

Press release

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Nordic Outlook: Central banks and oil help sustain growth New bond yield universe is forcing Riksbank to try new stimulus

Exceptional monetary policies, along with negative interest rates and bond yields, are contributing to better economic growth but are also raising many questions. Deflation risks will persist even after a stabilisation of oil prices. A more positive global outlook, especially for Europe, will depend on whether the United States is willing and able to sustain a stronger dollar while abstaining from escalating the ongoing currency wars. Despite policy dilemmas, Sweden's Riksbank will lower its key interest rate to -0.10 per cent and is ready to push the money-printing button. The Swedish government's unemployment target – the lowest jobless rate in the European Union by 2020 – appears increasingly distant, writes SEB Economic Research in the latest issue of its quarterly report *Nordic Outlook*.

Solid American economic activity and a cautious, much-anticipated lift for euro zone growth will coincide with mixed prospects in the BRICS countries (Brazil, Russia, India, China and South Africa). **Gross Domestic Product (GDP) in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) will be 2.6 per cent both in 2015 and in 2016.** This is somewhat higher than the SEB economists' November forecast and an acceleration from last year's 1.9 per cent. Meanwhile SEB is revising its forecast for the emerging market (EM) countries downward. As a result, overall global economic growth will be 3.7 per cent this year and 3.9 per cent in 2016. **Upside risks outweigh downside risks.** The potential for global recovery will improve if the United States can sustain a stronger dollar without getting involved in the ongoing currency wars.

"The world economy will receive strong growth support from various directions thanks to lower energy prices, rising asset prices, a new 'bond yield universe' with extremely low and sometimes even negative yield levels and – in many countries – weaker currencies," says Robert Bergqvist, Chief Economist at SEB.

"But because of both old and new challenges, potentially positive effects **will not have a full impact.** Among the reasons are heightened geopolitical worries, continued uncertainty about the long-term stability of the euro project and several large question marks connected to large-scale unconventional monetary policy, such as mis-pricing in both financial markets and the economy," Bergqvist maintains.

The oil price decline is having an impact on growth as well as inflation forecasts, creating economic policy challenges. In the US, **Consumer Price Index (CPI) deflation in 2015** will be 0.4 per cent; in the euro zone, it will be 0.3 per cent. Looking ahead, when (Brent crude) oil prices stabilise at about **USD 70/barrel**, inflation will rebound. Yet inflation targeting regimes will continue to be challenged – and questioned – due to sluggish global wage and salary growth, idle production resources and other factors. Despite CPI deflation, an increasingly tight US labour market indicates that the **Federal Reserve (Fed) will hike its key interest rate by 0.25 percentage points in September.** Even if the central bank subsequently raises the key rate at every second policy meeting, letting it reach 1.75 per cent by the end of 2016, US monetary policy will remain relatively expansionary, with low nominal and real interest rates as well as a large monetary policy-related securities portfolio totalling an unchanged USD 4.2 trillion.

"Inflation expectations and currency exchange rates are important components of central bank decision-making functions," says Håkan Frisén, Head of Economic Forecasting at SEB and Editor-in-Chief of *Nordic Outlook*.

“The ongoing ‘currency war’ – with interest rates, sovereign bond yields and central bank balance sheets as weapons – will continue in 2015-2016, led by the European Central Bank (ECB) and the Bank of Japan (BoJ). But now there are many central banks, including Sweden’s Riksbank, that are participating in the currency game. It is becoming more and more apparent that various emerging economies would also like to see expansionary monetary conditions, with structural reforms being put in place and inflation being pushed downward,” Friséén adds.

The currency game is strengthening the US dollar, affecting the Fed’s rate path. The **EUR/USD exchange rate will be squeezed down towards 1.05 at the end of 2015** and to 1.00 by the end of 2016. In terms of effective exchange rates, the dollar’s appreciation will be even more obvious, leading to talk of a “**super dollar**”. Overall global monetary policy and monetary conditions will remain sharply expansionary throughout SEB’s forecast period (2015-2016), providing **positive support to stock markets**.

The conditions are in place for the **US recovery** to shift into high gear. With households as the economic engine, SEB predicts **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 adverse effects of the stronger dollar. The labour market is continuing to improve. Unemployment, already near its equilibrium level of 5.5 per cent, will fall to a low 4.5 per cent by the end of 2016. Meanwhile alternative measures of resource utilisation indicate that there is still plenty of slack in the labour market, supporting SEB’s optimistic view that 2016-2016 US economic growth will be above trend.

Despite gradually improving growth prospects, **the euro zone is lagging behind the international recovery**. Lower oil prices, combined with a weaker euro and a more expansionary interest rate environment due to forceful measures by the ECB, are providing a rather clear **dose of economic stimulus**.

“But at the same time there are strong counterforces: heavy debt and political uncertainty both at home and in relation to Russia,” Robert Bergqvist warns. “This means that economic growth will remain **too weak to make a dent in the problems** of widespread unemployment and high debt.”

SEB’s economists believe that **GDP will grow by 1.2 per cent this year** (1.0 per cent in 2014) and accelerate further to **1.7 per cent in 2016**. They expect Greece to receive debt relief, but politically radical forces in various euro zone countries are increasing the uncertainty about the euro project and earlier agreements, while economic policy integration processes have ground to a halt.

Russia faces a deep recession in the wake of collapsing oil prices and the rouble crash of late 2014. SEB predicts that Russian **GDP will fall by 5.5 per cent in 2015** as budget austerity, economic sanctions and the rouble collapse squeeze the economy. 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 will provide 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 major economic and financial strains, Russia has enough financial muscle to avoid a fiscal crisis during the next couple of years.

“The role of EM countries in the global economy is increasingly important, especially in the economic policy field,” says Håkan Friséén. “The BRICS countries are deepening their cooperation, creating counterweights to such traditional institutions as the International Monetary Fund (IMF) and the World Bank, as demonstrated by expanded liquidity management cooperation between the central banks of Russia and China. The short-term economic prospects are mixed,” according to Friséén.

Most EM countries can expect slightly stronger growth during the next two years, but **China will be the exception; its growth will continue slowing from 7.4 per cent last year to 7.0 per cent in 2015 and 6.7 per cent in 2016**. The labour market will, however, be resilient to this deceleration – more jobs than previously are now being created by a given level of GDP growth. SEB expect further expansionary economic policy, but China faces a difficult balancing act between greater stimulus and mounting risks of unsustainably rapid credit growth.

SEB's economists see several reasons to stick to an optimistic view of the Swedish economy. Growth is expected to be above trend in 2015-2016, with **GDP increasing by 2.7 per cent yearly**. Domestic forces such as household consumption – sustained by good job growth and rising disposable incomes – and residential investments will continue to lay the groundwork for stable economic growth.

“We now also expect the manufacturing sector to contribute increased activity, aided by faster growth elsewhere in Europe and a weaker Swedish krona,” Håkan Frisé says. “The government appears unlikely to attract enough support to lower tax deductions on mortgage interest payments but – helped by principal repayment requirements and eventually by higher Riksbank key rates – **the home price upturn will level out towards the end of our forecast period. The government's jobs target (the lowest unemployment in the European Union by 2020) will be increasingly hard to fulfil.**”

“Despite economic expansion and strong job growth, a long-term increase in the labour supply – due to higher immigration and other factors – will mean continued high unemployment. In this environment, equilibrium unemployment (about 6.5 per cent today) risks climbing somewhat. A persistently high jobless rate – and falling wage and salary expectations – will slow the rate of pay increases in the coming round of pay negotiations. This will be one of the factors making it difficult for the Riksbank to achieve its 2 per cent inflation target,” Frisé concludes.

The Riksbank will lower its repo rate to -0.10 per cent in February and re-introduce its narrow interest rate corridor, leading to an effective Riksbank deposit rate of -0.20 per cent for banks. SEB's economists also anticipate an **expansion of SEK 50 billion** in the Riksbank's balance sheet (quantitative easing, or QE) during 2015, since they believe that -0.10 per cent is the minimum interest rate in order to ensure that individual savers will not be affected by negative deposit rates.

“**The reasons for the Riksbank to pursue a more expansionary policy** are falling inflation expectations, continued low inflation, more expansionary policies internationally and monetary easing that financial markets have already priced in,” Robert Bergqvist says. “But this is a **policy dilemma**, because the Swedish credit market is performing favourably and GDP growth is above trend. By pursuing this policy, the Riksbank is confirming that it will do anything to preserve the credibility of its inflation targeting.”

Not until the second half of 2016, one year after the Fed and a bit more than six months after the Bank of England, will the Riksbank raise its repo rate. This key rate will reach 0.50 per cent by year-end. The krona will remain undervalued, thereby providing support to the export sector; at the end of 2015 the EUR/SEK exchange rate will be 9.00 (8.90 at the end of 2016). The corresponding forecast figures for the USD/SEK rate are 8.60 and 8.90.

SEB's economists expect Swedish fiscal policy to be weakly expansionary but uncertain. Their earlier political conclusions seem to be proving correct: a rather defensive fiscal policy that is hampered by the parliamentary situation. But the potential for cross-bloc decisions between the Social Democratic-Green Party government and the opposition Alliance parties has probably improved as a result of their December Agreement and challenges in keeping the Alliance together. The prospects of more far-reaching reforms are gloomy. **The budget deficit will shrink from 2 per cent of GDP last year to a bit above 0.5 per cent in 2016; central government debt will remain stable at around 35 per cent of GDP.**

The Nordic economies in general 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 hard by falling oil prices. Denmark's now 33-year-old DKK/EUR peg is under pressure from massive currency inflows, due to the ECB's QE programme and Switzerland's change of currency policy. Although SEB has adjusted its **Norwegian growth** forecast ½ percentage point lower this year 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 expected. 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 currency 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.

External conditions affecting the **Baltic countries** are worsening due to the Russian recession. Offsetting this are slightly better euro zone prospects and lower energy costs, which will boost already strong real household incomes. Energy is a relatively large element of CPI in the Baltics. Overall, this means that SEB's economists are lowering their GDP growth forecasts for Latvia and Lithuania by as much as 0.5 per cent, mainly in Lithuania which has the largest trade with Russia. Latvia's GDP will grow by 2.5 per cent this year and 3.0 per cent in 2016. The corresponding forecast for Lithuania is 2.6 and 3.5 per cent. SEB is keeping its 2015 forecast for Estonia unchanged at 1.8 per cent and lowering its 2016 forecast marginally to 2.6 per cent.

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

International economy, GDP, year-on-year changes, %	2013	2014	2015	2016
United States	2.2	2.4 (2.3)	3.5 (3.4)	3.2 (3.1)
Euro zone	-0.5	1.0 (0.9)	1.2 (0.9)	1.7 (1.3)
Japan	1.6	0.2 (0.4)	1.1 (0.9)	1.1 (1.1)
OECD	1.4	1.9 (1.8)	2.6 (2.4)	2.6 (2.4)
China	7.7	7.4 (7.4)	7.0 (7.0)	6.7 (6.7)
Nordic countries	0.4	1.6 (1.5)	1.9 (1.8)	2.2 (2.1)
Baltic countries	3.2	2.5 (2.4)	2.4 (2.7)	3.2 (3.3)
The world (purchasing power parities, PPP)	3.1	3.5 (3.5)	3.7 (3.8)	3.9 (3.9)
Swedish economy. Year-on-year changes, %				
GDP, actual	1.3	2.0 (2.1)	2.7 (2.7)	2.7 (2.7)
GDP, working day corrected	1.3	2.1 (2.2)	2.5 (2.5)	2.5 (2.5)
Unemployment, % (EU definition)	8.0	7.9 (8.0)	7.4 (7.6)	7.0 (7.2)
Consumer Price Index (CPI) inflation	0.0	-0.2 (-0.2)	0.1 (0.3)	1.1 (1.5)
Government net lending (% of GDP)	-1.4	-2.0 (-1.5)	-1.2 (-0.9)	-0.6 (-0.2)
Repo rate (December)	0.75	0.00 (0.00)	-0.10 (0.00)	0.50 (0.50)
Exchange rate, EUR/SEK (December)	8.86	9.39 (9.35)	9.00 (9.00)	8.90 (8.80)

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