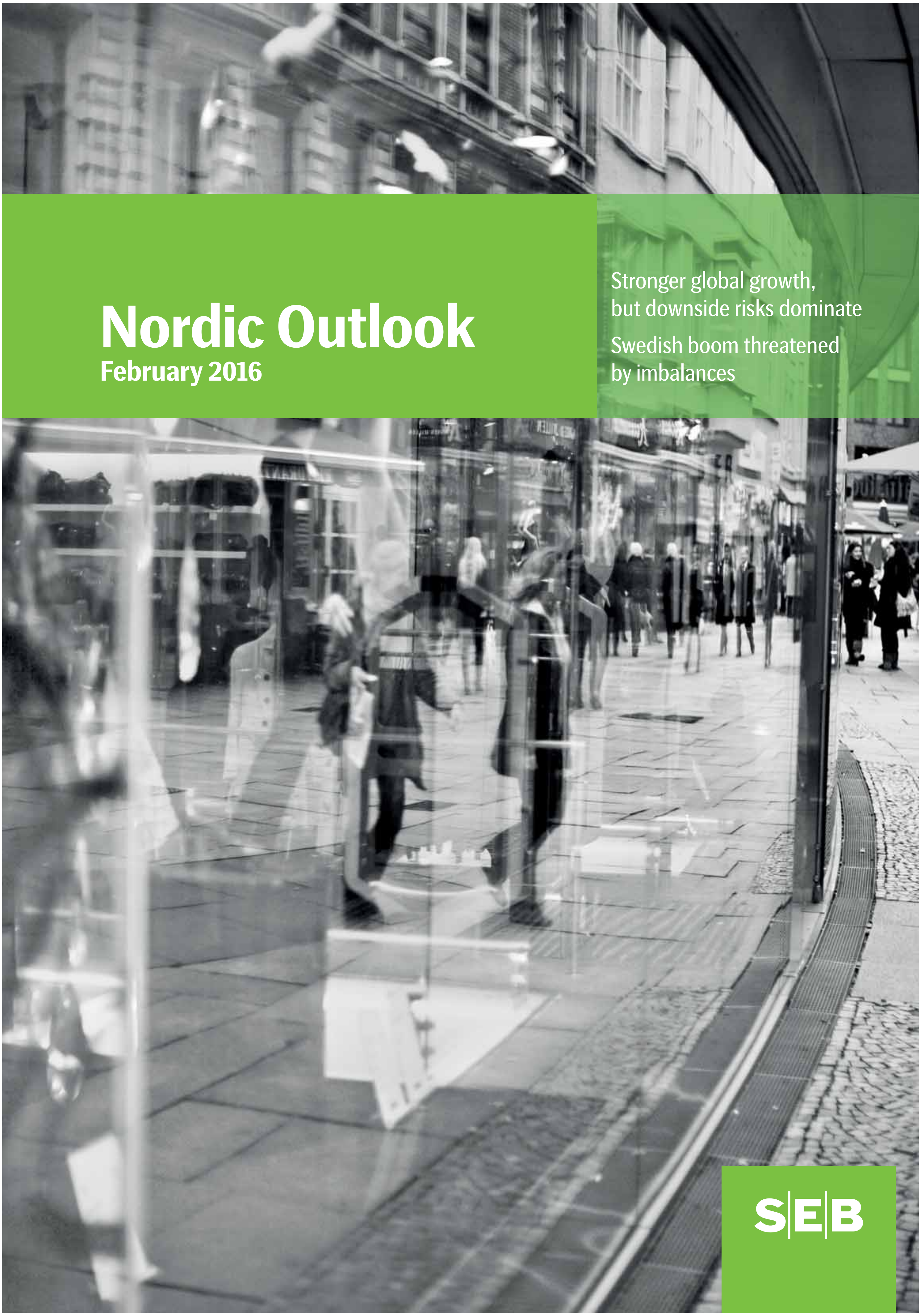

Nordic Outlook

February 2016

Stronger global growth, but downside risks dominate

Swedish boom threatened by imbalances

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Robert Bergqvist
Chief Economist
Japan
+ 46 8 506 230 16

Daniel Bergvall
Economist
The euro zone, Finland
+46 8 506 23118

Mattias Bruér
Economist
US, United Kingdom
+ 46 8 506 23294

Frederik Engholm-Hansen
SEB Copenhagen
Denmark
+45 3328 1469

Olle Holmgren
Economist
Sweden
+46 8 763 80 79

Elisabet Kopelman
Economist
+ 46 8 763 8046

Håkan Frisén
Head of Economic Forecasting
Sweden
+ 46 8 763 80 67

Erica Blomgren
SEB Oslo
Norway
+47 2282 7277

Stein Bruun
SEB Oslo
Norway
+47 2100 8534

Ann Enshagen Lavebrink
Editorial Assistant
+ 46 8 763 80 77

Andreas Johnson
Economist
China, India, Russia
+46 8 506 23295

Thomas Thygesen
SEB Copenhagen
Denmark
+45 3328 1008

SEB Research & Strategy, SE-106 40 Stockholm, Sweden

Stronger global growth, but downside risks dominate

- **Global economy resilient to industrial slump**
- **Oil will rebound despite structural squeeze**
- **Soft landing in China, but increased risks**
- **New ECB and BoJ stimulus measures**
- **Rising pay will trigger Fed hike after pause**
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In recent months, uncertainty regarding the strength of the global economy has mounted as industrial activity has faltered in many places. **The US economy ended 2015 on a weak note** and **worries about the Chinese economy** have impacted financial markets. These worries concern both the strength of China's ongoing deceleration and more long-term questions about currency policy, the credibility of official statistics and the ability of the authorities to deal with economic challenges. **Meanwhile a renewed decline in oil prices has intensified financial market volatility**. The energy sector weighs relatively heavily in global stock market indices, while low oil prices are squeezing public finances in many producer countries. This increases the risks that political instability, especially in the Middle East, will worsen the geopolitical situation. There is also selling pressure, mainly in the stock market, as producer countries are forced to use sovereign wealth funds to cover deficits.

We have lowered our GDP forecasts and now expect global GDP growth of 3.4 per cent in 2016 and 3.8 per cent in 2017, down from 3.6 and 4.0 per cent respectively in the last *Nordic Outlook*. Our 2016 revisions apply to both the 34 mainly affluent member countries of the Organisation for Economic Cooperation and Development (OECD) and the emerging market (EM) economies, while our 2017 adjustment applies only to EM countries. We thus see good reason to believe we are not facing a recession. **The US economy has underlying strength** due to the robust labour market and expansive service sector, and we believe that the positive effects of the oil price slide will kick in after some delay. Meanwhile, **financial market worries about China's economy seem exaggerated**, among other things because they do not actually reflect recent data. We also believe that oil prices are now close to bottoming out. The next few months will be turbulent, but we expect oil to rebound to about USD 45/barrel by year-end. In Europe, refugee crisis management and the threat of British withdrawal from the European Union ("Brexit") are raising many questions about the political future, **but this is unlikely to affect the economy especially much during the next couple of years**.

Global GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
United States	2.4	2.4	2.4	2.7
Japan	-0.1	0.6	1.0	0.5
Germany	1.6	1.7	1.9	2.0
China	7.3	6.9	6.5	6.0
United Kingdom	2.9	2.2	2.2	2.4
Euro zone	0.9	1.5	1.9	2.0
Nordic countries	1.6	2.1	2.2	2.1
Baltic countries	2.8	1.9	2.7	3.2
OECD	2.0	2.1	2.2	2.4
Emerging markets	4.7	4.0	4.3	4.7
World, PPP*	**3.5**	**3.1**	**3.4**	**3.8**

Source: OECD, SEB * Purchasing power parities

Although we do not foresee a recession, global growth remains fragile. Economies are still in need of monetary policy support, and capital spending is not taking off despite good profit levels. One reflection of this is that **central banks are increasingly starting to signal a view of the economy consistent with the "secular stagnation" thesis**. Inflation and inflation expectations are at uncomfortably low levels, strengthening this picture by pushing up real interest rates. Many central banks thus seem to have difficulty foreseeing any end point to their large-scale stimulus efforts. We seem to be stuck in a situation in which periods of **weakened risk appetite in financial markets provoke new central bank stimulus measures**. In an environment where monetary policies in many countries risk becoming stuck in an exceptional stimulus mode, it is inevitable that risks of financial bubbles and distorted resource allocation will eventually emerge.

Our forecast implies that the European Central Bank (ECB), the Bank of Japan (BoJ) and the Scandinavian central banks will intensify their stimulus measures in the near future, while the Bank of England (BoE) will delay its key interest rate hikes. **This means that the US Federal Reserve must carry out rate hikes on its own during the coming year**. We expect the Fed to continue its rate hikes rates because of an increasingly tight labour market, but due to concerns about an excessively strong US dollar the Fed will move very slowly. We are forecasting a historically very slow pace of rate hikes, with the next hike delayed until September; even so, we have a more aggressive rate path than is currently reflected by market pricing. We believe that such a path is compatible with **moderate dollar appreciation in effective terms, and we expect the EUR/USD exchange rate to reach 1.03 at the end of 2016**.

An environment of fragile growth and downside risks will generate uncertainty in stock markets, but our forecast still implies above-trend growth in the OECD and stabilisation in oil prices. Combined with continued central bank readiness to provide support in case of setbacks, this is reason for **cautious optimism about stock market performance this coming year**.

A different response to the oil price decline

The sharp decline in oil prices is now have a major impact on the world economy. **The historical pattern – in which the positive effects of lower oil prices predominate** because consumers and oil-importing countries are more sensitive to price changes than producer countries – **is now being challenged in various ways**. Lower oil bills are not having as great an impact on consumption and capital spending as expected. This may be due to a general lack of optimism, but also to uncertainty that the low prices will be long-lasting. Although we believe that prices will rise from today's extremely depressed levels (see theme article), oil will remain significantly cheaper than we have become accustomed to in recent years. Once oil-consuming businesses and households believe that there has been a permanent price shift, **there is a good chance that we will see delayed positive effects on consumption and capital spending**.

New behaviour patterns among producer countries are nevertheless a more important reason why the world economy is reacting differently from before. **The US has become an even more important oil producer than previously, which has had an impact**. Although shale oil producers have lowered their expenses, their break-even levels are still relatively high. This has led to reduced production and sharp cutbacks in capital spending activity. Secondary effects on the global economy and financial markets generally tend to be larger when the US economy is adversely affected.

Oil price to achieve public sector balance

USD/barrel

Country	Break-even	Country	Break-even
Bahrain	106	Iraq	80
Saudi Arabia	103	UAE	73
Algeria	95	Kuwait	67
Oman	95	Qatar	55
Iran	87		

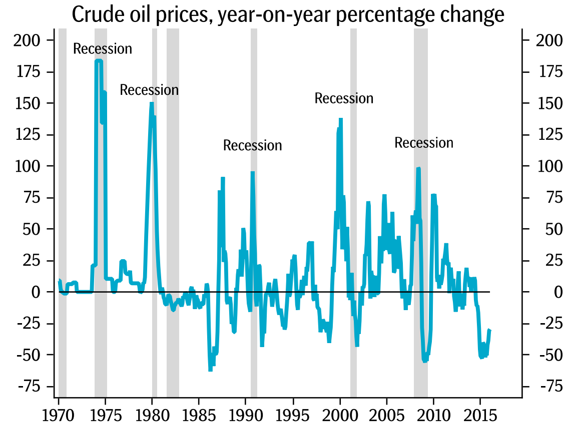
Source: International Monetary Fund (IMF), 2015

But the potentially largest impact on the world economy involves countries whose economic and political stability are dependent on oil prices. After the Arab Spring five years ago, many countries made costly welfare-related investments in order to defuse social unrest. **Because of this, many countries need high oil prices in order to achieve a balance in their public finances** (see above table). In addition, countries like Russia and Venezuela have also pursued policies that have resulted in a highly vulnerable political situation. Aside from the geopolitical risks connected to destabilising crises in producer countries, there is a direct influence on global financial markets. The large sovereign wealth funds that many producer countries have built up must now be used to cover their budget deficits. **This implies pressure on the stock market in particular** and has contributed to its recent weakness. In a later stage, these countries may need to make greater use of their foreign currency reserves, which will mainly affect the fixed income market.

Pressure on stock markets will decrease somewhat due to the oil price upturn that we foresee (see theme article). Another way of easing tensions may be for some countries to remove their US dollar pegs. Although it varies among different countries, we estimate that currency overvaluation is around 15 per cent. A depreciating currency helps boost oil revenue in national currency terms, reducing the problem of public sector deficits. Countries will also be forced to cut spending to reduce public deficits. Our main scenario is that the situation will be manageable in most countries. But conditions remain volatile and budget cuts will increase social and political risks. At worst, governments may completely lose control, resulting in civil wars and new refugee disasters. In light of this, **it is not illogical that financial markets respond with volatility when oil prices fall from already low levels**.

High oil price often coincide with US recessions

Crude oil prices, year-on-year percentage change



Source: Macrobond

Domestic strength makes the US resilient

The American economy is now being affected to a greater extent than usual by international developments. The manufacturing sector is being squeezed by a strong dollar and Chinese weakness, while the oil industry is playing a larger role than previously. **Yet our assessment is that at present, the US economy is relatively resilient**. Weak growth during the fourth quarter of 2015 was largely driven by inventory drawdowns. Industrial activity has generally not been a good leading indicator for the US economy in recent decades either, perhaps because manufacturing's share of the economy has decreased so much that industrial activity is no longer capable of steering the entire economic cycle. Major recessions have instead been triggered by domestic imbalances, for example the real estate crisis of the 1990s or the most recent financial and housing crisis.

The underlying domestic economy is strong, and households are benefiting from a robust labour market and good wealth positions. We also believe that the positive effects of the oil price decline will become clearer once households and businesses get accustomed to relatively low long-term oil prices. Meanwhile the negative contribution of the oil production downturn to GDP will ease. In a slightly longer perspective, the impact of the oil price decline will still not be entirely different from the patterns we have become accustomed to. **We expect US GDP growth of 2.4 per cent this year and 2.7 per cent in 2017.**

"Brexit" threat will probably be avoided

Promising a referendum on continued EU membership was a way for the British government to slow the advance of the EU-critical UK Independent Party in last year's parliamentary election. This tactic turned out favourably in the election, but now the government must also ensure a "Yes" vote in the referendum. Prime Minister David Cameron has declared that the best outcome for the UK would be a future in **a changed EU, not in today's EU. The government will thus have to show results in the current renegotiations** on membership conditions. If these results are perceived as inadequate, this may be a dangerous weapon in the campaign for a "No" vote.

British withdrawal from the EU would have a big impact on Sweden and Denmark. They would lose an important ally on such issues as trade liberalisation and resistance to excessive supranationalism. **Without the UK, EU cooperation would revolve even more around the euro**, which would tend to marginalise EU countries outside the euro zone. In the long term, it would not be surprising if these countries were pressured either to join the euro zone or accept a relationship to the EU similar to that of Norway and Switzerland today. New EU members in Eastern Europe would be affected in the same way. To these countries, good relations with the UK (and the US) have also always been important as the balance of power in their vicinity has shifted. Even today, the UK is regarded as a counterweight to centralisation efforts, whether coming from Brussels or Paris/Berlin. We see how Poland, for example, is showing increasing acceptance for UK demands on restrictions against EU migrants' access to British social welfare benefits.

The risk that London's position as a leading financial centre will be threatened has been discussed for a long time, especially among the British themselves, but **the Tory government is now trying to persuade the UK business sector to make a more concerted effort to shape public opinion** in favour of continued EU membership. UK withdrawal would otherwise lead to a number of technically difficult issues about how to organise a divided Europe in the future. The separation process would require a lot of energy in a situation where Europe needs to gather its forces to meet various challenges. In Germany and France, political leaders are eager to resolve these issues well before the German parliamentary election and the French presidential election in 2017.

The two sides have thus recently become more eager to reach an agreement. European Council President Donald Tusk has unveiled a draft that includes a watered-down version of the changes demanded by the UK. **If the other EU countries approve the agreement at the February 18-19 EU summit, the UK can hold its referendum as early as this June**. Public opinion polls currently indicate a rather even match, but betting organisations are quite convinced that in the end, the UK will stay in the European Union. This is also our main scenario. If an acute crisis flares up in the EU, for example related to the refugee crisis, this might possibly give the "No" side enough new wind in its sails that it can seriously challenge the country's EU membership. If our scenario proves correct, an important source of uncertainty will disappear. This will probably have a positive impact on the European economy.

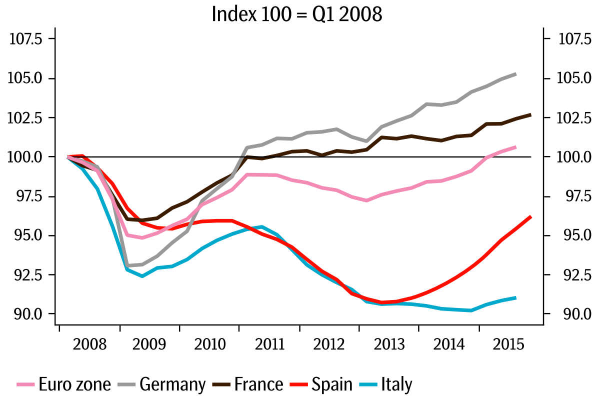
But cooperation is likely to remain fraught. There is broad-based opposition to the EU in the United Kingdom. Aside from concerns about the strains on the British social welfare system caused by EU migrants, there are fears that supranational ambitions, especially among EU technocrats in Brussels, will grow too strong to control. In particular, influential elements of the conservative press are pursuing a constant battle to protect London's independence against Brussels or Berlin/Paris. The EU bureaucrats' recent *Five Presidents' Report* calls for the creation of a political union by 2025, but the UK will probably fight this so intensively that it will **no longer be a matter of a two-speed European convergence, but of movements in two different directions**. An active resistance to tendencies towards concentration of power on the Continent has actually been at the core of British policy towards Europe for centuries. This is unlikely to change quickly.

Euro zone coping well with uncertainty

The economy of Western Europe continues to improve slowly. As a major net importer of oil, the euro zone can benefit greatly from lower energy prices. Because of downward pressure on inflation, real household incomes are rising despite low nominal pay hikes. Combined with job growth and falling unemployment, this is laying the groundwork for a consumer-led recovery. Meanwhile exports are benefiting from a relatively weak euro. A long period of low capital spending levels has contributed to relatively high capacity utilisation, which suggests that investment activity will increase somewhat during the next couple of years. ECB stimulus measures have helped to ease credit conditions, but banks in southern Europe are still weighed down by a large percentage of bad loans. Although leading indicators have fallen a bit in recent months, we are forecasting above-trend economic growth during the next couple of years. **We expect euro zone GDP to climb by 1.9 per cent in 2016 and 2.0 per cent in 2017**.

Euro zone: Recovery in different phases

Index 100 = Q1 2008



Source: Macrobond

The European Union's inability to manage the refugee crisis may have consequences for the entire EU project. The Dublin regulation, which specifies which member country should examine an asylum seeker's application, has ceased to function. This threatens the Schengen agreement on borderless travel. **If the Schengen system collapses, it would be a major symbolic setback for EU cooperation** and might be the starting point for broader tendencies towards dissolution. At present, however, we do not foresee the refugee crisis having very large economic consequences. Increased government spending will provide some demand stimulus while squeezing public finances. But even in Germany, which is resettling by far the most refugees in the euro zone, the effect will be no larger than 0.2-0.3 per cent of GDP, according to IMF estimates.

EM sphere hurt by shaky financial markets

Emerging market economies are under various kinds of pressure. Their currencies and stock markets were pulled along by financial market turbulence early in 2016. **Commodity-exporting economies have been hit especially hard** by the renewed decline in oil prices and worries about a Chinese hard landing. For example, the Russian rouble has weakened sharply and EM economies such as Saudi Arabia that have pegged their currencies to the US dollar are being squeezed. The Fed's monetary policy tightening is another source of uncertainty. Economies with large-scale foreign borrowing are especially vulnerable to currency depreciation, which increases their debt burden. Market volatility will probably continue for another while until oil prices bottom out or recover.

BRIC countries, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
China	7.3	6.9	6.5	6.0
India	7.1	7.3	7.5	7.7
Brazil	0.1	-3.5	-3.0	1.5
Russia	0.6	-3.7	-1.5	1.2
EM economies	4.7	4.0	4.3	4.7

Source: OECD, SEB

Yet numerous EM countries seem quite resilient to financial market worries. In many small and medium-sized economies, there is decent growth. For example, in many Asian emerging economies GDP growth is expected to accelerate cautiously in 2016 and 2017. The most serious growth problems are found in two of the BRIC countries, **Brazil** and **Russia**. In Russia's case, these problems are being made worse by the renewed oil price decline, but meanwhile we believe that Western sanctions will gradually be removed during 2016. **We expect China to successfully avoid a sharp deceleration in growth**, thanks to a strong service sector and continued stimulus measures, but growth will keep slowing. **India is a bright spot**; we expect growth to accelerate somewhat during the next couple of years, even though the reforms that will be required in order to achieve annual growth of more than 8 per cent appear unlikely to be put in place.

Downside risks of various kinds dominant

Our opinion that recession risks are small is based on several arguments. Resource utilisation is still relatively low, while central banks are prepared to act in case of clear deceleration. Corporate and household balance sheets are strong in most economies and we are far from the type of excesses among investors that usually trigger recessions. The US domestic economy remains strong. Under such conditions, it is difficult to present a recession as our main scenario. Yet there is obvious market turbulence, with elements of recession risks in financial pricing. This may reflect the fact that **the risk situation is more asymmetric than normal**, partly because upside potential is rather small. A high-growth scenario could most likely be generated if the positive impact of lower oil prices eventually materialised as a "ketchup effect". But if indicators clearly begin to strengthen and growth forecasts start to be revised upward, central banks will presumably withdraw stimulus measures and thereby help cool off financial markets.

It is also possible to argue that at present, there is one type of downside risks that **are actually highly improbable but have the potential to create a deep recession** ("tail risks"). One such risk is developments in China. After all, we know rather little about the capacity and ability of Chinese authorities to manage a serious crisis. An oil price collapse might also lead to meltdowns in important producer countries, with unpredictable geopolitical consequences. But even aside from such disaster scenarios, the risk of a worse economic performance than in our main scenario is 25 per cent, while the chances of a high-growth scenario are 10 per cent.

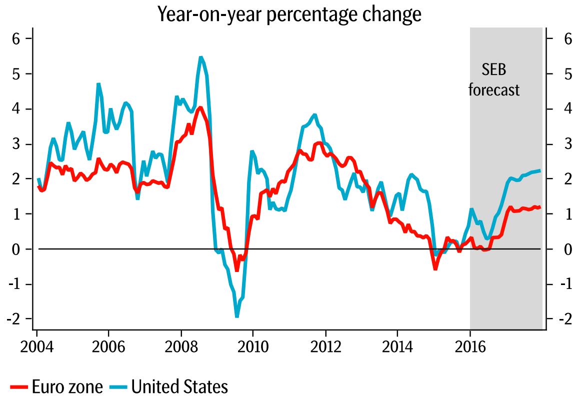
Inflation upturn will be delayed again

The renewed oil price decline is now squeezing CPI inflation again on a broad front. Price downturns are also occurring for other commodities, and especially food. This has led to sizeable downward revisions in our forecasts of total CPI in 2016. As annual averages, we now expect CPI to climb by 0.8 per cent in the US and by 0.2 per cent in the euro zone. Once energy price effects have disappeared from the 12-month figures at the end of this year, inflation will rebound. In 2017, CPI will increase by 2.1 per cent in the US and 1.1 per cent in the euro zone.

Our forecast for 2016 is well below the consensus estimate, but inflation expectations measured in the market for inflation-indexed bonds are even lower. It is not unusual for pricing in this market to overreact to major changes in oil prices, yet this raises the question of whether we are underestimating the secondary effects of the energy price decline. Falling inflation expectations are also causing headaches for central banks. It is not obvious that energy price effects can be disregarded when the market is pricing in long-term downward pressure on inflation. So far, however, the secondary effects have been small and core inflation has remained rather stable at just below 2 per cent in the OECD countries as a whole.

Consumer Price Index (CPI) inflation

Year-on-year percentage change



Source: Eurostat, BLS, SEB

A bit further ahead, the most important question will be how rising resource utilisation affects wage and salary hikes. Is the Phillips curve still relevant, or have increased mobility and global competition fundamentally weakened this relationship between unemployment and inflation? Several leading central banks are trying in various ways to signal that they would prefer to see accelerating pay increases. This reflects a concern that there is downward structural pressure on wages and salaries. **Yet our model estimates for the US do not indicate an end to the Phillips curve relationship**. This is one reason why we believe that pay hikes will gradually accelerate to 3½ per cent in 2017 once unemployment is expected to fall below equilibrium. However, continued low resource utilisation in the euro zone will hold back wages and salaries there. We expect upturns of about 1 per cent both in 2016 and 2017. In Germany, though, the resource situation is far tighter than in the euro zone as a whole, and pay will climb by about 3 per cent in 2016: still a bit too low to greatly narrow the differences in competitiveness within the euro zone. In Sweden, wage formation is relatively insensitive to variations in resource utilisation, and reactions also usually occur after a significant delay, which creates worries for the Riksbank (see theme article).

Growing central bank dilemmas

The world's central banks face growing policy challenges. Downside risks to growth have increased, while financial market volatility is rising and inflation expectations are falling. This will lead to further monetary stimulus in many countries. Meanwhile it is worrying that financial markets and risk appetite are in constant need of increasingly extreme monetary policy stimulus. **Being forced to "satisfy" finance markets, but meanwhile doubting the effectiveness of monetary policy, is a growing central bank dilemma**.

A number of central banks now 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. This belief in extremely low interest rates has several effects. Central banks are being forced to admit that it may take longer than the usual two-year horizon to achieve their inflation targets. Those central banks that begin the normalisation process are being forced to proceed slowly, especially since the zero lower bound and low inflation make policy mistakes asymmetrical in terms of costs. Limited monetary policy manoeuvring room also increases the need for a more expansionary fiscal policy when there is room fir it. **This new approach also means that the benchmark for what can be viewed as the normal level for long-term government bond yields will need to be lowered**. A downward adjustment in long-term reference yields makes share valuations more defensible but also poses growing challenges for the pension systems of many countries.

But there are also some other schools of thought, most notably represented by the Bank of International Settlements (BIS) but also embraced by several leading central banks – among other things concerning the principles behind inflation forecasting and the question of whether it is necessary to pay closer attention to **long-term structural changes related to growth and inflation dynamics**. Central bank models have traditionally assumed that deviations from historical growth and inflation trends are temporary phenomena. Nor have periods of divergences been regarded as lengthy enough to build up financial imbalances and jeopardise financial stability. This view is now starting to be questioned in the light of ongoing globalisation, digitisation and automation. Bearing these changes in mind, it may be difficult and risky to try to achieve inflation targets quickly without taking into account the state of the economy or the financial system. Especially in light of the risk of introducing new disruptions, it may prove more damaging than letting inflation remain at low levels.

Central banks have also increasingly focused on the currency market. One reason is probably that monetary policy effectiveness via interest rate and credit channels has decreased, **while financial market globalisation has increased the transmission power of exchange rates**. This suggests increased tensions and tendencies towards global currency wars. The Fed has lower tolerance for a strong currency after being surprised by the dollar's sustained negative effect on the economy. Japan is emulating Sweden by using negative interest rates to weaken the yen and boost inflation. Meanwhile a weak euro is needed so the euro zone's crisis-hit economies can get back on their feet. Various EM countries and oil producers are letting their currencies fall to offset lower commodity prices.

Central bank key interest rates

Per cent

	Today	Dec 2016	Dec 2017
Federal Reserve (Fed)	0.50	1.00	1.75
European Central Bank	0.05	0.05	0.05
Bank of England (BoE)	0.50	0.50	1.00
Bank of Japan (BoJ)	-0.10	-0.30	-0.30
People's Bank of China	4.35	3.85	3.85
Riksbank (Sweden)	-0.35	-0.45	0.50
Norges Bank (Norway)	0.75	0.50	0.75

Source: Central banks and SEB

Even if inflation moves upward as resource utilisation increases, many central banks will have difficulty achieving their inflation targets within a reasonable period. **As a result, global monetary policy will become more expansionary in 2016**. We expect the BoJ to keep its purchases of securities at today's JPY 80 trillion per year and instead cut its key interest rate by 0.1 percentage points in both the second and third quarter of 2016 to -0.30 per cent in order to weaken the yen and counter capital inflows. The ECB will lower its deposit rate in March by 10 basis points and expand its monthly securities purchases by EUR 15 billion to EUR 75 billion. Sweden, Norway and China will take further steps and cut their key rates.

Because of stimulus measures in other countries, the Fed will be forced to hike its interest rate against steady headwinds. We expect the bank to take a break, but we believe that the **tightening labour market will persuade the Fed to resume its cautious rate hikes in September**. During 2017 we also believe that rising wages and salaries will make rate hiking decisions easier. We expect the federal funds rate to reach 1.00 per cent by the end of 2016 and 1.75 per cent by the end of 2017. The BoE will delay its rate hikes and deliver the first one in February 2017. Early in 2017 we also believe that the Riksbank will be ready for an initial hike, due to good growth and a tightening resource situation in the Swedish economy.

Divergent challenges in Nordic countries

The Nordic economies now face divergent challenges. **Sweden will show an impressive GDP increase of 3.7 per cent this year**, with rapid job growth and unemployment already close to equilibrium. Large-scale refugee resettlement programmes will require extra spending, contributing in the short term to higher private and public sector consumption. Meanwhile there are increasing imbalances in the housing market. Looking ahead, housing and labour market reforms will be important in order to integrate the new arrivals, **thereby avoiding social tensions and major strains on public finances**. In the short term, the Riksbank will continue desperately trying to push the inflation rate higher. We expect both a key rate cut to -0.45 per cent and asset purchases soon. But we believe that rising resource utilisation will gradually become more important to monetary policy. By autumn the Riksbank will start signalling a shift towards tighter policy. The first rate hike will then occur early in 2017.

Nordics, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
Sweden	2.3	3.6	3.7	2.8
Norway	2.2	1.9	1.5	1.6
Denmark	1.1	1.3	1.8	2.2
Finland	-0.4	0.1	0.4	1.1

Source: OECD, SEB

The **Norwegian economy is weighed down by low oil prices**. Due to falling oil sector investments, the downturn will spread to other industrial activities. Household confidence has also fallen sharply, but expansionary monetary and fiscal policy – as well as a much weaker currency – will help maintain decent growth; we expect overall GDP to increase by 1½ per cent both in 2016 and 2017. The top priority of Norges Bank is to keep the krone weak, and the central bank is tolerating rather high core inflation. We believe that it will lower its key interest rate to 0.50 per cent in March but then abstain from further stimulus measures. The risk is on the downside, however: an oil price recovery may strengthen the currency in a way that forces Norges Bank to assume a dovish bias. We also believe that latent appreciation pressure will help delay rate hikes until late in 2017.

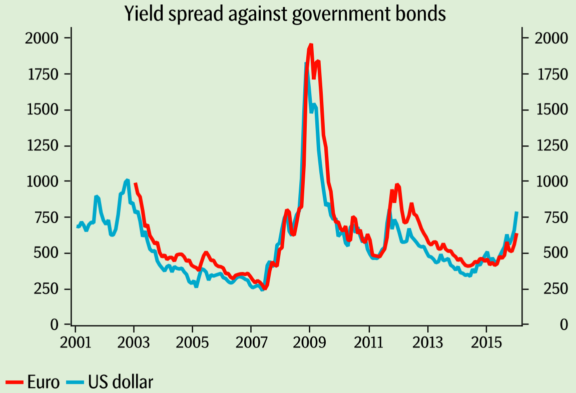
Finland is plagued by continued stagnation and competitiveness problems, partly due to depreciating currencies in nearby countries. Economic policymakers face a balancing act in trying to deal with both weak public finances and structural growth problems. Because of relatively tight fiscal policy, growth will remain weak, although we expect a slight acceleration in GDP growth to 0.4 per cent in 2016 and 1.1 per cent in 2017. **Denmark** will continue its modest recovery. Because of a sharp downturn in the GDP figure for the third quarter of 2015, we have adjusted our growth forecast downward and now expect GDP to increase by 1.8 per cent in 2016 and 2.2 per cent in 2017. A strong labour market will help sustain household consumption, but capital spending activity will meanwhile remain listless.

High yield stress: A threat to the economy?

The decline in oil prices is now squeezing financial markets on a broad front. Market pricing for high yield corporate bonds may be of interest when analysing the risks that financial market stress will feed back into the real economy and trigger a negative spiral. The default ratio (which includes bankruptcies and other suspensions of payments) in the high yield segment may, for example, be **an indicator of how serious the strains on the banking system are**. During the past year, we have seen how the decline in oil prices has driven up both bond spreads and actual defaults. This is especially clear in Norway, where the high yield market is completely dominated by the oil sector. In the US, the oil and energy sector accounts for about 20 per cent of the high yield market, while the percentage in the corresponding euro-denominated market is much lower.

Increased risks in the high yield market

Yield spread against government bonds

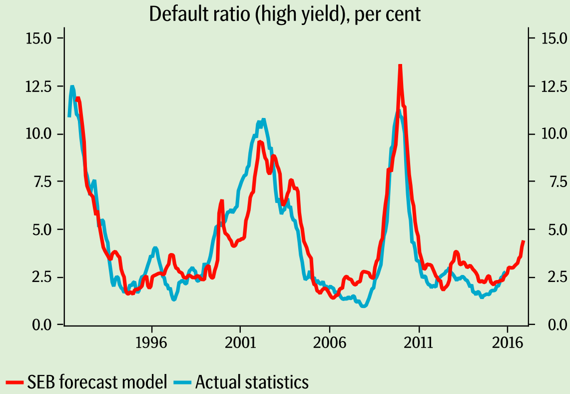


Source: Macrobond

This difference is reflected in spreads and default ratios. In the US, the upturn has been rather sharp, while it has been milder in the euro zone. The default ratio in the euro zone has been largely unchanged, while spreads have nevertheless widened somewhat as a result of generally shrinking risk appetite and falling stock markets. Our forward-looking model suggests that the default ratio in the US will climb rather rapidly in the near term. The model **indicates that we will soon reach levels that have only been exceeded during the three major recessions** since the early 1990s. When default ratios reach such high levels, there is a risk of a negative spiral – with banks and other investors pulling back and tightening credit conditions in a way that leads to renewed defaults etc.

US: Bankruptcies are continuing to climb

Default ratio (high yield), per cent



Source: Macrobond

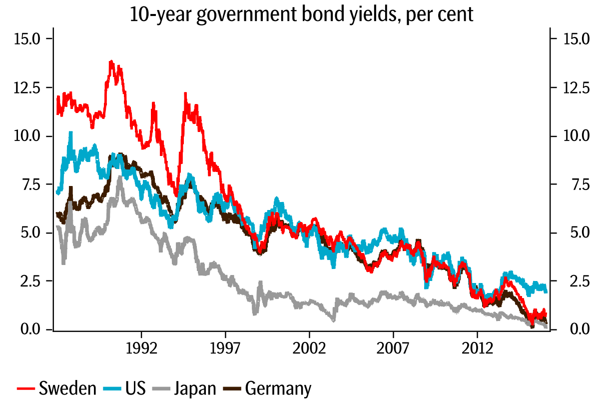
With such a large percentage of bankruptcies concentrated in the oil and energy sector, however, the current situation is a bit unusual. **The secondary effects of such a sectoral crisis are probably smaller than when the economy experiences large imbalances in the real estate or financial sectors, for example**. If our forecast of a generally resilient US economy – combined with a slight recovery in oil prices – proves correct, we can probably avoid a situation where financing problems in the high yield segment become so large that the crisis escalates. According to the Fed's Beige Book, US credit conditions are generally easing, which is also comforting. In light of this, our conclusion is that from a fundamental perspective the credit market has now made allowances for a more negative scenario than is found in our main forecast. But the high volatility that we are now seeing may very well continue for another while, leading to even wider spreads in the short term.

Depressed long yields despite Fed hikes

Early in 2016 long-term yields fell again, driven by growth concerns and disinflationary pressure from oil as well as by expectations of even more expansionary central bank policies globally. In the US, the fixed income market is not even expecting one Federal Reserve interest rate hike per year. After the introduction of negative key interest rates, Japanese 10-year government bonds are trading at new historic lows just above zero. In the euro zone, long-term bond yields are being squeezed by the ECB's signal of new monetary policy easing in March and the possibility of further steps after that. Yields on 10-year German government bonds have fallen to their lowest levels since last spring, when the high demand for bonds ahead of the start of the ECB's bond purchasing programme drove down yields nearly to zero.

Yields remain near historical lows

10-year government bond yields, per cent



Source: Macrobond

Our forecast of faster economic growth in the global economy and continued rate hikes by the Fed still suggests a **rising trend for long-term yields** during 2016 and 2017. We foresee a stabilisation in oil prices, which will also contribute to this picture. However, because we are now expecting the Fed to hold off on its next rate hike until September, **we have lowered our forecast of long-term US yields somewhat** compared to the last *Nordic Outlook* in November. We believe that German 10-year government bond yields will stay in the 0.40-0.60 per cent range during the first half of 2016 and then cautiously follow American yields higher, starting during the second half when the Fed resumes its rate hikes. **Because key interest rates will remain at historically low levels during the next two years, the upturn in long-term yields in both the US and Germany will be moderate**.

Our forecast is that 10-year US Treasury yields will stand at 2.30 per cent by the end of this year and then gradually rise to 2.80 per cent at the end of 2017. The corresponding German bonds will trade at 0.60 per cent by the end of 2016 and 1.20 at the end of 2017. The yield spread between 10-year US and German bonds will thus widen from today's 155 basis points to a maximum of 170 points at year-end and will then narrow to 160 at the end of 2017.

Renewed expectations of Swedish key interest rate cuts, combined with unexpectedly strong government finances, **have again led to a convergence in the yield spread between Sweden and Germany**. These factors will continue to push down Swedish yields during the first half of this year, while the Riksbank's government bond purchasing programme is underway in the spring. At mid-year, the yield spread against Germany for 10-year government bonds will be 35 basis points. **Looking a bit further ahead, however, the spread against Germany will trend higher**, among other things because of the Riksbank's rate hikes. Increased public sector borrowing due to the refugee crisis will contribute to an upturn in Swedish 10-year bond yields to 1.10 per cent at the end of 2016 and 1.90 at the end of 2017. This represents year-end spreads of 50 and 70 points against Germany, respectively.

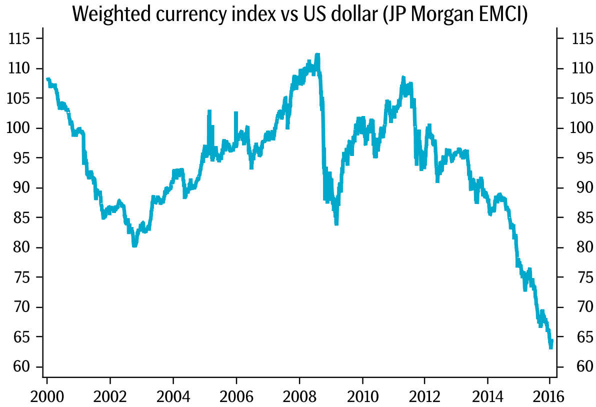
Signals from Norges Bank about relatively low 2016 issuance volumes will decrease supply-driven steepening pressure on the Norwegian government bond (NGB) curve. The krone will rebound, sustained by higher oil prices. This will be positive for NGBs, since **Norges Bank will be forced to maintain a dovish bias to dampen upward pressure on the currency**. We believe that the 10-year spread between NGBs and German equivalents will tighten to 80 basis points by the end of 2016.

Currencies remain a central bank focus

There is a continued strong interplay between the foreign exchange (FX) market and central bank actions. As central banks start running out of room for interest rate cuts and unconventional monetary policy, currencies become a last resort in their attempts to meet inflation targets. In such an environment, there is an increasing risk of currency wars. The trend towards a stronger US dollar, which began when the Fed started signalling tighter monetary policy almost two years ago, has put commodity prices under heavy pressure. Declining export revenues due to falling commodity prices have, in turn, put pressure on the currencies of commodity-producing countries. Further complicating the picture is that in recent years, many commodity-dependent emerging market countries have increased their USD-denominated debt.

Falling EM-currencies

Weighted currency index vs US dollar (JP Morgan EMCI)



Source: Bloomberg

Today the question is how far the dollar can continue to appreciate. For the Fed, the strength of the dollar is a headache that limits its manoeuvring room for further rate hikes, especially in the short term. Aside from creating more unfavourable exporting conditions for US companies, it boosts the debt burden of many EM economies that are already being squeezed by low commodity prices. This may have global repercussions that ultimately also affect the US. In such an environment, the world would probably feel a bit better if the dollar temporarily became weaker. Given our revised forecast of no second Fed rate hike until September, there is also a greater chance that dollar appreciation will take a break. On the other hand, low inflation is triggering further stimulus measures by the ECB and BoJ, whereas the BoE will hold off until 2017 before starting its rate hikes. Against this backdrop, we still expect **cautious dollar appreciation during the rest of 2016**. At the end of the year, the EUR/USD exchange rate will be 1.03 and the USD/JPY rate will be 130. In 2017 we believe that long-term valuation levels will be more important to currency movements. We expect a slight recovery to 1.05 for the EUR/USD rate, which is still far from our equilibrium level of 1.15-1.20.

Our forecast that oil prices are close to bottoming out and will soon slowly rebound will benefit commodity-related currencies. Looking a bit further ahead, we believe that many EM currencies will regain lost ground. This applies even more to undervalued commodity-dependent currencies such as the Canadian dollar and the Norwegian krone (NOK), which will find buyers as oil prices rebound. Although the recovery of the NOK will be delayed by a further central bank rate cut, at the end of 2016 the EUR/NOK rate will reach 9.20. The currency will then appreciate further to 8.50 per EUR by the end of 2017.

Our view that financial markets are now exaggerating the threats to the world economy, and that we will eventually see higher risk appetite, benefits cyclical currencies. This is a further reason to forecast stronger commodity-related currencies, but it also applies to the exchange rate of the Swedish krona (SEK) against more defensive currencies like the Japanese yen, the euro and the Swiss franc (CHF). Our ranking methodology (SEB FX Scorecard) currently places the SEK on top in several categories such as growth outlook, flows, valuations and positioning. But the Riksbank's struggle to push up Swedish inflation is holding down the krona. The central bank's threat of currency interventions is perceived as credible, especially by Swedish market players. This means that the EUR/SEK rate is stuck in the 9.10-9.50 range for another several months. After that, we see potential for a gradual, cautious appreciation as the Riksbank slowly begins to signal a policy shift in a tighter direction. The EUR/SEK exchange rate will fall to **about 9.00 at the end of 2016 and then further to 8.70** at the end of 2017, when Sweden's key rate hikes begin. The USD/SEK exchange rate will be about 8.75 at the end of 2016 and 8.30 at the end of 2017.

Positive stock market outlook despite risks

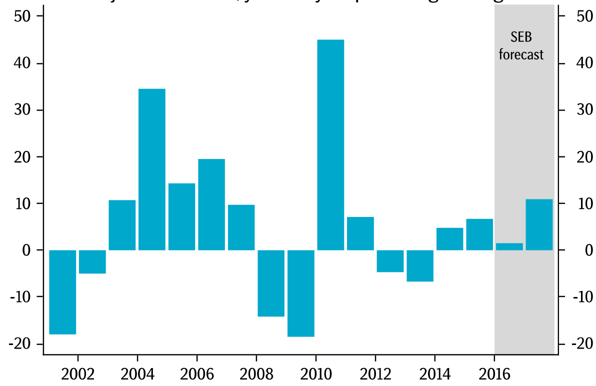
Falling oil prices and growth worries related to China and other EM economies, as well as weaknesses in US manufacturing, weighed down stock markets early in 2016. Tough conditions for the energy sector due to cheap oil are another explanation; squeezed margins for energy-related businesses will contribute strongly to continued downward revisions in profit forecasts, especially in the US. **Both in the US and Europe, expected earnings growth is now negative** (excluding the effects of share buy-backs). This means that despite the latest downturn, share valuations are consistent with historical averages.

One downside risk for the stock market is that the weakness in the energy sector might spread to the rest of the US economy and onward to Europe and China, for example due to commodity-related problems in the US credit market. Rising global economic growth and historically low interest rates should be able to drive sales and earnings higher and provide support for valuations. Central banks are prepared to help sustain economic growth, which benefits risk appetite **–** as market reactions to the dovish signals from the ECB and the BoJ's key rate cut demonstrated. But two pieces of the puzzle need to fall into place in order for our rather positive view of stock markets to become a reality: **Profit forecasts must again be revised upward and the US manufacturing sector must stabilise**.

The stock markets in advanced economies have the potential to perform better than those of EM economies. In addition, Europe will benefit more than the US from falling energy prices, while the **margins of US companies will be squeezed by rising labour and financing costs**. The weak start to 2016 points to continued major risks for EM equities. Meanwhile there are stabilising forces; shares are trading at a large discount compared to those of advanced economies, and Asian economies in particular will benefit from stronger consumption in the Western world.

Subdued Nordic profit growth in 2016

Adjusted after tax, year-on-year percentage change



Source: SEB

Nordic equities will benefit from the recovery in the euro zone, and valuations compared to the rest of Europe are not as strained as before. We have lowered expected earnings growth in 2016 to only slightly above 1 per cent, but in light of our macroeconomic scenario we see potential for stronger earnings growth in 2017 (more than 10 per cent), which should be reflected in stock market performance as early as this year. Depressed key interest rates are hurting the Nordic banking sector. High exposure to oil-related sectors – such as oil producers, oil-related services, shipping and transport – will result in negative earnings growth in Norway and Denmark this year but a large rebound in 2017. Our benchmark composite Nordic index (MSCI Nordic), at 254 at the end of 2016, will be equivalent to a total return of nearly 20 per cent. The corresponding total return on the OMX Stockholm exchange will amount to more than 20 per cent, with a benchmark of 1580 for the OMX30 index.

Theme: Lengthy oil price upturn during 2016

- **Price squeeze due to record inventories**
- **Non-OPEC output cuts and fall in capital spending pave the way for better balance**
- **Flexible shale oil will slow price adjustment**

The oil price slide accelerated again at the end of 2015. Early in 2016 we saw the lowest prices in over a decade. Oversupply and record inventories will continue to push down prices in the first half of 2016, and the subsequent upturn will probably be lengthy compared to earlier recovery periods. We have lowered our assumptions for Brent crude oil by USD 10 in both 2016 and 2017 to USD 40 and 50 per barrel, respectively. In the next few months, we believe that prices will remain around USD 30/barrel, followed by an upturn to USD 45 by year-end. Below is a review of factors that are important to future oil prices.

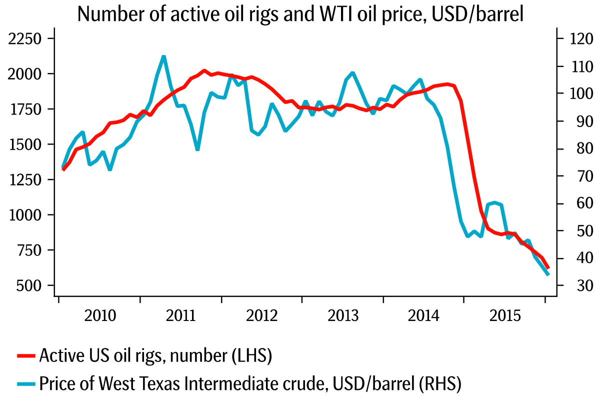
In the short term, the oil market will be dominated by large oversupply combined with record inventories, making it sensitive to even minor disruptions in supply and demand. These imbalances have recently worsened, due to expanded output in Iran after the nuclear agreement plus slightly lower US and Chinese demand both late last year and in forecasts.

The price strategy of the Organisation of the Petroleum Exporting Countries (OPEC) will remain crucial. The oil price slide during the 2008 financial crisis was followed by a rapid rebound orchestrated by OPEC, which quickly restored market balance by means of sizeable production cuts. OPEC's actions during the latest downturn have instead been characterised by an ambition to **slow the expansion of US shale oil production capacity** and thus preserve OPEC's market share. OPEC has declared that the market itself must find a balance and that the burden of adjustment must be assumed via prices rather than voluntary output limits. Recent attempts by Russia, a non-OPEC producer, to reach a common agreement on production ceilings were interpreted favourably by the oil market, but these attempts were quickly rejected by Iran. Many OPEC producers have adjusted their budgets to oil prices far above today's levels. This instead points to increased supply since they need to boost their volume to compensate for revenue losses due to lower oil prices (see also page 6).

But one fundamental reason for abstaining from coordinated action is that **OPEC's strategy is showing signs of beginning to work**, although it will take longer and require lower prices than Saudi Arabia had first expected. Production cuts and plunging capital spending will now gradually pave the way for market balance. The number of active oil rigs in the US has fallen sharply since peaking in the autumn of 2014. Rapid efficiency improvements in the shale oil industry have helped keep production up, but rig cutbacks now seem to be occurring faster than the productivity upturn. Investments in prospecting and development of new discoveries have generally responded to the price decline. SEB's review of investment budgets at more than 40 large oil companies suggests that the decline in investments will be roughly 25 per cent in both 2015 and 2016: the biggest cutbacks in 30 years. Shale oil investments in the US are falling even faster; a review of some 15 large producers points to cutbacks in the 40 per cent range in both years. OPEC also appears likely to lower investments sharply in 2016-2017.

The US oil industry has reacted to the price decline

Number of active oil rigs and WTI oil price, USD/barrel



Source: Baker Hughes, Macrobond

The question is what impact this will have on the oil market and how quickly. The main effects of today's capital spending decline will probably not occur until 2020-2025. But during 2016, we believe that the oil market will gradually move towards better balance as non-OPEC production falls. Historically, oil prices have often climbed sharply during such periods, since non-OPEC producers have reacted after a substantial time lag. One consequence of US shale oil capacity is that there is now one non-OPEC producer that can react quickly to changes in prices or demand. Compared to traditional oil companies, shale oil producers are small-scale, with lower capital costs and significantly shorter life cycles. The time from investment decisions until the first drop of oil starts flowing is about 3 months, compared to perhaps 5 years for traditional producers. Output is highest at the beginning of a well's service life. If and when oil prices start rising again, the shale oil supply can thus be boosted quickly. This suggests a lengthier upward price adjustment than in previous cycles.

Tighter credit conditions in the sector due to bankruptcies and credit market problems may, however, have a constraining effect and lead to a faster price upturn. Production disruptions due to increased geopolitical turmoil in the Middle East are another upside risk for oil prices. But downside risks still predominate. For example, Iran's re-emergence as a producer may occur faster than we have expected. Continued efficiency improvements in US shale oil production and a rising dollar exchange rate may have a bigger impact than we have assumed.

Two-speed economy with tightening labour market

- **More purchasing power drives consumption**
- **Manufacturing woes will not derail recovery**
- **Time for faster wage and salary growth**
- **Fed is taking a pause in key rate hikes**

The American economy continues to operate at two speeds. Export-oriented manufacturers are reeling while the domestically dominated service sector is growing, powered by household demand. Yet we believe that there is relatively little risk of recession; in recent decades, manufacturing activity has not been a good leading indicator for the economy as a whole. **GDP growth will reach 2.4 per cent this year and 2.7 per cent in 2017**. Our downward revision from earlier forecasts is mainly due to the inventory-driven slump late last year but lower business investment is also at play. The oil price decline, which slowed GDP growth in 2015 even though the US is a net importer of oil, will have a positive impact this year as households increasingly begin to use their higher purchasing power for consumption.

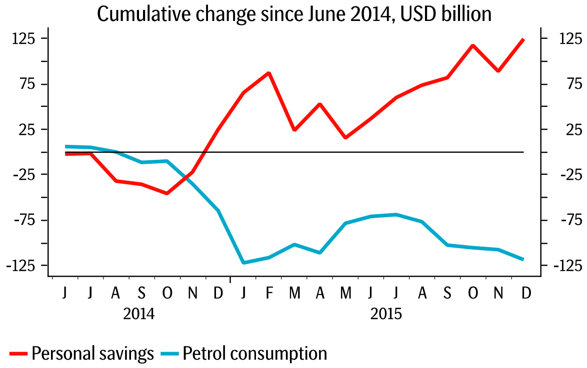
Because of lower oil prices, the inflation upturn in 2016 will be weaker than expected. Average annual increases in the consumer price index (CPI) will be 0.8 per cent in 2016 – well below consensus – and 2.1 per cent in 2017. **Core inflation is already close to 2 per cent, however**, while the Federal Reserve's favourite measure of core inflation (PCE) will probably climb after having flat-lined last year. Already **low unemployment will continue downward to 4.2 per cent by the end of our forecast period**, well below equilibrium. It will thus become increasingly difficult for businesses to find qualified employees, which will decelerate job growth. On the other hand, the tight labour market will probably lead to **faster pay increases**; according to our indicator models, hourly earnings will climb 3.5 per cent by the end of 2016. Because the labour market will eventually begin generating inflation, the Fed will resume its interest rate normalisation in September. The federal funds rate interval will be **0.75-1.00 per cent at the end of 2016** and 1.50-1.75 per cent by the end of 2017.

Households are showing their muscles

Households remain the most important growth engine. Robust job growth combined with a surge in purchasing power because of the oil price decline drove household consumption and, above all, disposable income higher last year. This year we expect another piece of the puzzle to fall into place as wages and salaries climb faster. The most important confidence indicators also signal robust consumption; both the Michigan and Conference Board indices are above their historical averages. Our overall assessment is that **household consumption will climb by 3.2 per cent in 2016 and 2.9 per cent in 2017**, compared to 3.1 per cent last year. This year's consumption growth will thus be the strongest in 11 years.

Petrol consumption and personal savings moving in opposite directions

Cumulative change since June 2014, USD billion



Source: EIA, BEA, SEB

If anything, the risk in our consumption forecast is on the upside. Since oil prices began falling in mid-2014, petrol (gasoline) consumption has decreased by a total of USD 110 billion. This lower petrol bill has largely gone into increased savings; **aggregate household savings are USD 120 billion higher today than when oil prices began to fall**. The increase in savings may be due to a belief among households that the energy price decline is temporary. But the longer oil prices are depressed, the more likely it becomes that this price situation is perceived as permanent and that households **will eventually use their higher purchasing power for consumption**. Because the savings ratio is already well above the level justified by the wealth position of households, they also have plenty of reserve spending power.

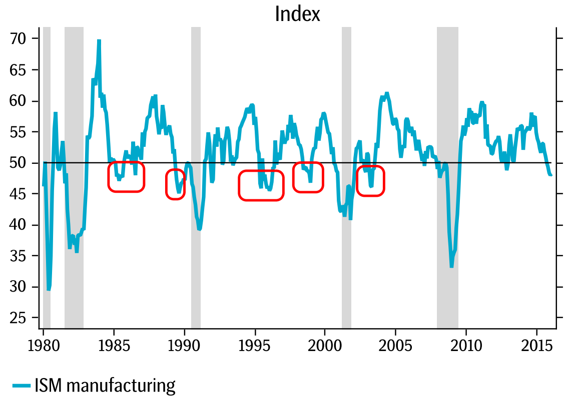
Capital spending remains subdued

Apart from residential construction, which rose by nearly 9 per cent last year, capital spending activity is sluggish. Indicators generally show a **de-coupling between manufacturing and services**. Among manufacturers, sentiment is gloomy. The Institute for Supply Management (ISM) purchasing managers' index for manufacturing is well below the growth threshold of 50. Real effective dollar appreciation of 18 per cent in the past 18 months, ongoing inventory drawdowns and weakening demand from key export destinations like China, Mexico and Canada may explain the downturn. Weakness in manufacturing is offset by the more domestically oriented service sector, and **our composite ISM index is now compatible with 2 per cent GDP growth**.

The growing weakness in manufacturing activity has increased the risks that contagious effects will trigger a broader economic downturn. Yet many indicators still suggest that the economy is highly resilient to this. In recent decades there have been multiple examples of the manufacturing sector being in recession while the economy as a whole continued to grow. In statistical terms, causality tests even show that in recent decades **the service sector has led the manufacturing sector and not vice versa**. One reason may be that manufacturing has shrunk so much as a share of the economy that manufacturing activity is no longer capable of controlling the overall economic cycle. It may also reflect the fact that in recent decades, severe recessions – such as the real estate crisis of the early 1990s and the latest financial crisis – have been triggered by domestic imbalances not directly connected to manufacturing. According to historical associations, we also have quite a way to go before the ISM manufacturing index signals a recession for the whole economy; the critical level is as low as 43. New orders indicators have rebounded according to the ISM manufacturing survey while holding on to robust levels in the service sector. However, actual company order backlog fell in December.

ISM below 50 not equal to US recessions

Index

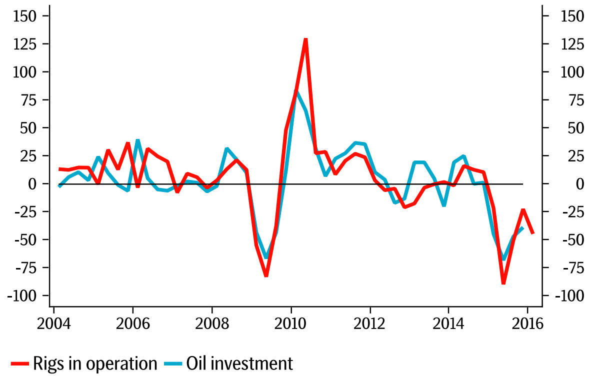


Source: ISM, NBER, SEB

Overall, we see the potential for business investments to accelerate from a growth rate of 3 per cent in 2015 to a yearly average of **4.5 per cent in 2016-2017**. **Oil-related capital spending continues to be a downward force** and has not yet bottomed out, despite plunging more than 40 per cent year-on-year in 2015: **equivalent to a negative GDP contribution of 0.4 percentage points**. Such indicators as the number of active oil rigs show continued short-term weakness, but given our forecast of oil price stabilisation these headwinds will gradually fade.

Oil investments remain depressed

Annualised



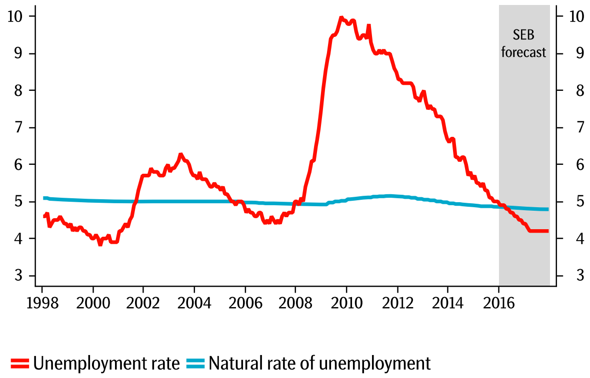
Source: Bloomberg, BEA, SEB

Higher pay increases are in the cards

The strength of the labour market is the most important fundamental factor in our relatively optimistic economic outlook. Last year 2.7 million jobs were created in the US, and in 2014 the number was 3.1 million – the strongest since the dotcom (IT) boom of the late 1990s. The commodities sector lost 130,000 jobs in 2015 because of the oil price slide, but this was offset by a wide margin in other sectors; the commodities sector accounts for a modest 0.6 per cent of total employment. Looking ahead, we foresee a gradual deceleration in job growth: an average of 200,000 jobs per month in 2016 and 170,000 in 2017. Unlike the Fed, we expect unemployment to keep falling, though at a slower pace**. It will total 4.5 per cent at the end of 2016 and 4.2 per cent at the end of 2017**. That is also a low level in a historical perspective; during the two preceding economic cycles, unemployment bottomed out at 3.8 and 4.4 per cent, respectively.

The labour market is tight

Per cent



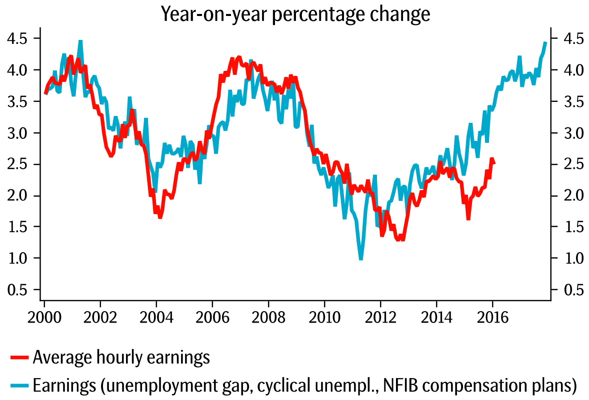
Source: Congressional Budget Office, SEB

Several indicators point to a tightening labour market. The quit ratio – a measure of the labour force mood and one of former Fed Chairman Alan Greenspan's favourite indicators – is showing a stable rising trend and has reached its highest level so far in this economic upturn. New applications for unemployment benefits are at levels that are historically compatible with monthly job growth of around 250,000. Small business hiring plans have climbed to a 7-year high. At the end of 2015, the number of firings was the lowest in 15 years. In terms of the vacancy/hiring ratio, job growth could have been even stronger if businesses had been able to recruit the right employees. The Fed's Beige Book report also indicates that it is difficult to find qualified job candidates in various sectors. In recent editions, the same trend is emerging for low-skilled labour, which should provide a good basis for wage growth.

Our indicator model, which includes the unemployment gap and small businesses' compensation plans, **points to an average hourly earnings increase of 3.5 per cent at the end of 2016 and 4.5 per cent at the end of 2017**. But our forecasts suggest more cautious wage and salary hikes, among other things because hourly earnings increases topped out at slightly above 4 per cent in the last two economic expansions. Meanwhile, experience shows that pay levels can accelerate rapidly once unemployment has dropped below equilibrium. For example, this happened in 2004-2006, when the Fed raised its key rate at 17 consecutive policy meetings.

Potential for wage growth acceleration

Year-on-year percentage change



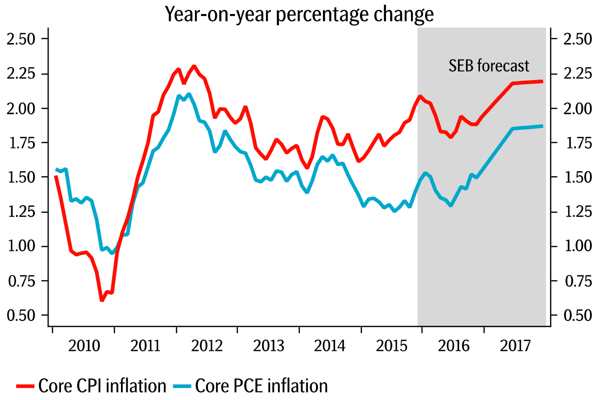
Source: BLS, SEB

Core inflation moving towards Fed target

Inflation, which bottomed out at zero last year, will move upward in 2016-2017. Base effects as earlier oil price declines disappear from the 12-month figures are an important driving force this year, but lagging USD effects and lower food prices will meanwhile slow the upturn. We are also revising our inflation path downward because oil prices have renewed their decline in 2016, although their effect is smaller because the weight of energy prices in the basket of goods and services has greatly diminished. CPI inflation will total **0.8 per cent this year and 2.1 per cent in 2017, according to our forecasts**.

The two measures of core inflation diverged last year

Year-on-year percentage change



Source: Macrobond, SEB

Energy prices rather than broad-based deflation pressure are thus the main factor holding down prices. This is reflected by **core inflation**, excluding food and energy prices, which has climbed to a 40-month high and **today is at around 2 per cent**. Allocating inflation between goods and services is also interesting. Prices are falling in the goods sector, in which international demand and USD effects have an impact. On the service side, however, prices are showing three per cent increases. Since wages and salaries, which dominate the cost picture at service businesses, are expected to rise faster, no slowdown in service inflation is in the cards. This indicates that we cannot dismiss the **Phillips curve**, which shows an association between unemployment and inflation.

But core inflation using the personal consumption expenditure (PCE) deflator is the Fed's main focus. Unlike ordinary core inflation, it flat-lined last year, but **we expect the gap to begin closing** in 2016 as health and other expenses that weigh heavily in the consumption deflator rise at a faster pace and regain lost ground. **Year-on-year PCE core inflation will amount to 1.5 per cent at the end of 2016 and 1.9 per cent at the end of 2017, according to our forecast**. This is close to the Fed's forecasts of 1.6 and 1.9 per cent, respectively.

Hesitant monetary policy tightening

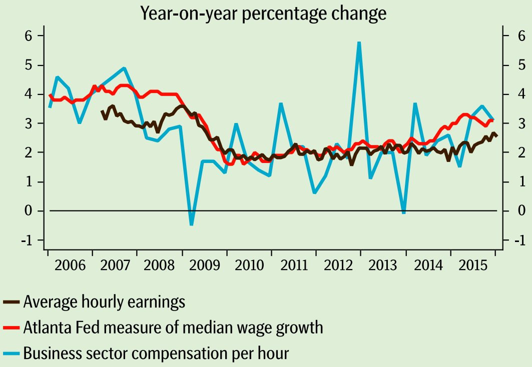
When the Fed raised its key interest rate in December 2015, it signalled that it expected to raise this rate in gradual steps at every second monetary policy meeting. Meanwhile financial market turbulence since the start of 2016 has tightened financial conditions, in turn reducing the need for rate hikes. Combined with recent economic statistics that have leaned towards the weak side, this suggests that the **Fed will take no further action until the autumn of 2016**. The market has reacted quickly since New Year and is now pricing in only one rate hike per year in 2016 and 2017.

Which wage metrics is the Fed tracking?

Wage growth, measured as average hourly earnings, has been stuck at low levels in recent years. Although average hourly earnings are one focus of market attention, there are alternative metrics that are already showing stronger earnings growth. The Atlanta Fed's alternative is a strong challenger; it compares today's wage level with that of 12 months ago for the same sample of individuals with jobs. According to this measure, earnings are growing by more than 3 per cent year-on-year, a rate historically more compatible with the current rather tight resource situation in the US labour market.

Wage growth metrics you should follow

Year-on-year percentage change



Source: Macrobond, SEB

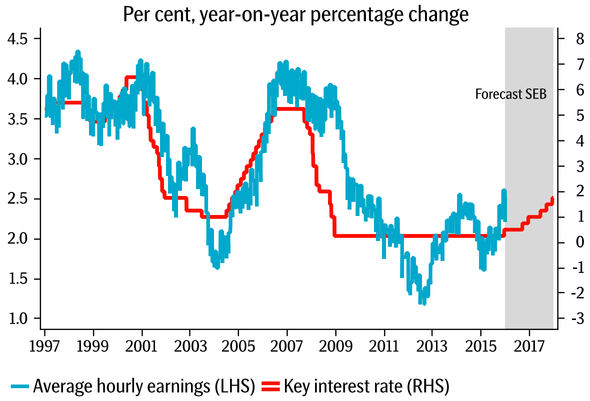
Which metric the Fed prefers is vital to monetary policy. Although the Fed naturally also keeps an eye on the monthly figure showing average hourly earnings, Fed Chair Janet Yellen provided further hints in a December speech. She mentioned that in addition, the Fed also carefully follows quarterly statistics on total business sector compensation, which is a key variable when calculating unit labour costs. According to this metric, earnings grew by 3.1 per cent year-on-year in the fourth quarter of 2015.

Vice Chairman Stanley Fischer has said that wage growth of around 3 per cent is compatible with the Fed's inflation target. An overall picture of various wage metrics thus shows that the rate of wage growth poses no major problems for the Fed when it comes to **continuing its interest rate normalisation, if and when market turbulence eases**.

But if wage growth now accelerates, in accordance with what both a tighter labour market and the indicators are showing, another piece of the puzzle will fall into place and **interest rate normalisation will continue**. During the previous rate hiking cycle, too, deflation risks were lurking around the corner and few market observers foresaw the long series of rate hikes that followed during 2004-2006. Faster pay increases will also persuade the Fed to act this time around. **The central bank will deliver 25 basis point hikes in September and December, according to our forecast**. We predict that the most important rate – the federal funds target rate – will be in the 0.75-1.00 per cent interval at the end of 2016 and 1.50-1.75 per cent at the end of 2017. Our assessment is thus that further monetary stimulus measures abroad will not stop the Fed, yet the US central bank's normalisation process will be significantly more leisurely than the historical pattern. Although the US is a typical example of a large closed economy, certain signals from the central bank are among indications that policy makers want to avoid excessively large, rapid USD appreciation. **The Fed will meanwhile continue to roll over maturing government bonds in its portfolio at least during 2016**, in our assessment. According to the Fed's communication, it will not begin winding down its balance sheet until the key interest rate reaches 1-1.50 per cent.

Wage growth has triggered hikes in past cycles

Per cent, year-on-year percentage change



Source: BLS, SEB

Calm fiscal situation before 2016 elections

Fiscal policy conflicts will not disrupt economic growth this year. Only after the elections, once the next Congress has taken its seats early in 2017, are renewed clashes possible as the debt ceiling and other issues return to the agenda. Last autumn, Congress approved a two-year budget that raises expenditure caps and will also help **make fiscal policy slightly expansionary in 2016 and 2017**. The federal deficit will increase from 2.4 per cent of GDP in 2015 to 2.7 per cent in 2017.

The main focus of national attention, of course, will be the presidential and congressional elections on November 8. Aside from the presidency, all seats in the House of Representatives and one third of those in the Senate are in play. According to betting organisations, **Hillary Clinton is the favourite** to win both the Democratic nomination and the presidency. Since the 1950s, however, it has been unusual for the same party to hold on to the presidency for three consecutive terms. The only example was the period 1981-1993, when Republicans Ronald Reagan and George H.W. Bush were in the White House.

It is still uncertain who will be Clinton's Republican opponent. According to the betting organisations, Donald Trump is a slight favourite to beat Marco Rubio and Ted Cruz. The outcome of the early primary elections is traditionally crucial in the process, but it may take far longer than this before a Republican presidential candidate emerges. Although Trump's staying power has been surprising so far, it is difficult to see him appealing to America's increasingly large Latino voting bloc. Instead Rubio is our favourite, especially because he is likely to get the party's support; he is also the Republican candidate who has polled the most successfully head-to-head against Clinton.

Small steps forward – large risks of new setbacks

- **Broad-based but slow growth; consumption tax hike on the way despite recession risk**
- **Oil price decline a two-edged sword: higher company profits but missed inflation target**
- **Meagre impact from Abenomics – Bank of Japan cuts key interest rate again**

Japan is struggling persistently to achieve sustainably higher growth and inflation. GDP statistics have undergone major revisions and the economic situation in 2015 has occasionally been described in terms of technical recession and stagnation. Three years after Prime Minister Shinzo Abe launched his "Abenomics", many still **doubt the effectiveness of this policy**. **We expect real GDP growth of 0.6 per cent in 2015**, after the economy went nowhere in 2014. This growth was relatively broad-based, but both private consumption and exports were weaker than expected. We expect GDP to accelerate to **1.0 per cent in 2016 but slow down to 0.5 per cent in 2017**. To achieve sustainable growth, good corporate earnings– thanks to lower oil prices and currency rate effects – need to result in capital spending, share dividends and higher pay. Downside risks continue to dominate and are connected to weaker domestic demand and credibility problems linked to Japan's weak public finances.

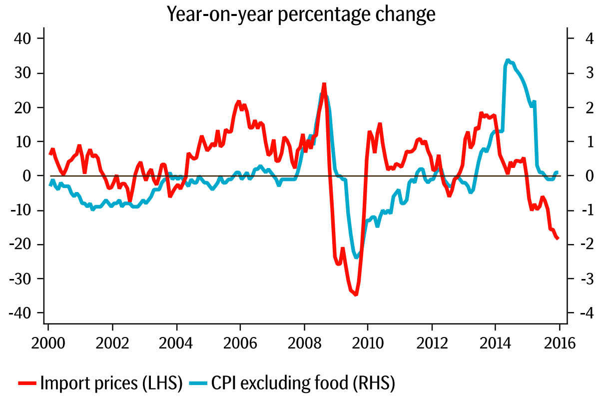
Unemployment today is 3 per cent, close to equilibrium (NAIRU). We expect it to stay near this level both in 2016 and 2017. Low unemployment is largely an effect of the shrinking labour supply due to an ageing population. There are hopes that this spring's pay negotiations will lead to rising real wages, thus strengthening private consumption. The Bank of Japan (BoJ) has described the outcome of these negotiations as critical to achieving higher inflation. Japanese politicians are also following the example of their German, British and US colleagues by pushing for higher minimum wages. Mr Abe wants 3 per cent annual hikes in minimum wages for a long period. This would be slightly above target for nominal GDP growth. But due to worries about the competitiveness of Japanese exporters, the pay demands of employees appear likely to be lower than in the previous wage round.

The first three "arrows" of **Abenomics** aimed at solving Japan's economic problems – more expansionary *monetary* and *fiscal policies* as well as *structural reforms* – were joined this past autumn by **three new arrows**: a quantitative target of boosting nominal GDP by JPY 600 trillion (though without any timeline), achieving a birth rate of 1.8 per woman (today 0.8 per cent) to stabilise population (now 127 million) at some 100 million and to expand social service systems so that family members are not forced to quit their jobs to care for children and the elderly.

Credit rating agencies and international organisations like the IMF, OECD and G20 are pressuring Japan to take control of its public finances and debt; Abe has promised that the primary budget balance will be ±0 per cent in 2020. Japan's public debt, today nearly 250 per cent of GDP, is expected to stabilise at this high level in the long term according to the IMF. This is one important reason for the government to implement its planned consumption tax hike in 2017 (possibly excluding food) despite the substantial risk of a new recession.

Inflation is being squeezed by lower import prices

Year-on-year percentage change



Source: Macrobond

Japan's oil and gas imports make up some 25 per cent of its total yearly imports of about USD 800 billion. Japan will thus potentially benefit from the global energy price collapse, but the problem is its impact on inflation and the risk of renewed deflation. Inflation was 0.5 per cent in 2015. Fading commodity price effects, higher resource utilisation and slightly higher pay will help decrease the risk of deflation. **We expect inflation of 0.2 per cent in 2016 and 1.7 per cent in 2017** (incl. tax hike).

Inflation expectations of some 1 per cent – well below the BoJ's 2 per cent target – have not been much affected by the quantitative and qualitative easing (QQE) programme launched in April 2013, which is at the heart of BoJ policy. Today's monetary base is 60 per cent of GDP, or twice as large as in the US or the UK. The BoJ is expected to cut its key rate further to -0.30 per cent but not expand its yearly securities purchases of JPY 80 trillion. The aim is to ensure that long-term yields do not rise and weaken the yen in order to reduce imported deflation. **We expect the USD/JPY exchange rate to be 130 at the end of 2016 and 125 at the end of 2017**.

Major emerging economies still facing headwinds

- **China: Financial market turmoil does not reflect the real economy**
- **India: Close to hitting the growth ceiling**
- **Russia: New oil collapse boosts uncertainty**
- **Brazil: Recession will continue in 2016**

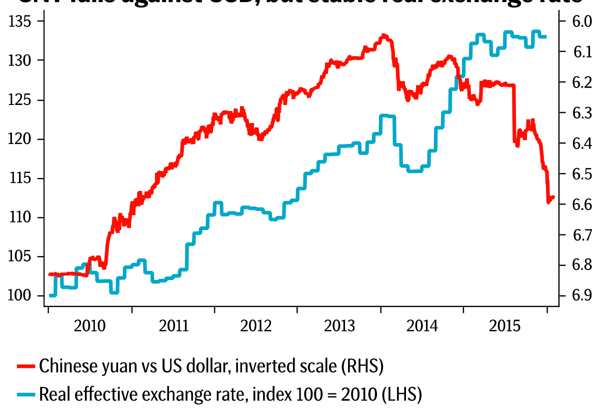
China: Increasing risk of policy mistakes

Early in 2016, a combination of plunging Chinese share prices, a weakening of the yuan and a renewed oil price fall had an impact on global financial markets. Like last summer, however, there is **no clear connection between financial market turbulence and China's real economy**. However, there are worries concerning the strength of China's ongoing deceleration. Year-on-year GDP growth slowed by 0.1 point to 6.8 per cent in the fourth quarter. The official purchasing managers' index for manufacturing has been just below the threshold of 50 in recent months. Industrial production has shown a stabilising trend measured year-on-year. Retail sales are chugging along at a healthy pace. The fall in exports has decelerated. Home prices continue to rise, but an overhang of unsold homes is hampering construction. The service sector is showing good growth but has cooled a bit due to a dampening of growth in financial services. A continued easing of economic policy by means of interest rate cuts and expansionary fiscal policy is providing support. We are **sticking to our forecast that China can avoid a hard landing** and that growth will decelerate gradually in 2016-2017, although the risk of serious policy mistakes has risen. **GDP growth was 6.9 per cent in 2015** and the target of "about 7 per cent" can thus be regarded as having been fulfilled, although actual GDP growth is probably well below what official figures show. We believe that growth will slow to **6.5 per cent in 2016 and 6.0 per cent in 2017**.

This market turmoil is due to a combination of negative sentiment about China and the authorities' clumsy handling of policy changes and response to plunging share prices. Stock market trends are not a reliable indicator of real economic performance, however. Trading on the Shanghai and Shenzhen exchanges is largely speculation-driven, and the powerful rally from late 2014 to mid-2015 took place despite weak economic data. Nor can the subsequent stock market crash be linked to changes in the real economy. The crash will in all likelihood have no major impact on growth either, since household exposure to the stock market is small. Instead, the biggest source of concern is **the authorities' attempts to stop the slide in share prices, which raise questions** about both their understanding of how financial markets function and their desire to continue the deregulation process.

Currency policy and yuan exchange rates are **far more important to the economy than the stock exchanges**. In August, China devalued the yuan as one step in shifting its currency policy towards more market-driven exchange rates. In December the People's Bank of China (PBoC) began publishing the value of the yuan against a basket of 13 currencies that is intended to serve as a reference point for the exchange rate. Markets have interpreted these changes in currency policy as a way of devaluing the yuan. Such expectations have generated clear downward pressure, and the PBoC has intervened with **purchases aimed at countering a major weakening in the currency**. China's shrinking foreign exchange reserve has further fuelled market worries (see theme article).

CNY falls against USD, but stable real exchange rate



Source: BIS, Macrobond

The main question is what the aim of PBoC currency policy is. Policy changes in recent years can be seen as **steps towards free-floating exchange rates**, but both the communication and timing of these changes have created concerns and have repeatedly surprised the markets. Depreciation against the dollar has been sizeable by Chinese standards, but measured in real trade-weighted terms the yuan has been relatively stable this past year. One key element of deregulation is to **end the yuan's strong dollar peg**. Introducing the currency basket is probably a way of trying to shift the focus of attention to the yuan's performance against a broader array of currencies. We believe that the PBoC will allow a gradual weakening against the USD in 2016 while trying to keep the CNY stable in trade-weighted terms. An expected appreciation of EM currencies will allow then yuan to strengthen slightly against the dollar in 2017. We expect the **USD/CNY** exchange rate to be **6.90 at the end of 2016** and **6.70 at the end of 2017**.

Inflation pressure is low; in December, CPI inflation was 1.6 per cent. We expect some acceleration during 2016, driven by expanded lending and continued rapid pay increases. Deflation worries should thus fade. As full-year averages, **we expect inflation of 2.0 per cent in 2016 and 2.5 per cent in 2017**.

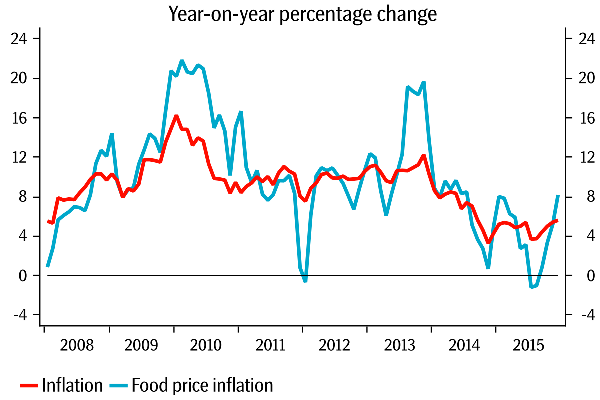
India: Close to hitting the growth ceiling

In the third quarter of 2015 year-on-year growth accelerated somewhat to 7.4 per cent, but it is **difficult to reconcile official GDP figures with other economic data** following the the revision of the GDP statistics early in 2015. Purchasing managers' indices are at historically low levels, and consumer confidence has weakened. Industrial production has accelerated, but meanwhile both exports and imports are very sluggish. Capital spending has not taken off despite reform ambitions aimed at improving the investment climate. Lending activity remains very weak. Inflation appears to have bottomed out, and it will thus be difficult to stimulate the economy by means of further key interest rate cuts without jeopardising inflation targets. The reforms that are needed to boost growth have not been put in place. As a result, the prospects of boosting growth above 8 per cent are poor.

Although India is close to a growth ceiling, its economy is still a **bright spot among emerging markets**. As a major net oil importer, India is clearly benefiting from lower oil prices, which help the country improve its current account balance and enable the government to raise fuel taxes without excessively impacting prices and private consumption. GDP grew by some 7.3 per cent in 2015. We expect **growth** to accelerate cautiously to **7.5 per cent in 2016 and 7.7 per cent in 2017**.

India: Inflation has rebounded

Year-on-year percentage change



Source: Indian Ministry of Statistics and Programme Implementation

In December 2015, CPI inflation was 5.6 per cent. The Reserve Bank of India's January 2016 inflation target is 6.0 per cent and will probably be achieved, but it will be a **challenge for the RBI to meet its targets** of 5 per cent at the end of March 2017 and 4 per cent ± 2 percentage points at the end of March 2018. In recent months, the inflation rate has accelerated. The government's Pay Commission has also recommended major salary hikes for public employees, which would risk contributing to general upward pressure on wages and salaries that may eventually push inflation higher. Since cutting its key interest rate in late September 2015, the RBI has left the rate unchanged at 6.75 per cent. There is limited room for more rate cuts; during 2016 we expect two cuts of 25 basis points each. We expect full-year **average inflation of 5.5 per cent in 2016 and 5.7 per cent in 2017**.

Prime Minister Narendra Modi's government is continuing its reform efforts but is **unlikely to succeed in implementing sufficiently vigorous measures to boost growth further**. The government will not be able to launch a national sales tax in April 2016 as planned. This tax is a key reform that will boost domestic trade and national tax revenue. For the moment, a number of controversies over what goods to include and how high the tax should be have blocked the reform. Other reform efforts, such as a loosening of labour market legislation, are also moving sluggishly. The government also appears unlikely to meet its privatisation target for the current fiscal year.

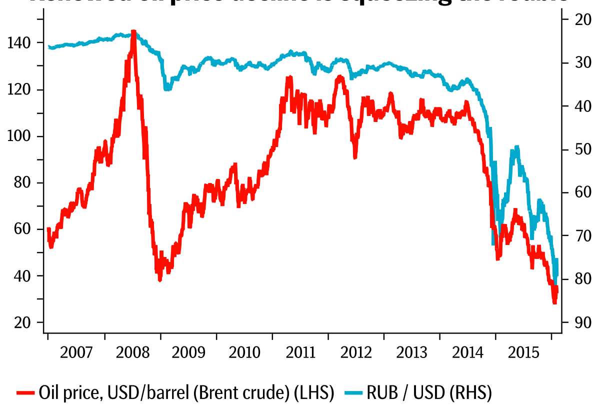
The **rupee** has weakened along with other emerging market (EM) currencies but thanks to reductions in India's current account and budget deficits the US Federal Reserve's rate hikes are only expected to result in a limited depreciation. **We expect an INR/USD exchange rate of 70.0 at the end of 2016 and 68.0 at the end of 2017.**

Russia: New oil collapse boosts uncertainty

The renewed oil price decline has increased uncertainty about the Russian economy, which had been hampered earlier by **Western sanctions** and **structural problems**. Because of Russia's heavy dependence on commodity exports, there is a high correlation between oil price changes and the rouble's exchange rate. The oil price decline is thus pushing down the value of the rouble. **SEB has revised its oil price forecast downward to USD 40/barrel in 2016 and to USD 50/barrel in 2017.** Currency depreciation drives up inflation, which then hampers household consumption and forces the central bank to pursue tighter monetary policies. In December real wages were down 10 per cent year-on-year, driven by high inflation, and no rebound is in sight for retail sales. One bright spot is that there are signs of stabilisation in manufacturing, which is being helped somewhat by rouble depreciation. Although industrial production has continued to fall year-on-year, the downturn has slowed.

Oil price declines also tend to reduce the Russian Federation's budget revenue, though rouble depreciation eases this effect by pushing up government oil revenue in local currency terms. Next September's parliamentary election is one reason the government will be cautious about cutting social spending, so as not to squeeze already hard-hit households further. Pensions, public sector salaries and defence spending are exempted from the latest budget cutbacks. Belt-tightening will instead impact public sector investments. **Budget austerity** will be long-lasting, **hampering growth for years to come**. To some extent, we expect the authorities to use the Reserve Fund (about 4.5 per cent of GDP) to cover deficits. We also expect them to let the rouble depreciate further and taxation of the energy sector will be raised.

Renewed oil price decline is squeezing the rouble



Source: Macrobond

Overall GDP fell by an estimated 3.7 per cent in 2015. Looking ahead, the decline in Russia's output will slow. **We expect GDP to fall by 1.5 per cent in 2016.** There is potential for a recovery in 2017, based on higher oil prices and an easing of Western sanctions; **we expect GDP to increase by 1.2 per cent**. Due to structural problems, growth will probably end up well below 2 per cent beyond our forecast horizon as well.

Because of its strong connection to oil prices, the rouble is one of the EM currencies that weakened the most early in 2016. In the near term the risk is on the downside, but in the second half we expect the rouble to regain some lost ground as oil prices recover. **By the end of 2016 we expect the RUB/USD exchange rate to be at 74 and by the end of 2017 at 80.** Inflation will fall a bit, although a continued weak rouble will slow the pace of its decline. Inflation averaged 15.5 per cent in 2015. We believe that **inflation** will decelerate to **9.8 per cent in 2016** and **6.4 per cent in 2017**.

The fighting in eastern **Ukraine** has become less intensive, but the trend is towards a **"frozen conflict"**, where the political status of the region remains unresolved. From Russia's perspective, the most important question is what will happen with the Western economic sanctions, which are sharply limiting the ability of Russian companies to borrow money in capital markets. Late in December 2015 the EU decided to extend its sanctions by six months, since Russia had not fulfilled the Minsk 2 agreement on the Ukraine conflict. Developments are hard to foresee, but there are initial signs that fulfilment of Minsk 2 is moving closer. Our **main scenario** is that the **EU and the US will begin easing their sanctions against Russia during the second half of 2016**.

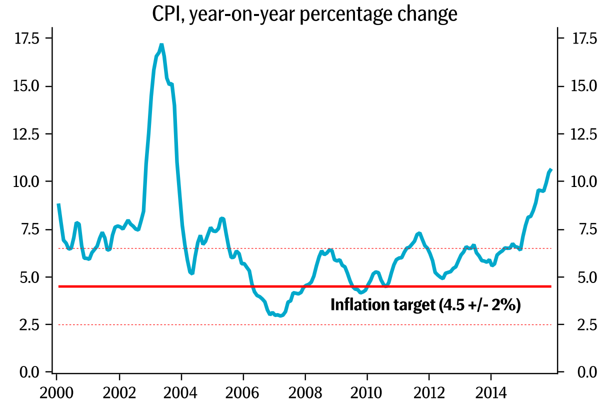
Brazil: Recession will continue in 2016

Brazil is experiencing a major economic downturn; in the third quarter of 2015, GDP fell by 4.4 per cent year-on-year. This was the sixth straight quarter of falling GDP. The downturn was broad-based. Driven at first by a sharp decline in capital spending, the GDP downturn now includes plunging private consumption. We expect consumption to fall in 2016, driven by high inflation and continued weakening of the labour market, although a temporary upswing can be expected in conjunction with the Olympic Games. Net exports are being helped by the depreciation of the real, but they are still hampered by China's lower commodity imports and are only expected to provide a limited contribution to growth. With inflation well above target and a budget deficit of around 10 per cent of GDP, Brazil also has little opportunity to boost demand by using expansionary economic policies. GDP fell by an estimated 3.5 per cent in 2015. **In 2016 the decline in GDP will slow to 3.0 per cent. In 2017 we expect GDP to increase by 1.5 per cent.**

In January the inflation rate was 10.7 per cent and was thus well above the central bank's target of 4.5 per cent ±2 points. Inflation has been driven higher mainly due to rising food prices, which are largely a result of the sharp depreciation in the currency. Annual average **inflation** was **9.0 per cent in 2015**. We believe that inflation will slow to **8.0 per cent in 2016**, falling further to **6.0 per cent in 2017**.

Brazilian inflation far above target

CPI, year-on-year percentage change



Source: Brazilian Institute of Geography and Statistics (IBGE)

The combination of falling GDP and rising inflation has put the central bank in a difficult situation. Since the key interest rate was raised by 50 basis points in July 2015, it has remained unchanged at 14.25 per cent. Increased inflation expectations and pressure on the currency are expected to force a 50 point hike in the first half of 2016.

The real has shown a weakening tendency against the dollar since late 2011. This depreciation accelerated in 2015, driven by declining commodity prices, but early in 2016 the real has coped better than many other EM currencies. One advantage of this currency depreciation is that the current account deficit has decreased sharply and is now entirely covered by foreign direct investments. **We expect the USD/BRL exchange rate to be 4.40 at the end of 2016 and 4.50 at the end of 2017.**

The sharp economic downturn is exposing Brazil's great need for **structural reforms**, especially in its pension and tax systems. Although the country's political leaders have become more aware of the need for reforms, the current prospects for extensive economic reforms are small. The **political situation is very uncertain** and is being further complicated by the impeachment process against President Dilma Rousseff that will begin in February. This process risks making reform efforts and fiscal belt-tightening even more difficult. Political uncertainty may also persuade companies to hold off on their investments, thereby worsening the economic downturn.

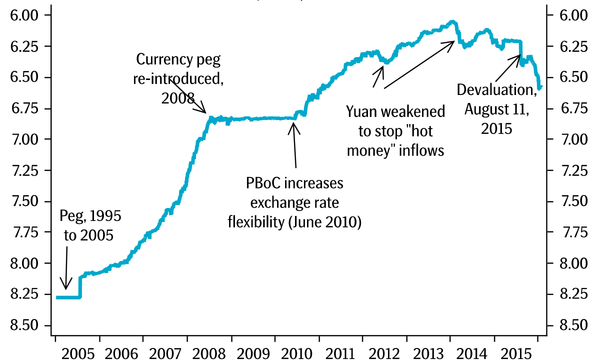
Theme: China's currency policy triggers major flows

- **China's currency tactics are far-sighted but a bit naïve; Beijing not part of currency wars**
- **Small currency steps for China – big effects on other countries and financial markets**
- **Outflow may reach USD 800 billion in 2016**

Financial market turbulence gives the impression that changes in China's exchange rate policy are something new. In fact **a number of changes have been implemented since 1948, when the yuan was introduced**. The difference is that because of a growing economy and ever closer integration with other countries, currency policy changes have a major global impact, both on the real economy and markets. Large capital flows have been set in motion, and much more will happen.

China's currency policy

CNY/USD, inverted



Source: Macrobond, SEB

During the period of the command-and-control economy, the yuan was locked into unrealistic levels against foreign currencies that were maintained by means of capital controls and a large-scale black market. As China began reforming itself towards a market economy in the late 1970s, yuan convertibility increased. During the 1980s and early 1990s, the yuan depreciated against the US dollar and reached a record low of 8.62 per USD in 1994. During 1997-2005, the yuan was pegged at 8.27. This peg was followed by a three-year period of gradual appreciation. A new peg was introduced in 2008.

China tries to keep out "hot money"

After the financial crisis, the yuan began a new appreciation phase. This appreciation finally became self-reinforcing, leading to large-scale currency inflows driven by expectations of continued appreciation ("hot money" inflows). The People's Bank of China (PBoC) tried to thwart these speculative inflows by depreciating the yuan during the spring of 2012 and early in 2014. This created market turbulence. China's intention was to eliminate the belief that the yuan could not depreciate against the dollar. Combined with an expansion of the trading interval, this was a way of getting the markets accustomed to two-way exchange rate volatility.

Overall, our review shows **long-term efforts** to **deregulate the currency** and to gradually **guide its exchange rate closer to a reasonable level against the USD**. These reforms have continued recently, but poor communication and timing have created concerns and repeatedly surprised the markets.

Not in currency wars, but creating outflows

What, then, is the purpose of China's currency policy? It is probably not aimed at improving the country's competitiveness. China has maintained its share of global exports and there are few signs of declining competitiveness. Foreign demand also plays a larger role for exports than exchange rates. In our view, China is not taking part in any currency wars. On the contrary, the PBoC has made supportive purchases to avoid excessively rapid depreciation, which would damage the yuan's future role as a global currency.

The clear **downward pressure on the yuan** is not being created by the PBoC, but **is due to market expectations that there will be further depreciation**. This has contributed to large currency outflows (see below). The yuan devaluation of August 2015 was poorly communicated and was interpreted as a sign that the Chinese economy is suffering from serious problems and that further large devaluations could be expected. The launch of the currency basket on December 11 was also interpreted as an indication of further devaluations.

Changes in China's currency policy must be viewed in light of the country's **long-term objective:** to achieve **a freely floating global currency**. To accomplish this, exchange rate changes must be market-driven, which rules out large-scale foreign exchange market interventions. The yuan's strong connection to the USD must also end. **The August devaluation** was part of a strategy to **give the market a bigger role in setting the exchange rate**. The PBoC's decision in December to publish the yuan's value against a basket of 13 currencies was a way of loosening its connection to the dollar. When the final objective is a freely floating currency, it is logical to focus on the yuan's performance against such a currency basket in particular.

A new risk element has emerged

China's currency policy changes, and the likely end of the yuan's 10-year appreciation – which has made it 50 per cent stronger in real effective terms – are creating new rules of the game. China and the rest of the world now face **a large new currency risk element** that is generating huge capital flows.

Market players both inside and outside China have been able to ignore yuan currency risk because of the PBoC's currency management. In the past decade, the PBoC has greatly increased its currency risk, while accepting the exchange loss that has arisen due to the stronger yuan. The PBoC's oversized currency reserve reached a full **USD 4 trillion in June 2014**. A benchmark for the optimal size of China's currency reserve **should be about USD 2 trillion** (according to the IMF's parameters for appropriate currency reserves).

China's net international investment position (NIIP)

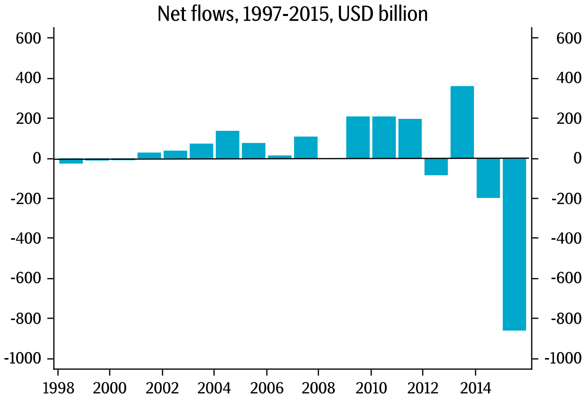
Q3, 2015. USD billion	Assets	Liabilities	Net
Direct investments	1,038	**2,852**	-1,814
Shares	159	554	-395
Bonds	98	233	-135
Deposits	**358**	383	-25
Loans	494	**387**	107
Trade credits	495	285	210
Miscellaneous	49	47	2
Currency reserve	3,590	0	3,590
Total	**6,281**	**4,741**	**1,540**

Source: State Administration of Foreign Exchange (SAFE)

China's 2015 current account surplus is expected to have been about USD 350 billion. This was insufficient to offset other capital outflows. The PBoC's **currency reserve decreased by about USD 515 billion last year**. This means that the total outflow of capital from China was a dizzying USD 865 billion.

Capital outflow of USD 861 billion in 2015

Net flows, 1997-2015, USD billion



Source: SAFE

Four sources of continued capital outflows

A new currency risk element creates large potential capital **outflows** from China, originating from four sources:

1. Chinese companies' principal payments on foreign currency loans: the risk of a weaker yuan and lower domestic interest rates give companies a reason to replace such loans with yuan-denominated ones – reduced debt is good but may generate large capital outflows.

2. Chinese companies' increased interest in foreign assets: if the yuan can weaken, they are motivated to lower their currency risk.

3. Currency hedging of foreign-owned assets (direct investments) **in China**: given an asset value of USD 2,852 billion, a one per cent currency hedge means an outflow of nearly USD 30 billion.

4. Decreased foreign interest in holding yuan-denominated assets.

It is difficult to make an outflow forecast for 2016, but an amount in the vicinity of what was recorded in 2015 – **USD 850 billion** – cannot be ruled out. Given an expected current account surplus of USD 325 billion, **China's currency reserve may thus shrink by USD 525 billion**.

IMF forecast, 2016

	USD bn
Exports	2,496
Import	1,809
Balance of trade	687
Balance of services	-266
Return on capital	-66
Transfers	-30
Current account balance	**325**

Source: IMF

China does not reveal details about the structure of its currency reserve, but various reports indicate that about 60 per cent may consist of US government securities. Fed analyses show that a USD 100 billion inflow shortage during a given month leads to short-term upward pressure on yields of 40-60 basis points (the long-term effect is about 20 bps). China's sales of securities thus pose an obvious risk of rising global long-term yields. Together with the needs of various oil producers to use their financial reserves due to low oil prices, global asset markets are expected to be pushed down by sales of securities.

Because the Chinese **yuan will be included in the IMF's Special Drawing Rights (SDR) currency basket** as of October 1 this year, central banks are expected to become more interested in buying the yuan. Central bank assets in SDR can be estimated at USD 280 billion. Given the yuan's 11 per cent weighting in the SDR, central banks need to buy about USD 30 billion worth of yuan. These purchases are likely to occur gradually and cannot cover the outflows reported above.

Exaggerated worries about tighter liquidity

Various market analyses have argued that China's currency interventions will drain short-term liquidity from the Chinese and global banking system. This is highly doubtful. When China built up its currency reserve, which peaked at USD 4 trillion, new yuan were created. But since its interventions have largely been sterilised (added liquidity is withdrawn by means of various market operations) – according to the IMF and other sources – additional short-term liquidity was limited. Now that the reserve is shrinking, China can simply **reduce its market operations and thereby restore liquidity to the market**.

China's liquidity management may periodically have a large impact on the very shortest-term interest rates. Experience shows that central banks sometimes face great difficulties in forecasting how the liquidity in the financial system may change. In China's case, it may also be in the interest of the authorities to allow rising short-term rates in order to reduce market interest in short-term speculation against the yuan. But excessive fluctuations may harm the credibility of their efforts to further develop China's financial markets.

Low inflation will contribute to more ECB stimulus

- **Growth is gradually improving**
- **Decent increase in employment**
- **Continued low inflation and falling inflation expectations put pressure on the ECB...**
- **...to cut interest and expand QE in March**

Economic growth recently seems to have accelerated a bit, and euro zone GDP probably increased at **a quarterly rate of about 0.4 per cent during the last three months of 2015**. This recovery will continue, though not at a convincing pace given the deep downturn we saw in the wake of the financial crisis. **Consumption**, which was an important growth driver in 2015, **will continue to expand at a healthy pace**, hand in hand with an improved labour market. **GDP will increase by 1.9 per cent this year and 2.0 per cent in 2017**. The risks are on the downside. A reduced stimulative effect from the weakened euro and uncertainty about the global economy and financial markets may restrain growth more than expected.

Inflation will remain squeezed by low oil prices and other factors; our forecast is now well below that of the European Central Bank (ECB). Low pay increases and high unemployment will help hold down inflation in a somewhat longer time perspective as well. The downturn in inflation expectations has regained new momentum since the ECB's December policy meeting, thus providing support for President Mario Draghi's dovish monetary stance. We expect **further ECB stimulus measures in March,** although verbal clashes between Draghi's doves and hawks from Germany and elsewhere will be harsh. **The ECB will lower its deposit rate for banks by 10 percentage points** to -0.40 per cent and **expand its bond purchases by EUR 15 billion per month** to EUR 75 billion.

While euro zone economic performance will continue to improve slowly, political developments will create uncertainty. Greece is still struggling to fulfil all the requirements to receive continued loans and eventually be rewarded with a debt write-down. The political uncertainty following Spain's December election is not expected to disrupt its recovery. Although the separatist parties in Catalonia have managed to reach agreement and form a regional government, there is massive opposition among political parties in Madrid and Catalonia's breakaway ambitions may help to facilitate political compromises at the national level.

GDP forecasts

Year-on-year percentage change

	2014	2015	2016	2017
Germany	1.6	1.7	1.9	2.0
France	0.2	1.2	1.4	1.7
Italy	-0.4	0.7	1.3	1.3
Spain	1.8	3.2	3.0	2.9
Greece	0.7	-1.5	-1.0	3.0
Portugal	0.9	1.7	1.7	1.8
Ireland	5.2	6.0	4.5	3.5
GIPS countries	2.0	2.8	2.6	2.9
Euro zone	**0.9**	**1.5**	**1.9**	**2.0**

Source: Eurostat, SEB

Refugee crises strains EU

The refugee influx is affecting the region in many ways. In the short term, euro zone economies will experience a **demand stimulus, while government finances will be strained**. These effects are small, however; the International Monetary Fund (IMF) estimates that despite the huge number of refugees, their fiscal impact on Germany will be a mere ¼ per cent of GDP. If integration efforts improve, **long-term growth effects may also be positive**. But if the current situation persists – with lower labour market participation by immigrants – according to the IMF the region's per capita GDP in 2020 will be somlower than in a scenario without incoming refugees.

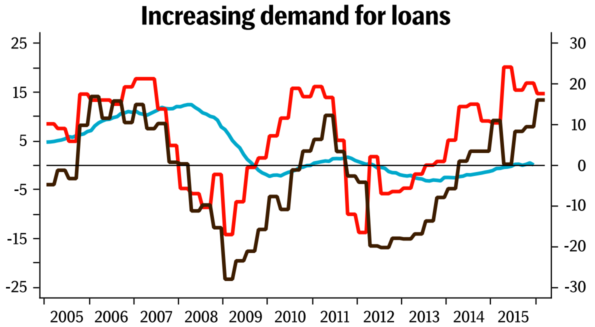
The impact of the refugee crisis on political cooperation in the European Union (EU) will probably be more important than its economic effects. The Dublin regulation on which member state should examine an asylum seeker's application has been scrapped in practice, without any new agreement replacing it. Meanwhile the Schengen pact on borderless travel is being challenged by border controls aimed at reducing refugee flows. If the **Schengen system collapses**, the economic consequences need not be so great, but it **would be a major symbolic setback for the EU project**. The refugee issue and its effects will remain in the spotlight for a long time to come, though perhaps above all they will **influence domestic policies in member states** as public finances are put under pressure. But if voter acceptance of further immigration decreases and populist and/or anti-EU parties continue to gain ground, the process of increasing border controls is likely to continue. When the EU cannot agree on a common solution, individual countries will make their own decisions in an effort to resolve their situation. The United Kingdom's EU membership renegotiation demands – which include not wanting to give other EU citizens the same rights to the social safety net as UK citizens – seem to be gaining support both at home and in other countries.

Indicators pointing slightly upward

Indicators are still signalling **some acceleration in economic growth, although their projections diverge**. Purchasing managers' indices (PMIs) fell slightly in January and the outlook appears somewhat weaker than a couple of months ago. The European Commission's Economic Sentiment Index (ESI) has risen gradually over the past year, despite falling slightly in January, while PMIs have stayed around 53-54. Together these indicators are signalling a quarterly GDP increase of about 0.4 per cent. PMIs in Germany and Spain are stable at around 55, Italy somewhat lower and France has again lagged behind in recent months. Indicators for both services and manufacturing are pointing towards expansion. The latest monthly PMI downturn, combined with a fall in Germany's ZEW financial sector sentiment index in January, create some uncertainty about how the euro zone is being affected by global growth concerns and financial market turbulence. Our euro zone leading indicator, originally developed by the ECB, is pointing to accelerating cyclical upswing. The main factors behind the indicator's positive outlook for 2016 are an increasing new orders/inventory ratio, real M1 growth, German business confidence and low interest rates.

Industrial production is now increasing at a moderate year-on-year pace of 1-2 per cent. Germany has been close to zero in recent months, but **in southern Europe – especially in Spain – we see an acceleration**. We expect industrial production in the region to grow by about 2 per cent yearly in 2016 and 2017. Exports have risen during the past year, sustained by a weak currency. According to indicators, the export situation will continue to improve. We also expect that an even weaker euro and a somewhat improved world economy will benefit euro zone exports. **We thus foresee annual increases of 4-4.5 per cent in exports during the next couple of years**.

Increasing demand for loans



Demand for loans, lhs
Expected demand for loans, lhs
Loans to non-financial companies, year-on-year percentage change, rhs

Source: ECB Bank Lending Survey

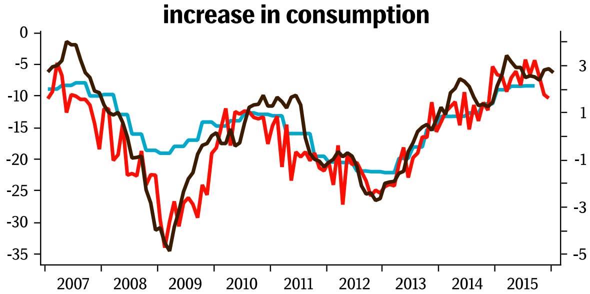
Capital spending will accelerate

A long period of low capital spending has led to relatively high capacity utilisation, despite moderate production growth. We thus foresee prospects for rising investment activity. This is also supported by the ESI, which is poised to rise further above its neutral level. Meanwhile housing investments will recover after many years of weakness. A **slow thaw in capital spending** is also being confirmed by a stabilisation in bank lending to non-financial companies. Demand for loans is increasing as well, according to the ECB Bank Lending Survey. The ECB's expansionary policy is helping, but there are still supply-side restrictions, especially in southern Europe. Banks in Spain, Italy, Greece and elsewhere are still struggling with high and in some cases rising percentages of bad loans. The IMF has estimated that doubtful loans total EUR 900 billion in the region's banking system and believes that new lending would benefit if these problems were dealt with. **Capital spending will rise by 2.5 per cent yearly in 2016 and 2017**.

Consumption remains a key driving force

Increased household consumption has been important to the 2014-2015 recovery, and we expect consumption to continue growing at a decent pace ahead. Household optimism is relatively high, despite some slippage during 2015. Meanwhile retail sector sentiment weakened late in the year. Looking ahead, consumption will enjoy support from higher employment. Although pay increases in the region as a whole are a mere 1 per cent yearly, real wages are still rising due to exceptionally low inflation. But trends are divergent; German wages and salaries are increasing at about 3 per cent while Spanish pay levels are rising by about 0.5 per cent. Extensive labour market slack suggests continued weak pay increases, and we expect 2016-2017 increases to be in line with those of 2015. Overall, **consumption will increase by more than 1.5 per cent yearly in 2016 and 2017**. This means that the net household savings ratio will remain at about 6.5 per cent.

High consumer confidence and continued good increase in consumption



Consumer confidence, net balance, lhs
Retail sales, year-on-year percentage change, rhs
Household consumer spending (nat'l accounts), y-o-y % change, rhs

Source: Eurostat, European Commission

Unemployment will continue downward

Above-trend economic growth is continuing to push unemployment lower. This downturn has recently been somewhat faster than expected. In November 2015 the jobless rate was 10.5 per cent, compared to 11.5 per cent a year earlier. Unemployment is now at its lowest level since July 2009. **The downturn is broad-based.** The lowest jobless levels were in Germany (4.5 per cent) and the Czech Republic (4.6), with the highest in Greece (24.5 per cent) and Spain (20.8). The biggest one-year decline was recorded in Spain. **The downturn is primarily driven by job creation**; in the first three quarters of 2015, employment rose by about 2 million (including more than 600,000 in formerly crisis-plagued Spain). Joblessness will keep falling and will drop below 10 per cent in 2017.

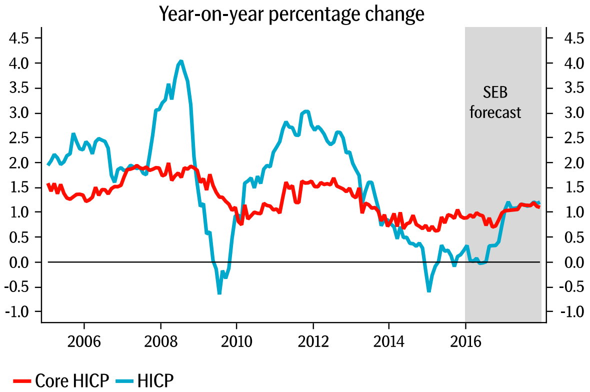
Measured as annual averages, **unemployment will be 10.2 per cent in 2016 and 9.9 per cent in 2017**.

Further downward revisions in inflation

Despite gradually improved growth and falling unemployment, inflation continues to surprise on the downside. Inflation pressure is low, and any rebound has again been postponed due to lower oil prices. But other factors such as falling prices for other commodities, low food prices, a generally low demand situation and low pay increases will also help dampen inflation in the medium term. **Inflation according to the EU's harmonised index of consumer prices (HICP) will be 0.2 per cent in 2016 and 1.1 per cent in 2017**. Core inflation will creep up from 0.9 per cent in 2016 to 1.2 per cent in 2017.

Near-zero inflation again in 2016

Year-on-year percentage change



Source: Eurostat, SEB

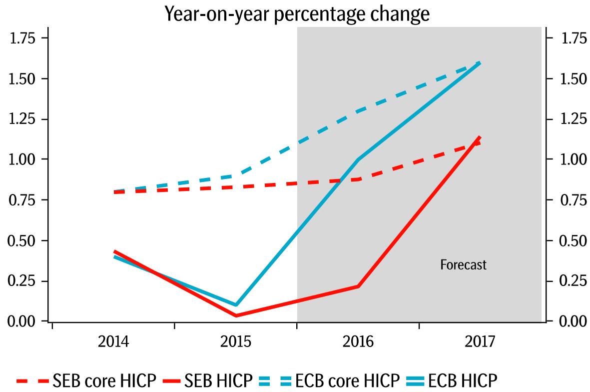
Low inflation – our forecast is 0.8 percentage points below that of the ECB (core HICP 0.4 points below) – and falling inflation expectations will continue to put pressure on the ECB. We expect the ECB to lower its inflation forecasts at the March policy meeting, and **several factors suggest that the ECB will expand its stimulus measures**. Low long-term inflation expectations are also a problem; since early December, 5-year inflation expectations (measured as break-even for inflation-linked bonds) have fallen from 1.1 to 0.7 per cent. Another important metric – 5-year inflation expectations 5 years ahead (measured using inflation swaps) – fell from 1.8 to 1.5 per cent. Yet market pricing is well below economists' expectations according to the ECB's survey. The difference can be explained by a depressed inflation risk premium, an estimated higher risk of negative price shocks and the fact that market pricing reacts faster than economists to oil price changes.

ECB will deliver stimulus measures in March

The probability of additional ECB actions has recently increased. The market is currently pricing in a 10 basis point cut in March and an additional 10 basis point cut in the third quarter. The communication at the January meeting was dovish, and statements about a policy review in March were interpreted more or less as a promise that further stimulus measures will occur. At the press conference, President Mario Draghi pointed out repeatedly that inflation had surprised the ECB on the downside and that there is a desire and determination to act. Our assessment is that Draghi's dovish faction will gain increased support due to low inflation and that pressure for more expansionary policy will be so great that the German-led hawkish faction will have to give in. We thus believe that the ECB will cut its deposit rate by **10 basis points to -0.40 per cent, while boosting its monthly bond purchases by EUR 15 billion to EUR 75 billion**. The timing of further stimulus measures is naturally uncertain, but we believe the ECB is ready to act as early as March. **Inflation is expected to begin falling** in February, and **falling inflation expectations will help change sentiment on the ECB Governing Council**. The US Federal Reserve will hold off on further interest rate hikes during the spring, which will also make it easier for the ECB to launch further stimulus measures.

ECB will have to revise its inflation forecast

Year-on-year percentage change

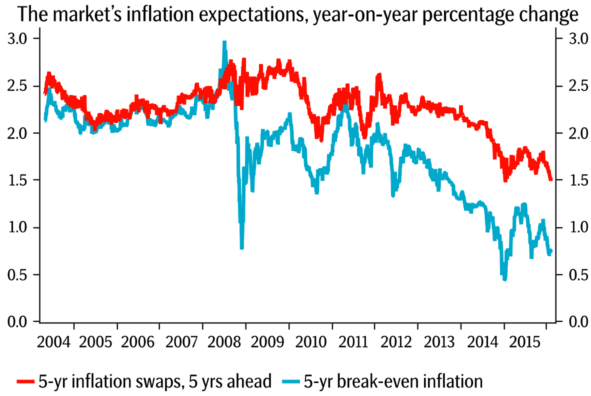


Source: ECB, SEB

Further monetary policy stimulus is not risk-free, however. The more measures are implemented, the more the ECB's monetary policy will diverge from what countries with good economic growth and high resource utilisation need. It cannot be ruled out that by using such arguments, the German-led faction at the ECB will manage to achieve a compromise by maintaining that monetary policy has already gone too far and that risks of imbalances will increase further if interest rates are kept too low for too long. In that case, the result may be similar to the one delivered at the December meeting – that the ECB will choose either an interest rate cut or more bond purchases. If so, **we are inclined to believe that more bond purchases are the most likely outcome this time around, after the interest rate cut that the ECB delivered in December**.

Falling inflation expectations a big problem for ECB

The market's inflation expectations, year-on-year percentage change



Source: Bloomberg

BREXIT referendum will not bring down British economy

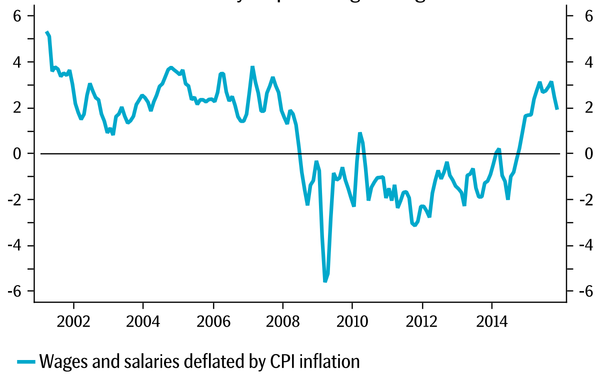
- **Households still the main engine of growth**
- **Slower inflation upturn...**
- **... will mean later key interest rate hikes**
- **Fiscal austerity will slow the economy more**

As in the United States, households and the service sector are dominant growth forces in the British economy. Meanwhile manufacturers are struggling and foreign trade is contributing more negatively to growth than in earlier forecasts. Fiscal headwinds will hamper growth, but **GDP will climb by 2.2 per cent in 2016 and 2.4 per cent in 2017** – in line with the consensus, but below our forecast in the last *Nordic Outlook*. The UK barely avoided deflation in 2015. **This year and 2017** will offer modest price increases, with **inflation of 0.5 and 1.4 per cent respectively**. The Bank of England (BoE) – which would like to see higher growth, domestic price pressure and core inflation before launching a normalisation of its key interest rate – will thus hold back for longer. **The first key rate hike will occur in February 2017**. At the end of our forecast period, the key rate will stand at 1.00 per cent. The market foresees an even more leisurely pace; it is pricing in an initial rate hike only late in 2017, but an already tight labour market may lead to earlier rate hikes. **Unemployment will continue downward to 4.7 per cent by the end of next year**, matching the bottom level during the last economic cycle.

Households are still the main engine of growth. Consumer confidence has fallen but remains high. Job growth, which has decelerated from a 25-year high, continues to boost incomes while the oil price decline pushes down inflation and boosts purchasing power. **The household savings ratio has fallen to a 50-year low**, but this will not sabotage the recovery. The slowdown in wage and salary growth is more worrisome, however, and is an important piece of the puzzle for the BoE. As recently as last summer, year-on-year pay increases were running at 3 per cent, compared to today's 2 per cent. The low inflation of recent years may perhaps have affected wage formation, which in that case is a warning sign for the BoE. We remain optimistic about both productivity and pay; tight resource utilisation suggests faster pay growth ahead. Home prices continue to rise at 5-10 per cent yearly. The brutal price surge in London has slowed; compared with the 2014 peak, prices are currently rising half as fast, at 12 per cent. At the national level, home prices are around 10 per cent above their 2008 peak, according to Nationwide's index; in London, prices are 50 per cent higher and **overheating risks are growing**.

Temporary setback in wage growth

Year-on-year percentage change



Source: Macrobond, SEB

Business confidence indicators are providing a mixed picture. Confidence is high in services and construction but lower in manufacturing, as also shown by industrial production. Nor are order books as full as six months ago. Because of the government's ambitious housing construction targets, construction activity remains strong. Despite strong pound appreciation in trade-weighted terms over the past few years, exports grew decently in 2015. But imports grew faster, and **foreign trade contributed negatively to growth** for the fourth straight year. Net exports will also contribute negatively to growth in 2016-2017, according to our forecasts.

Fiscal tightening will lower British growth by around one percentage point in both 2016 and 2017, which is somewhat more than last year. **The referendum on EU membership is approaching**. Both sides are showing an increasing willingness to compromise. For example, the UK's demand for restrictions on the right of immigrants to use the social welfare system has won support in Germany, France, the Netherlands and elsewhere. At present, the UK appears likely to reach an agreement with the EU at its February 18-19 summit, which would mean that the "Brexit" referendum can be held as early as this summer. Indeed, Prime Minister David Cameron says that a referendum is possible within a few months. While public opinion is somewhat volatile, betting organisations still foresee a high probability that the UK will remain in the European Union. That is also our main scenario. Monetary policy remains an important driver for the currency, and as the market has priced in delays in BoE rate hikes the pound has depreciated, especially against the US dollar. Political uncertainty will also push down the pound in the short term: **The EUR/GBP exchange rate will be 0.75 and the GBP/USD rate 1.37 at the end of 2016**.

Riksbank will cut key rate again despite strong economy

- **Industrial upturn will help broaden growth**
- **Temporary downturn in unemployment**
- **Major challenges in housing and labour market policies**
- **Cyclical inflation upturn delayed until 2017**
- **New Riksbank rate cut; first hike next year**

Swedish economic growth surged in 2015, and indicators point to continued strength this year. We have adjusted our 2016 GDP growth forecast marginally higher to 3.7 per cent and are sticking to our 2.8 per cent forecast for 2017. Despite strong indicators, **downside risks predominate**, due to growing domestic imbalances and political gridlock as well as uncertainty about international developments. A strong upswing in residential investments and consumption, partly driven by large-scale immigration, remain the foremost drivers of growth. A slight upturn in manufacturing is now also discernible.

Job growth is now accelerating to a rate of 2 per cent. At first this will lead to falling unemployment. However, during 2017 a rising labour supply due to migration will push unemployment higher. The number of asylum seekers is uncertain. After the government's sharp policy shift of recent months, the Swedish Migration Agency lowered its forecast. The Agency's main scenario now projects 100,000 asylum seekers in 2016. This is probably still somewhat too high. On the other hand, there are many indications that the necessary resources per asylum seeker were underestimated earlier, so our assessment of spending pressure and the stimulus to demand remain unchanged. Providing education and training, homes and jobs to those who are granted residence permits will be a major challenge to the political system for years to come. The main political blocs have different ideological recipes for how to act, creating blockages in political decision making. The government's weak parliamentary base will become especially clear in such a situation. **There is a major risk of a cabinet reshuffle or an extra election during the coming year**, although this is not our basic forecast.

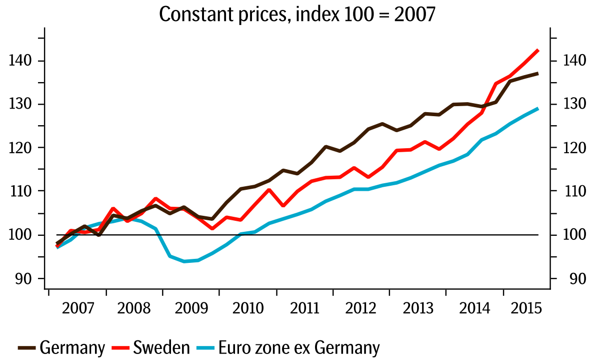
Unexpectedly low inflation and changes in global monetary policies will put continued pressure on the Riksbank. We predict that it will **cut the repo rate to -0.45 per cent in February**. We also believe that in the next few months, the Riksbank will be prepared to intervene in the foreign exchange market if the **EUR/SEK rate falls to the 9.00-9.10 range**. Yet our main scenario is that the bank will not be forced to act. Rising resource utilisation and strong economic growth suggest that in the second half of 2016, the Riksbank will start signalling tighter policy and give up its interventionist intentions. To some extent, we also believe that the King-Goodfriend report on the Riksbank will also play a part (see box). We believe the bank will begin rate hikes early in 2017.

Industrial upturn is discernible

Signals from Swedish manufacturers have mainly been positive, despite greater international uncertainty. We now see **clear signs that support our forecast of industrial recovery**. Both the National Institute of Economic Research (NIER)'s Business Tendency Survey and the manufacturing PMI are above their historical averages. Meanwhile merchandise exports and industrial production were relatively robust in the second half of 2015. In sectoral terms the picture is mixed, with weakness especially in metals and mining, while production of vehicles, forest products and pharmaceuticals is strong.

Strong service exports partly offset weakness for merchandise exports

Constant prices, index 100 = 2007



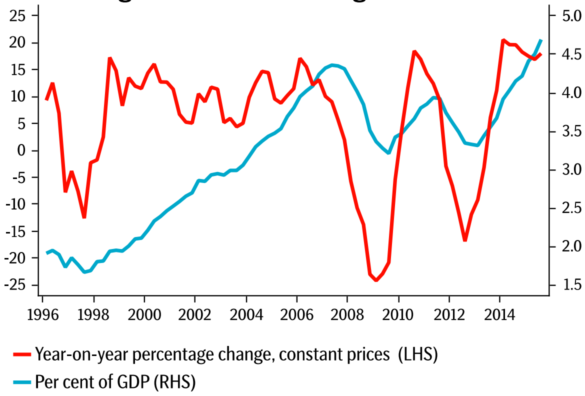
Source: Statistics Sweden, SEB

Because of rapidly rising service exports, total exports grew at a relatively healthy pace in 2015. This will continue in 2016 and 2017. One major reason behind the upturn in service exports is that companies traditionally classified as industrial are shifting their focus from goods towards more profitable services. A similar trend is under way in the euro zone and Germany, though it is more apparent in Sweden. This is positive, since it is often a matter of high-tech services and also indicates that the **image of a de-industrialising Sweden is exaggerated**.

Increased housing and public investments

The somewhat brighter outlook for manufacturers is reflected in a capital spending rebound. Businesses say they also plan to boost investments further this year. We expect this spending to climb by 4 per cent in 2016. Residential investments rose by nearly 20 per cent in 2015, contributing 0.7 percentage points to GDP growth. Very heavy demand for housing suggests that **the upturn will continue at largely the same pace in 2016 and 2017**. According to the National Board of Housing, Building and Planning, Sweden needs to construct 400,000 homes by 2020: twice today's construction pace. With the industry signalling at the outset that its capacity utilisation is high, it is unlikely that the country will achieve such a pace.

Housing construction is rising from a low level



Source: Statistics Sweden, SEB

Agreements across the lines between political blocs will be needed to speed up housing construction to the desired extent. Steps to increase housing market mobility would probably result in more efficient utilisation of current housing stock. Aside from simplifying construction rules, the outlook for broad compromise seems poor, given ideological differences. The opposition wants deregulation, while the government's main policy is subsidised rental units. Immigration will also require increased public investments. **We expect overall capital spending to grow by 6-7 per cent yearly in 2016 and 2017**, well above the historical average.

Home prices rose by 15-20 per cent last year but **are now showing clear signs of deceleration.** It is too early to draw the conclusion that home prices have declined, but we have adjusted our price forecast downward and now expect prices to rise only 5 per cent in 2016 and level out in 2017. This will be due to a new home loan repayment requirement and interest rate hikes.

Growing population = higher consumption

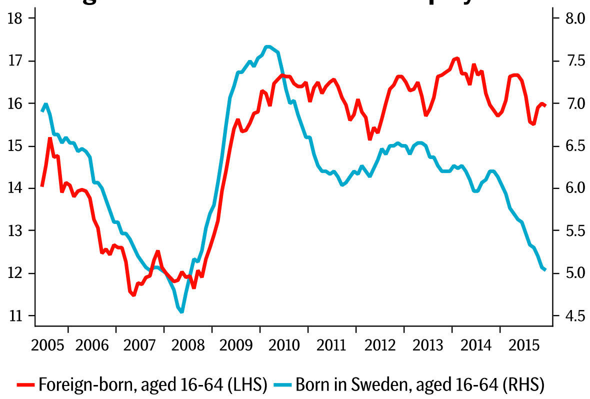
Because of job growth and strong real incomes, largely due to low inflation, household consumption grew rapidly in 2015. **There are good prospects for a continued upturn** as falling oil prices contribute to good real incomes this year as well, despite moderate pay hikes. Consumption will rise by 3.0 and and 2.8 per cent in 2016 and 2017, respectively, but per capita consumption growth will be substantially more modest. To some extent, households will lower their historically high savings ratio, at present 16 per cent of disposable income. But since households are expressing great concern about the future according to various surveys, we expect their savings ratio to remain high.

Large-scale immigration will lead to a relatively fast increase in public consumption, at first mainly related to rising expenses for temporary refugee housing and living allowances. During 2017, consumption will increase mostly because of higher expenditures for **schools and health care. We expect government consumption to increase by 3.5 per cent in 2016 and 2.5 per cent in 2017**.

Continued strong labour market

Job growth will accelerate further. During the past 2-3 years, unemployment has stayed high due to a rising labour supply, but in the past six months there has been a falling trend, according to the Labour Force Survey (LFS). The number of people registered at the Swedish Employment Service has been relatively unchanged, however, although a slight downturn was discernible in recent months. One explanation for this is that the LFS's telephone survey has difficulty including newly arrived individuals with inadequate Swedish language skills. The trend towards a higher percentage of non-respondents confirms this hypothesis. **But strong job growth suggests that unemployment will continue to fall** during the next 12-18 months. Then unemployment will climb as the many new arrivals begin to join the labour market. There is a risk that this upturn will occur somewhat later than in our forecast.

Big structural differences in unemployment



Source: Statistics Sweden, SEB

Breaking down the unemployed into people born in Sweden and abroad, we see that **unemployment among the foreign-born is** 15 per cent, or **about three times higher than for Swedish-born**. Labour force participation among the foreign-born is 65 per cent, 15 percentage points lower than for the Swedish-born. The composition of recently arrived asylum seekers points to a further decline in the next couple of years. To halt such a trend, a policy shift is needed to lower the thresholds for job seekers, but at present the government and the opposition have divergent analyses of what needs to be done.

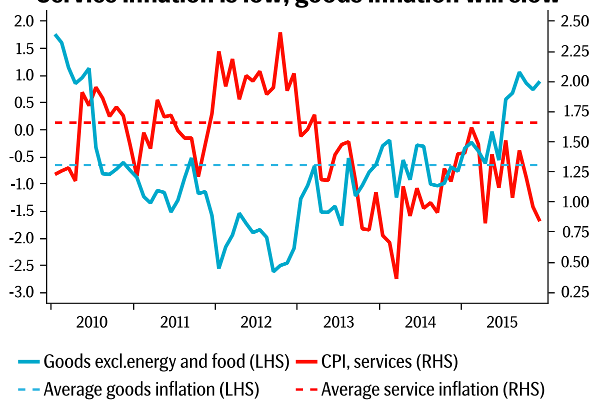
Less economic slack, but moderate pay hikes

Like the NIER, we believe that equilibrium unemployment is just below 7 per cent, which is close to the current jobless rate. Meanwhile surveys indicate that **businesses are starting to have more difficulty in finding suitable job applicants**. Yet we do not believe that labour market shortages are big enough (see theme article) to affect the current wage round especially much. The industrial unions were first in line and proposed 2.8 per cent yearly pay hikes, about the same as their starting bid in the 2013 wage round. Domestic sectors such as construction, transport and retail have proposed pay hikes 3-4 tenths of a point higher. Yet we are sticking to our forecast that collective agreements will end up below 2.5 per cent once negotiations are completed in the next few months. The likelihood of higher pay increases is biggest in the public sector, since shortages there are increasingly acute in many occupational categories. There are also signs that many employees are confident that they can push salaries hikes above the national agreements. **We expect overall wages and salaries to increase by 3.1 per cent in 2016 and 3.4 per cent next year**, although unexpectedly low wage drift is a downside risk.

Continued downward pressure on inflation

Last autumn there were signs of rising inflation, before oil prices renewed their downward slide. For example, food prices rose more than 3 per cent during one period. Goods prices are still climbing relatively fast, due to krona depreciation in 2013-2014. Yet service prices, which are determined to a greater extent by wages and the domestic economic situation, are rising significantly more slowly than their historical trend.

Service inflation is low; goods inflation will slow



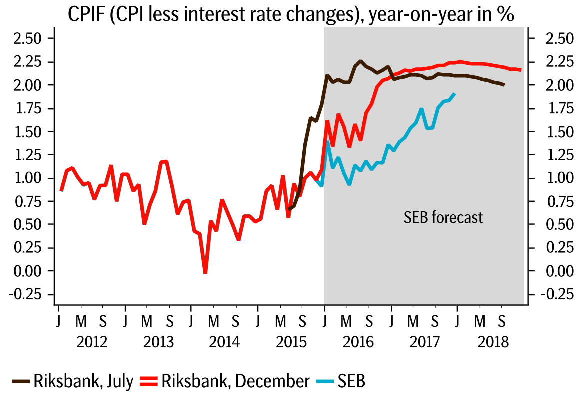
Source: Statistics Sweden, SEB

According to our models, upward price pressure due to currency exchange rates will ease this year; food price increases have already slowed significantly and international price declines will add further downside risks. The question now is **to what extent lower goods inflation will be offset by a cyclically driven upturn in service prices**. Historically, service prices have been rather strongly affected by economic cycles, but upturns have occurred late in the cycle and at higher resource utilisation than we see today. Only for brief periods has core inflation (defined as CPIF excluding energy, food, alcoholic beverages and tobacco) risen faster than 2 per cent over the past two decades. At those times, we have often seen a combination of higher international prices, a weak krona and cyclically driven service prices. These upturns have also followed big price increases for oil and other commodities. At present the picture is different on several points.

Our conclusion is that **both the Swedish and international economy needs to strengthen before inflation reaches the 2 per cent target**. The Riksbank will still get some help from higher indirect taxes, congestion fees and electrical grid fees, which are expected to contribute nearly 0.5 per cent to 2016 inflation, but these increases will be largely neutralised by lower oil prices and low rent increases. Rent negotiations seem likely to end up with the lowest hikes in 20 years; paradoxically, this is largely a consequence of record-low interest rates.

Riksbank's inflation forecast is still too high

CPIF (CPI less interest rate changes), year-on-year in %

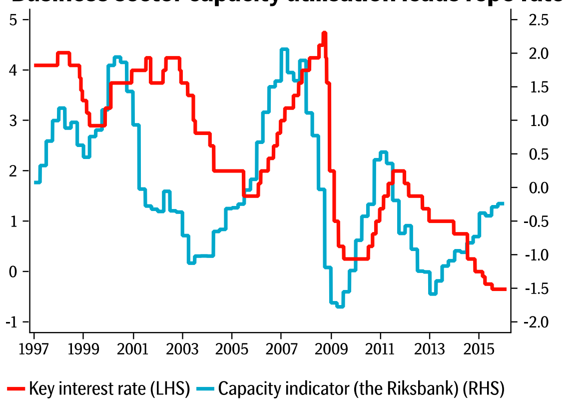


Source: The Riksbank, Statistics Sweden, SEB

New Riksbank rate cut; first hike in 2017

Because of downward revisions in the inflation path and further stimulus measures by the European Central Bank, we are reverting to our November forecast that **the repo rate will be cut by another 10 basis points to -0.45 per cent**, in February. Our interpretation of the Riksbank's latest meeting minutes is that further rate cuts are most likely. Increased government bond purchases cannot be ruled out, but there is not much room for this without further damaging the functioning of the market. Liquidity is also low for alternative asset types such as municipal and inflation-indexed bonds. The supply of mortgage-backed bonds is much larger, but they are hardly a reasonable alternative as long as the Riksbank is so clearly signalling concern about housing market imbalances.

Business sector capacity utilisation leads repo rate



Source: The Riksbank, Statistics Sweden, SEB

The Executive Board's decision to authorise Governor Stefan Ingves and Deputy Governor Kerstin af Jochnick to start currency interventions has lowered the threshold for action. We believe that the Riksbank will intervene if the EUR/SEK rate reaches 9.00-9.10, **but our main forecast is that it will not be forced to act in the next few months**. If it still intervenes in the FX market, there are many questions. The Riksbank has signalled that it is not aiming at any specific exchange rate but merely wants to avoid too rapid krona appreciation. We agree with Board member Martin Flodén (who dissented against interventions) that interventions must be large and consistent to have the desired effect. International criticism may be heavy. Both the King-Goodfriend report (see box) and the IMF generally advise against interventions. Reactions from neighbouring countries may also be forceful if a country with both high growth and inflation by European standards tries to gain advantages at the expense of others.

Although inflation remains below target, we believe that the Executive Board will gradually be influenced by rising resource utilisation and strong economic growth. Once the wage round is completed, there will also be less opportunity to affect expectations. In the second half of 2016, we believe that the Riksbank will become less focused on exchange rates and will signal approaching interest rate hikes. **We expect the first hike in February 2017**. Due to the downward adjustment in the inflation path, we have thus changed our forecast to a later date but are still a bit ahead of the Riksbank's rate path. By late 2017, the repo rate will be 0.5 per cent.

King & Goodfriend open to more flexibility

Swedish monetary policy debate has been heated in recent years. The Riksbank has launched exceptional measures amid strong growth and housing market overheating, testing the reasonableness of its inflation targeting. The conclusions of the recent review by Mervyn King, former governor of the Bank of England, and Marvin Goodfriend, a US economic professor ("K&G") will thus be important to future discourse. In their review of monetary policy from 2010 to 2015, it is interesting that K&G **approve of the Riksbank's 2010-2011 rate hikes**, which were heavily criticised both internationally and at home, but are critical of the bank for not realising the severity of the 2012-2013 euro zone crisis – among other things because it **based its decisions on assumptions about monetary policy in other countries that were far more aggressive than financial markets had priced in**. K&G also have opinions about the Riksbank's use of models and regard **naïve application of models as one important reason why the bank has systematically overestimated inflation**.

What role will their report have in shaping future monetary policy? Their recommendations in three areas are especially interesting. **K&G seem to want to close the door to currency interventions** by proposing amendments to the Sveriges Riksbank Act in such a way that "the choice of exchange rate regime is a matter for government, and that the mandate to meet the inflation target is subject to the Government deciding that the exchange rate should float freely". But we do not believe that this is so important, since the Riksbank has clearly noted that it does not believe that temporary interventions are part of the prevailing regime.

On several points, K&G would like to **expand the Riksbank's role related to financial stability and macroprudential supervision**. One element of this is a proposal that the Riksbank and the Financial Supervisory Authority should establish a joint Prudential Policy Committee and that this body should have a far bigger role than today's Financial Stability Council. For example, the Committee should be the primary source of reports on financial stability, currently done separately by the respective public authorities.

By even without formal changes, K&G advise the Riksbank to adopt a more flexible stance in meeting its inflation target. Speed in fulfilling the inflation target should be weighed against risks of imbalances that may damage the real economy. Taking into account imbalances in the housing market or household borrowing in this way is fully legitimate. K&G are signalling that it is not reasonable for the Riksbank to constantly call for help from other branches of the policymaking system in managing risks related to home prices, household debt ratios and the like. The Riksbank has a full mandate to act independently using monetary policy. **The report thus supplies the Riksbank with good arguments for abstaining from further stimulus in the special situation now prevailing**. Looking ahead, we believe that this will influence the Riksbank.

One overall conclusion we can draw is that **the report does not advocate any far-reaching change in the monetary policy framework**. It suffices to make some changes in the allocation of economy policy roles among different players and for the Riksbank itself to avoid some unnecessary mistakes and also adopt a more flexible stance towards its mandate. K&G even explicitly advise the government against giving the Riksbank a dual mandate that also includes unemployment.

Widening yield spreads against Germany

Late in 2015 Swedish long-term bond yields rose, unlike German ones, driven by smaller expectations of key interest rate cuts after strong economic growth figures and forecasts that rising refugee costs would boost the government's borrowing requirement. Since then, renewed expectations of Swedish rate cuts combined with unexpectedly strong government finances have led to a re-convergence with German yields. **These factors will continue to push down Swedish yields during the first half of 2016**. The Riksbank will probably remain biased against further stimulus measures.

Despite risks ahead, we believe government finances will show continued signs of strength in the near future, which among other things may persuade the National Debt Office to temporarily cut back its bond auction volume in February. The Riksbank will also continue its aggressive purchases of government bonds; by June 30 we expect its holdings of outstanding nominal government securities to reach 35 per cent of the total. On the same date, the yield spread against Germany on 10-year government bonds will be 35 basis points.

Looking a bit further ahead, however, the trend of Swedish yields will probably be upward both in absolute terms and compared to Germany. The most important reason is our forecast that in 2017 the Riksbank will begin hiking its key rate. We also expect expenditure pressure due to the refugee crisis to be largely funded through increased public borrowing. **At the end of 2017, we foresee a spread against Germany of 70 basis points, which means a yield of 1.90 per cent**.

Riksbank will hold down SEK a bit longer

Both relative economic performance and long-term valuation suggests that the krona will strengthen ahead, but the Riksbank's signals that it will take action in case of a clear appreciation are holding it back. The result has been that tendencies towards a stronger exchange rate that have been discernible during the past six months have been reversed. The Riksbank's signals that it does not intend to weaken the currency, but only prevent it from appreciating too fast, suggests that during the next six months the EUR/SEK exchange rate is stuck in approximately the 9.10-9.50 range. Given our forecast that this year the Executive Board will gradually shift towards a more neutral currency policy stance, **during the second half the krona may appreciate to about 9.00 per EUR**. Our forecast of key interest rate hikes during 2017 suggests that the exchange rate will move towards 8.70 at the end of 2017. The USD/SEK rate will be around 8.75 at the end of 2016 and 8.30 at the end of 2017. The trade-weighted KIX index will fall to 104 at the end of 2017, which is somewhat stronger than the Riksbank's forecast implies and also somewhat stronger than the average since 1995.

Hard-pressed government, election risk

Various factors are now affecting public finances. Rising refugee-related expenditures are squeezing national, regional and local governments. There is also heavy spending pressure in other areas such as health care and defence. Meanwhile the strong economy is causing a surge in tax revenue. Overall, **government finances now look somewhat better** than at the time of the last *Nordic Outlook*. With the help of creative bookkeeping, we now expect the government to stay below the expenditure ceiling. Although budget deficits will continue to expand somewhat, public debt will still remain rather constant as a percentage of GDP growth.

Yet the government is under heavy pressure to show that it has a coherent political plan. The autumn budget bill was overshadowed by the refugee crisis. Now the spring budget bill will provide an opportunity for a new approach. Although the influx of refugees has decreased, there is still great uncertainty, with limited manoeuvring room as the refugee resettlement costs and rule-mandated appropriations grow. Because the ruling Social Democrats are steadily losing ground in opinion polls, there is great internal pressure on the government from the labour movement. Many people are calling for **a large, aggressive programme that puts almost everything in one basket**. For example, the chairman of the Trade Union Confederation (LO) has called for a Löfven Plan, named for the prime minister. Many economists also recommend major education and training programmes, infrastructure and housing construction. As for labour market policy, the ideological differences between the leftist government and the Alliance opposition are more and more clear. The Social Democrats want to avoid low-paying jobs as much as possible, instead pinning their hopes on education, training and subsidised jobs.

Public finances

Per cent of GDP

	2014	2015	2016	2017
Net lending	-1.7	-1.1	-1.1	-1.3
Borrowing req., SEK bn	72	33	28	57
Gen. gov't gross debt	44.9	44.3	43.7	43.5

Source: Statistics Sweden, SEB

In this situation the Finance Ministry has no easy task. Although Finance Minister Magdalena Andersson has abandoned the principle of funding new programmes "krona-by-krona", it is not risk-free to pursue large unfunded programmes in a situation of deficits and large underlying spending pressures. Unfunded demand stimulus is a two-edged weapon as GDP growth is already high and the labour market is close to equilibrium, The government's weak parliamentary position creates additional difficulties. **As a result, we expect few new measures in the spring budget bill**. Programmes to speed up housing construction will probably be a major ingredient, but we do not expect any big breakthrough in this area either.

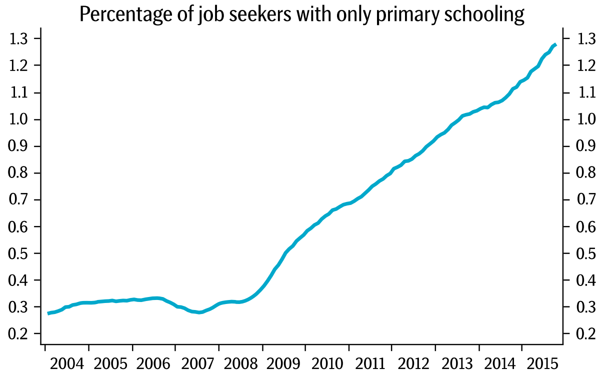
The political situation is volatile. The Alliance parties, which governed from 2006 to 2014, are ahead in opinion polls. This increases pressure on the Alliance party leaders, especially on the largest Alliance party, the Moderates, to precipitate a change of government. But it is less than gratifying to govern in a situation where crisis management dominates the agenda. It seem like Alliance party leaders are intent on taking power only after winning the 2018 election, preferring that the Social Democratic-Green Party government continue suffering through a difficult parliamentary situation. Given the distribution of seats in Parliament, it is difficult for the **Alliance to take over power directly**. Since they have fewer seats than the leftist parties, they need the active support of the Sweden Democrats (SD), a right-wing nativist party. An extra election would probably enable the Alliance to win more seats than the leftists; passive support from SD would then suffice. But SD would probably be the big winner in such an election and thus make clear demands. At present, our main scenario is thus that the government will remain in power under conditions that can be described as a "light" version of the now-defunct December Agreement, in which the Alliance pledged not to block the leftist government's budgets. But various scenarios are conceivable in which a new election would be difficult to avoid. If the government begins to pursue more clearly leftist policies, Alliance forces that want to take over power directly may gain the upper hand and push the country into a government crisis.

- **Unemployment is close to equilibrium; new less-educated arrivals are boosting NAIRU**
- **Resource indicator normal, but high levels for construction, retail and public sector**
- **Wages and inflation react to resource utilisation only after a long time lag...**
- **... which is awkward for the Riksbank and often causes policy errors**

The question of how long the economy can grow before wages and prices accelerate inflation has been crucial to the US Federal Reserve's analyses in recent years, while the Riksbank has focused entirely on inflation expectations and short-term inflation trends. But given GDP growth that is well above trend and unemployment that has begun to fall, **the connection between resource utilisation and inflation is becoming ever more important**.

Rapid increase in share of job seekers with little education

Percentage of job seekers with only primary schooling



Source: Swedish Employment Service

Unemployment already at equilibrium?

According to estimates by the National Institute of Economic Research (NIER), Sweden's equilibrium unemployment – or non-accelerating inflation rate unemployment (NAIRU) – will climb from 6.9 per cent this year to 7.3 per cent in 2017. This would imply that the current jobless rate, about 7 per cent, is close to equilibrium. NAIRU is expected to rise in the future because a growing percentage of the unemployed are immigrants with little formal education. Although some asylum seekers are highly educated, Swedish Employment Service statistics show that the educational level of foreign-born individuals joining the Swedish labour market is dropping. This trend appears likely to strengthen in the next couple of years. The percentage of unemployed people with only primary education or less has risen over the past five years and, by all indications, will rise further when those who arrived during the refugee crisis of recent years become available in the labour market.

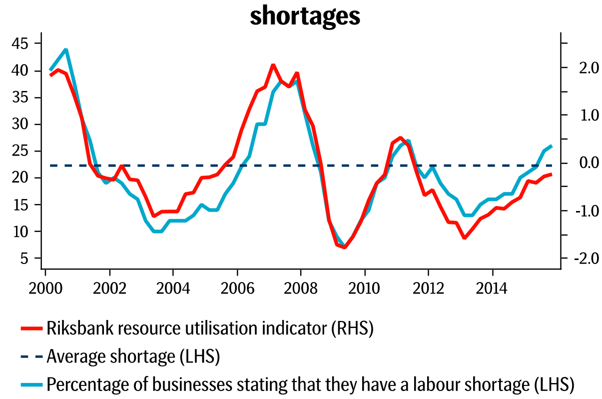
Even with heavy spending on education and subsidised jobs, **many will probably not be regarded as qualified for vacant positions**. There is a major risk that equilibrium unemployment will increase significantly in the next couple of years. The upturn may very well be several percentage points. The NIER highlights this risk in its latest forecast.

The Riksbank has avoided taking a position on the resource situation in the past 2-3 years. In 2012 it made a rather laconic statement in its *Monetary Policy Report* that equilibrium unemployment was in the very broad interval of 5.0 to 7.5 per cent. Major disagreements on the Executive Board at that time may have contributed to this unwillingness to take a position, but at the same time it is genuinely difficult to obtain stable estimates of equilibrium unemployment. This is especially true given the large shifts in the structure of the labour force that we will face over the next few years.

Shortages a better metric for utilisation

Direct measurements of recruitment problems, for example in the NIER Economic Tendency Surveys, are often a more robust metric for the resource situation than equilibrium estimates. At present the Riksbank seems to share that view, and for some years it has been publishing a resource utilisation indicator that summarises a number of utilisation metrics, although one should be aware that questionnaire data risk reacting to changes rather than levels of resource utilisation.

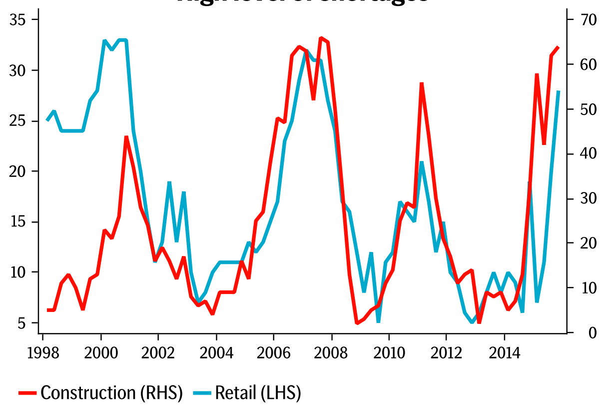
Riksbank resource utilisation indicator and labour shortages



Source: The Riksbank, National Institute of Economic Research, SEB

The Riksbank's resource utilisation indicator has been climbing gradually since mid-2013 and was just below zero at the end of last year. Since the indicator is calibrated in such a way that zero is equivalent to a normal situation, **it currently confirms the NIER's estimate that we are close to equilibrium** unemployment. The percentage of businesses stating that they have difficulty finding suitable job applicants, which is an important sub-series in the indicator, has climbed just above its historical average. It is hardly surprising that the resource situation is tightest in such domestic sectors as construction and retail, where we are now on a par with historical peak levels.

High level of shortages



Source: National Institute of Economic Research

In a historical perspective, there is also an alarming shortage in the public sector, which is not included in the Riksbank's indicator. The public sector time series started in 2005 and has climbed rapidly since a temporary downturn related to the financial crisis. Assuming that economic growth – in keeping with our forecast – continues to be driven mainly by construction and by private and public consumption, there is a great risk that **bottlenecks will emerge earlier than the composite resource utilisation indicator is signalling**. The demand for labour in the construction- and public sectors are very likely to climb to levels that have not been recorded since the 1980s.

Sharply rising labour shortage in the public sector

Percentage stating that they have a labour shortage

Source: Swedish Employment Service

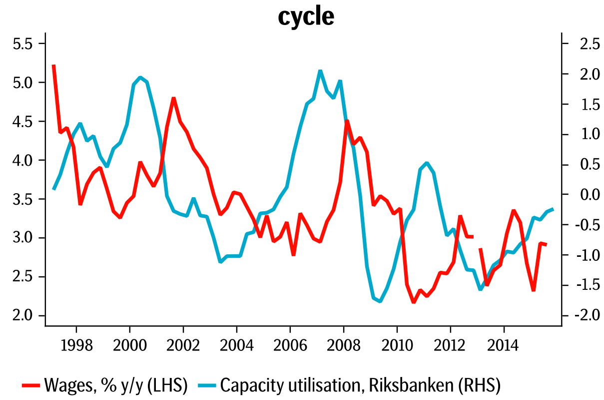
Moderate and delayed inflation effects

In the last *Nordic Outlook*, we pointed out that internationally, changes in the output gap and divergences from equilibrium unemployment have had a rather small impact on inflation since the introduction of inflation targeting. There are also signs that these effects may have weakened since the financial crisis. In November we analysed these developments internationally, but the pattern is similar in Sweden; if anything, the delays between a resource situation and inflation have been longer than in other countries. This situation can be partly explained by the krona's unique pro-cyclical movements.

Pay increases have accelerated from about 3 to 4.5 per cent, see graph below, but not until 1-2 years after the Riksbank's resource utilisation indicator has reached its cyclical peak. One reason behind the delay may be the three-year cycle of pay negotiations. It is also notable that the level of pay increases in agreements has not been affected very much by resource utilisation. This is highly dependent on labour union strategy. Employee organisations want to avoid demanding excessively high pay increases in periods of economic expansion, in order to avoid an excessive slowdown in job creation. During downturns, unions instead do not accept especially low pay increases, with reference to the general demand situation in the economy. Wage rounds thereby assume an indirect stabilisation policy role, which is one reason why the correlation between resource utilisation and inflation is relatively weak in Sweden.

The construction and public sectors seem to be facing shortages that may become more severe than they have been for years. This may result in shorter lead times than have historically been the case. The potential for **importing labour from other countries, on the other hand, may help ease the labour shortages** that arise. So far, no strong tendencies towards accelerating wage inflation are visible either.

Wages and salaries increase late in the economic cycle



Source: The Riksbank, The National Mediation Office

Inflation upturns resulting from rising resource utilisation have also been relatively small. They have also lagged somewhat further behind wages and salaries. Although the connection is moderate, our analysis still shows that **economic upturns eventually lead to higher inflation** and that – on various occasions – following a delay, CPIF inflation has climbed well above target, even if exchange rates and international prices have been strong contributing factors. Although upturns in inflation have been temporary, this can be explained by rather steep downturns in the economic cycle shortly afterward.

Our conclusion from this resource gap analysis is that the Riksbank has little chance of pushing up inflation before the economy is strong enough and international prices have taken off. Continuing to increase monetary stimulus well into an economic upturn may, however, lead to a situation where the **Riksbank is forced into abrupt policy shifts once inflation climbs**. Experience also shows that inflation will then remain high even after the economy has turned downward, creating the opposite dilemma for monetary policymakers, as the Riksbank's interest rate hikes during 2008 clearly illustrated.

Growth forecast cut as investment and exports fall short

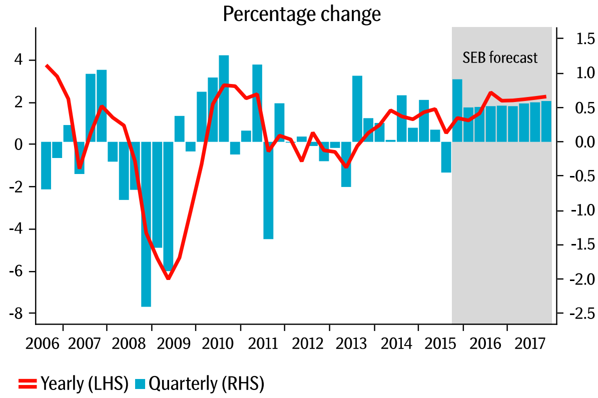
- **Forecast lowered after growth slump**
- **Immigration to spur fiscal easing**
- **Monetary policy reversal challenged by ECB**

Surprisingly weak third quarter GDP numbers published at the end of 2015 left Danish growth on a weakening trend and with the slowest annual growth rate in two years. Quite extreme moves in some main components increased the likelihood that the numbers will again see substantial (upward) revisions. We are also discounting a decent bounce in (yet to be released) Q4 GDP. Nonetheless, the end result is likely to be lower growth than we originally had forecast. It also seems that we are getting less 'bang for the buck' than usual when it comes to employment growth turning into GDP growth. This leads us to lower our expectations moderately for the latter part of our forecast horizon as well. Taking these factors into account **our new forecast for growth in 2015-2017 is 1.3, 1.8 and 2.2 per cent** (down from 1.8, 2.2 and 2.5 per cent).

Despite weak GDP in the past couple of quarters, employment has continued to grow at annualised rates above 1 per cent, which is a main factor in our belief in a continued recovery. The growth in employment and income supports an ongoing recovery in consumption, which has clearly been the strongest part of the Danish growth story lately with growth rates around 2 per cent.

Recent disappointments will not ruin the recovery

Percentage change

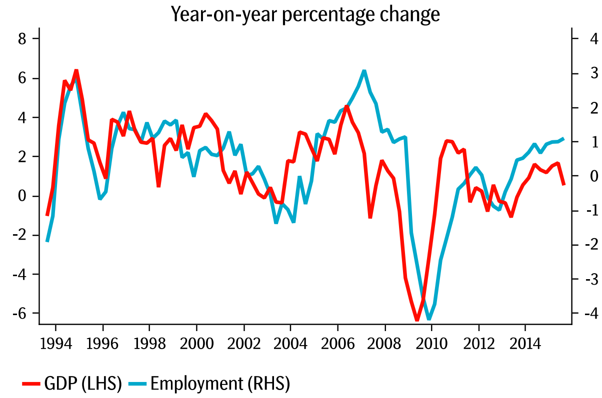


Source: Statistics Denmark, SEB

Home prices have remained a supporting factor even if the pace of increases has decelerated slightly – especially with regard to one-family houses. A still high level of consumer confidence (even after dropping during 2015) is testament to the solid factors backing current trends in consumer spending. Despite solid growth in consumption, households managed to increase savings significantly in the first three quarters of 2015. This is most likely because the windfall gains from cheaper oil are only being spent cautiously, if at all. Given high recent savings, continued job growth and strong home price appreciation, we see room for **consumption to pick up from around 2 per cent to nearly 3 per cent during 2016-2017**.

Employment is not delivering growth like before

Year-on-year percentage change



Source: Statistics Denmark, SEB

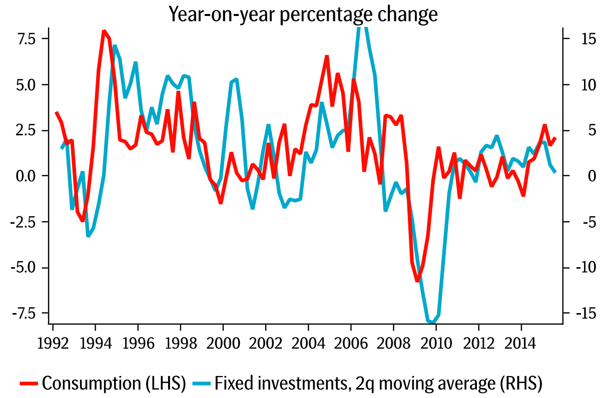
While the standard drivers are in place to generate a solid recovery, actual growth rates have fallen short of normal recovery speed. Similar to the experience seen elsewhere, not least the United States, productivity growth has remained weak and strong job growth has not corresponded to the same economic growth numbers as before. This may well be a short-term phenomenon and may be partly due to misallocation of capital in years prior to the crisis that affects the return on investment in subsequent years. However, the main ingredient missing is investment. This could be the result of greater policy uncertainty, a tighter and more regulated financial system or structural worries that lead to caution. We still expect growth and especially investment to accelerate, but we are trimming our forecast of capital spending since it does not seem to be working as a strong accelerator, unlike historical experience.

The main disappointments in 2015 have been investment and exports. In Q3, capital spending was hurt by very weak transport equipment (ships), but the disappointment does not just relate to this quarter. After growing 4 per cent in 2014, **investments are expected to grow only about half a per cent in 2015. In 2016-2017 we foresee a recovery back to 4-5 per cent**.

The weakness in exports might also be one reason for softness in capital spending. Sluggish exports are likely the result of weakness in emerging markets and the general moderation in global manufacturing. We now see that exports fell slightly in 2015 after growing by 2.6 per cent in 2014. However, we are not too worried about short-term export weakness, given the continued underlying improvement in domestic demand in the euro zone, the main destination for Danish goods. We expect **exports to get back on track relatively fast, with growth just shy of 2 per cent this year and above 4 per cent next year**.

Investments disappoint, consumption strengthens

Year-on-year percentage change



Source: Statistics Denmark, SEB

The country's external balance has deteriorated but only slightly, since weakness in exports has been more or less mirrored by imports. This likely reflects the weakness we have seen in fixed investments, which are normally a main driver of import demand. With a current account surplus still above 6 per cent of GDP, this does not strike us as especially worrying.

Public sector demand has been soft but in line with expectations. The new government intended to pursue a stricter fiscal policy and started out by pushing for cost-cutting at the municipal and regional levels. The result has been savings on child care, schools, public transport, elder care and other core welfare services, but our forecast still pencils in moderate growth in public spending in the next couple of years despite the government's intention. This is due to the immigration boom, although migration policy has just been tightened significantly.

The costs associated with refugees are mostly falling on local governments, since the central government only fully covers the first year. After that, associated costs mostly affect regional budgets. But local governments will hardly be able to bear this substantial burden, so some compensation must be offered unless there will be more significant cost-cutting on local core services. Such an outcome would lead to a public outcry and increase the risk that the broader population could turn more hostile towards immigrants in general. This would not help foster smoother integration.

In December the government adjusted its 2016 budget, setting aside more funds for refugee-related expenses, but according to local governments this is unlikely to be enough. About 20,000 asylum seekers came to Denmark in 2015 and the influx is expected to reach 25,000 in 2016. Because of uncertainty about the fiscal situation, the government has postponed discussions on income tax cuts until there is more clarity. **The 2015 deficit is expected to be 2.5 per cent of GDP and should move towards 1 per cent in 2017.** Overall fiscal position is not an issue, with debt below 45 per cent of GDP.

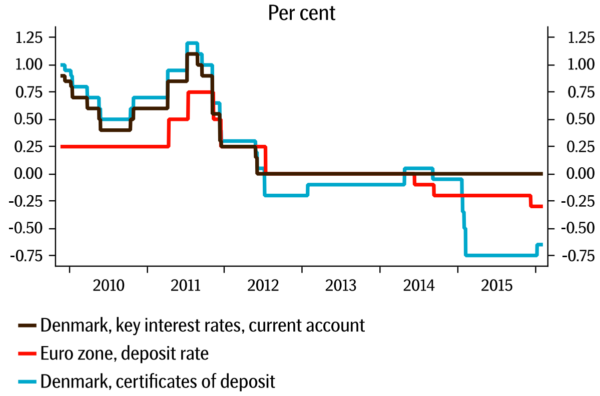
Inflation dynamics have remained subdued, both on core and headline measures. This is due to both moderate pay increases plus secondary effects of low energy prices. Wages will only pick up gradually as labour market slack slowly disappears in the next few years. This process is more advanced in Denmark and is mirrored in a slightly higher inflation than in the euro zone.

Timing of next monetary change uncertain

The Nationalbank hiked its deposit rate by 10 basis points at the start of 2016. The effect on money market rates was offset by the simultaneous reduction of current account limits by DKK 31 billion. The monetary policy adjustment was due to large foreign exchange (FX) outflows in December (DKK -49 billion) and especially intended to ensure liquidity in the certificate of deposits market. Due to the Danish monetary policy corridor (two-tier system), sufficient volume has to be invested in certificates of deposit to maintain an effective monetary policy transmission mechanism. The Nationalbank seems to consider the lower limit of volume in certificates of deposits to be somewhere in the DKK 80-100 billion range. We estimate that there has been continued FX outflow since the monetary policy adjustment in early January. This increases the probability of a unilateral Danish interest rate hike. On the other hand, the ECB's recent dovish stance should persuade the Nationalbank to wait as long as possible before a rate hike. **Due to recent krone flows, the timing of a monetary policy adjustment over the very short term is therefore uncertain.** The market is pricing in approximately a 60 per cent chance of a 10 bp hike in coming 3 months, which seems pretty fair.

Rate spread narrows

Per cent



Source: Statistics Denmark, SEB

While the short-term timing of key rate hikes is very uncertain, we still have a firm view that the **longer-term market pricing of rate hikes by the Nationalbank is too aggressive**.

Consumption, not oil, the main risk for growth

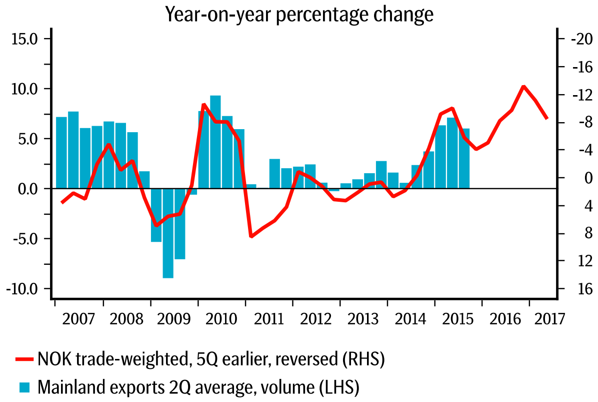
- **Forecasts for mainland GDP lowered**
- **Consumption growth will slow further, only partly offset by firmer non-oil investments**
- **Norges Bank to cut its key rate in March**

Momentum has slowed markedly over the past 1 ½ years as extensive cutbacks in the petroleum sector have hit the rest of the economy. Growth in mainland GDP – excluding oil, gas and shipping – has thus slowed from 2.8 per cent year-on-year in the second quarter of 2014 to approximately one per cent in the final quarter of 2015. While severe, many forecasters would probably have predicted a recession if they had known that oil prices would plunge by 70 per cent and real investment in oil and gas extraction would drop by a quarter over the period. The fallout has been mitigated by supportive fiscal policy, lower interest rates and a sharply weaker krone.

Oil prices have stayed lower than expected for a long time. The impact on capital spending should be modest in the near term, except for exploration activities, but there is a risk of further cost-cutting and additional layoffs in oil services and among other suppliers – with some secondary effects also influencing sentiment among businesses and consumers alike.

Weaker NOK provides a boost to exports

Year-on-year percentage change



Source: Statistics Norway, SEB

The weak **exchange rate is providing an important offset**, since the NOK has depreciated almost 20 per cent in trade-weighted terms since the second quarter of 2014 and by 6-7 per cent over the past year. This depreciation is boosting non-petroleum exports, although the forecast is for slower growth in 2016 because some exporters are being hit hard by the global slump in petroleum investments. The flip side of the sharply weaker currency is higher inflation, due to rising import prices. This is squeezing household spending power and reducing private consumption.

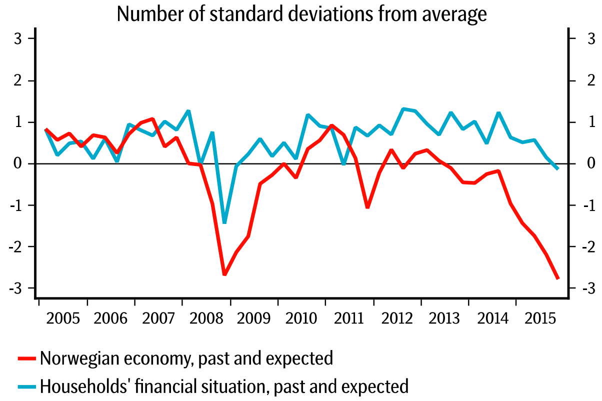
We are lowering our forecast of mainland GDP growth in 2016 from 1.8 to 1.6 per cent – still a slight acceleration from 2015 – and **to 2.2 per cent for next year**. Our forecasts for **overall GDP growth are unchanged at 1.5 per cent and 1.6 per cent in 2016 and 2017**, respectively, since oil and gas exports should hold up a bit better. This makes up for a slightly more negative assessment of investment in the sector.

Consumers to pull back

In our view, the main risk to the outlook for the Norwegian economy is not oil-related developments as such (prices, capital spending), but the possibility that consumers will start acting as their apparently very depressed mood would suggest. Private consumption again showed below-trend growth in 2015, though the annual growth rate did pick up from 1.7 per cent in 2014 to 2.2 per cent in keeping with our forecast. However, **we are trimming our 2016 forecast to 1.5 per cent** from 2.0 per cent in the November *Nordic Outlook* and are **lowering our forecast for 2017 to 2.3 per cent**.

Consumers are apparently very gloomy

Number of standard deviations from average



Source: Finance Norway, SEB

According to the benchmark quarterly survey, consumer confidence ended 2015 at its lowest level since a one-quarter plunge in late 2008, on the face of it suggesting a decline in consumption of some two per cent year-on-year. This depressed level is due to an extremely negative view of the current state and future outlook for the Norwegian economy while consumes' assessment of and prospects for their own financial situation is only slightly below the historical norm.

The momentum of consumption slowed throughout 2015, although sequential growth likely was slightly better in the fourth quarter than the previous one. However, spending on goods only managed to hold steady after declining in the third quarter. Momentum going into 2016 is softer than previously assumed, while the outlook for key fundamentals is bleaker.

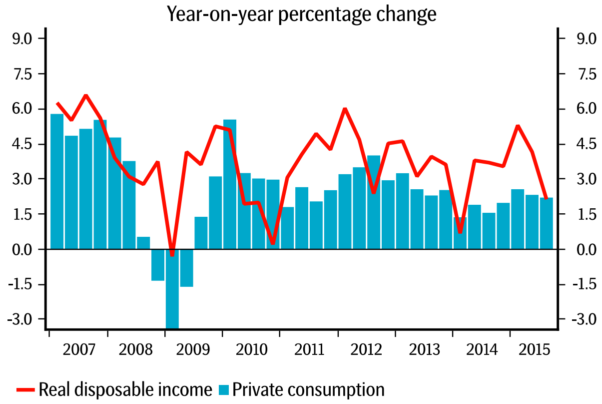
Higher inflation undermining real incomes

Firstly, nominal wage growth should be a bit softer in 2016 than the previously assumed 2.7 per cent rate, reflecting the slowdown in the economy and particular in manufacturing, which will set the pace for the upcoming wage round. We are now foreseeing a 2.5 per cent overall pay hike.

In addition, CPI inflation looks set to be a bit stronger in 2016 than in 2015. The headline rate eased quite a bit at year-end 2015 due to highly volatile electricity prices (because of unusually mild weather), while the CPI-ATE index – which excludes taxes and energy and is closely watched by Norges Bank – showed an annual rate of 3.0 per cent, well above the central bank's 2.5 per cent medium-term target. The year-on-year inflation rate for domestic goods and services shows signs of slowing, while price increases for imported goods are stronger, lifted by previous NOK depreciation.

Slower income growth to dent consumption

Year-on-year percentage change



Source: Statistics Norway

Although imported inflation should ease before long, annual **CPI inflation should lift from 2.1 per cent in 2015 to 2.5 per cent in 2016**. As a result, real wages will be unchanged from 2015, when the gain was the smallest in 20 years. A **slowing in inflation to 2.1 per cent in 2017** will lift real wages again. **CPI-ATE inflation** – excl. taxes and energy – **should hold at 2.7 per cent in 2016 but slow to 2.1 per cent next year**.

Meanwhile, lacklustre employment will hold back aggregate income. Although other components will make a healthy contribution, **growth in households' real disposable income in 2016 should be roughly half** the approximately 3 per cent rate in 2015 and consumption growth is likely to slow accordingly.

Unemployment to rise more slowly

The Labour Force Survey shows a marked deterioration. The unemployment rate jumped from 3.5 per cent in 2014 to 4.4 per cent in 2015. Part of this increase reflected a surprising expansion in the labour force, while full-year employment growth was halved from 1.1 per cent in 2014 to 0.5 per cent.

The growth in the labour force is still expected to moderate, in line with the norm during periods of below-trend growth. While employment growth will be sluggish, the increase in LFS unemployment should be slower going forward, and the **unemployment rate should average 4.9 per cent in 2016.**

Our forecast might seem to be on the low side, considering the strong influx of refugees. The inflow of asylum seekers thus totalled slightly more than 31,000 in 2015 and a similar number is expected in 2016. The government's supplementary 2016 budget bill assumed that 60 per cent of applicants would be granted permanent residence in Norway and that it would take approximately a year from their arrival for asylum seekers to become residents of a municipality. The timing of the impact will also be affected by a mandatory training programme, which in principle lasts up to two years. The impact on the labour market should be gradually felt from 2017. By itself, it might affect the LFS unemployment rate by some ¼ percentage point by the second half of the year. The risk might be on the upside, but by that time employment should be recovering in tandem with firmer economic growth.

Don't get too bearish

SEB's commodity analysts have cut their oil price forecasts by USD 10/barrel to USD 40/barrel in 2016 and USD 50/barrel next year. Still-depressed prices might negatively impact the petroleum sector, in the near term mainly exploration activities and further cost-cutting measures, potentially causing additional layoffs in oil services and among other suppliers and with some secondary effects. In this regard, it is worth remembering that long-dated oil prices – not spot prices – are crucial for investment decisions and are what break-even levels for new projects should be measured against.

In volume terms, **we expect capital spending in the petroleum sector to decline by 12.5 per cent in 2016**, a marginal ½ percentage point more than previously predicted but slightly less than the assumed 14.5 per cent drop last year, and by a **further 7 per cent in 2017** (previously -5.5 per cent).

Our forecasts call for a further marked decline, but capital spending in the petroleum sector is not headed for a free fall. Recent developments show that operators are starting to reap the gains from widespread cost-cutting, which – together with concept changes – vastly reduces break-even oil prices and improves project economics. For example, capital spending for Phase 1 of the vast Johan Sverdrup offshore field, expected to start production in 2019, has reportedly been cut by 30 per cent in USD terms. This should reduce its break-even oil price towards USD 30/barrel.

In mid-December, the plan for development and operation was submitted for the Oseberg Vestflanken 2 project, with an investment cost estimated at NOK 8 billion and production scheduled to start in spring 2018. Partners have also indicated likely approval of two other projects (Trestakk and Snilehorn) where capital spending will be on a similar scale. Finally, the

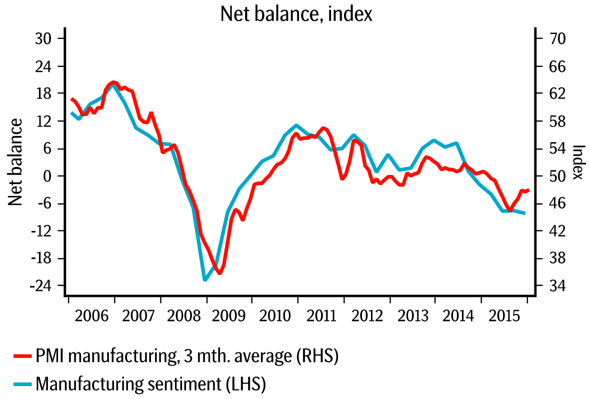
CEO of Statoil – the largest Norwegian oil and gas operator – has all but pre-committed to the decision set for 2017 for the development of the large Johan Castberg field in the Barents Sea, with production set to start in 2021-22. Here the revisions, including a downsized project and a different platform solution, have reportedly cut planned capital spending almost in half to NOK 50-60bn, thereby lowering the break-even oil price to somewhat above USD 50/barrel.

Divergent signals for manufacturing

The pullback in the petroleum sector will still continue to burden other sectors, in particular manufacturing – excluding energy and mining – where production declined in each quarter of 2015, the longest period of back-to-back quarterly declines since 2009. The near-term outlook is for manufacturing to continue languishing, although the maximum contraction rate hopefully was passed in late 2015.

Surveys are hinting at a trough

Net balance, index



Source: Statistics Norway, Norwegian Association of Purchasing and Logistics (NIMA)

Manufacturing surveys remain on the weak side, with production even weaker. The quarterly Business Tendency Survey showed manufacturing sentiment slipping at the turn of the year to its weakest level since early 2009, as declining orders depressed production expectations. The investment goods sector is mired in a deep recession. More surprising is the setback in sentiment in the intermediate goods sector, which might reflect severe secondary effects, although some typically export-oriented intermediate goods producers report stronger order inflow from foreign markets.

While the sentiment survey does not suggest any fundamental change, the manufacturing purchasing managers' index posted a marked upside surprise by rising to a nine-month high in January as the new orders component shot up to its highest level in almost a year. We normally downplay the importance of the PMI, since it has a rather poor record of tracking short-term changes in production and tends to be volatile on a month-to-month basis. However, the smoothed trend has slowly gained traction since late last summer and it is hard to completely dismiss the message of some sort of stability.

Norges Bank will cut rates further

Although Norges Bank decided to maintain its key policy rate at 0.75 per cent at its December meeting, the message was decisively dovish on back of the sluggish growth outlook, which has once again been revised lower. Norges Bank's rate path signals a 25 basis point rate cut by mid-2016, with a 40 per cent probability of a further cut to 0.25 per cent after the summer. The bank thus has manoeuvring room to mitigate downside risks to growth because of plunging capital spending in the petroleum sector. Keeping the NOK weak is the bank's main objective, in our view. Norges Bank is thus overlooking elevated core inflation, driven by higher imported inflation.

The renewed plunge in oil prices since the turn of the year, coupled with further deteriorating growth momentum, are likely to persuade Norges Bank to **cut the key rate to 0.50 per cent at its March meeting**. The already highly expansionary policy and our projection for stronger non-oil domestic demand suggest that the key rate will bottom out at 0.50 per cent, but the risks are skewed towards an even lower key rate. In particular, once oil prices stabilise and recover part of their fairly severe losses, there is potential for a fairly sharp krone rally. Norges Bank will thus be forced to maintain a dovish bias, possibly cutting rates further to prevent overly rapid krone appreciation later this year. Meanwhile, the bank is **unlikely to start raising the key rate until Q4 2017.**

To the extent that further rate cuts coupled with dovish communication fail to maintain a weak krone and the economy meanwhile worsens, **a more expansionary fiscal policy is likelier than unconventional monetary policy measures**. To us, such measures seem either ineffective or unfeasible. Meanwhile, there is ample room to increase fiscal spending, since the "fiscal policy rule" stipulates spending in relation to the size of the Government Pension Fund Global (GPFG), not the size of volatile petroleum revenues.

NOK to recover part of its losses

Lower oil prices and Norges Bank's dovish policy have been extremely harmful to the NOK. Given our expectations of continued downside pressure on oil prices and a lower key interest rate in the current quarter, the krone remains vulnerable in the very near term. The currency has reached extremely low levels against both the EUR and the USD and our long-term fair value model suggests that it is undervalued.

For the Norwegian krone to begin correcting towards its long-term fair value, oil prices must stabilise at a higher level and Norges Bank's easing cycle must become exhausted. If, on the other hand, the government began to consider increased fiscal spending to support domestic demand, this would reduce the likelihood of additional rate cuts by Norges Bank and contribute to NOK-positive capital flows, since more capital from the GPFG would find its way into the Norwegian economy. In all, we expect a gradually stronger krone starting this summer, with the **EUR/NOK exchange rate at around 9.20 by year-end 2016 followed by 8.50 at the end of 2017.**

The positive NOK outlook should lift demand for NGBs. Once the NOK rebounds with higher oil prices, it will be positive for NGBs as Norges Bank will likely be forced to maintain a dovish bias, putting downside pressure on long-term yields. The **10-year spread vs. Germany should tighten to 80 basis points by the end of 2016**.

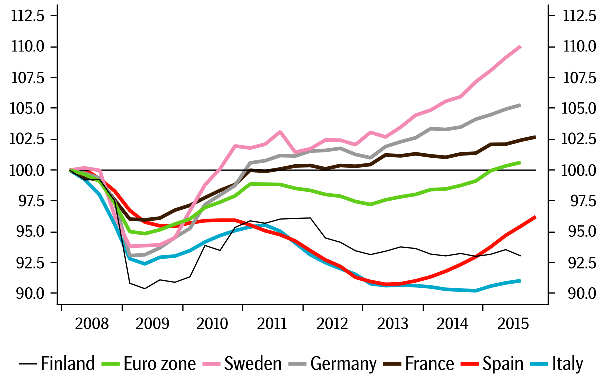
Austerity programmes hampering short-term growth

- **GDP growth has stagnated at a low level...**
- **... but indicators show some improvement**
- **Exports are receiving only limited help**

Finland's economic performance remains shaky. A disappointing third quarter of 2015, with GDP falling 0.5 per cent compared to the previous quarter, awakened fears that the economy was entering its fifth recession since 2008. We believe this was not the case, though the margin was thin. The recovery was, and remains, very weak in a Nordic and European perspective. GDP is 7 per cent lower than in the first quarter of 2008. This is on a par with Portugal, for example, while Italy is in even worse shape and Spain somewhat better. In the short term, the recovery is being hampered by several forces. Exports are squeezed by Russia's recession and by competitiveness problems compared to neighbouring countries with weak currencies, while domestic fiscal austerity is holding back households and businesses. On the plus side exports will rise ahead; stimulus from low interest rates and political reforms that will eventually improve competitiveness. After largely unchanged GDP in 2015 (+0.1 per cent), **growth will accelerate to 0.4 per cent in 2016 and 1.1 per cent in 2017**, somewhat lower than in the November 2015 *Nordic Outlook*.

GDP lagging behind euro zone and Nordics

Index 100=2008 Q1



Source: Macrobond

Indicators have shown some improvement recently. Both the European Commission's Economic Sentiment Indicator (ESI) and the OECD's leading indicator rose at around the turn of the year. According to the ESI's sub-indicators, there was a relatively broad improvement in the outlook in 2015. But the manufacturing sector remains shaky, and exports are still falling. Further ECB stimulus measures, a weaker euro and an easing of the sanctions against Russia during the second half of 2016 will provide some support. **Exports** will start to rebound 2016, **increasing by 1.6 per cent in 2016 and 3.5 per cent in 2017**. The weak recovery in industrial production and exports – combined with low resource utilisation – will result in **continued weak capital spending** during our forecast period, though the decline will be replaced by a slight increase.

Households are being squeezed on several fronts. Unemployment has surprised on the upside (9.4 per cent in December 2015) and will remain at that level for some months before falling slightly to annual averages of 9.2 per cent this year and 8.9 per cent in 2017. The rate of pay hikes will remain low, around 1.5 per cent, but low inflation of 0.2 per cent in 2016 and 1.0 per cent in 2017 will help sustain real income. The weak housing market creates uncertainty and downside risk. After falling slightly, prices were unchanged at the end of 2015. We expect a weak trend ahead but no major price declines. Continued public austerity programmes and pressure on wages and salaries aimed at improving competitiveness will **limit the room for consumption during the next couple of years**.

As a result of the crisis, public deficits have been high and debt has risen. Several cost-cutting packages have been launched to deal with the situation, but due to slow growth the deficits have not improved. They will shrink in the coming years as growth improves a bit and new cost-cutting packages have an impact. **The deficit will fall to 2.5 per cent of GDP in 2017**, when debt reaches 65 per cent of GDP, twice the 2008 level.

The government has begun a large-scale **effort to reduce deficits** and improve competitiveness by up to 5 per cent. There is a great need for reforms; according to the OECD's scenario, public debt will reach about 100 per cent of GDP around 2030 if policies are unchanged. The government's proposals include increasing the retirement age, eliminating certain public holidays, shortening paid holidays and cutting sick pay. Overall, these reforms are aimed at cutting the public deficit by EUR 4 billion (about 2 per cent of GDP) starting in 2019, especially by reducing expenditures. In addition, the health care system will be reformed to cut costs another EUR 3 billion by 2030. The government wants to solve some of these issues through talks between unions and employers, who will be able to present their own proposals for achieving similar effects. These proposals led to strikes last autumn, and several attempts to reach agreement have failed. A new attempt is currently being made, and if the two sides fail to reach a consensus the government will resort to legislation. The government is expected to make some concessions if it appears possible for the two sides to reach a consensus, and cost-cutting will then be somewhat smaller than the government's target.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2014	2015	2016	2017
GDP OECD	2.0	2.1	2.2	2.4
GDP world (PPP)	3.5	3.1	3.4	3.8
CPI OECD	1.7	0.6	0.8	1.6
Export market OECD	3.3	4.5	4.9	4.8
Oil price, Brent (USD/barrel)	99.5	53.4	40.0	50.0

US

Yearly change in per cent

	2014 level, USD bn	2014	2015	2016	2017
Gross domestic product	17,616	2.4	2.4	2.4	2.7
Private consumption	12,061	2.7	3.1	3.2	2.9
Public consumption	3,163	-0.6	0.8	0.5	0.0
Gross fixed investment	2,937	5.3	3.9	3.7	6.3
Stock building (change as % of GDP)		0.0	0.2	-0.2	0.0
Exports	2,350	3.4	1.1	3.0	5.7
Imports	2,895	3.8	5.0	4.2	6.8
Unemployment (%)		6.2	5.3	4.7	4.2
Consumer prices		1.6	0.1	0.8	2.1
Household savings ratio (%)		4.8	5.2	5.8	6.0

EURO ZONE

Yearly change in per cent

	2014 level, EUR bn	2014	2015	2016	2017
Gross domestic product	10,072	0.9	1.5	1.9	2.0
Private consumption	5,605	0.8	1.6	1.7	1.8
Public consumption	2,125	0.9	0.5	1.0	1.0
Gross fixed investment		1.2	1.8	2.5	2.5
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	4,493	3.9	4.3	4.5	4.2
Imports	4,118	4.2	4.3	4.4	4.0
Unemployment (%)		11.6	10.9	10.2	9.9
Consumer prices		0.4	0.0	0.2	1.1
Household savings ratio (%)		6.5	6.5	6.5	6.4

OTHER LARGE COUNTRIES

Yearly change in per cent

	2014	2015	2016	2017
GDP				
United Kingdom	2.9	2.2	2.2	2.4
Japan	-0.1	0.6	1.0	0.5
Germany	1.6	1.7	1.9	2.0
France	0.2	1.2	1.7	1.7
Italy	-0.4	0.7	1.3	1.3
China	7.3	6.9	6.5	6.0
India	7.1	7.3	7.5	7.7
Brazil	0.1	-3.5	-3.0	1.5
Russia	0.6	-3.7	-1.5	1.2
Poland	3.4	3.6	3.6	3.8
Inflation				
United Kingdom	1.5	0.0	0.5	1.4
Japan	2.7	0.8	0.2	1.7
Germany	0.1	0.2	0.8	1.9
France	0.1	0.0	0.2	0.7
Italy	0.2	0.0	0.2	0.7
China	2.0	1.4	2.0	2.5
India	7.3	4.9	5.5	5.7
Brazil	6.3	9.0	8.0	6.0
Russia	7.8	15.5	9.8	6.4
Poland	0.0	-0.9	0.8	2.0
Unemployment, (%)				
United Kingdom	6.2	5.5	4.9	4.7
Japan	3.6	3.4	3.2	3.1
Germany	5.0	4.7	4.6	4.8
France	10.3	10.4	10.4	10.2
Italy	12.7	12.4	12.2	12.0

The Baltics

	2014	2015	2016	2017
GDP, yearly change in per cent				
Estonia	2.9	1.3	2.4	3.0
Latvia	2.4	2.8	2.7	3.5
Lithuania	3.0	1.6	2.8	3.2
Inflation, yearly change in per cent				
Estonia	0.5	0.1	1.3	2.7
Latvia	0.6	0.2	0.7	2.2
Lithuania	0.2	-0.7	0.3	1.2

FINANCIAL FORECASTS

		03-Feb	Jun-16	Dec-16	Jun-17	Dec-17
Official interest rates						
US	Fed funds	0.50	0.50	1.00	1.25	1.75
Japan	Call money rate	-0.10	-0.20	-0.30	-0.30	-0.30
Euro zone	Refi rate	0.05	0.05	0.05	0.05	0.05
Euro zone	Deposit rate	-0.30	-0.40	-0.40	-0.40	-0.40
United Kingdom	Repo rate	0.50	0.50	0.50	0.75	1.00
Bond yields						
US	10 years	1.86	2.05	2.30	2.50	2.80
Japan	10 years	0.08	0.10	0.20	0.35	0.45
Germany	10 years	0.31	0.50	0.60	0.90	1.20
United Kingdom	10 years	1.51	1.75	2.00	2.40	2.80
Exchange rate						
USD/JPY		118	128	130	125	125
EUR/USD		1.10	1.05	1.03	1.04	1.05
EUR/JPY		130	134	134	130	131
GBP/USD		1.46	1.40	1.37	1.41	1.46
EUR/GBP		0.76	0.75	0.75	0.74	0.72

SWEDEN

Yearly change in per cent

	2014 level, SEK bn	2014	2015	2016	2017
Gross domestic product	3,918	2.3	3.6	3.7	2.8
Gross domestic product, working day adjustment		2.3	3.4	3.5	3.0
Private consumption	1,812	2.2	2.6	3.0	2.8
Public consumption	1,031	1.3	2.0	3.5	2.5
Gross fixed investment	922	7.5	8.0	7.3	6.0
Stock building (change as % of GDP)	10	0.1	0.1	0.1	0.0
Exports	1,744	3.5	4.6	5.8	4.6
Imports	1,600	6.3	5.2	7.3	6.4
Unemployment (%)		7.9	7.4	6.7	6.6
Employment		1.4	1.4	1.6	1.5
Industrial production		-2.3	2.2	3.0	4.0
CPI		-0.2	0.0	0.6	1.6
CPIF		0.5	0.9	1.2	1.5
Hourly wage increases		2.7	2.6	3.1	3.4
Household savings ratio (%)		15.3	16.2	16.5	15.6
Real disposable income		2.2	3.3	3.4	1.7
Current account, % of GDP		5.7	6.4	5.8	5.5
Central government borrowing, SEK bn		72	33	28	57
Public sector financial balance, % of GDP		-1.7	-1.1	-1.1	-1.3
Public sector debt, % of GDP		44.9	44.3	43.7	43.5

FINANCIAL FORECASTS	03-Feb	Jun-16	Dec-16	Jun-17	Dec-17
Repo rate	-0.35	-0.45	-0.45	0.00	0.50
3-month interest rate, STIBOR	-0.35	-0.45	-0.40	0.10	0.65
10-year bond yield	0.83	0.85	1.10	1.55	1.90
10-year spread to Germany, bp	52	35	50	65	70
USD/SEK	8.47	8.67	8.74	8.56	8.29
EUR/SEK	9.36	9.10	9.00	8.90	8.70
TCW	130.1	127.4	126.5	125.6	123.2
KIX	109.8	107.5	106.8	106.1	104.0

NORWAY

Yearly change in per cent

	2014 level, NOK bn	2014	2015	2016	2017
Gross domestic product	3,139	2.2	1.9	1.5	1.6
Gross domestic product (Mainland)	2,474	2.3	1.4	1.6	2.2
Private consumption	1,254	1.7	2.2	1.5	2.3
Public consumption	671	2.9	2.5	3.1	2.5
Gross fixed investment	717	0.0	-3.1	-0.9	1.3
Stock building (change as % of GDP)		0.4	0.2	0.0	0.0
Exports	1,231	2.2	3.4	2.2	1.8
Imports	889	1.5	1.0	1.7	3.2
Unemployment (%)		3.5	4.4	4.9	4.9
CPI		2.0	2.1	2.5	2.1
CPI-ATE		2.4	2.7	2.7	2.1
Annual wage increases		3.1	2.7	2.5	2.6

FINANCIAL FORECASTS	03-Feb	Jun-16	Dec-16	Jun-17	Dec-17
Deposit rate	0.75	0.50	0.50	0.50	0.75
10-year bond yield	1.31	1.35	1.40	1.60	1.95
10-year spread to Germany, bp	102	85	80	70	75
USD/NOK	8.63	8.95	8.93	8.46	8.10
EUR/NOK	9.54	9.40	9.20	8.80	8.50

DENMARK

Yearly change in per cent

	2014 level, DKK bn	2014	2015	2016	2017
Gross domestic product	1,943	1.1	1.3	1.8	2.2
Private consumption	931	0.9	2.2	2.5	2.8
Public consumption	512	0.2	1.2	0.5	0.7
Gross fixed investment	387	4.0	0.6	4.1	4.3
Stock building (change as % of GDP)		0.3	-0.4	0.1	0.0
Exports	1,037	2.6	-0.5	1.8	4.2
Imports	919	3.8	-1.0	2.8	5.0
Unemployment (%)		5.0	4.5	4.2	4.0
Unemployment, OECD harmonised (%)		6.1	6.0	5.4	4.8
CPI, harmonised		0.6	0.5	0.6	1.5
Hourly wage increases		1.3	1.5	2.0	2.5
Current account, % of GDP		6.2	7.0	6.5	6.0
Public sector financial balance, % of GDP		0.0	-2.5	-2.0	-1.0
Public sector debt, % of GDP		43.5	43.0	41.0	40.0

FINANCIAL FORECASTS	03-Feb	Jun-16	Dec-16	Jun-17	Dec-17
Lending rate	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.64	0.80	0.85	1.10	1.35
10-year spread to Germany, bp	33	30	25	20	15
USD/DKK	6.76	7.10	7.24	7.17	7.10
EUR/DKK	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	206	-0.4	0.1	0.4	1.1
Private consumption	114	0.5	0.8	0.5	0.6
Public consumption	51	-0.2	0.0	-0.2	-0.2
Gross fixed investment	42	-3.3	-2.0	1.0	2.2
Stock building (change as % of GDP)		0.4	-0.1	0.0	0.0
Exports	78	-0.7	-1.0	1.6	3.5
Imports	79	0.0	-1.4	1.6	2.5
Unemployment (%)		8.7	9.4	9.2	8.9
CPI, harmonised		1.2	-0.2	0.2	1.0
Hourly wage increases		1.5	1.5	1.5	1.8
Current account, % of GDP		-0.9	-1.0	-0.9	-0.9
Public sector financial balance, % of GDP		-3.3	-3.1	-2.8	-2.5
Public sector debt, % of GDP		59.3	62.5	64.5	65.0

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