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# Press release

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# Nordic Outlook: Stronger global growth, but downside risks dominate – Swedish boom threatened by imbalances

Global economic growth has the potential to gain strength but is imbalanced and fragile. Downside risks dominate, despite many years of expansionary monetary policies and sharply falling energy prices. The world's manufacturers are facing strong headwinds due to weak demand, surplus production capacity and a decline in commodity prices, but in many countries the service sector is still showing good resilience. A combination of expected growth deceleration in China without a hard landing, US domestic consumption power and Europe's gradual recovery will lead to a cautious acceleration in growth. In the 34 mainly affluent member countries of the Organisation for Economic Cooperation and Development (OECD), GDP growth will increase from 2.1 per cent in 2015 to 2.2 per cent this year and 2.4 per cent in 2017. Our forecast assumes that the price of Brent crude oil will rebound towards USD 45/barrel by the end of 2016, although downward pressure on oil prices will persist in the short term.

## Powerful capital flows in motion as normalisation processes begin

**The world economy faces challenges** that are large, complex and strongly linked together. The fall in commodity prices and emerging and oil-dependent economies' increased debt burden in US dollars and other foreign currencies have revealed structural weaknesses. China and various oil-producing countries will be forced to sell off foreign assets worth hundreds of millions of dollars, among other things putting pressure on global stock and fixed income markets. These forces may both be strengthened or weakened by the US Federal Reserve (Fed)'s recent key interest rate hike, its first since 2006, and China's shift in currency policy after 10 years of a steadily appreciating yuan. Yet we do not regard China's transition to a more flexible exchange rate policy as a sign of its participation in a global currency war. Normalisation processes have begun, but they will be anything but easy and will require intensified global cooperation among central banks and other organisations.

**China's GDP growth** in 2016 will be 6.5 per cent (6.9 per cent in 2015) and will fall to 6.0 per cent in 2017. The country will consequently avoid a hard landing, among other things with the help of further monetary and fiscal stimulus and an expanding service sector. The deceleration is structural – and thus expected – as well as cyclical. The manufacturing sector is struggling with overcapacity, and China's rapidly increasing debt in recent years – along with the weak balance sheets of its state-owned enterprises – is making the economy vulnerable.

## Emerging markets both a drag anchor and a risk to the global economy

**Russia and Brazil** are showing serious growth problems and their economies will shrink further in 2016. Currencies and stock markets have been pulled down by financial market turbulence. India's economic performance is the opposite, and GDP growth will climb from just above 7 per cent last year to nearly 8 per cent in 2017. Emerging market (EM) economies account for about 60 per cent of global GDP and have contributed more than 80 per cent of global growth in recent years. Today they are both a drag anchor and a large asymmetric risk factor – with worrisome political elements – to the global recovery.

**Western Europe** is taking small steps forward, and its economy is gradually gaining strength. The euro zone is benefiting from low interest rates, the decline in oil prices and a weak euro. Consumption-driven growth is being helped by low inflation, which improves households' purchasing power as unemployment continues to fall. A cautious upturn in capital

spending is also expected, due to relatively high capacity utilisation. We expect euro zone GDP growth to be 1.9 per cent this year (up from 1.5 per cent in 2015) and to reach 2.0 per cent in 2017. The overall economic effects of the refugee crisis will be fairly small, but political uncertainty will increase. Meanwhile European Union cooperation is being tested because of the threat that the United Kingdom may exit the EU. Our main scenario is that this "Brexit" threat will be avoided and that the UK will remain a member, but divergent visions of the EU's future will continue to create tensions between London and Brussels.

## Above-trend but not impressive US growth – Fed taking a break until September

**The US economy** is showing domestic strength but is being affected by the international situation to a greater degree than usual. The final months of 2015 were weak. We expect GDP growth in 2016 to be the same as in 2015: 2.4 per cent. Growth will climb marginally to 2.7 per cent in 2017. US manufacturers have been squeezed by a nearly 20 per cent appreciation in the dollar (in real effective terms) over the past 18 months. The effects of the oil price decline are more mixed: oil sector investments are falling, while households have gained significantly more purchasing power. The manufacturing sector's share of the economy has shrunk and the service sector – which is growing – has become a more important driving force in the US economic cycle. The absence of domestic imbalances, which historically have triggered recessions, will enable the US to show above-trend – but hardly impressive – growth in 2016 and 2017.

**Overall, global disinflationary forces dominate** due to surplus production capacity and downward pressure on wages and salaries, as well as globalisation and digitisation. In most countries, the upturn in inflation has again been delayed due to the renewed oil price slide. Increased resource utilisation will help limit the risk of deflation. In the United States, unemployment will reach such a low level that wage growth will rebound, especially in 2017. Looking ahead, we expect inflation to climb but remain below the inflation targets in most countries at the end of our forecast period.

## "Secular stagnation" thesis increasingly pivotal in central bank discussions

**Global monetary policies will be more expansionary in 2016**. Periods of weakened risk appetite in financial markets seem to constantly provoke new central bank stimulus measures. Although the Fed will hike its key interest rate twice during 2016 and three times in 2017 to a year-end level of 1.75 per cent, its normalisation process is being held back because the rest of the world is moving in the opposite direction. Troublingly low inflation expectations, combined with downside risks to growth, will force the European Central Bank (ECB) and the Bank of Japan (BoJ) to lower their key rates and expand asset purchases (quantitative easing or QE). The Swedish and Norwegian central banks will also cut their key interest rates. The Bank of England (BoE) will hold off on any rate hikes until 2017. The appreciation of the US dollar with be determined by the Fed and by capital flows; it will be relatively cautious during 2016: The EUR/USD exchange rate will stand at 1.03 by the end of this year and 1.05 at the end of 2017. The BoJ's policies will focus on weakening the yen. A stabilisation of oil prices will enable a number of EM currencies to recover. This will make it easier for the Fed to hike its key rate.

Given the risk of rising real interest rates (due to falling inflation), many central banks will have difficulty foreseeing any end point to their stimulus efforts. More and more central banks seem to agree that the **short-term real equilibrium interest rate** – the interest rate that leads to inflation-free full employment and a balance between capital spending and saving – is **zero or even negative**. Among other things, this implies that **future rate hikes will be gradual** and more cautious than before and that the benchmark for what can be viewed as a **normal level for long-term government bond yields will need to be lowered**. The long period of low inflation will also force central banks to re-assess the extent to which long-term and structural forces should influence monetary policy. It is also likely that central banks will be under increasing pressure to admit that it may take longer than the usual two-year horizon to achieve their inflation targets.

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## Nordics face divergent challenges – Norway fairly resilient to oil price slide

The Nordic economies face divergent challenges. The Norwegian economy is weighed down by low oil prices, which are pushing down capital spending and adversely affecting household optimism. Expansionary monetary and fiscal policy and a greatly weakened krone will still help maintain decent growth. We expect **Norway's GDP growth** to be 1.5 per cent in 2016 and 1.6 per cent in 2017. Norges Bank will lower its key interest rate to 0.50 per cent, and its first rate hike will occur late in 2017. Finland is plagued by continued stagnation and competitiveness problems. Economic policy will aim at stabilising public finances and meanwhile deal with structural growth problems. **Finnish GDP growth** will reach 0.4 per cent this year and 1.1 per cent in 2017, an upturn that will be partly sustained by low interest rates and the weak euro. Denmark will continue its modest recovery. A strong labour market will help sustain household consumption, but overall growth will be hampered by lower capital spending activity. **Danish GDP growth** will end up at 1.8 per cent in 2016 and climb to 2.2 per cent in 2017, which is close to trend growth.

## Swedish economic boom, with growing imbalances and downside risks

Sweden ended 2015 in an economic boom. Employment is increasing rapidly. Looking ahead, however, the outlook is dominated by downside risks due to growing domestic imbalances and political gridlock, as well as uncertainty about international developments. **Swedish GDP** will grow by 3.7 per cent this year and then slow a bit to 2.8 per cent in 2017. The strongest growth drivers are residential investments and consumption, partly stimulated by rising demand due to the refugee crisis. A slight upturn in manufacturing is also discernible and will give the Swedish economy a broader growth platform to stand on.

The economic consequences of refugee flows are difficult to assess, due to great uncertainty about both the size of the migration and the political reaction function. The number of new arrivals may decrease compared to earlier forecasts. On the other hand, the necessary resources per asylum seeker may have been underestimated. We are thus sticking to our previous assessment of spending pressure and demand stimulus. **We expect the central government budget to show deficits of 1.1 per cent of GDP this year and 1.3 per cent in 2017.** Yet public sector debt will fall by about 1 percentage point to 43.5 per cent of GDP in 2017, compared to 2015. Weak support in public opinion polls will increase the pressure on the government and the finance minister to invest more aggressively in education and training, infrastructure and housing construction. However, a more expansionary fiscal policy is a two-edged weapon in Sweden's current economic situation. The government has abandoned the principle of financing new programmes "krona-by-krona" but is prepared to defend the legally mandated expenditure ceiling. Overall, this implies that in light of the political situation, the contents of the spring budget bill will be rather meagre, with few new reforms.

Sweden is moving gradually towards increased resource utilisation. **Unemployment** will fall during the next 12-18 months to a low of 6.4 per cent. Due to an increased labour supply, the jobless rate will then climb to 6.8 per cent by the end of 2017. Our assessment is that structural unemployment – today about 7 per cent – may climb significantly in the next couple of years in the absence of a policy shift that lowers the barriers for new arrivals in Sweden to join the labour market. The growing signs of labour shortages in certain occupational categories will not affect the outcome of the ongoing **nationwide wage and salary negotiations;** we expect three-year collective agreements that end up with annual pay hikes below 2.5 per cent. During the next couple of years, the rate of pay increases is expected to remain at levels below what is compatible with achieving the Riksbank's 2 per cent inflation target, but this year various tax hikes will help push up inflation. Looking ahead, our **main scenario is moderate and delayed inflation effects.** By the end of 2016, CPIF inflation (excluding interest rate changes) will be 1.4 per cent and by the end of next year 1.9 per cent.

## Riksbank pressured to cut repo rate to -0.45 per cent; krona a joker in the pack

Continued low inflation and the fact that other central banks are moving in a more expansionary direction are putting pressure on an already stressed-out Riksbank, which has a short-term focus. The bank will lower its repo rate to -0.45 per cent in February and will not carry out its first rate hike until early in 2017. If the krona begins a clear appreciation trend or

if it reaches SEK 9.00-9.10 per euro during the next six months, we expect the Riksbank to intervene and sell kronor in the foreign exchange market. But this is not our scenario. We expect a shift in monetary policy during the second half of 2016, after the national wage round has ended and with the focus of attention returning to household debt. This will lead to a stronger krona: by the end of 2016, the krona will be trading at 9.00 per euro and 8.75 per dollar. At the end of 2017 the EUR/SEK exchange rate will be 8.70 and the USD/SEK rate 8.30.

The recently published evaluation of the Riksbank's policies during 2010-2015 is not expected to influence Swedish monetary policy in the short term, but it will form the backbone of a political review of the Sveriges Riksbank Act. In practice, the report does not propose any far-reaching change in the Swedish monetary policy framework, but it aims important criticism of the bank's flexibility, both concerning the role of economic modelling results for its decision making in a complex environment and the Riksbank's need to accept the fact that it may take time to achieve its inflation target. In addition, the report advises politicians to abstain from introducing a dual targeting mandate that would also include unemployment. We expect any changes in the Riksbank Act to be minor.

## Domestic policy stalemate is worrisome, both in the short and long term

The political situation in Sweden is volatile. The Alliance opposition parties are enjoying a surge in the opinion polls. This puts them, especially the dominant Moderate Party, under internal pressure to act in ways that will enable them to take power. Yet the economic and social policy challenges resulting from the refugee crisis make governing very difficult and demanding. Alliance party leaders are thus remaining focused on taking power after winning the 2018 election; above all, they realise the risks of taking over in the current parliamentary situation, where they will become directly dependent on the Sweden Democrats, a right-wing nativist party. But it is not difficult to imagine scenarios that might cause the scales to tip. A further upswing in public support for the Alliance, more clearly leftist policies by the curent Social Democratic-Green Party government or internal tensions within the ruling coalition on refugee policy are a few factors that might trigger a government crisis and a possible extra election. **Our conclusion is thus that there is a great risk of a cabinet reshuffle or an extra election during the coming year, but this is not our main scenario**.

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

| *International economy, GDP, year-on-year changes, %* | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| United States | 2.4 | 2.4 (2.5) | 2.4 (2.9) | 2.7 (2.6) |
| Euro zone | 0.9 | 1.5 (1.5) | 1.9 (2.0) | 2.0 (2.1) |
| Japan | - 0.1 | 0.6 (0.6) | 1.0 (1.1) | 0.5 (0.8) |
| OECD | 2.0 | 2.1 (2.1) | 2.2 (2.4) | 2.4 (2.4) |
| China | 7.3 | 6.9 (6.9) | 6.5 (6.5) | 6.0 (6.3) |
| Nordic countries | 1.6 | 2.1 (2.1) | 2.2 (2.3) | 2.1 (2.2) |
| Baltic countries | 2.8 | 1.9 (2.0) | 2.7 (2.7) | 3.2 (3.3) |
| The world (purchasing power parities, PPP) | 3.5 | 3.1 (3.1) | 3.4 (3.6) | 3.8 (4.0) |
| *Swedish economy. Year-on-year changes, %* | | | | |
| GDP, actual | 2.3 | 3.6 (3.2) | 3.7 (3.6 ) | 2.8 (2.8) |
| GDP, working day corrected | 2.3 | 3.4 (3.0) | 3.5 (3.4) | 3.0 (3.0) |
| Unemployment, % (EU definition) | 7.9 | 7.4 (7.4) | 6.7 (6.8) | 6.6 (6.8) |
| Consumer Price Index (CPI) inflation | -0.2 | 0.0 (0.0) | 0.6 (1.0) | 1.6 (1.9) |
| Government net lending (% of GDP) | -1.7 | -1.1 (-1.2) | -1.1 (-1.6) | -1.3 (-1.8) |
| Repo rate (December) | 0.00 | -0.35 (-0.45) | -0.45 (-0.25) | 0.50 (0.75) |
| Exchange rate, EUR/SEK (December) | 9.39 | 9.19 (9.20) | 9.00 (8.70) | 8.70 (8.60) |

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