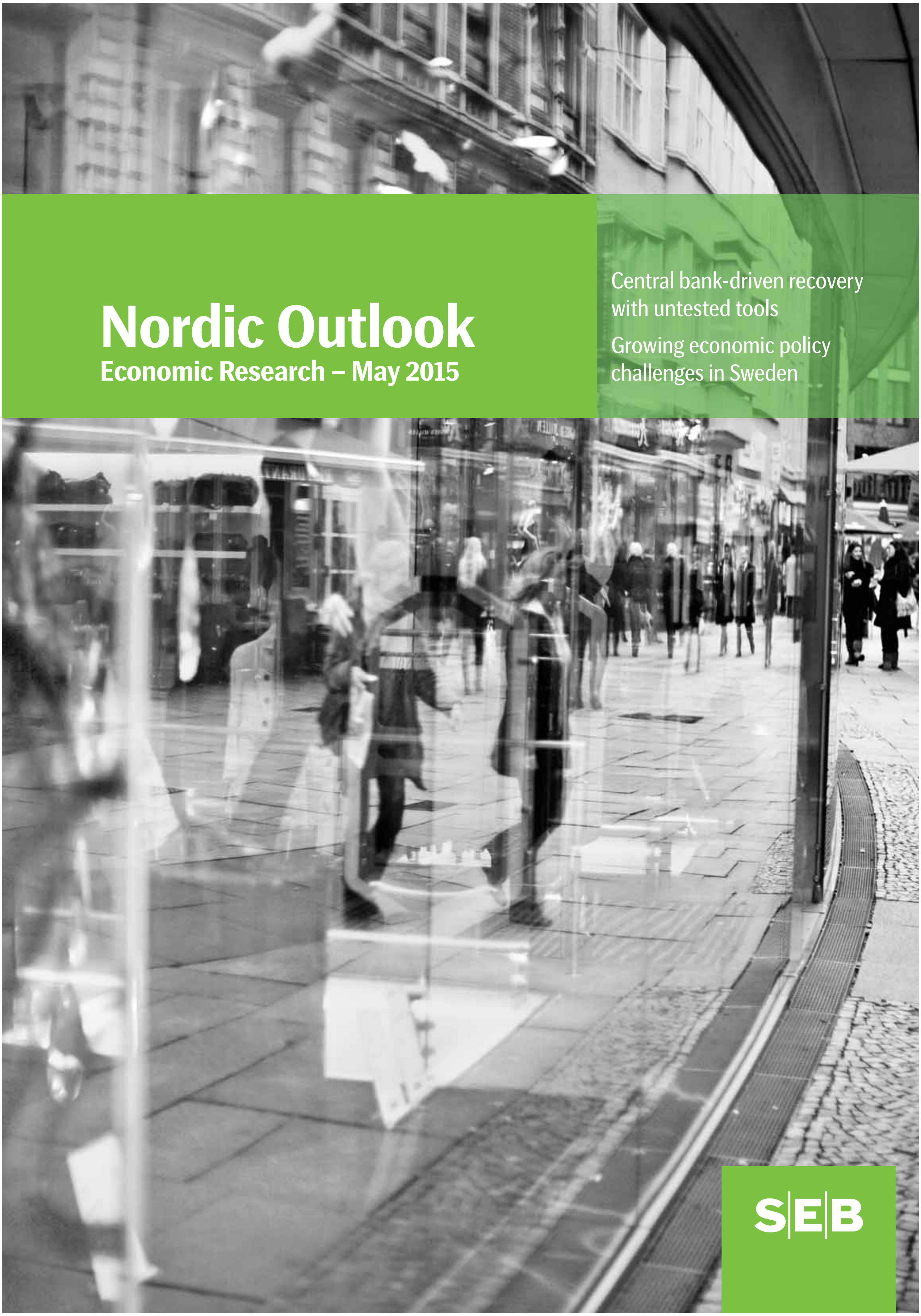
Nordic Outlook

Economic Research – May 2015

Central bank-driven recovery with untested tools

Growing economic policy challenges in Sweden



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Central bank-driven recovery with untested tools

- **Currency shifts drive global rebalancing**
- **Brief US slump, but cautious households**
- **Brighter euro zone outlook despite Greece**
- **Fed will start gentle rate hikes in September**
- **EUR/USD will be below parity by year-end**
- **Riksbank key rate has not yet bottomed out**

The global economy continues to be driven by changes in central bank policies. European Central Bank (ECB) stimulus policies have had an unexpectedly rapid impact on optimism and inflation expectations, stabilising the outlook for all of Europe. In the United States, however, disappointments predominated early in 2015. Although this was largely due to temporary causes, it is clear that the strong dollar contributed. In emerging markets, the signals have been mixed, although signs of weakness have dominated, especially since the growth slowdown in China has been somewhat sharper than expected. **Overall, we have adjusted our 2015 global GDP forecast downward from 3.7 to 3.4 per cent**, mainly because we have lowered our US growth forecast from 3.5 to 2.7 per cent. Our 2016 forecast is unchanged at 3.2 per cent.

Global GDP growth

Year-on-year percentage change

	2013	2014	2015	2016
United States	2.2	2.4	2.7	3.2
Japan	1.6	0.0	1.1	1.3
Germany	0.1	1.6	2.2	2.3
China	7.7	7.4	6.8	6.5
United Kingdom	1.7	2.8	2.5	2.4
Euro zone	-0.4	0.9	1.7	2.1
Nordic countries	0.3	1.6	1.8	2.1
Baltic countries	3.2	2.6	2.5	3.1
OECD	1.4	1.9	2.3	2.7
Emerging markets	4.8	4.7	4.3	4.9
World, PPP*	**3.2**	**3.4**	**3.4**	**3.9**

Source: OECD, SEB * Purchasing power parities

Falling oil prices and currency movements due to divergent monetary policies are generally positive for the world economy as a whole. Oil-importing countries are rather inclined to use increasing economic manoeuvring room for capital spending and consumption. Demand in producer countries is far less sensitive, since in many cases their response to the price drop is to reduce their build-up of reserves from oil trading profits. **The consequences of ongoing currency shifts show a similar gap between winners and losers.** In the euro zone and Japan, for example, depreciating currencies are leading to both higher growth and higher inflation. This is precisely what these economies need, and any economic policy tightening is definitely not imminent. Countries like the US and China are instead bearing the burden of stronger currencies, but have room to respond to their negative impact on growth and inflation with stimulus measures or by easing the pace of key interest rate hikes. The International Monetary Fund (IMF) has estimated that this asymmetry in policy response has stimulated the world economy by about ½ percentage point, based on currency movements so far since August 2014.

In most cases, currency and asset price movements are a deliberate result of economic policies, yet they carry obvious risks. **Stimulus may contribute to risk-taking that leads to mispricing and misallocation of resources.** Nor is the effectiveness of such policies convincing; asset prices are driven higher, but bigger wealth gaps diminish their impact on household consumption (see the theme article “Central bank policies and risk-taking”, page 13, and the box entitled “Crisis for inflation targeting”, page 9). The impact of negative interest rates and yields is still uncertain, but ECB asset purchases have already affected how the market functions. Negative yields far out on the yield curve may create problems, for example affecting the solvency of the pension industry. Because of uncertainty connected to the effects of economic policies, combined with US disappointments, **we are assessing the risks in our forecast as symmetrical**; our earlier assessment was that upside potential predominated.

Looking ahead, the Federal Reserve (Fed)’s choice of strategy will be crucially important to financial markets and the policies of other central banks. We believe that the increasingly tight US labour market will persuade the Fed to start hiking its key interest rate in September, despite low price and wage inflation. In this environment, we expect the dollar to continue climbing rather fast, with the EUR/USD exchange rate falling towards 0.95 by year-end. The Fed will then face a balancing act to ensure that its rate hikes avoid pushing the dollar too high and disrupting financial markets both globally and at home. We expect cautious rate hikes, with the key rate reaching 1.5 per cent by the end of 2016. Combined with the imminent end of ECB stimulative purchases, this will help EUR/USD move back to parity. Continued loose monetary policy, along with low underlying inflation pressure, will allow **the low interest environment to persist during 2015-2016**. Combined with a modest upturn in global economic growth,

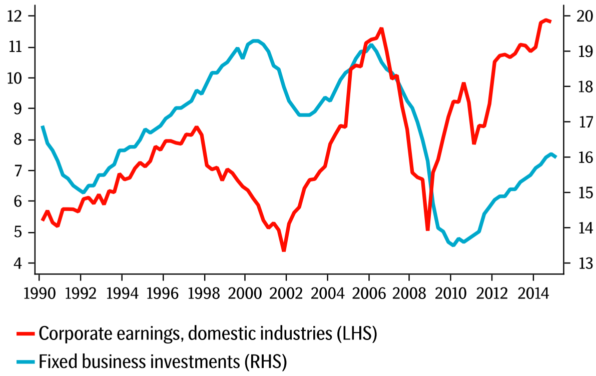
this will lay the groundwork for a further stock market upturn.

Temporary US slump but no real resurgence

The US economic slump early in 2015 was probably driven largely by unfavourable weather and labour disputes in major ports. We thus expect a rebound soon and are **sticking to our forecast that the US economy will continue to grow at an underlying annual pace of 3 per cent**. But a downward revision of our full-year 2015 figure is inescapable. Good real incomes, rising wealth and a strong labour market point to an accelerating in private consumption. There is also potential for an upturn in capital spending, due to good earnings, rising capacity utilisation and ageing production equipment.

US: High earnings but weak investment response

Per cent of GDP



Source: Macrobond

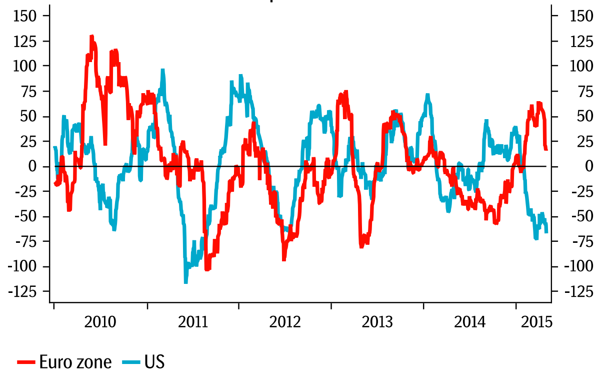
The strong dollar has hampered exports to a slightly greater extent than we had expected, although this does not change our basic view that the US economy is well equipped to bear the burden of a stronger currency. But we are also seeing signs of caution in the domestic economy that are helping prevent growth from reaching levels typical of previous recovery phases. Thus household saving has recently climbed, perhaps indicating that **US consumers also feel some doubts about the sustainability of a recovery that is dependent on central bank policies**. Capital spending activity has been subdued until now despite rising corporate earnings, probably because resource utilisation is still relatively low. But there may also be more structural reasons. For example, many firms seem to be having trouble adjusting their real return requirements on investments to the new interest rate environment. Companies also seem to be utilising new investments more efficiently, limiting the need for expanded volume.

Unexpectedly rapid euro zone improvement

The ECB's stimulus programme has contributed to a faster-than-expected upturn in the euro zone outlook. At the outset, interest rates were already very depressed, reducing the potential impact of QE policy compared to the situation in the US and UK, for example. However, the currency effect will be far stronger, while the oil price downturn is providing much-needed support. **Household and business optimism has risen, and both credit demand and inflation expectations are up.** The export-led recovery will thus spread to consumption and capital spending. We now expect euro zone GDP to rise by 1.7 per cent in 2015 and 2.1 per cent in 2016: an upward revision by 0.5 and 0.4 percentage points, respectively. Looking ahead, continued significant euro depreciation will help strengthen competitiveness further, especially for German exporters. The Spanish economy is also growing relatively fast, while France and especially Italy are lagging.

Euro zone: Upside surprises

Surprise Index



Source: Macrobond, Citibank

The increasingly critical situation in Greece poses risks, however (see box, page 24). Our main scenario is still that an agreement forcing the Greek government to make concessions will be reached at the last minute. But the likelihood of a Greek exit from the euro zone (Grexit) has risen, and **the long-term consequences of a country's withdrawal from the currency union should not be underestimated**. To mitigate these risks, deeper collaboration between the remaining member countries will probably be required, but economic policy integration efforts are currently at a standstill.

New parliamentary situation in the UK

Despite weaker growth figures early in 2015, we believe that the British economy will continue to expand a bit above trend. The current focus of attention is the May 7 parliamentary election, but we do not believe that its outcome will have such a great impact on the direction of fiscal policy. Regardless of who wins, fiscal policy will be distinctly contractive after this year's neutral stance. **However, there are questions about general political developments.** Neither Labour nor the Tories are likely to come close to winning the 326 seats needed for a majority. The formation of a government thus looks set to be rather complicated. Several new, untested parties may play a key role, which reduces predictability. This may be important in a situation where the UK must clarify its long-term policy ambitions in relation to Europe over the next few years.

EM economies will be tested by Fed hikes

The Fed's approaching rate hikes are a source of uncertainty for emerging market (EM) economies in general, although the resilience of individual countries varies greatly. Yet a number of EM economies are expected to follow the Fed and hike their own key rates to reduce the risk of large-scale capital outflows and currency depreciation. Among the weakest EM economies from this standpoint are Brazil, South Africa and Turkey.

Another cloud on the horizon is the rapid increase in USD-denominated borrowing by private companies in recent years. The data are scanty but in economies like Chile, Turkey and Taiwan, corporate foreign borrowing has climbed fast in recent years and is now equivalent to more than 20 per cent of GDP. Widespread currency depreciation would risk triggering clearly negative effects, since the local-currency costs of servicing these loans would climb sharply.

In most EM economies, growth is decent though slower than before the financial crisis. For example, we expect GDP growth in most Asian emerging economies to accelerate cautiously in 2015 and 2016. In **India**, the growth outlook is turning brighter. Plunging inflation and improved central government finances will make it possible to stimulate the economy with more expansionary monetary and fiscal policies. The governing Bharatiya Janata Party has unveiled a growth-friendly budget, although key reforms are conspicuously absent. In **China**, deceleration continues, driven by a weak housing market. We do not believe that the country will achieve its 7.0 per cent growth target for 2015, but policymakers are showing no major signs of concern, probably because they can stimulate the economy by continuing to loosen monetary and fiscal policies. Continued gradual deceleration to more sustainable growth rates will increase the likelihood of a soft landing, especially if further reform efforts can occur at a decent pace.

Of the BRIC countries, both Brazil and Russia are showing clear problems. In **Brazil**, the economy has decelerated sharply. The need for large-scale structural reforms is increasingly apparent. The corruption scandal surrounding the state-owned oil company Petrobras is harming already weak capital spending, and political turmoil is making reform efforts more difficult. The recession in **Russia** will be deep this year. The oil price decline has helped trigger sizeable rouble depreciation, in turn causing rapidly accelerating inflation and growing capital flight problems. But the rouble has recovered somewhat since winter, driven by an oil price upturn and signs that the latest ceasefire in eastern Ukraine seems to be holding. Our main scenario is also that Western economic sanctions will not escalate, among other things due to increasingly divergent positions in the European Union.

Lower potential growth on a broad front

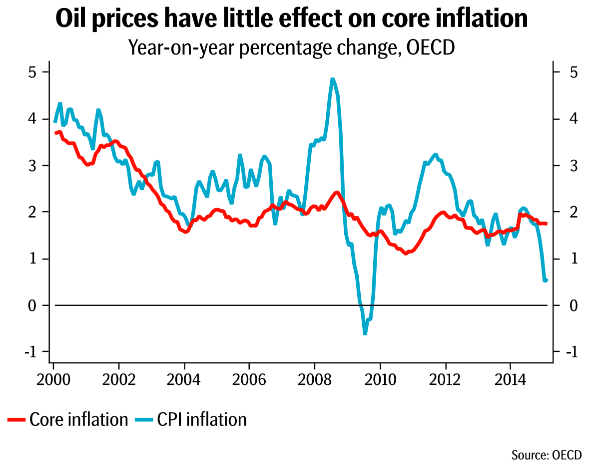
Sluggish post-crisis recovery has led to repeated downward revisions in the economic outlook. One explanation that focuses on the supply side is that slow growth is due to the difficulty of pushing real interest rates down to a level that creates equilibrium between saving and capital spending. Other explanations are based on our being in a phase where demographics and technological advances are leading to underlying weak growth. In its latest *World Economic Outlook*, the IMF analyses potential growth since the turn of the millennium (see theme article, page 32). Its conclusion is that potential growth in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) fell relatively sharply during the financial crisis (from 2.3 to 1.4 per cent) but is now on its way to recovering somewhat. In the emerging market (EM) countries, potential growth has held up so far, **but we are now facing a clearer deceleration to somewhat above 5 per cent**. The downturn is due to a weaker demographic trend and less potential for technology transfer (catching up) as the gaps compared to the OECD narrow.

Potential output growth and its driving forces

Per cent

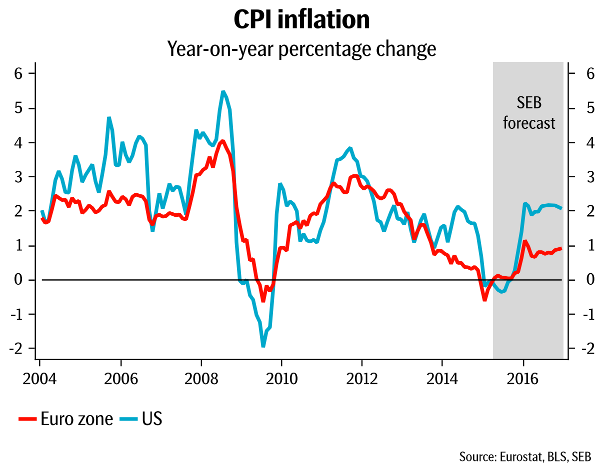
OECD countries	**2001-07**	**2008-14**	**2015-20**
Total	**2.3**	**1.4**	**1.7**
Employment growth	0.6	0.3	0.2
Capital productivity	0.9	0.6	0.7
Total factor productivity	0.8	0.5	0.8
EM economies			
Total	**6.8**	**6.4**	**5.3**
Employment growth	0.8	0.6	0.3
Capital productivity	2.3	2.9	2.1
Total factor productivity	3.7	2.9	2.9

Sources: IMF staff estimates

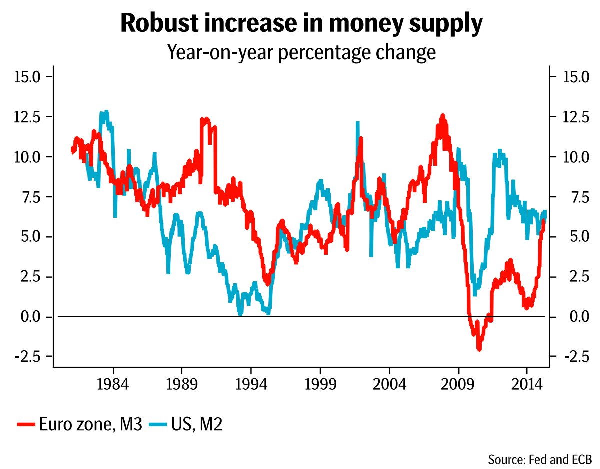


Inflation at a new crossroads

Falling oil prices now dominate the short- and medium-term inflation picture. Overall CPI inflation in the OECD countries is now about ½ per cent, and we expect it to continue downward to zero during the third quarter. Then the effects of lower oil prices will begin disappearing from 12-month figures; together with slightly rising oil prices, this will cause headline inflation to move upward. Inflation will remain low during the next couple of years, but there is relatively little risk that the oil price decline will start a broad deflation process. **So far, the secondary effects of oil prices on core inflation have been limited**, which is very consistent with our estimates of a 0.3-0.4 per cent annual effect in 2015 and 2016. Inflation expectations have also rebounded – especially in the euro zone, where ECB stimulus measures have had an impact. They are nevertheless still at levels that are uncomfortably low for central banks.



In a slightly longer perspective, pay increases and the effectiveness of monetary policy will be crucial to the inflation trend. For example, we are now seeing how the money supply and household and business lending are starting to rise in the euro zone. Meanwhile the US money supply is growing at a healthy pace. **This indicates that the transmission mechanism is working better, since central bank stimulus is reaching the economy.** It is a signal of increased economic activity, which will lead to rising resource utilisation and thus higher inflation ahead. But we are sticking to our view that a growing money supply in itself is not so important to inflation.



Unemployment is continuing to fall. In countries like the US, Japan, Germany and the UK, it is now close to equilibrium. Yet generally speaking, the rate of pay increases in the OECD countries remains low. Increased global competition in the labour market seems to be helping weaken the association between resource utilisation and pay increases. In the US, there are signs that hourly earnings have accelerated in recent months, although other earnings metrics provide a divergent picture. **Central banks and governments are increasingly beginning to see the weak wage response as a problem.** This makes it hard to meet inflation targets, while holding back demand for consumption and widening the gaps in society.

In Japan, Germany, the UK and elsewhere, decision makers are trying to influence wage formation by means of verbal interventions. In Germany, both the Bundesbank and leading politicians have declared that higher pay increases can help decrease imbalances in the euro zone by narrowing gaps in competitiveness and stimulating German imports. In Sweden the Riksbank has so far chosen a more cautious policy, avoiding appeals for higher collective pay agreements. Raising minimum wages is another strategy that has been tried in the US, Germany and the UK, for example. US companies in low-wage sectors such as retailing also seem open to voluntarily raising their lowest wages. **Overall, we believe that the rate of pay increases will slowly climb in the next couple of years.** The likelihood that falling wages will drive economies into a deflationary spiral has recently decreased further.

Difficult balancing act for the Fed

Monetary policy continues to drive up asset prices and debts to new records. The ECB's monthly purchases of EUR 60 billion worth of assets – more than EUR 1.1 trillion if the programme runs its full course – has stabilised and raised inflation expectations globally. The QE programme turned out to be far bigger than we had anticipated and **has contributed to unexpectedly strong downward pressure on the entire yield curve**. This is not unproblematic; negative effects on the functioning of the market cannot be ruled out. Negative interest rates increase the risk of insolvency in the pension industry, for example in Germany. Yet by all indications, the ECB will continue to insist on the need to complete its QE programme. We believe that an improved economic outlook, the Fed's coming key rate hikes and a stabilisation of the situation in Greece will contribute to increased expectations of a reduction ("tapering") of ECB asset purchases.

Central bank key interest rates

Per cent

	2015 May	2015 Dec	2016 Dec
Federal Reserve (US)	0-0.25	0.75	1.50
ECB (euro zone)	0.05	0.05	0.05
Bank of England (UK)	0.50	0.50	1.25
Bank of Japan	0.10	0.10	0.10
Riksbank (Sweden)	-0.25	-0.40	0.00
Norges Bank (Norway)	1.25	1.00	1.25

Source: SEB

Our central bank forecast implies more expansionary global monetary conditions in 2015, even though the Fed is expected to begin its rate hiking cycle this autumn. Due to slower growth and low inflation in a number of emerging economies, such as China and India, the key interest rates in these countries will continue to converge towards the low levels prevailing in the West. Although various central banks will follow the Fed's example and begin cautious hiking cycles – the Bank of England early in 2016 and the Riksbank and Norges Bank the following autumn – global monetary policy will remain ultra-loose next year as well.

The Fed's monetary policy deliberations are the natural epicentre for the shaping of policy by other central banks and future financial market performance. The Fed's statements this spring indicate that it is now ready to begin raising its key rate. Its top officials have tried to set the stage for a rate hike by emphasising the tighter resource situation and trying to tone down low earnings growth to date. Their strategy has been to shift attention from the timing of the first hike, instead signalling very cautious hikes ahead – among other things by indicating that a **neutral key rate today may be around 2.5 per cent instead of 4-4.5 per cent as earlier**. We are sticking to our forecast that the first hike will occur in September, though low inflation and weak economic data have marginally increased the probability that it may be delayed a little longer than this. We then expect the key rate to slowly be raised to a level of 1.50 per cent by the end of 2016. The size of the Fed's balance sheet, currently USD 4.5 trillion (five times larger than before the crisis) will not change during our forecast period.

The trend of total financial conditions – changes in exchange rates, long-term yields, credit spreads and asset prices – will be important in shaping the policies of the Fed and other central banks. The Fed and the US face a balancing act. By accepting a stronger dollar and abstaining from "currency wars", they are increasing the potential for more balanced global growth. Meanwhile we believe that the Fed's gentle interest rate path will not push up the dollar so high **that protectionism will become a major issue in the 2016** presidential election campaign. Nor will dollar appreciation on the scale that we foresee create excessive problems for EM countries that are highly dependent on cheap USD-denominated borrowing.

Various Nordic central bank dilemmas

Economic forces in the Nordic countries are divergent. **Sweden** still has a two-speed economy. Consumption and housing construction are contributing to relatively strong growth, while the manufacturing recovery has been weaker than normal. In **Norway**, growth is being pushed down by the oil sector; contagious effects will make themselves felt in the future. After an earlier housing market crisis, demand in the **Danish economy** is now growing both among households and businesses; upside risks predominate as home prices begin to climb. **Finland** is showing broad-based weaknesses; indicators are not pointing to any rebound soon, although a weaker euro and improved euro zone economic conditions will help.

Crisis for inflation targeting?

Increasingly aggressive monetary policies that pump up asset prices and lead to negative interest rates and yields, yet are not really capable of boosting consumption and capital spending, are fuelling discussion about the appropriateness of inflation targets. This international discourse has flared up occasionally in the past decade, without resulting in any clear changes. But we can note that some fresh ideas are in the wind when it comes to important issues related to inflation targeting policy:

How dangerous is Consumer Price Index (CPI) deflation, actually? One justification for today's aggressive monetary policies is that a general decline in prices would lead to postponement of consumption and capital spending, thereby causing a deeper recession. But this is not obvious. Studies by the BIS, for example, show that the historical association between deflation and growth has been very weak except for the 1930s depression. In addition, if disinflationary forces are supply side-driven and can help boost household purchasing power without squeezing corporate earnings, it is even more unlikely that they would have a paralysing effect on demand.

Do inflation targets provide stability and predictability? An inflation target is usually called "intermediate", and its ultimate purpose is to create stable long-term conditions for economic players. One important element of this is to prevent high and varying inflation from creating arbitrary reallocations of wealth. But if policies aimed at keeping CPI inflation close to target create great financial volatility in themselves, one of their fundamental purposes has been lost. Growing wealth gaps also hamper consumption and decrease the effectiveness of monetary policy, further accentuating this dilemma.

Have inflation targets been set too high? Some observers argue that inflation targets should be lowered, since it is too difficult to reach 2 per cent inflation in a world of globalisation and robotisation. But there are no theoretical arguments why, in the long term, it should be easier to stabilise inflation at a lower level. On the contrary, a few years ago IMF Chief Economist Olivier Blanchard instead proposed raising the targets to 4 per cent, with the aim of creating greater monetary policy manoeuvring room in recessions by reducing the problems of the zero lower bound on interest rates. It remains to be seen to what extent today's negative interest rate and bond yield experiments will influence this analysis.

Overall, the debate seems to be moving in a direction that emphasises the disadvantages of inflation targeting to a greater extent. This is especially true of situations where policymakers are supposed to respond to relatively small deviations in inflation, regardless of what forces are behind them. In the next few years, we may see a movement towards a gentler interpretation of inflation targets, **for example with a renaissance for the concept of "leaning against the wind" and avoiding asset price excesses**. One important question in this context is how well new macroprudential policies can work alongside with – and complement – inflation targeting policies.

No far-reaching change in the monetary policy framework is likely to occur within the foreseeable future. At present, there is no clear alternative. Neither in the practical nor the theoretical debate is there any obvious consensus view. Inflation targets are also the basis for central bank independence; legislative changes in this area are both sensitive and complex. **A deep new economic crisis will probably be needed to trigger change.**

The central banks face various types of challenges. Denmark's **Nationalbank** has successfully defended its krone-euro peg; speculative currency flows have decreased. But we do not believe it has room for any rate hike in 2015. **Sweden's Riksbank is fighting hard to restore confidence in its inflation target**, focusing clearly on influencing inflation with the help of a weak krona. After cutting the repo rate in March between policy meetings, the bank left the rate unchanged at its April meeting but instead expanded the volume of its asset purchases. The Riksbank's strategy is to use various stimulus measures such as rate cuts and QE while also being open to currency interventions. The ECB's stimulus measures will put continued pressure on the Riksbank, which we believe will cut the repo rate once more to -0.40 per cent, most likely in July. The bank will consider rate hikes no earlier than the second half of 2016. Rising home prices, combined with **great difficulties in implementing macroprudential tightening measures, imply increased risks to the economy**.

Norges Bank's ambition is also to avoid a stronger currency, but its focus is instead on avoiding deterioration in competitiveness, which might intensify the negative impact of the oil price decline on demand. We believe that the slowdown is sharp enough to allow a key rate cut soon, but market expectations of two rate cuts seem a bit aggressive, given relatively high resource utilisation in the Norwegian economy. A first rate hike to 1.25 per cent will come in December 2016.

Nordics and Baltics, GDP growth

Year-on-year percentage change

	2013	2014	2015	2016
Sweden	1.3	2.1	3.0	2.7
Norway	0.7	2.2	1.0	1.6
Denmark	-0.5	1.1	2.0	2.5
Finland	-1.3	-0.1	0.4	1.0
Estonia	1.6	2.1	2.2	2.7
Latvia	4.2	2.4	2.4	2.7
Lithuania	3.2	3.0	2.6	3.5

Source: OECD, SEB

Bond yields have not bottomed out

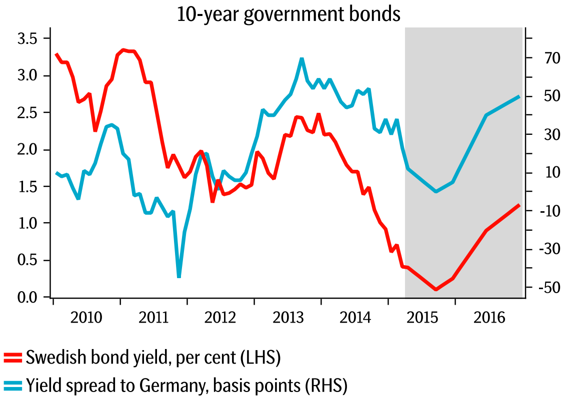
Because of loose global monetary policies, long-term bond yields will remain historically low throughout our forecast period. In economies where monetary policy continues to move in an expansionary direction (such as the euro zone, Norway and Sweden), bond yields have probably not bottomed out. In the US, cautious key rate hikes will mean that the upturn will be modest compared to earlier hiking cycles. The search for returns in a world where many central banks are continuing to ease monetary policies will help hold back the yield upturn in the US as well. In the short term, weak economic signals may lead to greater uncertainty about the Fed's rate hikes, which will push down long-term yields somewhat further before an upturn begins. At the end of 2016, the yield on a 10-year US Treasury note will stand at 2.70 per cent.

The ECB's QE programme has had a major impact on interest rates as well as yield spreads. Negative yields have proliferated to more countries and further out on the yield curve. This has raised the question of whether an asset shortage will force the ECB to trim its buying volume, but we believe it is too early for the bank to signal a need for a less expansionary monetary policy. **QE will continue to push down German bond yields over the next six months.** A bit further ahead, expectations of smaller asset purchases and rising inflation expectations will help push long-term yields higher in the euro zone as well. By the end of 2016, the German 10-year yield will stand at 0.75 per cent. Political risks, especially worries about a Greek exit from the euro zone, may occasionally affect the market by boosting investor interest in German government bonds and creating wider yield spreads in the euro zone periphery.

In Sweden, we expect a further key rate cut to -0.40 per cent this summer. The Riksbank will also keep buying government bonds at least until early autumn. **This suggests that the yield spread to Germany may shrink somewhat closer to zero.** The spread will then widen again as the market begins to discount earlier key rate hikes in Sweden than in the euro zone. By the end of our forecast horizon, Swedish 10-year yields will be 50 basis points above their German counterparts. This implies a 10-year yield of 1.25 per cent in December 2016.

Swedish yield spread to tighten further

10-year government bonds



Source: Macrobond, SEB

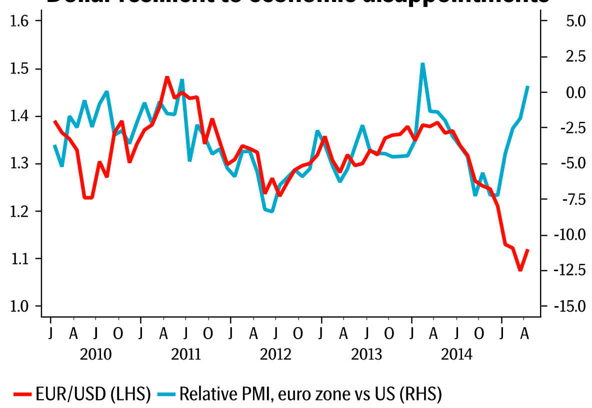
In Norway, too, we foresee room for a narrower spread vs. Germany, among other things due to favourable supply factors and prospects that the krone will eventually appreciate. We believe that the spread against Germany will be 85 bps in December 2016, for a 10-year government bond yield of 1.60.

Dollar appreciation speeding up

The interplay between monetary policy and foreign exchange (FX) market trends is increasingly important; central bank policies largely determine exchange rates, while central banks themselves also depend on the FX market response. This is especially clear with regard to the EUR/USD exchange rate. After sharp euro depreciation early in 2015, the EUR/USD rate has stabilised at just below 1.10 during the past month. This has coincided with indications of slightly weaker US economic performance, which have helped postpone expectations of Fed rate hikes. Meanwhile there are signs that stock market-driven currency flows have recently pushed up the euro.

We nevertheless believe that the EUR/USD exchange rate will continue to fall. It is not unusual for a currency movement to halt temporarily; corrections often occur when an exchange rate has been adjusted by as much as 25 per cent in a short period. As the chart indicates, the dollar has also proved resilient to economic disappointments. Many years of extremely low US interest rates have led to large-scale USD borrowing by economic players outside the US. At present, such borrowing is not nearly as attractive, since US interest rates are well above German ones, for example. **This may lead to restructuring that will contribute to USD appreciation.** Once the Fed begins its key interest rate hikes, we believe that the EUR/USD exchange rate will move down towards 0.95 by the end of 2015. Our assessment of long-term equilibrium is well above EUR/USD parity, however. We believe that the exchange rate will slowly move in that direction in 2016, as economic conditions in the euro zone continue to improve.

Dollar resililent to economic disappointments



Source: Macrobond

Since the Bank of England will be one of the first central banks to follow the Fed in hiking its key rate, the pound is likely to appreciate further against the euro. The pound cannot actually keep pace with the dollar's rise, **but we believe the EUR/GBP rate may trade down towards 0.67 by the end of 2015**. Despite a clear appreciation against the euro, we believe that the pound will remain fairly close to its long-term equilibrium rate in trade-weighted terms.

Currency rates have assumed a key role now that the Riksbank is trying to restore confidence in its inflation target. This change has occurred quickly; as recently as a year ago, the krona exchange rate was of secondary importance, **but now it appears to be the main tool for boosting inflation expectations**. Recent cuts to negative interest rates and bond purchases have successfully weakened the krona against various currencies, including a falling euro. At present, the market is underweighted in kronor and the Riksbank must probably continue to signal significant dovishness in order to avoid krona appreciation. But in the long term, it is unreasonable to believe that the Riksbank can keep up with the ECB in terms of stimulus measures. Even if the Riksbank can prevent appreciation in the near future, we expect the krona to rise against a weak euro as early as the second half of 2015. By year-end, the EUR/SEK exchange rate will be 8.95. However, the krona will weaken significantly against the dollar, with the USD/SEK rate moving up past 9.40 by year-end.

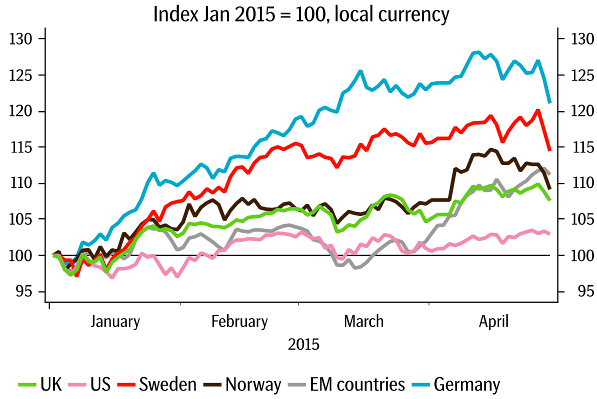
Norway's central bank is also trying to counter currency appreciation. Partly due to the negative impact of the oil price decline, unlike the situation in Sweden the central bank is focused on **the role of the Norwegian krone in growth and competitiveness rather than inflation expectations**. We expect another key rate cut soon, which should keep the krone weak in the near future. With oil prices rising towards USD 70 per barrel during the autumn, pressure on the Norwegian economy will ease and the central bank can lower its guard. This should allow room for the krone to appreciate somewhat in the autumn. By year-end, we expect the EUR/NOK exchange rate to stand at 8.25.

Stock markets have further potential

Stock markets have kept climbing so far this year, especially in markets helped by a weaker currency. The MSCI World Index has gained only 5 per cent, **while Nordic exchanges are up 24 per cent overall and the OMX Stockholm 17 per cent**. Euro zone equities have benefited both from ECB stimulus and a weaker euro, while the strong USD has held back US shares. Oil price fluctuations have affected equities in some EM countries, as well as in Oslo. Translated to the same currency (USD), the gaps are much narrower. For example, the gain in Sweden is only a few percentage points better than in the US.

Big differences in stock market gains so far in 2015

Index Jan 2015 = 100, local currency



Source: Macrobond

Continued central bank stimulus in Europe, Japan and China – combined with a cautiously positive macro outlook – will help sustain the stock market globally. The Fed's key rate hikes pose a risk. **But as long as these hikes are justified by an improved economy, we do not view them as a major threat to the stock market.** Europe is the main region whose economic forecasts are being revised upward, as the ECB loosens its monetary policy. This will continue to benefit European equities, compared to the US. EM stock markets will benefit from rising world trade due to a strong US economy. Asia will be helped by monetary easing in China, among other things, while the outlook is worse for regions and countries with large current account surpluses or heavy dependence on commodities, such as Latin America, Turkey and Russia.

In the Nordic region, too, we see potential for a continued rally. We expect earnings in Nordic listed companies to climb about 14 per cent this year, up from 6 per cent in 2014. In 2016 we expect average earnings growth of some 11 per cent, a relatively cautious forecast since it does not close the gap compared to the earlier trend created in 2011-2013. At present Nordic equities, like those elsewhere in the world, have relatively high valuations. **The stock market has been driven more by low interest rates and bond yields rather than by expected earnings, which has contributed to rising valuations.** Today Nordic equities are trading at a price/earnings ratio of 17 and Swedish equities at 18 (based on 12-month forward-looking earnings estimates), which is some 35 per cent above average valuations for the past 10 years.

Under normal conditions, these would be viewed as high valuations, but assuming continued low interest rates and yields, it is possible to argue that share prices will go higher. Due to low interest rates, future earnings discounted to present value translate into higher valuations, lowering the return requirement on equities. This requirement consists of a “risk-free” alternative return plus a risk premium on equities. For example, earlier this year SEB Equities lowered its estimate of risk-free interest for the next 10 years to an average of 2.5 per cent. Assuming an unchanged 4 per cent risk premium, this implies a return requirement of 6.5 per cent, or 2 percentage points lower than the estimate made a few years ago. This suggests that equities will be traded at higher P/E ratios ahead.

- **Monetary expansion will continue, along with strong asset price and debt growth**
- **Financial and economic cycles increasingly out of synch – both smaller and larger risks**
- **Global dependence on central bank policies will persist for a long time to come**

Despite Fed rate hikes, global monetary policies – helped by the European Central Bank (ECB), Bank of Japan (BoJ) and various emerging market (EM) economies – will become more **expansionary in 2015-2016**. "Zero interest rates" and even negative rates will continue to characterise central banks.

Since 2007, the world's central banks have tripled their balance sheets to USD 22 trillion (December 2014). This increase is evenly divided between developed and EM economies. While the West has focused its securities purchases on *domestic assets*, EM countries have bought *foreign assets*, including US, Japanese and European securities. Japan is expected to speed up its bond purchases to about USD 830 billion a year, and the ECB's quantitative easing (QE) now totals USD 1.23 trillion. German Bundesbank purchases exceed the expected net supply of the country's government bonds.

Global assets and liabilities are growing fast – faster than the underlying economy. Central banks are playing the main role. Private and public debt is at record levels; deleveraging after the Lehman Brothers crash (2008) is viewed by many, such as the International Monetary Fund (IMF) and Bank for International Settlements (BIS), as inadequate. Growing debts, which in many cases end up partly in central bank balance sheets, help sustain economic growth but increase vulnerability to new growth reversals and to rising interest rates and yields. Central bank actions also increase the probability that various types of risks will be mispriced.

Large-scale asset purchases by central banks are intended to push down risk premiums and boost risk-taking in the private sector, encourage portfolio reallocations and reinforce expectations of rising inflation and continued low (real) interest rates. The aim is to show that the struggle to preserve the credibility of inflation targets enjoys priority and will promote growth, jobs and inflation.

The financial cycle – shifts in credit growth and asset prices – has shown growing amplitude over the past 40-50 years. Variations in the cycle have played a role in macroeconomic performance. The latest peak was powered by low interest rates, massive credit expansion and financial creativity (sub-prime), reduced risk aversion, the creation of the euro and underestimation of globalisation's impact on both financial (Asian savings surplus) and real economic (lower inflation) performance. There are thus similarities with today's situation. Although the authorities have taken new micro- and macro-prudential actions, there is still uncertainty about the effectiveness of such measures in "taming" the financial cycle.

Financial and economic cycles becoming decoupled

The economic cycle is moving upward, but at a frustratingly slow pace. Growth is still hampered by surplus global production capacity (supply-side effects) and by weak cyclical and structural demand. There is a major risk that sizeable structural forces might diminish the effectiveness of monetary policy and increase the likelihood of new problems.

The weak or fading direct impact of monetary policy on growth and inflation, for example due to structural reasons, risks widening the divergence between financial and economic cycles, though the financial cycle is often far more lengthy than the economic cycle. The financial expansion of recent years may thus still be viewed as fairly short-term. Yet this does not prevent the possible emergence of problems, for example in terms of excessive **risk-taking**, new financial imbalances and increased **economic inequality between households**.

Are we seeing excessive risk-taking?

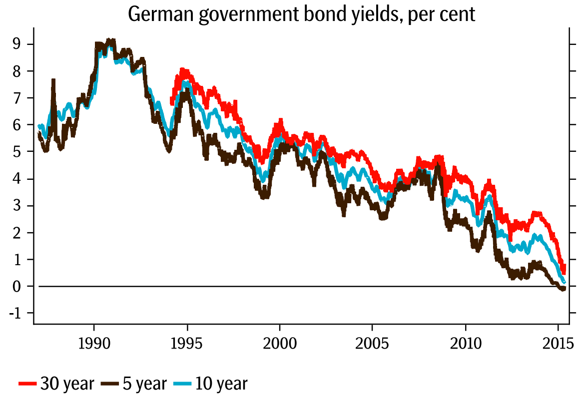
It is reasonable to ask whether central banks are overstimulating the financial cycle and risk-taking. The financial market is highly dependent on their balance sheet policies. **Risk premiums are being pushed down.** The longer a low interest rate environment and asset purchases last, the more economic players will be lulled into relying on extremely low funding costs, high stability due to growing central bank "safety nets" and positive asset price trends.

There are factors that may justify today's seemingly pumped-up financial prices, but tensions will grow unless general economic conditions improve. The global stock market (MSCI World) is 25 per cent above its previous peak in 2007, driven by the search for returns in a low interest rate environment and by plentiful new central bank money. The monetary base has swelled by the equivalent of 20 per cent of global stock market capitalisation. Yet today's **stock market valuations are being sustained by the low interest environment** (discounting effect), lower **oil prices** and **global growth**, which will increase from 3.4 per cent in 2014 to 3.9 per cent in 2016.

Bond market pricing is driven by central banks' key rates and future expectations (see the theme article in *Nordic Outlook*, August 2013, on the building blocks and direction of long-term yields). The euro zone fixed income market is showing signs of **asset shortages due to the ECB's large government bond purchases**, which are pushing yields into negative territory even for long maturities. The current yield on a 30-year German bond is below 1 per cent. If the ECB succeeds in meeting its inflation target of just below 2 per cent, an investor today is accepting more than a 1 per cent negative real return. Although the ECB is showing **few signs of concern about the functioning of the market**, we expect the discussions about slowing its bond purchases to intensify, for example as the German yield curve shows more and more negative yields. Yields have not yet bottomed out.

Falling long-term yields: a 30-year trend

German government bond yields, per cent



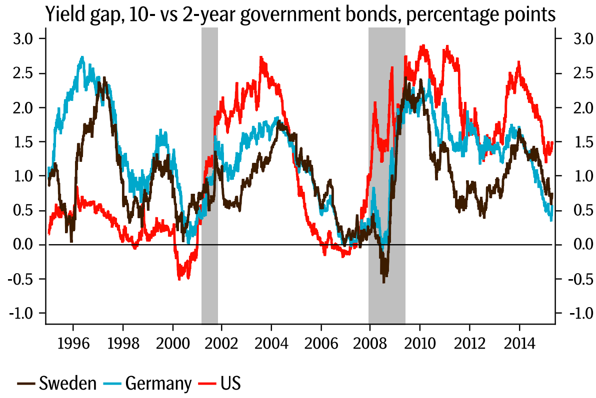
Source: Macrobond

Pension funds face growing challenges, especially in countries with systems based on very long-term debts amtched by shorter-term assets, and where the return to the owners is fixed or guaranteed. Such international organisations as Standard & Poor's, Moody's and the European Insurance Occupational Pensions Authority (EIOPA) are warning that more and more euro zone countries, including Germany, will face the challenge of low or negative yields over long periods. This may require rewriting regulations and policies and forcing pension funds to diversify more to **avoid solvency problems**.

The risk in the global banking system is regarded as lower, however. During the crisis years, banks were forced to adapt their business models to new and expected regulatory systems and requirements. Meanwhile the authorities have carried out large-scale bank stress tests. The low interest rate environment also helps improve opportunities for maintaining high and growing debts – both private and public – thereby reducing credit risk in the economy. Potential problems today are gradually weaker profitability in the banking system due to low interest rates and the emergence of a credit market outside the regulated system. Exactly how these risks will look and evolve is unclear. This is a source of concern to regulators.

Yield curves are increasingly flat

Yield gap, 10- vs 2-year government bonds, percentage points



Source: Macrobond

Low interest rates and greater access to loans have contributed to rising **home prices**. Here too, we believe that countries like the US, UK, Spain and Denmark – which have undergone major home price corrections – are still **far from levels that indicate excessive risk-taking**. In countries that have had a continued positive home price trend such as Norway and Sweden, the risk levels of their low interest rate policies are substantially higher.

But a marked increase in inequality...

Central bank policies have had limited spillover effects in the real economy, **because their wealth effects are unevenly distributed**. The thrust of economic policies in recent years has created greater inequality between households. Austerity policies have led to higher unemployment, while one aim of central bank monetary policies has been to boost asset prices, thus benefiting households that often already enjoy a good financial situation. This has fuelled discussions about redistribution policy, an issue we have analysed repeatedly in *Nordic Outlook* over the past few years.

There are still hopes that rising asset prices will ultimately lead to higher economic and job growth that affects all of society, especially households with weaker financial positions. Yet there is an obvious risk that a protracted period of slow growth, with central banks driving up asset prices, will increase social and political tensions in the future.

Continued dependence on central banks

The world must be prepared for **higher future volatility, for several reasons**. Economic, financial and political risks are no smaller today than they were before the crisis. Meanwhile the risk picture in the financial system has become more difficult to assess, since the risks inside and outside the financial system – as well as between countries and regions – are shifting. Today's financial system is probably also less capable of absorbing risks, due to regulations that limit its market-making function. Greater volatility may be painful to various economic players, forcing central banks to take new actions. There is also a strong expectation that central banks will respond to renewed uncertainty, the risk of asset price declines and growing signs of insufficient market liquidity. This set of expectations and market behaviours may both lead to problems further ahead.

- **Crude oil prices will climb towards a new USD 70/barrel equilibrium**
- **Stock build-up and an Iran agreement pose a downside risk**
- **US cost squeeze means lower break-even**

We are sticking to our scenario that Brent crude oil prices will reach USD 70 per barrel at the end of 2015 and then remain at around that level during 2016. In recent issues of *Nordic Outlook*, we have discussed the changes in supply and demand that are behind our forecast of a new equilibrium that is well below the levels that prevailed until mid-2014. OPEC – with Saudi Arabia as its key player – is currently showing no signs of a desire to reduce supply. This confirms our thesis that underlying supply and demand conditions have changed. Instead, OPEC wants to keep prices from rebounding to such high levels that US oil production will take off again. In this way, the cartel hopes to avoid a scenario in which oil prices would again fall, with the final outcome that OPEC would lose market share without being able to keep prices up in the long term. Below we review some of the key factors affecting the oil market and our analysis of the risk picture.

The instability in the Middle East and North Africa is likely to persist, which will help soften the decline in oil prices. Although the turmoil caused by the Islamic State (IS) does not seem to be disrupting current oil production to a very great extent, it is blocking investment in new production facilities, especially in northern Iraq. The escalation of the conflict in Yemen is of importance mainly because of increased uncertainty related to the Bab-el-Mandeb strait, through which 3.8 million barrels of oil per day pass into the Red Sea bound for the Mediterranean and Western Europe.

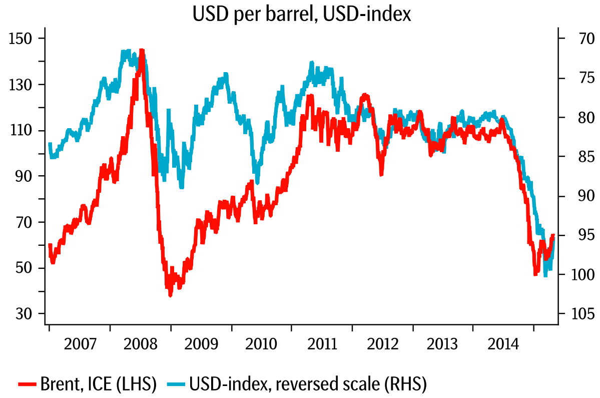
Iran's nuclear negotiations are contributing to uncertainty about the oil market balance. June 30 is the deadline for a final deal, following the framework agreement reached in early April. If the deal goes through, it will add about 0.7-1.0 million barrels per day to global oil supply in 2016. This would push down prices by USD 5-15/barrel, according to US Department of Energy estimates. An agreement with Iran would also help increase stability in Iraq, thereby improving the potential for higher oil production and thus push down the outlook in oil prices in the medium term.

US oil production now exceeds 9 million barrels per day. West Texas Intermediate (WTI) prices fell from an average of USD 100/barrel in the first quarter of 2014 to USD 48/barrel in Q1 2015. This price drop was big enough to bring an end to rapid US crude oil production growth, driven by sharply lower drilling activity. There are numerous estimates of the total shale oil production cost in the US. Based on these, our conclusion is that USD 60/barrel seems to have been a reasonable 2014 level. But the decline in crude oil prices has triggered intense cost-cutting. Rents on oil rigs, for example, have fallen 30 per cent, and various employee benefits in the industry have rapidly been trimmed. Meanwhile, productivity has quickly increased. We thus believe that the critical WTI price level at which production can begin to rebound has fallen to around USD 60/barrel, which is supported by the apparent view among many major oil companies that their return on US investments is better than elsewhere. Looking ahead, our conclusion is that higher US production may once again contribute to downward price pressure in the global oil market.

Other crude oil production (excluding OPEC and the US) is now at some 45 million barrels/day. Without new capital spending, this production volume would decline by about 5 per cent yearly. In recent years, new investments have prevented this from happening but investment activity is now falling sharply due to lower crude oil prices and the crisis in Russia. Hence, there is a clear risk that production in these countries will decrease in the next five years.

Strong correlation between USD and oil prices

USD per barrel, USD-index



Source: ICE, Macrobond

In all, we estimate that **a global balance between supply and demand in the oil market would require OPEC to produce 29.5 million barrels/day in 2015**, slightly below the organisation's formally announced cap of 30 million barrels. But according to the latest available statistics (March), the cartel's production stood at 31 million barrels. This means that right now we have global surplus oil production, which is leading to stock build-up. The question is how this imbalance will be resolved. Last year, demand rose by a very modest 0.7 per cent. Estimated demand growth this year is a bit above 1 per cent. Low prices could lead to a faster upturn in demand, but historically such adjustments have been rather slow. Our overall assessment is that the ongoing stock build-up, combined with a possible breakthrough in negotiations with Iran, will mean **that the short- and medium-term risk in our oil price forecast is on the downside**.

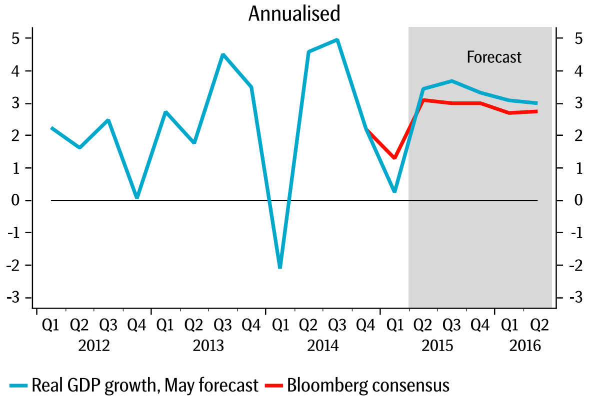
Growth slump will be temporary this year too

- **Stronger consumption growth is expected**
- **Conditions favour stronger capital spending**
- **Strength of the dollar is curbing exports**
- **Fed will hike its key rate in September**

Just as in 2014, the US economy slowed precariously early this year. Yet such indicators as service and construction sector confidence, as well as auto sales, have recently shown strength – a sign that the slump will be temporary. This reinforces our view that severe winter weather and the now-resolved port labour disputes on the west coast contributed greatly to the growth slowdown. The weather factor may also explain why households cut back consumption and have thus substantially boosted their savings since New Year. Furthermore, since 1985 first quarter growth has been by far the weakest of the four. Looking ahead, consumption will become an increasingly powerful economic engine, contributing to good growth figures. **GDP growth will be 2.7 per cent this year and 3.2 per cent in 2016.** This forecast is compatible with robust job growth and falling unemployment; **the jobless rate will be 5.1 per cent at the end of 2015 and 4.5 per cent at the end of 2016**. Faster hourly earnings increases are thus also in the cards.

Real GDP growth: Temporary setback

Annualised



Source: BEA, Bloomberg, SEB

The appreciation of the dollar is curbing both exports and inflation. The currency has climbed by some 15 per cent in trade-weighted terms since mid-2014. This is expected to lower GDP growth by more than half a percentage point this year. On the other hand, the decline in oil prices will provide a correspondingly large stimulus; the US is still a large net importer of petroleum products. With regard to inflation, though, the exchange rate and oil prices are pulling in the same direction. We predict **low inflation: 0.1 per cent this year and 2.1 per cent in 2016**. The strength of the dollar is one reason why the Federal Reserve will raise its key interest rate cautiously; the first hike will come only in September, according to our forecasts. **By the end of 2016, the key rate will stand at 1.50 per cent.** The real key rate will thus end up at close to zero – monetary policy will remain expansionary for a few more years despite the tight resource situation in the labour market. Yet our forecast is more aggressive than prevailing market pricing, which indicates a key interest rate of 1 per cent in December 2016.

Household consumption will accelerate

Household consumption has been unexpectedly weak in recent months, despite **strong income growth accompanying the robust labour market**. Contrary to our earlier forecasts, the household savings ratio has climbed steeply so far this year, even though rising wealth points towards lower household saving. Since consumer confidence remains at healthy levels, the harsh winter weather in parts of the US may explain the dip in consumption. During the spring, consumption is likely to rebound. The decline in inflation so far during 2015 is also boosting purchasing power, with lower petrol (gasoline) prices making more room for consumption of other goods. Meanwhile household balance sheets are in comparatively good shape, and lending is pointing upward. Measured as annual averages, **household consumption will grow by 3.1 per cent this year and 2.8 per cent in 2016**.

Weather slows down growth once again

The US experienced extreme weather again this winter. According to the National Climatic Data Center, some of the coldest temperatures on record were measured in the north-east. Since 20 per cent of the population live there, this hurt both consumption and production. Meanwhile the west coast reported record heat; this means that average national temperatures effectively concealed dramatic weather conditions. West coast heat may also impact the real economy: California, in particular, has gone through a drought in recent years and water use restrictions have been introduced. The last three cold winters were preceded by near-record warmth during the winter of 2012. It is thus too early to say that recent extremely cold winters are the new normal.

Now that the large supply of homes for sale has been whittled down, there is reason for optimism about construction. The number of new households is increasing rapidly and home mortgage interest rates are low. The construction outlook was also unusually upbeat in the Fed's latest Beige Book. Housing starts will reach a yearly rate of 1.3 million by the end of 2016 according to our forecast, compared to 926,000 today. Residential investments will thus contribute decently to GDP in the next few years. **According to the Case-Shiller index, home prices** – which are still well below their 2006 peak – **will climb by 6 per cent this year and 4 per cent in 2016**.

Good potential for capital spending

The steep decline in oil prices since last year is continuing to squeeze investments in oil and gas extraction – a business that accounts for around 1 per cent of GDP. **The number of active oil rigs in the US is falling by nearly 50 per cent year-on-year.** Overall, however, the oil price decline is having positive net economic effects, among other things via stronger household consumption, since the US remains a large net importer of petroleum products.

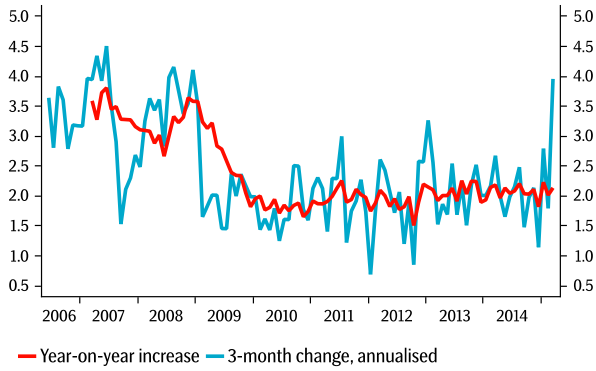
Outside the oil sector there is good potential for faster capital spending growth – viewed on the basis of market valuations of companies, higher investments are also a rational decision. When Tobin's Q ratio (total market value of a company's shares divided by the replacement cost of capital assets) is as inflated as today, it means that market valuation exceeds the actual value of assets and that companies should thus take the opportunity to step up their pace of capital spending. **Business investments will increase by an average of more than 6.5 per cent in 2015-2016, according to our forecast.**

Weak productivity growth also indicates a need to invest. Productivity fell on a quarterly basis during the fourth quarter of 2014, and most indications are that the downturn also continued during the first quarter of 2015. It is unusual for productivity to fall for two quarters in a row when the economy is growing. Looking at the past 30 years, this has only happened twice before. In other words, companies are ordinarily quicker in adjusting their overall costs when earnings are squeezed; this past winter's growth slump seems to have taken businesses by surprise. Viewed in a longer perspective as well, **productivity growth is weak and declining**. Measured as annual averages, it has stagnated. Measured using a 5-year average, productivity growth has more than halved compared to before the financial crisis. One explanation for this decline is the feeble growth in capital stock since 2009.

Unemployment will continue downward

The current decline in productivity can be interpreted as meaning that companies will need to trim their headcount in the near future. In light of this, the weak employment growth report in March was worrisome. But various factors suggest that this job creation reversal was temporary. **Our assessment is that no lengthy slump is in the cards.** The level of new jobless benefit claims is still low and is compatible with employment growth in excess of 200,000 per month. Meanwhile the number of job vacancies is at a 15-year high and dismissals has been pushed down to levels that, in earlier cycles, coincided with unemployment of around 4 per cent. At the same time, job growth in small businesses is close to its highest level in the past decade. Overall, we believe that **job growth will average 230,000 per month in 2015-2016**, which implies a slight downturn compared to 2014, when employment growth was the second strongest in 30 years. Our job creation forecast is compatible with continued falling unemployment. **The jobless rate**, which stood at 5.5 per cent in March, **will continue downward to 5.1 per cent at the end of 2015 and 4.5 per cent at the end of 2016**. Looking ahead, a stabilisation in labour force participation suggests a somewhat slower decline in unemployment compared to 2011-2014, when it fell by an average of 0.9 percentage points per year. Unemployment is approaching its equilibrium level (NAIRU), and this seems to be having an impact in the form of **faster hourly earnings increases**. Viewed over recent months, hourly earnings growth has accelerated, while year-on-year increase remains at modest levels.

Hourly earnings have risen faster recently



Source: BLS, SEB

Strength of dollar is curbing growth

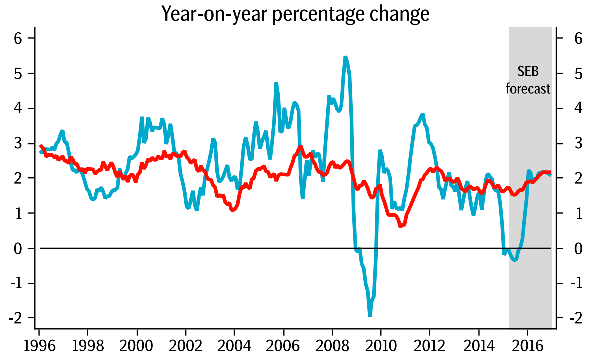
The US economy is relatively closed: exports are equivalent to only 13 per cent of GDP and imports 16 per cent. According to OECD statistics, the US is the least open economy of the 40 or so countries the organisation tracks. This is one reason why the US growth dynamic is dominated by household consumption and business investments, rather than by impulses from foreign trade. In 2014 the strong American economy also went hand in hand with an upturn in the dollar. A disappointing growth rate early in 2015, while **the dollar has appreciated by around 15 per cent** in trade-weighted terms, nevertheless raises **questions about the resilience of the economy**. According to the Fed's big macroeconomic model, dollar appreciation will make a negative growth contribution of about half a percentage point both in 2015 and 2016. Lower oil prices will provide an effective counterweight, however, at least in 2015. For the Fed, the effect on inflation is also important – a strong dollar keeps import prices down. But research usually shows that exchange rate-driven inflation effects are rather small when the inflation target enjoys high credibility. **Dollar appreciation to date is expected to push core inflation a few tenths of a per cent lower in 2015-2016.**

Inflation will soon bottom out

US inflation will hit bottom a couple of months from now, according to our forecasts. Oil prices are stabilising and are expected to climb somewhat during the second half of 2015, which suggests faster inflation ahead. Core inflation, which excludes food and energy prices, will also begin to climb again after mid-year, according to our forecast. Underpinning this forecast is the fact that **it is difficult to see signs of deflationary tendencies when we disregard the effects of oil prices and exchange rates**. For example, an index that excludes only energy prices is currently climbing at around 2 per cent year-on-year, up from 1.5 per cent a year ago. **Service sector prices are generally rising**. Since services account for 62 per cent of the price basket, this will have a substantial impact on the main index once energy prices stabilise. **We thus predict inflation of 0.1 per cent in 2015 and 2.1 per cent in 2016.** Core inflation will be 1.7 per cent this year and 2.1 per cent in 2016, according to our forecasts.

Low inflation in 2015

Year-on-year percentage change



Source: BLS, SEB

Debt ceiling issue will soon come up again

The improvement in US federal finances since 2010 has been the fastest in 50 years. In fiscal 2014, which ended in September, the budget deficit was a mere 2.8 per cent of GDP. Now that neither new tax hikes nor spending cuts are likely, **fiscal policy is expected to have a neutral effect on growth in the coming year**. The easing of fiscal policy uncertainty is noticeable in various ways. The partial closure of federal government activities in 2013 created a public opinion backlash that Washington seems to have taken to heart. The focus is instead on next year's presidential election – with Democratic candidate Hillary Clinton as the favourite among betting firms – and the political climate at the moment is dominated by cooperation rather than confrontation.

In light of this, our main scenario is that the debt ceiling issue, which caused so many headaches a few years ago, will not lead to renewed political drama when it comes up again later this year. In 2014 Congress decided to allow the federal debt to rise until March 2015. But now that a debt ceiling is again binding, actual federal debt is bumping up against it once again. As long as Congress does not vote either to raise or to again ignore the debt ceiling, the **Treasury Department must use accounting tricks to pay its bills**. But during the fourth quarter of 2015, the situation is expected to become critical and a solution must be reached before then.

Fed is preparing to normalise interest rates

The coming **monetary policy normalisation is closely related to the inflation trend** – the first rate hike will occur only when the Fed is "reasonably confident" that inflation will move higher towards its 2 per cent target. What, then, is actually required in order for the Fed to reach that level of confidence? According to Fed Chair Janet Yellen, the central bank is watching a broad spectrum of indicators, though the following occupy a special position: the labour market, inflation, wage and salary growth and inflation expectations. Given our forecast that both headline and core inflation will bottom out only this summer, we believe that June might be too early for an initial rate hike: **a September hike is still our main scenario**.

The Fed's latest key rate forecasts also suggest a September hike, since the central bank predicts that its most important key rate will stand at 0.625 per cent at year-end. If the current key rate interval remains in place, that level is compatible with two 25 basis point hikes in 2015, for example in September and December. As for 2016, the Fed predicts a key rate level of 1.875 per cent at year-end, which is slightly above **our forecast of 1.5 per cent**. Although the gap between the Fed and market expectations is narrowing, market pricing still points to far more cautious rate hikes; according to forward contracts, the key rate will reach 0.35 per cent at the end of 2015 and slightly above 1 per cent at the end of 2016.

Since the **Fed nowadays keeps a close eye on financial conditions** – a composite index of interest rates, stock markets and exchange rates – the actual key interest rate profile will probably be affected by how financial markets react once the tightening cycle has been launched. For example, **the more the dollar appreciates, the fewer rate hikes are required** to achieve the desired monetary tightening. If the first rate hikes lead to what the Fed views as excessively powerful tightening via the dollar and long-term yields, the central bank will probably move more slowly after that. This time around, the hiking cycle may thus not offer the same transparency as in the previous cycle, when the Fed raised its key rate at each meeting between June 2004 and June 2006.

On the other hand, it is not unusual that the market is worried about the real economy and asset values as the Fed's first key rate hike approaches; this was also the pattern in 1988, 1994 and 2004. Among other things, this uncertainty will probably lead to greater stock market volatility this time as well, but without interrupting the general upturn phase.

Meanwhile it is worth remembering that the key rate hikes that the central bank is currently signalling **will hardly result in a tightening of monetary policy**; given the Fed's key rate and inflation forecasts, the real key rate will end up at close to zero in 2015-2016, compared to an average of 1.5 per cent in 1990-2007. According to historical experience, the next cyclical downturn begins an average of three years after the first Fed rate hike. If the Fed raises its key interest rate in September as we expect, the historical average indicates that the next US recession will arrive in the third quarter of 2018.

Small steps towards higher pay in a tight labour market

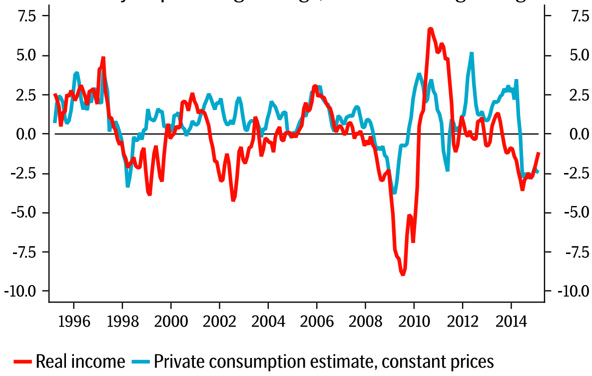
- **Slow recovery after 2014 tax hike**
- **Exports helped by yen and rising demand**
- **BoJ will not achieve its inflation target**

After last year's abrupt slowdown, there has been no quick rebound in the Japanese economy. Fourth quarter growth was unexpectedly weak, partly due to inventory adjustment. Early 2015 offered new disappointments. Household demand remains depressed after last year's consumption tax hike. Major industrial firms have become somewhat less optimistic, according to the Tankan survey from the Bank of Japan (BoJ). Despite a weak start to 2015, we expect the recovery to gain new traction this year and next. **GDP will increase by 1.1 per cent in 2015, followed by 1.3 per cent in 2016**: well above the long-term trend of 0.5-0.75 per cent and a slight upward revision for 2016. **The drivers are expansionary monetary policy, gradually improving international demand, a strong labour market and lower energy prices**. OECD rules of thumb suggest that the oil price decline since last summer may boost growth by ½ percentage point. A temporary upswing in private consumption before the next planned tax hike in the spring of 2017 will benefit growth in 2016.

Foreign trade is a growth engine once again. Exports bounced back during the second half of 2014. The upward trend will continue, sustained by improved competitiveness due to the weak yen and increased demand from the US, the EU and various Asian countries. Unclear data around the Chinese New Year make it difficult to interpret Japanese exports to Asia in early 2015; our main scenario is that the region will be resilient to somewhat lower Chinese growth. **Household demand also looks a bit more promising**. Inflation is decelerating as the effects of last spring's tax hike fade. This strengthens purchasing power. The tight labour market will also open the way for slightly higher pay increases. The companies in the Tankan survey indicate that they are facing the tightest labour market since early 2008; small and medium-sized businesses have not seen anything like this since the early 1990s. The ratio of jobs per job seeker is continuing to climb, after a temporary pause in 2014. The government is pressuring large export firms let their gains from the yen depreciation spill over into higher collective wage and salary agreements. These efforts look set to bear fruit; this spring's centralised negotiations in 62 of Japan's biggest companies will lead to the highest pay increases since before the financial crisis, although the changes will still be small. Above all, companies have shown greater willingness to boost their base salaries, and not just their seniority increases, which is necessary in order to achieve genuine wage hikes.

Falling real incomes have squeezed spending

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



Source: Cabinet Office, Japanese Ministry of Health, Labour and Welfare

It is uncertain to what extent higher pay at major companies will spread to non-exporting small and medium-sized firms, which do not benefit in the same way from the weak yen. The tighter labour market suggests general wage and salary hikes, but this is meanwhile hampered by Japan's inflexible labour market – with its combination of lifetime employment and temporary low-paying jobs. The latter category has steadily increased and now accounts for more than one third of the labour market. This has contributed to a weak income trend throughout the economy and probably also to poorer productivity growth, due to weak incentives for professional development. To summarise, we expect increased support for consumption over the next couple of years from improved real wages, but the rate of pay increases will still not rise to a level compatible with the BoJ's 2 per cent inflation target. **Inflation will end up at 0.7 per cent in 2015 and 0.9 per cent in 2016**.

The BoJ's inflation readings will fall to negative figures this spring, increasing the pressure for new stimulus measures. We expect the central bank to expand its asset purchases to JPY 100 trillion this July, contributing to a further weakening of the yen to 140 per USD at the end of 2016. Looking ahead, it will be crucial for Japan to stick to the reform agenda in the third "arrow" of Abenomics, which aims at expanding the labour supply and boosting productivity by making the economy more flexible. After his election victory last December, Prime Minister Shinzo Abe has ensured himself another four years for reform work. Although there has been a shortage of quick, radical actions, it is too early to write off Abenomics, especially if future reforms can be enacted against a backdrop of stronger international economic conditions.

Emerging Asia resilient to China's growth slowdown

- **High USD debt is creating certain risks**
- **China: Hard landing becoming less likely**
- **India: Stimulus policy will boost growth**

Except for China, **growth is expected to accelerate cautiously in most Asian emerging economies**. Good domestic demand – sustained by strong labour markets, rapid earnings growth and expansionary monetary policies – is driving this trend. Price pressure has continued to ease, and in some economies inflation has fallen below zero; monetary policy has been loosened further in Indonesia, South Korea and elsewhere. External demand is strengthening due to good US growth and an improved euro zone outlook. We thus believe that the region can cope with continued deceleration in China.

One **cloud on the horizon** is the **Fed's approaching monetary policy tightening**. It appears unlikely that the Fed's key interest rate hikes will lead to sharp rate hikes in emerging Asia; instead, local conditions will determine the shape of monetary policy. But a **bigger source of concern for many emerging economies is USD-denominated borrowing by private companies**, which has increased rapidly in recent years. In Asia, too, there are examples of large-scale foreign borrowing. As currencies in the region have weakened against the US dollar, local-currency cost of servicing the loans has risen. A lack of reliable data makes it hard to assess how large these risks are, but more extensive weakening of currencies will risk having a negative impact on individual economies, such as Malaysia.

Private sector foreign debt (companies and banks)

Percentage of GDP

Country	1996	2014
Malaysia	27.7	27.9
South Korea	24.2	18.7
India	6.5	13.0
Taiwan	8.7	23.8
Indonesia	26.0	11.0

Source: BIS

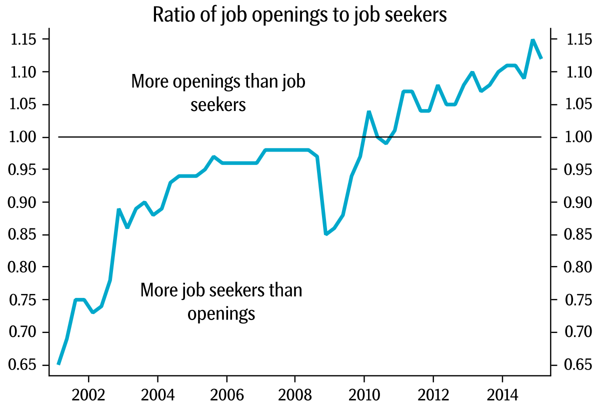
China: Weak start to 2015

Because of seasonal variations, Chinese economic data are always difficult to interpret early in the year. But signals of weakness at the beginning of 2015 were confirmed when **first quarter GDP growth ended up at 7.0 per cent** year-on-year: a clear deceleration compared to 7.3 per cent in the fourth quarter. This slowdown is still being driven by waning domestic demand. Aside from exports, most economic data have been weaker than expected. For example, March industrial production was up 5.6 per cent year-on-year, the slowest increase since 2008. Capital spending continues to decelerate.

The National People's Congress lowered China's 2015 growth target to "about 7.0 per cent", but it will still be **challenging to achieve this target. Economic policy easing will need to intensify**. Yet policymakers are not signalling any concern. Instead they point out that there is still plenty of room to ease fiscal and monetary policy. The labour market is also showing no clear signs of weakening and should be able to cope with a slowdown to 7 per cent growth. The ratio of jobs to job seekers is continuing upward. Wages are climbing at a healthy pace. We believe that further cuts in interest rates and bank reserve requirements, expanded liquidity in the banking system and more expansionary fiscal policy – including a larger budget deficit – combined with accelerating international growth – will enable China to end up close to its growth target. Decelerating capital spending will continue to push down growth during the next couple of years, however. **We expect GDP to increase by 6.8 per cent in 2015 and by 6.5 per cent in 2016.**

Continued strong labour market

Ratio of job openings to job seekers



Source: Ministry of Human Resources and Social Security of the People's Republic of China

Chinese authorities will probably **abstain from overly extensive stimulus measures** for as long as they can, in order to avoid a rebound in lending and prevent large-scale new investments from worsening the overcapacity problem. The weak residential property market is still the main reason behind decelerating growth. We thus expect a continued easing of housing market policy, but the fundamental problem – a large supply of unsold homes – will persist in the short term. It will thus take time before any positive impact on construction is apparent.

In a slightly longer perspective, it is fortunate that China's growth is decelerating gradually, since this will reduce the risk of a hard landing. We can already see **various signs that the probability of a hard landing has diminished**. While the deceleration in China's exceptional capital spending boom has pushed down short-term GDP growth, it has reduced the problems of unproductive investments and excess capacity. Because the authorities have resisted the temptation to mobilise powerful stimulus measures, economic reform will also be easier. For example, reforms of local government debt management are decreasing risks to the financial system. The **deposit guarantee** that was introduced on May 1 is another step towards the removal of caps on the interest rates paid to account holders, which may occur as early as this year. Economic policy makers also have ambitions beyond the borders of China. The Asian Infrastructure Investment Bank (**AIIB**), initiated by China last autumn, at first encountered lukewarm interest but now has nearly 60 member countries. It is regarded as a triumph for Chinese influence in Asia.

Inflation pressure is very low; in March, inflation stood at 1.4 per cent. The 2015 target has been lowered from 3.5 to 3.0 per cent, but in practice it is a ceiling rather than a traditional inflation target. Over the next few months, inflation may cool further, driven by lower commodity prices, but is expected to rebound late this year. China will thus avoid deflation. **We expect inflation of 1.5 per cent in 2015, rising to 2.0 per cent in 2016.**

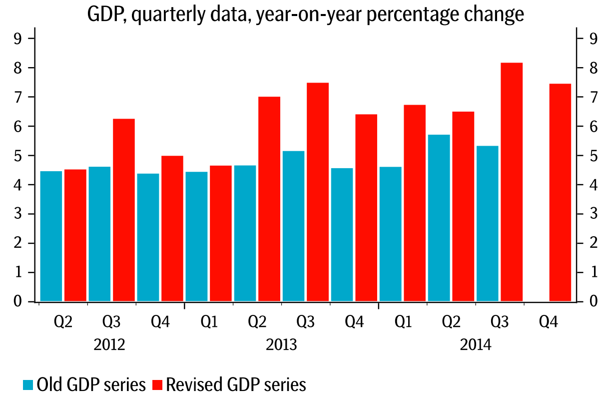
At present there are economic arguments for depreciating the **yuan**: to stimulate exports but also to counter deflationary tendencies by boosting import prices. But for political reasons, Chinese authorities are unlikely to carry out a meaningful depreciation. Given their long-term goal of turning the yuan into a global currency, they must avoid obviously influencing the exchange rate. Depreciation would also create tensions in relations with the US. **We expect a USD/CNY exchange rate of 6.20 at the end of 2015 and 6.10 at the end of 2016.**

India: Looser economic policies lift growth

The **upwardly revised GDP figures** unveiled in late January created **uncertainty**, which still persists. The Reserve Bank of India (RBI) has also commented on the difficulty of obtaining a clear picture, since the sharp upward revisions contradict other economic data. GDP growth in 2013 was revised upward from 4.7 to 6.4 per cent. One main explanation that has been suggested is that new measurements indicate a faster upturn in the manufacturing sector. Otherwise the perception of subdued economic activity persists. India's purchasing managers' indices for both the manufacturing and service sectors are well below historical averages. Exports and imports have weakened in recent months, and car sales remain sluggish.

Sharp upward revisions of historical GDP figures

GDP, quarterly data, year-on-year percentage change



Source: Indian Ministry of Statistics and Programme Implementation, SEB

Meanwhile there are bright spots. Industrial production surged in February, though it is too early to say whether this upturn will continue. The economy is generally in better shape than a few years ago, with smaller current account and budget deficits as well as far lower inflation. This creates room **to stimulate the economy with looser fiscal and monetary policy**. We are sticking to a scenario of cautious growth acceleration ahead. **We expect GDP to climb 7.5 per cent in 2015 and accelerate further to 7.8 per cent in 2016.** India will thus surpass China's growth rate, providing a new perspective on developments in the world's two most populous countries. But this should be viewed in light of per capita GDP in India, which is less than half as high as in China. Given suitable economic policies, there is thus great potential for rapid growth.

In late February, the Narendra Modi government submitted its budget. The target of trimming the deficit to 3 per cent of GDP will be met a bit more slowly, while public infrastructure spending will expand. Corporate tax will be cut and a national sales tax will take effect by April 1, 2016, replacing local taxes. Overall, **the budget will have a positive growth impact**, though it does not deliver reforms as extensive as many hoped.

Inflation has fallen steeply: from 8.2 per cent in March 2014 to 5.2 per cent in March 2015. This is already well below the RBI's 6 per cent target for January 2016 and is driven by lower oil and food prices. **We expect inflation to average 5.5 per cent in 2015 and 5.4 per cent in 2016.** The sharp drop in inflation has created room for the RBI to soften monetary policy. Early in March, the bank cut its key interest rate for the second time this year, to 7.5 per cent. **We expect further cuts of 50 basis points, bringing the year-end 2015 key rate to 7.0 per cent.**

Unlike many other emerging market currencies, the rupee has not weakened to any great extent against the USD during the past year. We expect no major exchange rate shifts in 2015 either. **At the end of 2015 we foresee an INR/USD rate of 60.0 and at the end of 2016 an exchange rate of 56.0.**

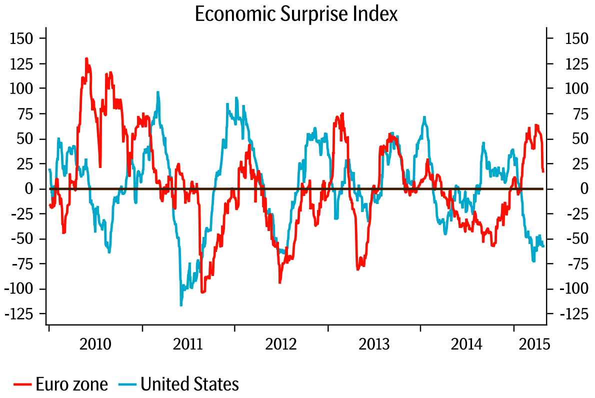
Improved outlook but persistent uncertainties

- **Low oil prices, weak euro, QE are helping**
- **Consumer confidence and consumption up**
- **ECB will continued bond purchases as planned – too early to taper**

Recent statistics have revealed upside surprises in the euro zone, in clear contrast to the US. Low oil prices, a weaker euro and the European Central Bank's quantitative easing (QE) policy have helped shift sentiment in a positive direction. But economic growth remains fragile, with underlying problems such as high debt levels and political uncertainty. Greece's debt issues in particular are a recurrent source of concern.

Statistics have brought upside surprises

Economic Surprise Index



Source: Macrobond, Citibank, SEB

The recovery is now faster than expected and is spreading to more and more sectors. The weak euro will push up exports faster and help revive capital spending. **Household confidence has improved and retail sales have taken off**. Although unemployment is high, employment is rising, while low inflation boosts purchasing power. **GDP will climb by 1.7 per cent in 2015 and 2.1 per cent in 2016**. Compared to *Nordic Outlook* in February, we have raised our forecast 0.5 and 0.4 percentage points, respectively. Economic performance in the euro zone is continuing to diverge; Germany and Spain are growing at a decent pace, while Italy and France are lagging.

Continued political uncertainty

Big crisis-driven austerity is past, and euro zone fiscal policy will be neutral in 2015-2016. Stimulus proposals at the EU level, such as the Juncker Plan, will only marginally affect demand. **Public sector deficits will fall slowly to 2.0 per cent of GDP in 2016**, and public debt will fall slightly to 93 per cent of GDP 2016. This relatively high debt level, combined with future demographic strains, points to the need for reforms that will improve both the structural budget balance and the way euro zone economies function. Small steps are being taken, but protest parties are gaining ground in many countries creating political obstacles. **The ECB's expansionary policy also risks shifting the focus away from fiscal policy** and slowing the pace of reform and increased economic policy integration.

GDP

Year-on-year percentage changes

	2013	2014	2015	2016
Germany	0.1	1.6	2.2	2.3
France	0.4	0.4	1.1	1.6
Italy	-1.7	-0.4	0.7	1.3
Spain	-0.1	2.1	2.9	3.0
Greece	-3.9	0.8	2.0	2.6
Portugal	-1.4	0.9	1.7	2.2
Ireland	0.2	4.8	3.3	3.0
GIPS countries	-0.7	2.1	2.7	2.9
Euro zone	**-0.4**	**0.9**	**1.7**	**2.1**

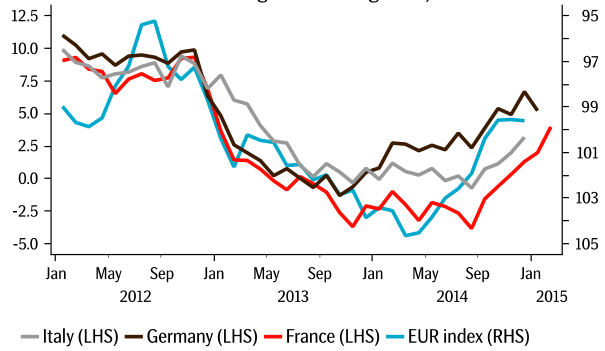
Source: Eurostat, SEB

Weaker euro is stimulating exports

Gradually stronger world economic conditions, a weaker euro and improved competitiveness are helping sustain output and demand. Euro depreciation is leading to higher exports, with a certain lag. The effect may vary, for example depending on how long the currency's low exchange rate is expected to last.

Weaker euro is strengthening exports

Year-on-year percentage change (6-month moving average, nominal trade-weighted exchange rate)



Source: Eurostat

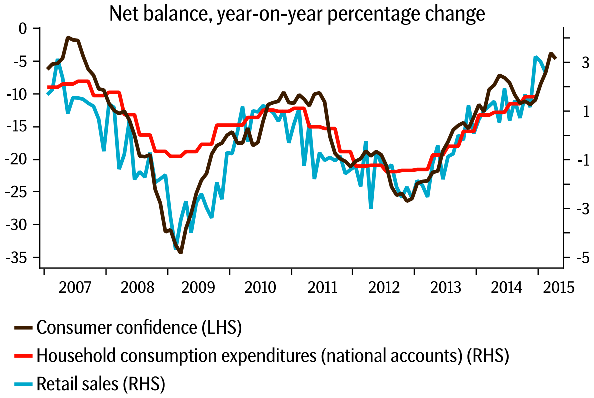
We estimate that 10 per cent euro depreciation will lift exports some 3-4 per cent. Since May 2014 the euro has fallen by 20 per cent against the dollar and 10 per cent on a trade-weighted basis. We expect the euro to lose another 10 per cent against the USD and half of that trade-weighted. This is one reason why we foresee 4.5 per cent export growth in 2015 and 5.0 per cent in 2016. Due to a broad-based upturn in demand, imports will also rise, limiting the contribution of net exports to growth; the current account deficit will stay at about 2 per cent of GDP.

Consumers are increasingly optimistic

Domestic demand was depressed in large portions of the euro zone during the crisis years but is now recovering. This is especially clear in the household sector. **Consumer confidence has surged in recent months** (in March/April to the highest level since July 2007) and **retail sales rose at their fastest pace in years early in 2015**. More cyclically sensitive segments such as car sales have also taken off. The upturn is broad-based: Spain and Italy are approaching German consumer confidence levels, while France lags behind. Improved labour markets, higher purchasing power and low interest rates due to the ECB's stimulus measures are behind the upturn. During the first half of 2015, we expect euro zone consumption to regain its 2008 (pre-crisis) level, but there are major regional gaps. German consumption is up 15 per cent, while Spanish consumption remains nearly 10 per cent below its pre-crisis level. **We expect euro zone consumption growth of 1.6 per cent in 2015 and 1.8 per cent in 2016**.

Households: Improved outlook and consumption

Net balance, year-on-year percentage change



Source: European Commission, Eurostat

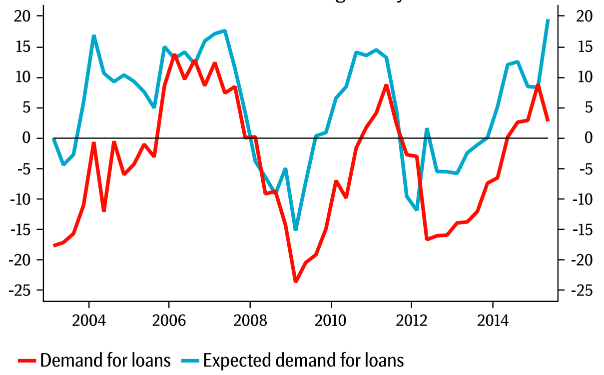
Weak capital spending continues to hamper economic performance, although the situation has improved somewhat. Increased exports and forward-looking business indicators suggest that the investment upturn that was discernible late in 2014 is continuing. This forecast is supported, for example, by an increase in demand for loans, which is expected to accelerate. Overall, we anticipate a very cautious upturn in capital spending: 1.5-2.0 per cent yearly in 2015 and 2016.

Inflation will slowly rebound

The labour market reflects the general economic situation well. **Unemployment** remains high (11.3 per cent in March) but **is slowly improving**, shrinking by 0.5 percentage points in the past year. Meanwhile the situation varies greatly between countries. In Germany unemployment is historically low, while in both Greece and Spain it is well above 20 per cent. **Successively higher economic growth will mean continued labour market improvement**; the euro zone jobless rate will fall to an average of 10.7 per cent in 2016. This is still well above its equilibrium level, which we estimate at approximately 10 per cent.

Greater demand for loans

ECB Bank Lending Survey

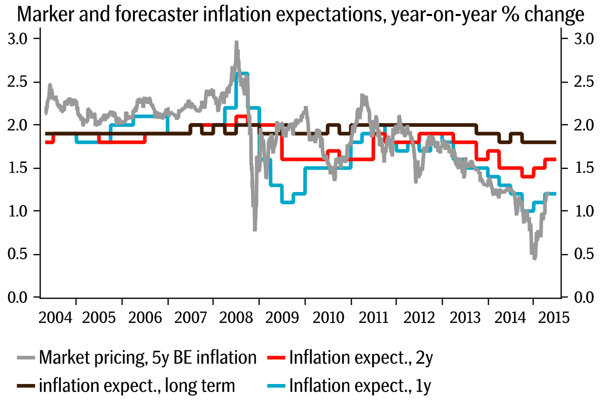


Source: ECB

Partly due to low resource utilisation in the euro zone, global disinflationary force are especially strong there, since pay increases are low and it is hard for companies to raise prices. A weaker euro will push up inflation somewhat, but historical experience indicates that such effects will be short-lived. The decline in consumer prices has slowed in recent months, however. In April, inflation according to the Harmonised Index of Consumer Prices (HICP) was 0.0 per cent, compared to -0.6 per cent in January. We expect HICP inflation of around zero over the next six months before a slight upturn, as the effect of falling oil prices disappears from 12-month statistics. **We foresee HICP inflation of zero in 2015 and 0.8 per cent in 2016**. Core HICP inflation will be 0.6 per cent in both years.

Low inflation expectations but weak upturn

Marker and forecaster inflation expectations, year-on-year % change



Source: ECB, SEB

Inflation expectations have rebounded, largely due to ECB asset purchases and the cautious rise in oil price. But they need to move higher if the ECB is to be comfortable and confident that the market will rely on inflation to reach the bank's target in the foreseeable future.

ECB asset purchases a game-changer

The ECB's quantitative easing programme has changed economic conditions in various ways. The euro has weakened and inflation expectations have climbed. Interest rates, which were already low, were squeezed further during the first month of QE. **In some countries, government bond yields are now below zero well out on the yield curve**. The ECB is buying bonds with negative yields but has currently set a limit of -0.20 percent (its own deposit rate). Now that yields are being pushed down, the ECB cannot buy German government securities that have maturities below 3 years, for example.

The ECB's bond purchases are an open mandate; they can be expanded or continue longer than promised (September 2016). But even though the ECB has only been buying bonds for two months (about EUR 60 billion a month), there are already discussions about a phase-out ("tapering"). At the ECB's latest monetary policy meeting in April, however, **ECB President Mario Draghi dismissed concerns that there might not be enough bonds to buy**, describing the QE programme as a marathon that had just begun. In the coming months, the ECB will focus on preventing Fed rate hikes from leading to an upturn in euro zone bond yields as well. The ECB must also be active in easing the contagious effects of the turmoil in Greece and of a possible "Grexit". Before these issues are resolved, which is unlikely before autumn at the earliest, it will be difficult for the ECB to change its course. Looking further ahead, we can discern three questions that will dominate the discussion of future ECB actions and change the probability of tapering:

1) Will QE yield unexpectedly positive effects? If the ECB can claim that the impact of QE is stronger than expected and that the problems it has targeted are being resolved, this might lead to tapering. It can say that the euro zone economy is moving in the right direction, although growth remains fragile, inflation expectations are low and deflation risks persist. The credit market situation is also improving but remains fragmented. Outstanding loans are shrinking, although a marginal increase for households was noted in March.

2) Is it dangerous to continue QE because it will lead to the build-up of excessive imbalances? So far, this question about central bank QE programmes has not been a focus of attention. Such policies are aimed at pushing down interest rates and yields, and in the case of the ECB ensuring they are decoupled from those in the US as the Fed moves toward rate hikes. But euro zone rates and yields might become so depressed that new problems arise, changing the discussion.

3) Is it technically difficult to continue (due to bond shortages)? While euro zone QE is under way, public sector deficits are falling, suggesting that it may be hard to find enough bonds to buy. Meanwhile the ECB can change its rules if needed, buying bonds with yields below its deposit rate and buying other assets. If the ECB wants to expand its balance sheet, it will find assets, even if this puts pressure on markets.

The two first points suggest that the QE programme will continue as planned. To ensure the greatest possible impact on financial markets, Draghi and the ECB would like to avoid discussions about a change of course. Problems with **lack of bonds to buy might increase ahead though.** A possibility for the ECB is to reduce the monthly purchases and at the same time continue purchases after September 2016. To be able to increase the balance sheet to earlier highs (just over EUR 3 trillion), the ECB does not have to continue buying EUR 60 billion worth of bonds a month as long as the programme is not terminated in advance (before September 2016).

Greece's situation is increasingly critical

Our **main scenario is that a bail-out agreement will finally be put in place**. This probably means that the Greek government will be forced to accept continued austerity, though perhaps rhetorically describing it as agreeing to new, more effective and fair reforms. Greece can thus avoid defaulting (which no developed country has done with IMF debt) and leaving the euro zone. An agreement will probably come at the last moment, so both sides can claim they did everything they could in the talks. A straightforward debt write-off is probably still too difficult for lenders to swallow.

We still believe that all parties want to make every effort to keep the euro zone together. But the risk of a "Grexit" has increased. Greek government liquidity is very strained, and all available cash in the public sector is being mobilised to meet loan payments. The situation in the banking sector is at least equally important, though. Growing mistrust and outflows from banks are making access to ECB liquidity necessary, while the ECB does not wish to increase emergency liquidity assistance. So far the secondary impact on other crisis countries has been small, although some effects have been discernible in the past month, with 10-year government bond yields in Portugal, Italy and Spain at higher levels.

The **effects of Grexit are hard to assess**, both for Greece and the euro zone. Greece would probably capital controls, experience a sharp devaluation and government takeovers of banks. Public debt would be renegotiated and the IMF/World Bank would have to provide bail-outs. At present, Greece has a primary surplus, making it easier for the government to adjust the budget. It would be a painful process, but there are many examples of countries that recovered surprisingly fast after deep crises.

In the euro zone, stock markets would probably fall while yield spreads between countries widened. Meanwhile the ECB's bond-buying programme is in place and could be front-loaded to counter an upturn in yields. In the medium term, we would probably see some stabilisation after the exit of a country that had created such great uncertainty. In the long term, the biggest risk is that a Grexit would show that countries can actually leave the euro zone under exceptional crisis conditions. If the euro zone were viewed as a currency arrangement rather than a union, this would be an important signal. This realisation may persuade economic players to react more forcefully to future signals of country-specific crises.

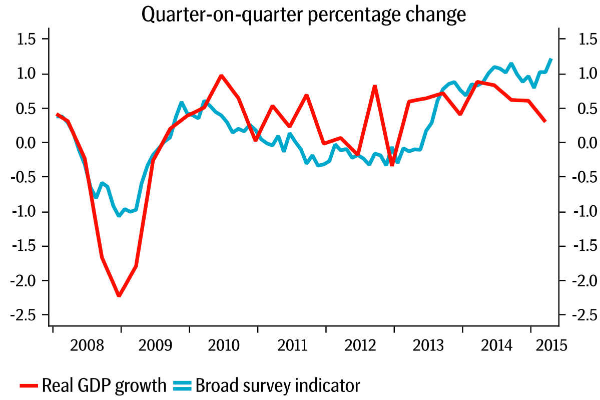
Fiscal headwinds in 2016, regardless of election outcome

- **Low inflation boosting purchasing power**
- **Low unemployment will lift earnings...**
- **... and justify interest rate hikes in 2016**

Last year the UK recorded its highest GDP growth since 2006, topping the G7 countries. This year began on a weaker note, but despite uncertainty about the May 7 parliamentary election there is good reason for optimism ahead. The oil price decline is having a net positive effect on the economy. Strong household and business indicators signal that the slump will be temporary. We thus expect continued above-trend growth. **GDP will climb by 2.5 per cent this year and 2.4 per cent in 2016**. The UK will barely avoid falling prices. Our forecast is **0.1 per cent inflation this year and 1.0 per cent in 2016**: well below consensus. **Unemployment will continue downward**, and high resource utilisation will be the Bank of England (BoE)'s main justification for eventually hiking its key rate.

Real GDP growth and indicator

Quarter-on-quarter percentage change



Source: Markit, SEB

The general election appears likely to be the closest in modern times. According to betting firms, the Conservatives (Tories) are slightly favoured to win the most parliamentary seats, while a **minority government including Labour has the lowest odds**. The latest opinion polls show Labour and the Tories winning almost exactly the same number of seats, but both will get far less than the 326 seats needed for a majority. Meanwhile the Tories' current coalition partner, the Liberal Democratic Party, is losing ground. Instead the Scottish National Party is gaining support. The SNP is on the political left and is thus a conceivable ally of Labour but not the Tories. Labour leader Ed Miliband has ruled out a coalition with the SNP, though. Despite the pledge of an EU referendum in 2017, both financial market players and companies prefer a Tory-led government. Yet based on election manifestos, **2016 fiscal policy will be clearly tighter** regardless of whether Labour or the Tories win. This year, fiscal policy is having a neutral impact on GDP.

Inflation will remain around zero until year-end. Direct and indirect effects of lower oil prices will hold down inflation, as will the appreciation of the pound under way since New Year. **Inflation will be 0.1 per cent this year and 1.0 per cent in 2016**: a bit lower than we foresaw in February's *Nordic Outlook*. The risk of deflation is not regarded as imminent, however. Household inflation expectations have recently risen somewhat. Looking ahead, they will remain compatible with the BoE's 2 per cent target. Pay expectations are also high, though rising productivity will keep unit labour costs in check.

Today's low interest rates and rising real earnings are **giving companies incentives to increase capital spending** and boost the efficiency of existing staff – productivity also showed a positive trend late in 2014. With **productivity starting to regain lost ground**, a slower downturn in unemployment is also likely ahead; last year the jobless rate fell by a full 1.2 percentage points. **Unemployment**, which is already around its equilibrium level, **will be 4.7 per cent at the end of 2016**.

Wages and salaries are climbing. Combined with low inflation, this will provide **decent real income increases** after several lean years. The conditions are thus in place for robust household consumption, despite fiscal tightening in 2016. **Household consumption will increase by a yearly average of 2.4 per cent in 2015-2016**, according to our forecasts. The risk is on the upside: if anything, rising financial and tangible wealth suggests lower household saving. The increase in home prices has slowed, however, both in the red-hot London market and nationally. Overheating risks in the housing market have thus receded, although prices have surpassed their 2007 peaks according to Nationwide's index.

Our forecast is still that the **first step in the normalisation of the key interest rate will come in February 2016**. At the end of 2016, the key rate will stand at 1.25 per cent. Given the UK's modest inflation outlook, the risks in our key interest rate forecast are on the downside. With the Federal Reserve hiking its key rate somewhat faster while the European Central Bank eases its monetary policy, the pound is likely to weaken against the US dollar but appreciate against the euro. **At the end of 2016, the GBP/USD exchange rate will be 1.50 and the EUR/GBP rate 0.67**.

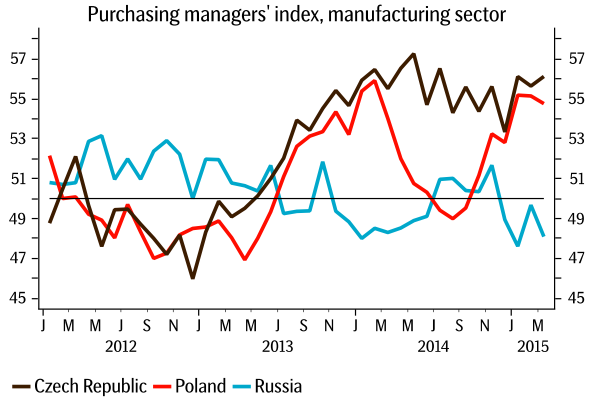
Central Europe resilient to Russian woes and geopolitics

- **Strong real incomes helping Central Europe**
- **Reserves will protect Russia in short term**
- **Ukraine will avoid default**

Central Europe and the south-eastern portion of Eastern Europe remain resilient to the Russia-Ukraine conflict as well as to Russia's food import sanctions and accentuated economic weakness. The main reason is **favourable conditions for households**. Strong real incomes, falling unemployment and low interest rates are allowing continued robust private consumption. Looking ahead, these economies will also be helped by an **improving outlook for exports to Germany** – which is a substantially larger trading partner for Central Europe than Russia – and fiscal easing (but not in Hungary) after several years of relatively tight budget policy. But **overall growth figures will be modest during 2015-2016** as exports to Russia fall. Weak business investments will also strengthen only slowly (though fairly speedily in Poland) due to nearby geopolitical turmoil. Poland, where the demand level is sustained by relatively solid fundamentals both in the economy and the banking system, will grow fastest in Central and Eastern Europe, by about 3.5 per cent yearly. But this is no higher than Poland's potential growth rate of 3-3.5 per cent. SEB's forecasts generally remain somewhat below consensus.

Czechs chug along, Poles pick up, Russians reel

Purchasing managers' index, manufacturing sector



Source: Markit

First quarter growth figures were still decent. **Sentiment indicators reinforce the impression that Central Europe will be resilient to the Ukraine-Russia conflict**, which has been our view ever since Russia annexed Crimea in March 2014. Consumer confidence is at a historically good level; last winter the Czechs matched their record high. Purchasing managers' indices for manufacturing are well above the expansion threshold of 50: for example, around 55-56 in Poland and the Czech Republic.

As elsewhere on the continent, **inflation remains very low in Central Europe**, mainly due to low energy prices but also because of some lingering idle resources. We expect currency movements during the coming year to be small, with temporary short-term depreciations as some central banks, perhaps via more expansionary monetary policy (in the Czech Republic by changing the currency target), try to push down exchange rates to boost import prices and thereby end the CPI deflation of the past six months (zero in the Czech Republic).

We still expect the Ukraine conflict to be long-lasting. The ceasefire, most recently the "Minsk 2" agreement in February, will be fragile. **Russia wants to disrupt Ukraine's westward orientation**, which aims at NATO membership by 2020 and applying at the same time to join the EU. In December 2014, the Ukrainian parliament voted to end the country's nonaligned status. Minsk 2 includes amendments to the Ukrainian constitution in the direction of "decentralisation". In practice, this means expanded autonomy for the Donetsk and Luhansk regions. Russia will probably use these regions to retain its influence on Ukraine and thereby prevent rapprochement with the West.

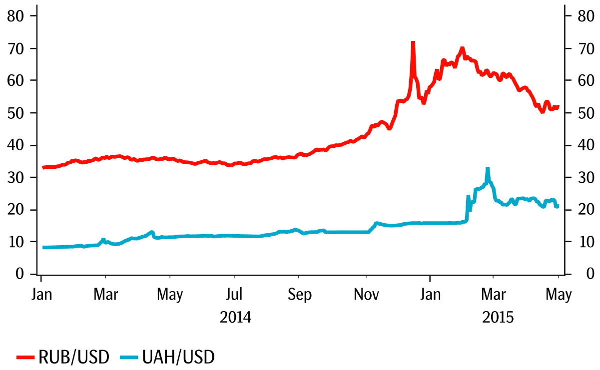
The sanctions policy by various Western nations and Russia's countermoves (a ban on imports of food and agricultural products for at least one year starting in August 2014) is **increasingly difficult to assess**. The US has continuously maintained more strident rhetoric than the EU and has advocated a tougher policy towards Russia, probably because the economic risks are far less for the US. This situation will persist. The EU is continuously evaluating whether to extend or escalate sanctions. Widening intra-EU divisions on attitudes towards Russia are discernible. At first, the motives were mainly economic. Recently some countries have tried not to provoke Moscow in order to ensure the ceasefire. Looking ahead, the recent rise of nationalist but pro-Russian political parties (for example in France, Greece and Hungary) may complicate a unified EU stance. Our main scenario is that **Western sanctions will not escalate but will stay in place at least throughout 2015.**

Volatile conflict currencies bouncing back

The currencies of both Russia and Ukraine have both recovered somewhat since winter, after plunging dramatically by 50 and 70 per cent, respectively, against the USD following the outbreak of the conflict in February 2014. The rouble has strengthened from about 70 to the dollar in January 2015 to 51. The hryvnia has appreciated from around

33 per USD late in February 2015 to 21. These currencies have benefited from signs that the latest ceasefire has held up relatively well, although escalating battles are also reported occasionally from eastern Ukraine. The rouble has also been helped by the stabilisation and upturn in oil prices and by a clear improvement in the current account balance during the first quarter. The IMF's announcement of greatly expanded bail-out loans to Ukraine is the main reason behind the hryvnia's partial recovery. **Both currencies risk volatility ahead**, since the conflict will probably flare up now and again. We predict **further rouble appreciation over the next year**, based on somewhat higher oil prices and better real economic performance in the second half of 2015. But in the near term, there is a substantial risk of a temporary rouble weakening due to a possible downward correction in oil prices during the second quarter. We expect the **hryvnia** to weaken to 30 per USD during the coming 12 to 15 months due to high inflation and a low currency reserve that is too small to restore confidence for the current exchange rate of 20 and 22.

Partial recovery for hryvnia and rouble in recent months



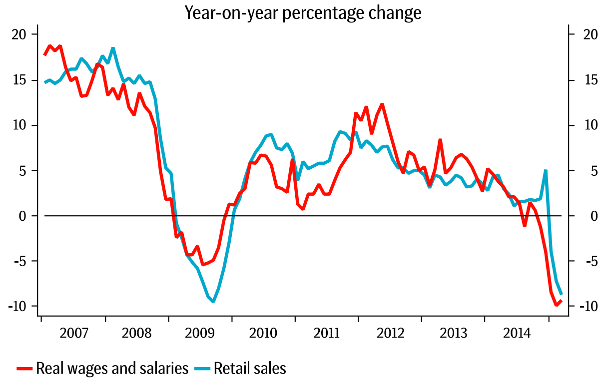
Source: Macrobond

Russia is moving towards a **large, broad-based GDP decline this year** due to the oil price downturn, a rouble-driven inflation shock in the first half of 2015 (effects of the currency slide from November 2014 to January 2015) and continued Western financial sanctions that are making it much harder to borrow in USD. The downturn is driven by private consumption and capital spending. **GDP will shrink by 4.0 per cent in 2015, and we expect zero growth in 2016.** Oil prices will rise somewhat and help stabilise the economy in 2016. **Our forecasts have been revised slightly upward** compared to *Eastern European Outlook* in March 2015. This is because of an **unexpectedly fast recovery for the rouble**, which eases inflation pressure, and unexpectedly large oil and gas output. Somewhat lower inflation pressure will slow the downturn in household consumption and, to some extent, capital spending. **Inflation** will culminate this spring at 17-18 per cent; it will **average 14 per cent in 2015 and 8 per cent in 2016**.

Because of Russia's initially low central government debt and large currency reserve, the economy has plenty of financial muscle, but the downgrading of its sovereign credit rating by international rating agencies to junk status last winter reflects the fiscal challenges faced by the government, mainly caused by the oil price decline. Our assessment is that Russia's **strong financial reserves will provide protection during 2015-2016**. But these reserves will meanwhile become increasingly depleted. The Russian economy, which has been plagued by major structural problems for many years, will be in fragile condition by the end of our forecast period.

Russia: Falling real wages are lowering consumption

Year-on-year percentage change

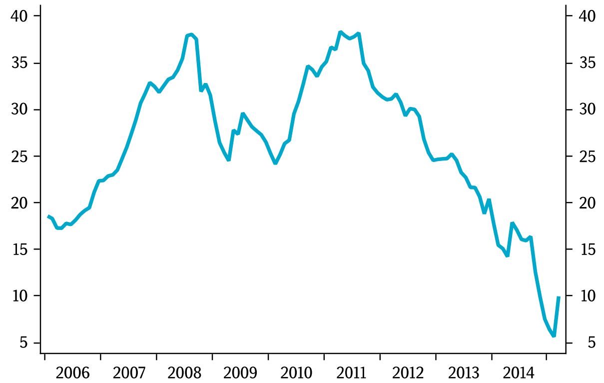


Source: Russian Federal State Statistics Service

Ukraine is in an acute economic crisis, with nearly empty central bank reserves and a year-on-year GDP decline of nearly 15 per cent in the fourth quarter of 2014; the first quarter of 2015 is expected to be even worse. The approval this March of **expanded bail-out loans**, mainly from the IMF, and a coming debt write-down by private bond holders after negotiations this spring will **enable the country to avoid default**. An initial loan disbursement was made in March, and the debt write-down is among the conditions that must be in place before a second disbursement early this summer. The IMF has commended the Ukrainian government on its reform efforts.

Ukraine: Currency reserve down to critical level

USD billion



Source: National Bank of Ukraine

This year Ukraine's GDP will continue to fall sharply, by 8.0 per cent. The downturn will be broad. Both industrial output and exports are being disrupted due to destroyed production facilities and smashed infrastructure. Household consumption is falling because of surging inflation; this March the inflation rate was 46 per cent. Capital spending is being squeezed by geopolitical uncertainty. Currency depreciation – which has moderated after some recent appreciation, combined with stronger global demand for steel, grain and other agricultural products – will contribute to weak **export-driven GDP growth of 2.0 per cent in 2016**.

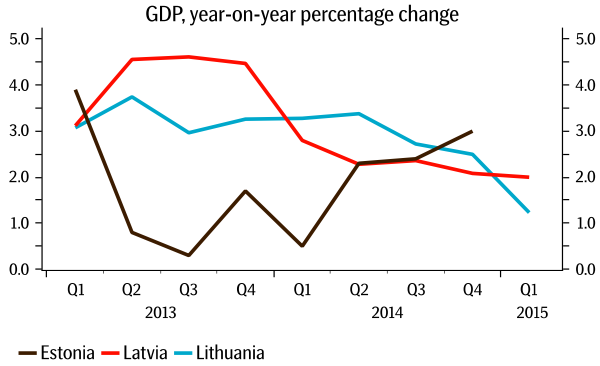
Robust private consumption is providing decent growth

- **Continued good real incomes**
- **Weak capital spending activity**
- **High labour cost pressure will start raising inflation in Estonia and Latvia during 2016**

Growth in Latvia and Lithuania slowed moderately last year to 2.4 and 3.0 per cent, respectively, in line with SEB's forecasts. Estonia's growth rose unexpectedly to 2.1 per cent. This was despite weak demand in major export markets like Russia (all three Baltics) and like Finland and Sweden (Estonia) as well as negative sanction and confidence effects on manufacturing and agriculture from the Russia-Ukraine conflict.

Modest impact on growth in the Baltics from the Ukraine conflict that broke out in Q1 2014

GDP, year-on-year percentage change



Source: National statistical offices

Good domestic demand sustained GDP growth last year, since exports rose very little. Growth was driven mainly by robust private consumption, fuelled by strong real household incomes. Capital spending activity generally remained weak, although construction held up relatively well in Latvia and Lithuania. **Exports rose by a few per cent** despite average GDP growth of an anaemic 0.6-0.9 per cent in Russia and the euro zone, a plunging Russian rouble and stagnation in Finland. **This was partly due to successful geographic diversification away from Russia and Ukraine**, for example in the food product sector, which was hampered by the Russian import ban. Lithuania has the largest exposure to Russia both with regard to total exports and food. But worth noting is that the lion's share of exports to Russia – which make up some 20 per cent of the total – consists of foreign transit goods.

This economic picture will largely apply to the Baltics in 2015-2016 as well, and the pattern is similar in all three countries.

Private consumption will continue to increase at a healthy pace, helped by real wage increases averaging 4.5-5.5 per cent (highest in Latvia) per year, gradually falling unemployment and low interest rates, although credit growth will probably remain weak. **Consumer confidence is historically high**: only Lithuania showed a temporary dip during last year's geopolitical turmoil. Healthy household confidence is mainly because of positive earnings and labour market trends, but also because the three countries have good internal as well as external balances. Small budget and current account deficits are expected this year. Looking ahead, **business investments will increase only gradually**, sustained by EU structural funds and residential construction. Uncertainty about the Ukraine conflict will continue to hamper foreign investments in the Baltics as well. **Export growth will slowly accelerate** this year as Western European economies grow faster, but Russia will pull down demand; not until 2016 will exports gain slightly better momentum. Sentiment among manufacturers is also cautious, according to the European Commission's monthly surveys. This indicator has improved marginally in the past few months and is at historically moderate levels – still somewhat below the readings when the Ukraine conflict broke out.

Our GDP growth forecasts for the Baltics: 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, following by a slight upturn to 2.7 per cent in 2016. The imminent presidential election may cause political instability in Latvia, but the economy is robust. Lithuania's growth will slow a bit this year, to 2.6 per cent, which the continued slowdown during the first quarter of 2015 also signals. Next year, Lithuania's growth will rebound to a solid 3.5 per cent. Estimated potential growth in the Baltic economies is 3-3.5 per cent. **We are thus forecasting decent GDP growth**.

Inflation will remain low in all three countries. **But in Estonia and Latvia, it will rebound next year relatively fast** and average more than 2 per cent. This upturn is a consequence of **high labour cost pressure, especially in Estonia**, which stood out for several years as having the fastest unit labour cost increases of all OECD countries (about 6 per cent annually in the most recent two years). Wages and salaries are growing rapidly in Estonia partly because since 2014, unemployment has been below its structural level of about 8-9 per cent. Our jobless rate forecast for 2015 is 6.5 per cent. In the next couple of years, Latvia and Lithuania will reach their equilibrium unemployment levels of some 9-10 per cent.

Strong growth, but new economic policy challenges

- **Consumption, construction driving growth**
- **Fragile recovery for manufacturing**
- **New housing market upturn increases risks**
- **Higher CPI but Riksbank still under pressure**

Robust expansion in late 2014 confirms our picture of relatively strong growth, driven by rising residential construction and consumption. With Western European recovery gaining momentum, Sweden's industrial output and merchandise exports will rebound this year. But underlying uncertainties about the world economy and domestic economic policy conditions are hampering growth, as confirmed by weak indicators in recent months. **We have raised our 2015 GDP growth forecast to 3.0 per cent**, mainly due to last year's strong finish. **Our 2016 forecast remains at 2.7 per cent**.

Despite rising inflation, the Riksbank is still under pressure to take further actions. Unemployment remains high and inflation expectations are still a bit below target. Due to the European Central Bank's large-scale QE programme, the krona tends to climb as soon as the market stops believing more monetary stimulus measures will be introduced. We believe that the **Riksbank**, after increasing its asset purchase programme by SEK 40-50 billion at its April meeting, **will lower the repo rate to -0.40 in July**, which will be its bottom level. Also, additional asset purchases might be added. Due to accelerating credit growth, unconventional monetary policy is riskier in Sweden than elsewhere. But despite the implementation of macro-prudential measures, the bank will hardly take financial stability risks more into account when formulating its policies.

Manufacturers remain hesitant

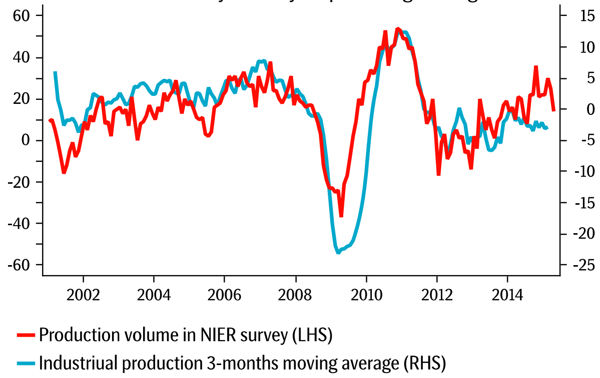
Manufacturing sector indicators are divergent, although some improvement is discernible. Stronger economic conditions in Western Europe along with a weaker krona suggest a stronger trend. But so far, industrial production and merchandise exports have been disappointing and the picture of a fragile, uncertain situation for manufacturers thus persists. Despite weakness in manufacturing, total exports rose at a decent pace in 2014 because **service exports increased by more than 7 per cent**. Strong service exports will help boost total exports by 4 per cent a year in 2015 and 2016, well below normal in recovery phases over the past few decades.

Residential construction expanding rapidly

Total capital spending rose by 6.5 per cent last year. Housing construction increased by more than 20 per cent, which is more than half of the total investment upturn. Strong upturns in housing starts late in 2014 suggest that residential construction will continue to grow at about the same rapid pace this year. Other construction investments also increased greatly, while manufacturing sector investments stagnated.

Surprisingly weak industrial production

Net balance year-on-year percentage change



Source: Statistics Sweden

As in many countries, we are seeing a **weaker link between manufacturing profits and investment volume**. One major reason is that many exporters do not expect today's weak krona exchange rate to last long, but view currency-driven profit levels as temporary. Gradually rising demand in the manufacturing sector suggests that the investment upturn will broaden this year, as Statistics Sweden's investment survey indicates, for example. **We expect capital spending to rise by 7.0 per cent this year and 6.5 per cent in 2016**, making it the fastest-growing demand component in 2015-2016.

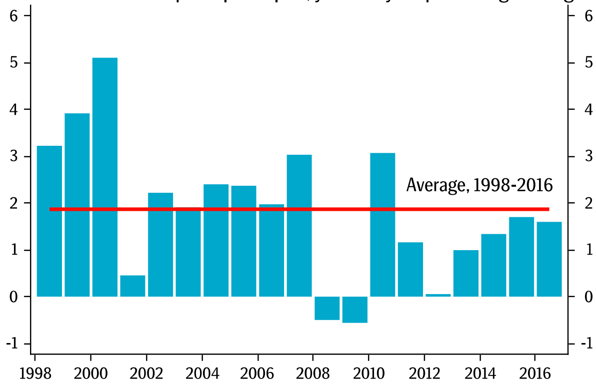
Consumption up despite household doubts

Besides residential investments, rising household consumption is the strongest force behind growth. Due to low inflation and rising employment, **real incomes will rise at a healthy pace both this year and next**. Although higher taxes will dampen the upturn a bit, this will be offset by higher unemployment benefits and sick pay. Overall, fiscal policy will have a neutral impact on household finances during our forecast period. The consumption upturn will also be sustained by rapidly rising asset prices, including home prices now climbing almost by 15 per cent year-on-year. Despite these strong underlying drivers, continued high saving and modest consumer confidence levels indicate that households are somewhat concerned about the future. This is probably based on uncertainty about both international events and domestic developments, for example related to the housing market and long-term policies concerning taxation, health care and social services.

These factors will probably continue to hold back consumption and help keep the increase below 3 per cent annually in 2015-2016. While certainly strong, this is well below peak levels during historical recoveries. It is also important to note that due to strong population growth, the per capita increase in consumption is even more modest in a historical perspective.

Modest consumption growth in historical terms

Household consumption per capita, year-on-year percentage change



Increased home price risks ahead

The Riksbank's recent aggressive rate cuts have added fuel to the red-hot housing market. The home price upturn is **now nearly 15 per cent year-on-year**, matching the highest levels of the past 20 years. Aside from falling interest rates, the price surge is being driven by rapidly growing population and a low supply of homes. To some extent, the recent acceleration can also be explained by the desire to buy a home before the planned principal repayment requirement on mortgage loans takes effect. This was supposed to happen on August 1, 2015 but has now been postponed due to legal technicalities.

Although the government is likely to make decisions enabling the launch of some form of principal payment requirement during the coming year, tools aimed at curbing household debt have been problematic. Conceivable alternatives – such as reduced tax deductions on interest payments or higher real estate taxes – are tough to enact due to election campaign promises. This most likely means that **home prices will continue to climb a bit further during our forecast period**, but that the difficulty of finding effective macroprudential or tax measures will increase the risks that unsustainable imbalances will build up in the housing market.

Strong job growth, but high unemployment

Job growth has recently accelerated further to 1.5 per cent year-on-year. **Yet unemployment is stuck at a high level** and leading indicators point to a continuation of this pattern. The reason why unemployment remains high is that the labour supply is being driven upward by rapid population growth. Increased labour force participation is also pushing the labour supply higher. The upturn in the participation rate seems to be levelling out but population growth is pulling in the opposite direction. As a result, **unemployment is likely to fall only slowly**. The forecast for both job growth and unemployment has been revised upward. Rapid immigration and changes in fiscal policy both indicate that equilibrium unemployment is slowly rising and is now somewhat below 7 per cent.

The labour market

Per cent and year-on-year percentage change

	2013	2014	2015	2016
Unemployment, %	8.0	7.9	7.6	7.3
Job growth	1.1	1.4	1.5	1.1
Labour force	1.1	1.3	1.1	0.8
Population aged 16-64	0.1	0.3	0.7	0.5
Productivity	1.0	0.5	1.5	1.4

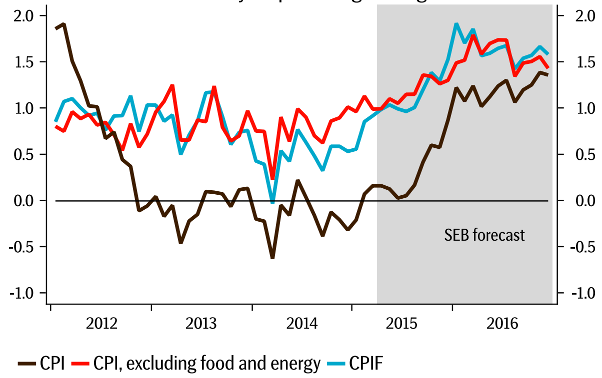
Source: Statistics Sweden, SEB

Higher inflation, but below 2 per cent target

Given a combination of a weak krona and higher petrol prices, inflation will probably rise gradually during the second half of 2015 and CPIF will be close to 1.5 per cent at the end of the year. Upward pressure from these two factors will culminate early 2016 and then gradually fade. But in January 2016, higher indirect taxes (reduced home renovation deductions and higher petrol tax) will help lift inflation by 0.3-0.4 percentage points. Modest pay increases and low world market prices will push prices down throughout our forecast period. These are among the factors preventing the Riksbank from achieving its 2 per cent target during our forecast period. CPI inflation, close to zero this March, is expected to gradually move closer to CPIF (CPI excl. interest rate effects) as downward pressure from lower mortgage interest costs vanish from 12-month figures.

Inflation has bottomed out but is still below target

Year-on-year percentage change

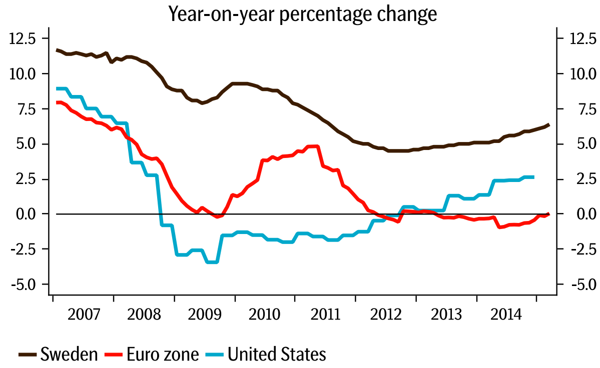


Riksbank under continued pressure

Rising inflation and higher growth will give the Riksbank some breathing space but we expect that it will cut the repo rate once more **to -0.40 per cent in July**. Pressure remains on the Riksbank to defend its inflation target. **The 2016 wage round will be very important** to the medium-term inflation environment, but it looks as if employers want clear evidence that the Riksbank is really willing and able to push up inflation, before they agree to faster pay hikes. Our assessment is that pay increases will end up at a level that will make it hard to achieve 2 per cent inflation. In the short term, the main source of pressure is the risk of krona appreciation on expectations that the Riksbank cannot match the ECB's QE. But we believe that the Riksbank will shift its focus from the EUR/SEK exchange rate to weighted indices (KIX or TCW) and that USD appreciation will provide relief. **The Riksbank expanded its asset purchases by SEK 40-50 billion at its April meeting** but more purchases might come. Most probable is additional bond purchases but also a "funding for lending" programme might be launched on short notice. Given the purchases so far, the balance sheet will expand by SEK 80-90 billion (2-2.5 per cent of GDP). Since the Fed and the Bank of England will hike their key rates during the coming year, it is also **reasonable for the Riksbank to begin a hiking cycle by the end of 2016**.

Lending to households rising relatively fast in Sweden

Year-on-year percentage change



Source: Macrobond

Accelerating household lending and home prices show the risks of the current relatively late-cyclical monetary stimulus. The corresponding risks in the US and the euro zone are far less, since both regions adjusted their home prices and household debts downward during the financial crisis. At present, their increases are also far milder, especially the growth in debts. But we do not believe that rising financial risks will affect monetary policy especially much in the near term.

Unexpectedly large declines in German government bond yields have helped push down Swedish yields as well. The 10-year yield spread against German bonds has also fallen to 10-15 basis points, in line with our earlier estimate. Assuming continued purchases of government bonds in the relatively small Swedish bond market, **yield spreads against Germany are likely to shrink further over the next six months**. This means that 10-year Swedish government bond yields will fall to a record-low 0.25 per cent by the end of 2015. Our forecast that the Riksbank will hike its key interest rate by the end of next year implies a renewed widening of the yield spread. **The 10-year yield will rise to 1.25 at the end of 2016**.

Krona close to bottoming out

Further **Riksbank actions will cause the krona to remain weak in the next few months**. We believe it **will trade around 9.30 per euro by mid-2015**. But in the long run, the Riksbank will find it hard to match the ECB's QE policy, while stronger world economic conditions will help push up the krona. The **EUR/SEK exchange rate will fall to 8.95 in December and further to 8.80 by the end of 2016**. The krona will weaken against the dollar until mid-2016, reaching just above 9.40, then recover somewhat as the euro gains strength against the dollar.

New rules for fiscal policy

In its spring budget, the Social Democratic-led government begun to shape its own economic policy. Room for manoeuvre is limited, since public finances are showing deficits and the government is sticking to the principle of funding new reforms "krona by krona". The government's December Agreement with the opposition Alliance parties also imposes restrictions, for example on what changes in the official fiscal framework will be allowed.

We thus expect a neutral/cautiously expansionary fiscal policy, in which new reforms are fully funded but increased expenditures in rule-governed appropriations such as sick pay and integration of immigrants will worsen the deficit. Important tax hikes that the government has implemented or announced so far are elimination of rebates on employer social contributions for young employees, lower tax deductions on home renovations and a reduction of the earned income tax credit. The tax hikes proposed total SEK 30-35 billion. A cyclical improvement in heavily taxed portions of the economy, employment, consumption and construction, will help reduce the public sector deficit from -1.9 to -0.7 per cent of GDP between 2014 and 2016. Public sector debt will remain at a bit above 40 per cent of GDP, but spending pressure in such areas as immigration, sick pay, defence and infrastructure poses a risk for the public balance.

On the whole, it is clear that the government is not pleased with the restrictions surrounding fiscal policy. One sign of this was when the government indicated its willingness to replace the official target of a public finance surplus of 1 per cent of GDP with a balanced budget target. More recently, leading government representatives have signalled that they also wish to examine the potential for finding alternative methods for funding infrastructure investments and other measures, for example stimulus measures for residential construction. These methods may include introducing a separate capital investment budget or shifting from cash to accrual accounting. Government loan guarantees and off-budget public-private projects have also been discussed.

Perhaps it is not so strange for such ideas to surface at a time when monetary policy ammunition is starting to run out, while unemployment remains high. But there are many objections in principle that have generally helped lead to the rejection of unconventional funding solutions. One is that there are really no reasons why certain types of expenditures should have a special position and not be included in normal prioritisation among various objectives. Another is that in the long run, even urgent public expenditures must be funded. If the government wishes to postpone funding them for stabilisation policy reasons, it can do so within the existing framework. Changes in the long-term rules of the game for public finances should also be made by a broad parliamentary majority.

Theme: Driving forces of potential GDP

- **Demographic changes are leading to lower potential GDP growth**
- **Lower trend growth in EM economies as they become technologically more advanced**
- **Swedish productivity is rebounding but will not regain lost ground**

One recurrent theme of policy discussions in recent years is the question of whether the world economy is facing a lengthy period of slow growth. A shift towards lower potential GDP would, for example, mean that neutral interest rates – and thus also the interest rates that central banks should aim for in their next hiking cycle – are lower than before.

Potential output growth and its driving forces

Per cent

OECD countries	**2001-07**	**2008-14**	**2015-20**
Total	**2.3**	**1.4**	**1.7**
Employment growth	0.6	0.3	0.2
Capital productivity	0.9	0.6	0.7
Total factor productivity	0.8	0.5	0.8
EM economies			
Total	**6.8**	**6.4**	**5.3**
Employment growth	0.8	0.6	0.3
Capital productivity	2.3	2.9	2.1
Total factor productivity	3.7	2.9	2.9

Sources: IMF staff estimates

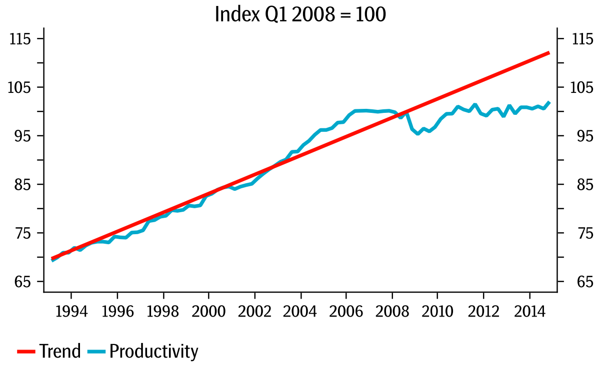
Estimates of potential GDP reflect the trend of population growth (labour supply) and investments (capital stock) as well as changes in total factor productivity. The last-mentioned factor in particular has been controversial; it is connected, among other things, with our view of technological advances since the IT revolution. According to IMF analyses[1], total factor productivity growth in advanced economies has steadily decelerated, compared to the excessive levels of the early 2000s. This slowdown reflects a combination of diminishing productivity gains connected to IT investments, especially in the technology-intensive IT and telecom sectors, but also in portions of the service sector – especially in wholesaling, retailing and distribution. The movement of employees from manufacturing to low-productivity service jobs has meanwhile contributed to lower productivity growth in the economy as a whole.

Yet the slowdown during the most recent period is highly cyclical. After weakening early in the financial crisis, productivity growth is now back at the levels prevailing just before the crisis. Looking ahead, the productivity growth trend will be hampered to some extent by the low investments made during the crisis. Today's rather low resource utilisation will also contribute to a downturn in investments, which is consistent with the historical pattern. Lower growth in the labour supply due to an ageing population is, however, of greater significance in keeping potential GDP growth from reverting to the levels that prevailed during the period 2001-2007. Looking ahead, potential growth will nevertheless climb somewhat compared to 2008-2014.

During the financial crisis, potential growth in the EM countries was partly sustained by rising investments, but this factor is now decreasing in importance. In addition, there is a declining potential for productivity increases as a consequence of EM economies taking advantage of technology already available in advanced economies (catching up). As in advanced countries, potential growth will also be lowered by demographic factors. Overall, potential EM growth in the period 2015-2020 will be 1½ percentage points lower than it has been in the past 15 years, but still three times as high as in advanced economies.

Sweden: Large gap compared to earlier productivity trend

Index Q1 2008 = 100



Source: Statistics Sweden

Cyclical patterns in Sweden, too

In Sweden, productivity growth has been even weaker since the financial crisis than in other countries. A return to the earlier trend would raise the productivity level by nearly 10 per cent, but at present there is nothing to indicate such a trend. In the Economic Tendency Survey published by the National Institute of Economic Research, for example, companies do not express any great hopes of being able to boost their production using their existing labour force. The levelling out of productivity growth has several underlying explanations.

[1] *"Where are we headed? Perspectives on potential output. World Economic Outlook, April 2015.*

Economic policymakers have focused on reducing employee absences due to illness and early disability retirements. Combined with large immigration, this has helped increase employment among individuals with lower-than-average productivity. Meanwhile there has been a shift between economic sectors. Service sectors that have lower productivity levels are increasing their share of the economy at the expense of high-productivity manufacturing.

Productivity

Year-on-year percentage change

	Average 1996-2007	Average past 15 years	Average past 2 years
Manufacturing	6.6	4.3	1.3
Construction	1.6	-0.3	3.5
Energy etc.	-0.7	-0.5	-3.3
Retailing	4.6	2.8	1.3
Real estate	0.9	-0.9	-0.9
Other services	1.8	1.1	1.5
Corporate sector	3.5	2.0	1.2
Public sector	0.3	0.0	-1.2
GDP	2.7	1.8	0.7

Source: Statistics Sweden

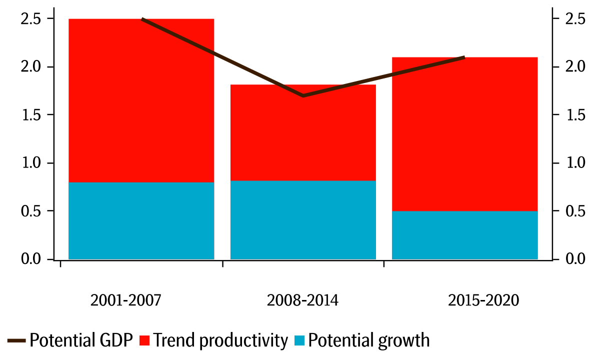
Even though the gap will not close in terms of levels, we foresee potential for a recovery in yearly productivity growth as the economy gains strength. The above table shows productivity growth over the past two years, compared to the past 15 years and the pre-crisis period (1996-2007), which showed a very strong growth trend in a historical perspective. In recent years, it has mainly been in the cyclically depressed manufacturing sector that productivity growth has been lower than before. There has also been a certain slowdown in retailing. But the construction sector, whose expansion is now well above the historical average, is showing unusually high productivity growth. The category "Other services" also shows a combination of a high activity level and good productivity growth. Looking ahead, our conclusion is that generally higher output growth will probably boost the productivity growth rate.

It is also worth noting that in recent years, GDP productivity has been hampered by negative growth figures in the public sector (see table). This estimate should be interpreted cautiously, however, since the measurement methods used are unverified. It has only been a few years since the national accounts began to include an estimate of actual productivity changes. They previously made a standardised assumption of unchanged productivity.

When we compile our analysis of potential growth in Sweden, we see the same pattern as in the IMF's estimates for all of the OECD countries. In the Swedish analysis, however, we have chosen to use total productivity growth in the economy, including changes in capital stock. The chart below presents our conclusion: potential GDP growth in Sweden will be somewhat above 2 per cent during the period 2015-2020. A lower potential job growth rate is the main reason why we will not revert to pre-crisis trend growth. But this assessment is uncertain, considering the difficulty of predicting the size of immigration flows and integration policy outcomes.

Potential growth

Year-on-year percentage change

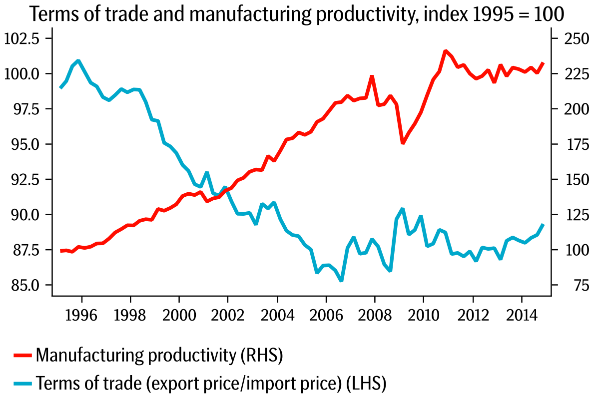


Source: SEB

Actual incomes in the economy are also affected by prices of goods and services produced. Rapid technological advances in some sectors, especially telecom products, are one explanation for the very rapid productivity growth of the period 1996-2007. But this productivity growth led to rapidly falling world market prices for these products, which were reflected in a downward trend for Sweden's terms of trade (export prices divided by import prices) during the same period. Because of these price declines, **the welfare gain to Sweden was less than this high productivity growth indicated**. Since 2006, terms of trade have been unchanged or have moved slightly higher, which has eased the effects of lower productivity growth on national income in current prices. The shift in the terms-of-trade trend is equivalent to an estimated 0.2-0.3 percentage points in the productivity growth trend at GDP level.

Terms of trade gains offset lower IT-related growth

Terms of trade and manufacturing productivity, index 1995 = 100



Source: Statistics Sweden

Upside risk as headwinds fade

- **Risk to growth shifts to the upside**
- **Lower mortgage rates fuel housing market**
- **Rate hikes in the autumn at the very earliest**

Full-year growth came in at 1.1 per cent in 2014 – 0.1 per cent above our estimate – as both business and consumer demand picked up by the end of the year. **GDP grew 0.5 per cent from the third to the fourth quarter and this is the pace of growth we expect the economy to sustain during most of 2015**, with a slight acceleration as we approach 2016.

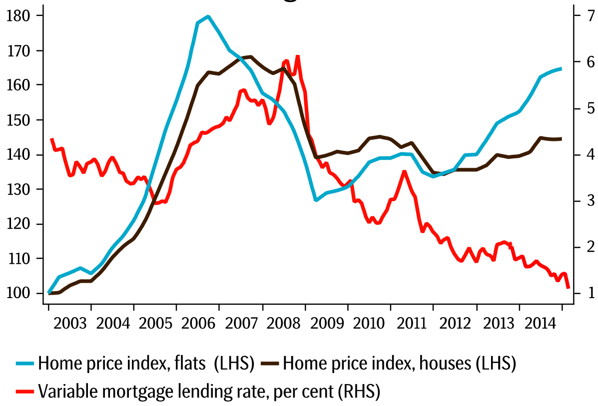
We have mentioned both downside and upside risks in prior issues of *Nordic Outlook*. But it appears that downside risks, mainly related to weakness in the euro zone, are abating. SEB is revising euro zone growth forecasts for both 2015 and 2016 upward by around ½ percentage point, and this more than outweighs slower US and global growth estimates. The reason is a significantly tighter trade link to more proximate countries. We are sticking to our earlier **forecasts of 2 per cent growth in 2015 and 2.5 per cent in 2016**, while emphasising that **the balance of risk has swung to the upside**.

We expect to see further acceleration in consumption, supported by a firming labour market, rising real income (due to oil) despite moderate wages and, to a higher degree in 2015 than before, also house prices. Business investments and exports should enjoy solid support from the improvements in the euro zone as well.

Inflation will remain moderate, with wage and salary growth below historical levels, but core inflation has shown sustained increases since November. We foresee **inflation of 0.4 and 1.2 per cent in 2015 and 2016**, outpacing the euro zone by half a percentage point.

The housing market enjoys a powerful cocktail of supportive policies, firming fundamentals and improving sentiment that will help increase the dynamism of the market and thus possibly lead to stronger home price appreciation. Anecdotal evidence from brokers suggests that this is already happening. Home prices have been recovering for some time from the 20-30 per cent collapse we saw from 2006 to 2009, and this positive trend is likely to get a further boost. Most importantly, rate cuts by Danmarks Nationalbank – a reaction to the attack on the DKK/EUR peg and the ECB's QE programme – have pushed Danish deposit rates deep into negative territory. This has spilled over into mortgage markets, which are at new lows. This not only applies to short-term rates but also to 30-year rates, which play a crucial role in the housing market.

Will the housing market take off?



Source: Statistics Denmark, SEB

While only a third of mortgage financing today is via 30-year fixed rate loans (15 years ago it was all loans), these loans still play a dominant role in mortgage lending activity. Banks consider 30-year fixed rate loans the benchmark; as long as you can afford a home based on the 30-year rate you are likely to get credit approval. Thus the recent drop in long-term yields could impact approvals significantly, ignite **stronger momentum in housing and provide a powerful feedback loop to the real economy. This is a clear upside risk in our forecast for 2016.**

We consider it unlikely that the Nationalbank will hike its key interest rate before year-end, even though pressure on the krone has abated. A reversal of the huge (DKK 300 billion) currency inflow early in the first quarter of 2015 has still not occurred. The currency reserve was unchanged in March, even as the DKK moved to its cheapest level vs. the EUR. We believe we need to see an outflow of around DKK 75-100 billion before the Nationalbank will touch its key rate. The bank also decided to suspend its issuance of government bonds at the peak of the foreign exchange market attack. One negative side effect of this was to significantly limit market liquidity. Before hiking the interest rate, restarting bond issuance might thus be a priority. This means that we believe the market is pricing in too quick a normalisation of the Danish-German key rate spread at a time when the ECB is pumping out billions via QE and the uncertainty surrounding Greece still lingers in the background.

No later than September 15, Denmark must hold a parliamentary election. Our view is that regardless of who wins, economic policy is unlikely to change much, since it is largely clustered around the middle of the political spectrum.

Growth slowing to well below par in 2015

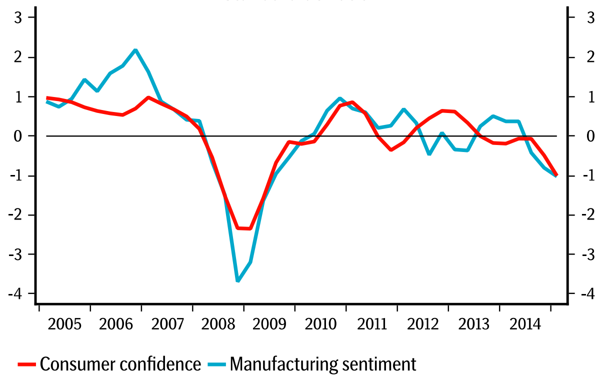
- **Forecasts nudged lower**
- **Inflation to moderate somewhat**
- **Norges Bank to deliver one more cut**

The near-term outlook for the Norwegian economy continues to be coloured by sharply downshifting investment in the petroleum sector. The negative demand impulses have slowed momentum in the broader economy already, but have yet to be fully felt and some effects will filter through with a lag.

Growth in mainland GDP – excluding oil, gas and shipping – is set to slow to a well below-trend rate, but developments at least so far are not as dire as suggested by surveys. Consumer confidence and manufacturing sentiment are thus at levels well below the historic norm and at their lowest since 2009.

Surveys portend sub-par growth

Standard deviation



Source: Statistics Norway, Finance Norway, SEB

We have nudged our growth forecasts for **mainland GDP** marginally lower from February's Nordic Outlook to **1.6 per cent for 2015** and **2.2 per cent in 2016** – almost as we did in 2014 – though risks for next year are tilted to the downside. We still expect **overall GDP** to grow by **1.0 per cent in 2015** but have lowered our **forecast for 2016 to 1.6 per cent** on extended weakness in petroleum sector investment. Here, our projection is still for a 14 per cent drop this year, but we are lowering our forecast for 2016 to a decline of 8 per cent.

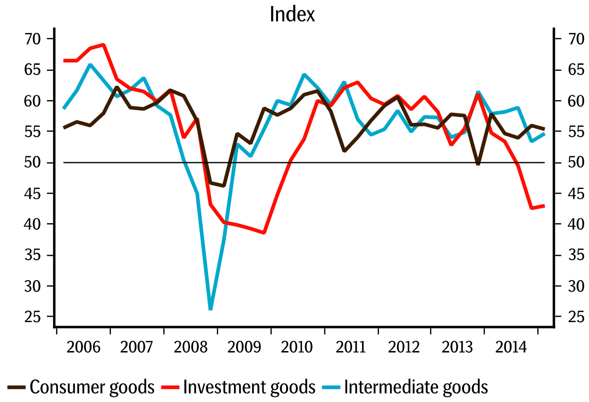
Investment goods start feeling chilly winds

Manufacturing production was surprisingly strong up until late 2014, but the negative impact from weaker capital spending in the petroleum sector is starting to take its toll on output. Momentum within the investment goods sector has turned – which was to be expected, considering the markedly weaker trend in incoming orders previously reported by producers.

Output of intermediate goods has been negatively affected as well, but momentum in this export-oriented sector should turn upward before long. Hence, foreign demand is firming in line with improving growth in Norway's main European markets and because competitiveness has improved due to the weaker NOK and slower wage growth. Although growth in exports of non-petroleum goods might have slowed after the strong run through 2014, full-year growth should still be stronger in 2015, mitigating the impact from softer overall domestic demand.

Production expectations differ widely

Index



Source: Statistics Norway

The manufacturing Business Tendency Survey suggested slower activity ahead. Sentiment eased slightly to a six-year low, burdened by the investment goods sector, but weakness is seemingly not feeding on itself; producers of intermediate and consumer goods see ongoing demand growth.

Soft consumption

Slower economic growth seems to make more of an impact on labour markets. The Labour Force Survey thus shows the unemployment rate jumping from an (exaggerated) low of 3.2 per cent in mid-2014 to 4.1 per cent in the first quarter of 2015, the highest in years. Part of it reflects a rapid increase of the labour force, but employment has seemingly turned abruptly weaker from very solid growth at the start of 2015 to a sequential decline in the first quarter (denting the year-on-year growth rate to 0.9 per cent). Labour markets are undoubtedly weaker, but the extent of the very recent turn in employment seems exaggerated and part of it should be reversed.

We expect full-year growth in private consumption to ease a tad to 2.0 per cent in 2015, a moderate pace by Norwegian standards. However, spending on goods was surprisingly firm in the first quarter as sequential growth eased only marginally from the solid rate in the previous quarter. We nonetheless expect some slowing ahead, though it should prove transitory as our 2016 forecast is for consumption to gain 2.5 per cent.

Growth in households' real disposable income is set to slow from 2.5 per cent in 2014. Coming on the heels of the surprisingly marked deceleration in wage growth from 3.9 per cent in 2013 to 3.1 per cent in 2014, wage negotiations concluded thus far suggest a further slowing: **we have lowered our forecast for 2015 wage growth to 2.8 per cent** which would be the first sub-3 per cent rate in 20 years.

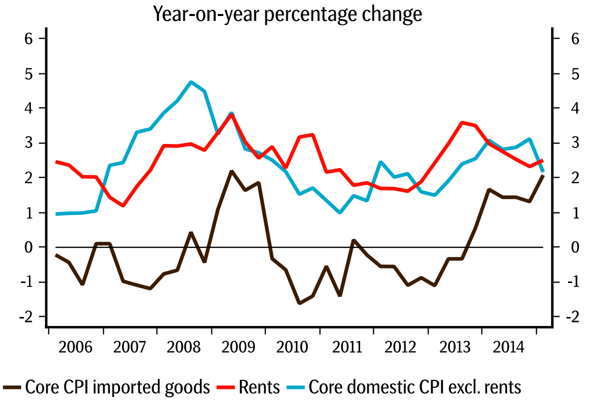
Inflation moderating only slowly

The trend in consumer prices has been rather steady since the marked pickup seen over the second half of 2013. Since early 2014, CPI inflation has fluctuated near 2.0 per cent while the core measure excluding taxes and energy has averaged 2.4 per cent, in line with the medium-term monetary policy target.

As such, developments contrast with surprising softness from mid-2010 to spring 2013 when core inflation was 1.1 per cent on average despite growth in mainland GDP at or above trend and average wage growth of 4.0 per cent in 2010-12. At the time, we found little evidence of any demand-driven softness. On the contrary, those sectors keeping a lid on domestic inflation were the same ones where similar demand components showed above-average growth.

Inflation to trend modestly lower

Year-on-year percentage change



Source: Statistics Norway, SEB

Rather steady inflation over the past year seems puzzling considering the sharp slowing among European peers, weaker growth momentum at home and abating cost pressure. A first thing to note is that plunging oil prices have less impact in Norway as hydro power is the dominant energy component, and electricity makes up slightly more of the CPI basket than petrol. In fact, electricity prices are currently "neutral" for overall inflation, which they pulled down quite a bit a year ago.

Secondly, food prices are to some extent shielded from international developments due to import restrictions and high tariff barriers. (Sharply lower year-on-year food price inflation in March looks exaggerated.) Moreover, interest rates are less important for the housing component than in, say, Sweden. In Norway, rents are more tied to overall CPI inflation due to a high degree of indexation in addition to maintenance costs. Rents led the initial inflation lift, and while the annual rate has moderated since the peak in late 2013, the recent trend of 2.5 per cent puts a floor under domestic inflation.

Finally, changes in the exchange rate can potentially have quite an impact, since imported goods make up 28 per cent of the CPI basket and almost a third of the core index. After having pulled down the total for four years, imported goods have pushed up inflation since late 2013 as a lagging response to the marked depreciation of the krone.

Our forecast is for **core CPI inflation to average 2.3 per cent in 2015**, partly because the currency effect might yield some upward pressure in the next few months, while **2016 should see some moderation to 2.1 per cent**. The trend should remain higher than among European peers. Although growth is currently sub-par, the degree of slack in the Norwegian economy – measured by the output gap (modestly negative) or unemployment relative to the historic norm – is thus much smaller. Similarly, while wage growth is slowing, it is still running higher and should continue doing so next year as well. Hence, underlying domestic cost impulses differ.

Norges Bank is focusing on the NOK

The decision to leave the key interest rate unchanged in March suggests that Norges Bank is reluctant to cut rates further, but the macro forecasts in its March Monetary Policy Report justify another cut in May or June. Data must exceed the central bank's own forecasts for it to refrain from lowering rates. We believe slowing growth momentum and a deteriorating output gap will probably prove **sufficient to prompt one 25 basis point (bp) reduction to 1.00 per cent during the first half of 2015**. We are convinced that Norges Bank's main objective remains to keep the NOK weak, but not necessarily weaker. Given current market expectations of almost two rate cuts this year, an unchanged key rate would result in substantial and unwanted NOK appreciation, but our macro outlook does not justify a much looser monetary policy. We expect Norges Bank to **hike rates again to 1.25 per cent in December 2016**.

The NOK exchange rate is closely connected to the outlook for Norges Bank policy and is more driven by currency speculators than capital flows. Monetary policy is still regarded as slightly negative for the NOK and risks pushing the EUR/NOK rate higher in the short term. However, the market's key rate cut expectations are aggressive and a repricing during H2 2015 is likely. Coupled with rebounding oil prices, we expect the NOK to trade higher during the second half of this year. We expect the **NOK to strengthen gradually vs. the EUR to 8.25 and 8.10 by the end of 2015 and 2016**, respectively.

Norwegian government bonds (NGBs) will be supported by the upcoming redemption of the shortest bond in May, since investors normally reinvest cash flows across the yield curve. This should also help the 10-year spread vs. Germany to tighten. NGBs still offer a substantial pick-up vs. German equivalents, and the positive long-term NOK outlook should support tighter yield spreads later this year. There are signs of the NOK 50 billion gross supply target for 2015 being lowered, which should support spread performance further. Overall, we expect **a slight tightening of the 10-year spread vs. Germany to 90 bps at the end of this year**, implying a 10-year yield of **1.10** per cent.

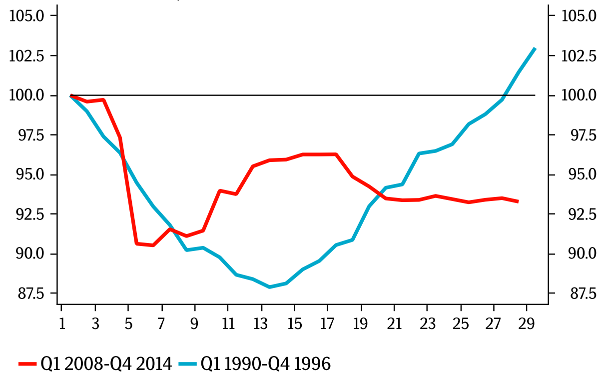
Continued headwinds and weak outlook

- **Highest unemployment in 10 years**
- **Low oil prices and weak euro are providing some relief and benefiting exports**
- **New government will continue austerity**

The Finnish economy remains anaemic. No recovery like that in the other Nordic countries and elsewhere in Europe seems imminent. Due to the structural and cyclical problems that it has grappled with in recent years, Finland is in a **weak starting position**. GDP is nearly 7 per cent lower than before the crisis. The corresponding figure in the euro zone is -1 per cent and in Sweden +7 per cent. Economic performance has been far worse than after the early 1990s recession. **Indicators are pointing to a growth rate just above zero**; industrial production and exports have fallen for three straight months, consumption is weak and home prices are falling. The bright spots are low inflation, which is allowing real wage increases, and a weaker euro that is improving Finland's competitiveness and exports. But the negative forces will prevent anything but a very feeble recovery, despite the low GDP level. **GDP will grow by 0.4 per cent in 2015 and 1.0 per cent in 2016**.

Far weaker GDP recovery than in the 1990s recession

GDP, index 100 = Q1 2008 and Q1 1990



Source: Eurostat

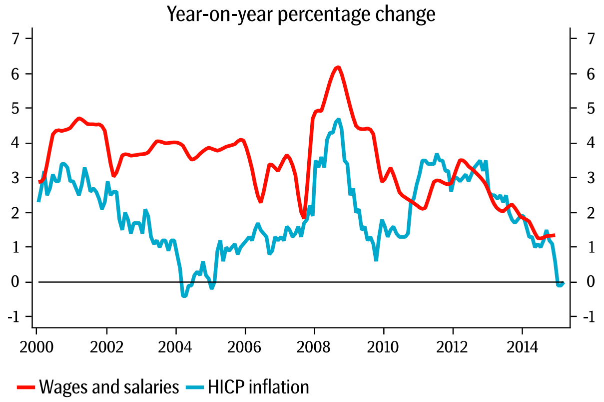
There is broad-based weakness in economic indicators, although the trend in construction and manufacturing is more negative than in services. Yet there are signs that exporters will be able to redirect deliveries to other countries as trade with Russia falls. This will help push export growth up above zero in 2015. Combined with a weak import trend, this will be enough to ensure that **net exports will contribute positively to growth**. The current account deficit will remain around 2 per cent of GDP in 2015-2016. Capital spending, which has fallen by more than 5 per cent for two years in a row, will continue to be squeezed by idle capacity and lack of optimism. Construction investments will also be weak; the housing market is shaky and prices are falling slightly. Yet lending to businesses is continuing to increase by about 5 per cent, which indicates some activity on the capital spending front.

The labour market has also been disappointing. Last year's downturn in unemployment has ended. Despite a decent level of job openings, unemployment has risen again to 9.4 per cent, well above its 7.5-8.0 per cent equilibrium. This indicates matching problems. **Unemployment will continue to climb** a bit further before levelling out and falling slowly in 2016.

Households are being pulled in different directions. Pay increases are slowing as unemployment rises. Fiscal policy remains constrictive, but low inflation is leading to real wage increases. Interest rates are low and the stock market has climbed. Inflation will remain low in 2015-2016, driven among other things by downward pressure on wages due to the need to restore competitiveness. The household savings ratio has fallen in recent years but is now levelling off. **After falling for two years, consumption will rise by 0.2 per cent in 2015 and 0.5 per cent in 2016**. Continued high unemployment and a weak stock market will pose downside risks.

Falling inflation will lead to real income increases

Year-on-year percentage change



Source: Statistics Finland

After April's election, fiscal policy remains tight. In 2014 the public sector deficit rose to 3.2 per cent of GDP: above the EU's 3 per cent limit for the first time since euro zone accession. Public debt was 59.3 per cent of GDP in 2014, just below the 60 per cent limit. **The new government will not enact any major fiscal policy changes**. It will supplement a continued focus on cost-cutting and deficit reduction with efforts to improve the labour market, reform health care and tighten spending by local authorities.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2013	2014	2015	2016
GDP OECD	1.4	1.9	2.3	2.7
GDP world (PPP)	3.2	3.4	3.4	3.9
CPI OECD	1.6	1.7	0.5	1.6
Export market OECD	2.7	3.6	4.9	5.4
Oil price. Brent (USD/barrel)	108.7	99.5	60.0	70.0

USA

Yearly change in per cent

	2014 level, USD bn	2013	2014	2015	2016
Gross domestic product	17,704	2.2	2.4	2.7	3.2
Private consumption	12,120	2.4	2.5	3.1	2.8
Public consumption	3,189	-2.0	-0.2	0.1	0.0
Gross fixed investment	2,943	4.7	5.4	4.8	8.4
Stock building (change as % of GDP)		0.0	0.0	0.2	0.0
Exports	2,352	3.0	3.2	2.4	6.1
Imports	2,902	1.1	4.0	5.1	5.7
Unemployment (%)		7.4	6.2	5.3	4.7
Consumer prices		1.5	1.6	0.1	2.1
Household savings ratio (%)		4.9	4.8	5.8	6.5

EURO ZONE

Yearly change in per cent

	2014 level, EUR bn	2013	2014	2015	2016
Gross domestic product	10,750	-0.4	0.9	1.7	2.1
Private consumption	5,627	-0.7	1.0	1.6	1.8
Public consumption	2,123	0.3	0.7	0.5	0.5
Gross fixed investment		-2.5	1.0	1.6	2.2
Stock building (change as % of GDP)		0.0	-0.1	0.0	0.0
Exports	4,456	2.1	3.7	4.5	5.0
Imports	4,067	1.3	3.8	4.0	4.2
Unemployment (%)		12.0	11.6	11.1	10.7
Consumer prices		1.4	0.4	0.0	0.8
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	2.8	2.5	2.4
Japan	1.6	0.0	1.1	1.3
Germany	0.1	1.6	2.2	2.3
France	0.4	0.4	1.1	1.6
Italy	-1.7	-0.4	0.7	1.3
China	7.7	7.4	6.8	6.5
India	6.4	7.2	7.5	7.8
Inflation				
United Kingdom	2.6	1.5	0.1	1.0
Japan	0.4	2.7	0.7	0.9
Germany	1.2	0.1	0.4	1.7
France	0.8	0.1	0.0	0.7
Italy	1.3	0.2	0.0	0.5
China	2.6	2.0	1.5	2.0
India	10.1	7.3	5.5	5.4
Unemployment, (%)				
United Kingdom	7.8	6.3	5.3	4.9
Japan	4.0	3.6	3.5	3.4
Germany	5.2	5.0	4.9	4.8
France	10.2	10.3	10.6	10.5
Italy	12.2	12.7	12.2	12.2

EASTERN EUROPE

	2013	2014	2015	2016
GDP, yearly change in per cent				
Estonia	1.6	2.1	2.2	2.7
Latvia	4.2	2.4	2.4	2.7
Lithuania	3.2	3.0	2.6	3.5
Poland	1.7	3.3	3.4	3.6
Russia	1.3	0.6	-4.0	0.0
Ukraine	0.0	-6.5	-8.0	2.0
Inflation, yearly change in per cent				
Estonia	3.2	0.5	0.5	2.3
Latvia	0.0	0.7	0.7	2.1
Lithuania	1.2	0.2	-0.4	0.3
Poland	0.8	0.1	0.0	1.5
Russia	6.8	7.8	14.0	8.0
Ukraine	-0.3	12.1	37.0	18.0

FINANCIAL FORECASTS

		30-Apr	Sep-15	Dec-15	Jun-16	Dec-16
Official interest rates						
US	Fed funds	0.25	0.50	0.75	1.25	1.50
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	2.04	2.10	2.20	2.45	2.70
Japan	10 years	0.33	0.30	0.35	0.40	0.45
Germany	10 years	0.36	0.10	0.20	0.50	0.75
United Kingdom	10 years	1.84	1.75	1.90	2.20	2.45
Exchange rate						
USD/JPY		120	125	130	135	140
EUR/USD		1.12	1.00	0.95	0.98	1.00
EUR/JPY		134	125	124	132	140
GBP/USD		1.54	1.46	1.45	1.48	1.50
EUR/GBP		0.73	0.69	0.66	0.66	0.67

SWEDEN

Yearly change in per cent

	2014 level, SEK bn	2013	2014	2015	2016
Gross domestic product	3,908	1.3	2.1	3.0	2.7
Gross domestic product, working day adjustment		1.3	2.1	2.8	2.5
Private consumption	1,817	1.9	2.4	2.8	2.7
Public consumption	1,029	0.7	1.9	1.0	0.8
Gross fixed investment	904	-0.4	6.5	7.0	6.5
Stock building (change as % of GDP)	8	0.0	0.2	0.1	0.1
Exports	1,745	-0.2	3.3	3.9	4.3
Imports	1,594	-0.7	6.5	4.7	5.4
Unemployment (%)		8.0	7.9	7.6	7.3
Employment		1.1	1.4	1.5	1.1
Industrial production		-4.0	-2.0	2.5	3.0
CPI		0.0	-0.2	0.2	1.2
CPIF		0.9	0.5	1.1	1.6
Hourly wage increases		2.6	2.9	2.8	3.0
Household savings ratio (%)		15.6	16.0	15.6	14.7
Real disposable income		2.1	2.7	2.6	1.6
Trade balance, % of GDP		1.4	0.8	1.0	1.0
Current account, % av GDP		6.9	5.8	5.7	5.8
Central government borrowing, SEK bn		131	72	65	17
Public sector financial balance, % of GDP		-1.4	-1.9	-1.3	-0.7
Public sector debt, % of GDP		38.7	43.9	44.3	43.6

FINANCIAL FORECASTS	30-Apr	Sep-15	Dec-15	Jun-16	Dec-16
Repo rate	-0.25	-0.40	-0.40	-0.40	0.00
3-month interest rate, STIBOR	-0.21	-0.35	-0.35	-0.30	0.15
10-year bond yield	0.49	0.10	0.25	0.90	1.25
10-year spread to Germany, bp	13	0	5	40	50
USD/SEK	8.35	9.15	9.42	8.98	8.80
EUR/SEK	9.35	9.20	8.95	8.80	8.80
TCW	131.0	131.6	130.5	127.3	126.5
KIX	113.3	113.8	112.8	110.0	109.4

NORWAY

Yearly change in per cent

	2014 level, NOK bn	2013	2014	2015	2016
Gross domestic product	3,054	0.7	2.2	1.0	1.6
Gross domestic product (Mainland)	2,402	2.3	2.3	1.6	2.2
Private consumption	1,227	2.1	2.1	2.0	2.5
Public consumption	645	1.7	2.5	2.5	2.3
Gross fixed investment	713	6.8	1.2	-3.5	1.2
Stock building (change as % of GDP)		0.4	0.4	0.1	0.0
Exports	1,189	-3.0	1.7	2.0	2.1
Imports	870	4.3	1.6	1.4	3.2
Unemployment (%)		3.5	3.5	4.2	4.3
CPI		2.1	2.0	2.2	2.2
CPI-ATE		1.6	2.4	2.3	2.1
Annual wage increases		3.9	3.1	2.8	3.0

FINANCIAL FORECASTS	**30-Apr**	**Sep-15**	**Dec-15**	**Jun-16**	**Dec-16**
Deposit rate	1.25	1.00	1.00	1.00	1.25
10-year bond yield	1.53	1.20	1.10	1.30	1.60
10-year spread to Germany, bp	117	110	90	80	85
USD/NOK	7.54	8.45	8.68	8.37	8.10
EUR/NOK	8.44	8.45	8.25	8.20	8.10

DENMARK

Yearly change in per cent

	2014 level, DKK bn	2013	2014	2015	2016
Gross domestic product	1,919	-0.5	1.1	2.0	2.5
Private consumption	904	0.1	0.7	2.5	3.0
Public consumption	513	-0.5	1.4	1.3	0.5
Gross fixed investment	359	1.0	3.7	4.0	4.3
Stock building (change as % of GDP)		-0.2	0.2	0.1	-0.1
Exports	1,030	0.8	2.6	3.1	4.9
Imports	929	1.5	3.8	4.0	5.0
Unemployment (%)		4.4	4.0	3.8	3.5
Unemployment. OECD harmonised (%)		7.0	6.5	5.8	5.0
CPI, harmonised		0.8	0.6	0.4	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, % av GDP		-0.8	0.0	-2.0	-1.0
Public sector debt, % av GDP		44.5	43.5	43.0	41.0

FINANCIAL FORECASTS	**30-apr**	**Sep-15**	**Dec-15**	**Jun-16**	**Dec-16**
Lending rate	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.46	0.20	0.25	0.55	0.80
10-year spread to Germany, bp	10	10	5	5	5
USD/DKK	6.66	7.46	7.85	7.61	7.46
EUR/DKK	7.46	7.46	7.46	7.46	7.46

FINLAND

Yearly change in per cent

	2014 level, EUR bn	2013	2014	2015	2016
Gross domestic product	206	-1.3	-0.1	0.4	1.0
Private consumption	113	-0.6	-0.2	0.2	0.5
Public consumption	51	0.6	0.2	0.2	0.4
Gross fixed investment	41	-5.3	-5.1	0.1	2.0
Stock building (change as % of GDP)		-0.3	0.6	0.0	0.0
Exports	76	-0.7	-0.4	2.0	3.7
Imports	77	-1.6	-1.4	1.5	3.2
Unemployment (%)		8.4	8.7	9.4	9.1
CPI. harmonised		2.2	1.2	0.0	0.6
Hourly wage increases		2.1	1.5	1.5	1.8
Current account, % of GDP		-1.8	-1.9	-2.0	-1.8
Public sector financial balance, % av GDP		-2.5	-3.2	-2.8	-2.5
Public sector debt, % av GDP		55.8	59.3	61.5	62.0

Economic Research available on Internet.
Nordic Outlook is also available on the Internet: www.sebgroup.com under ”Latest research reports”.

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