Press release

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Nordic Outlook: Central bank-driven recovery with risks
Swedish growth despite economic policy challenges

This year began with new events confirming that the global growth train is not moving along a completely straight track. The euro zone has delivered upside surprises despite the problems of Greece. The world economy is now being driven almost entirely by the actions of central banks, in an environment of negative interest rates and bond yields as well as enormous asset purchases. But this toolkit is far from problem-free, while inflation targeting policies are being questioned. We expect Swedish economic growth to be above trend, despite uncertainties both in other countries and at home. The Riksbank is taking out an extra insurance policy by lowering its key interest rate to -0.40 per cent. At the end of 2016, the repo rate will still be at 0 per cent.

Partly due to cold weather, growth in the **United States** – which is showing underlying economic strength – temporarily screeched to a halt. Meanwhile signs of weakness predominated in a generally fragmented picture for **emerging market (EM) economies**; China is acting purposefully to find a policy mix that will reduce excess capacity, stabilise asset markets and rebalance the economy.

"The European Central Bank (ECB)'s expansionary policies have had an unexpectedly rapid impact on optimism and rising inflation expectations, stabilising the outlook for all of **Europe**," says Robert Bergqvist, Chief Economist at SEB. "And despite complex shifts in leadership roles among global economic engines – and with Brent crude oil prices stabilising at USD 60-70 per barrel – we expect the global growth rate to continue to speed up. **GDP growth in the 34 mainly affluent countries of the countries of the Organisation for Economic Cooperation and Development (OECD) will accelerate from 1.9 per cent in 2014 to 2.7 per cent in 2016**," Bergqvist notes.

"According to our central bank forecast, **global monetary conditions will become more expansionary in 2015**," says Håkan Frisén, Head of Economic Forecasting at SEB and Editor-in-Chief of *Nordic Outlook*. "Because of slower growth rates and low inflation in a number of EM economies, the key interest rates in these countries may also converge towards the lower levels prevailing in the West. Monetary policies are driving up **asset prices and debts to new records** and having a **major impact on currencies**. This is growth-friendly and is driving the global rebalancing process, with the euro zone and Japan getting help with growth and inflation, while China and the US can respond with new stimulus measures or more gentle interest rate hikes," according to Frisén.

The low inflation environment will continue to predominate. OECD inflation will move downward towards zero this autumn. As earlier oil price declines vanish from the twelve-month figures, the inflation rate will rebound. A bit further ahead, the effectiveness of monetary policy and its impact on demand and global resouce utilisation, as well as earnings growth, will determine the inflation trend. **Central banks and governments in various countries** – such as Germany, the United Kingdom, Japan, the US and Sweden – **are beginning to see weak wage response to increased economic activity as a problem**.

"**The shape of monetary policy poses risks and new questions**," says Robert Bergqvist. "Increasingly aggressive policies pump up asset prices and outstanding debts, but are not really capable of boosting consumption and capital spending; the 'financial cycle' is showing strength while the economic cycle is somewhat sluggish. Analyses by SEB and the International Monetary Fund (IMF) show that various factors are hampering (potential) growth, while global surplus capacity persists. Isolated monetary stimulus without support from complementary fiscal and macroprudential policies may contribute to exaggerated risk-taking and thus to mispricing that leads to misallocation of resources," Bergqvist adds.

"**The consequences of negative interest rate sare unknown, raising questions about inflation targeting**," says Håkan Frisén. "The historical association between deflation and growth is weak, which means that an aggressive monetary policy as a response to supply side-driven disinflationary impulses is not self-evident. Nor are the large wealth redistributions that we are now seeing consistent with the original intention of inflation targeting: to help increase stability and predictability for economic players."

The Federal Reserve (Fed)'s policy choices are the natural epicentre of the financial market and for the shaping of monetary policy by other central banks. The US economy is showing an underlying growth rate of 3 per cent. Good real incomes, rising asset prices and falling unemployment (4.5 per cent by the end of 2016) are expected to accelerate the increase in private consumption. There is also potential for an upturn in US capital spending. **SEB expects American GDP to grow by a moderate 2.7 per cent this year** (up from 2.4 per cent in 2014) and then reach **3.2 per cent in 2016**. The Fed faces a difficult balancing act. The bank is expected to focus on the resource situation, despite slow wage and salary growth to date. The first **Fed rate hike is expected in September**. The Fed's strategy is to shift attention from the timing of the first hike and instead focus on the cautious hiking cycle ahead – among other things by indicating that a neutral key rate today is about 2.5 per cent (compared to 4-4.5 per cent earlier, according to the Fed). We believe that there is also acceptance for a strong dollar, as long as long-term yields do not rise. **The EUR/USD exchange rate is expected to fall to 0.95 by the end of this year**.

The euro zone has delivered upside surprises, despite recurring problems with Greece. It is important that inflation expectations are up, but the ECB is probably not yet completely satisfied. **GDP will grow by 1.7 per cent this year** (0.9 per cent in 2014) and **2.1 per cent in 2016**. This is an upward revision of 0.5 and 0.4 percentage points, respectively, compared to our February forecast. The weak euro, lower energy prices, low interest rates and rising asset prices are boosting growth, especially in Germany and thus in most of the euro zone, despite sluggish growth in Italy and France.

"**We expect Athens to give in to the reform demands of other countries**, but the likelihood of 'Grexit' has increased, due to the country's severe liquidity problems and political instability. By the end of June, a third Greek rescue package must be in place," Håkan Frisén says. "The long-term consequences of a Greek exit from the euro zone must not be underestimated; all euro zone countries would be saddled with a currency risk premium. After the Fed's first key rate hike and a hopefully constructive Greek solution, there will be increased expectations that the ECB will reduce its monthly asset purchases (tapering). This is expected to lead to a **rebound in the EUR/UDS exchange rate to parity during 2016**," according to Frisén.

The emerging market economies will obviously be tested when the Fed raises its key interest rate in the autumn. This is expected to make affordable dollar-denominated borrowing in various EM countries more expensive. The economies that may be regarded as especially vulnerable include Brazil, South Africa and Turkey. Russian households are being squeezed hard as real incomes fall sharply, and the country's economy will shrink by 4.0 per cent this year. China's deceleration is continuing, driven by the housing market; Beijing will have difficulty achieving its new growth target of "about 7 per cent". **We expect China's GDP to grow by 6.8 per cent this year** (7.4 per cent in 2014) and by **6.5 per cent in 2016**. Chinese policymakers are showing no major concern about developments; there is room for more expansionary fiscal and monetary policies, for example by lowering interest rates and bank reserve requirements. However, China is now being surpassed in terms of growth by **India (GDP will grow by 7.5 per cent this year and 7.8 per cent in 2016)**, which can loosen its fiscal and monetary policies and make them more growth-friendly, due to lower inflation and stronger government finances.

The economic outlook in the Nordic countries remains divergent. The oil price decline is hurting **Norwegian GDP growth, which will reach only 1.6 per cent this year** (the mainland economy) and **2.2 per cent in 2016**. Capital spending is being squeezed, and contagious effects on consumer confidence and the labour market are starting to be visible. Meanwhile wage and salary growth is showing tentative signs of weakness. This opens the way for **Norges Bank to go ahead with a further key interest rate cut to 1.00 per cent**. Norway's higher interest rates will help sustain the krone, which will be traded at 8.10 per euro by the end of 2016. After an earlier housing market crisis in Denmark, demand is now increasing and growth is benefiting from the weak euro (via its peg to the Danish krone), low interest rates and rising home prices. **Danish growth will reach 2.0 per cent this year and 2.5 per cent in 2016**. Finland is facing continued challenges. Indicators are not pointing to any rapid economic rebound. Growth is being squeezed by both structural (challenges for the information and communications technology sector) and economic (Russian demand) forces. The Finns are pinning their hopes on expansionary monetary conditions, helped by ECB policies, and on the ability of a new coalition government to act decisively and not launch an excessively tight fiscal policy. **Finnish growth will be 0.4 per cent this year** (-0.1 per cent in 2014) and **1.0 per cent in 2016**.

The three Baltic countries are expected to show robust private consumption, helped by continued good real income increases (4.5-5.5 per cent yearly). The Baltics have also been resilient to the Russia crisis, successfully diversifying exports away from Russia and Ukraine. But capital spending activity remains weak, and rising labour cost pressure will cause growing challenges ahead. **Estonia's** strongly export-dependent economy is slowly emerging from a relatively deep slump in 2013-2014; **GDP will expand by 2.2 per cent this year** and **2.7 per cent in 2016**. **Latvia** will see unchanged growth of **2.4 per cent this year** compared to 2014 and a cautious acceleration to **2.7 per cent next year**. The imminent presidential election may cause political instability, but the economy is robust. **Lithuania's growth** will slow a bit this year, to **2.6 per cent, but will rebound to 3.5 per cent in 2016**. Potential growth in the Baltic economies is 3-3.5 per cent, which means that our forecasts show that decent GDP growth is in the cards for the three countries in the near future.

The Swedish economy is not immune to economic policy challenges in other countries and at home, yet we expect good GDP growth of 3.0 per cent this year, up from 2.1 per cent in 2014, and **2.7 per cent in 2016**. The driving forces behind growth are household consumption and increased construction. Given an undervalued krona, faster growth in Germany – Sweden's most important export market – will create good conditions for a continued yet fragile recovery in manufacturing. Household caution and a high savings ratio may be signs of concern about the economy, in light of the unstable political situation in Parliament and the Riksbank's extreme monetary policy, which is now laying the groundwork for a housing market bubble and home price declines ahead.

"The Social Democratic-led government's economic policy manoeuvring room is limited, since public finances today are in deficit," says Håkan Frisén. "New reforms must be funded according to the 'krona by krona' principle. We expect the budget deficit to shrink to 0.7 per cent of GDP (public sector debt will be 44 per cent of GDP) but spending pressure in such areas as immigration, sick pay, defence and infrastructure risk leading to a more negative balance, despite cyclical improvement in heavily taxed portions of the economy," according to Frisén.

"The government would like to have greater fiscal policy flexibility, through proposals to abandon the official target of a surplus in public finances and its intention to introduce a separate capital investment budget," says Robert Bergqvist. "The government's December Agreement with the opposition Alliance parties is helping to increase uncertainty about economic policy. **Tactical considerations ahead of the 2018 election risk hampering constructive collaboration between the government and the Alliance parties. Gridlock in the current 'limbo Parliament' may thus give rise to long-term economic problems**," Bergqvist adds.

Despite job growth, **unemployment in Sweden is stuck at high levels**. By the end of 2016 it will remain at 7.2 per cent. The explanation is an increased labour supply due to rapid population growth (primarily immigration) and higher labour force participation. This implies that equilibrium unemployment is slowly rising; it is now probably just below 7 per cent. **The government's target of "the European Union's lowest unemployment in 2020" seems unachievable**, for example when compared to unemployment in Germany today (the lowest in the EU), without a vigorous Swedish labour and education policy.

The Riksbank is playing the main role in Swedish economic policy, for both better and worse. During 2015, the central bank has taken major, purposeful steps: introducing a negative repo rate (-0.25 per cent), a government bond-buying programme (SEK 80-90 billion per month) and a lower forecast (1.25 percentage points) of future rate hikes.

"We anticipate that **in July the Riksbank will take a further step, lowering its repo rate to -0.40 per cent**," says Håkan Frisén. "The bank will be under continued pressure to ensure that the krona does not appreciate against the euro and eager to avoid low wage and salary expectations when the Swedish wage round begins late in 2015. We also believe that the Riksbank will need to revise its inflation path downward, although most indications are that inflation has bottomed out. In order for the Riksbank's 'exchange rate policy' to have a clear impact, the weak krona must be perceived as sufficiently long-lasting to allow exporting companies to dare to make investments and hire new staff, while importers dare to raise prices in Sweden and succeed in doing so. The Riksbank will hike its key interest rate only late next year, and it will reach 0 per cent **at the end of 2016**," according to Frisén.

The ongoing acceleration in household borrowing and home prices demonstrates the risk of relatively late-cyclical monetary stimulus, especially in a situation of already record-high debt and pumped-up home prices. But since the Riksbank is now being forced to prioritise its inflation target, the **responsibility for financial stability rests with the government** and its authorities. The recent seback in the Swedish Financial Supervisory Authority's plans to impose minimum principal repayment requirements on mortgage loans show the difficulty of implementing macroprudential policies. Although an adjustment to an improved mortgage repayment culture is under way, this is hardly sufficient to slow down the home price upturn, which is partly structurally driven.

"Reduced mortgage **interest deductions** are one step that may help cool off the housing market and meanwhile strengthen government finances," according to Robert Bergqvist. "But both the ruling Social Democrats and the Moderates – the leading opposition party – seem opposed to this. This means that other tools will be needed to achieve a stable, sustainable credit and housing market trend," Bergqvist concludes.

Key figures: International & Swedish economy *(figures in brackets are forecasts from the February 2015 issue of **Nordic Outlook**)*

International economy, GDP, year-on-year changes, %	2013	2014	2015	2016
United States	2.2	2.4 (2.4)	2.7 (3.5)	3.2 (3.2)
Euro zone	-0.4	0.9 (1.0)	1.7 (1.2)	2.1 (1.7)
Japan	1.6	0.0 (0.2)	1.1 (1.1)	1.3 (1.1)
OECD	1.4	1.9 (1.9)	2.3 (2.6)	2.7 (2.6)
China	7.7	7.4 (7.4)	6.8 (7.0)	6.5 (6.7)
Nordic countries	0.3	1.6 (1.6)	1.8 (1.9)	2.1 (2.2)
Baltic countries	3.2	2.6 (2.5)	2.5 (2.4)	3.1 (3.2)
The world (purchasing power parities, PPP)	3.2	3.4 (3.5)	3.4 (3.7)	3.9 (3.9)
Swedish economy. Year-on-year changes, %				
GDP, actual	1.3	2.1 (2.0)	3.0 (2.7)	2.7 (2.7)
GDP, working day corrected	1.3	2.1 (2.1)	2.8 (2.5)	2.5 (2.5)
Unemployment, % (EU definition)	8.0	7.9 (7.9)	7.6 (7.4)	7.3 (7.0)
Consumer Price Index (CPI) inflation	0.0	-0.2 (-0.2)	0.2 (0.1)	1.2 (1.1)
Government net lending (% of GDP)	-1.4	-1.9 (-2.0)	-1.3 (-1.2)	-0.7 (-0.6)
Repo rate (December)	0.75	0.00	-0.40 (-0.10)	0.00 (0.50)
Exchange rate, EUR/SEK (December)	8.86	9.39	8.95 (9.00)	8.80 (8.90)

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