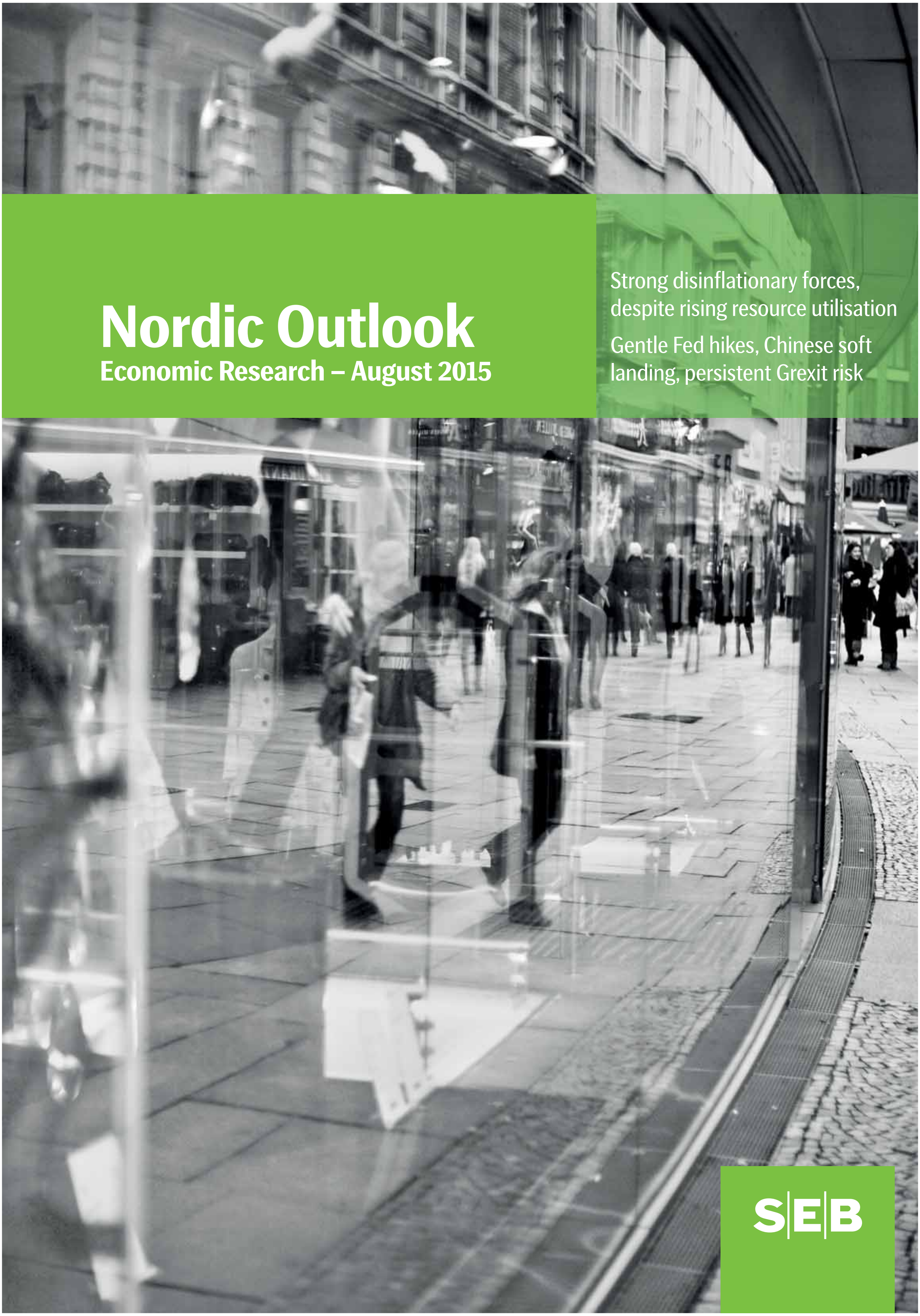
Nordic Outlook

Economic Research – August 2015

Strong disinflationary forces, despite rising resource utilisation

Gentle Fed hikes, Chinese soft landing, persistent Grexit risk



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This report was published on August 25, 2015.

Cut-off date for calculations and forecasts was August 20, 2015.

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Strong disinflationary forces, despite rising resource utilisation

- **US speeds up despite cautious households**
- **Euro zone resilient to Greek debt crisis**
- **Soft landing in China despite devaluations**
- **Clearer structural problems in EM countries**
- **Fed to start gentle hiking cycle this autumn**
- **EUR/USD rate will fall again**

World economic growth remains lacklustre and without clear direction. The **US economy** has not really taken off, although the labour market is continuing to show strength. In **Japan**, the first half of 2015 was dominated by weak consumption and disappointing exports. The **euro zone** recovery has continued at a moderate pace, without being significantly hampered by the Greek debt crisis, while the British economy has accelerated after first quarter weakness. Emerging market (EM) economies have been dominated by mounting uncertainty. China's stock market downturn, combined with a devaluation of the yuan, is raising questions about its economic stability, while falling commodity prices are pushing down many EM currencies. Countries like Brazil, Russia and Ukraine are showing deeper economic and political crisis symptoms.

Global GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
United States	2.4	2.4	3.1	2.6
Japan	-0.1	0.8	1.3	1.0
Germany	1.6	1.9	2.3	2.0
China	7.4	6.8	6.5	6.3
United Kingdom	3.0	2.7	2.5	2.5
Euro zone	0.8	1.6	2.1	2.0
Nordic countries	1.6	1.8	2.1	2.1
Baltic countries	2.6	2.2	2.7	3.4
OECD	1.9	2.2	2.6	2.4
Emerging markets	4.7	4.1	4.7	5.0
World, PPP*	**3.4**	**3.2**	**3.8**	**3.9**

Source: OECD, SEB * Purchasing power parities

There are various reasons why the world economy has not really gained momentum. In several issues of *Nordic Outlook*, we have discussed the risk of "secular stagnation", in which obstructive forces on the supply side of the economy decrease the effectiveness of monetary policy. These seem to be making themselves felt to a somewhat greater extent than we had previously expected. **Low capacity utilisation and high return requirements in the business sector are hampering capital spending.** Meanwhile, due to a lack of household optimism, **rising wealth is not stimulating consumption in a normal way**. This may also explain why the purchasing power injection from falling oil prices looks set to be weaker than expected. On the supply side, **weaker demographic factors** and **structural problems in many EM economies** are becoming clear as the forces of globalisation slow. Weaker underlying growth dynamism may possibly make the world economy more vulnerable to regional crises in places like Russia and Ukraine or Greece, but resilience to these crises mainly seems rather strong.

Yet the main features of our forecast scenario remain intact. The US economy is speeding up to an annual growth rate of around 3 per cent. The euro zone is showing good resilience to the Greek debt crisis; a weak currency and low energy prices will help GDP grow by more than 2 per cent in 2016. We are also sticking to our forecast that China's deceleration will occur gradually and in a controlled way. Strong economic expansion in India will help maintain overall growth in the EM economies. **Overall, we expect global GDP growth to be 3.2 per cent this year and 3.8 per cent in 2016**, slightly lower than in May's *Nordic Outlook* for both years.

Unlike the last *Nordic Outlook*, **we believe that downside risks now predominate**. This is mainly due to increased uncertainty about the strength of the Chinese slowdown and risks of policy mistakes in treacherous economic terrain in many countries. On the upside, there is potential that positive effects from the oil price fall might make themselves felt.

Fed rate hikes, despite inflation dilemma

In spite of unclear cyclical patterns, estimates of economic resource utilisation in various regions are important as a basis for long-term growth forecasts – and thus forecasts of central bank policies and financial markets. In general, resource utilisation in the world economy is relatively low, but both the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) have adjusted their output gap estimates to some extent. One reason is that the underlying potential growth trend is not as strong as previously thought. The long period of low resource utilisation may also have contributed to labour market exclusion.

Unemployment in the three largest OECD countries (the US, Japan and Germany) is close to equilibrium, supporting the view that the output gap is not so large. Because of supply side constraints in the labour market, we believe that GDP growth in the US will peak at just above 3 per cent in 2016, then approach its long-term trend in 2017. The euro zone jobless rate is well above equilibrium despite the situation in Germany, which means that from a supply side perspective there is a plenty of room for above-trend growth. We thus expect euro zone GDP growth to be roughly the same in 2017 as in 2016: about 2 per cent. It is normal for Europe to lag behind the US in the economic cycle, but the gap this time around looks set to be unusually large. **Looking at the 34 mainly affluent OECD countries as a whole, growth will decelerate a bit in 2017.** The situation will stabilise somewhat in crisis-hit countries like Brazil and Russia, helping growth in the EM economies accelerate compared to 2016. Global growth will thus also rise marginally from 3.8 to 3.9 per cent.

Output gap in selected countries

Per cent of GDP*.

	2015	2017
United States	-1.2	0.0
Japan	-0.3	0.0
Euro zone	-2.5	-1.5
Germany	-0.5	0.0
United Kingdom	-1.0	-0.5
Sweden	-2.0	-0.5
OECD (34 countries)	-1.5	-0.5

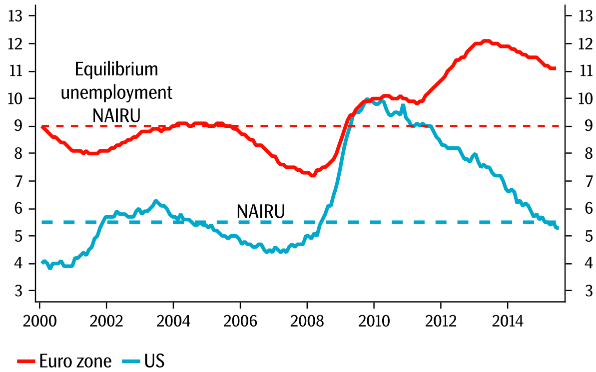
* Negative figures mean idle capacity
Source: IMF, OECD, SEB

But although the labour market in important countries is close to equilibrium, deflationary forces continue to dominate, as reflected in low pay increases and a global price squeeze, especially for commodities. **We have revised our inflation forecasts downward in most economies.** An index that adds US inflation to unemployment (the popular "misery index") is now at its lowest level since the 1960s. Sometimes this index can lead to a false sense of security, as illustrated by its low level just before the financial crisis in 2007. As in today's situation, this was because of an unusual combination of low unemployment and inflation levels. According to the classic Phillips curve, there is supposed to be a stable relationship between inflation and unemployment: its absence is a source of headaches for the Fed. Can we rely on inflation and pay increases to remain low, or do we risk a "ketchup effect" once the labour market become overheated?

The US Federal Reserve has now clearly signalled that it is prepared to begin key interest rate hikes, even though price and wage inflation remains low. We believe that this time around, the Fed has unusually ample manoeuvring room, among other things because financial imbalances are less prominent than they were in 2007. We thus anticipate that **the first rate hike will occur in September** but then foresee a very cautious approach; for example, the second rate hike will not come until March 2016. The Fed's slow rate path is the reason for our view that **bond yields will move higher but will remain historically low**. The differences between US and UK monetary policy on the one hand, and Japan and the euro zone on the other, will drive foreign exchange (FX) trends during the coming year. For example, we anticipate that **the EUR/USD exchange rate will reach parity in mid-2016**. The interest rate scenario we foresee will also create potential for a **certain upturn in stock markets** during the next couple of .

Different gaps in the labour market

Per cent



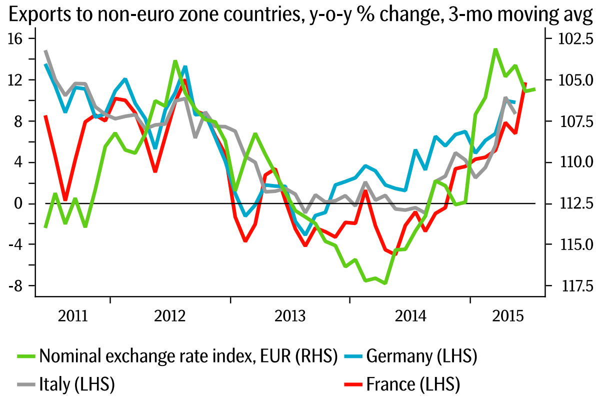
Source: OECD

Euro zone: Better growth but political issues

Economic conditions in Western Europe have stabilised recently. **Despite a strong currency and tight fiscal policy, the UK is showing fairly rapid expansion. Meanwhile euro zone GDP growth accelerated in the first half.** The German economy is expanding at a healthy pace, but Spain in particular has surprised on the upside with year-on-year growth of about 3 per cent. The outlook in France and Italy has also brightened a little, after earlier stagnation and recession. It is hard to discern any big contagious effects, for example in terms of household and business optimism or bond yield spreads in other crisis-hit countries against Germany. Looking ahead, a weaker euro and easier credit conditions due to European Central Bank (ECB) stimulus will benefit growth. Meanwhile the oil price downturn is especially important to the region, which is a sizeable net importer of petroleum products. The euro zone as a whole has thus been resilient to the Greek debt crisis.

Weaker euro is stimulating exports

Exports to non-euro zone countries, y-o-y % change, 3-mo moving avg



Source: ECB, Eurostat

The new bail-out agreement between Greece and its lenders confirms that all parties are aiming at compromises. **We expect the country to receive new bail-out loans and debt restructuring** that includes a combination of lower interest rates and more amortisation-free years. Yet it is difficult to discern a path that will ensure long-term stability. For example, the Greek economy is again sliding into a clear recession that may sabotage the budget estimates on which the pending agreement is based. A snap election is expected to give renewed support for Tsipras present policy, but our assessment is that the probability for Greece leaving the euro area (Grexti) is close to 50 per cent in the long term.

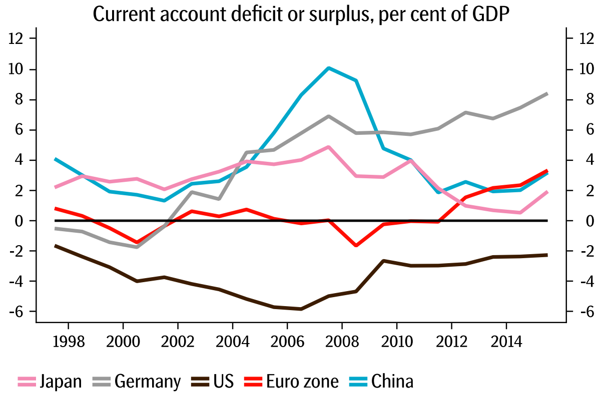
A Grexit would probably not have such a large direct impact on macroeconomic performance in the euro zone, since protective firewalls have been built up, **but the long-term consequences of a withdrawal could be larger**. The Greek crisis shows the difficulty experienced by euro zone countries in solving their common problems and how an unclear allocation of responsibility can break down trust in democratic institutions. There are also major challenges to the euro project in a broader perspective. There is strong opposition to moving further in a federalist direction and intensifying cooperation in ways necessary to ensure the long-term stability of the euro.

New pattern of global imbalances

The recent appreciation of the US dollar combined with tentative American growth and Chinese instability accentuate the issue of global imbalances. Based on a current account perspective, the situation has changed since the financial crisis, when **large Chinese surpluses and sizeable US deficits dominated the picture**. Since then, China's surpluses have decreased significantly.

New pattern of global imbalances

Current account deficit or surplus, per cent of GDP



Source: International Monetary Fund

The big German current account surplus will instead play an increasingly dominant role in both European and global imbalances. Our forecast of a weaker euro suggests that the surplus will continue to grow. This trend illustrates the tensions that arise when large economies are stuck in various currency structures that make a market adjustment of exchange rates more difficult. A German stimulus policy that increases domestic demand would ease global imbalances. To the euro zone, increased German import demand combined with a faster growth rate for pay and prices would be even more important. International and especially US pressure for a more expansionary policy in Germany will certainly escalate, but we do not expect any major change of policy to occur.

Growing challenges for EM countries

In many emerging market (EM) economies, growth has been decelerating since 2010 and the outlook is troubled. GDP growth is being hampered by various structural problems. Demographics pose clear obstacles in China and Russia, for example. Meanwhile productivity growth has fallen in a number of countries after a period of large investments that have often not been efficiently allocated (for example in China). This summer's mounting EM uncertainty was partly due to China's stock market crisis and economic deceleration, as well as the shift in currency policy (yuan devaluations). More important, however, were negative effects connected to falling commodity prices and worries about capital flight triggered by future hikes in US interest rates. Historically, however, EM asset prices are often resilient to tighter Fed policy if rate hikes are based on stronger US economic growth. Weakening EM currencies help exporters, but at the same time they pose a threat to countries with especially high foreign borrowing, such as Turkey and Malaysia.

China's deceleration is mainly driven by a weak housing market and lower capital spending. The recent export downturn indicates competitiveness problems, though China's exports are substantially more dependent on changes in international demand than on exchange rates. We are sticking to our assessment that growth will gradually slow in controlled

Why is China devaluing?

In three small steps during mid-August, the People's Bank of China allowed the yuan to weaken by a total of **5 per cent against the US dollar**. Over the past 10 years, the yuan has risen in *real effective terms* by about 5 per cent yearly, but during the past year the pace of appreciation has doubled as the currency has followed the dollar upward. We see three main reasons for China's latest currency policy decision:

Political motives. Letting market forces to play a bigger role in exchange rates opens the door for the yuan to join the IMF's Special Drawing Rights (SDR) currency basket. However, this process is expected to take several years. Starting the discussion now is a political confirmation of China's growing economic importance and a response to US efforts to postpone a decision on changing the IMF's voting rights structure.

Weak growth. Domestic economic performance has been worse than expected. This is one reason why China has again become more dependent on exports, which complicates its "rebalancing strategy" away from exports towards more domestically driven growth. The IMF has indirectly sanctioned the devaluation by pointing out in its *2015 External Sector Report* that the yuan is actually overvalued today.

Fed rate hike. Imminent Fed interest rate hikes have probably influenced the timing of the decision. These hikes will probably cause further appreciation of the dollar against many EM currencies. A more flexible exchange rate regime gives the yuan more room to avoid following the dollar upward, resulting in additional losses of competitiveness.

We believe that the yuan will undergo some further devaluation in the next six months, bringing the CNY/US exchange rate to around 6.xx. Such a comparatively minor devaluation is not likely to have major international consequences.

fashion. Beijing has both the monetary and fiscal policy muscles to help sustain the economy but will probably act cautiously in order not to encourage unsound risk-taking in the private sector.

BRIC countries, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
China	7.4	6.8	6.5	6.3
India	7.1	7.5	7.8	8.0
Brazil	0.2	-2.0	0.2	1.8
Russia	0.6	-4.0	-1.0	1.5
EM economies	4.7	4.1	4.7	5.0

Source: OECD, SEB

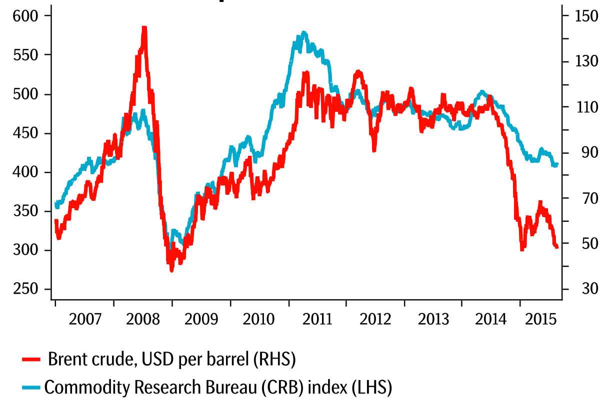
India has the brightest prospects of the larger EM countries. Its economy is benefiting from lower commodity prices, which are pushing down inflation and strengthening government finances. This is making room for economic stimulus measures that will help growth accelerate gradually. Structural reforms are also on the way, although the pace of reform is not living up to high expectations, due to political resistance. The outlook for **Russia** and **Brazil** remains troubled, and political problems are making their situations worse. The price squeeze on commodities is hitting both countries hard, and economic sanctions are deepening Russia's economic downturn. The sanctions will probably remain in place during 2016, which will contribute to a more lengthy recession.

Continued commodity price squeeze

Prices of commodities, especially oil, have declined once again in recent months. Brent crude oil prices have fallen to below USD 50/barrel, leading various investments to be shelved. Yet surprisingly many oil-producing countries have kept up their output despite the low prices. For example, US-based producers have managed to slash costs far more than expected and can thus operate profitably even at lower oil prices. So far, Saudi Arabia's tactic of keeping up output and squeezing prices to outcompete other energy producers has thus failed.

Looking ahead, rising production capacity combined with more efficient energy consumption **will exert lasting downward pressure on energy prices**. Iran's imminent "re-entry" into the global market after its nuclear energy agreement with world powers in July will intensify this imbalance. More members of the Organisation of the Petroleum Exporting Countries (OPEC) may, like Saudi Arabia, be forced to maintain their output for reasons of government finances. The OPEC meeting in December is thus expected to confirm the overproduction situation. At present, global oil supply exceeds demand by about 2 million barrels per day, leading to gradual stockpiling. Overall, we estimate that the equilibrium price of crude oil is around USD 60-70. We expect an annual average price of USD 54/barrel this year (USD 60 in May's *Nordic Outlook*), **USD 55 in 2016 and USD 60 in 2017**. Downside risks predominate, although geopolitical disruptions might lead to higher prices.

Price squeeze on commodities



Source: Macrobond

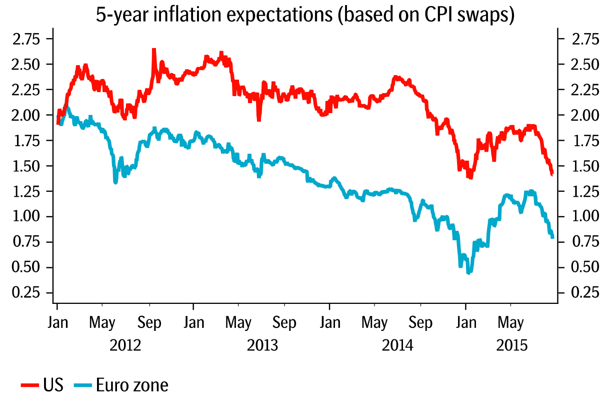
Weak actual and expected demand from emerging market economies will not only squeeze oil prices. Shrinking investments in Chinese infrastructure and housing construction, for example, will also push down the prices of other commodities. This price pressure will be reinforced by an expansion of production capacity for many commodities in recent years. Another price-squeezing mechanism is that lower oil prices will reduce costs of other commodity production. Looking ahead, these forces will contribute to a continued price squeeze.

Inflation outlook being revised downward

A renewed decline in oil prices is creating another wave of downward pressure on inflation. Headline inflation (CPI) has again fallen in recent months, leading to lower inflation expectations. We have revised our forecasts radically lower, and looking ahead we expect this downward pressure to be intensified because of a sharper drop in petrol (gasoline) prices than crude oil prices. So far petrol prices have not kept pace with falling crude oil prices, but we eventually expect the relationship between them to normalise. In the US, we predict that CPI inflation will average 1.2 per cent in 2016: a downward revision by a full percentage point. **In the euro zone, we believe that the 2016 average will be as low as 0.7 per cent. In both cases, we are well below consensus.** As for core inflation, the gaps between the US and the euro zone are wider, reflecting differences in resource utilisation and other factors.

Inflation expectations falling again

5-year inflation expectations (based on CPI swaps)



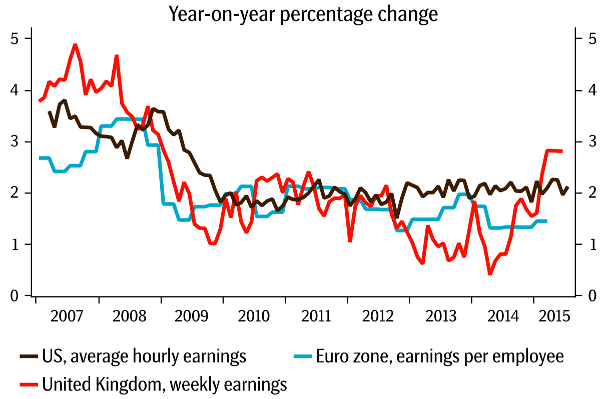
Source: Bloomberg

Although we are adjusting our inflation forecasts downward, deflation risks are small. The monetary policy transmission mechanism has improved, as evidenced by a rising money supply, for example. In particular, ECB actions have improved the situation in euro zone credit markets. Low productivity growth in recent years has also contributed to rising unit labour costs, posing a future upside risk to our inflation forecast.

The ambition to speed up inflation with the help of currency depreciation has played a major role in monetary policy in recent years, but it is difficult to see any clear associations between currency movements and inflation. This is especially true of large economies, where domestic factors are far more important, but in small economies with large foreign trade like Sweden and Norway we can see that the recent weakening in exchange rates has helped to push up inflation.

Continued low wage and salary increases

Year-on-year percentage change



Source: Macrobond

Today rising wages are the missing piece of the puzzle needed to make the recovery completely self-sustaining and bring inflation up to solid ground. Although the labour market situation is now relatively tight in large economies like the US, Germany and Japan, wages will not take off. It does not seem to help that central banks are more or less explicitly advocating faster pay hikes and that higher legally mandated minimum wages are becoming more common in many countries. Recently the UK has been an exception, but it is too early to determine whether the rate of pay hikes there will remain high. Such factors as the **global price squeeze and greater labour market mobility and competition** still dominate the picture.

Low inflation complicates monetary policy

Seven years after the Lehman Brothers collapse, the world economic situation **remains far from normal**. This colours public discourse and the monetary policy outlook. Inflation and inflation expectations remain uncomfortably low in many economies, although **deflation risks are smaller today than they were a year ago**. This gives central banks a greater degree of freedom, especially since the price squeeze can largely be attributed to supply side forces.

Two major institutions, the Bank for International Settlements (BIS) and the IMF, exemplify the dilemma of central banks with their divergent policy recommendations. The BIS welcomes the start of central bank normalisation processes. One main reason is that zero interest rate policies **damage long-term productivity growth through poorer allocation** of financial resources. The BIS also believes that central banks **cannot entirely hand over responsibility for the risks of financial bubbles**. The IMF, however, seems able to accept these risks in an environment where fiscal policy does not have room to support growth; any new problems will have to be dealt with in the future. The IMF's conclusion is thus that central banks, including the Fed, should hold off on beginning to hike their key rate and should even accept inflation that climbs above the targets they have set.

The IMF's approach has generally had a greater impact on the monetary policies being pursued than that of the BIS, especially when it comes to the actions of the Fed over a long period. But at present we are also seeing a tendency towards a split between the Fed and the IMF. The IMF's recommendation that the Fed should hold off on rate hikes until next year is partly based on concerns about the stability of the international system. For its part, the Fed wishes to let domestic considerations determine its actions as much as possible. But indirectly, the Fed and other banks that are early in the hiking cycle will still be dependent on the international situation. In an environment of rapid contagious effects between countries and financial markets, **central banks are being forced – more than previously – to keep track of how overall monetary conditions change over time**. Currency rate movements naturally play a part, but reactions to long-term yields, credit spreads and share prices also have an impact on how short-term interest rates should be changed in the future.

Central bank key interest rates

Per cent

	Dec 2015	Dec 2016	Dec 2017
Federal Reserve (US)	0.50	1.25	2.25
ECB (euro zone)	0.05	0.05	0.05
Bank of England (UK)	0.50	1.25	1.75
Bank of Japan	0.10	0.10	0.10
Riksbank (Sweden)	-0.45	-0.25	0.75
Norges Bank (Norway)	1.00	1.25	1.75

Source: Central banks and SEB

Our forecast implies that the **Fed** will begin its rate hikes in September but will then move very slowly; the second rate hike will not occur until March 2016. Towards the end of 2017, the key rate will stand at 2.25 per cent. We do not expect the Fed to begin shrinking its System Open Market Account (SOMA) until the second half of 2016, when all or part of continuously maturing government securities will not be reinvested in the market. The **Bank of England** (BoE) will hike its key rate in February, reaching 1.75 per cent by the end of our forecast period. We expect the **ECB** to stick to its plan and continue buying EUR 60 billion worth of bonds each month until at least September 2016; if anything, these purchases may be expanded. We also believe that the **Bank of Japan** (BoJ) will expand its government securities purchases in October. **Various EM countries**, including **China**, may also pursue more expansionary policies in 2016. **Taken together, this implies continued very loose monetary policies on a global level.**

Riksbank rate cut, despite decent growth

The Nordic countries are showing divergent economic trends. In Sweden and Denmark the recovery is solid, while the Norwegian economy is being hampered by the consequences of falling oil prices. For a long time, the Finnish economy has been grappling with structural problems. Looking ahead, the growth outlook appears rather good for the Nordic region as a whole. Both Sweden and Norway are benefiting from weak currencies and dynamic conditions for households, while Denmark will be helped by expansionary fiscal policy. Developments in the housing market are a key issue for several countries, especially Sweden, where residential construction is an important driver of economic growth. But due to the country's rapidly increasing population, imbalances are increasing in the housing market and driving up prices to very high levels.

Right now the central banks in Sweden and Norway are focusing on different problems. In Sweden, the Riksbank is **continuing its struggle to restore confidence in its 2 per cent inflation target**, which is especially important in light of the coming wage round. Because of the need to further adjust its inflation outlook lower, we expect the Riksbank to cut its key interest rate one more time this autumn, to -0.45 per cent, despite decent economic growth and increased housing market imbalances. After that, we believe the interest rate will have bottomed out, but rate hikes will not begin until late 2016. In Norway, **Norges Bank is focusing more on economic growth and competitiveness** and has signalled a high probability of another rate cut in September.

Nordics, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
Sweden	2.3	3.0	2.8	2.5
Norway	2.2	1.3	1.4	1.8
Denmark	1.1	2.0	2.5	2.5
Finland	-0.4	0.0	0.9	1.3

Source: OECD, SEB

Fed rate hikes and policy mistakes

The Fed's rate hiking path will be very important to future events in the real economy and financial markets. The Fed's task is made more difficult because to a great extent, the bank is operating in unknown terrain. For example, it is difficult to know how inflation processes actually work in today's economic environment or predict various financial market reactions to rate hikes in an environment where other central banks are continuing their stimulus policies. Another source of uncertainty is to what extent interest rate policy can actually assume that macroprudential supervisors will deal with the risks of financial bubbles. Above, we discussed the divergent priorities of the BIS and the IMF when it comes to what policy mistakes they see as the most important to avoid. By waiting too long for rate hikes, a central bank risks an **overheating scenario** that ultimately leads to inflation that is difficult to manage. Bubbles in asset markets that finally burst are often ingredients in such a scenario. Yet excessively early, aggressive rate hikes may prematurely kill a recovery. Such a recession scenario will largely be driven by financial market turmoil – including a relatively forceful stock market downturn, for example.

The Fed's signals indicate that it mainly wants to avoid the second policy mistake, i.e. prematurely killing the recovery. For example, it has emphasised that the economy will not be harmed by a tight labour market or a period of above-target inflation. Japan in the early 1990s and Sweden in 2010-2011 have been cited as cautionary tales because of their excessively early policy tightening. Looking at the Fed's own experiences of hiking cycles, we can see that it had difficulty managing the situation mainly during two periods: **after the 1930s Great Depression** and **after the collapse of the Bretton Woods system in the early 1970s**. During these periods, the Fed faced mistrust, with falling stock markets and rising unemployment as direct consequences. In more normal times, these changes usually occur well into the hiking cycle. One interpretation is that **after major crises, the Fed does not have full knowledge of what far-reaching changes the economy has undergone** and thus runs a greater risk of making mistakes.

But although the Fed now faces big challenges, at present it is unreasonable to issue a main forecast that implies a failure to bring about a soft landing in the economy. There are two main conditions that might lead to a main forecast of such failure:

- If we believe that **economic policymakers face such big goal conflicts**, for example between inflation and financial stability, that it seems unlikely that the situation can be handled without pushing the economy into recession.
- If the central bank, for various reasons, paints itself into a corner and is clearly signalling a rate hiking pattern that forecasters believes will trigger a recession.

But at present it appears as if the **Fed has rather ample manoeuvring room** and is also showing great humility in its task by signalling a **willingness to continuously evaluate various steps**. We have chosen to forecast a rate path that is far gentler than both the historical norm and the Fed's own rate path signals. This reflects our view that the Fed will encounter rather severe headwinds in an environment of strong deflationary forces, in which several other leading central banks are continuing their stimulative policies.

Although our rate path forecast is very gentle in historical terms, it implies that the Fed will slowly lead the world economy towards more normal financial conditions. However, it is not entirely unlikely that disinflationary forces will prove stronger than we have assumed and that appreciation pressure on the dollar will be so overwhelming that the Fed is forced to stop hiking rates and even begin cutting them. An alternative scenario, **in which a convergence in the world economy instead occurs because the Fed is "trapped" and forced to backtrack**, would have major consequences for our interest rate and currency forecasts. Pricing in the fixed income market is even gentler than our main scenario, which can be interpreted as meaning that the market is assigning a fairly high probability to such an alternative.

But we believe that Norges Bank tends to overestimate the contagious effects from the oil industry. We thus see a greater likelihood that the bank will abstain from a rate cut as the economy shows more resilience. As in Sweden, the first rate hike will occur late in 2016, though from a significantly higher 1.0 per cent starting point.

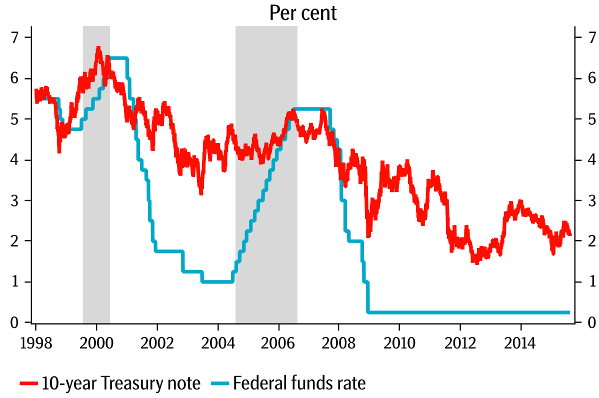
Flatter curve due to Fed rate hikes

The Fed's rate hikes, combined with continued gradual improvement in the economy, will put upward pressure on long-term yields both in the US and Europe. A September rate hike has not been fully discounted and may thus affect market interest rates and yields. Looking further ahead, there are several reasons why the long-term yield upturn will be very moderate and bond yields will remain at historically low levels throughout our forecast period. The Fed will be proceeding far more cautiously than its historically normal behaviour, based among other things on an assessment that the neutral interest rate has shifted downward. In addition, long-term yields will be squeezed by a continued mild inflation outlook. In such an environment, Fed rate hikes may possibly be interpreted as excessively hasty. In that case the upturn in long-term yields will at least temporarily be held back by lower expectations regarding both future inflation and the Fed's continued rate hikes.

The latest hiking cycle in 2004-2006 illustrates that key interest rate hikes do not necessarily have a great impact. **During this period, long-term yields were largely unchanged, or even declining, well into the rate hiking cycle.** The sluggish reaction of long-term yields was mainly explained at the time by structural factors – the global savings surplus and large US government bond purchases by foreign central banks – rather than as a sign of policy mistakes by the Fed.

US: The Fed's rate hiking cycles

Per cent



Source: Macrobond

Euro zone bond rates rebounded in May from historically low levels. One driving force was speculation about an early phase-out of the ECB's quantitative easing (QE) programme, but probably most important was that risk premiums were pushed down too far by one-sided positioning for lower yields. **Speculation that the ECB would cut back on the pace of its asset purchases has now largely ended**, among other things because of a renewed inflation squeeze. Our main forecast is that the ECB will stick to its plan to buy EUR 60 billion worth of bonds at least until September 2016. But it is also rather likely that the ECB's need to revise its inflation forecasts downward may fuel speculation of further stimulus measures, which may push market yields lower this autumn.

The spread between 10-year sovereign yields in the US and Germany is already at historically high levels. **German yields will thus have difficulty keeping up with rising US yields.** Our forecast is that 10-year US yields at the end of 2015 will be 2.45 per cent, rising to 2.80 per cent at the end of 2016 and 3.10 per cent at the end of 2017. Equivalent German bonds will trade at 0.70 per cent at the end of 2015, 1.20 per cent at the end of 2016 and 1.50 at the end of 2017.

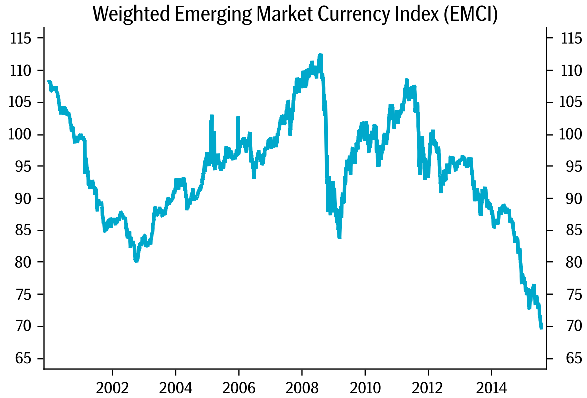
Swedish 10-year sovereign yields are now at about the same level as German ones. A further repo rate cut to -0.45 per cent in September will probably cause Swedish long-term yields to drop below German levels. In addition, the Riksbank's government bond purchases – which are somewhat larger than the ECB's purchases as a percentage of outstanding supply – will have an impact. In 2016 Swedish yields will rise faster than German ones in the run-up to the Riksbank's interest rate hikes late in the year. Swedish 10-year yields will rise from 0.65 per cent at the end of 2015 to 1.75 per cent at the end of 2017, or 25 bps above the equivalent German yield at the end of 2017.

Central banks driving exchange rates

For years, monetary policy has been the dominant driving force for currency exchange rates. Feedback has also gradually become more evident, with exchange rates emerging as a vital factor in the shaping of monetary policy. **When the Fed begins its interest rate hikes, this will strengthen the dollar, mainly against commodity-heavy and EM currencies.** Though the Fed has not yet acted, such currencies have weakened considerably in recent years.

Sharp currency depreciation in EM economies

Weighted Emerging Market Currency Index (EMCI)



Source: JP Morgan

Monetary policy divergence will increase when the Fed and BoE slowly move towards tighter policies as the ECB, BoJ and other central banks boost their stimulus. This suggests that the trend towards a stronger USD and GBP will continue, but the question is how much stronger a dollar the Fed can tolerate. There are obvious negative consequences to a stronger dollar, for example in trade and corporate earnings. If the Chinese economy becomes shaky and yuan devaluations go further than we have assumed, the level of pain will be raised by a further decline in the EUR/USD exchange rate. But fundamentally, we believe that the US economy is relatively insensitive to exchange rate fluctuations. Fed comments regarding the dollar have been extremely cautious so far. **Our forecast is that the**

EUR/USD rate will move towards parity in mid-2016. This is somewhat later than we previously expected, but it implies a level where the dollar is far stronger than its equilibrium. When ECB asset purchases begin to approach their conclusion, we thus believe that the EUR/USD rate will move a bit upward to 1.10.

The pound has also climbed on speculation of an imminent monetary tightening. Our forecast is that the BoE will begin rate hikes in the first quarter of 2016. **But the valuation of the pound is also becoming stretched**, and further appreciation may cause the BoE to hesitate. We believe that the EUR/GBP exchange rate will bottom out at 0.66 at mid of 2016. The pound will also appreciate more against the Swedish krona, with the GBP/SEK rate reaching levels around 13.60.

Sweden's Riksbank is another central bank that is likely to ease its monetary policy. Its actions at the July policy meeting clearly illustrate that the bank is taking its inflation target very seriously. In this process, the exchange rate of the krona has assumed a central role in monetary policy. The bank's actions are continuing to pull down the krona. But underlying factors such as relatively strong Swedish economic growth and low valuations are pulling in the other direction. We also believe that many FX market players are already positioned for a weaker krona and that future rebalancing flows suggest a stronger SEK. In our assessment, further action by the Riksbank in September or October will continue to push down the krona in the short term, but signs of slightly higher inflation in the fourth quarter of 2015 will enable the Riksbank to lower its guard and allow a somewhat stronger krona. **Our EUR/SEK forecast is 9.20 at the end of 2015 and 8.80 at the end of 2016.**

The Norwegian krone has recently been under downward pressure due to falling commodity prices. After its June rate cut, we expect Norges Bank to hold off on further action, but both the bank's own rate path and market pricing point to further rate cuts. Historically, the EUR/NOK exchange rate has rarely climbed above 9.00. If we are right about Norges Bank abstaining from further rate cuts this autumn while oil prices recover a bit, the EUR/NOK rate will probably move downward towards levels that are more justified by fundamentals. **We expect the EUR/NOK rate to be 8.40 at the end of 2016.**

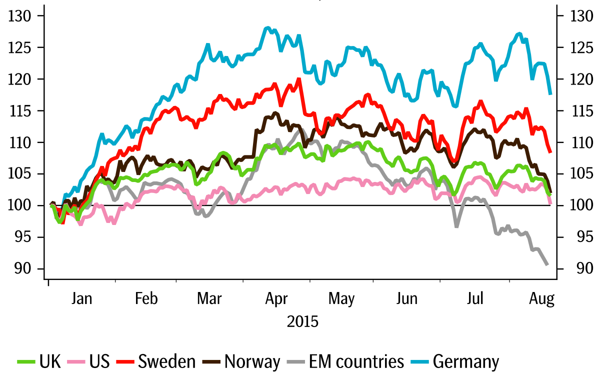
Transition towards growth-driven equities

This summer's dramatic Greek debt crisis had only a temporary impact on risk appetite. Instead, questions about **China's economy and currency policy have emerged as a major uncertainty factor** for global stock markets. Plunging share prices on the Shanghai Stock Exchange account for much of the recent weak performance of the EM equity index, but other EM stock markets are also showing weakness compared to those of developed market (DM) countries. Meanwhile falling commodity prices are squeezing markets in producer countries, such as the oil-heavy Oslo Stock Exchange. The beginning of the Fed's rate hikes is also a risk factor.

Although global economic and financial market global trends seem more mixed and uncertain than before, we are still in a phase of the economic cycle that is usually favourable to equities. The economic recovery in the US and Europe is still helping sustain corporate earnings. Because of low inflation pressure, central banks in the euro zone, Japan, China and elsewhere are expanding their stimulus measures. Cheap central bank liquidity will thus continue to sustain stock markets, especially in Europe. According to historical patterns, the effects of somewhat higher Fed interest rates will be offset by a stronger US economy and a continued low-inflation environment.

Choppy stock market indices: EM sphere the loser

Index 100 = Jan 2015, local currencies



Source: Macrobond

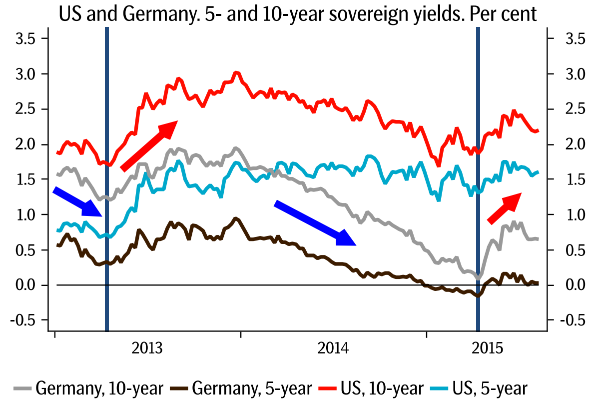
Looking ahead, we also foresee a better outlook for stock markets in DM economies compared to EM economies. Although EM stock exchanges have low valuations in a historical perspective compared to DM exchanges, we believe this reflects excessively optimistic growth and earnings forecasts. The Fed's rate hikes may also initially generate some limited turbulence, especially in the EM sphere. Among EM equities, Asia appears to have greater potential than Latin America. In DM economies, European stock markets appear capable of continuing to perform better than those in the US.

Early in 2015, Nordic equities were stimulated by the ECB's QE programme, but developments in Greece later curbed risk appetite. In particular, the Finnish stock market has struggled due to increased uncertainty about Russia and the Norwegian market due to renewed oil price declines. Denmark has performed best, while the Swedish stock market has not yet recouped this summer's limited price slide. Yet improved economic conditions in Europe, with little fall-out from the Greek debt crisis, will enable the earlier picture of rising company earnings and stock markets to prevail. **After-tax earnings will climb by 15 per cent this year in Sweden and a bit more in Denmark and Finland, while earnings growth in Norway will only be a few per cent – weighed down by oil prices.** Overall earnings growth in the Nordic region will gradually decelerate from 12 per cent this year to around 9 per cent in 2016 and 2017. Along with our SEB Macro Equity model, this supports our forecast of a renewed upturn for another couple of months in the MSCI Nordic stock market index. Valuations compared to earnings remain relatively high but are justified by continued low interest rates. Alternative metrics such as equity capital valuations do not seem as high in a historical perspective.

- **Fed at epicentre despite ECB's QE policy: cautious Fed hikes = low long-term yields**
- **Our "building block" model for long-term yields still points to a very cautious upturn**
- **Changed market dynamics boost the risk of higher volatility, even in a low-yield setting**

Fixed income markets have been dramatic in 2015. Various European sovereign bonds, even with long maturities, traded this spring at negative yields after the **ECB launched a quantitative easing programme** totalling EUR 1.1 trillion. Even 10-year US treasury notes were squeezed to 1.70 per cent, close to their record low of 1.45 per cent. The ECB's vigorous purchases implied "promises" of a long-term market presence, lowered perceived risks and created concerns about bond shortages. Compensation for credit, interest rate and liquidity risks fell to levels that finally became hard to justify based on expected economic and financial performance.

Are we seeing the start of a sustainable yield upturn?
US and Germany. 5- and 10-year sovereign yields. Per cent



Source: Macrobond

Late in April, German yields surged sharply; within two weeks, 10-year yields went from near zero to 1 per cent. But future developments are **far from clear**. The ECB's QE programme will run until "*at least September 2016*". The market expects that the ECB will take steps to keep low euro zone yields "isolated" from any upturns in long-term US yields. Better economic conditions and the desire of central banks – the Fed and Bank of England – to begin rate hiking cycles **point to higher long-term yields,** but this summer's **new yield declines raise questions** about what will happen ahead.

Despite ECB – Fed at global yield epicentre

Changes in US monetary policy obviously affect financial market prices, interest rates and yields. The main message from the Fed is that the **stage is set** for rate hikes ***"later this year"***. The Fed's monetary policy conclusion depends heavily on its analysis that in the past 20 years, the relationship between idle resources (output/unemployment gaps) and inflation has not changed. As unemployment falls, the Fed's first interest rate hiking cycle in 11 years is also approaching.

But several factors suggest continued caution by the Fed:

- **Tightening via maturities**: After starting its hiking cycle, the Fed will probably abstain from re-investing part of the maturing securities in its USD 4.5 trillion portfolio. If this occurs, it will have a tightening effect on monetary conditions that may partly replace the need for interest rate hikes.
- **Financial conditions**: Changes in dollar, long-term yields, credit spreads and share prices – and the performance of the real economy – will together help shape Fed policies. After a long period of low interest rates, there is especially great uncertainty about how financial markets will react
- **Global factors**: Some countries cannot pursue more expansionary policies, so there is heavy pressure from Europe, some EM economies and the IMF on the US – with its large impact on global financial conditions – to maintain loose policies, given persistent global growth risks and weak inflation.
- **Inflation**: Although resource utilisation suggests rising inflation ahead, it is reasonable to assume that the Fed can accept inflation above its 2 per cent target.
- **Domestic politics**: Policies that push up the USD risk generating protectionist debates as the presidential election approaches, making Fed tightening more difficult.

Overall, this suggests that Fed rate hikes will be slow. Along with continued ECB sovereign bond purchases, this will continue to exert downward pressure on long-term yields.

Changed dynamics mean more volatility

In spite of trends, there are reasons to expect **greater yield movements** ahead. Various events this past year confirm a higher probability that there will be periods of substantially worse market liquidity and diminished market depth, forcing central banks to be well-prepared to calm the markets.

There are several driving forces. First, the **risk-absorption capacity** of the financial system is worse today than before, partly due to new regulations and requirements being imposed on financial institutions. There is not the same opportunity – or desire – among financial intermediaries to use their balance sheets to hold large fixed-income portfolios and thereby influence prices. Second**, their internal systems** have been adapted to new risk management methods. Third, there is a larger element of **market players buying securities to hold until maturity** (e.g. central banks or banks, due to rules and requirements). Fourth, **QE policies** have forced the market to search for returns and adopt a one-sided approach to risk. Low yields on various credit alternatives create no incentives to change the structure of financial portfolios. **Together, this worsens liquidity and results in larger yield movements**.

Three building blocks for long-term yields

To clarify the picture of the future long-term yield trend, we begin with the **three main building blocks** of yields: *expected short-term (real) interest rates, expected inflation* and *term premium*, i.e. compensation for the extra risk involved in holding an investment for a given extended period of time. The three boxes below present our **conclusions about these forces** and their underlying components (see also *Nordic Outlook*, August 2013). The arrows summarise the direction of long-term yields in relation to a historical pattern.

Building block 1: Expected key (real) interest rate

Overall: downward pressure (↘) on long-term yields

1	Current key interest rate	↘
2	Central bank intentions and communication	↘
3	Market's short-term interest rate expectations	↗
4	Alternative policy tools/effects	↘
5	Return requirements on tangible investments	→

Source: SEB

Today's US **key interest rate (1)** is 0-0.25 per cent. This is a historically low level, which also pushes down long-term yields. Our earlier analyses have pointed out a downward shift in normal key rates, which has recently also been confirmed by the Fed. Since other countries are also continuing to pursue zero interest rate policies, this limits the ability of the US to hike rates (unless the Fed allows the dollar to appreciate sharply).

The Fed's **intentions** and **communication (2)** are clear. The hike it has announced for *"later this year"* will be followed by more hikes, but weighed at all times against economic – and financial – developments. This suggests a cautious hiking cycle that will diverge from the Fed actions we have seen earlier.

Market expectations (3) are, however, expected to push long-term yields up as the growth outlook improves. Once **alternative tools (4)** are in place, for example affecting household debt and reducing the asset price inflation risk, future yield increases can be postponed. **Return requirements on tangible assets (5)** are affected, for example, by the underlying strength of the economy and structural changes. There are indications that businesses and financial investors will be forced to move in the direction of lower return requirements, but there is still rather great uncertainty about this.

Building block 2: Expected inflation

Overall: downward pressure (↘) on long-term yields

1	Central bank credibility	↘
2	Fluctuations in inflation	↗
3	Economic and monetary developments	→
4	The symmetry of the inflation risk outlook	↘

Source: SEB

The credibility of central banks (1) has helped stabilise inflation expectations, but perhaps at too low a level. It is reasonable to assume that this credibility will persist. There is a risk of establishing a perception that the Fed will do too much while inflation is still low. The effect on long-term yields will thus be neutral or downward during a certain period.

In addition, inflation **volatility (2)** has decreased, despite large fluctuations in commodity and energy prices in recent years due to weather-related factors and geopolitical conflicts. We expected continued downward price pressure on energy. Central banks also possess the tools needed to prevent monetary expansion from triggering higher inflation. They will continue to be helped by **globalisation of production chains**, which has pushed prices down. In addition, the **world economy (3)** continues to operate with idle resources. At present, **there is still a major risk that inflation will instead be too low (4)**.

Building block 3: The term premium

Overall: upward pressure (↗) on long-term yields

1	Interest rate volatility	↗
2	Automatic hedging against yield movements	↗
3	Structural (safe-haven flow) investments	↘

Source: SEB

Variations in interest rates may be connected to cyclical and structural forces. **Volatility (1)** has fallen in recent years but trended upward in the past year – probably related to the market's risk-absorption capacity, low interest rates and asymmetrical risk regarding future capital gains. The term premium for a financial portfolio has also been squeezed due to **automatic hedging (2)**, since rising/falling interest rates have gone hand in hand with falling/rising share prices. Rising yield (= market price decline) has thus been offset by a rising stock market. This risk-reducing correlation may now cease: **fixed income and equity portfolios may lose value at the same time**.

Both share and bond prices have risen simultaneously, which is explained by **structural capital flows (3)**. In other words, the Fed and then the ECB (along with Japan, the UK and other countries) have launched vigorous QE policies. Regulations and requirements also generate a persistent demand for sovereign bonds. The geopolitical environment along with persistent economic, financial and political challenges for the euro zone are expected to make fixed income investments attractive.

Our analysis and review show there is good reason to continue believing in **a global environment of low long-term yields and slow upward adjustment**. The macroeconomic environment shows no strong signs of bottleneck problems and rising inflation pressure. Downside risks remain for both economic growth and inflation. A possible withdrawal of the ECB's QE policy during 2016 can most likely be implemented in the same way that the Fed managed to phase out its monthly securities purchases without generating a yield-driving effect. Central banks will aim at slow normalisation processes. Repricing of risk premiums, for example due to higher volatility, may take us somewhat higher but will not change the big picture. **This gives us reason to continue believing in a low yield environment during the next couple of years**.

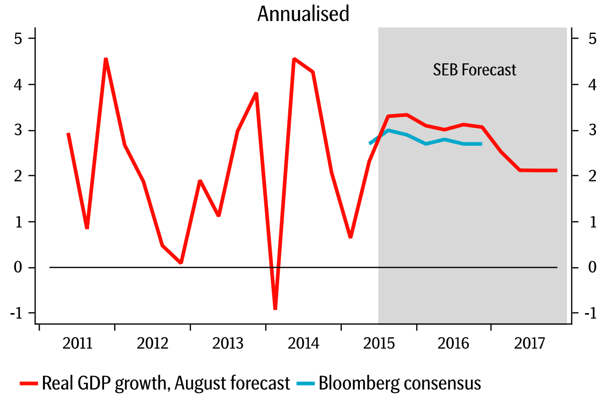
Fed will hike its key interest rate at a gradual pace

- **Robust consumption despite obstacles**
- **Housing market a bright spot**
- **Lower joblessness will lead to wage growth**
- **Inflation will be squeezed for another while**

After a very weak first quarter of 2015, the American economy showed better growth figures in Q2, but so far without the fireworks that the boom in purchasing power justifies. While manufacturing is hampered by the strong US dollar, **service sector indicators are exuding optimism** and are suggesting that the recovery will continue as planned, with households as the engine. Overall, **we predict GDP growth of 2.4 per cent this year, 3.1 per cent in 2016 and 2.6 per cent in 2017** – above consensus forecasts. This pace exceeds potential growth, and the output gap will close. **Unemployment, already near equilibrium**, will fall to 4 per cent in 2017, justifying a **gradual key interest rate normalisation** by the Federal Reserve (Fed) despite downward inflation pressure. The first rate hike since 2006 will occur in September, and at the end of our forecast period the Fed's key rate will stand at 2.25 per cent: above current market pricing.

Robust real GDP growth

Annualised



Source: Macrobond, SEB, Bloomberg

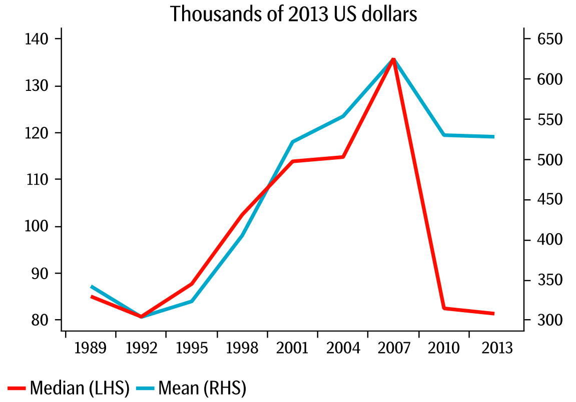
Robust consumption despite obstacles

Household consumption will remain the most important growth engine in the economy, and **in 2015 consumption growth will be the highest since 2006**. Meanwhile confidence indicators, especially the Conference Board's survey – which provided a real negative shock in July – show that household optimism remains shaky. Retail sales have also fallen short of expectations this summer, even though the preconditions for strong consumption are in place. Purchasing power is good in the wake of falling oil prices, low inflation and rising employment. Wage and salary growth remains fairly flat, however; most metrics suggest 2 per cent pay increases. Assuming an increasingly tight resource situation, we continue to anticipate accelerating pay growth in 2016-2017. Both households and businesses already expect wages and salaries to rise by around 3 per cent.

Meanwhile **structural factors are holding back consumption**. At the aggregate level, household net wealth is at record levels, but its **distribution is strikingly uneven**, as Fed studies illustrate. The net wealth of the average (mean) household shrank by 15 per cent during the economic crisis years 2007 to 2010 and then remained constant between 2010 and 2013, which is the last year surveyed. For the median household, however, net wealth in 2013 was a full 40 per cent below its peak in 2007. **The net wealth of the median household is thus at the same level as in the early 1990s**.

Median and average net worth

Thousands of 2013 US dollars



Source: Fed survey of consumer finances

In terms of pay increases, the median household was also a loser; between 2010 and 2013 median earnings fell nearly 5 per cent to 46,700 dollars, a 20-year low. But for the average household, earnings rose by 4 per cent to USD 87,200 during the same period. The above may be one reason why many households are choosing to save more than traditional wealth-based ratios suggest, which may explain why **the consumption boom that the upturn in purchasing power would justify has not materialised so far**. The 2007-2009 recession is still having an impact, and many households want to keep adding to their savings. Meanwhile the labour market is providing higher incomes and **will help boost household consumption by 3.0 per cent this year and an average of 2.6 per cent in 2016-2017, according to our forecasts**.

Greece will not disrupt the US economy

If and when the Greek debt crisis becomes acute again, the US may be affected, mainly through two channels: the real economy (via international trade flows) and the financial channel (via interest rates, yields, exchange rates and stock markets). The real economic channel probably has a negligible impact. Greece accounts for 0.4 per cent of the world economy, and US exports to Greece total USD 770 million or 0.004 per cent of American GDP. Even if the Greek crisis should lead to a slowdown in the euro zone, the real economic impact would probably be minor in the US. American exports to the entire European Union are equivalent to 1.5 per cent of US GDP. According to our rule of thumb, 1 percentage point lower real GDP growth in the euro zone would result in 0.1 point lower real GDP growth in the US, provided the financial conditions do not show excessive tightening.

The total effect may be larger than this, however. Financial conditions, often expressed as an index of interest rates, yields, exchange rates and share prices, may tighten substantially. This, in turn, may have consequences in the real economy. When the European debt crisis was at its worst in 2012, its total impact on the US economy was estimated at 1 percentage point lower GDP growth. But even if the Greek crisis flares up again, there are many indications that its effects on the US economy will be smaller. Three years ago the US economy was on less solid ground, the banking system was more vulnerable and the European Central Bank (ECB) had weaker protective structures in place.

Housing market has a tailwind

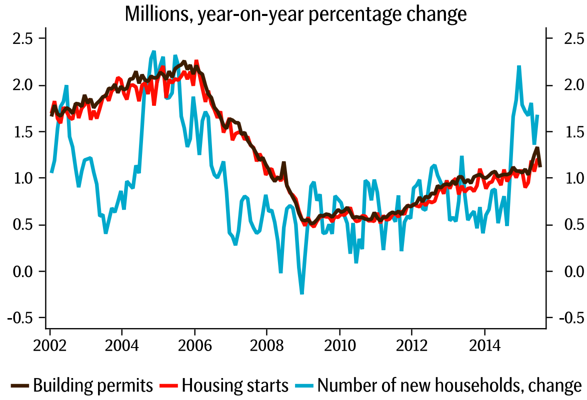
After last year's sluggish trend, the housing market is the most obvious bright spot so far during 2015. Confidence is high among construction companies, while building permits, housing starts and home sales have gained strength. **The building boom rests on a stable foundation**; supply is low in relation to sales and residential lending is increasing, while it is gradually becoming easier to get a home mortgage loan. Employment among first-time buyers aged 25-34, a key demographic, is increasing at an annual rate of 3.5 per cent, twice as fast as for the rest of the population. So far during the recovery, first-time buyers have been underrepresented. But a normalisation seems to be under way, and **the number of new households exceeds housing starts by a wide margin**. This is one reason why building permits have climbed to 2007 levels, according to the latest statistics.

Yet a new home price bubble is not in the cards. According to the Case-Shiller index, home prices are still more than 10 per cent below their 2006 peak, while incomes are 35 per cent above the level of nine years ago. The home ownership rate, which reached 69 per cent before the housing bubble burst, has declined and is now at 63.4 per cent, the lowest level since the late 1960s. This downturn means that 7 million fewer homeowners can share the positive wealth effects of the home price upturn. The continued decline in home ownership meanwhile suggests that no home price bubble is inflating.

Residential investments will grow by an annual average of nearly 9 per cent in 2015-2016 and by more than 5 per cent in 2017. **Home prices**, which rose by less than 4 per cent last year, **will not reach their previous peaks until the end of 2017, according to our forecasts**.

Housing starts and number of new households

Millions, year-on-year percentage change



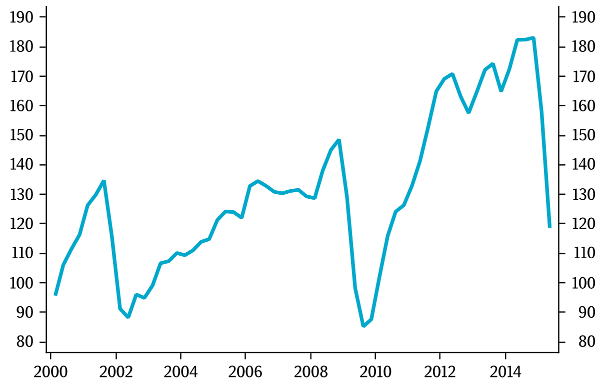
Source: Bloomberg, US Census Bureau, SEB

Capital spending remains subdued

Business investments have hardly increased at all over the past three quarters. **One factor holding back such spending is energy-related investments**. In the mining, oil and gas sector, capital spending in real terms has fallen sharply for two quarters in a row. Although this sector accounts for a small proportion of total private investments, its impact is sizeable when the declines are so large. The worst contraction in the sector appears to be over, however. The number of new wells has stabilised, according to statistics. Costs have also quickly been trimmed. For example, the break-even for profitable investments has fallen by as much as USD 30/barrel.

Mining- and oil-related investments

Index



Source: BEA, SEB

Outside the oil sector, there is good potential for faster capital spending growth; the service sector in particular will benefit from the fact that households are on firmer ground. Service **business confidence is close to record-high levels**. In manufacturing, however, confidence has fallen due to the strong dollar and tepid demand from key export markets. The dollar has appreciated by about 20 per cent in the past year, which has also contributed to a resumption of growth in the US trade deficit. **Foreign trade will contribute negatively to GDP in the coming year**, according to our forecasts.

Manufacturing nevertheless accounts for a modest 12 per cent of the US economy and 8.7 per cent of employment, and our **composite indicator is compatible with at least 4 per cent GDP growth**. As earlier in the recovery, however, the indicator provides a more optimistic picture than actual GDP figures show. One explanation is that small businesses are still lagging behind, although the trend is upward even among such companies. According to small businesses, **regulation and higher taxes are a large and growing problem**. In particular, health care reform and far-reaching regulatory changes in the financial sector are squeezing many small businesses. Meanwhile weak demand is viewed as a diminishing problem.

A comparatively low investment ratio, the level of company earnings and valuations and weak productivity growth (the weakest long-term trend since the early 1980s) indicate a need to invest, but spare manufacturing capacity and order bookings point to weak capital spending in the short term. Overall, **business investments will grow by a modest 3 per cent this year and by an average of more than 7 per cent in 2016-2017**.

Unemployment will continue to fall

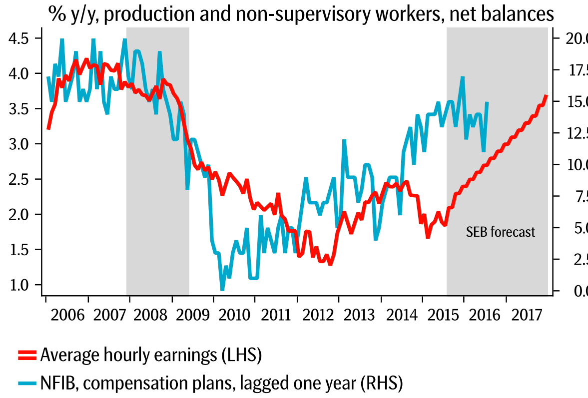
The labour market remains strong, with robust job growth and falling unemployment. **We predict that employment will grow by an average of 220,000 per month in 2015-2017**. This is slightly lower than in 2014, when the increase was the second strongest in 30 years. As a GDP indicator, the labour market is signalling continued good economic momentum; the number of hours worked is currently 2.7 per cent above the second quarter average. If productivity stays about the same, the supply side thus indicates at least 3 per cent GDP growth.

According to the Chicago Fed, only 80,000 new jobs per month will be needed to keep unemployment stable. Job growth will thus continue to push down unemployment from today's levels, which are already close to the Congressional Budget Office's estimate of equilibrium unemployment. **By the end of 2017 unemployment will be 4 per cent, according to our forecasts**. That level is also low in a historical perspective; during the previous two economic cycles, the jobless rate bottomed out at 3.8 and 4.4 per cent, respectively. Our forecast presupposes that labour force participation stabilises. Otherwise there is a risk that unemployment will fall further than our forecasts indicate.

Despite lower jobless numbers, wage and salary growth remains weak. Wage rigidity during the deep recession of 2008-2009 is one reason why hourly earnings are not rising. Despite double-digit unemployment levels, pay continued to climb during the crisis years, which may now lead to low increases. The lag between the resource situation and earnings may also be long and varied; after the three previous economic downturns, it took three to five years before wage inflation began. Another conceivable explanation is that the resource situation is less tight than the low unemployment figures indicate. We believe that wages will show stronger increases in 2016-2017: **average hourly earnings will rise by 2.2 per cent in 2015, 3 per cent in 2016 and 3.5 per cent in 2017**.

Modest wage growth

% y/y, production and non-supervisory workers, net balances



Source: BLS, NFIB, SEB

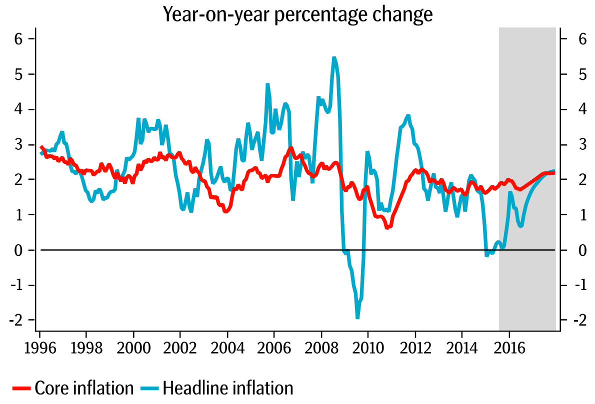
During the past year, a number of states have raised their legal minimum wage. Employers such as McDonald's and Wal-Mart have also announced their own minimum wage hikes. Thus **the pay levels of low income earners are growing the fastest**; in sectors where the average wage is below USD 12.50 per hour, wage growth is about 1 percentage point higher than for overall US hourly earnings. However, the impact on total hourly earnings will be small, since these sectors account for only 20 per cent of total employment.

Inflation will remain squeezed in 2016

Inflation fell steeply last winter and remains close to zero but it will gradually creep higher, according to our forecasts. The latest oil price decline, combined with an ever-stronger dollar, will keep price increases down. Our inflation forecast for 2016 is nearly **one percentage point below the average market forecast**. Meanwhile core inflation will remain stable just below 2 per cent during the next couple of years, and in 2017 core inflation will reach 2.1 per cent.

Target inflation in 2017

Year-on-year percentage change



Source: BLS, SEB

The trend towards more rental housing will keep core inflation up; rents are showing 3 per cent increase rates. Partly due to services in general, the **deflation risks in the US economy are small**; excluding energy, service prices are increasing at an annual rate of 2.5 per cent. When energy prices disappear from the 12-month figures, this will help to boost inflation; services account for a sizeable 62 per cent of the price basket. This summer's oil price decline probably explains why the market's inflation expectations proved wrong, but expectations based on break-evens are still compatible with 2 per cent price increases. **After near-zero inflation this year, we expect consumer prices to rise by 1.2 per cent in 2016 and 2.1 per cent in 2017**.

Strategically important trade agreement

This summer, the US Congress gave President Barack Obama the green light to negotiate a free trade agreement, the Trans-Pacific Partnership (TPP) between twelve nations including Japan, with which there is currently no trade agreement in place. While opening new free trade channels, the agreement is also important from a geopolitical standpoint as a counterweight to China's emerging strength in the Asian-Pacific region. TPP will be the world's largest free trade area. The agreement has not yet been finalised and will probably be implemented in 2016 at the earliest.

Its direct impact on the US economy is expected to be small, since the US already has bilateral free trade agreements with many of the other TPP countries. According to economic theory, the effects of a free trade agreement are greatest when the countries in question specialise in different types of products. But in both the US and Japan, a sizeable proportion of manufacturing is capital-intensive, reducing the positive effects of an agreement between them. The US is also a relatively closed economy where exports and imports together total less than 29 per cent of GDP, compared to Germany and the UK, where the corresponding figures are 85 and 57 per cent. This also suggests that the agreement will have little macroeconomic impact in the US.

No fiscal policy drama

After the powerful austerity measures of recent years in US public finances, the next few years are likely to provide less fiscal policy drama. **The federal budget deficit will increase from 2.4 per cent of GDP in 2015 to 2.8 per cent in 2016**. We foresee a minor tightening of fiscal policy in 2017; the federal deficit will end up at 2.5 per cent. As earlier, our assessment is that the debt ceiling issue will not be a source of conflict and will not create obstacles to the economic recovery process when it comes up again in Congress later this autumn. Media reports are instead focusing on the early campaigning and debates leading up to next year's presidential election.

Fed will hike its key rate in September

Communication from the US Federal Reserve indicates that its first key interest rate hike is approaching and that **the chances of a rate hike in September are rather large**. The central bank is basing its decision on a combination of labour market and inflation data. According to the Fed's monetary policy press release in July, certain additional improvements will be necessary in the labour market – which the latest job growth report has now provided. So if employment doesn't collapse in August, the labour market situation will give the **green light for a rate hike at the Fed's September policy meeting**, in our assessment. The inflation picture will naturally also play a part in the interest rate decision. Here the Fed will have to be "reasonably confident" that in the medium term, inflation will move higher towards its 2 per cent target. Despite the latest oil price decline, the Fed's inflation picture was unchanged at its July meeting, and the central bank still expects inflation to move towards its target over time. Fed Chair **Janet Yellen has also toned down the importance of faster earnings growth** in the interest rate decision, but rising wages and salaries naturally strengthen the view that the economy is approaching full employment.

There are also arguments in favour of letting the Fed hold off for another while. The most important reason for delaying interest rate hikes is that it is **better to risk an initial rate hike being too late than too early**. If the central bank subsequently discovers that its monetary policy is too expansionary, this can easily be offset with additional rate hikes. On the other hand, it is likely to take longer to discover and reverse excessively early rate hikes. Meanwhile the dilemma is likely to be the same at the time of the Fed's December policy meeting. Another reason to hold off is that **financial conditions** – based on a composite index of interest rates, yields, share prices and exchange rates – **have already tightened by the equivalent of 100 basis points compared to one year ago**. But the fundamental reason for raising interest rates is that a central bank sees that the resource situation justifies a tighter monetary policy. The question is thus whether financial conditions have already tightened more than – or in line with – what the Fed seeks to achieve.

Looking beyond the first rate hike, the Fed's key interest rate path will probably be influenced by how financial markets react to the hikes. For example, the more the US dollar appreciates, the fewer rate hikes will be needed to achieve the desired monetary tightening. Since many other central banks are still easing their monetary policies, the **Fed is also likely to proceed far more cautiously than in earlier hiking cycles**. So does the fact that rather large bond maturities in 2016 and 2017 risk driving long-term yields higher. Our key interest rate forecast is that the September hike will be the only one in 2015 and that the federal funds rate will stand at 0.25-0.50 at year-end. **As for 2016 and 2017, our year-end key interest rate forecasts are 1.25 and 2.25 per cent, respectively**. This is a somewhat faster pace of rate hikes than the market is pricing in. The rate path will hardly result in a tightening of monetary policy; in real terms, the key interest rate will not be positive until 2017. By way of comparison, the real key interest rate averaged 1.5 per cent in 1990-2007.

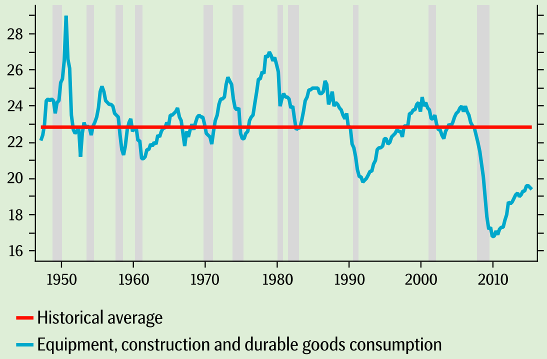
A record-long recovery?

The Federal Reserve's imminent key interest rate hikes raise the question of when the US economic recovery will end. Due to the long period of exceptional monetary policy stimulus, it may be difficult to rely on historical precedents. But the following is a discussion of several factors which suggest that the recovery may continue for quite some time.

Both in terms of nominal and real GDP, the current recovery is the weakest on record. One important explanation for this is that the growth trend for the working-age population is now at a low 0.5 per cent per year, which is well below the historical average. Another explanation is that the deep recession of 2007-2009 is casting its shadow over the recovery. The first years of the economic upturn were characterised by debt deleveraging in the household sector, and there is still reason for Americans to continue salting away money. This holds back consumption and has contributed to an anaemic but stubborn recovery that is already the sixth longest since the mid-1850s.

Big upside in the most cyclical sectors

Per cent of GDP



Source: BEA, SEB

The situation in the most cyclical sectors of the US economy may be helpful in determining the durability of the cyclical upturn. These sectors include consumption of durable goods, equipment investments and construction of homes and commercial properties. The above chart shows that these sectors have recouped some lost ground since bottoming out. They have increased by about three percentage points to some 20 per cent of GDP but are still have three points below their historical average and another point below the peak levels during the last two cycles. Historical experience also indicates that once they peak, the cyclical downturn does not follow immediately, but occurs more than two years later. According to this metric, the next recession would not arrive until 2020.

The steepness of the yield curve is another recession indicator. Only after the Fed has tightened its monetary policy so much that the yield curve inverts is a new recession usually lurking around the corner. Even if the Fed hikes its key interest rate in September, such an event is distant; monetary policy normalisation is expected to proceed at a leisurely pace, since an open output gap and low inflation will give the central bank some manoeuvring room. It is therefore very likely that **the recovery will continue at least as long as in the 1990s,** when economic expansion lasted for a record-long 120 months.

Misery index is very low

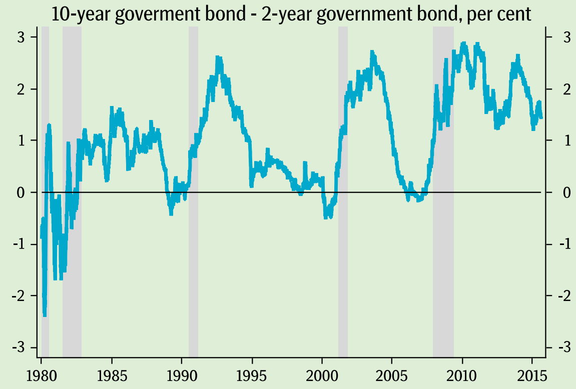
Misery index = inflation + unemployment

Source: Macrobond, NBER, SEB

One traditional indicator for assessing the situation in the economy is the "misery index", which **consists of inflation plus unemployment**. Its current level of 5.5 per cent is the lowest since the 1960s. Looking back at the past 40 years, the economy has gone into recession only when the misery index has reached between 8 and 10 per cent. At the same time, the misery index can sometimes lead to a false sense of security. The index was at a low level just before the financial crisis broke out in 2007. As in today's situation, this was because of an unusual combination of low unemployment and inflation levels. According to the classic Phillips curve, there is supposed to be a stable and inverse relationship between inflation and unemployment; its absence is a source of headaches for the Fed. Can we rely on inflation and pay increases to remain low, or is there a risk of a "ketchup effect" once the labour market becomes sufficiently overheated? In 2007 we never got an answer to that question, because when the crisis broke out, it drove up unemployment before inflation took off. At present, financial imbalances appear less prominent, decreasing the probability that the recovery will be interrupted during the next couple of years.

Inversion of the yield curve triggers reccessions

10-year goverment bond - 2-year government bond, per cent



Source: Macrobond, NBER, SEB

The road to recovery remains paved with setbacks

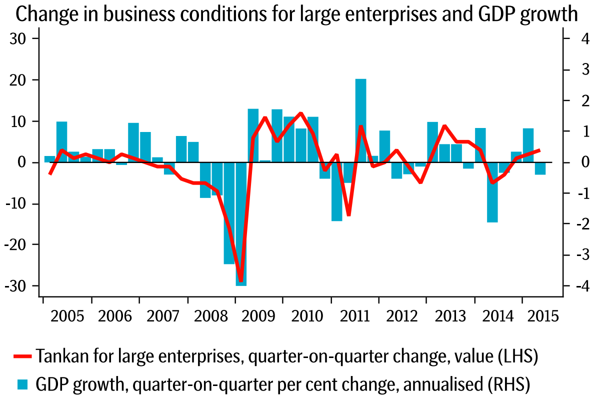
- **Disappointing exports, partly due to China**
- **Cautious – and hard-pressed – households**
- **The Bank of Japan needs to do more**

After two quarters of positive GDP growth, the economy again shrank in the second quarter of 2015 (by 0.4 per cent compared to Q1). The first half saw weak private consumption and new foreign trade disappointments. **We are revising our 2015 GDP forecast to 0.8 per cent**, three tenths lower than in May's *Nordic Outlook*. **In 2016 the economy will grow by 1.3 per cent and in 2017 by 1.0 per cent**, in both cases faster than the 0.5-0.75 per cent long-term trend. Downside risks predominate; for example, we have not factored in a possible further consumption tax hike to 10 per cent in 2017.

Confidence surveys suggest that the slump in Q2 was temporary. The quarterly Tankan business sentiment survey by the Bank of Japan (BoJ) showed a slight upturn in Q2. Business capacity utilisation is at pre-crisis levels; along with the corporate tax cut, this will help encourage capital spending.

Tankan indicates modest growth

Change in business conditions for large enterprises and GDP growth



Source: Bank of Japan, Cabinet Office

Despite yen depreciation, exports have not become the growth engine that Japan desperately needs. This is reflected in weak manufacturing sector performance and may be partly due to offshoring of production, but unexpectedly weak international demand – especially from China but also the EU– has also contributed to disappointments so far in 2015. Looking ahead, though, we foresee a larger GDP contribution from foreign trade, sustained by a continued US-led global recovery. **Signs of weakness in China – and steps to weaken the yuan – pose a downside risk**. On the other hand, a cautious resumption of Japan's nuclear power production may eventually boost GDP by slowing imports.

Last year's consumption tax increase is still casting its shadow over the economy. Consumer confidence has not rebounded to its recent peaks, not to mention the levels it reached before the financial crisis. After falling sharply during 2014, consumption is at about the same level as in early 2013. **"Abenomics", Prime Minister Shinzo Abe's overhaul of economic policy, has so far provided meagre rewards to households**. Already low savings narrow households' room for manoeuvre. The government may be forced to cut social benefits in order to meet its budget targets, which is another reason for caution.

One key question is to what extent a tight labour market will lead to faster pay increases. Government pressure has had an upward effect on wage formation among major companies, but wages and salaries show few signs of rising on a broad front. The relatively high percentage of jobs with insecure employment conditions will probably continue to hold back pay increases. But real incomes are being helped by a slowdown in the inflation rate, driven by falling energy prices and the disappearance of last year's tax hike from 12-month figures. Japan's inflation is now below ½ per cent, and only a bit above zero if fresh food is excluded (the BoJ's target variable). The BoJ adjusted its forecast downward in July but still predicts a rapid upturn to nearly 2 per cent inflation in 2016. This estimate is based on a gradual rise in oil prices to around USD 70 per barrel within a couple of years, which appears unlikely to happen. **Our forecast is 0.8 per cent inflation this year, followed by 0.5 per cent in 2016 and 0.9 per cent in 2017**. Meanwhile the upturn in inflation expectations has ended; market-based metrics stand at around one per cent in the long term, and companies' expectations have fallen this year according to the Tankan survey.

We still expect the BoJ to expand its stimulative asset purchases in a third stage from JPY 80 to JPY 100 trillion yearly in October. This will weaken the yen to 130 per dollar by year-end, followed by 140 and 135 by year-end 2016 and 2017. But the yen is no longer clearly overvalued, and most of its depreciation is behind us.

Looking ahead, demographics will set a limit on Japan's growth. Reforms aimed at boosting the percentage of women in the labour force, such as expanded child care, have shown some success but the gap between men and women remains around 20 percentage points. Steps to boost productivity have not yet had any noticeable impact on the economy. One focus of attention is the introduction of a new corporate governance code that will increase pressure for professional management in major companies. Government budget deficits are actually shrinking, however, which will **strengthen confidence in Japan's ability to manage its gigantic sovereign debt**.

Decent growth despite financial market turbulence

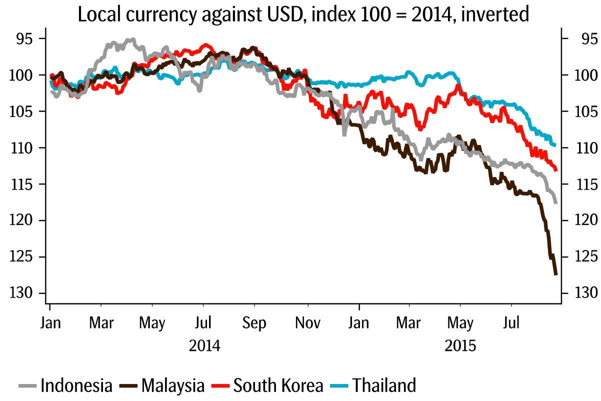
- **Downward pressure on Asian currencies**
- **China: Financial turmoil creates uncertainty**
- **India: Cautiously accelerating growth**

Growth in emerging Asia has stagnated in recent quarters. A renewed commodity price decline is squeezing inflation and stimulating consumption, but external demand is meanwhile hampered by the deceleration in China. Exports have weakened in recent months despite decent demand from the US and Europe, but they are expected to take off in the next few quarters, driven by good US growth. Because of a continued slowdown in China, we expect **growth** in the region as a whole to be **close to current levels in 2016 and 2017**.

Domestic demand remains good thanks to strong labour markets, low inflation pressure and low key interest rates. Thailand and Singapore are seeing deflation. The renewed oil price downturn is reinforcing the trend towards supply side-driven low inflation and will make the expected inflation upturn in late 2015 mild in most economies. Monetary policy easing will continue a bit longer in some countries: aside from China and India, also Indonesia and South Korea.

Downward pressure on Asian currencies

Local currency against USD, index 100 = 2014, inverted



Source: Macrobond

Recently **many currencies in emerging Asia have weakened noticeably**. This downward pressure is being caused by such factors as falling commodity price, worries about Chinese economic growth and the devaluation of the yuan. The US Federal Reserve's interest rate hikes are approaching, which intensifies nervousness. The ringgit is the biggest loser, driven by Malaysia's large-scale commodity exports and its exposure to the Chinese economy.

The Fed's rate hikes, as such, need not lead to increased volatility. Historically, emerging market (EM) asset markets have performed well despite Fed hikes, since these hikes have ordinarily occurred during periods of stable global growth. The exception was in 1994, when a combination of faster-than-expected hikes plus the "tequila crisis" in Mexico caused an abrupt halt in the ongoing stock market rally in EM countries. **Given** our scenario of **cautious Fed rate hikes, financial market turbulence in the EM sphere should be limited**.

If the Fed raises its key rate faster than expected, however, the consequences may be serious for certain EM economies. For example, Turkey and South Africa are highly vulnerable due to large current account deficits. Some Asian emerging economies are also in the danger zone. Monetary policy in **Hong Kong** and **Singapore** is closely tied to the US, and the **Fed's rate hikes** will have **direct effects** that risk harming overheated housing markets. **Malaysia is also vulnerable** due to its large-scale foreign borrowing; currency depreciation is increasing the costs of borrowing. Generally speaking, it will be individual economies rather than the region as a whole that will be affected by the Fed's key rate hikes.

China: Continued stimulus measures

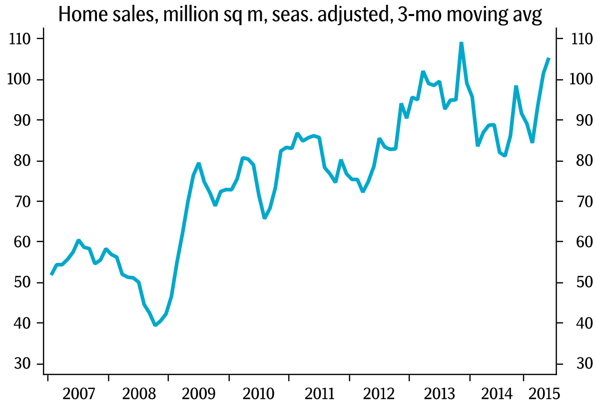
Second quarter GDP growth exceeded expectations, ending up at **7.0 per cent** year-on-year – the same as in Q1 – but economic activity is tepid and the third quarter began weakly. Purchasing market indices fell in July, with both the official PMI and Markit/Caixin index coming in well below historical averages. Industrial production slowed and exports were far worse than expected, while imports remained weak.

The authorities have tried to respond to this economic sluggishness with even looser monetary and fiscal policies, for example by lowering interest rates and reserve requirements as well as making continued infrastructure investments. In late June, the People's Bank of China (PBoC) cut its key rate for the third time in 2015. The authorities have gradually intensified their policy easing. The positive growth effects of these measures are not yet fully visible. Meanwhile there is ample room for continued stimulus. We also expect China to benefit from accelerating growth in other countries. We are thus sticking to our view that growth will only slow gradually in the next couple of years. **In 2015, we expect GDP to rise by 6.8 per cent**. Growth will then decelerate to **6.5 per cent in 2016** and **6.3 per cent in 2017**. However, the **economic situation was clouded** by this summer's **stock market plunge** and the central bank's **currency policy reorientation**. There is greater uncertainty about reform efforts and about the risk of policy errors connected to deregulation of financial markets.

The main explanation behind decelerating Chinese growth is the weak housing market, but housing is showing signs of stabilisation. The number of home sales has recovered. Prices also climbed slightly month-on-month in May, June and July after 12 straight months of declines. This stabilisation occurred after an easing of housing policy. Restrictive rules on home purchases have been loosened, and banks have been instructed to speed up the approval of new home loans. Meanwhile the PBoC's rate cuts have also had an impact in the form of falling home loan interest rates. Despite this recent improvement, because of the large number of unsold homes a **weak construction market will continue to hamper economic growth for a long time to come**.

Signs of recovery in the housing market

Home sales, million sq m, seas. adjusted, 3-mo moving avg



Source: National Bureau of Statistics of China

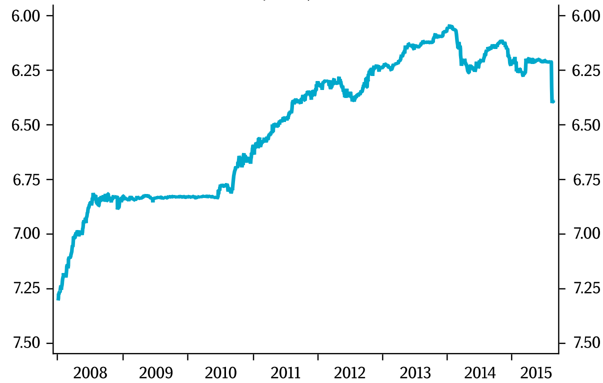
The authorities are also trying to encourage growth by propping up the financial system. The size of aid programmes to deal with the financial problems of local public agencies has been doubled. The terms for investors who buy newly issued local government bonds have been improved. These bonds are now accepted as collateral for new loans from the PBoC. The cost of the aid programme is borne by the banks. Although they must accept lower interest rates on their lending, they are instead benefiting from improved financial asset quality.

The yuan was unexpectedly devalued in August. The devaluations occurred soon after the publication of weak export figures, and ambitions to help sustain exports are among reasons for the policy shift. It is probably also a security measure to deal with a situation in which future Fed interest rate hikes will drive up the dollar and thus the yuan to even stronger levels. Yet we believe that the devaluations are primarily an element of efforts to deregulate China's financial market: in this case by introducing a new foreign exchange regime in which the market will play a larger role in the exchange rate. Viewed in a long-term perspective, underlying export performance has been decent. China has an explicit goal of transitioning away from its old growth model based on public investments and exports. This also suggests that future currency rate adjustments will be modest. Foreign demand also plays a more important for exports than the exchange rate. PBoC interventions to prevent the yuan from weakening also contradict the export argument, and the bank has not expressed any major concerns about the economic situation.

The International Monetary Fund is indirectly playing an important role in Chinese currency policy. In *its 2015 External Sector Report*, the IMF emphasized that the Chinese yuan was "no longer undervalued". Instead, calculations suggested that the yuan was actually overvalued by about 10 per cent against a broad currency basket. This means that any American criticism against China's devaluations will carry less weight. A more flexible Chinese currency policy also implies that the yuan is moving closer to its goal of being included in the IMF's Special Drawing Rights (SDR), a basket of reserve currencies. Changes are thus moving in the right direction, although deregulation of China's financial market also entails risks of policy mistakes. We believe that depreciation will continue, though at a calm pace. We expect a **CNY/USD exchange rate of 6.60 at the end of 2015 and 6.70 at the end of 2016**. The CNY/USD rate will be **6.40 at the end of 2017**.

A sizeable yuan depreciation

CNY/USD, inverted



Source: Macrobond

Inflation pressure remains **very low**, but CPI inflation accelerated to 1.6 per cent in July, driven mainly by rising food prices. Core inflation has been around 1 per cent during the past six months. We are adhering to our view that **China will avoid deflation** and that inflation will climb during the second half. We foresee average annual **inflation of 1.5 per cent in 2015**, accelerating to **2.0 per cent in 2016 and 2.5 per cent in 2017**. **We expect the central bank to lower its key interest rate another 25 basis points** in Q4 2015 to 4.60 per cent. We then expect another rate cut early in 2016 to 4.35 per cent.

This spring and summer, the Shanghai and Shenzhen stock exchanges fell sharply. In light of their huge earlier rally, this correction was not unreasonable from a valuation standpoint. But the downturn was of great concern to the authorities, who launched various measures to try to stop the share price slide. Listings were suspended, short sales were banned and state-controlled bodies in the financial market made supportive share purchases and even persuaded private organisations to do likewise. Meanwhile financial institutions were urged to continue lending to investors for share purchases.

We expect the stock market downturn to have only a small impact on the real economy. The total exposure of Chinese households to the stock market remains small and is dominated by a small percentage of wealthy households. However, the aggressive and naïve way that the authorities handled the stock market slide was surprising. It contrasts clearly with the conclusion of the Chinese Communist Party's Third Plenum in November 2013 that the market must play a "decisive role" in resource allocation. Official actions **raise questions about future reform efforts**. During the upturn phase, however, the authorities actively helped to fuel the market rally. They are thus probably worried that a stock market slide will damage their own reputation. We are thus sticking to our assessment that economic reforms will continue during the next couple of years and that measures to stop the stock market slide should not be interpreted as a deliberate shift towards a more anti-market policy.

India: Rising impatience about reforms

Official GDP figures for the first quarter ended up at a solid 7.5 per cent year-on-year. This faster GDP growth, in the wake of the revised measurement methods launched early this year, is nevertheless difficult to detect in other economic indicators, which point to continued sluggish performance. The purchasing managers' indices for both manufacturing and services are far below historical averages. Industrial production has not taken off strongly, while capital spending has stagnated and car sales are shaky. A sharp downward revision of GDP figures for Q4 2014 has also contributed to uncertainty. Yet more expansionary monetary and fiscal policies and the renewed commodity price decline may enable growth to climb somewhat further. **We expect GDP to increase by 7.5 per cent in 2015**, with a cautious acceleration to **7.8 per cent in 2016 and 8.0 per cent in 2017**.

After falling steeply in 2014, CPI inflation has been close to 5 per cent in the past six months but fell to 3.8 per cent in July. Inflation expectations have also fallen greatly, and the Reserve Bank of India (RBI) has a good chance of meeting its target of 6 per cent inflation by early 2016. We expect average **inflation of 5.1 per cent in 2015 and 5.0 per cent in 2016 and 2017**. Slower inflation has made room for monetary policy easing. Early in June, the RBI lowered its key rate for the third time to 7.25 per cent. **We expect another cut** to 7.0 per cent late in 2015. In Q1 2016, the RBI will cut its key rate to 6.75 per cent.

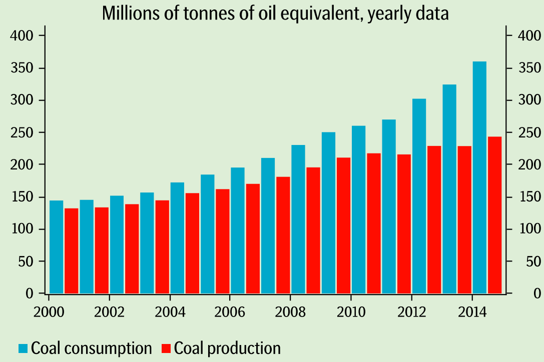
The Narendra Modi government has now been in power for more than a year, and there is **growing impatience that more reforms have not been implemented**. The need for reforms is large, with various structural problems – for example in energy supply (see box) – obstructing the economy. To improve the growth outlook, a recovery in capital spending is needed, especially in infrastructure, but such investments are being held back by high company debts combined with unpredictable regulations and other structural problems. **The government can only take credit for a small proportion of the improvements in the economy**, in the form of slower inflation and smaller budget and current account deficits. But it has actually pushed through some reforms. For example, such sectors as insurance have been opened up to foreign market players. But **in the most important reform areas**, such as the over-regulated labour market, it is **difficult to see any progress**. Plans to introduce a national sales tax look set to be postponed until April 2017 due to political resistance. Attempts to reform legislation related to land purchases have failed so far. There has also been some concern about the continued independence of the RBI, due to a proposal that the government should be allowed to appoint four out of seven members of a future monetary policy committee. The Modi government will probably try to intensify its reform efforts, but resistance from the political opposition and from special interests is likely to continue impeding this process.

Energy crisis may hurt long-term growth in India

India's chances of achieving faster growth are being hobbled by structural problems. One example is energy supply. Today, coal accounts for around half of energy consumption. It will remain the most important energy source in the foreseeable future. Coal mining cannot keep up with rising demand, and companies are forced into expensive imports. Power cuts are common, and these problems look set to become worse in the future. The International Energy Agency (IEA) estimates that India's energy needs will double by 2040.

Widening gap between coal consumption and output

Millions of tonnes of oil equivalent, yearly data



Source: BP

Despite large-scale coal resources, India still cannot meet the rising demand. The main explanations are regulations and the central government-owned company Coal India, which supplies about 80 per cent of production and enjoys a monopoly-like position. Mining is inefficient and production increases are difficult to achieve due to corruption, coal resources that are difficult to access and capacity shortages in the railway system. The Modi government has taken steps to try to improve this situation, but the problems of the coal sector are an instructive example of the difficulties India has in pushing through reforms. Coal India employees responded to attempts at deregulation with large-scale protests, forcing Modi to promise that the company will continue to be mainly government-owned.

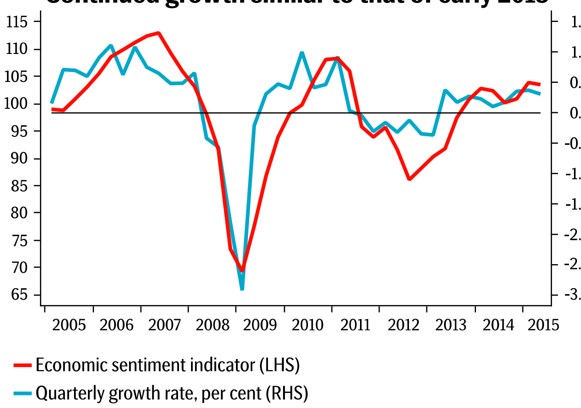
Unlike other Asian currencies, the **rupee** has been resilient to recent turmoil and has only weakened slightly against the US dollar so far this year. One reason is that falling oil prices have reduced imports. We expect an INR/USD exchange rate of **67.5 at the end of 2015** and a slightly weaker **70.0 at the end of 2016**. The INR/USD rate will be **66.0 at the end of 2017**.

Continued recovery with long-term question marks

- **Few contagious effects from Greek crisis**
- **Exports benefiting from weak euro**
- **Slowly declining unemployment**
- **ECB policies continuing as planned due to low inflation**

During the first half of 2015, euro zone growth accelerated. Germany is growing at a brisk pace, France has left stagnation behind, Italy has emerged from a year-long recession and **Spain has surprised on the upside** with year-on-year growth of about 3 per cent. Second quarter growth euro zone was 0.3 per cent and Indicators foresee second half expansion of about the same as in the first half. **We expect GDP growth of 1.6 per cent in 2015 and about 2 per cent in 2016 and 2017**. The output gap is roughly 2.5 per cent of GDP in 2015. The euro zone recovery cycle is lagging behind that of the US and UK. Unemployment compared to equilibrium levels shows clear national differences. Looking ahead, this will contribute to wider interest rate gaps as the European Central Bank (ECB) keeps its rate unchanged throughout our forecast period while the Federal Reserve (in September) and Bank of England (in February) begin rate hikes.

Continued growth similar to that of early 2015



Source: Eurostat, European Commission

The risk picture is relatively balanced. The combined effects of low oil prices, a weak euro and ECB stimulus measures have the potential to accelerate growth further. On the other hand, despite the new loan programme, there are still downside risks connected to any renewed problems with Greece and its lenders concerning the monitoring and implementation of reforms. The snap election is expected to give renewed support for Tsipras and present policy but creates a vacuum in the near term. In the export sector, there are downside risks related to greater uncertainty about the Chinese economy. In addition, there is continued uncertainty connected to economic and political relations with Russia.

The euro zone faces challenges ahead. The task of economic integration remains sluggish, creating uncertainty about the long-term future of the euro. Growth is not strong enough to significantly push down high unemployment. Nominal GDP growth is also being held back by low inflation. This is one reason why sovereign debt as a percentage of GDP remains at high levels. Gross general government debt will fall to 93 per cent of GDP in 2017. Public budget deficits will fall slightly to just below 2.0 per cent of GDP in 2016-2017. Because of fragile underlying finances, room for fiscal stimulus is limited. **Fiscal policy will be largely neutral or slightly contractive in 2015-2017**. The GIPS countries (Greece, Italy, Portugal and Spain) will tighten by 0-1 per cent of GDP yearly. Despite pressures to launch stimulus measures, German fiscal policy will be only weakly expansionary. Looser German policy would have major signalling value, although it would hardly change the main features of the euro zone economic situation.

Speculation that the ECB would cut back its asset purchases has vanished completely. At present, low inflation makes it more likely that asset purchases will be expanded than that they will decrease, compared to the plan that was announced.

GDP forecasts

Year-on-year percentage changes

	2014	2015	2016	2017
Germany	1.6	1.9	2.3	2.0
France	0.2	1.2	1.6	1.6
Italy	-0.4	0.7	1.3	1.3
Spain	2.1	3.2	3.2	3.0
Greece	0.8	-2.0	0.0	2.0
Portugal	0.9	1.7	2.2	2.2
Ireland	5.2	4.5	4.0	3.5
GIPS	2.2	2.4	2.8	2.9
Euro zone	**0.8**	**1.6**	**2.1**	**2.0**

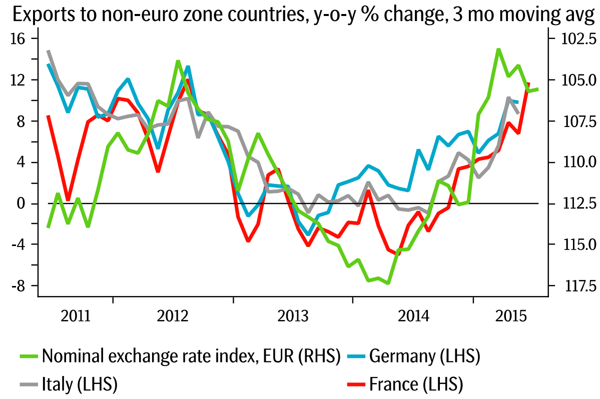
Source: Eurostat, SEB

Exports continue to benefit from weak euro

Exports are continuing to climb, although at a somewhat slower pace in recent months. There are indications that vital income from tourism is now increasing in southern European countries. Ireland, Spain and Portugal showed decent economic growth figures during the spring, and their upturn is relatively broad-based in terms of sectors. In Spain, for example, exports of agricultural and chemical products as well as durable goods are increasing. The global economy is showing certain signs of weakness, and this has held back euro zone industrial production despite the weak currency. **Exports will keep rising at a steady pace, growing by an average of about 4.5 per cent yearly in 2015-2017**. Due to successively stronger domestic demand, imports have also taken off following their decline during the crisis years. The **euro zone's external position will improve**, and the region as a whole has shown a current account surplus for some years. Its competitiveness continues to improve, which benefits exports, but as imports increase the current account will again worsen.

Weaker currency is bolstering exports

Exports to non-euro zone countries, y-o-y % change, 3 mo moving avg



Source: ECB, Eurostat

Little macro impact from Greek uncertainty

Greece is fighting an uphill battle; growth began to improve in mid-2014 but has become more uncertain since then. Even though growth surprised on the upside in the first half, the outlook is weak. Indicators, the effects of capital controls and shuttered banks point to a decline in GDP during the second half. We are revising our GDP forecast sharply downward to -2 per cent this year. Falling prices and falling nominal GDP will worsen public finances. The restrictions in the banking system are hampering the economy, and the banks are in generally bad shape with a rising percentage of bad loans. The downward spiral is difficult to stop, and **2016 will consequently also be a year without growth**.

The euro zone and the International Monetary Fund are in a difficult position. A new loan programme is in place but there are still underlying disagreements on what policy that is the proper one. Elements of earlier crisis solutions have created impasses, making it difficult to reach agreement. The IMF is pressuring Germany on the issue of debt write-downs, which the IMF supports. The US has also backed the IMF's position. A large percentage of Greek public debt consists essentially of claims by taxpayers in other countries. This makes the discussion more difficult. The IMF's policy also implies not only that continued bail-outs should be tied to the trend of sovereign balance and debt, but that it also wishes to oversee the reforms in greater detail. This is viewed by Greece as a limitation on its sovereignty. Under the bail-out agreement, several difficult issues must be addressed, such as reforming the Greek pension system and labour market, specifying privatisation programmes and making the public administration less political and more professional. It is worth noting that these reforms are more structural in nature than austerity-related. Despite difficulties, a new support programme is now in place and more money has been paid out to Greece. Implementation of the new programme will most probably not be easy and lined by disagreements this fall and coming years. **We then expect the country to, in addition to the loans, receive a debt restructuring** that includes a combination of lower interest rates and more amortisation-free years. Ultimately the IMF is likely to contribute to a solution, if only in order to safeguard Greece's repayments to the IMF.

New bail-out loans will buy time, but it is uncertain whether such a strategy can succeed in the long term. Although **no player actually wants to trigger a "Grexit"**, today it is difficult to discern a path that will ensure long-term stability. The snap election creates a vacuum in the near term. Our assessment is that it is a locical attempt by Tsipras to use the time between decided loan-packages and the first assessment of Greece (probably in October) to root out critics within Syriza and strengthen his parliamentary support. One uncertainty is how many voters deflectors from Syriza and euro-opponents can muster. We believe that the probability of Grexit in the next few years is close to 50 per cent. Such an event would probably not have such a large direct impact on macroeconomic performance in the euro zone, since protective firewalls have been built up. In the long term, the consequences could be larger. The Greek crisis may serve as a cautionary tale on the difficulty experienced by euro zone countries in solving their common problems and on how an unclear allocation of responsibility can break down trust in democratic institutions.

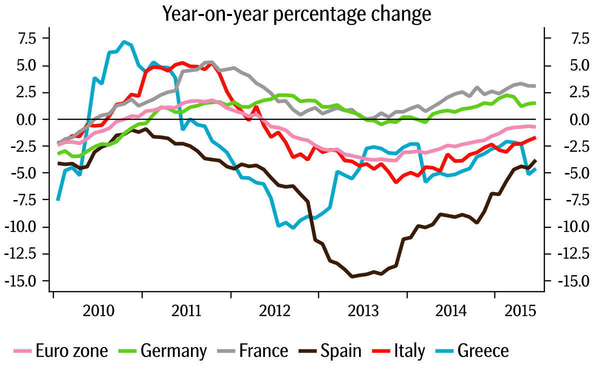
Capital spending will climb from low level

Capital spending activity remains weak. The uncertain future outlook and a sluggish credit market are holding it back. But despite the relatively slow upturn in output, capacity utilisation in the manufacturing sector is in line with its long-term average. This indicates that the long period of weak business investments will soon result in expansion needs. Continued recovery and low interest rates, combined with easier credit conditions, will contribute to a modest **2-3 per cent yearly upturn in capital spending during 2015-2017**.

Yet there are still restrictions in the credit market. The willingness of banks to lend money is low in some countries, among other things due to a continued large quantity of bad loans. The gaps between countries are wide, and above all it is small business and medium-sized enterprises that are being squeezed when banks adjust their balance sheets. This limits the stimulus effects of low interest rates and expansionary monetary policies. One way of attacking the credit supply problem is to reform the banking system in order to reduce bad loans and clean up balance sheets. In any event, ECB studies show that events are slowly moving in the right direction, both because of increased demand for loans and greater willingness by banks to lend money. Expected demand for loans is not far from pre-crisis levels. New lending to households is increasing, while corporate lending is relatively unchanged.

Bank lending: continued large geographic differences

Year-on-year percentage change

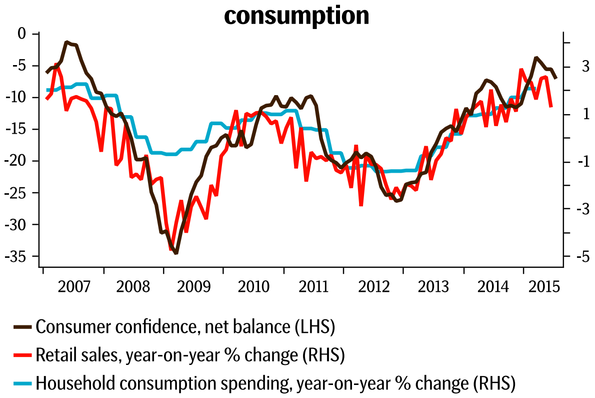


Source: ECB

Decent growth in consumption

In recent years, euro zone households have been squeezed by higher unemployment and crisis packages. Thus **consumption did not reach the same level as in the first quarter of 2008 until this year**. The household savings ratio has been relatively stable or slightly falling during the crisis. After bottoming out early in 2013, consumption has now speeded up. Retail sales point to a continued favourable trend. Consumer confidence is at a decent level, despite a slight decline in recent months. Car sales are rising faster than in several years, indicating improved optimism. There are major regional differences, though confidence gaps have recently narrowed. In particular, optimism has improved in Spain but there is still a long way to go; German consumption has climbed 15 per cent since early 2008, but it has fallen by 8 per cent in Spain. Overall, we expect low inflation, increased employment, improved confidence and positive economic performance in most countries to **help consumption increase by around 2 per cent yearly in 2015-2017**.

High consumer confidence and continued increase in consumption



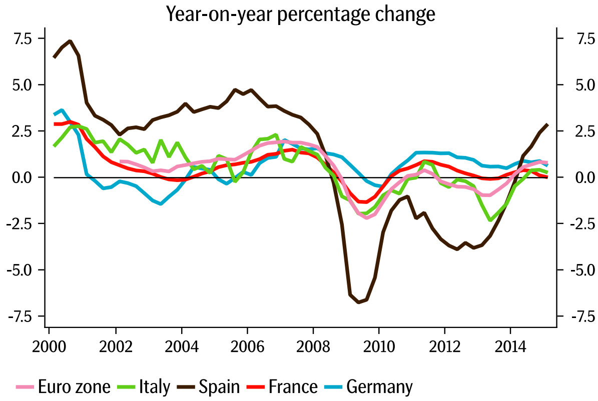
Source: Eurostat, European Commission

Slow decline in unemployment

Euro zone unemployment is on its way down from earlier record levels and stood at 11.1 per cent in Q2 2015. It is falling rather broadly, but with large national differences in level and pace. Italy (12.7 per cent in July), where joblessness has again climbed recently, and France (10.2 per cent), where it has remained flat, have performed worse than average. Germany's labour market remains hot, with unemployment at a historically low 4.7 per cent. Job vacancies keep rising and are far more than during the previous two high-growth periods.

Employment is increasing

Year-on-year percentage change

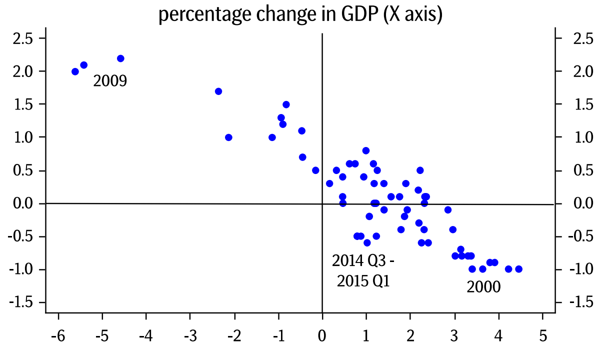


Source: Eurostat

Employment is increasing in all four of the largest euro zone countries. Spain stands out: in Q1 2015, employment rose 2.9 per cent year-on-year. The trend over the past year has been clearly positive. In this respect, too, France and Italy show weaker performance. Labour force participation has been relatively stable during the crisis, which has contributed to higher unemployment. We are now seeing a slight downturn in the labour supply, which will help push down unemployment. **The jobless rate**, measured as annual averages, **will fall from 11.1 per cent in 2015 to 10.3 per cent in 2017**.

Unemployment is falling faster than historical associations indicate

Year-on-year change in unemployment (y axis) and year-on-year percentage change in GDP (X axis)



Source: Eurostat

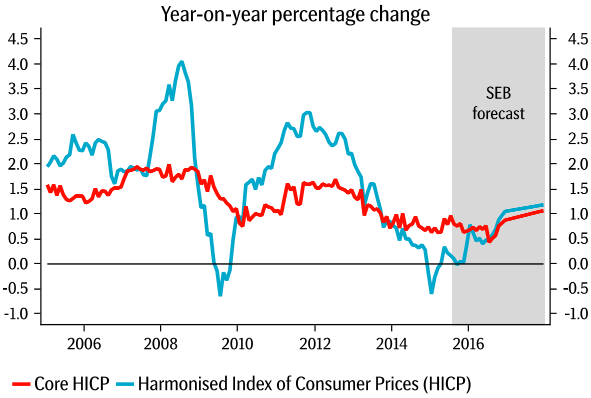
The sluggish recovery will create challenges ahead. Equilibrium unemployment is about 9 per cent, a high level that will take several years to reach. Since early 2014, GDP has grown by about 1 per cent year-on-year, reducing unemployment by about 0.5 percentage points annually. In recent years, the jobless rate has fallen faster than its historical correlation with GDP growth (Okun's Law). This indicates that output is increasing more in labour-intensive sectors. Looking ahead, if the correlation becomes more normal, it is uncertain whether the rising economic growth that we foresee will be enough to speed up the decline in unemployment. Reforms that help make it easier for businesses to hire are thus urgent, to prevent chronic unemployment from reducing the chances of many employees from finding jobs in the future.

Inflation expectations falling again

A pay squeeze – driven by high unemployment and austerity packages combined with falling energy prices and generally low international price pressures – is pushing down inflation and inflation expectations. Inflation did start creeping higher in the first half of 2015, and ECB policies meanwhile caused inflation expectations to rise. Since May, **oil prices have again fallen. This will push down inflation and inflation expectations**. The ECB will thus remain under pressure to deliver stimulus measures and achieve its inflation target.

Low inflation pressure - unchanged prices in 2015

Year-on-year percentage change



Source: Eurostat, SEB

In June, HICP inflation was 0.2 per cent compared to year earlier. It is expected to remain at around zero during much of the autumn before slowly climbing. Measured as annual averages, **prices will be unchanged in 2015 and then increase by 0.7 per cent in 2016 and 1.1 per cent in 2017**: well below the ECB target. Core inflation was also a low 0.8 per cent in July. Continued high unemployment, modest pay increases and the contagious effects of low energy prices are among the reasons why the upturn will be weak, with a rate of increase in line with HICP. Inflation expectations have recently diverged. According to an ECB survey among economists, inflation expectations increased in Q3, whereas market pricing implies falling expectations in the past two months (measured as 5-year inflation expectations in 5 years).

ECB will continue as planned

The ECB's quantitative easing (QE) programme has been a game-changer. Aside from its effects on inflation expectations, interest rates and yields, the ECB has demonstrated that it is prepared to do a lot to keep the euro project together. This has helped limit the contagious effects of the Greek crisis, for example in terms of yield spreads in other crisis-hit countries. Because of low inflation, a modest recovery, high public debts and continued Greek risks, **the ECB will need to pursue a very expansionary policy for a long time to come**.

Last spring's market discussions on whether the ECB should begin decreasing its asset purchases have largely vanished. The signals are clear: ECB **bond purchases** totalling about EUR 60 billion a month **will continue for as long as they are needed**. Before inflation and inflation expectations approach levels in line with the ECB's inflation target of close to but below 2 per cent, its purchases will continue. The ECB has said that the QE programme will last until September 2016. Securities issued by additional European institutions can be made added if needed to avoid a shortage of assets. We believe that **the ECB will not cut its refi rate below zero; if more is needed, it will do so by means of asset purchases**. However, it may become increasingly clear that this exceptional stimulus policy does not suit everyone, especially the German economy. Home prices in Germany have climbed about 20 per cent since 2008, and the increase is now showing signs of accelerating. An even weaker euro will further stimulate the German economy, which will cause the country's large, internationally criticised current account surplus to grow further. The overheating problem is not acute at the moment, but another several years of more expansionary ECB policies may increase tensions.

Elections with fewer uncertainty factors

The left-wing Syriza party's success in Greece's parliamentary election led to financial turmoil that shook Europe. Elections will soon be held in two other countries that have suffered through major belt-tightening programmes: in Portugal this October and Spain by no later than December 20 (late October or November seem likely). **Yet the risk of increased political uncertainty**, similar to events in Greece, **is rather low**.

As in Greece, new political parties are gaining ground in Spain, driven by displeasure with established parties and the effects of belt-tightening programmes. The 2011 parliamentary election gave Mariano Rajoy's People's Party (PP) a major victory, but the situation today is uncertain. Dissatisfaction with belt-tightening and corruption scandals has contributed to falling approval for PP and the socialist PSOE. Two new parties, the leftist Podemos (We Can) and centrist Ciudadanos (Citizens), have gained public support. Yet we do not expect a major transformation of the political landscape. The new parties are more centrist than Syriza, they will split the protest vote and recent events in Greece appear to be hampering their expansion by scaring voters. The emergence of new parties in may lead to a more diversified political landscape that might foster cooperation between parties. The September regional election in Catalonia, which is regarded as a covert referendum on independence from Spain, is a headache for the government. To buy support, the government and the PSOE have recently opened the way for discussions on greater regional autonomy.

Portugal has no protest parties, but the socialist opposition previously endorsed Syriza's policies. This support has diminished, though, due to Greece's problems. The opposition now backs the Lisbon government's agreements with lenders, reducing the possibility of a big political shift after the election.

- **This summer's euro zone crisis is the most serious to date, but probably not the last**
- **Greece's debt crisis will leave behind permanent scars in European politics**
- **New problems in Athens keep "Grexit" alive**

This summer's Greek debt crisis will have **far-reaching political consequences**. The discussions leading to the July 13 crisis agreement between Athens and its lenders (the "Troika") focused on **trust**, persuading Greek political leaders to **acknowledge their problems**, getting Germany to make big political **concessions** and safeguarding **global security**. The agreement itself is unique in imposing major constraints on Greek economic policy makers. The crisis again showed both the imbalances in the euro zone and a number of severe shortcomings in the "infrastructure" of the euro project.

The "exit" concept is here to stay

European Commission President Jean-Claude Juncker admitted the existence of a "detailed Grexit scenario" and Germany proposed a Greek "time-out" from the euro and the potential for a parallel currency. This has forever changed perceptions of the currency union. Thus all 19 euro zone countries, to varying degrees, will now carry a **currency risk premium**. This may mean higher future borrowing costs for various countries.

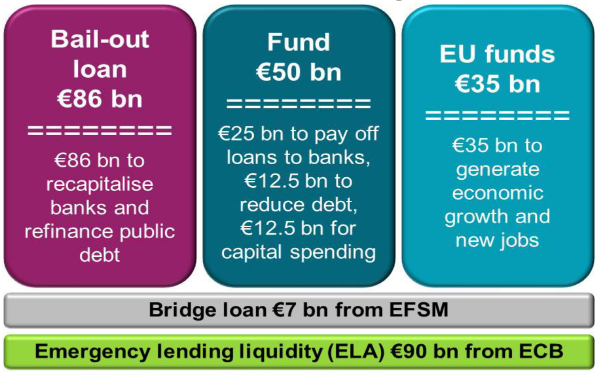
Greece's latest crisis agreement in brief

- A third **EUR 86 billion** bail-out is being added to the previous two (240 billion), for a total of **EUR 326 billion**.
- Public debt will reach about **200 per cent of GDP**.
- A Greek **debt restructuring** is expected before the end of 2015 – but **no debt *write-down*** is currently planned.
- If a *write-down* occurs, it needs to be **EUR 150 billion** (40 per cent) and would bring public debt down to 120 per cent of GDP (regarded as a sustainable level.)
- **The 2012 debt write-down** was about EUR 110 billion, or roughly EUR 10,000 per Greek.

But the Greek crisis also confirmed that today there are **no legal options for ejecting individual countries** from the euro project. The only possibility that seems available is for a country to introduce its own means of payment, in practice giving up the euro while remaining in the euro zone. This hypothetical solution resembles the way the Exchange Rate Mechanism (ERM) crisis of 1992-93 was handled. Instead of jettisoning the entire fixed rate system, the fluctuation bands for ERM currencies were set at ±15 instead of ±2.25 per cent.

Winning full financing until 2018 will not mean Athens can relax. The bail-out will be evaluated continuously and any deviations from Greece's promises will mean bail-out payments can be suspended.

Greece: The third bail-out package



Unexpected US intervention was another factor in getting Germany to agree to the rescue package. Conspiracy theorists even argue that during crisis talks, the US persuaded the International Monetary Fund (IMF) to publish its Greek debt analysis early to hasten an agreement. Washington's reasons include fears that Greece's problems may add to heightened political instability in the Middle East, Turkey and the Balkans.

New German concessions – little in return

Germany's strategy late in the crisis talks was apparently to try setting **demands** so high that Greece would **spontaneously withdraw and abandon the euro**. This strategy failed, but during recent euro crises Germany has consistently maintained that greater financial help to various countries should go hand in hand with efforts to achieve **greater euro integration** and, in practice, **less economic policy independence**.

New roadmap for EU political union unveiled

During the June 25-26 European Union Summit, the President of the European Commission presented a report entitled ***Completing Europe's Economic and Monetary Union***. This is a "roadmap" for a three-stage process of **achieving an EU political union during the period 2015-2025**. The report is very similar to the roadmap that the Commission unveiled in 2012.

A substantial deepening of economic, financial and political integration between euro zone countries will be crucial in creating long-term stability in the currency zone and reducing the risks of new euro crises. The following three elements are crucial in creating a deeper EMU:

1. 1. A **fiscal** (transfer) **union** enabling the redistribution of tax money between the 19 euro zone countries;
2. An **economic policy** that harmonises countries' taxation levels, pension and benefit systems etc.;
3. A democratic **supranational political infrastructure** including a single government and a new parliament.

At present, such **federalism is out of favour** and it is becoming ever more difficult to set tough performance criteria for individual countries. As **anti-austerity policies keep gaining ground**, Germany's attitude along with steps towards greater integration and federalism instead risk fuelling extreme and populist forces not only in Greece but elsewhere in the EU.

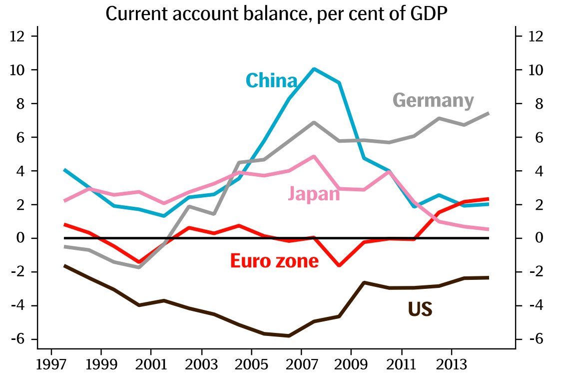
Back doors into "fiscal union"

There is little indication that euro zone countries – with few exceptions – are prepared to take political steps to create a fiscal union. This is indirectly confirmed by their rejection of a Greek debt write-down, although French President François Hollande is among those wishing to keep that option open. A 30-40 per cent "haircut" would violate the fundamental disciplinary principles of the euro project: a country should not plague other euro zone members with its poor public finances.

Absent a debt write-down, there is a "back door" to fiscal union. It requires a change in German economic policy: the country's yearly financial surplus (about 8 per cent of GDP) must be cut and demand increased, or investment capital must be "directed" to other euro zone countries. Since the euro was created in 1999, Germany's net international investment position (NIIP) has climbed from near-zero to almost EUR 1.4 trillion. But today **Berlin has little interest in pursuing a more expansionary, growth-sustaining economic policy**. Meanwhile relations between Paris and Berlin have cooled.

German national surpluses at record levels

Current account balance, per cent of GDP



Source: Macrobond

The second "back door" into a fiscal union is already in place. The European Central Bank (**ECB**)'s unconventional monetary policy and **sovereign bond purchases enable governments to borrow extensively on favourable terms** but without using other countries' tax money. ECB policies have helped stabilise inflation expectations, but the flip side is that they block the signalling function of interest rates and bond yields. Credit and interest rate risks as well as credibility problems are not correctly priced. In addition, during the Greek crisis the ECB has been forced to abstain from making independent credit evaluations when lending. This is politically understandable yet illogical, since Greece actually defaulted on June 30.

Greece's path begins with an uphill climb

The Greek government has very little time to regain the confidence of its own people (stopping the bleeding from Greek banks), its euro zone colleagues (normalising relations) and other countries, including IMF members. **The Greek economy has been damaged** by the domestic political events of 2015 and the closure of the banking system. Capital controls are likely to persist in some form; Cyprus was forced to retain them for two years. Lower household purchasing power and lingering uncertainty that hampers capital spending are likely to lower short-term economic growth. A recovery will begin in 2016, after a 25+ per cent decline in the economy since 2008. Improved optimism and lower interest rates will improve growth prospects but normalisation will take a very long time.

A sizeable majority of the Greek parliament has voted to approve the crisis agreement. This signals that Greek politicians are acknowledging the crisis. Despite the split in his own party, Prime Minister Alexis Tsipras enjoys popular support – at least in the short term. This increases the likelihood that he will win the **snap election in September: the fourth since 2012**. The political opposition is also weak. It is crucial for Tsipras' future and political stability that growth returns in 2016, unemployment begins to fall and tax revenues increase.

Critics maintain that the **EU has gone too far** in trying to influence political events in one country and in practice is **seizing the role of guardian over economic policy makers**. Others argue that we must start getting used to this. If the euro zone is to achieve long-term stability, its 19 members will need to move towards greater federalism, a more supranational system, expanded common fiscal (transfer) policies and thus reduced economic policy independence at the national level.

The worst euro crisis – but not the last

It is unique for an EU, euro zone and OECD country to default. It is historic that withdrawal from the EU's currency union has been discussed. Continued high unemployment and debt as well as growing demographic challenges will make the currency union vulnerable in a world where the euro zone is squeezed by the "Great Transformation" = globalisation plus demographic, technological and environmental change.

The main problem for the euro zone will not be finding solutions to redistribute sovereign debt between members (most recently Greece). It will be solving the currency union's long-term economic, financial, political and institutional problems. Euro zone countries diverge greatly in terms of competitiveness, industrial structure and tax compliance. This indicates that Athens is far from closing the door to a "Grexit".

The Greek crisis may lead to **political after-shocks in the form of destabilising populism/extremism**. Germany and France hold elections in 2017, the same year that British Prime Minister David Cameron has promised a referendum on continued EU membership (some media predict a referendum in June 2016). The Greek debt crisis has again made the choices clear: **take steps towards political union and greater integration or risk continued instability and recurrent crisis**. The challenges of keeping the euro project and the EU together will grow. Germany will play a key role; the country is not likely to continue supporting and guaranteeing the system unconditionally. The question may arise: *Does the financial price exceed the political advantages?*

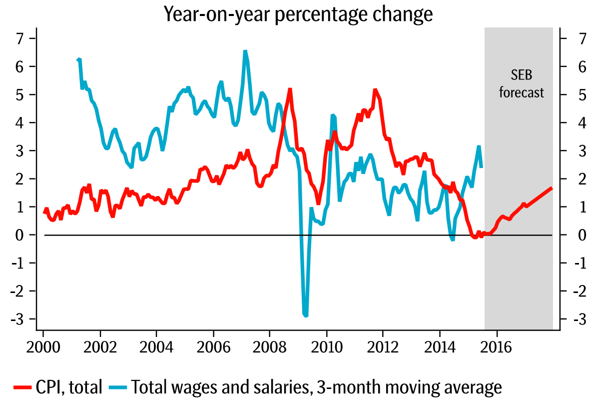
Households are the most important growth engine

- **Unemployment below equilibrium**
- **...is driving up wage and salary growth**
- **...but inflation will remain low**
- **The BoE will hike its key rate at a slow pace**

British economic growth has taken off again after a first quarter 2015 deceleration. Household and business indicators are exuding optimism. In manufacturing, confidence is low but overall indicators are compatible with far higher growth figures than hard data are showing. After topping the G7 countries in GDP growth last year, **the economy will grow by 2.7 per cent this year and 2.5 per cent in both 2016 and 2017**, we believe: higher than the consensus forecast. The UK will barely avoid falling prices in 2015. **Inflation will be 0.1 per cent this year, 0.7 per cent in 2016 and 1.4 per cent in 2017**, below both consensus and the Bank of England's inflation target. Instead, low unemployment will be the BoE's main argument for a gradual interest rate normalisation. We are still predicting that the first key rate hike will occur in February 2016.

Pay increases far exceeding inflation

Year-on-year percentage change



Source: ONS, SEB

Now that job growth is slowing from a 25-year high in 2014, **productivity will assume a major role**. The latest figures also show stronger productivity increases after several years of sluggishness. In recent years, the jobless rate has fallen rapidly and is well below the OECD's estimate of equilibrium unemployment. Looking ahead, we predict a gradual **decline in unemployment to 4.7 per cent at the end of 2017**, matching the low in the previous economic cycle. **Rising wage and salary curves** are evidence of a tight resource situation. Real hourly earnings will increase by 2.5 per cent this year: the fastest pace since 2007. The oil price slide is having a positive net impact on the economy, mainly because it is stimulates household purchasing power. This is probably another reason why consumer confidence has climbed to historically high levels. **Household consumption will rise by 3 per cent this year**, the strongest increase since 2005. Consumption will also grow decently in 2016 and 2017 despite expenditure cuts that the new all-Conservative government has unveiled. Fiscal policy will thus have a clear tightening bias in 2016 and 2017. The budget deficit will shrink from just over 5 per cent of GDP last year to 2 per cent by the end of our forecast period.

Lower oil prices will also benefit capital spending outside the oil industry. Business confidence is high, especially in the construction and service sectors, even though the **referendum on EU membership is approaching and may occur as early as June 2016**: a year earlier than originally planned. Public opinion surveys show that the British will probably vote for continued membership. If Prime Minister David Cameron can also improve membership conditions for the UK, the majority in favour of membership is likely to be overwhelmingly large.

One source of concern is the current account deficit, which swelled to 6 per cent of GDP last year. The deficit has never been larger in peacetime, and there is a risk that foreign investors may hesitate if the public opinion situation before the EU referendum becomes more even. This, in turn, risks driving the pound lower and inflation higher. But our main forecast is instead that inflation will remain low during the next couple of years. Our inflation forecasts have been revised downward due to lower oil prices. When oil price changes disappear from the 12-month figures, however, we expect inflation to move gradually upward. **Price increases will still end up below target in 2017 as well**, measured as annual averages. Low international prices and an appreciating pound will offset faster price increases. Improving productivity will hold back unit labour costs, so pay growth will not drive inflation much.

We are sticking to our forecast that the **first step in the BoE's interest rate normalisation will occur in February 2016**. Historically, there has been a strong correlation between UK and US key interest rates, with US policymakers in the driver's seat. This time around, BoE rate hikes will be even slower than Fed ones; the key rate will be 1.25 per cent at the end of 2016 and 1.75 per cent at the end of 2017. When the ECB loosens monetary policy, the pound is likely to climb against the euro in the coming year. At the end of 2016, the EUR/GBP rate is 0.67 and the GBP/USD rate is 1.57.

Central Europe resilient to continued Russian recession

- **Russia is being squeezed by low oil prices and sanctions, but inflation shock is fading**
- **Sanctions policy will continue in 2016**
- **IMF will save Ukraine from bankruptcy**

Economic trends in Eastern (including Central) Europe will persist during the next two years. Conflict-embroiled **Russia and Ukraine will remain economically weak** but regain some growth. Their currencies will appreciate. However, in the short term such upturns will be hampered by low oil prices and a weak currency reserve, respectively. Meanwhile **Central Europe, and to some extent the south-eastern part of Eastern Europe, will continue to show good stable growth** – mainly driven so far by dynamic private consumption. Looking ahead, growth will also benefit from gradually rising exports and capital spending, though the latter will be hampered by nearby geopolitical turmoil. Strong real household incomes, falling unemployment, relatively minor trade ties with Russia and growing demand in the far more important German market are the main reasons behind good resilience to Russian weakness and Ukrainian instability. Only the Baltics, Bulgaria and various Central Asian countries have large trade exposure to Russia. The **Greek crisis poses no direct threat** to Eastern Europe. The Balkan countries have some financial and trade exposure, but nothing dramatic. Only Bulgaria and Macedonia are in the higher-risk zone, with Greek banks holding over 20 per cent of banking assets. Bulgaria also has relatively high exports to Greece (3.5 per cent of GDP).

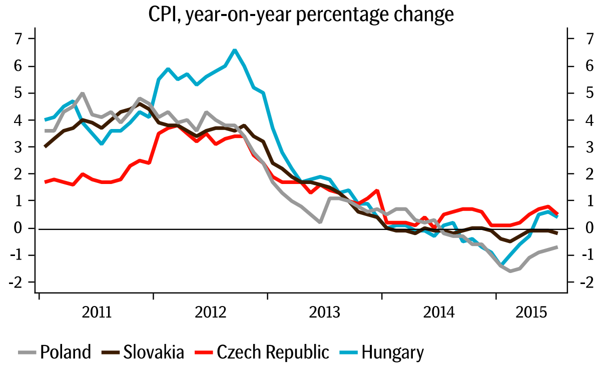
Poland and Czech Republic lead the way

In **2015-2016 Poland and the Czech Republic will see the region's fastest growth**, with GDP increases averaging over 3.5 per cent, just above Poland's potential growth but well beyond Czech potential. This year the Czechs will enjoy the fastest expansion, with favourable economic conditions, especially for the auto industry, and strong job growth. Growth is also broadening in Poland, where previously low political risk rose sharply after May's unexpected presidential election victory by Andrzej Duda of the opposition Law and Justice Party. Meanwhile the governing coalition of Civic Platform and the small agrarian People's Party is losing public support as the October parliamentary election approaches. A change of government, with the conservative Law and Justice taking power, might lead to more populist policies: for example, tax hikes on banks and a more euro-critical stance, including looser fiscal policies. This would not significantly change the growth picture but could temporarily weaken the zloty.

Inflation has bottomed out or will soon do so in most countries, except Russia and Ukraine. It will **climb weakly** next year, after falling commodity prices push it down this autumn. In most countries, price upturns will eventually be driven by labour shortages and relatively fast pay growth. **The interest rate-cutting cycle is over in most of Central Europe, but only cautious rate hikes will occur in 2016-2017.** The ECB's loose monetary policy is one reason why central banks in these countries will choose slow rate hikes; otherwise their currencies risk climbing too much, making it even **harder to achieve their inflation targets** looking ahead two years.

Inflation in Central Europe bottoming out after sharp decline

CPI, year-on-year percentage change



Source: National statistics offices

A lengthy Russia-Ukraine conflict

One fundamental assumption in our Eastern European analysis since the **Russia-Ukraine conflict** broke out in early 2014 has been that it would be **long-lasting**. This remains true. Russia wants to disrupt Ukraine's westward orientation, which aims at NATO membership by 2020 and joining the EU by the same year. An imminent political decentralisation process in Ukraine will also give Russia opportunities to gain more influence over the infected Donetsk and Luhansk regions in the east. Greater regional autonomy was part of the latest "Minsk 2" peace agreement in February 2015. In July, the Ukrainian parliament preliminarily approved a constitutional amendment to this effect. Meanwhile Minsk 2 itself appears fragile. This summer there have been reported flare-ups between rebels and Ukrainian forces, among the worse since the deal was signed.

The EU and US (plus various other countries) will **continue their sanctions policy** against Russia, which in turn has imposed counter-sanctions. As we predicted, the EU decided in June to extend its economic sanctions for another six months, until January 31, 2016. They include stringent restrictions on Russian borrowing in European capital markets as well as an arms embargo and a ban on some technology exports to

Russia's energy sector. The US, which was more strident than the EU about sanctions early in the Ukraine conflict, has imposed similar economic sanctions against Russia. The EU and US also have "blacklists" of key individuals in politics, business and organisations in Russia and Ukraine, including travel bans and freezing of bank assets; the EU blacklist runs until September 15. Russia responded to the EU extension by adding another year to its ban on food and agricultural imports from countries pursuing a sanctions policy against it, which it imposed in August 2014. **There is a high probability that neither side will end sanctions during 2016 either.**

We believe that **Russia will lose the most in the sanctions war**. The negative economic effects are relatively big in Russia, but small among those hit by its counter-sanctions. Financial damage in Russia has also been more than expected. Russia's import restrictions have been relatively toothless, since it buys food and agricultural products from many countries; only Lithuania has significant exposure to these goods (4 per cent of total exports). But individual producers and farmers as well as transport companies are relatively hard hit by Russian sanctions. Meanwhile Russia has hurt itself, since lower supplies have helped fuel higher food prices. The IMF recently did a model calculation showing that sanctions against Russia and counter-sanctions, via weaker consumption and capital spending, may have lowered Russian GDP by 1-1.5 per cent.

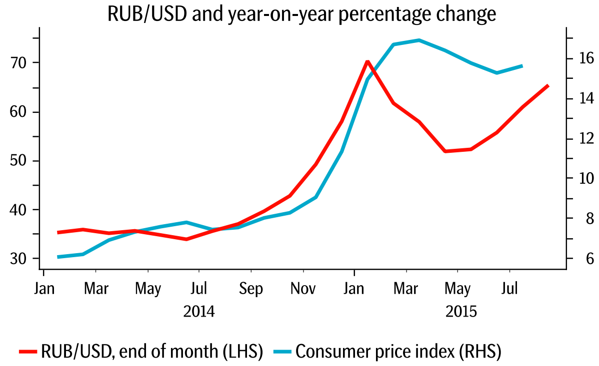
Continued Russian recession next year

In the second quarter, Russia's GDP slide accelerated to 4.6 per cent year-on-year from 2.2 per cent in Q1. This downturn was driven by continued declines in private consumption and capital spending. Meanwhile the worst inflation shock, triggered by the massive rouble depreciation of late 2014, has begun to fade somewhat after apparently culminating at nearly 17 per cent in March. Yet inflation remained at a high 15-16 per cent, implying that real wages fell more than 8 per cent in Q2.

Russia's growth outlook deteriorated further after the recent relatively sharp **oil price slide**, which we believe represents a long-lasting downturn. In recent months, the consensus among professional economists about 2015 growth has become less pessimistic, after the earlier oil price and rouble stabilisation and a lower-than-expected GDP downturn in Q1. We are choosing not to follow this wave of GDP forecast revisions. Because of sagging indicators (manufacturing PMI, for example, fell to 48.3 in July from 48.7 in June and has remained below the expansion threshold of 50 since 2014), we are **adhering to our forecast of -4.0 per cent in 2015 from the May issue of *Nordic Outlook*. We are adjusting our 2016 forecast downward from zero to -1.0 per cent**. The main reason is a **lower Brent oil price assumption** for 2016: USD 55/barrel, compared to USD 70 earlier, but also signs that sanctions policies will continue. In **2017 Russia will revert to growth** of 1.5 per cent, sustained by somewhat higher oil prices, improved international economic conditions and lower, more normal inflation and interest rates that will enable household consumption to bounce back after three very weak years. Unemployment, which has climbed this year from a historically low 5 per cent to 6 per cent – close to equilibrium level – will continue somewhat higher. **Inflation will fall** from an average of 15 per cent in 2015 to 6 per cent in 2017. Eventually a stronger rouble will help push down inflation. The lower inflation outlook and weak economy will allow **further stepwise key interest rate cuts**, though the central bank will slow the pace this autumn due to the shaky rouble. The bank has cut its key rate from a crisis level of 17 per cent in December to 11 per cent, most recently in July. We foresee a 7 per cent key rate by the end of 2016.

Russian inflation has peaked after currency-driven upturn

RUB/USD and year-on-year percentage change



Source: Macrobond, Russian Federal State Statistics Service

Ukraine will avoid default

Overshadowed by all the attention on Greece, **Ukraine is in an acute debt financing crisis**. Because of its previous dramatic currency depreciation (especially early in 2015) and a continued plunge in GDP, Ukraine's currency reserve has been drained and **public debt** has surged from about 70 per cent of GDP at the end of 2014 to more than 100 per cent. It **will move towards 150 per cent this year**. As recently as June, the government itself feared default this summer, but in late July it managed to make a critical Eurobond interest payment of USD 120 million. We still believe that despite such pressures, Ukraine will **avoid default. The International Monetary Fund will probably provide continued bail-outs**. This summer the IMF retracted its spring demands that Ukraine must first reach agreement with private lenders on a debt write-down before it disburses more money. A debt write-down is likely; Ukraine is aiming at 40 per cent (over USD 15 billion). The next crunch date is September 23, when a bond matures.

Ukraine's GDP slide will accelerate this year; in June we lowered our forecast from a GDP decline of 8 per cent to **12 per cent**. The downturn will be broad. Industrial production and exports are being disrupted due to destroyed production facilities and smashed infrastructure. Household consumption is plunging because of the currency-driven inflation shock, but Ukraine's currency stabilised after the IMF announced in March 2015 that it would expand bail-out loans. Capital spending is being squeezed by geopolitical uncertainty. **We are lowering our GDP forecast for 2016 from +2 per cent to +1 per cent.** Domestic demand will remain depressed, with households being squeezed by continued very high inflation, though lower than this year. **We expect weak export-led growth of 2 per cent in 2017.** The important agricultural and steel sectors will lead the recovery, which will begin cautiously during 2016.

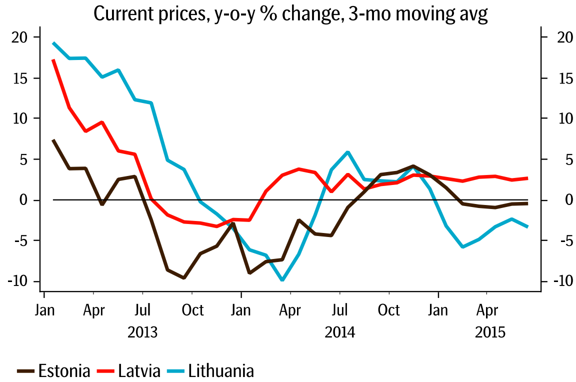
Decent growth is sustained by household consumption

- **Hampered by Russia and geopolitical fears**
- **Lithuania: Sharply lower growth forecast**
- **Wages will drive inflation in Estonia, Latvia**

Rising private **consumption will continue to sustain growth in the Baltics as exports and capital spending are again hampered next year by Russia's recession and import restrictions, as well as geopolitical uncertainty** due to the Ukraine conflict. Consumption is rising at a healthy pace. Real household incomes are sharply higher due to gradually falling unemployment, high nominal pay increases and low inflation, although prices will begin to surge in Estonia and Latvia next year. Despite low interest rates, credit growth will remain relatively low for another year, partly because of international uncertainty. The Lithuanian housing market has finally reawakened. This may drive credit demand somewhat higher. Exports are weak and recovering slowly. Over time, growing demand in Western and Central Europe and reorientation to new markets in Asia, the Middle East and elsewhere will offset lost sales to the important Russian market. So far this has not happened in Estonia and Lithuania, where exports have been surprisingly weak this year, mainly due to the weak Finnish economy, Russia's food import ban and lower oil prices. Business investments, which were low even before the Ukraine crisis, are gradually rising – sustained by EU structural funds, housing construction and low interest rates. Overall, we expect **accelerating but moderate GDP growth in 2016-2017**. Not until 2017 will the expansion become broad-based and reach its 3-3.5 per cent potential. **Worsening supply constraints in the labour markets** will hamper long-term growth.

Exports still weak, but increasing a bit in Latvia

Current prices, y-o-y % change, 3-mo moving avg



Source: National statistical offices

All three economies are in **relatively good internal and external balance**. **There is currently no inflation**. Low energy prices and weakly rising international inflation will restrain future price pressure as well. **In Lithuania, inflation will rise very slowly** to a 1.2 per cent average in 2017: a price squeeze on electricity due to new energy channels will help keep inflation extremely low in 2016. **In Estonia and Latvia, inflation will climb faster**, due to larger accumulated **wage pressures**, to averages of 2.7 and 2.2 per cent respectively in 2017. Tight labour markets may cause somewhat higher inflation than in our forecasts. Estonia's jobless rate of about 6.5 per cent is already a couple of percentage points below equilibrium, and the other two countries will move towards balance situations (9-10 per cent) in the coming year. We anticipate that **public budgets and current accounts will show small deficits in 2015-2016**. But pressure to boost public expenditures, among other things for defence, may increase budget deficits. And current account deficits risk expanding in the long term as import activity increases.

Here are our GDP forecasts for each of the Baltic countries:

Estonia's strongly export-dependent economy is slowly emerging from a relatively deep slump in 2013-2014. Retail sales have been dynamic for some time and showed a 10 per cent year-on-year increase in June – the strongest surge since February 2012. Manufacturing is still underperforming, though. Second quarter GDP was a decent 1.9 per cent higher year-on-year, after a weak start to the year. Growth will average 2.2 per cent this year and climb gradually to 3.4 per cent in 2017.

Latvia is chugging along better than the other Baltics and seems the most resilient to Russian weakness and import sanctions. Unlike Estonia and Lithuania, total exports have shown stable growth since the Ukraine conflict began early in 2014, although they have increased at a modest 2-3 per cent rate in current prices. Successful geographic diversification of food exports may have helped. But GDP growth is mainly driven by private consumption, which speeded up in the second quarter to a year-on-year pace of 2.7 per cent, from 1.9 per cent in Q1. On average, GDP will increase by 2.4 per cent this year, 2.7 per cent in 2016 and 3.8 per cent in 2017.

Lithuania is more affected by Russia's recession and sanctions than we expected. Food and other agricultural exports have been relatively hard hit, but the transport sector has held up well and is showing overall positive growth. Retail sales have remained strong. The real estate market has begun to show movement, although prices are still sluggish. The GDP increase in Q2 – 1.3 per cent year-on-year – was unexpectedly weak. **We are lowering our GDP growth forecasts relatively sharply to 2.0 per cent in 2015 and 2.8 per cent in 2016**. We foresee 3.2 per cent growth in 2017.

Good growth, but major economic policy challenges

- **No real momentum in manufacturing sector**
- **Households cautious despite good finances**
- **Increased tensions in national wage round**
- **Inflation rising, but will not reach target**
- **Riksbank will lower its key rate once more**
- **Cautious budget, but pressures mounting**

During the first half of 2015, growth largely followed our estimates in May's *Nordic Outlook*. **Our forecast of a 3.0 per cent GDP increase this year remains unchanged.** Gradually improving economic conditions in Europe and the US suggest that GDP will keep growing above trend in 2016 and 2017: we expect increases of 2.8 and 2.5 per cent, respectively. Growth is thus relatively good in international terms, but if we factor in Sweden's rapidly increasing population, its performance is less impressive. Lethargic international economic growth is holding back exports. Due to the cautious behaviour of households and businesses, growth will not be fast enough to push down unemployment in a clearer way.

Sweden's wage round will enter its most intensive phase early in 2016. High pay demands in some domestically oriented fields – especially the public sector – may create tensions, given the benchmark role of manufacturing in wage formation. But depressed inflation expectations and a long period of good real wage increases suggest that collective pay hikes will not be high. **We expect them to average 2.4 per cent per year:** two tenths higher than in the preceding three-year period, but somewhat below Riksbank forecasts. A weaker krona and higher indirect taxes will still help push up inflation from today's low levels. CPIF (CPI excluding interest rate effects) will reach nearly 2 per cent early next year but fall again, ending 2017 below the Riksbank's 2 per cent target.

Because of low inflation expectations and the risk of krona appreciation, the Riksbank remains under pressure. We believe **it will cut the repo rate once more to -0.45 per cent this autumn** but make no asset purchases beyond those already announced. Late in 2016, the bank will begin hiking the key rate, but it will be a low 0.75 per cent at the end of 2017. Such loose monetary policy will lead to worsening imbalances related to the housing market and household debt. We expect the Riksbank to eventually pay a bit more attention to this, but the struggle to preserve the credibility of its inflation target will continue to dominate monetary policy. The rapid population increase will also create heavy demand for housing and fuel higher home prices. Although housing construction is increasing, it is not happening fast enough to ease imbalances.

The political situation is dominated **by gridlock and a lack of constructive cooperation between the political blocs**. The non-socialist opposition is trying to update its policies with an eye to winning the 2018 election, while the leftist minority government is trying to deal with both its vulnerable parliamentary situation and internal conflicts. We expect a relatively cautious 2016 budget in September, but the finance minister will be under gradually increasing pressure to enact more aggressive policies. The official budget surplus target will probably be transformed into a balanced budget target, but this will have little impact during the next couple of years.

Upturn in manufacturing but no real lift-off

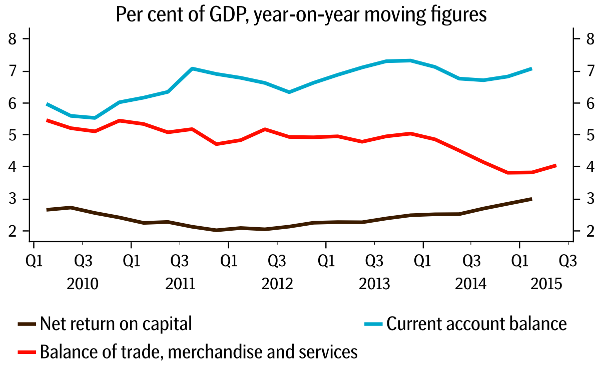
Merchandise exports and industrial production rose in the first half of 2015 after remaining largely flat since late 2012, driven mainly by somewhat improved European economic conditions and a weak krona. Forward-looking **indicators do not signal that any vigorous recovery is on the way**. Slightly better growth in Europe and the US is being offset by deceleration in China and various other emerging market (EM) countries. The slowdown in the EM sphere is clearly reflected in falling exports and production in the mining and metals industry, while the vehicle and telecom sectors seem to be benefiting the most from stronger economic conditions in Europe.

Overall merchandise exports will remain weak this year, rising by about 2 per cent. Growth will accelerate to nearly 4 per cent in 2016 and 2017. Yet total exports will increase relatively rapidly because **service exports appear likely to climb by nearly 10 per cent this year**. This expansion is occurring in such sectors as business services, transport, tourism and financial services. This strong service export trend has been apparent for a fairly long time and will probably continue in 2016-2017, but growth will not be as impressive as in 2015.

The trade surplus has gradually decreased in the past five years, mainly because merchandise imports have increased faster than merchandise exports, but in the past six months the surplus has rebounded because of the sharp oil price decline. Strong domestic demand compared to other countries suggests that Sweden's trade surplus will again shrink in 2016 and 2017. The current account surplus has remained high because **net capital income has increased to nearly 4 per cent of GDP**. Thanks to low interest rates, interest expenses for Sweden's debts abroad are falling. Although Swedish interest income abroad is also decreasing, a large proportion of assets abroad consist of direct investments and equities, and capital income is thus substantially more robust than expenses.

Lower trade surplus, but continued strong current account

Per cent of GDP, year-on-year moving figures

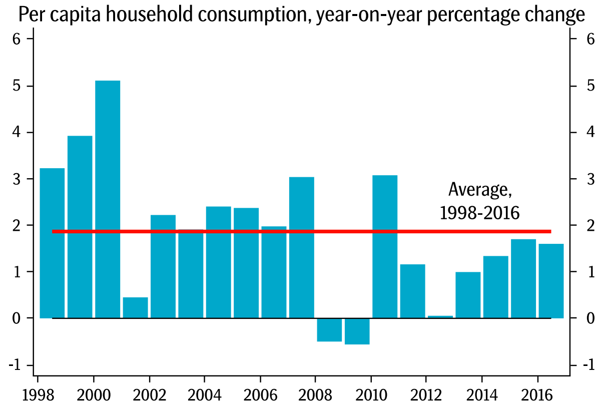


Source: Macrobond

driven by growing population; per capita, it is increasing more slowly than the historical average.

Modest consumption upturn in historical terms

Per capita household consumption, year-on-year percentage change

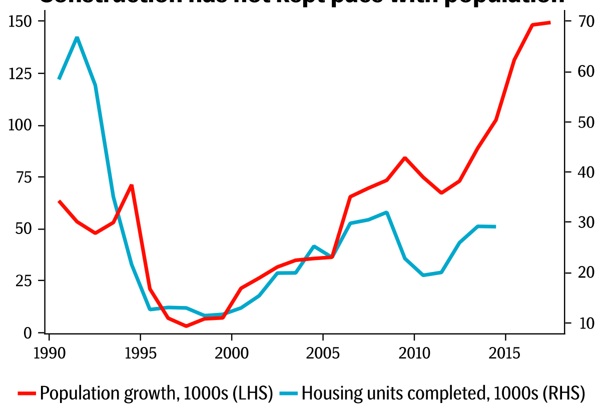


Source: Statistics Sweden

Home-building will push up investments

Industrial companies remain cautious about investments related to expansion, although the latest survey indicates a slight upturn this year after declines in 2013 and 2014. Domestically oriented sectors have more ambitious plans. Above all, a continued rapid increase in housing construction is contributing to a rather good rate of increase for total capital spending. A record-setting population increase over the next couple of years will create strong pressure for home-building. According to Statistics Sweden's updated forecast, population will grow by nearly 150,000 annually in 2015-2017. In light of this, construction of some 30-40,000 housing units per year is far from sufficient, **making the housing issue a major economic policy challenge** in the future. Overall housing construction will climb to 5.5 per cent of GDP in 2017. Total capital spending will grow by 6 per cent in 2016 and 2017.

Construction has not kept pace with population



Source: Statistics Sweden

Cautious households continue to save

Private consumption is growing at a relatively good pace and has gradually accelerated so far in 2015. Good real wages suggest that consumption will keep growing at a 2½ per cent pace in the next couple of years, although rising inflation will erode purchasing power a bit in 2017. Consumption is partly driven by growing population; per capita, it is increasing more slowly than the historical average.

Households have maintained their savings ratio despite strong wealth increases and rising employment. **Concerns about future home prices and the sustainability of public social benefit systems** are probably important reasons. Households may also be seeing the housing situation in a very long time perspective. Although the imbalance between housing supply and demand will drive up prices in the short term, it will create major problems when the next generation is ready to house-hunt. If households factor in this generational problem, rising home prices will create a motivation for increased savings that may neutralise traditional expansionary wealth effects.

Household income and consumption

Year-on-year percentage change

	2014	2015	2016	2017
Consumption	2.4	2.5	2.6	2.5
Real incomes	2.6	4.0	2.1	2.6
Savings ratio, %	15.8	16.9	16.5	16.6

Source: Statistics Sweden, SEB

Interest rates, population driving prices

Home prices started rising again when the Riksbank began cutting interest rates in 2012. They are now growing at 15 per cent year-on-year. Lending to households has also taken off. The annual increase is about 7 per cent: higher than the 4 per cent of income compatible with a constant debt ratio. There is little indication that the upturn will cease in the near future. Interest rates on mortgage loans may be squeezed further, and political disagreements about details the launch of loan amortisation requirements will probably be delayed until summer 2016. When such repayment requirements are introduced, home prices increases will probably slow down. Given high loan-to-value ratios, even modest interest rate hikes will have an impact on prices and lending**. We believe that home price increases will slow to 8-9 per cent during 2016** and that prices will then level out in 2017.

The risk picture is complex. The very rapid population increase suggests that the home price upturn may accelerate and last longer, but historical and international experience indicates that rapid, lengthy upturns such as Sweden's generally lead to major price declines. International organisations are warning about this in increasingly forceful terms.

The labour market

Per cent and year-on-year percentage change

	2014	2015	2016	2017
Unemployment, %	7.9	7.5	7.3	6.9
Job growth	1.4	1.2	1.3	1.2
Labour force	1.3	0.8	0.9	0.8
Population aged 16-64	0.3	0.9	1.2	1.2
Productivity	0.6	1.6	1.4	1.5

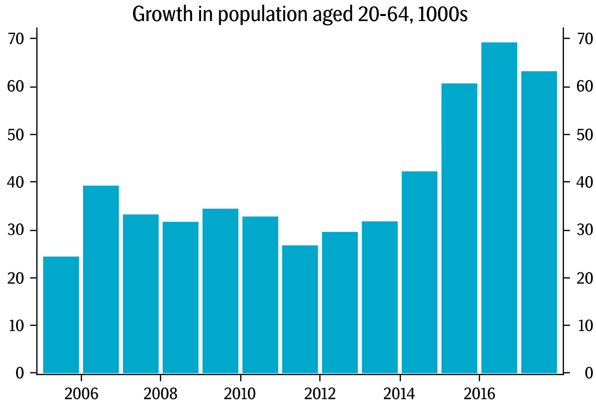
Source: Statistics Sweden, SEB

Rapid job growth, stubborn unemployment

Employment has continued to grow at a healthy pace in 2015, averaging 1.5 per cent year-on-year. Decent GDP growth suggests that this growth will continue at about the same pace. This is supported by the number of job vacancies listed at the Public Employment Service, which has reached a new record.

Rapid increase in working-age population

Growth in population aged 20-64, 1000s



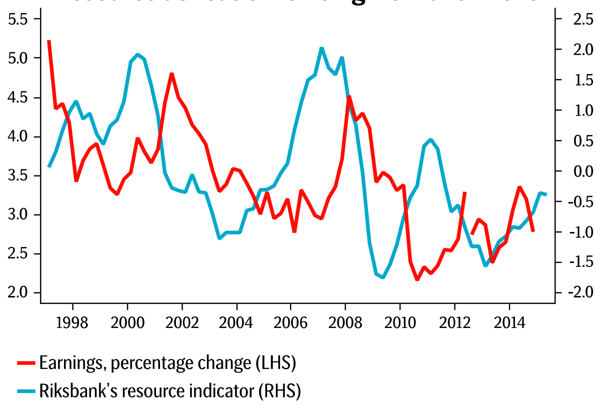
Source: Statistics Sweden

The trend of unemployment is more difficult to read, but in recent months a downturn is discernible, although summer statistics are especially uncertain. The labour force trend is also very hard to assess. The driving force in the rapid labour force upturn of recent years has been strong population growth and a higher participation rate, due to a large decline in the number of people with disability pensions and on long-term sick leave. The participation rate increase appears to be peaking, but population growth is accelerating; the number of working-age people will increase by 60,000-70,000 per year during 2015-2017, according to Statistics Sweden's forecast. Although labour force participation is relatively low in the main categories of people that are driving population growth, the upturn is so strong that unemployment is falling very slowly.

Capacity utilisation climbing gradually

The growing number of people with little formal education and with weak Swedish language skills indicates that the equilibrium unemployment level will rise. We agree with the National Institute of Economic Research (NIER)'s estimate that during the next 2-3 years, it will approach 7 per cent. Given our forecast, this would imply that unemployment will reach equilibrium by the end of 2016. **The Riksbank's indicator shows that resource utilisation has climbed in the past year**, but the level does not yet signal that wage and salary increases will accelerate. Although some capacity restrictions may be felt late next year, increased international labour market mobility will help ensure that they are milder than during earlier expansions.

Resource utilisation is rising from a low level



Source: The Riksbank

Pay hikes a bit higher in new agreements

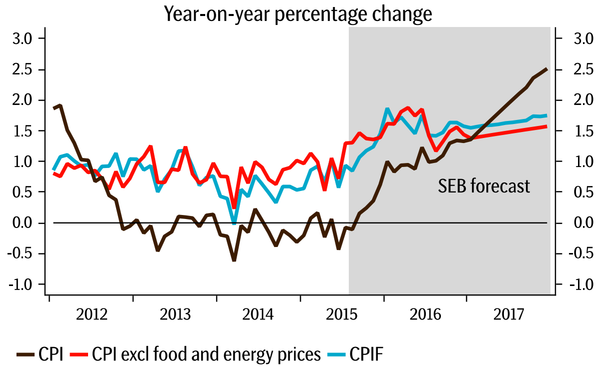
We expect the national wage round early next year to result in a slightly higher rate of pay increases than the collective agreements signed early in 2013 (see theme article) – driven by higher pay demands in the public sector and a somewhat stronger economic situation. Low inflation expectations will pull in the opposite direction, however. We expect **total pay increases of 3.0 per cent during 2016 and 3.2 per cent in 2017**. Although this is more than during the latest three-year period, it is lower than the historical average of 3.5 per cent and somewhat below the Riksbank's forecast. A gradual strengthening of productivity growth will also make average unit labour cost in 2016-2017 lower than in 2013-2015.

Higher inflation, but below target

In July, inflation was surprisingly high: CPIF climbed by 0.9 per cent year-on-year. CPI excluding energy and food prices rose 1.3 per cent, which indicates that underlying inflation pressure is increasing. Core inflation has been volatile over the past 6-12 months, though, largely due to big fluctuations in foreign travel prices. For this reason, we regard the inflation upturn in July as temporary. But this upturn still supports the **perception that a weak krona is helping fuel rising inflation** after the depressed levels of recent years. Higher import prices and higher price expectations in the retail sector also point to rising core inflation during the rest of 2015. Together with a slowing of downward energy price movements, this will cause CPIF to climb to about 1.5 per cent in December of this year, but the impact of the recent oil price decline may be larger than we have assumed. This implies a downside risk in our forecast.

Inflation has bottomed out but is unlikely to reach the Riksbank's 2 per cent target

Year-on-year percentage change



Source: Statistics Sweden, SEB

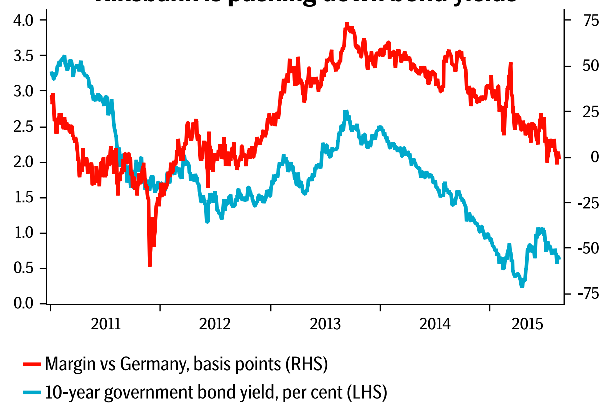
Higher indirect taxation – in the form of reduced deductions for home renovation costs and higher petrol taxes – will cause the inflation rate to speed up further early next year. **Yet CPIF will not actually reach 2 per cent**, and we also expect the inflation rate to slow a bit during the second half of 2016 when the effects of krona depreciation gradually fade. Successively stronger economic conditions and somewhat higher international prices will trigger higher inflation again in 2017. We expect CPI to gradually converge towards CPIF during the coming year, driven by base effects from falling mortgage rates in 2014 and the first half of 2015. During 2017 CPI will increase faster than CPIF, since we expect mortgage rates to rise.

Desperate Riksbank will cut key rate again

We believe that the Riksbank will need to revise its inflation forecasts downward this autumn. Combined with the risk that the krona will appreciate as soon as the market begins to doubt the determination of the bank's Executive Board, this suggests a further rate cut. **We are thus sticking to our forecast of a repo rate cut of 10 basis points to -0.45 per cent.** Since both inflation and growth figures have recently been somewhat higher than expected, there is a greater probability that the Riksbank will hold off until October, but our main scenario is still that the rate cut will occur in September. We believe this will be the last rate cut and that the central bank will make no further bond purchases after those announced in July are completed in December. The main trend is still that inflation will rise and that economic growth appears to be strengthening in line with the Riksbank's forecasts. Once collective pay agreements are in place, the Riksbank's need and ability to influence expectations will also diminish, but continued very low inflation expectations and the possibility that the European Central Bank might extend its quantitative easing programme are factors that may force the Swedish central bank to take further action.

The rate path in the Riksbank's July report implies that the repo rate will start rising in mid-2016, revert to zero by year-end and reach about 0.5 per cent by the end of 2017. This forecast assumes that CPIF will climb above 2 per cent by early 2016 and remain there for another two years. Our own inflation forecast is below 2 per cent throughout our forecast period, which suggests a gentler path. However, we believe that the **Riksbank will eventually become less focused on inflation**, amid falling unemployment and increasing financial imbalances. After the Fed and Bank of England have begun their key interest rate hikes, the Riksbank will begin a cautious rate hiking cycle from an extremely low starting level. We expect an initial repo rate hike to -0.25 per cent late in 2016 and continued hikes to 0.75 per cent by the end of 2017.

Riksbank is pushing down bond yields



Source: Macrobond

Long-term bond yields lower than Germany

Because of the Riksbank's aggressive monetary policy, Swedish 10-year government bond yields are now on a par with German ones. Once the repo rate has been cut again in September, we believe that the spread vs Germany may **become negative, falling to -10 basis points**. The Riksbank also plans to buy nearly 20 per cent of outstanding bonds, somewhat more than the ECB's corresponding German bond purchases. Sweden's low ratio of government debt to GDP also suggests that the impact on yields may be larger here. Next year and in 2017, yields will rise faster in Sweden than in Germany as the Riksbank prepares and starts its rate hikes. Ten-year Swedish government bond yields will be 1.35 per cent at the end of 2016 and 1.75 per cent at the end of 2017: 15 and 25 points above corresponding German yields, respectively.

Riksbank will keep down krona a bit longer

Despite strong economic data, the krona has recently fallen, driven by actual and expected Riksbank stimuli. But July's high inflation figure led to a rebound of nearly SEK 0.15 against the euro as expectations of further key rate cuts subsided. This underscores how important monetary policy is to the currency. Our forecast of a further key rate cut combined with continued expansionary policy signals suggests that the krona will remain weak, but both domestic and foreign market players already seem to have taken large positions based on a falling krona, thus limiting room for further weakening. The tug-of-war between these opposing forces is quite even. **We expect a EUR/SEK exchange rate of around 9.20 at year-end**. As inflation moves closer to target next year and the Riksbank's rate hikes approach, both relative economic situations and relative monetary policies suggest a slightly stronger krona. In a long-term perspective, the krona is undervalued, which will also support an upturn. Our forecast is that the EUR/SEK rate will be 8.80 at the end of 2016 and 8.60 at the end of 2017. This implies USD/SEK rate of 8.40 at the end of next year and 7.80 at the end of 2017.

Tactical trench warfare = political gridlock

Swedish politics is currently dominated by tactical trench warfare rather than constructive cooperation. The non-socialist Alliance's focus is on revising and reformulating its policies with an eye to winning the 2018 election. Meanwhile the leftist government must deal with both its weak parliamentary position and internal tensions between Social Democrats and Greens. There has also been criticism of government policies from within the Green Party and the labour movement. Opinion polls now show such a powerful tailwind for the right-wing populist Sweden Democrats that they are challenging the Moderates (the leading Alliance party) and Social Democrats for the position of the second largest or even largest party. This has the potential to transform the domestic political landscape. The question is how long the other parties, especially in the Alliance, dare to honour the December Agreement (DA), which allows the government to stay in power and pass its budgets.

After their 2014 election loss and subsequent change of party chairman, the Moderates have been undergoing an identity crisis. Their coming party congress (October 15-18) will enable them to establish a clearer strategy. Party leaders are likely to win support for their proposal for somewhat more restrictive immigration policies, although this is likely to be controversial. As for economic policy, the party will probably eagerly pursue the issue of fiscal discipline and responsibility by underscoring the principle of financing reforms "krona-by-krona" and resisting proposals to change the official surplus target to a balanced budget target. Whenever possible, it will also seek to emphasise its disagreement with the government on "jobs vs benefits" issues. Criticism of the DA among Moderates seems to have receded, but may easily flare up again if the Sweden Democrats really threaten to become the largest opposition party or if the government begins to pursue more clearly leftist policies with the aid of the DA.

The government is also under pressure from the Trade Union Confederation (LO), the Left Party and others to pursue a more expansionary fiscal policy. Their critique is fuelled, for example, by the government's target of achieving the lowest unemployment in the EU by 2020, which seems increasingly unattainable without aggressive government action. Finance Minister Magdalena Andersson is trying to please both sides by not diverging too far from the call for fiscal responsibility she pursued during the election campaign. Her manoeuvring room is shrinking, since the government is being hit by **unplanned expenses in areas such as immigration policy, defence, infrastructure and sick pay**. This limits its chances of spending more on signature issues like social benefits and schools. There are also constraints on taxation, because during their campaign the Social Democrats promised not to raise taxes that many middle class voters consider sensitive, for example hiking real estate tax or cutting mortgage interest deductions.

In such a situation, it is natural to try to increase manoeuvring room by studying the potential for changing the official economic policy framework, for example by replacing the surplus target with a balanced budget target or somehow spinning off capital spending from the normal budget process. The NIER has now approved the principle of a balanced budget target, which indicates that this will eventually be enacted. The government has a good chance of winning the political battle with the Moderates on this point. But otherwise we do not believe that changes in the policy framework will be enacted.

Public finances

Per cent of GDP

	2014	2015	2016	2017
Net lending	-1.9	-1.4	-0.8	-0.2
Gen. gov't gross debt	43.8	44.1	43.4	43.0
Central gov't debt*	35.6	35.9	35.3	34.9
Borrowing req., SEK bn	72	60	17	15

Source: Statistics Sweden, SEB *Unconsolidated

Cautious budget, despite calls for stimulus

The spring budget bill was the first breakthrough for the government's fiscal policy after last autumn's political crisis. Revenue enhancements of SEK 8 billion (rising to SEK 20 billion in 2016) will finance school-related spending, higher unemployment benefits and infrastructure investments, for example. Meanwhile the government unveiled preliminary proposals for the autumn budget bill, including cutbacks in home renovation deductions, limits on indexation of the breakpoint for paying central government income tax, higher energy (fuel) tax and a phase-out of the earned income deduction, which together could raise around SEK 20 billion. Negotiations on the contents of the budget bill, which will be unveiled on September 21, have not yet been completed within the government or with the Left Party. The government has proposed cutting taxes for pensioners, eliminating the time limit on sick pay and expanding parental insurance. **Overall fiscal policy will be largely neutral or mildly expansionary**. The government will probably be criticised by left-wing Social Democrats and LO for not acting forcefully enough. This criticism may be difficult to deflect in an environment of weak public opinion figures, unemployment well above target and a monetary policy that has reached the end of the road.

Conflicting forces will affect public finances. Good growth in parts of the economy that yield good tax revenue – such as employment, consumption and construction – are bringing plenty of money into the government's coffers. So far this year, tax revenue has been higher than the National Debt Office and others had estimated, thereby lowering the borrowing requirement. However, there is underlying cost pressure in the areas of sick pay, immigration and capital spending. Our main forecast is that reforms will largely be financed in full but that other spending increases will be deficit-finance. **The shortfall in public sector net lending will fall from 1.4 per cent of GDP this year to near-balance in 2017**. Government debt will remain relatively stable at a bit above 40 per cent of GDP.

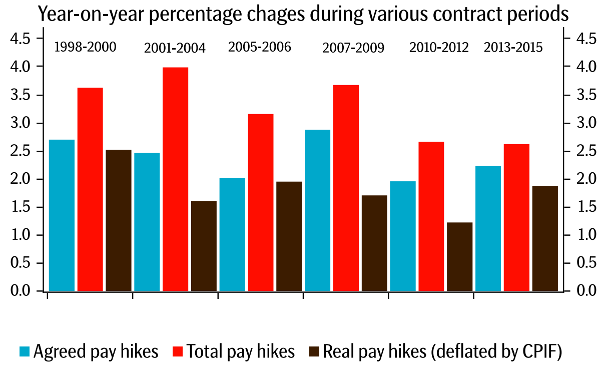
- **High real wage increases, but modest profit squeeze in recent years**
- **Weak international pay increases in spite of tighter labour markets**
- **Higher collective agreements than last time around, but lower than Riksbank's forecast**

The interplay between economic policy and wage formation is very important to Sweden's ongoing experiment with unconventional monetary policy. Irritation among unions and employers – because the Riksbank's failure to fulfil its inflation target threatens to destabilise wage formation – was the main reason for last summer's monetary policy shift. **Because of the coming wage round, the initiative will now lie with the labour market parties**. Once collective agreements are in place, the Riksbank will have far less opportunity to influence inflation via the expectations channel than in recent years.

Agreements covering most of the labour market expire next spring, including contracts for 1.6 million employees that run out at the end of March 2016, with a focus on manufacturing. A month later, 0.9 million people mainly in domestically oriented sectors will see their contracts expire. In recent rounds, industrial unions and employers have been eager to provide a benchmark for the whole wage round well before their agreements expired. The wage round will thus probably enter a crucial stage at the very start of 2016. But this autumn, the two sides will formulate their strategies after the National Institute of Economic Research unveils its wage formation report in October. If earlier patterns recur, a coordinated union platform could be presented in November.

High real wage increases despite low pay agreements

Year-on-year percentage chages during various contract periods



Source: Statistics Sweden

Different views on room for pay hikes

Union and employer positions in the wage round are based on different factors. This is true, for example, of such traditional areas as the general economic situation and Sweden's competitiveness, but also how wage formation should interact with monetary and fiscal policies. Because of low inflation in recent years, **real wages have climbed rapidly despite low nominal pay hikes**. This is especially true if we use actual CPI figures, although Riksbank key interest rate cuts help reinforce this picture. The unexpectedly rapid increase in real wages is a key element of the employer side's argument that there is very little room for pay hikes this time around. The union side will argue that negotiations should assume that in the future the Riksbank will meet its 2 per cent inflation target, given the aggressive shift in monetary policy it has now implemented.

It is hard to determine to what extent the real wage trend has actually squeezed the earnings of Swedish companies. Partly because of low productivity increases, earnings have fallen as a percentage of sales, according to the national accounts. Yet businesses are not directly dissatisfied with their profitability, according to the NIER's business sentiment surveys and other sources. Nor do quarterly reports and share prices indicate that a squeeze on margins is especially widespread. This is partly due to the weak krona and the fact that inflation has been squeezed significantly by lower interest rates and falling energy prices. The Riksbank shows a certain ambivalence on the issue. **While emphasising with increasing clarity that the inflation target should be respected as an anchor in the wage round, the bank is cautious about directly expressing a desire for higher pay increases.** Greater opportunities for companies to raise their margins in a stronger economic climate are viewed as the most important channel towards faster inflation in the short term. Higher pay increases are expected to have a bigger impact in a later stage of the economic cycle, though the Riksbank forecasts that the rate of pay increases will rise from 2.6 per cent this year to 3.2 per cent in 2016.

Actual inflation during the next 3-4 months will be important to the credibility of the inflation target in the wage round. We believe that inflation will climb during the rest of 2015, mainly because the effects of last autumn's energy price fall will vanish from the 12-month figures. But the recent renewed decline in energy prices will slow the upturn, and the Riksbank will probably need to adjust its inflation path sharply downward in its autumn forecasts. This is likely to strengthen **the employers' argument that the Riksbank inflation target is not credible**.

Resource utilisation and wage formation

The question of how much slack there is in the economy will be important in the coming wage round. For example, NIER has estimated that recent tax changes and large-scale immigration have helped **increase equilibrium unemployment to nearly 7 per cent**. This would imply that cyclical unemployment is now only one per cent of the labour force. The trend towards labour shortages in various sectors also indicates that there is little slack in the economy. Yet actual pay increases have recently been unexpectedly low, indicating continued fierce competition for jobs in much of the labour market.

In some sectors, labour shortages may become an argument for higher pay increases. This is especially true of the public sector, where there are major shortages of teachers and health care workers, among others. This may also play a role in union coordination efforts and how the unions deal with relative changes in earnings. **The ambition to reduce pay gaps between women and men is broadly accepted**, but there is no consensus on how this should affect centralised agreements. The main industrial union – the male-dominated IF Metall – has not been inclined to take a back seat in the national pay agreements. This has included pointing out that this would imply double discrimination against the union's own female members. In a situation where labour shortages are larger in female-dominated occupations, however, the gender equality aspect may be easier to handle in this wage round.

But the union side is likely to be generally cautious about using the resource situation in the economy as an argument for higher pay. The Trade Union Confederation (LO) views prevailing unemployment as well above equilibrium. This is an important precondition behind its vigorous demands for substantially more aggressive economic policies. This applies especially to fiscal policy, with LO clearly rejecting the government's more cautious stance. One side effect of LO's strong view that unemployment is cyclical is to shift the focus from the need for structural changes in the Swedish labour market. Given a rising number of people with low levels of formal education and/or inadequate Swedish language skills, one could otherwise argue that **stabilisation policy must be supplemented with loosening of labour market legislation and measures to stimulate low-wage jobs** in order to bring about a larger downturn in unemployment. The trade union movement would like to avoid discussing this sensitive topic for as long as possible.

Is industry's lead role being questioned?

The manufacturing sector has traditionally played a dominant role in Swedish wage rounds. The 1997 Industrial Cooperation and Negotiation Agreement, which was updated in 2011, has cemented this role. It regulates negotiating mechanisms between industrial unions and employers in various fields and thus does not apply only to pay conditions. One important principle is that industrial pay agreements should be signed first, so that they can serve as a benchmark for other parts of the labour market. This has occasionally been called into question by other labour market sectors and by independent academic commentators. One argument is that this structure is rooted in a fixed exchange rate regime, in which protecting the competitiveness of manufacturers dominated wage formation. Given floating exchange rates, the inflation target is instead the anchor and domestically oriented sectors play a rather important role. Yet industry has retained its normative role. One reason is that it is unrealistic to assume that the short- and medium-term exchange rates will move in a direction that restores competitiveness if pay increases diverge from those in other countries. Although the role of industry is fundamentally an issue for the labour market parties, both **the Riksbank and the government are actively working to ensure that industry will keep its benchmark role**. In particular, this has permeated the work of the Swedish National Mediation Office.

The situation may become more controversial this time around. If collective agreements result in pay increases well below what the Riksbank foresees, this may trigger further monetary stimulus measures. Any resulting krona depreciation would benefit manufacturers at the expense of domestically oriented sectors. The latter thus have stronger motives than usual for opposing a low benchmark in industry.

Riksbank's pay hike forecast is too high

Our overall assessment is that 2016 pay agreements will end up somewhat higher than those of 2013, but the difference will be small. Average agreed annual pay increases in 2013-2015 ended up at 2.2 per cent. We expect the 2016-2017 pacts to come in at 2.4 per cent. We believe that these agreements will run for 3 years, with an option to terminate them after 2 years. **Total annual pay increases are likely to end up at nearly 3 per cent in 2016-2017**, which is below the Riksbank's forecasts (3.2 per cent in 2016 and 3.4 per cent in 2017).

Aside from the above domestic factors, international trends indicate that pay increases will remain subdued. The labour market is now relatively tight in Germany and the US, for example, but this has had no clear impact in the form of higher pay. Central banks in a number of countries support higher pay increases and higher minimum wages are becoming a more common element of economic policy, but pay hikes are still modest. Such factors as an **increased global price squeeze and competition in the labour market**, combined with **low productivity growth in recent years**, remain very important.

In such an environment, it is difficult to foresee any clear change in the Swedish earnings trend. Employers are demanding firmer evidence that the inflation target is reachable before being prepared to allow higher pay increases. On the union side, attitudes are naturally more divided, but various reasons discussed above indicate that their final demands will be modest. By stepping up the tone of their critique of the Riksbank, the labour market parties helped precipitate a shift in monetary policy. Now that this has been implemented, the Riksbank is unlikely to get very much help in meeting its inflation target. The situation illustrates the dilemma that Sweden's economic policy and wage formation framework is experiencing. Different players act rationally based on their points of departure, but the imbalances in the economy still risk becoming worse.

Expansion more and more robust

- **New government, new policies, same economy**
- **Rate hikes drawing closer**
- **Home price gains fuelling intervention risk**

A new government is in place after the June 18 election – power has shifted from left to right. And while some political issues already seem to be affected more than we initially expected, the economic implications are likely moderate. Thus, we see little reason to change our forecast for 2015-2016 and expect trends to stay intact into 2017. **We expect GDP growth of 2 per cent in 2015, moving up to 2.5 per cent in 2016-2017.**

Recent macroeconomic figures have come in more or less as hoped. **First quarter GDP numbers published shortly after May's *Nordic Outlook* showed another quarter of steady growth around half a per cent.** Consumption has been contributing more and more lately and has again become a main driver of growth – a sign of health. Investment is extremely volatile and was very weak in Q1. With home prices rising fast, residential construction could easily pick up. Lastly, exports are strongly supported by firming euro zone growth.

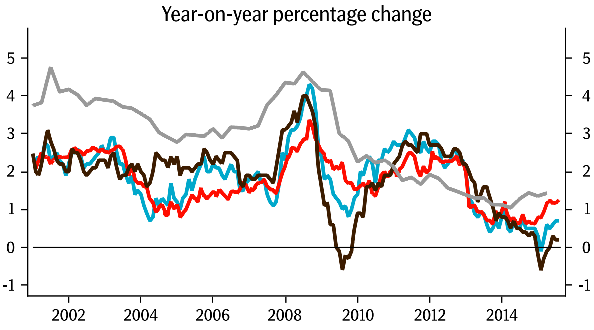
We foresee these trends continuing into 2016 and 2017. Given SEB's forecast of stronger global growth in the next couple of years, and with Denmark's competitiveness looking very solid – we see no reason why Danish exports should not benefit, with positive spill-over into investment too. While annualised GDP has grown about 2 per cent lately, employment has grown around 1 percent for the past year and a half. Wages and salaries have been edging up slowly but have still not surpassed 1.5 per cent and are still far below normal growth.

However, as the economic expansion gains speed and matures and the labour market slowly tightens, we expect pay increases to pick up moderately. With an outsized current account surplus we would not regard this as worrying, rather the opposite. Combined with accelerating wages, solid home price trends and in 2016-2017 likely increases in consumer leverage as banks become more accommodative, we **expect** to see **solid consumption growth in the next couple of years**.

Headline inflation is running at 0.7 per cent but is still outpacing euro zone inflation by almost half a percent. As mentioned in prior reports, we expect this divergence to last, since Denmark is a little ahead of the euro zone in this growth cycle. Inflation is only expected to firm very slowly, however.

Inflation still outpacing euro zone

Year-on-year percentage change



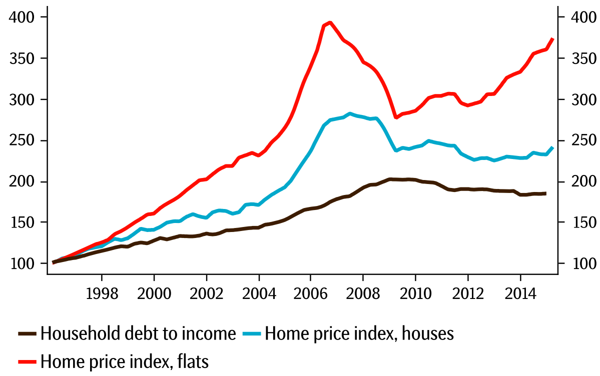
Source: Statistics Denmark, SEB

Housing – the elephant in the room?

In some segments, the Danish housing market is starting to see a return to the 'good old' days prior to the great credit crisis. Home sales are rising. In and around Copenhagen, anecdotally a sale often closes within days after listing or at the first 'open house'. Home prices saw their fastest gains since 2006 in the first quarter of 2015 – at a year-on-year rate solidly above 10 per cent, although developments are still highly varied across the country. Project sales, which take place before construction is finalised, are seeing the biggest gains.

Lending boom to return?

Index 100 = 1996



Source: Statistics Denmark, SEB

We expect the cocktail of ultra-low rates (even if we should see a few hikes – more below) and firming economic expansion to keep prices rising at a fast clip, especially in major cities that see a solid pace of new demand from ongoing urbanisation. For example, as always this time a year, new university students in the cities are fighting a tough battle for an affordable place to live in a tight market.

The trend of home prices is something that causes concern at the Nationalbank. This summer the central bank adjusted its home price forecast upward and took the opportunity to issue a warning; vigilance is required – especially in Copenhagen – because of risks of self-fulfilling spirals where people buy in expectations of capital gains. The bank's Q2 *Quarterly Overview* states: "...recent development in the market for project sales in Copenhagen resembles somewhat what happened in the run-up to the housing bubble in 2005-2007."

The Nationalbank often worries about overheating. On this account they do have a point, but we think they are perhaps a bit early. As indicated by the difference between urban house prices and flat prices, many regions are still below their prior peak. Loan-to-value ratios are also lower. So far it is mostly in Copenhagen that warning signs are starting to flash, since more people are moving there and boosting residential demand. No doubt low interest rates are creating an environment where speculative behaviour flourishes – if only because the extra mortgage loan cost of an extra 200,000, or even million DKK is unusually low. So bubble risk is elevated.

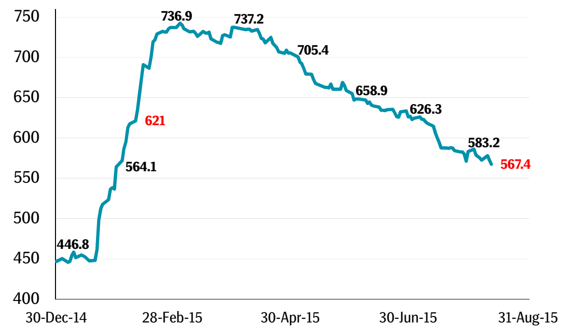
With monetary policy ruled out due to the krone-euro peg, macroprudential or fiscal policy would be the way to cool housing. The Nationalbank favours a return to more pro-cyclical housing taxation – something that has very little political support. Other suggestions include limitations in access to interest-only loans or imposing income-based borrowing limits. It would perhaps also be controversial to put a brake on the market before more of it has recovered from the last crisis. Hence, in the short run none of these things are likely to happen, although we see it as quite likely that such a need could arise later in our forecast horizon.

Could a rate hike come sooner than expected?

We are still monitoring closely how the reversal of foreign exchange flows related to last winter's attack on the DKK/EUR peg is developing. Our main expectation was that after an initial period of outflows, as foreign investors unwound positions, outflows would abate because we did not believe Danish pension funds would reverse their decisions on hedging euro exposure so quickly. Until May, the latest available numbers, they did not. However, outflows and interventions by the central bank have continued at a steady pace so far. We cannot see who is driving the latest flows, but we still expect moderation to kick in before too long for the reasons mentioned above.

Nonetheless, Denmark has a lower currency reserve than seen prior to the final interest rate cut in February (DKK 621 billion), treasury bill issuance has partly started again, so what is left of extraordinary measures is the suspension of treasury bond issuance. Given the current flows, the central bank could well act on CD rates (certificates of deposit) combined with a lower limit on the amounts that banks can deposit at higher rates at the central bank prior to normalising bond issuance, since issuance should be announced well in advance before restarting. Any initial CD rate hike, combined with a lowering of current account limits, should have a limited impact on short-term money market rates.

Foreign exchange reserves are shrinking
Estimated size of currency reserves, DKK bn



Source: The Nationalbank, SEB

New government, new policies, same economy

Denmark held parliamentary elections in June. The outcome was a new government. It could easily turn out to be fragile, since it consists of only one party: the right-wing liberal party Venstre, which won only 34 seats out of 179. It enjoys parliamentary backing from the nationalist Danish People's Party, the Conservatives and the Liberal Alliance – with such diverse interests that it will be tough to govern. With 37 seats, the People's Party actually holds more seats than the governing party, Venstre.

So far, it is too early to make confident statements about what this young government is going to do, but its intentions were presented in a government statement, as is customary. This statement reveals a tighter fiscal stance than the former government and assigns higher priority to tax cuts than spending – specifically mentioning adjusting public investment. A regional spending agreement has already been reached and the government also showed a tougher stance towards spending. Our forecast had already predicted tighter fiscal policy in 2016, so we will not need to make material adjustments on this account. Job creation will stay in focus by trying to increase incentives to work, lowering benefits for those without jobs and lowering income tax. Whether this will create more jobs or more poor people remains to be seen. Limiting inequality is no longer an official target of the government.

We have seen some changes on more ideological issues. During the election, no material gap between the two main sides was apparent on issues such as immigrants and refugees. However, the new government has clearly toughened the rhetoric on immigration. And action has been taken too; public benefits to refugees who are granted asylum are set to be cut in half. Still, we do not see material economic effects from new immigration policy – it is mostly symbolic.

Still slowing but not slumping

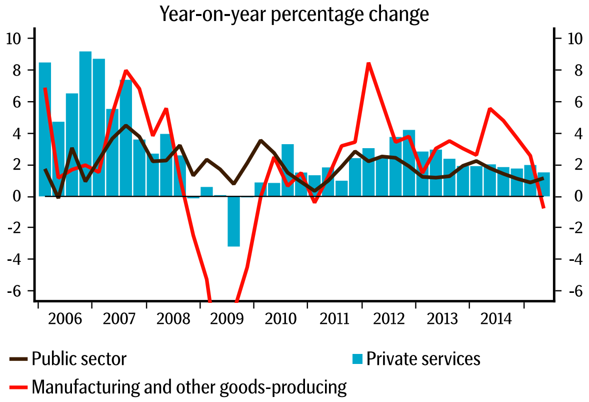
- **Growth forecasts nudged lower**
- **Inflation remains surprisingly sticky**
- **Norges Bank maintains a dovish bias**

The pullback in the petroleum sector is having more of an impact on the rest of the economy, but apart from a marked effect on manufacturing and some petroleum-related services, so far the slowing has been less severe than feared. While more of an effect is expected, the setback in the broader economy is not expected to turn into a slump.

Growth in mainland GDP – excluding oil, gas and shipping – has gradually moderated so far in 2015 to 0.2 per cent from the first to the second quarter. Meanwhile, the year-on-year rate decelerated sharply from 1.9 per cent in the first quarter to 0.9 per cent, reflecting a spurt in spring 2014.

Manufacturing is leading the slowdown

Year-on-year percentage change



Source: Statistics Norway

Sector-wise, the slowing is the sharpest within the goods-producing sector, in particular manufacturing – where value added dropped 2.3 per cent in the year to the second quarter. In addition, the annual growth rate slowed in the broad and dominant private service sector.

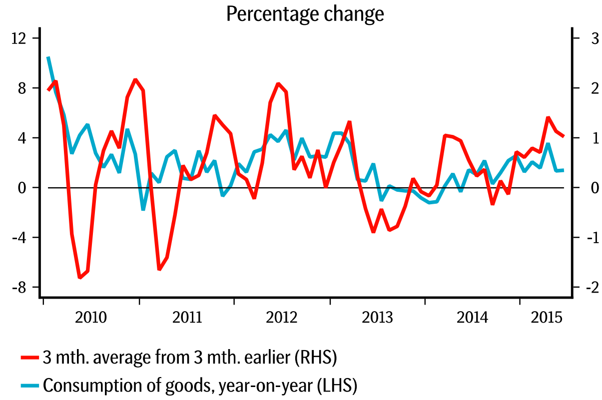
Developments in the second quarter were on aggregate as assumed in the May issue of *Nordic Outlook*. However, while forecasts for e.g. private consumption and exports of non-oil goods are revised higher for 2015, business investment is weaker and the GDP report included negative back revisions. Moreover, the renewed decline in oil prices and the downward revision in the oil price forecast is making an impact on the outlook. We are trimming our forecast for **growth in mainland GDP** two tenths to **1.4 per cent in 2015 and 2.0 per cent in 2016,** while growth should be a **trend-like 2.4 per cent in 2017**. The forecast for **overall GDP growth in 2015 is lifted to 1.3 per cent.** However, we now expect capital spending in the petroleum sector to drop a slightly steeper 9 per cent next year, and the forecast for **growth in overall GDP is cut to 1.4 per cent in 2016 before picking up to 1.8 per cent in 2017.**

Surprisingly firm consumption

Private consumption has been surprisingly firm relative to previous predictions. The quarterly growth rate in spending on goods thus accelerated from 0.7 per cent in the first quarter of the year to 1.1 per cent in the second, the strongest quarterly gain since early 2013. Although spending on services lost some momentum, the year-on-year gain in overall private consumption held up well at 2.5 per cent in the second quarter.

Consumption picked up in the second quarter

Percentage change



Source: Statistics Norway

Momentum in consumption is expected to moderate quite a bit in the very near term, in part as the acceleration in the spring quarter got an extra boost from very volatile spending on electricity and as auto sales show signs of slowing. We are nudging our full-year forecast for overall private **consumption upward to 2.7 per cent for 2015 but slightly lowering our 2016 forecast to 2.3 per cent** due, among other things, to an expected delay before labour markets start turning.

Nonetheless, consumption has held up surprisingly well considering sliding consumer confidence and weaker labour markets. Sentiment has deteriorated because of a very negative assessment of the general economic situation and outlook. In sharp contrast, households' assessment of their own finances has held up well above the historic norm.

Labour market weakening narrowly based

There is no mistaking the weaker labour market. Employment has turned softer, but at a minimum the Labour Force Survey

(LFS) indicates that job growth in the second quarter recovered the loss in the previous one, suggesting stabilisation. Meanwhile, the extent of rising unemployment differs on various measures.

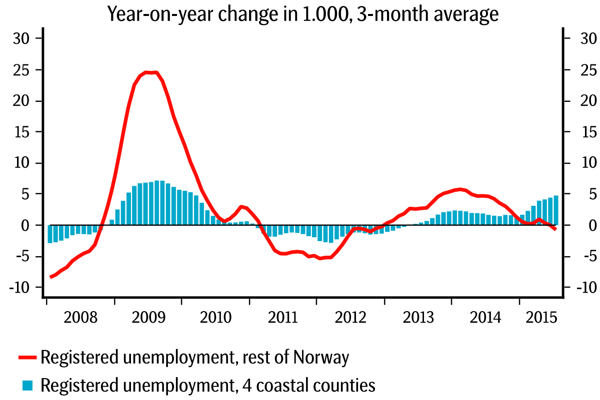
The LFS shows a marked deterioration, with the unemployment rate up from a low 3.2 per cent to 4.3 per cent over the year to the second quarter, the highest since early 2005. However, one third of the increase owes to students aged 24 and younger seeking part-time jobs: in this demographic, the seasonally adjusted unemployment rate has shot up from 7.0 per cent to 10.5 per cent over the past year. Admittedly, the unemployment rate for people aged 25 and older is up by 0.7 percentage point over the period, but at 3.3 per cent it is only marginally higher than last autumn.

We suspect that the sharp rise in labour force participation among young people is transitory. Hence, we are lifting **our forecast for LFS unemployment only a tad to 4.3 per cent in 2015** and **4.5 per cent in 2016** (peaking at 4.6 per cent).

Registered unemployment as reported by the Norwegian Labour and Welfare Administration (NAV) – historically a more reliable measure – is creeping only modestly higher: the seasonally adjusted rate of 2.9 per cent in July was only slightly above the 2014 average. However, this metric might be lagging behind widespread lay-offs in the petroleum industry, where many people are receiving severance pay. Moreover, the number of people in official labour market programmes jumped in June and July, partly reflecting the influx of new jobless claims but also the fact that allocations for such activities were raised in the government's spring budget.

Rise in unemployment narrowly based so far

Year-on-year change in 1.000, 3-month average



Source: NAV

The NAV report shows that at least so far, the increase is confined to the four counties along the southern and western coast that are most dependent on activity in the petroleum sector. Unsurprisingly, the county of Rogaland – which includes the "oil capital" Stavanger – accounts for the better part of the increase. Outside these counties, registered unemployed in July was unchanged from a year earlier. Similarly, details of the LFS survey show employment in these four counties stalling over the past year (and declining in Rogaland). Job growth the rest of the country has eased, but here employment was still rising 0.8 per cent in the year to the second quarter.

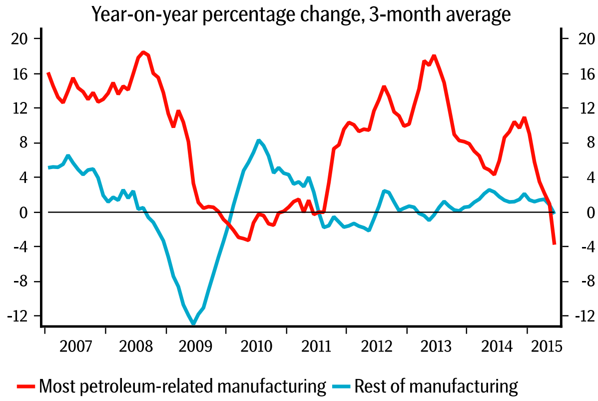
Manufacturing hit hardest

Sharply lower petroleum-related capital spending continues to affect the manufacturing sector, in which output declined more than 4 per cent during the first half of 2015.

Investment goods, the previous stellar performer, fell the most, with output dropping 6 per cent in the year to the second quarter. Production of ships and oil platforms (occasionally quite volatile) is plunging, especially since the conclusion of some large projects in the early spring. Production of machinery and equipment is sharply lower, while repair and installation of machinery is in a weaker trend. These sub-sectors are the ones most closely related to the petroleum sector. By our calculation, their output has turned sharply from rising 11.0 per cent year-on-year in the fourth quarter of 2014 to declining almost 4 per cent in the year to the second quarter. As such, they account for most of the slowdown in manufacturing.

Manufacturing output sharply lower

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

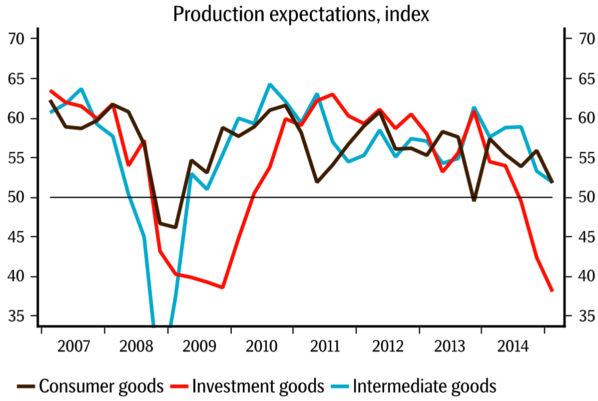


Source: Statistics Norway, SEB

However, output in the rest of the sector is lacklustre as well, showing a slight decline in aggregate production from the first to the second quarter. The latter is mainly due to declining output of fabricated metal products, possibly a second-round effect from plunging capital spending in the petroleum sector.

Extended weakness in manufacturing

Production expectations, index



Source: Statistics Norway

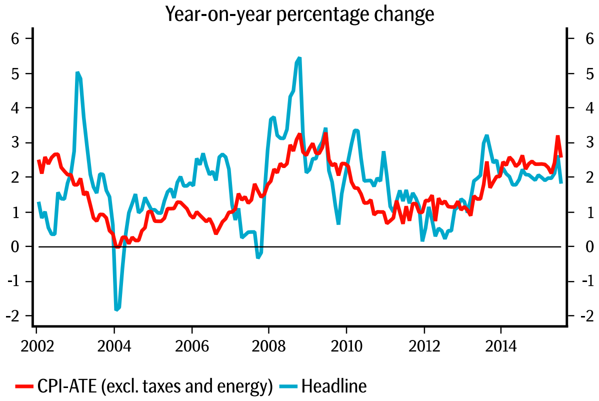
Export-oriented parts of the manufacturing sector should start benefitting from firmer demand from abroad and the boost from the sharply weaker NOK exchange rate. However, the most recent manufacturing Business Tendency Survey suggests continued weakness in overall output.

Core inflation at target

Core consumer prices as measured by CPI-ATE (excluding energy and taxes) have been volatile this summer, partly due to shifting seasonal pattern for certain items. Hence, the year-on-year rate jumped to a six-year high of 3.2 per cent in June before correcting to 2.6 per cent in July. Core inflation has averaged 2.5 per cent so far in 2015, marginally higher than in 2014 and equal to Norges Bank's medium-term target. Electricity has put a lid on overall CPI inflation.

Core inflation in line with target

Year-on-year percentage change



Source: Statistcs Norway

One key reason for "sticky" core inflation is higher prices for imported goods (almost one third of the core CPI basket), fuelled by lagging effects from previous NOK depreciation. Continued currency weakness should keep imported inflation running rather high in the near term, but this effect should wane over the course of 2016.

At the same time, service inflation should decelerate going forward in response to slower wage growth, while there are tentative signs that the rent component (21 per cent of the core index) is stabilising after trending quite a bit lower through 2014. **We are lifting our forecast of core CPI inflation to 2.6 per cent in 2015, but a moderation to 2.3 per cent is expected in 2016 and to 1.9 per cent for 2017.**

Norges Bank anxious about growth

Norges Bank is worried about the impact of lower oil prices on economic activity and thus cut its key interest rate by 25 basis points to 1.00 per cent at the June meeting, despite projecting inflation close to target. The revised rate path was softer than expected, including a 70 per cent probability of another cut on September 24. We have argued that the June reduction was the final one, since we believe economic growth will slow less than assumed by Norges Bank. Moreover, from a financial stability standpoint the threshold for cutting the key rate even further is now higher. Although the recent relapse in oil prices is pressuring Norges Bank, so far the spill-over effects from petroleum have proved less severe than feared last autumn.

We thus expect **Norges Bank to maintain a clear dovish bias while likely refraining from delivering another cut**. Since we expect the Fed, BoE and Riksbank to raise their key rates during the coming year, we believe there is **room for Norges Bank to cautiously lift its key rate by late 2016**.

NOK pressured by oil prices

The recent renewed decline in oil prices has caused investors to once again turn negative on Norway and the krone. Speculations that lower oil prices and a concurrently weaker growth outlook will lead to a more dovish monetary policy are driving the EUR/NOK exchange rate higher. On aggregate, speculative investors now hold a short NOK position, but the krone remains vulnerable in the short term should oil prices fall further.

Our expectation of Norges Bank maintaining a dovish bias for most of this year suggests that the krone will remain weak. However, the EUR/NOK rate is now very high from a historical perspective and our long-term fair value model suggests that the NOK is clearly undervalued. We expect oil prices and monetary policy to become more neutral factors for the krone towards the end of this year, suggesting that the EUR/NOK rate should cautiously correct towards its long-term fair value. We expect a **EUR/NOK exchange rate of around 8.90 by year-end 2015 followed by 8.40 and 8.10 by the end of 2016 and 2017, respectively.**

Tighter long-term yield spread vs. Germany

Norwegian government bonds (NGBs), and especially those with shorter maturity, have been supported by falling oil prices and dovish monetary policy. The long end of the curve has followed German yields. However, Norwegian long-end bonds tend to outperform their German equivalents when bonds sell off. Our forecast of a rise in the German 10-year yield should imply a tightening of long-end NGB spreads vs. Germany. The performance of long-end NGBs have previously been negatively affected by heavy supply. This pressure should ease going forward, as we expect a lower supply, which will especially benefit longer-term bonds.

We foresee a **10-year Norwegian government bond yield of 1.60 per cent by mid-2016, implying a spread vs. Germany of 70 bps**. Since the market increasingly expects Norges Bank to start hiking rates late next year, the Norwegian 10-year yield will rise slightly faster than its German equivalent. We forecast a spread of 80 bps at the end of 2017.

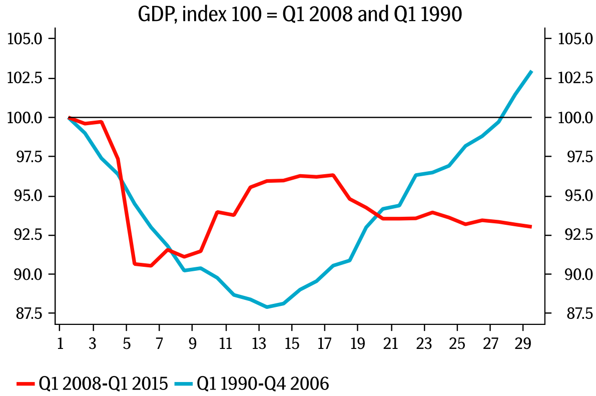
Zero growth in 2015 after three years of falling GDP

- **Recession ending, but weak outlook**
- **Low oil prices and improved European economy will help fuel some growth**
- **Continued fiscal belt-tightening**

The Finnish economy is still anaemic. GDP is 7 per cent lower than in the first quarter of 2008 and the economy has just emerged from its fifth recession of the latest crisis period. **The outlook remains weak**. Continued structural and cyclical problems are plaguing the economy. In addition, the new government's austerity measures will improve public finances at the expense of demand. **The weaknesses in the economy are broad-based, but there are bright spots**. A cheaper euro will improve the situation of exporters. New oil price declines will result in lower inflation and higher real incomes, while falling imports will improve the current account and net exports. The risk picture is relatively balanced. On the downside there are risks of deteriorating conditions in Russia, while strong purchasing power may enable Finnish consumers to provide upside surprises. **Overall, 2015 will be a year of zero growth. In 2016 GDP will increase by 0.9 per cent, and in 2017 by 1.3 per cent**. Our forecast is lower than in May's *Nordic Outlook* and below the consensus estimate.

Far weaker GDP trend than after the 1990s recession

GDP, index 100 = Q1 2008 and Q1 1990



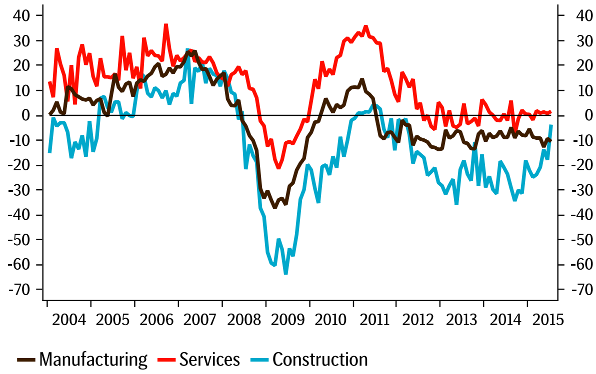
Source: Eurostat

Indicators point to continued weak growth

Economic indicators remain weak, although recent months have shown some improvement. The European Commission's overall sentiment indicator rose in June and July, but such movements have generally been small in the past 2-3 years. Some improvement can be noted in the construction sector; instead, manufacturing is now the sector that is showing the most negative sentiment. The domestically oriented service sector has the most upbeat view of the economic situation, although its index level is also relatively low.

Indicators are not pointing to any quick recovery

Net balance



Source: European Commission

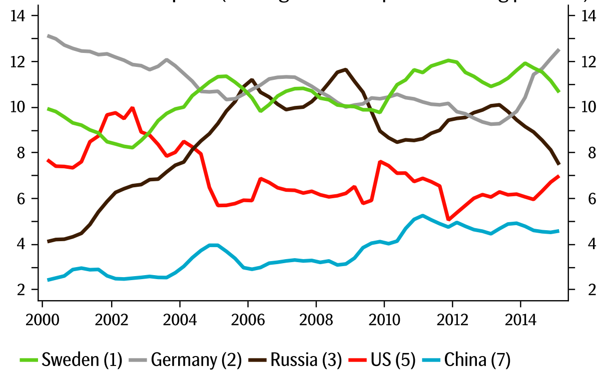
Weak export recovery

Exports recovered in the second quarter (up nearly 8 per cent in current prices) after plunging early this year. Exporters' order expectations have strengthened since late 2014, but exports are hampered by trade disruptions with Russia. The share of exports sold to Russia has fallen, though, and dependence on exports to countries like the US and Germany has increased.

Because of competitiveness problems and the downturn in its telecom and electronics industry, Finland's international market share has fallen in recent years. It has lost ground to Sweden, as well as the euro zone as a whole. Sweden's monetary policy ambitions to weaken the krona are having a negative impact on some sectors in Finland, especially forest products, but the krona appreciation that we foresee will ease the pressures on Finnish industry somewhat. A slowdown in pay increases and a generally weaker euro will also have positive effects on exports in the next couple of years. Meanwhile weak domestic demand has caused a decline in imports. As a result, net foreign trade will have a positive effect on GDP, while the current account balance improves. **Looking ahead, exports will thus gradually improve. As annual averages, they will be unchanged this year and then climb by 2.3 per cent in 2016 and 3.5 per cent in 2017**.

Trade with Germany and the US is increasing

Per cent of total exports (ranking of most important trading partners)



Source: IMF

Capital spending is continuing to fall

Because of a long period of weaknesses in demand, output and exports, capacity utilisation in the economy is low. This is one reason why capital spending has shown a falling trend for nearly three years. Continued low capacity utilisation – combined with a sharp downturn in lending to non-financial companies – indicates that the downturn in capital spending will continue this year as well, though at a slower pace. Although sentiment in the construction industry has improved somewhat, the turnaround will take time. New construction is falling in all areas, and a decreasing number of building permits points to weak residential construction ahead. Home prices are continuing to fall slightly, but we foresee no rapid price decline that would change the situation of households. **Capital spending will fall by 1 per cent in 2015**, a clearly milder downturn than in prior years, **and will then increase by 1 per cent in 2016 and 2 per cent in 2017**.

Unexpectedly high unemployment

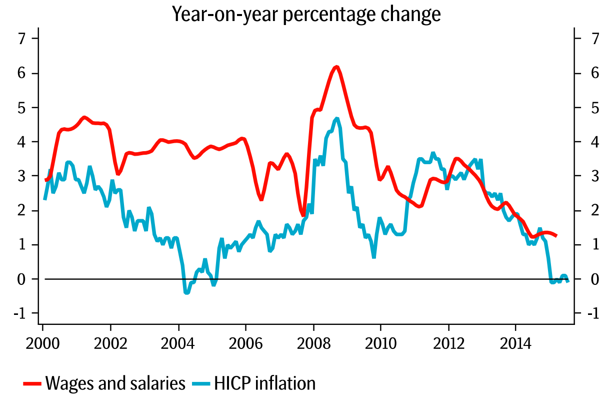
Unemployment totalled 9.7 per cent in June: an increase of more than 1 percentage point during the past year and the highest level since February 2000. **The upturn in joblessness has been larger than expected, given the GDP situation**. The clear downward trend in employment so far during 2015 is expected to continue in the same direction for the rest of the year. Companies need to improve their competitiveness and productivity before hiring new employees, and this will keep unemployment up in the coming months. Despite rising unemployment, the labour force has been relatively stable in recent years. We are now seeing it shrink slowly, which will help lower the unemployment rate somewhat in 2016 and 2017. Finland's population is growing, but for demographic reasons the labour force will decrease in the long term as the average age increases. This will push down growth potential, but given the large quantity of idle resources this will become important only in a longer time perspective. Unemployment will continue to climb towards 10 per cent during the autumn and winter before starting to decline. **Measured as annual averages, unemployment will stand at 9.6 per cent in 2015 and 2016 and decrease to 9.2 per cent in 2017**.

Low inflation leading to real wage increases

Inflation pressure is low and is being pushed down again by low oil prices. Meanwhile pay increases have decelerated and will be at low levels in 2016-2017, which will hold back both headline and core inflation. Households are being squeezed by high unemployment and fiscal belt-tightening, but low inflation is helping to boost real wages. Together with low interest rates, this is providing some room for consumption. The household savings ratio has fallen in recent years and will continue to do so. Given the weak outlook, households want to increase savings, but at present there is no financial room for manoeuvre to do so. Consumer confidence has fallen in recent months, yet remains at a level that suggests higher consumption ahead. **Consumption will increase by a weak 0.2 per cent this year, by 0.5 per cent in 2016 and by 0.8 per cent in 2017**.

Falling inflation will lead to real income increases

Year-on-year percentage change



Source: Statistics Finland

Continued budget austerity

Budget discipline has been prioritised both in domestic economic policy and in Finland's positions on the euro project. But the ambition to prevent public debt from surpassing 60 per cent of GDP appears to have failed; the limit will be breached this year. The new government that took power in May, with Centre Party leader Juha Sipilä as prime minister, plans to continue pursuing belt-tightening policies despite the weak demand situation. Broad cutbacks in expenditures will have a total impact of EUR 10 billion on the budget balance in the next 4-5 years. The government also wants to bring about a social contract between unions and employers that will improve competitiveness; if such a contract is reached, the government is prepared to withdraw some of its austerity measures.

The public sector deficit will decrease by means of belt-tightening and slightly higher growth. The deficit will again exceed 3 per cent of GDP in 2015 but will then fall to 2.3 per cent in 2017. Public debt will grow somewhat further, exceeding 60 per cent of GDP throughout our forecast period, but Finnish public debt is well below the euro zone average. The narrow spread against Germany on 10-year government bonds (currently about 15 basis points) shows that investors still have strong confidence in the country.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2014	2015	2016	2017
GDP OECD	1.9	2.2	2.6	2.4
GDP world (PPP)	3.4	3.2	3.8	3.9
CPI OECD	1.7	0.5	1.0	1.7
Export market OECD	3.3	4.7	5.5	4.8
Oil price, Brent (USD/barrel)	99.6	54.1	55.0	60.0

USA

Yearly change in per cent

	2014 level, USD bn	2014	2015	2016	2017
Gross domestic product	17,616	2.4	2.4	3.1	2.6
Private consumption	12,061	2.7	3.1	2.8	2.5
Public consumption	3,163	-0.6	0.2	0.0	0.0
Gross fixed investment	2,937	5.3	4.0	7.7	6.6
Stock building (change as % of GDP)		0.0	0.3	0.0	0.0
Exports	2,350	3.4	2.4	6.1	6.1
Imports	2,895	3.8	5.9	5.6	6.8
Unemployment (%)		6.2	5.3	4.7	4.2
Consumer prices		1.6	0.2	1.2	2.1
Household savings ratio (%)		4.8	5.0	5.6	6.2

EURO ZONE

Yearly change in per cent

	2014 level, EUR bn	2014	2015	2016	2017
Gross domestic product	10,067	0.8	1.6	2.1	2.0
Private consumption	5,628	1.0	1.7	2.0	1.9
Public consumption	2,122	0.6	0.5	0.5	1.0
Gross fixed investment		1.2	1.8	3.0	2.5
Stock building (change as % of GDP)		-0.1	0.0	0.0	0.0
Exports	4,465	3.8	4.3	4.6	4.6
Imports	4,091	4.1	4.3	4.4	4.5
Unemployment (%)		11.6	11.1	10.7	10.3
Consumer prices		0.4	0.0	0.7	1.1
Household savings ratio (%)		7.1	7.0	7.0	7.0

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2014	2015	2016	2017
GDP				
United Kingdom	3.0	2.7	2.5	2.5
Japan	-0.1	0.8	1.3	1.0
Germany	1.6	1.9	2.3	2.0
France	0.2	1.2	1.6	1.6
Italy	-0.4	0.7	1.3	1.3
China	7.4	6.8	6.5	6.3
India	7.1	7.5	7.8	8.0
Inflation				
United Kingdom	1.5	0.1	0.9	1.4
Japan	2.7	0.8	0.5	0.9
Germany	0.1	0.2	1.2	2.0
France	0.1	0.0	0.5	0.7
Italy	0.2	0.0	0.5	0.5
China	2.0	1.5	2.0	2.5
India	7.3	5.1	5.0	5.0
Unemployment, %				
United Kingdom	6.3	5.3	4.9	4.8
Japan	3.6	3.4	3.3	3.3
Germany	5.0	4.7	4.6	4.5
France	10.3	10.3	10.2	10.0
Italy	12.7	12.5	12.5	12.5

EASTERN EUROPE

	2014	2015	2016	2017
GDP, yearly change in per cent				
Estonia	2.1	2.2	2.7	3.4
Latvia	2.4	2.4	2.7	3.8
Lithuania	2.9	2.0	2.8	3.2
Poland	3.3	3.4	3.6	3.7
Russia	0.6	-4.0	-1.0	1.5
Ukraine	-6.5	-12.0	1.0	2.0
Inflation, yearly change in per cent				
Estonia	0.5	0.4	2.3	2.7
Latvia	0.7	0.4	1.7	2.2
Lithuania	0.2	-0.4	0.3	1.2
Poland	0.1	-0.8	1.2	2.0
Russia	7.8	15.0	9.5	6.0
Ukraine	12.1	45.0	18.0	10.0

FINANCIAL FORECASTS

		19-Aug	Dec-15	Jun-16	Dec-16	Jun-17	Dec-17
Official interest rates							
US	Fed funds	0.25	0.50	0.75	1.25	1.75	2.25
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.05	0.05	0.05	0.05	0.05	0.05
United Kingdom	Repo rate	0.50	0.50	0.75	1.25	1.50	1.75
Bond yields							
US	10 years	2.13	2.45	2.60	2.80	2.95	3.10
Japan	10 years	0.37	0.40	0.40	0.45	0.45	0.50
Germany	10 years	0.63	0.75	0.90	1.20	1.35	1.50
United Kingdom	10 years	1.97	2.10	2.30	2.60	2.75	2.90
Exchange rate							
USD/JPY		124	130	135	140	138	135
EUR/USD		1.11	1.07	1.00	1.05	1.07	1.10
EUR/JPY		137	139	135	147	148	149
GBP/USD		1.56	1.57	1.52	1.57	1.57	1.62
EUR/GBP		0.71	0.68	0.66	0.67	0.68	0.68

SWEDEN

Yearly change in per cent

	2014 level, SEK bn	2014	2015	2016	2017
Gross domestic product	3,915	2.3	3.0	2.8	2.5
Gross domestic product, working day adjustment		2.4	2.8	2.6	2.7
Private consumption	1,817	2.4	2.5	2.6	2.5
Public consumption	1,029	1.9	2.0	1.5	1.0
Gross fixed investment	912	7.4	7.0	6.5	6.0
Stock building (change as % of GDP)	8	0.2	0.0	0.1	0.0
Exports	1,744	3.3	4.1	4.9	4.6
Imports	1,596	6.6	5.3	6.2	5.9
Unemployment (%)		7.9	7.5	7.3	6.9
Employment		1.4	1.2	1.3	1.2
Industrial production		-2.0	2.5	3.0	4.0
CPI		-0.2	0.1	1.1	2.0
CPIF		0.5	0.9	1.6	1.6
Hourly wage increases		2.8	2.6	3.0	3.2
Household savings ratio (%)		15.8	16.9	16.5	16.6
Real disposable income		2.6	4.0	2.1	2.6
Trade balance, % of GDP		0.8	1.0	1.2	1.1
Current account, % av GDP		6.8	7.3	6.5	6.0
Central government borrowing, SEK bn		72	60	17	15
Public sector financial balance, % of GDP		-1.9	-1.4	-0.8	-0.2
Public sector debt, % of GDP		43.8	44.1	43.4	43.0

FINANCIAL FORECASTS	19-Aug	Dec-15	Jun-16	Dec-16	Jun-17	Dec-17
Repo rate	-0.35	-0.45	-0.45	-0.25	0.25	0.75
3-month interest rate, STIBOR	-0.27	-0.35	-0.10	0.10	0.35	0.85
10-year bond yield	0.62	0.65	0.95	1.35	1.55	1.75
10-year spread to Germany, bp	-1	-10	5	15	20	25
USD/SEK	8.58	8.60	8.95	8.38	8.13	7.82
EUR/SEK	9.48	9.20	8.95	8.80	8.70	8.60
TCW	132.5	129.8	128.2	124.8	123.0	121.2
KIX	112.9	110.6	109.2	106.3	104.8	103.3

NORWAY

Yearly change in per cent

		2014 level, NOK bn	2014	2015	2016	2017
Gross domestic product		3,053	2.2	1.3	1.4	1.8
Gross domestic product (Mainland)		2,400	2.2	1.4	2.0	2.4
Private consumption		1,225	2.0	2.7	2.3	2.5
Public consumption		646	2.7	2.1	2.3	2.0
Gross fixed investment		709	0.6	-3.8	0.4	1.5
Stock building (change as % of GDP)			0.2	0.8	-0.3	-0.1
Exports		1,200	2.7	1.2	1.7	1.7
Imports		873	1.9	2.3	1.4	2.2
Unemployment (%)			3.5	4.3	4.5	4.5
CPI			2.0	2.0	2.3	2.0
CPI-ATE			2.4	2.6	2.3	1.9
Annual wage increases			3.1	2.8	2.7	3.0
FINANCIAL FORECASTS	**19-Aug**	**Dec-15**	**Jun-16**	**Dec-16**	**Jun-17**	**Dec-17**
Deposit rate	1.00	1.00	1.00	1.25	1.50	1.75
10-year bond yield	1.39	1.40	1.60	1.95	2.10	2.30
10-year spread to Germany, bp	76	65	70	75	75	80
USD/NOK	8.33	8.32	8.70	8.00	7.71	7.36
EUR/NOK	9.21	8.90	8.70	8.40	8.25	8.10

DENMARK

Yearly change in per cent

		2014 level, DKK bn	2014	2015	2016	2017
Gross domestic product		1,919	1.1	2.0	2.5	2.5
Private consumption		904	0.9	2.5	3.0	3.0
Public consumption		513	0.2	1.3	0.5	0.5
Gross fixed investment		359	4.0	2.2	4.6	5.9
Stock building (change as % of GDP)			0.3	-0.3	0.0	0.1
Exports		1,030	2.6	3.4	3.6	4.2
Imports		929	3.8	3.2	4.2	5.3
Unemployment (%)			5.0	4.5	4.2	4.0
Unemployment, OECD harmonised (%)			6.1	5.8	5.2	4.6
CPI, harmonised			0.6	0.6	1.2	1.6
Hourly wage increases			1.3	1.7	2.2	2.6
Current account, % of GDP			6.2	7.0	6.5	6.0
Public sector financial balance, % av GDP			0.0	-1.5	-0.5	0.5
Public sector debt, % av GDP			43.5	43.0	41.5	40.0
FINANCIAL FORECASTS	**19-Aug**	**Dec-15**	**Jun-16**	**Dec-16**	**Jun-17**	**Dec-17**
Lending rate	0.05	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.73	0.85	1.00	1.30	1.45	1.60
10-year spread to Germany, bp	10	10	10	10	10	10
USD/DKK	6.75	6.97	7.46	7.10	6.97	6.78
EUR/DKK	7.46	7.46	7.46	7.46	7.46	7.46

FINLAND

Yearly change in per cent

	2014 level, EUR bn	2014	2015	2016	2017
Gross domestic product	205	-0.4	0.0	0.9	1.3
Private consumption	113	0.5	0.2	0.5	0.8
Public consumption	51	-0.2	0.2	0.2	0.3
Gross fixed investment	41	-3.3	-1.0	1.0	2.0
Stock building (change as % of GDP)		0.4	0.0	0.0	0.0
Exports	76	-0.7	0.0	2.3	3.5
Imports	77	0.0	0.0	1.4	2.7
Unemployment (%)		8.7	9.6	9.6	9.2
CPI, harmonised		1.2	0.1	0.6	1.0
Hourly wage increases		1.5	1.8	2.0	2.2
Current account, % of GDP		-1.9	-2.0	-1.8	-1.6
Public sector financial balance, % av GDP		-3.2	-2.8	-2.5	-2.3
Public sector debt, % av GDP		59.3	61.5	62.0	62.0

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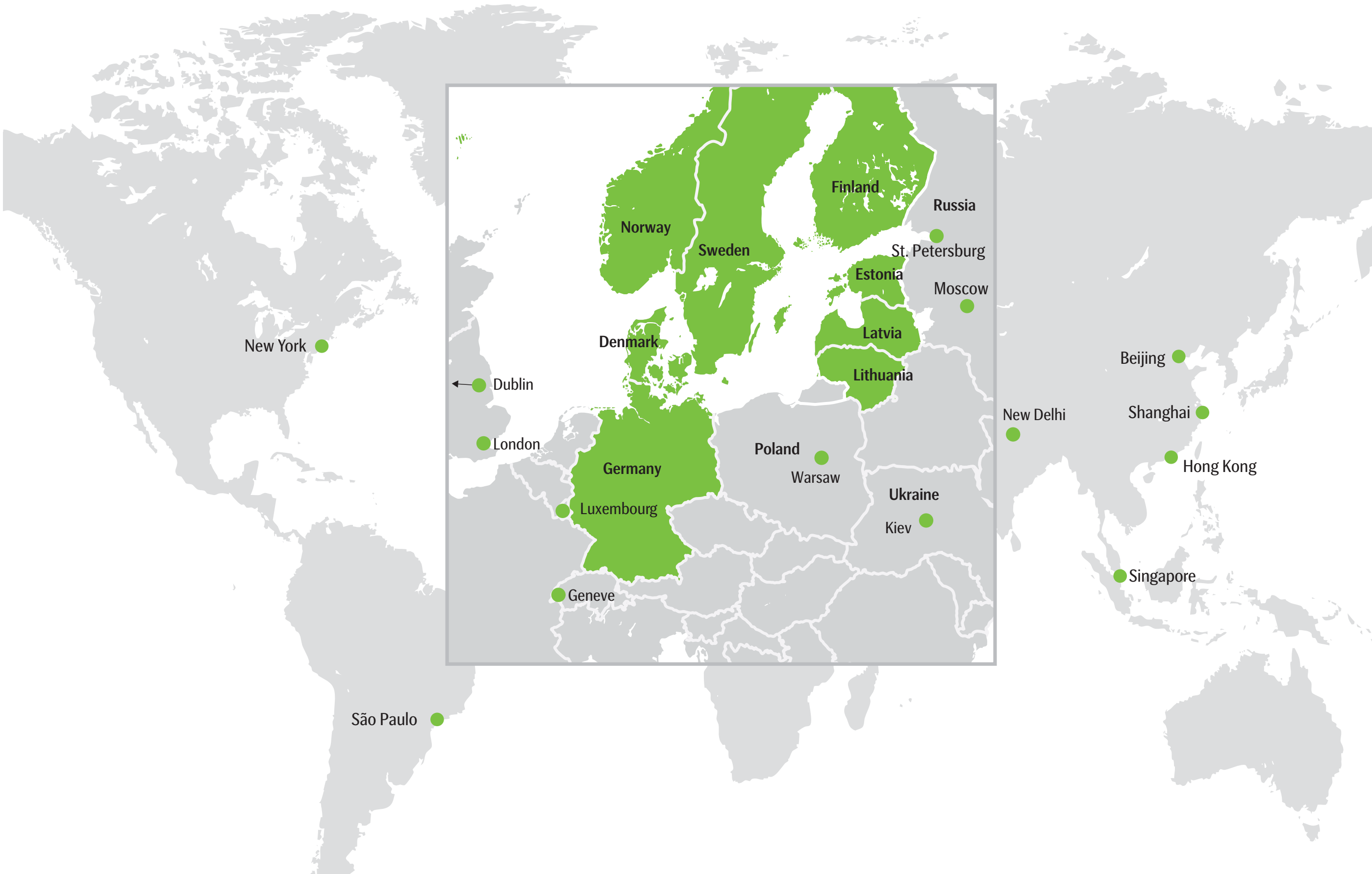

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SEGR0090 2015.08