Press release

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Nordic Outlook: Strong disinflationary forces, despite rising resource utilisation
Gentle Fed hikes, Chinese soft landing, persistent Grexit risk

The world economy is hesitating. Looking back at developments this spring and summer, the lingering impression is that global growth is not really willing to take off. One reason is still-cautious behaviour among businesses and households in developed market (DM) countries. Low interest rates, rising asset prices and stronger purchasing power are thus not providing the same stimulus to capital spending and consumption that would normally have been the case. Meanwhile uncertainty about emerging market (EM) economic performance has intensified. In China, the stock market downturn combined with a change in currency policy (devaluation of the yuan) is raising questions about the country's economic stability, while countries like Brazil, Russia and Uraine are undergoing deeper economic and political crises. The demographic and structural problems of EM countries have become clearer as the forces of globalisation have slowed. The growth in world trade has decelerated, compared to the pre-crisis situation.

Gentle monetary policies wll help sustain a multi-speed world economy

Yet the main features of our forecast scenario remain intact. **In the United States, the economy will soon speed up** to an annual growth rate of around 3 per cent, from nearly 2.5 per cent this year. The US manufacturing sector is being hampered by a strong dollar, but the service sector is exuding optimism and the housing market once again has a tailwind. American household incomes will be sustained by rising employment and, eventually, also faster wage and salary growth. In Japan, the first half of 2015 was dominated by weak consumption and exports. Meanwhile Western European economic conditions have stabilised. Despite a strong currency and tight fiscal policy, the United Kingdom is experiencing rather fast economic expansion. **The euro zone is showing good resilience** to the Greek debt crisis, and it is difficult to discern any major contagion effects. The German economy is expanding at a healthy pace, but Spain in particular has surprised on the upside. A weaker currency, easier credit conditions due to the European Central Bank (ECB)'s stimulus programme and low energy prices will **help euro zone GDP growth accelerate** from just over 1.5 per cent this year to 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**. The recent export downturn may indicate some competitiveness problems, but China's exports are substantially more dependent on changes in international demand than on exchange rates; we believe that the recent yuan devaluations should be viewed as a step in the deregulation of the financial market. China's deceleration is mainly driven by a weak housing market and lower capital spending, and in these areas there are certain signs of stabilisation. Meanwhile Beijing has both the monetary and fiscal muscles to help sustain the economy. 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. Strong expansion in India will help keep overall EM economic growth high. **Overall, we expect global GDP growth to reach 3.2 per cent this year and 3.8 per cent in 2016**, slightly lower than in May's *Nordic Outlook* for both years.

Because of a tighter labour market situation, GDP growth in the US will peak in 2016 and then approach its long-term trend in 2017. Various factors suggest that the economy will continue to expand for quite some time to come, for example a continued upside for cyclical sectors and a very leisurely normalisation of interest rates. In the euro zone, however, unemployment remains high and no supply-side constraints will make themselves felt during our forecast period. GDP growth will thus remain at roughly unchanged levels in 2017. Looking at the 34 mainly affluent countries in the Organisation for Economic Cooperation and Development (OECD) as a whole, growth will thus decelerate a bit towards the end of our forecast period. In the EM countries, however, growth will improve in 2017 as the situation in crisis-hit countries like Russia and Brazil stabilises, while India will continue its rapid growth. **Global GDP growth will end up at 3.9 per cent in 2017**, marginally above its 2016 level.

The labour market is approaching equilibrium in many countries

Assessments of resource utilisation in the economy of different regions are important as a basis for making forecasts about central bank policies and financial markets. **Unemployment in the three largest OECD economies (the US, Japan and Germany) is close to equilibrium, but as yet there are few signs of faster pay increases**. Because of a global price squeeze, especially for commodities, **deflationary forces continue to dominate**. Inflation and unemployment are not following their classic inverse relationship, which is creating headaches for the US Federal Reserve (Fed). Can we rely on inflation and pay increases to remain low, or do we risk a "ketchup effect" once the labour market becomes sufficiently hot? The Fed has now clearly signalled that it is prepared to begin key interest rate hikes, indicating that it is not ready to abandon old analytical frameworks, but it probably views the risk of prematurely killing the recovery as greater than the risk of an overheating scenario if the central bank should wait too long. This implies that **the Fed can be expected to proceed very cautiously with its key rate hikes**. Our main scenario is still that **the first rate hike will occur in September** but that the second hike will not come until March 2016. The rate path we foresee is far more gentle than both the historical pattern and the path signalled by the Fed itself, reflecting our view that the Fed will encounter rather severe headwinds in a low-inflation environment where several other leading central banks are continuing their stimulative policies. We believe that the Bank of England (BoE) will follow the Fed's example and begin rate hikes in February. However, the Bank of Japan (BoJ) will expand its stimulus measures this autumn, while the ECB continues monthly bond purchases at least until September 2016, as planned; if anything, these purchases may be expanded. The differences between US and UK monetary policy, on the one hand, and euro zone and Japanese policy on the other, will drive foreign exchange (FX) trends during the coming year. We thus anticipate that the **EUR/USD exchange rate will again fall, reaching parity (1.00) in mid-2016**. Meanwhile the Fed's slow rate path is the reason for our view that **bond yields will move higher but remain historically low**. Although global economic and financial market trends seem more mixed and uncertain than before, we are still in a phase of the economic cycle that is usually favourable to equities. Emerging market countries are the most vulnerable to Fed rate hikes, but history shows that EM asset prices are usually **resilient to tighter Fed policy if rate hikes are based on stronger US economic growth**.

Good growth in Sweden, but major economic policy challenges

Our forecast of 3.0 per cent Swedish GDP growth this year remains unchanged, and GDP will keep growing above trend in 2016 and 2017, partly sustained by gradually stronger international economic conditions. **Yet there has been no real lift-off in the manufacturing sector**. Merchandise exports and industrial production rose during the first half of 2015, but forward-looking indicators do not signal that any vigorous recovery is on the way. Better growth in Europe and the US is being offset by deceleration in China and various other EM countries. Service exports appear likely to climb by nearly 10 per cent, however, contributing to a relatively rapid increase in total exports. Despite lower trade surpluses, Sweden's current account surplus remains high due to capital income.

The rapid population increase is affecting domestic economic performance in various ways. **Private consumption is growing at a relatively good pace**, but per capita consumption is increasing somewhat more slowly than the historical average, since households are continuing to build up their savings. Rapid housing construction is helping to boost overall capital spending despite cautious businesses, but this is **not enough to ease the imbalances in the housing market**. Employment is growing at a healthy pace, also partly due to rapid population growth, and **unemployment is falling very slowly**.

Next year the collective agreements covering most of the Swedish labour market will expire. Depressed inflation expectations and a long period of good real wage increases suggest that high pay agreements are unlikely, despite labour market tensions. **The wage round this coming winter and spring will thus not solve the Riksbank's dilemma**. Inflation is climbing, partly due to a weaker krona, but will not reach the central bank's 2 per cent target. In the short term, the Riksbank will remain under pressure from low inflation expectations and falling oil prices. We expect **a further repo rate cut to -0.45 per cent this autumn** as the Riksbank continues its struggle to restore the credibility of the inflation target. We expect the Riksbank eventually to pay greater attention to the risks of rising home prices and debt, and its first key rate hike will occur in late 2016. In the short term, one further rate cut will push down the krona, but signs of slightly higher inflation will enable the Riksbank to lower its guard and allow a somewhat stronger krona. **The EUR/SEK exchange rate will be 9.20 at the end of 2015 and 8.80 at the end of 2016**. Because of the further key rate cut, Swedish 10-year government bond yields will probably drop below German yields, but long-term yields will then rise faster than in Germany as the Riksbank prepares its rate hikes. Sweden's political situation is dominated by gridlock and a lack of constructive cooperation between the political blocs. We expect a relatively cautious 2016 budget in September, but there is increasing pressure to enact more aggressive policies.

Rather good outlook elsewhere in the Nordic region

The economic outlook in the other Nordic countries is mixed. **In 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**; 2015 will be a year of zero growth after three years of falling GDP. For the region as a whole, the growth outlook appears rather good. A weak currency and resilient households will limit the scale of the slowdown in Norway, while Danish growth will accelerate with the help of expansionary fiscal policy and good consumption growth. In Norway, Norges Bank is focusing more on risks to growth and competitiveness than on inflation, which has been in line with the central bank's target for some time. The bank has continued to signal a high probability of a further rate cut this autumn. We believe that Norges Bank exaggerates the risks of contagion from the oil industry and that the next step will be a rate hike late in 2016.

Rising private consumption will continue to sustain growth in the Baltic countries as exports and capital spending are again hampered next year by Russia's recession and import restrictions, as well as by geopolitical uncertain due to the Ukraine conflict. GDP growth will accelerate in all three countries but remain moderate, reaching its potential pace only in 2017. Estonia's strongly export-dependent economy is slowly emerging from a relatively deep slump. Latvia seems the most resilient of the Baltics to Russian weakness and import sanctions, while Lithuania is more adversely affected than we expected; we are sharply lowering our GDP forecast there.

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

International economy, GDP, year-on-year changes, %	2014	2015	2016	2017
United States	2.4	2.4 (2.7)	3.1 (3.2)	2.6
Euro zone	0.8	1.6 (1.7)	2.1 (2.1)	2.0
Japan	-0.1	0.8 (1.1)	1.3 (1.3)	1.0
OECD	1.9	2.2 (2.3)	2.6 (2.7)	2.4
China	7.4	6.8 (6.8)	6.5 (6.5)	6.3
Nordic countries	1.6	1.8 (1.8)	2.1 (2.1)	2.1
Baltic countries	2.6	2.2 (2.5)	2.7 (3.1)	3.4
The world (purchasing power parities, PPP)	3.4	3.2 (3.4)	3.8 (3.9)	3.9
Swedish economy. Year-on-year changes, %				
GDP, actual	2.3	3.0 (3.0)	2.8 (2.7)	2.5
GDP, working day corrected	2.4	2.8 (2.8)	2.6 (2.5)	2.7
Unemployment, % (EU definition)	7.9	7.5 (7.6)	7.3 (7.3)	6.9
Consumer Price Index (CPI) inflation	-0.2	0.1 (0.2)	1.1 (1.2)	2.0
Government net lending (% of GDP)	-1.9	-1.4 (-1.3)	-0.8 (-0.7)	-0.2
Repo rate (December)	0.00	-0.45 (-0.40)	-0.25 (0.00)	0.75
Exchange rate, EUR/SEK (December)	9.39	9.20 (8.95)	8.80 (8.80)	8.60

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