Press release

Stockholm, May 18, 2016

Nordic Outlook: Difficult policy choices amid slow global growth Sweden is on a roll, but its path ahead is not risk-free

Parallel with new downward adjustments in most growth forecasts, some global sources of concern from early 2016 have partly faded. For example, oil prices and stock markets have regained part of their earlier sharp declines, and central banks have made their policies even more expansionary – or postponed normalisation processes. Some of the worries about China have also diminished. Yet global economic growth will remain anaemic and fragile in 2016: GDP growth in the 34 mainly affluent countries of the Organisation for Economic Development and Cooperation (OECD) will reach 1.9 per cent this year, down from 2.1 per cent in 2015. In 2017, OECD growth will accelerate to 2.3 per cent.

Downside risks continue to dominate the outlook, though to a slightly lesser degree than before. Political risks in the United States (the presidential election) and the European Union (a potential British exit or "Brexit" – as well as elections in such countries as Spain, France and Germany in 2016-2017), a possible Chinese hard landing, global indebtedness and lack of credibility and limited manoeuvring room for economic policymakers – are factors that are causing concern.

Multi-dimensional policy challenges as economic associations weaken

The concept of secular stagnation – a lengthy period of slower growth, along with low interest rates and low inflation – is gaining a firmer foothold in economic discourse. Clear global signs of a high propensity to save and weak willingness to invest are pushing down real interest rates. Interest rate policy is actually accommodative rather than proactive, with nominal key interest rates being forced downward by falling real interest rates. The role of fiscal policy is also likely to expand as monetary policy ammunition runs out and its effectiveness weakens. The question is whether political leaders have the strength, and the fiscal manoevring room, to seize the initiative.

Meanwhile there are growing questions about the long-term sustainability of the economic policy system. After decades of financial and economic deregulation, the market economy's dependence on policy decisions has never been greater. Price signals in the financial market are being obscured by the enormous securities purchases of central banks, which in turn are driving up asset prices, despite lethargic economic growth. Central banks have gained increasing influence on the credit supply, which implies obvious risks of poorer resource allocation. Monetary policy has also contributed to greater economic inequality, but we are now seeing negative interest rates assuming a political dimension in the opposite direction: being interpreted as a hidden wealth tax, especially in countries with a tradition of large-scale saving in interest-bearing accounts – such as Germany. The boundaries between central banks and political systems are becoming more and more fluid, which also raises questions about the independence of central banks.

Weak wage response confuses central banks

Japan, Germany, the United Kingdom and – to some extent – Sweden are examples of countries where tighter labour markets have so far not triggered normal wage and salary acceleration. In various countries, both political leaders and central banks have signalled that speedier pay increases would be desirable. Higher legal minimum wages, for example in the US and the UK, are signs of weakening confidence in the ability of market forces to create equilibrium and balance. Looking ahead, there are still signs that a tight US labour market will finally push wages upward. We expect US pay increases of 3.5 per cent in 2017, resulting in rising inflation to an extent that the Fed will find rather comfortable. In a number of countries, however, mounting competition due to globalisation and digitisation – as well as surplus production capacity – will hold down the inflation rate. We predict that Brent crude oil prices will move a bit higher, to around USD 45-50 per barrel in 2016-2017, which will reduce deflation risks.

Inflation is not dead, but it will be difficult for central banks to achieve their inflation targets. Our US inflation forecast is sufficient for the Fed to continue hiking its key interest rate – next time to 0.50-0.75 per cent in September. By the end of 2017, the federal funds rate will stand at 1.00-1.25 per cent. This will help push down the EUR/USD exchange rate to 1.10 at the end of 2016, before the euro rebounds slightly in 2017 towards its underlying equilibrium exchange rate. Despite doubts about the effectiveness of monetary policy, a number of central banks will continue their stimulus programmes. Because of troublingly low inflation in both the euro zone and Japan, the European Central Bank (ECB) will keep the door open to more securities purchases, while the Bank of Japan will cut its key interest rate from today's -0.10 per cent to -0.30 per cent, among other things in a desperate effort to weaken the yen. We believe that the UK and Sweden will follow the US and begin their rate hiking cycles during the first half of 2017. We expect monetary policies to become more coordinated within the framework of a re-assessment of the International Monetary System, in order to avoid destabilising capital flows and competitive devaluations.

Good Chinese growth outlook – worse US outlook, especially in 2016

China's deceleration path is relatively close to our forecasts that its economy will avoid a hard landing. Beijing's easing of fiscal and monetary policies is softening the negative effects of surplus production capacity and housing inventory, as well as high indebtedness among both state-owned and private companies. China's domestic economy has good potential to take over as the economic engine of the future, but there is great uncertainty as to when this rebalancing will have a bigger impact. We expect GDP growth of 6.5 per cent in 2016, down from 6.9 per cent in 2015, and slowing to 6.3 per cent in 2017. In the other BRIC countries, economic performance will be highly divergent. While India will grow by 7.5 per cent, both Russia and Brazil will be mired in deep recession this year due to structural problems, low oil prices and political worries, but we generally expect some degree of stabilisation in the emerging market (EM) sphere during 2017.

We do not believe that the broad-based US growth slump early this year reflects underlying weaknesses. Financial conditions have recently loosened, due to such factors as low interest rates, rebounding share prices and a weaker dollar. Households can look forward to better economic conditions related to the labour market, earnings and wealth effects. Combined with somewhat higher oil prices, the situation in the manufacturing sector will stabilise. Economic growth will bounce back in the second half of 2016. Yet full-year GDP growth will reach only 1.9 per cent, down from 2.4 per cent in 2015. Next year, growth will amount to 2.5 per cent.

In the November US presidential election, we believe that Republican candidate Donald Trump has a 35-40 per cent chance of being elected. Despite his confrontational and largely unrealistic protectionist programme, Trump attracts voters by playing on their underlying frustrations about current economic policy and the role of the United States in the world. If Trump's economic policies were implemented, US and world economic growth would be threatened by reversals.

Recovery in Western Europe despite political fears

Western Europe's recent economic performance has been relatively stable. Early in 2016 the euro zone reached the same level of GDP as before the Lehman Brothers collapse of 2008. In our view, the euro zone has the potential for GDP growth above its trend rate (1.0 per cent) during the next two years. We expect euro zone GDP to increase by 1.7 per cent in 2016 (marginally higher than in 2015) and to reach 1.8 per cent in 2017. But the euro zone is a currency union with imbalanced growth and is surrounded by major political concerns. Germany faces growing criticism from the International Monetary Fund (IMF), the US and the other euro zone countries because of its EUR 290 billion yearly financial savings surplus (8 per cent of GDP) and overly cautious economic policies. The banking sector, especially in southern Europe, is being squeezed by high corporate debts, doubtful loans and a low interest rate environment. This is hampering growth. Populism is gaining ground in an increasing number of countries, causing major tensions for the EU project. How the refugee crisis is managed – both in the short and long term – and how relations with Turkey will evolve are important and unanswered political questions, although their economic impact will be minor.

The UK's "Brexit" referendum on June 23 represents a political crossroads for Europe and the EU project. We foresee a 65 per cent chance that the Remain side will win. If there is a weak majority in favour of the Leave alternative (which is a 25 per cent probability), there is likely to be room for new negotiations with the EU followed by another referendum.

Nordic divergence – Baltic convergence

The Norwegian economy has bottomed out, with domestic demand gaining strength despite falling oil investments. The labour market and the manufacturing sector are showing some bright spots. The government's fiscal policy will become even more expansionary – the biggest stimulus programme since 2009 – and we foresee one more key rate cut to 0.25 per cent by Norges Bank. We expect overall Norwegian GDP to grow by 1.2 per cent this year, down from 1.6 per cent in 2015. In 2017, growth will be marginally higher: 1.5 per cent. Last year's disappointing economic growth in Denmark is difficult to explain, but the current outlook is favourable – helped by stronger domestic demand. We expect Denmark to show a 1.5 per cent growth rate in 2016 and 2.2 per cent in 2017. The Finnish economy has also passed its low point but faces a long uphill struggle. Exports will show some improvement, while households are being squeezed from several directions. Yet low inflation is allowing an improvement in purchasing power, which is being offset by continued public sector austerity. We expect Finland's GDP growth in 2016 to reach 0.7 per cent, marginally higher than last year. Next year the economy will grow by 1.1 per cent.

The outlook for Estonia, Latvia and Lithuania is improving, but downside risks remain. Private consumption is an important driver of economic growth and is benefiting from strong labour markets. Expected wage and salary increases will give households more purchasing power in an environment where inflation remains low, but at the same time these increases pose a threat to the competitiveness of the Baltic countries. In 2017, Estonia and Latvia will experience inflation that exceeds the ECB's target. Public sector finances are strong, serving as a potential shock absorber and giving the three governments flexibility in case of renewed economic weakness. We expect GDP growth in the Baltic countries to come in at nearly 2.5 per cent this year, accelerating by another 0.5-1.0 percentage points in 2017. This means that these countries will achieve their potential growth rates.

Swedish public opinion on EU divided – "euro the price to pay to stay in the EU"

British withdrawal from the European Union would have a larger political than economic impact on Sweden and would change the power balance in the EU to the advantage of the euro zone countries. It would increase pressure on Sweden to adopt the euro. In May, SEB chose to commission Demoskop to conduct a survey aimed at measuring the opinions of the Swedes on remaining in the EU and adopting the euro. According to the survey, 47 per cent of respondents would want Sweden to leave the EU if introducing the euro became mandatory for member countries; 38 per cent would accept the euro if given that choice. Our intepretation is that Swedes are surprisingly willing to accept the euro as "the price they have to pay" in order to stay in the EU. The same poll also confirms that unlike the British, the Swedes are not currently prepared to start a fight about renegotiating their country's relations with the EU.

Sweden's GDP growth will decelerate, but undramatically, in 2017. Record growth in public sector consumption – the highest in 20 years, driven by refugee-related spending, residential construction and a slightly faster export upturn due to a weak krona – will help decrease GDP growth to 4.0 per cent in 2016, down from 4.1 per cent in 2015. Growth will be 2.8 per cent next year, which is still well above trend. Smaller immigration flows as well as bottlenecks in the construction sector will slow economic growth in 2017. Despite rapid job growth, rising labour force participation has been instrumental in keeping unemployment higher than expected so far. During 2016, unemployment will drop below 6.5 per cent. It will then climb again late in our forecast period. Equilibrium unemployment is 6.5-7.0 per cent, which implies tighter resource utilisation and will make it difficult for the government to meet its target of achieving the lowest unemployment in the EU by 2020. Now that this year's national wage round is over, we have adjusted our 2016 forecast of wage and salary increases downward from 3.1 to 2.7 per cent. We expect the 2017 wage round to result in faster pay increases due to a tighter labour market situation. Taken together, this will result in rising CPIF inflation (consumer price index minus interest rate changes), which will nevertheless not reach the Riksbank's 2 per cent target by the end of 2017.

Is Sweden a "bumblebee" that defies the law of gravity without a parachute?

Swedish public finances are surprisingly strong, but there is still no shortage of challenges. Rapid GDP growth is giving an extra push to tax revenues, since this growth is employment-driven and is also dominated by highly taxed demand segments such as construction and private consumption. After achieving a balanced budget in 2015, Sweden is expected to show fiscal surpluses during 2016 and 2017, while government debt will fall from 45 per cent in 2014 to 40 per cent in 2017. The official expenditure ceiling is no longer being threatened, among other things due to downward revisions in projected immigration. This is increasing pressure on Finance Minister Magdalena Andersson to become more aggressive about pushing down unemployment, thereby hopefully turning around the powerful public opinion headwinds that the Social Democratic-led minority government is facing ahead of the September 2018 election.

But fiscal expenditures are not without dangers in a situation of large underlying spending pressures. Many key public sector functions are hard-pressed. Meanwhile budget increases for defence, integration of immigrants into Swedish society, labour market training and skills development programmes will probably be necessary. And eventually there will also be risks posed by higher debt service expenditures and cyclical downturns. Political logic suggests that the finance minister will be forced to find a compromise between stimulus measures and a continued firm grip on spending, but next autumn's budget for 2017 is likely to end up with even more expansionary fiscal policy. The more stimulus measures the government unveils, the more difficult it would be for the centre-right Alliance parties – which lost the 2014 election after eight years in power – to remain passive in Parliament. We thus cannot rule out that the government's policies may face growing opposition this autumn.

The Riksbank's repo rate path is being driven by both domestic and international forces. Resource utilisation in Sweden is now more stretched than the historical average. Meanwhile fiscal policy is becoming more expansionary, household credit is growing and the krona is undervalued. Swedish inflation will not move cyclically higher until 2017. But international forces – low global real interest rates – and the risk that the ECB will keep the door open to further stimulus measures, due to low inflation pressure, will cause Sweden to slow its monetary policy normalisation process in order not to trigger an undesirably high krona exchange rate. The recent King-Goodfriend report on the Riksbank will speed up the central bank's process of adopting a new metric for its inflation target (CPI today), re-assessing its analytical and forecasting models and accepting divergences from its inflation target both in terms of level and timing. The multi-year review of the Sveriges Riksbank Act that is beginning this spring is not expected to result in any major changes in the monetary policy framework, but will lead to greater clarity mainly regarding the Riksbank's financial stability mandate.

Our forecast is that the Riksbank will begin to reverse its negative key interest rate in April 2017. By the end of 2017, the repo rate will stand at 0.25 per cent. The bank will be forced to accept some appreciation of the krona. At the end of 2016, the EUR/SEK exchange rate will be 9.00 and the USD/SEK rate will be 8.20. Our corresponding forecast for the end of 2017 is a EUR/SEK exchange rate of 8.70 and a USD/SEK rate of 7.80. During our forecast period, the krona will appreciate by about 5 per cent in trade weighted KIX terms.

Key figures: International & Swedish economy *(figures in brackets are forecasts from the February 2016 issue of **Nordic Outlook**)*

International economy, GDP, year-on-year changes, %	**2014**	**2015**	**2016**	**2017**
United States	2.4	2.4 (2.4)	1.9 (2.4)	2.5 (2.7)
Euro zone	0.9	1.6 (1.5)	1.7 (1.9)	1.8 (2.0)
Japan	0.0	0.6 (0.6)	0.5 (1.0)	0.5 (0.5)
OECD	1.9	2.1 (2.1)	1.9 (2.2)	2.3 (2.4)
China	7.3	6.9 (6.9)	6.5 (6.5)	6.3 (6.0)
Nordic countries	1.6	2.2 (2.1)	2.2 (2.2)	2.0 (2.1)
Baltic countries	2.8	1.8 (1.9)	2.6 (2.7)	3.1 (3.2)
The world (purchasing power parities. PPP)	3.4	3.1 (3.1)	3.1 (3.4)	3.7 (3.8)
Swedish economy. Year-on-year changes. %				
GDP. actual	2.3	4.1 (3.6)	4.0 (3.7)	2.8 (2.8)
GDP. working day corrected	2.3	3.9 (3.4)	3.8 (3.5)	3.0 (3.0)
Unemployment. % (EU definition)	7.9	7.4 (7.4)	6.9 (6.7)	6.5 (6.6)
Consumer Price Index (CPI) inflation	-0.2	0.0 (0.0)	0.9 (0.6)	1.4 (1.6)
Government net lending (% of GDP)	-1.6	0.0 (-1.1)	0.4 (-1.1)	0.1 (-1.3)
Repo rate (December)	0.00	-0.35	-0.50 (-0.45)	0.25 (0.50)
Exchange rate. EUR/SEK (December)	9.39	9.19	9.00 (9.00)	8.70 (8.70)

For more information. please contact
Robert Bergqvist. +46 70 445 1404
Håkan Frisén. +46 70 763 8067
Elisabet Kopelman. +46 8 763 8046
Daniel Bergvall +46 8 763 8594
Mattias Bruér. +46 8 763 8506
Olle Holmgren. +46 8 763 8079
Andreas Johnson +46 8 763 8032

Press contact
Anna Helsén. Press & PR
+46 70 698 4858
anna.helsen@seb.se