unemployment in the near future will prevent major shortage situations from occurring. Measured as annual averages, **unemployment will climb to 9.1 per cent in 2015 and then fall to 8.5 per cent in 2016**.

The rate of pay increases has slowed gradually since 2012, largely in line with inflation. Because of the oil-driven decline in inflation, **households will enjoy real wage hikes ahead in spite of low pay increases**. In its latest report, the Finnish central bank recommended that employer and employee organisations introduce a negotiating system in which the export sector's room for pay hikes should serve as a benchmark for the entire economy. If this is enacted, it will gradually improve Finland's competitiveness and be another step of the country's painful post-crisis adjustments.

Falling inflation will lead to real income increases

Year-on-year percentage change



Source: Statistics Finland

Households are squeezed by a weak economy, high unemployment, tight fiscal policy and a shaky housing market. The latest statistics indicate a levelling-out of home prices. We expect unchanged prices in 2015-2016, although the weak economic situation poses a risk. Consumption has fallen two years in a row, but we are now seeing potential for a weak increase. We expect consumption to grow by 0.3 per cent in 2015 and 0.5 per cent in 2016.

Continued tight fiscal policy

No changes in fiscal policy can be expected in the near term; the focus is now on the **April 19 parliamentary election**. In recent years, fiscal policy has focused on bringing down the deficit and thereby turning around the trend towards rising government debt. This motive is strengthened by demographic factors that will put pressure on future public sector finances. Tight fiscal policy has contributed to weaker economic growth; long-term confidence effects have been perceived as more important than stimulus measures.

The Centre Party, which is ahead in opinion polls, has said it wishes to freeze public expenditures at their 2014 level and cut spending if required. Our forecast is that **Finland's tough fiscal policy will continue and will have a slight constrictive effect on growth**. Because of weak growth, low pay increases and low inflation, tax revenue will increase slowly, making the government's task harder. The public sector deficit will shrink from 2.5 per cent of GDP in 2014 to 2.0 per cent in 2016. Public debt will reach 62 per cent of GDP in 2016.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2013	2014	2015	2016
GDP OECD	1.4	1.9	2.6	2.6
GDP world (PPP)	3.1	3.5	3.7	3.9
CPI OECD	1.6	1.7	0.1	1.8
Export market OECD	2.7	3.6	5.7	5.2
Oil price, Brent (USD/barrel)	108.7	99.6	60.0	70.0

USA

Yearly change in per cent

	2013 level, USD bn	2013	2014	2015	2016
Gross domestic product	17,078	2.2	2.4	3.5	3.2
Private consumption	11,653	2.4	2.5	3.3	2.8
Public consumption	3,143	-2.0	-0.2	0.2	0.0
Gross fixed investment	2,395	4.7	5.2	7.5	8.4
Stock building (change as % of GDP)		0.0	0.1	0.2	0.0
Exports	2,325	3.0	3.1	5.1	6.1
Imports	2,788	1.1	3.9	5.8	5.7
Unemployment (%)		7.4	6.2	5.2	4.7
Consumer prices		1.5	1.6	-0.4	2.4
Household savings ratio (%)		4.9	4.8	5.3	6.2

EURO ZONE

Yearly change in per cent

	2013 level, EUR bn	2013	2014	2015	2016
Gross domestic product	9,881	-0.5	1.0	1.2	1.7
Private consumption	5,530	-0.7	0.6	1.0	1.4
Public consumption	2,086	0.2	0.3	0.3	0.4
Gross fixed investment	1,937	-2.4	1.2	1.5	2.2
Stock building (change as % of GDP)		-0.1	0.0	0.0	0.0
Exports	4,312	2.0	2.9	3.2	4.4
Imports	3,971	1.2	2.3	2.8	4.0
Unemployment (%)		12.0	11.6	11.2	11.0
Consumer prices		1.4	0.4	-0.3	0.9
Household savings ratio (%)		6.7	6.9	7.1	6.9

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2013	2014	2015	2016
GDP				
United Kingdom	1.7	2.6	2.8	2.5
Japan	1.6	0.2	1.1	1.1
Germany	0.1	1.5	1.6	2.0
France	0.4	0.4	0.8	1.1
Italy	-1.9	-0.3	0.3	0.8
China	7.7	7.4	7.0	6.7
India	5.1	7.0	7.3	7.6
Inflation				
United Kingdom	2.6	1.5	0.2	1.4
Japan	0.4	2.7	1.0	0.7
Germany	1.2	0.1	-0.1	1.5
France	0.8	0.1	-0.3	0.3
Italy	1.3	0.2	-0.5	0.2
China	2.6	2.0	1.7	2.0
India	10.1	7.2	5.7	5.4
Unemployment, (%)				
United Kingdom	7.8	6.4	5.8	5.3
Japan	4.0	3.6	3.5	3.4
Germany	5.2	5.0	4.9	4.8
France	10.2	10.4	10.6	10.5
Italy	12.2	12.5	12.4	12.2

EASTERN EUROPE

	2013	2014	2015	2016
GDP, yearly change in per cent				
Estonia	1.6	1.8	1.8	2.6
Latvia	4.2	2.4	2.5	3.0
Lithuania	3.3	3.0	2.6	3.5
Poland	1.7	3.3	3.0	3.4
Russia	1.3	0.5	-5.5	-1.0
Ukraine	0.0	-6.5	-5.0	0.0
Inflation, yearly change in per cent				
Estonia	3.2	0.5	1.1	1.8
Latvia	0.0	0.7	0.7	1.8
Lithuania	1.2	0.2	0.4	0.7
Poland	0.8	0.1	0.2	1.5
Russia	6.8	7.8	16.5	9.5
Ukraine	-0.3	12.1	25.0	15.0

FINANCIAL FORECASTS

		Feb 5th	Jun-15	Dec-15	Jun-16	Dec-16
Official interest rates						
US	Fed funds	0.25	0.25	0.75	1.25	1.75
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.05	0.05	0.05	0.05	0.05
United Kingdom	Repo rate	0.50	0.50	0.50	0.75	1.25
Bond yields						
US	10 years	1.79	1.50	2.00	2.25	2.50
Japan	10 years	0.37	0.30	0.35	0.40	0.45
Germany	10 years	0.37	0.20	0.50	0.70	0.90
United Kingdom	10 years	1.50	1.30	1.70	2.10	2.60
Exchange rate						
USD/JPY		118	125	128	135	140
EUR/USD		1.14	1.08	1.05	1.05	1.00
EUR/JPY		134	135	134	142	140
GBP/USD		1.52	1.46	1.46	1.50	1.43
EUR/GBP		0.75	0.74	0.72	0.70	0.70

SWEDEN

Yearly change in per cent

	2013 level, SEK bn	2013	2014	2015	2016
Gross domestic product	3,775	1.3	2.0	2.7	2.7
Gross domestic product, working day adjustment		1.3	2.1	2.5	2.5
Private consumption	1,761	1.9	2.6	2.8	2.7
Public consumption	988	0.7	1.3	1.0	0.8
Gross fixed investment	834	-0.4	5.0	4.7	5.5
Stock building (change as % of GDP)	1	0.0	0.4	0.1	0.1
Exports	1,660	-0.2	2.3	4.1	4.9
Imports	1,470	-0.7	5.2	4.4	5.4
Unemployment (%)		8.0	7.9	7.4	7.0
Employment		1.1	1.4	1.5	1.1
Industrial production		-4.0	-2.0	3.0	3.5
CPI		0.0	-0.2	0.1	1.1
CPIF		0.9	0.5	0.8	1.4
Hourly wage increases		2.6	2.7	2.8	3.0
Household savings ratio (%)		15.4	15.4	15.2	14.3
Real disposable income		1.8	2.4	2.7	1.6
Trade balance, % of GDP		1.4	0.8	1.0	1.0
Current account, % av GDP		7.3	6.3	5.8	5.5
Central government borrowing, SEK bn		131	72	60	20
Public sector financial balance, % of GDP		-1.4	-2.0	-1.2	-0.6
Public sector debt, % of GDP		38.6	39.9	40.2	39.7

FINANCIAL FORECASTS	Feb 5th	Jun-15	Dec-15	Jun-16	Dec-16
Repo rate	0.00	-0.10	-0.10	-0.10	0.50
3-month interest rate, STIBOR	0.06	0.05	0.00	0.05	0.65
10-year bond yield	0.65	0.35	0.65	1.10	1.40
10-year spread to Germany, bp	28	15	15	40	50
USD/SEK	8.25	8.52	8.57	8.77	8.90
EUR/SEK	9.42	9.20	9.00	8.95	8.90
TCW	130.6	128.4	126.8	126.9	126.5
KIX	113.1	111.3	109.8	109.9	109.6

NORWAY

Yearly change in per cent

	2013 level, NOK bn	2013	2014	2015	2016
Gross domestic product	2,987	0.7	2.1	1.0	1.8
Gross domestic product (Mainland)	2,347	2.3	2.6	1.7	2.2
Private consumption	1,201	2.1	2.1	2.0	2.5
Public consumption	629	1.7	3.2	2.1	2.2
Gross fixed investment	705	6.8	1.1	-2.8	2.0
Stock building (change as % of GDP)		0.4	0.4	0.0	0.0
Exports	1,169	-3.0	0.5	2.1	2.2
Imports	857	4.3	0.9	1.7	3.2
Unemployment (%)		3.5	3.5	4.0	4.0
CPI		2.1	2.0	2.4	2.3
CPI-ATE		1.6	2.4	2.5	2.3
Annual wage increases		3.9	3.5	3.1	3.3

FINANCIAL FORECASTS	Feb 5ht	Jun-15	Dec-15	Jun-16	Dec-16
Deposit rate	1.25	1.00	1.00	1.00	1.25
10-year bond yield	1.32	0.90	1.20	1.45	1.75
10-year spread to Germany, bp	95	70	70	75	85
USD/NOK	7.56	8.15	8.10	8.00	8.25
EUR/NOK	8.63	8.80	8.50	8.40	8.25

DENMARK

Yearly change in per cent

	2013 level, DKK bn	2013	2014	2015	2016
Gross domestic product	1,886	-0.5	1.0	2.0	2.5
Private consumption	892	0.1	0.5	2.0	3.0
Public consumption	504	-0.5	1.0	1.2	0.3
Gross fixed investment	346	0.9	2.1	2.2	4.0
Stock building (change as % of GDP)		-0.2	0.1	-0.1	0.0
Exports	1024	0.8	2.9	3.3	4.0
Imports	916	1.5	3.6	3.0	4.0
Unemployment (%)		4.4	4.0	3.8	3.5
Unemployment, OECD harmonised (%)		7.0	6.6	5.8	5.0
CPI, harmonised		0.8	0.6	0.3	1.2
Hourly wage increases		1.3	1.3	1.7	2.2
Current account, % of GDP		6.8	6.2	6.5	6.5
Public sector financial balance, % of GDP		-0.8	0.0	-2.0	-1.0
Public sector debt, % of GDP		44.5	43.5	43.0	41.0

FINANCIAL FORECASTS	Feb 5th	Jun-15	Dec-15	Jun-16	Dec-16
Lending rate	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.27	0.10	0.40	0.60	0.80
10-year spread to Germany, bp	-10	-10	-10	-10	-10
USD/DKK	6.52	6.89	7.09	7.09	7.44
EUR/DKK	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	202	-1.3	0.0	0.7	1.0
Private consumption	111	-0.6	-0.1	0.3	0.5
Public consumption	50	0.6	0.0	0.3	0.5
Gross fixed investment	43	-5.3	-3.0	0.5	2.0
Stock building (change as % of GDP)		-0.3	0.2	0.0	0.0
Exports	78	-0.7	0.2	2.5	3.7
Imports	79	-1.6	-1.0	1.5	3.4
Unemployment (%)		8.4	8.7	9.1	8.5
CPI, harmonised		2.2	1.2	0.2	0.6
Hourly wage increases		2.1	1.5	1.5	1.8
Current account, % of GDP		-1.2	-1.2	-1.2	-1.0
Public sector financial balance, % av GDP		-2.4	-2.5	-2.2	-2.0
Public sector debt, % av GDP		57.0	60.0	61.5	62.0

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