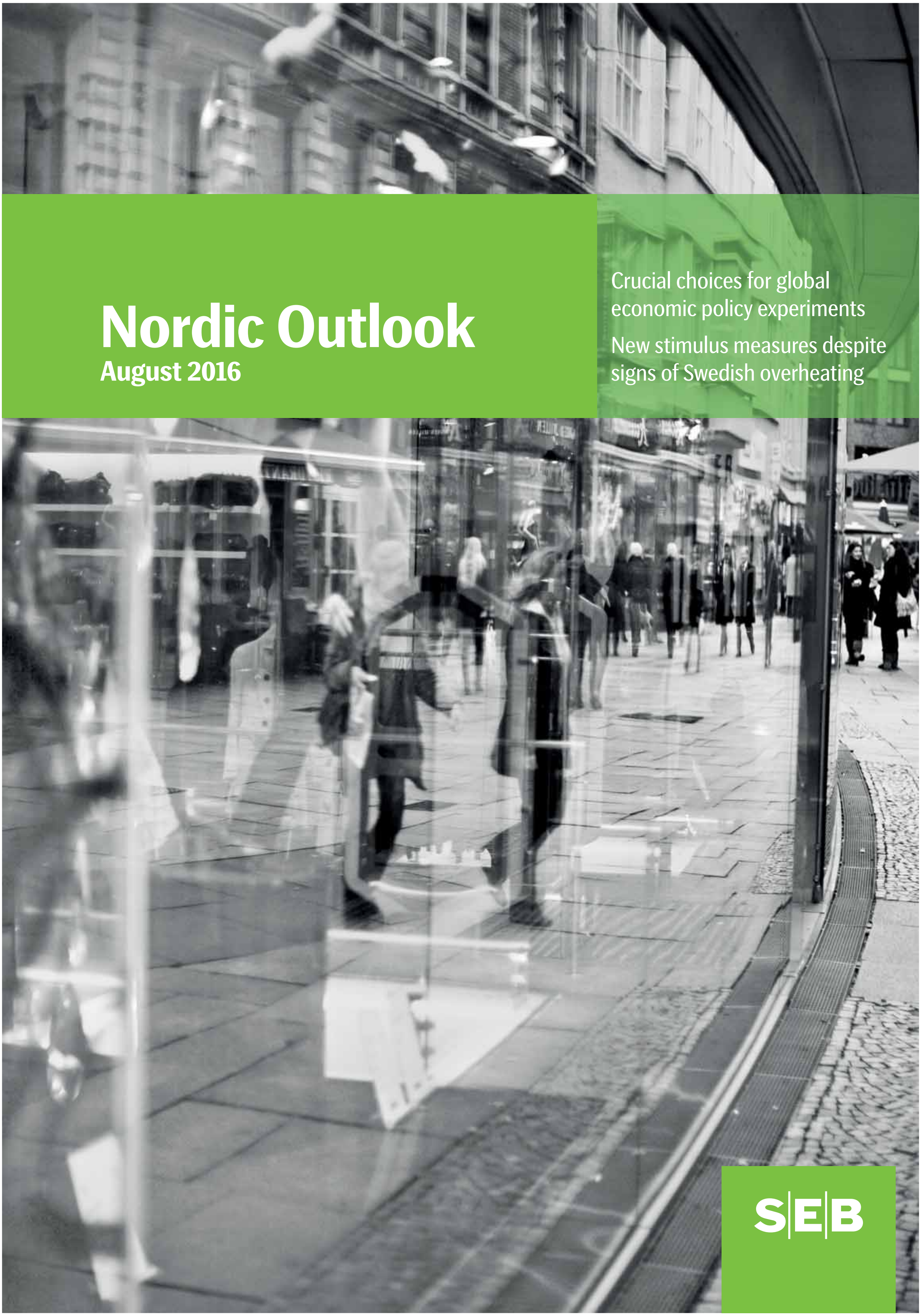
Nordic Outlook

August 2016

Crucial choices for global economic policy experiments

New stimulus measures despite signs of Swedish overheating



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Crucial choices for global policy experiments

- **Weak pound easing negative Brexit effects**
- **New political winds even after Clinton wins**
- **Euro zone growth despite bank problems**
- **EM acceleration but slowdown in China**
- **Low inflation amid less economic slack**
- **Carry-driven FX markets holding back SEK**
- **Potential for equities despite high valuations**

Recent economic and political events have taken unexpected twists and turns. Forecasting conditions seem a bit contradictory. The Brexit referendum, trends in the US presidential election campaign including the successes of Donald Trump, the rising fortunes of right-wing populist parties in Europe and reversals for democracy in various emerging economies clearly represent a heightened political risk level. On the other hand, financial markets have apparently become more resilient to political uncertainty in recent years. For example, the initial shock reaction after the United Kingdom voted to exit the Europe Union ("Brexit") was followed by a significant **stock market rally triggered by signals of looser central bank policies and mainly positive economic indicators**. Meanwhile bond yields have reached new record lows, given the prospect of further liquidity injections and lower key interest rates.

It is too early to draw firm conclusions about the economic impact of the Brexit process, but we are sticking to our view that **it is the political risks that are the most serious**. An initial downturn in British sentiment indicators was followed by strong retail trade and employment figures, for example. Our forecast implies **near-zero GDP growth in the UK during the second half of 2016**. After that, a weak currency and looser economic policies will contribute to a slow recovery. Given the limited impact on the British economy, contagious effects will not be so large either. **Euro zone economies will be slowed by the weak pound**, but domestic conditions are sufficiently expansionary that GDP growth will be a bit above-trend.

We have adjusted our forecast for the US economy downward after the unexpectedly weak second quarter GDP figure. In recent weeks, however, economic signals have been predominantly positive. Expansionary financial conditions combined with fading negative impulses from the oil sector will mean good prospects of a stronger second half, but GDP growth will be moderate during the next couple of years. This is partly because labour market constraints are beginning to have an impact. In emerging market (EM) countries, financial markets have recently been generally resilient, with rising share prices and currencies – partly due to more stable energy and commodity prices. Our forecast of a **controlled deceleration in Chinese economic growth** is unchanged, while GDP growth in **India will show a cautious acceleration** to 8.0 per cent in 2018. Brazil and Russia are struggling with continued problems, but after large GDP declines in 2015 and 2016 we foresee slightly positive growth figures in 2017 and 2018. For the **EM** economies as a whole, **GDP growth will climb from 4.2 per cent this year to 4.7 per cent in 2017 and 4.8 per cent in 2018**. Overall **global** growth will rise from **3.1 per cent this year to 3.5 per cent in 2017 and 3.6 per cent in 2018**. For 2017, this represents a downward revision by 0.2 percentage points compared to our May forecast.

Global GDP growth

Year-on-year percentage change

	2015	2016	2017	2018
United States	2.6	1.6	2.4	2.0
Japan	0.5	0.5	0.5	0.5
Germany	1.7	1.7	1.6	1.6
China	6.9	6.6	6.3	6.0
United Kingdom	2.2	1.7	0.9	2.0
Euro zone	1.7	1.6	1.7	1.7
Nordic countries	2.2	2.1	2.0	2.0
Baltic countries	1.8	2.2	2.8	3.1
OECD	2.3	1.7	2.0	2.0
Emerging markets	3.9	4.2	4.7	4.8
World, PPP*	**3.1**	**3.1**	**3.5**	**3.6**

Source: OECD, SEB * Purchasing power parities

In this environment, central banks face several dilemmas. Moderate growth, downside risks connected to political uncertainty and troublingly low inflation are creating pressure for more stimulus measures. On the other hand, the **effectiveness of further unconventional monetary policy will become lower and lower**, while risks related to overblown asset prices and high indebtedness will increase. Especially in Japan and the euro zone, further downward pressure on interest rates would also have adverse consequences for the banking system, eventually weakening the transmission mechanism even more. We anticipate one further key interest rate cut by the Bank of England (BoE), as well as extensions and expansions of bond purchases by the European Central Bank (ECB), the Bank of Japan (BoJ) and others, but generally speaking, monetary policy has reached the end of the road. We have nevertheless postponed the forecasted starting point of the normalisation process in various countries. In Sweden the first rate hike will occur in the autumn of 2017, and in the UK in mid-2018. **The US Federal Reserve (Fed) will thus be alone in raising its key rate this coming December**, and the federal funds rate will reach 1.50-1.75 per cent by the end of 2018.

Such a situation strengthens the argument that fiscal policy should assume more of the burden. But it is difficult to believe that any major breakthroughs will occur, since countries most in need of stimulus measures also have very little room for government budget largesse. Continued disappointing growth, in a situation where all other potential sources of economic stimulation have been exhausted, might lead countries to **experiment with the so-called helicopter money concept (see the theme article on page 14)**, but aside from the practical problems, it is unlikely that the decent growth we foresee will help trigger such drastic actions.

Given our views regarding cyclical and economic policies, it is difficult to foresee any strong near-term rebound in interest rates and bond yields. **Yields will remain close to historical lows during the coming year** and then move higher as the Fed gradually hikes its key rate and the ECB phases out its bond purchases. By the end of 2018, global 10-year yields will generally be about 70 basis points higher than today. **The foreign exchange (FX) market is dominated by a search for returns, which benefits currencies in high-yield (EM) countries**. The Fed's action in December may help push the EUR/USD exchange rate below 1.10 for six months. Further ahead EUR/USD will move towards levels more in line with its historical average, reaching 1.15 by the end of our forecast period. Sweden's Riksbank has gained credibility for its ambition to keep the krona weak. Only when it decouples its interest rate policy from the ECB in mid-2017 do we foresee prospects of a movement towards fundamentally justified levels. **We expect stock markets to climb moderately and see the greatest potential in Europe**, but optimistic consensus forecasts for corporate earnings represent a general risk of reversals.

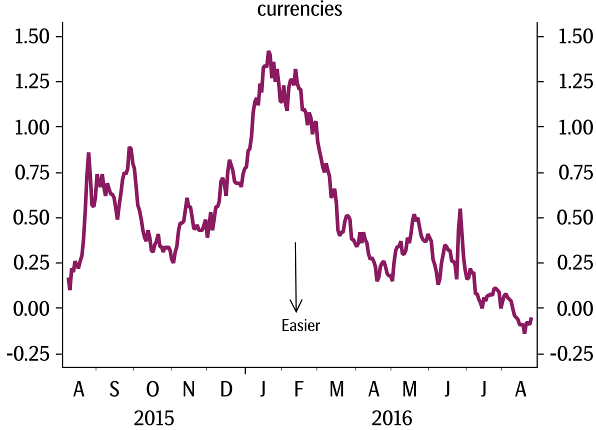
Clinton victory would dispel some worries

Because of weak US economic figures in both the first and second quarters, **we are adjusting our full-year GDP growth forecast for 2016 from 1.9 to 1.6 per cent**. Indicators have rebounded in recent months, though, and we see several reasons why the final months of the year may be rather strong. Aside from strong underlying consumption growth, financial conditions changed rather sharply last spring. With a certain time lag, this will help sustain the real economy. In addition, the negative impulse from a sharp drop in oil investments will also gradually fade, while the inventory cycle will probably shift to an expansionary direction after five straight quarters of contraction. **Yet GDP growth will be moderate, at 2.0 per cent in 2017 and 2.4 per cent in 2018**. This will be partly due to supply-side restrictions in the labour market, which will make themselves felt when unemployment has fallen well below the levels that the Fed has stated as the equilibrium.

This autumn the presidential election is likely to dominate the news. In both the United States section and in the theme article on page 20, we analyse the candidates' economic programmes. **We have lowered the probability of a Donald Trump victory from 35-40 per cent to 15 per cent**. After the Republican convention, Trump has not managed to change his approach in a more statesman-like direction to any great extent, though he has become less provocative on foreign and security policy issues. This will make it hard for him to broaden his voter base enough to win "swing states" such as Florida, where ethnic minority groups make up a significant percentage of the population. Despite Trump's generally unconventional behaviour, his economic policy programme largely follows traditional Republican patterns. This means large unfunded tax cuts for high income earners, which should logically limit his voter appeal even more. If Hillary Clinton is the next president, there will probably not be any dramatic economic policy changes, although her programme also includes protectionist elements.

Financial conditions stimulating growth

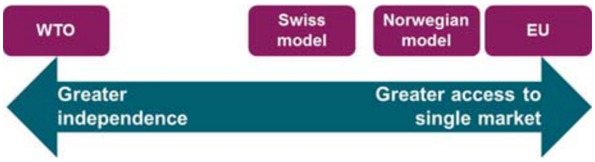
Weighted index of interest rates, credit spreads, equities and currencies



Source: Bloomberg

Brexit negotiations with unclear contours

The United Kingdom's decision to leave the EU raises many issues, both at the national and European level. The referendum divided the nation, among other things illustrated by clear lines between the choices of different regions as well as internal conflicts within political parties. Because the matter of appointing a new prime minister was so quickly resolved and Theresa May then clearly declared that the referendum outcome must be respected, uncertainty has decreased. It is thus likely that the "exit clause" (Article 50 of the Lisbon Treaty) will be activated during 2017. The negotiations will be complicated, but **our main scenario (70 per cent probability) is that Brexit negotiations will be carried out in a constructive way** and that the UK can sign mutually beneficial trade agreement with both the EU and other partners. We also believe that the most probable outcome is that the UK's future relations with the EU will follow the Swiss model. Unlike the Norwegian model, for example, this includes restrictions on the EU's four freedoms: freedom of movement for goods, services, capital and people.



Declining investments due to uncertainty about the UK's long-term relations with other countries is the biggest economic risk. We predict that GDP will stagnate completely during the second half of 2016, yet **several factors suggest that this slump will be mild**. The BoE has managed to restore confidence in financial markets after their initial shock reaction. This autumn's UK budget bill will probably also ease fiscal policy somewhat, strengthening the picture of an economic policy that is shifting in a more expansionary direction. It is difficult to determine what the British government's ambition to make the economy "super-competitive" will mean in practice. But such a focus may have a symbolic importance, complementing the competitive improvements resulting from the depressed pound exchange rate. But GDP growth in 2017 as a whole will be a mere 0.9 per cent. This means that the UK economy will grow far more slowly than that of the Western world in general.

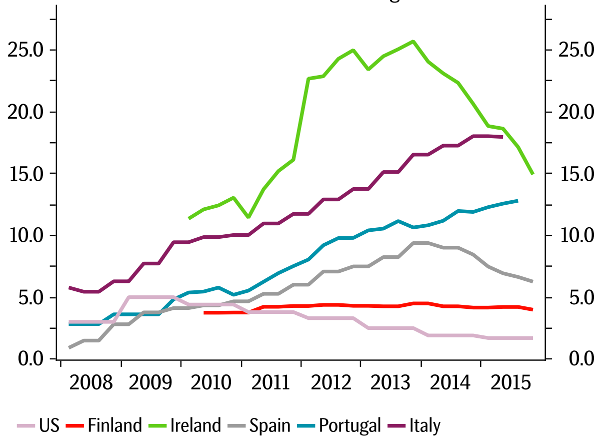
Decent momentum despite bank problems

The Brexit process will also affect the political process in the euro zone. Anti-EU sentiment is also growing in many countries belonging to the currency union, and if the conditions surrounding British withdrawal appear attractive, more countries may choose to follow suit. The outcome of the French presidential election in the spring of 2017 and the German federal parliamentary election the following autumn will be important in determining future choices. Refugee crises and terrorist threats also urgently require constructive cooperation, but the governments of many EU countries have limited manoeuvring room because of domestic public opinion. In light of the UK referendum outcome, **we do not believe that the EU establishment will dare to continue in a federalist direction**. In practice, this means that the euro currency project will remain without a completed infrastructure that would give the euro zone long-term stability.

Despite various sources of concern, the euro zone economy will continue to grow at a pace of between 1½ and 2 per cent, which is above trend and implies that unemployment will continue to fall. Domestic drivers are relatively strong, with a household sector benefiting from low inflation, job growth and an improved wealth position due to rising home prices. Capacity utilisation has now also reached levels where capital spending usually takes off. But continued banking sector problems (see the box on page 27) are holding down the pace of lending and hampering the effectiveness of ECB stimulus measures. Italy has the highest proportion of bad loans, but the problem exist in varying degrees elsewhere in the region. Reassuring results in the stress tests conducted by the European Banking Authority (EBA) have not persuaded financial markets. These problems risk becoming chronic as long as interest rates are so depressed.

Continued large proportion of bad loans

Per cent of total lending



Source: IMF

Still some downward bias in the risk situation

Market turmoil after the Brexit decision was short-lived and US indicators have recently rebounded, reducing the short-term downside risks in our forecast. The stabilisation in energy prices and the increased probability of a controlled deceleration in China have also contributed. In the long term, however, there are various risks we can highlight even though the probability of each of them is quite low. Our alternative scenario in which Brexit negotiations lead to severe disruptions in cooperation between the UK and the EU is one example. This can also be linked to broader risks of a populist and protectionist trend, for which a Trump victory in the US presidential election might be a catalyst. Another risk is that we will finally see a relatively sharp decline in asset prices due to growing distrust in the ability of central banks to manage the situation in the long term. This may be linked to an unexpectedly rapid surge in inflation at a later stage of the cycle.

Upside potential is relatively small. One possibility is that we will see a sharper upturn in consumption because of increasingly strong labour markets in many countries. Our estimates suggest that saving in the US is unusually high relative to households' underlying financial strength, which is probably also true in a number of other countries. If the widening shortfall in productivity growth during the past few years can be reversed, this may lead to a virtuous cycle via improved profitability and rising capital spending. Overall, we are sticking to our assessment in May that **the risks of worse economic performance than in our main scenario is 20 per cent, while the probability of a high-growth scenario is 15 per cent**.

Greater resilience among EM economies

The stock markets and currencies in the EM sphere have generally continued to recover in recent months. Driving forces have been decreased worries about a Chinese hard landing, higher oil and other commodity prices as well as further downgraded expectations concerning Fed rate hikes.

Puzzling economic cycle

After a clear rebound right after the financial crisis, the world's advanced economies have had difficulty achieving the growth figures that prevailed in earlier recoveries. **The lack of a cyclical pattern is especially clear in our current forecast**. In both Japan and the euro zone, GDP growth will be at a constant level during the period 2015-2018. No real cyclical pattern is discernible in the US or the UK either. This raises questions about where in the economic cycle we actually are.

Labour market developments provide a different picture, though, with a clear cyclical trend. US unemployment has declined faster than expected, for example. The jobless rate has also fallen to historically low levels in Japan, Germany and the UK. **Actual unemployment in many countries is now close to equilibrium**. The International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD) and others are thus reporting small output gaps. This situation is having slightly paradoxical consequences. While public discourse today focuses on the problems of weak economic growth and the low effectiveness of monetary policy, forecasters and decision makers must also begin thinking about whether supply-side restrictions will hamper growth in the relatively near future. Generally speaking, many factors suggest continued low inflation during this period, but cyclical inflation may emerge at a later stage.

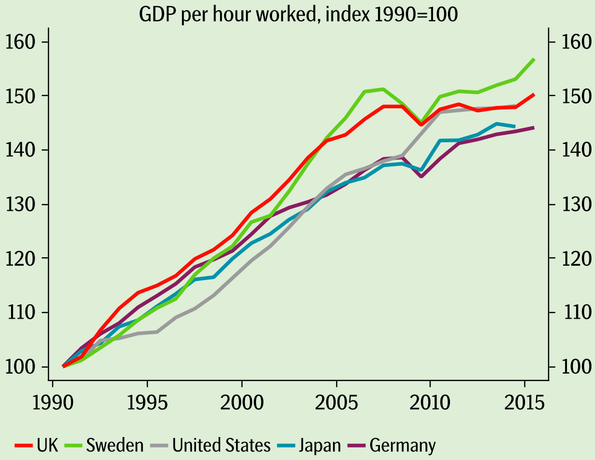
Output gap in selected countries
Per cent of GDP*

	Q 2 2016	Q4 2018
United States	-0.5	0.5
Japan	0.0	0.0
Euro zone	-2.5	-1.0
Germany	-0.5	0.5
United Kingdom	-1.0	-1.0
Sweden	-1.0	0.5
OECD	-1.0	0.0

*Negative figures mean spare capacity
Source: OECD, SEB

In fact, we are now moving towards an acid test. If old associations between the resource situation and inflation still prove correct, financial market re-pricing may be significant. The background situation is that almost no interest rate hikes are being priced in today and that inflation expectations – as measured by the market for inflation-linked bonds – are very depressed. For central banks, this situation is not simple. While they want to show they are aware that the inflation process has changed, there is hardly any alternative to output gaps as a framework for analysis and communication. With a bit of exaggeration, we can also say that **a clear association between resource utilisation and inflation is nearly essential if the system of inflation targeting** and independent central banks is to work reasonably well.

Productivity growth has lost momentum
GDP per hour worked, index 1990=100



Source: Macrobond

Labour markets have performed so strongly despite anaemic growth because labour productivity levelled out after the financial crisis. **In nearly all countries, productivity growth is far below its previous trend**. Most forecasters assume that the gap between the current and previous trend will not close. There are several reasons for this caution, for example a long period of low capital spending and economic policies aimed at creating jobs for people with lower productivity. Yet the above gap indicates that there is potential for faster productivity increases in the future. If only part of the gap could be closed, this would be very important for medium-term growth potential and especially for earnings growth in the business sector. One possibility (which we discussed in the theme article "Low productivity growth – the new normal?" in the last *Nordic Outlook*) is that we may experience a new surge of productivity growth due to the delayed effects of digitisation and the technological revolution of the past decade.

SEB's currency index for EM economies has risen by about 4 per cent in the past quarter. Commodity-exporting economies have benefited, with the Russian rouble and Brazilian real among the fastest-rising EM currencies. As long as commodity prices do not weaken substantially or expectations about Fed rate hikes do not generate market turmoil, **we foresee good prospects of further currency appreciation**.

Among the BRIC economies, **India** will continue to show strong growth – with annual GDP increases of 7½ to 8 per cent during our forecast period. In **China**, growth has stabilised in recent quarters and short-term uncertainty has decreased. Our forecast of a controlled deceleration remains in place, and growth will gradually slow to 6.0 per cent in 2018. Although they have lowered their ambitions a little, high growth targets risk giving Chinese policymakers an excessively short-term focus, causing them to assign lower priority to long-range structural reforms. In both **Russia** and **Brazil**, GDP continued to fall during the second quarter of 2016, but these economies are showing clear signs of stabilisation. Our forecast is that they will both see marginally positive GDP growth in 2017. The Russian economy will benefit from slightly higher oil prices, while rouble appreciation will help slow inflation and thus also slow the deterioration in household purchasing power. In many smaller EM economies, growth is decent though far slower than before the financial crisis. We expect overall growth in the EM sphere to speed up somewhat in 2017 and 2018 despite China's deceleration.

GDP growth, BRIC countries and EM sphere
Year-on-year percentage change

	2015	2016	2017	2018
China	6.9	6.6	6.3	6.0
India	7.3	7.6	7.8	8.0
Braziienl	-3.5	-3.5	0.5	2.0
Russia	-3.7	-0.4	1.0	1.5
Emerging markets	3.9	4.2	4.7	4.8

Source: OECD, SEB

Stable oil prices, but mainly downside risks

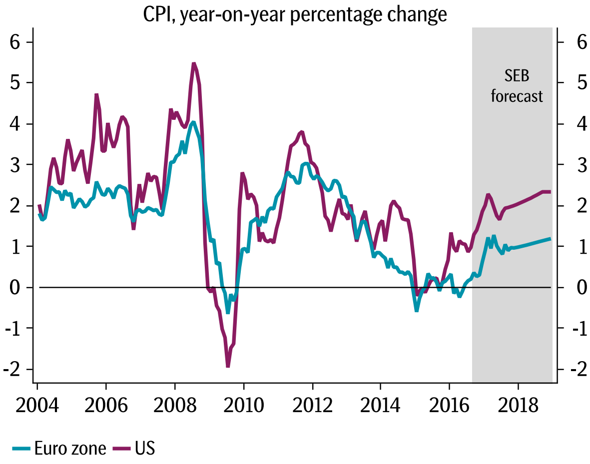
Oil prices have risen to slightly higher levels after bottoming out at below USD 30 per barrel. So far this year, production in countries outside the Organisation of the Petroleum Exporting Countries (OPEC) has fallen somewhat after rapid increases in 2013-2015, while global oil stockpiles have stabilised after an earlier upturn. We do not foresee any major drama in the price situation over the next couple of years. Given a modest increase in demand, combined with the drastic cutbacks in capital spending of the past few years, **crude oil prices will climb somewhat from an average of USD 50/barrel during the second half of 2016 to USD 55 in 2017 and USD 60 in 2018**. The risks are on the downside, however. North American market players are now showing major efficiency gains. Fresh figures show an annualised productivity increase of nearly 25 per cent. Break-even levels are thus falling rapidly, increasing resilience when prices fall as well as the desire to make new investments as soon as a rising price trend begins to take hold. The long-term trend towards increasing opportunities to use substitutes for fossil fuels is also continuing.

Low-inflation environment will persist

Inflation has recently been rather flat, largely following our earlier forecasts. This autumn, base effects from previous oil price changes will drive up headline inflation. The effects of currency movements are also clear, as we can see in Swedish and especially Norwegian figures. The depreciation of the pound will also push inflation higher in the UK. Pay increases have generally remained subdued, although the tight US labour market situation is beginning to have some impact.

During 2017-2018, the low-inflation environment of the past decade will be tested as the output gap closes in advanced economies (see box on page 8). Meanwhile political decisions will have a greater effect on wage formation – for example due to minimum wage hikes in some countries. The trend towards limitations on mobility, especially for labour, that is discernible as a result of the Brexit decision may also cause the national resource situation to have a bigger impact on price and wage formation. Yet our main forecast implies that disinflationary forces will continue to predominate. The above structural changes will hardly have time to become very important over the next couple of years. Earlier experience also indicates that the effects of tighter resource utilisation on inflation appear only after a certain time lag. Inflation will thus remain uncomfortably low for many central banks, but differences in resource situation will have an impact. The moderate inflation upturn that we foresee in the US will give the Fed a great degree of freedom, while the ECB must continue its struggle to maintain confidence in its inflation target.

Low but rising inflation
CPI, year-on-year percentage change



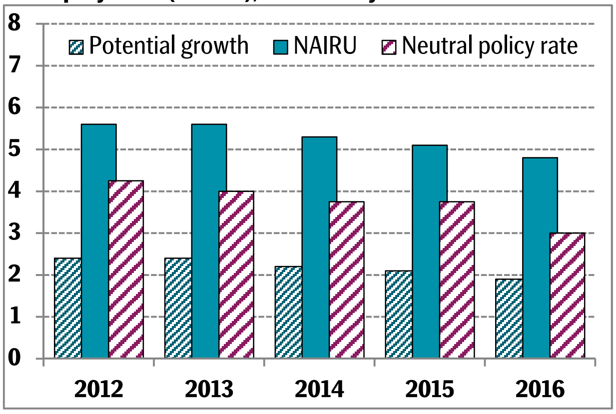
Source: Eurostat, BLS, SEB

Monetary policy having ever-weaker effect

Because of downside growth risks, weak inflation pressure and low inflation expectations, **overall global monetary policy will remain very expansionary throughout our forecast period**. But unconventional policy is also increasingly being **questioned**, even by institutions like the IMF and the Bank for International Settlements (BIS). This policy is pushing up asset prices on a broad front, but its impact on the real economy is not impressive. Risks associated with further driving up **asset prices and private indebtedness** have led to a renewed focus on the role of fiscal policy. Low interest rates provide greater budget room, but in the countries with the greatest need for fiscal stimulus, for example in southern Europe, the government financial situation is still worrisome. Because of the limited room for both monetary and fiscal stimulus, so-called **helicopter money** (see the theme article on page 14) cannot be ruled out as a drastic economic policy instrument.

Central banks are struggling with major challenges. High **indebtedness** and **credit risk** in individual sectors are weakening monetary policy transmission and squeezing the banking system. **Profitability problems** in the financial sector, due to both sector-specific trends and the unconventional monetary policy of recent years, today constitute an important **restriction** on further interest rate cuts, for example in Japan and the euro zone. The situation is especially difficult for banks that are highly dependent on deposits from the public and where most lending occurs at variable interest rates.

Fed forecasts: Potential growth, equilibrium unemployment (NAIRU), normal key interest rate. Per cent



A high propensity to save and low investment appetite are continuing to **push down real global short-term interest rates**. This matters a lot when assessing how expansionary current monetary policy actually is, and what is a suitable pace for carrying out future normalisation processes. Making this headache worse for central banks is that analyses provide different answers as to whether the ongoing **real interest rate squeeze is permanent/sustainable or temporary/cyclical**. Our conclusion has been – and remains – that this squeeze is relatively sustainable. Several central banks are in the process of shifting their view in this direction. A clear example is the Fed (see chart), which has **made sizeable downward adjustments when it comes to estimating the neutral level for both real and nominal short-term interest rates**. Other central banks have followed – or are expected to follow – the Fed's conclusions on real interest rates.

Central bank key interest rates

Per cent

	Today	Dec 2016	Dec 2017	Dec 2018
Federal Reserve (Fed)	0.50	0.75	1.25	1.75
European Central Bank	0.00	0.00	0.00	0.00
Bank of England (BoE)	0.25	0.05	0.05	0.50
Bank of Japan (BoJ)	-0.10	-0.20	-0.20	-0.20
People's Bank of China	4.35	3.85	3.85	3.85
Riksbank (Sweden)	-0.50	-0.50	-0.25	0.25
Norges Bank (Norway)	0.50	0.25	0.25	0.75

Source: Central banks and SEB

The Fed's analyses show that the US long-term equilibrium real interest rate is 1 per cent. At present, the remaining adjustment needs following the Great Recession of 2008-2009 also imply that the short-term neutral interest rate is further depressed and stands close to zero. In light of this, **the current real short-term interest rate of around -1 per cent is less expansionary than many observers, including the Fed, had previously assumed**. When assessing the total effect of monetary policy, however, we should also add in quantitative easing (QE) programmes and the Fed's large monetary policy fixed-income portfolio.

Because of a strained resource situation and rising inflation, we believe that the **Fed** will hike its key rate in December and that four more hikes will occur during the following two years, bringing the key rate to 1.50-1.75 per cent by the end of 2018. In an environment of asymmetric risks, this normalisation needs to occur cautiously. In our Fed forecast, for example, we have factored in an increased level of consideration for the stability of global financial markets. Because of low inflation and challenges for euro zone banks, the **ECB** will be forced to extend its QE programme another six months to September 2017 and maintain a zero interest rate throughout our forecast period. The **BoE** will carry out a further key rate cut this autumn to 0.05 per cent (-20 points) and hike its key rate in mid-2018. The **BoJ** will continue its QE program throughout out forecast period. The Nordic central banks will thus be pressured into additional stimulus measures: **Norges Bank** will cut its rate to 0.25 per cent and the Riksbank will extend its QE program by six months. The Norwegian key rate will be raised in mid-2018, while the Riksbank will begin its rate hikes in the fourth quarter of 2017; by mid-year 2018 Sweden's key rate will be positive again.

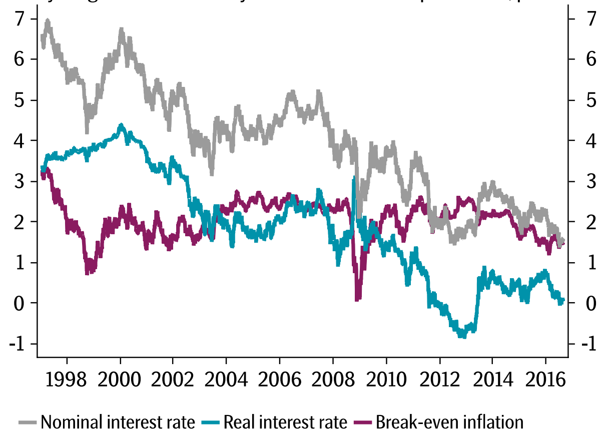
Central bank QE puts lid on long-term yields

The downward trend for long-term bond yields persists, and 10-year yields set new record lows on a broad front this summer. The downturn in yields is partly a reaction to the Brexit vote and expectations that other central banks will follow suit when the BoE's loosens its monetary policy further. But we are also in the midst of a long-term trend that reflects **the Fed's changed view on how quickly and how much it can raise its key rate**. This, in turn, reflects the fact that the "secular stagnation" concept (see the theme article in the May issue of *Nordic Outlook*) is increasingly finding its way into the Fed's reasoning and forecasts. One consequence is that a neutral interest rate is estimated at well below the historical norm; during that past year alone, the Fed has revised its estimate downward by 0.75 percentage points.

The Fed is thus being compelled to make significant changes in its forecasts, an indication that it is now having great difficulty interpreting what is happening in the economy. This forces the central bank to place greater emphasis on incoming data and less on its own forecasts and models. **In such an environment, the market is also cautious about discounting future rate hikes**, and our view that there will be twice-yearly Fed rate hikes is not being fully discounted today. Meanwhile the search for returns puts limits on how much long-term yields in different countries can diverge from each other. In Europe and Japan, long-term yields remain under pressure due to large-scale bond purchases by central banks. Because the ECB's purchases will continue until mid-2018, though at somewhat lower volume, German yields will continue to pull down international long-term yields for some time to come. This is one reason why the US upturn will also be milder than in earlier cycles.

US: Real interest rates are again falling

10-year government bond yields and inflation expectations, per cent



Source: Macrobond

Our forecast is that 10-year US Treasury yields will be 1.60 per cent at the end of this year and will then gradually climb to 2.30 per cent at the end of 2018. The equivalent German government bonds will trade at 0.05 per cent at the end of 2016 and 0.60 per cent at the end of 2018. The yield spread between 10-year US and German bonds will thus be at a rather constant level of around 160-170 basis points during our forecast period. Compared to the May issue of *Nordic Outlook*, **we have revised our forecast for long-term American yields at the end of 2017 downward** by 40 bps.

However, there are also factors that might lead to a faster upturn than would seem to be in the cards today. Several major economies appear to be close to full resource utilisation. This means that **the question of national inflationary impulses vs global disinflationary forces will now be highlighted** in a way it has not previously been during the recovery. In the US, there are visible signs that both wages and inflation will move higher. The downturn in long-term US yields this year has not been driven by falling inflation expectations – on the contrary, these have been relatively stable – but instead by falling real interest rates. Inflation expectations are at historically low levels, increasing the risk of major re-pricing when the inflation trend shifts higher. As for the risk picture in the euro zone, a decision by the ECB to remove its earlier self-imposed restriction against buying bonds with yields below the ECB's own deposit rate (-0.40 per cent) may decrease the need to move further and further out on the German yield curve, **easing downward pressure on German 10-year yields and leading to a somewhat steeper German yield curve**.

During the summer, the spread between Swedish 10-year government bonds and the corresponding German yields has narrowed from excessive levels of around 50 bps in the late spring to just below 20 bps. Expectations of Riksbank rate hikes have been scaled down following the Brexit vote, but more importantly the Riksbank's QE purchases and a diminished Swedish government borrowing requirement have led to a growing shortage of long-term government bonds. We believe that this autumn the Riksbank will announce an extension of its bond purchases until the end of next spring, and we expect the result to be that **the yield spread against German 10-year bonds will shrink to zero this autumn**. Looking further ahead, however, we expect the spread to widen again when the focus of attention shifts to coming interest rate hikes. Low Swedish government bond liquidity will create a risk that these bonds will then start to be traded with a certain premium. Swedish 10-year yields will climb from -0.05 per cent at the end of 2016 to 1.40 per cent at the end of 2018. This implies a narrowing of the yield spread against Germany to zero at the end of 2016, then a gradual widening to 80 bps at the end of 2018.

Nordics, GDP growth

Year-on-year percentage change

	2015	2016	2017	2018
Sweden	4.2	3.7	2.8	2.3
Norway	1.6	1.2	1.4	1.8
Denmark	1.0	1.4	2.3	2.3
Finland	0.2	0.7	1.0	1.2

Source: OECD, SEB

Norwegian 10-year government bonds are being traded today with a large premium compared to their German peers. Trading in Norwegian bonds normally includes a large element of currency positioning. The prospects for a gradually strong krone may thus increase demand for these bonds. The search for returns suggests that the market should be able to swallow an increased supply of bonds over the next couple of years. In addition, lower government oil revenue will not be offset by increased bond issues. **We thus expect the 10-year yield spread against Germany to shrink from around 115 bps to 70 bps at the end of 2017**, equivalent to a yield of 1.00 per cent. The yield spread will stabilise at around 80 bps by the end of 2018 as Norges Bank cautiously starts hiking its key rate.

Carry market squeezing the krona

Due to lower volume and low volatility, the FX market has begun to focus on returns. In such a "carry"-driven market, investors **use the currencies of countries with the lowest interest rates for borrowing and exchange them for higher-returning alternatives**. This is especially true of the many EM countries where the key interest rate is high(er), and valuations are attractive in many cases. We believe this theme will continue to dominate the FX market in the near future.

The Fed has become more dovish, showing hesitation about coming key rate hikes. This has negatively affected the US dollar exchange rate. During 2016, numerous **EM currencies have appreciated sharply at the dollar's expense**, but probably the USD remains overvalued in traded-weighted terms. Yet we believe that the USD will appreciate in a short-term perspective when the Fed's December rate hike begins to be fully priced in. Continued monetary policy expansion by other major central banks will then limit the Fed's manoeuvring room, since the Fed wants to avoid excessively strong transmission via the exchange rate channel. US portfolio flow statistics indicate that reserve managers have a continued need to bring home USD-denominated liquidity, which also limits the dollar's upside. The US current account deficit will also climb next year, amplifying the negative flow situation. In a longer perspective, we thus believe that the EUR/USD exchange rate will move higher and **by the end of our forecast period reach 1.15**, that is, in the upper band of the recently established 1.05-1.15 range that we believe will remain in place.

FX market undergoing structural change

The global foreign exchange (FX) market has grown significantly during the past 30 years. Between 2001 and 2013, average daily volume more than quadrupled to USD 5.3 trillion, according to the BIS. **New 2016 data to be published by the BIS early in September may show a decline in activity since 2013**. Although there are signs that today's low-return environment is fuelling greater investor demand for currencies as a new asset class, more important is that the large-scale QE policies of central banks – whose objective in some countries has been a weaker currency – has added uncertainty to forecasts. In addition, new market "players" have appeared (automated trading programmes), contributing to occasionally irrational currency movements, while other players (such as hedge funds) have cut back their market presence. In an environment of new uncertainty factors, with currencies being traded close to their equilibrium levels and narrower gaps between the key interest rates of different countries, many players apparently regard the foreign exchange market – seen over time – as a zero sum game and are thus abstaining from strong views on currencies or from trading in the FX market.

After the initial shock following the Brexit referendum, we believe that the downward adjustment of the pound (almost 20 per cent since November 2015) has ended. In fundamental terms, the pound is now clearly undervalued. If sentiment indicators rebound in the next few months from very depressed levels, the currency may also surge higher. But the market will also be reminded of the challenges that now await when new trade agreements with other countries must be negotiated. Because the British are intent on restricting free movement, this means they may be given only restricted access to the single market. This, in turn, means they need to be highly competitive by means of a weak pound. **Our forecast is that the EUR/GBP exchange rate will gradually fall from today's level of 0.86 to 0.75**, which still implies an undervalued pound.

Because Sweden has the most negative key interest rate, the krona will have difficulty holding its own in a carry-driven market, but valuations and positioning will clearly benefit the currency. The theme article on page xx discusses how these forces change over time. The Riksbank has gradually earned greater credibility for its ambition to keep the krona weak**. As long as it sticks to this, we find it hard to foresee the EUR/SEK exchange rate falling below 9.25**. When the Riksbank decouples its policies from the ECB and initiates cautious rate hikes, we envision a movement towards 8.75 by the end of our forecast period: still a somewhat weaker krona than our estimated equilibrium exchange rate of 8.60.

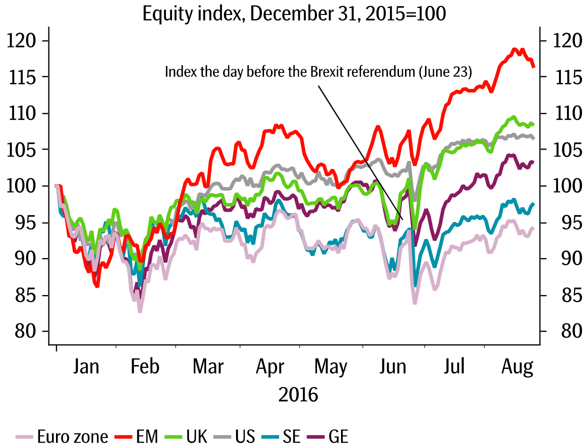
The Norwegian krone exchange rate will benefit from a more neutral stance by Norges Bank as well as from better activity in the economy. Since the krone is still closely tied to oil prices, our oil price forecast represents a positive environment for the currency. The NOK's valuation is still attractive, even though the currency-oriented focus of Norges Bank will prevent the EUR/NOK rate from reaching our long-term equilibrium level of around 8.35 for some time to come. We expect a **EUR/NOK rate of 9.20 at the end of 2016 and 8.90 at the end of 2017**.

Valuations may slow stock market upturn

Signals of gentler central bank policies provided new support for risk appetite this past summer. In many countries, equity indices are above the levels that prevailed at the beginning of 2016 and directly before the Brexit referendum. Global share valuations are thus back at more **stressed levels that require relatively good news from both macroeconomic data and the interest rate environment**. Despite our positive global growth scenario, we foresee a risk that the market may again be forced to lower its corporate earnings forecasts for 2017 and 2018, though not to the same extent as they did in 2015 and 2016. Even our slightly more cautious earnings forecasts should nevertheless provide support for a moderate upturn in stock markets during the coming year.

Stock markets bounced back after Brexit shock

Equity index, December 31, 2015=100



Source: Macrobond

We foresee **greater potential for European stock markets than US ones**. The reason is more attractive valuations, lower pressure on margins due to rising wages and salaries a well as greater exposure to global growth. The banking sector will, however, continue to pose a downside risk for European equities. Nordic banks diverge clearly from banks elsewhere in Europe, though, which is largely reflected in their valuations. Share buy-backs will remain a positive factor in stock markets. **EM stock markets** have recently benefited from **more dovish Fed signals and more stable commodity prices**. Looking ahead, they will remain sensitive to new US key rate hikes and a stronger dollar. But valuations are meanwhile lower than in advanced economies and can be expected to rise now that their growth outlook is beginning to stabilise. This is especially true of Asian economies, where geopolitical risks are meanwhile lower than in Latin America.

Higher exposure to investment goods and EM economies **suggests that Nordic stock markets may perform better than those elsewhere in Europe**. Swedish and Norwegian equities are also benefiting from competitive exchange rates. In Stockholm, as well as globally, we expect share prices to enjoy support from modestly rising corporate earnings. Swedish equities also have somewhat lower valuations than global stock markets. In addition, there is a continued high level of merger and acquisition activity, and recurring buy-out offers indicate that in many cases share price levels are regarded as attractive to invest in. Earnings forecasts may need to be trimmed, but this is therefore not necessarily an obstacle to a continued share price rally.

Beyond the populist challenge

Political developments undoubtedly include some dramatic elements. One of these is reversals in the global democratisation process that began after the fall of the Berlin Wall. Russia and Turkey are current examples, but crushed hopes after the Arab Spring as well as authoritarian trends in Asian countries like Thailand and Bangladesh are also part of the picture. Another dimension is the underlying currents of dissatisfaction reflected in the successes of Donald Trump and growing support for populist anti-EU parties in Europe. **The new situation implies that completely new scenarios for global and European developments are conceivable.** These may include the collapse of the EU or the elimination of fundamental trade agreements. Further ahead, the security policy situation may also drastically deteriorate.

In our main forecast, our assessment is that the Brexit negotiations will be carried out in a constructive spirit and that neither Donald Trump nor Marine Le Pen will be elected president. But even if we are right, there are signs of change in the economic policy climate, with theses that have been dominant for decades are beginning to be questioned. This has been clearest in English-speaking countries; even the establishment side – in the form of the Remain campaign in the UK and Hillary Clinton's programme – has focused on the interests and cohesion of its own population. This has been reflected, for example, in **proposals for higher minimum wages and protectionist-oriented measures that benefit the domestic business sector**.

Such elements are actually not uncommon in American election campaigns, but this time they also seem to be synchronised with a change of position among leading economists in research reports and policy debates. Because political institutions at both the national and supranational level have not been able to offer policies that can take better care of globalisation's losers or **reverse the general trend towards widening economic gaps**, there is undoubtedly cause for reassessments. The consequences of monetary policy, in the form of overblown asset prices and mounting debt levels, also reinforce the picture of a system that has difficulty giving clear answers to questions that are important to large parts of the population.

One example of this new current is a column in the July 10 *Financial Times* by Larry Summers, a professor and former US treasury secretary. He presents some contemporary examples of the damaging effects that can arise when supranational regulations force national governments to take actions that can harm both their economy and their democratic legitimacy. Summers' thesis is that we must step away from today's **"reflex globalism"** and instead craft international agreements in such a way that they are based, in an understandable way, on the best interests of citizens. This is the best way to support responsible national governments and give them enough legitimacy to contribute to the constructive international cooperation that is so greatly needed. In the long term, this would also be the surest way of ensuring that fundamental free trade principles are not undermined.

Naturally it is too early to determine how much impact these ideas will have once more orthodox proponents of globalisation and economic liberalism hone their counterarguments. Yet some kind of change is likely, and the positive scenario may be the emergence of a constructive compromise that can win broad support, **thereby disarming the proponents of threatening, destructive populism**.

Another interesting question is how European politics in general and the euro project in particular would be affected by such a change in the English-speaking countries. In the past half century we have seen how major ideological shifts such as the **neo-liberal revolution of the Reagan-Thatcher era** in the early 1980s and the **modernisation of the social democratic/social liberal alternative by Clinton and Blair** influenced the whole Western world. With varying delays and degrees of success, these trends also had an impact on Continental Europe and the Nordic countries. This was partly because their ideas as such had an impact, but also because for small economies the costs of following their own path was so high.

It is not obvious how the EU and the euro project might be affected. The EU project has its own background and history that goes back further than the globalisation of the past quarter century. EU cooperation might conceivably be made easier if the English-speaking countries move in a direction closer to the Continental view of national social welfare systems and wage gaps. But an increased focus on the risks of putting straitjackets on national governments is certainly a more important aspect. For example, Summers mentions that Italy's chances of resolving its banking crisis are hampered by EU regulations. Even now, our assessment is that the institutions in Brussels will have a hard time continuing to pursue their plans **to finish building the infrastructure for euro zone cooperation** and that the trend will instead be towards greater self-determination. This headwind would be further strengthened by a greater international focus on the disadvantages of supranational structures. In addition, countries outside the euro zone, in Eastern Europe and the Nordic region, would gain ideological support for their resistance to a federalist trend. Summers ideas thus strengthen the argument that the EU would work better if it went back to basics by furthering the original reasons for the organisation.

- **Greater central bank focus on “helicopter money”: an attractive redistributive tool**
- **This “helicopter” is piloted by politicians, not central banks – Japan closest to lift-off**
- **A high long-term price to pay, with dubious outcomes for growth and inflation**

As the monetary policy toolkit empties, there is more intensive debate on whether central banks can use “helicopter money” (HM) to boost growth and inflation. HM can be seen as the third and **final stage of monetary policy** after **conventional** (*key interest rate changes*) and **unconventional** (*changes in central bank balance sheets and negative key rates*) **policies reach the end of the road**. In brief, HM means that central banks **create money that government unilaterally transfers to one or more socioeconomic players**. In reality, HM is a fiscal policy measure achieved via the central bank.

HM à la Friedman and Bernanke

The HM concept was minted by US economist **Milton Friedman** in his 1969 book *The Optimum Quantity of Money* as a potential way to stimulate growth and inflation: *“Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is...hastily collected by members of the community...”* When former Fed chairman **Ben Bernanke** referred to the same theory in a 2002 speech, he was nicknamed “Helicopter Ben”.

There is a greater need to **develop policy tools** in response to ever more limited economic policy manoeuvring room, modest growth and inflation figures and mounting worries about approaching economic downturns. Unconventional monetary policy, including securities purchases (QE) and negative interest rates, faces growing scepticism today. This policy has indeed helped **ease financial conditions, but its impact on the rest of the real economy is hard to assess**. Its drawbacks over time also seem to eliminate its advantages (see BIS Working Papers No 570: *Unconventional monetary policies – a re-appraisal*). This makes **HM worth a new look**.

Total major central bank assets, 2007 and 2016

USD bn	2007	% of GDP	2016	% of GDP	Change
BoJ	945	15	3,870	76	+2,925
ECB	1,320	13	3,190	27	+1,870
Fed	900	6	4,500	25	+3,600
BoE	130	6	525	22	+395

Source: BIS

“The helicopter is already flying”

Many people say **HM is already a fact** since central banks are buying government securities and **keep expanding their purchases and/or reinvesting** funds from maturing securities. If these new portfolios are regarded as “perpetually” funded by central banks’ expanded bank reserves, we approach the HM concept, but the portfolios have maturities; HM aims to give the economy a **permanent** supply of nominal purchasing power that is not perceived as reversible.

Critics argue that the impact of QE policy has been weakened because central banks have signalled that these portfolios are temporary, while maintaining strict inflation targeting. A clear division of responsibility between central banks and governments is also said to have further weakened policy.

HM policy has various purposes, among them to
a) boost **GDP and job growth** and thus inflation and wages;
b) raise **inflation expectations** – and weaken the currency;
c) avoid Ricardian equivalence: HM **does not increase the need for future tax revenue**, which otherwise risks giving the private sector incentives to save its expanded nominal purchasing power to pay for future tax hikes.

In practice, HM is a form of “monetary financing” that blurs the boundary between government and central bank balance sheets. **The helicopter transaction** can be implemented in two ways (see the illustration below). The government can issue **new bonds** that are purchased directly by the central bank (1). These securities must be viewed as perpetual and carry no interest expense. The central bank credits an equivalent sum to the government’s account. As the latter uses the money, the HM effect is transferred to the banking system (2). The central bank can **directly credit** the government’s account, which eventually affects the banking system’s balance (net deposits and lending) with the central bank.

Schematic: Central bank balance sheet

	Assets		Liabilities			
	Foreign assets (FX reserves)		Bank notes/coins			Monetary base
1	**Gov’t securities**	△+100	Borrowing from banks	△+100	2	
	Other domestic assets		**Borrowing from the public**	△+100	1	
				△-100	2	
	Lending to banks		Equity capital			
	Total assets	△+100	Total liabilities	△+100		

The expanded **monetary base** – the core of money supply expansion – increases the probability of inflation, which many countries want. The risk of **hyperinflation** and the desire to create only a monetary transfer and boost demand can be managed by imposing **reserve requirements** on banks (forcing them to maintain a given sum in an account with the central bank) equivalent to the increased quantity of new money. If the central bank **pays interest** to banks on their expanded deposits, the public sector has not cut its funding costs. If it **does not pay interest**, in practice this is a tax on banks (if they pay interest to their customers). This may lead to necessary changes in interest rate management system to achieve HM effect.

Today’s global economy is dominated by a high propensity to save and by a weak desire for capital spending in the private sector. There are many explanations. High saving is connected to demographic forces: ageing populations, heavy debt and uncertainty, greater economic inequality and falling returns. Low investment, in turn, is due to a global production capacity surplus, the low price of capital and technological changes. **This imposes demands on how to shape HM policy**.

The government can distribute newly created money by: ① **depositing** it in households’ bank accounts, ② **cutting or refunding taxes**, ③ **distributing cheques to pay for consumption** or ④ **investing in infrastructure projects**.

Examples: US and Australia distribute money
As part of the 2008 crisis package, US citizens received a tax refund of a maximum of USD 300 per person, distributed in the form of a cheque. In Australia, the government deposited AUD 950 per person in bank accounts. In both cases, funding came from traditional government borrowing outside the central bank.

The world is struggling with **increased economic inequality**, which not only reduces the effects of monetary policy on growth but also contributes to greater social and political tensions. Households with poorer financial resources normally are more inclined to consume. HM should thus be distributed in ways that boost its effectiveness. To achieve the greatest impact, consumption cheques should have an expiration date so that they are used to boost consumption and growth.

A general **direct transfer of money** to the households is likely to have a **low impact** on growth/inflation. There are many indications that this money will go towards savings and paying down debts. Improved household balance sheets may have an effect on consumption, but probably after a long delay.

Nor is transferring money directly to companies to boost their capital spending likely to have the intended effect, among other things due to the prevailing global surplus of production capacity. This suggests that any investments right now should focus on public infrastructure projects or other public investments, possibly in cooperation with the private sector.

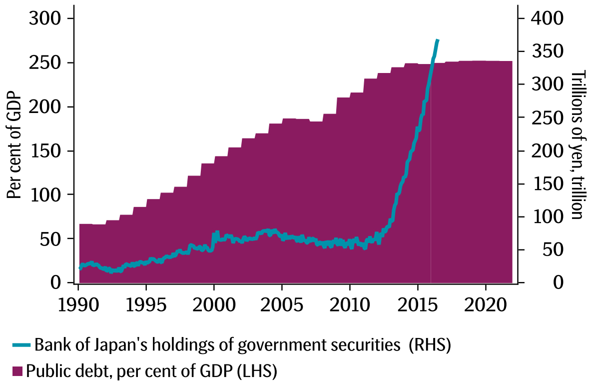
Passive and active helicopter money

HM policy is a matter of achieving a direct monetary transfer that strengthens the balance sheet of the private sector. In practice, HM can be created both **passively and actively**. Active HM has been described above; passive HM is described below. The crucial factor is choosing between a passive or active policy is what effect on expectations is desired.

Central banks can implement HM policy **passively** by agreeing that all or part of their **monetary policy portfolio will permanently remain** in the balance sheet. They can also do so by choosing to **write down** the value of part of their holdings of government securities, thereby making permanent the transfer of money that has previously been reversible. This write-down affects a central bank’s equity capital, thereby giving the government more manoeuvring room to borrow new money for an even more expansionary fiscal policy.

But the impact on the economy is probably greater with the active approach, since it more clearly affects expectations; the impact of a “technical announcement” that the monetary policy portfolio will become perpetual and/or that government bond holdings are being written down will not be the same.

High public debt is owned by the Bank of Japan
Japan's public debt and the Bank of Japan's holdings of government securities



Source: Bank of Japan, IMF

Japan – first to send up a helicopter?

The country **closest to enacting HP is Japan**. The reasons are its monetary policies of the past two decades and the failures of Abenomics in recent years, plus high public debt. HM is expected to have more impact in countries with high public debt, such as Japan, which limits the room for fiscal stimulus; further public debt risks having a negative effect through increased private saving due to worries about future tax hikes.

One HP alternative for Japan is to write down public debt by letting the Bank of Japan alone accept a loss. This means that the potentially reversible monetary stimulus generated by the current QE programme would become permanent, providing room for the Japanese government to increase public debt, and possibly also leading to higher inflation expectations.

HM involves **operational, legal and institutional issues**. Today various countries explicitly ban governments from directly funding themselves via the central bank in order to strengthen central bank independence. Implementing these changes will take time. HM also implies handing back influence on monetary policy to politicians after many years of investments in credibility. National debt policy would also disappear in practice. Monetary financing is not good, but the alternative may be worse. HM would take us into uncharted territory, but **there is a major risk that its impact on growth may not materialise, due to uncertainty about how expectations will be affected**.

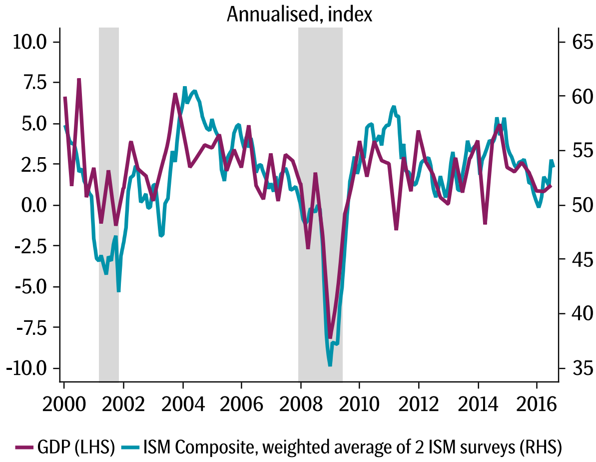
Temperature rising ahead of presidential election

- **Little Brexit-vote impact on US economy**
- **Unemployment close to bottoming out**
- **Hillary Clinton probable election winner**
- **Fed will hike key rate again in December**

Recent months have primarily offered positive economic news, while expansionary financial conditions and business confidence indicators suggest that the strong trend will continue. The Brexit process is unlikely to hamper the US economy to any significant extent, yet due to unexpectedly weak activity in the first half we expect GDP growth to reach only a modest 1.6 per cent in 2016. This eases pressure on the Federal Reserve to tighten monetary policy. **In 2017 the economy will grow by 2.4 per cent and in 2018 by 2.0 per cent. Unemployment**, which is already close to its equilibrium level, will continue to fall gradually and reach **a low 4.2 per cent by the end of our forecast period**. The ever-tighter labour market also implies faster pay increases, which are a key factor in driving inflation. We expect core inflation as measured by CPI to be close to, or somewhat above, 2 per cent throughout our forecast period. **Core inflation measured by the Fed's main target variable, the personal consumption expenditure (CPE) deflator, will reach its target in 2018.**

Stronger growth ahead

Annualised, index



Source: Macrobond, SEB

The central bank is thus moving closer to achieving both its labour market and inflation targets. But due to lingering Brexit uncertainty and shaky GDP growth, we believe that the Fed will remain passive in the near term, **raising its key interest rate again only at its December policy meeting**. Both in 2017 and 2018, we expect two rate hikes per year, implying that the most important **key rate will be in the 1.50-1.75 per cent range at the end of 2018**. Fed key rates are low in a historical perspective. This is mainly justified by an assessment that the real neutral interest rate has fallen below previous levels. International considerations and financial market stability also seem to have played a larger role in the Fed's reaction function. One underlying assumption in our forecast is that **Democratic candidate Hillary Clinton will win the presidential election this autumn**, which we regard as an 85 per cent probability.

Strong consumption growth will decelerate

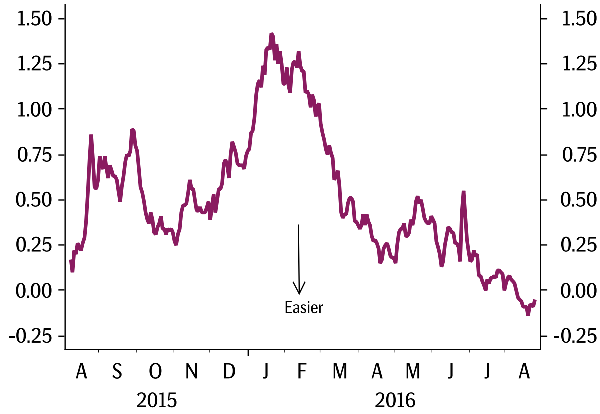
Households were completely dominant as a growth force during the second quarter, when consumption grew by a full 4.2 per cent annualised rate: the strongest since 2014. Both robust income growth and lower saving explain the upturn. There is **reason for continued optimism** even if the consumption increase slows from its current frenzied pace. Although saving has fallen in recent months, the household savings ratio is significantly higher than fundamental factors justify. Household balance sheets are in good shape and home prices are climbing, while the labour market is approaching full employment. **Wage and salary growth continues to accelerate**: measured as average hourly earnings, we forecast a 3 per cent increase rate at the end of 2016 and a 3.5 per cent rate by the end of 2017. **Household consumption will climb by 2.8 per cent both this year and next**. In 2018, consumption growth will be 2.4 per cent. **The risk in our consumption forecast is on the upside**. If households keep spending more of their room for purchasing power than earlier oil price declines generated, consumption may exceed our forecast. Our main reason for making **a more cautious main forecast** is that households have an increasingly gloomy view of the future – possibly coloured by the dirty, divisive and demonising presidential election campaign.

Companies waking up from their lethargy

Although household consumption will decelerate a bit, we expect GDP growth to reach an annualised 3 per cent rate during the second half as other parts of the economy assume more of the burden. Financial conditions have become more expansionary; the difference compared to the situation in late January, when they were tightest, is equivalent to **an interest rate cut of 150 basis points**. Business confidence indicators have climbed both in non-manufacturing and manufacturing sectors, and **our composite ISM indicator is compatible with 2.5 per cent GDP growth**. The stabilisation of oil prices also means that dramatic declines in oil-related investments are probably behind us. Measured as the number of active oil rigs – a leading indicator – we expect oil investments to grow during the second half. In manufacturing, the situation also looks better; **the sector has left its recession behind**, and both domestic and export order bookings are pointing upward. Manufacturing, which accounts for about 12 per cent of GDP and 9 per cent of total employment, is thus pulling its weight again. **Manufacturing capacity utilisation remains low, however, holding back the capital spending upturn**. Its level is around 75 per cent. Historically, only when capacity utilisation exceeds 80 per cent will capital spending show robust growth rates. Business investments, which grew by 2.1 per cent last year, will fall by 0.5 per cent this year. **In 2017 and 2018 they will grow by 4.6 and 4.9 per cent, respectively**.

Financial conditions stimulating growth

Weighted index of interest rates, credit spreads, equities and currencies



Source: Bloomberg

Foreign trade has contributed negatively to economic growth in recent years, mainly driven by the large dollar appreciation of 2014. Major exporting companies now foresee brighter prospects again. After three quarters of negative figures, exports increased again during the second quarter. We expect them to climb by 5.5 per cent in 2017 and 6.1 per cent in 2018, but since imports will also increase, **foreign trade will continue to contribute negatively to growth**.

Meanwhile there is reason to believe that inventory investments can help lift growth again, after five quarters of negative contributions to GDP. This long negative period is related to slumps in the manufacturing and oil sectors, but indicators now show that inventory levels are normal again.

Housing market will continue to strengthen

The decline in housing investments during the second quarter was probably temporary. Underlying construction activity still looks robust, and confidence among construction companies is stable at high levels. The mix of job growth, the increasing number of households and very low home mortgage interest rates suggests that the housing market will continue to strengthen. Although construction investments have climbed by a yearly average of 10 per cent from 2012 to 2015, **there is still a large upside**; housing starts per capita are about 45 per cent below their 1968-2003 average. Overall, **construction investments will grow by 6-7 per cent yearly in 2016-2018**.

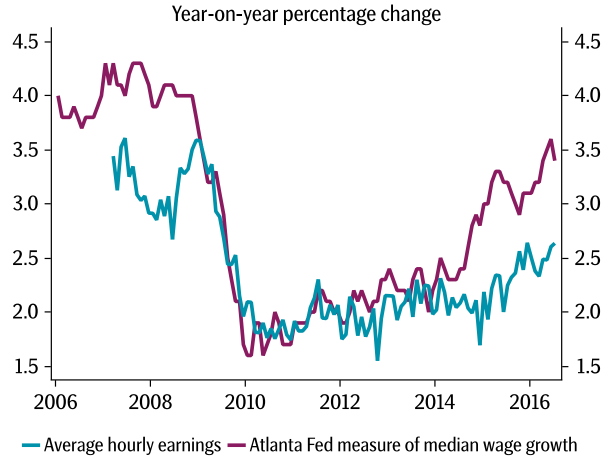
Sales of existing homes are growing strongly, while the market for new homes is more sluggish. One important reason is that newly constructed homes are 30 per cent more expensive. While **home prices according to the Case-Shiller index are still eight percentage points below their 2006 peak**, new homes are significantly more expensive today than when the housing bubble burst a decade ago. A low supply of new homes is driving their prices higher but is also holding down the pace of the sales upturn. However, new home sales surprisingly accelerated in July to their highest level in almost nine years. As such, this segment may finally also respond to the more traditional housing market dynamics.

Conditions for faster pay hikes are in place

After a weak figure of just above zero in May, job growth has speeded up again, but the big picture is that the pace of this growth is slower than in 2013-2015, when employment rose by an average of 225,000 per month; the corresponding figure so far in 2016 is 186,000. Yet this year's job growth remains about **twice as high as the pace that is compatible with constant unemployment**. This implies that the labour market may be moving towards overheating, since we have already reached its non-accelerating inflation rate unemployment (NAIRU), or equilibrium, according to estimates by both the Fed and the Congressional Budget Office. Looking ahead, we predict a gradually continuing slowdown in job growth to an average of 100,000 per month in 2018. This forecast is compatible with **a continued slow decline in unemployment to 4.2 per cent by the end of our forecast period**. This is very low in a historical perspective; in April 2000 unemployment stood at 3.8 per cent, and then we must go back to the 1960s to find such low levels.

Wage growth is drifting higher

Year-on-year percentage change

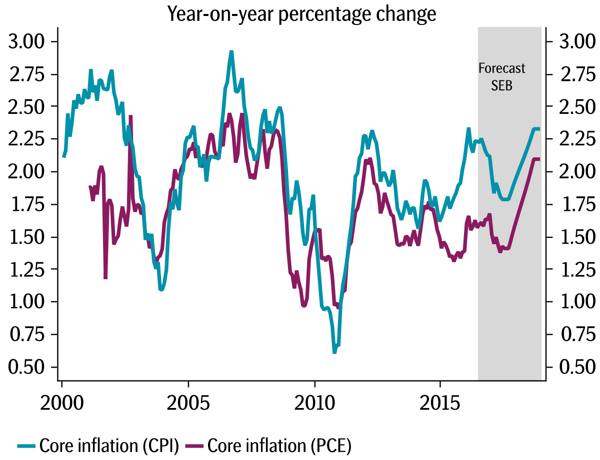


Source: Macrobond, SEB

So far the tight labour market has had only a limited impact on wage formation, but various pay indicators now show rising tendencies. Also according to average hourly earnings, the highest-profile metric, wage growth is showing signs of acceleration. **By the end of 2017, the annual rate of increase will be 3.5 per cent, according to our indicator-based forecasts**. The risks in our wage and salary forecast are on the downside. The Phillips curve, which describes the historical association between unemployment and inflation, seems to have become rather flat viewed over recent economic cycles. This means that the labour market situation has become less important to wage formation. Low inflation expectations are also likely to hold back pay increases, while weak production does not justify rapid wage increases either.

Core inflation is close to target

Year-on-year percentage change



Source: Macrobond, SEB

Inflation is on the way

As stipulated by a tighter resource situation, inflation curves have rebounded in the past year. The upturn in core inflation has been driven by rising service sector prices. Heavy cost components such as rents and pharmaceuticals have been dominant forces, but the upturn is rather broad-based. Wage inflation has climbed somewhat, to 2.5 per cent annually, after being stable at around 2 per cent in recent years. This has also contributed to price increases, especially in service companies, where wages and salaries dominate costs.

Core inflation as measured by the Consumer Price Index (CPI) now exceeds 2 per cent, but the picture is complicated by the Fed's greater historical focus on core inflation measured by the personal consumption expenditure (CPE) deflator in the national accounts. Both measure inflation excluding food and energy, yet there are clear methodological differences. The CPE deflator captures changes in consumption patterns more quickly, while giving medical costs a heavier weighting. The CPI, however, gives more weight to housing and transport expenses. Housing costs have climbed at notable speed, while medical costs have fallen since the introduction of Obamacare, which is reflected in these indices; the gap between the two has been unusually wide in recent years.

How tight is the labour market?

Most indicators of the labour market resource situation are now close to 2005 levels, which we believe was the last time the labour market showed full employment. The exception is the participation level, which has trended downward.

Current unemployment levels are probably consistent with equilibrium unemployment (NAIRU), although this concept is not always so easy to define. According to the Fed's median forecast, equilibrium unemployment is 4.8 per cent. The Congressional Budget Office makes a similar estimate. In theory, wage and salary growth should accelerate when unemployment falls below NAIRU, which we are seeing signs of today. **Average hourly earnings have climbed somewhat faster so far this year** than earlier in the economic recovery. The annual rate is now at 2.6 per cent. Our forecast of a 3 per cent increase rate towards the end of this year is the level that is compatible with price stability, according to Fed Chair Janet Yellen. According to various alternative measures of earnings, pay growth is also higher today than in previous recovery years.

Another way to look at today's labour market gap is in relation to historical experiences. **The last time unemployment reached NAIRU was probably in 2005, when both pay growth and core inflation speeded up in earnest**. Eleven years ago, unemployment was higher than today but the broadest measure of underemployment, U6, actually indicated a somewhat tighter labour market situation than we are seeing now. Another sign of high resource utilisation is when employees dare to quit, since the number of job openings is at high levels. Nowadays the number of job openings is higher than in 2005, and voluntary resignations are also trending higher.

The most important argument against believing that the labour market is showing full employment today is the low participation rate. The percentage of working-age people with jobs or available for the labour market has not recovered since the financial crisis. One important driver is the ageing population, but there are probably also cyclical factors. This suggests that there are actually some idle resources in the labour market.

Our overall conclusion is nevertheless that today's labour market situation is so strained that we should be aware that **a reaction may suddenly occur on the wage and salary side**. This also implies that **supply-side restrictions will hamper GDP growth ahead**. This is one important reason behind our forecast of slower growth, 2.0 per cent, in 2018.

Core inflation measured using the **Consumer Price Index will be 2.2 per cent in 2016, 1.8 per cent in 2017 and 2.2 per cent in 2018** as annual averages. Core inflation measured using the CPE deflator is a bit lower but will be close to the Fed's target in 2018. Various factors will prevent an even clearer inflation upturn. The global price squeeze will continue, since **there are still idle resources in the world economy**, as indicated by continued price declines in the goods sector. It is also uncertain how American wages and salaries will be affected by the tighter labour market situation, considering the structural changes that have occurred in the labour market during recent decades.

Temperature rising ahead of election

Due to a combination of economic recovery and tight fiscal policy, the federal budget deficit has shrunk from nearly 10 per cent of GDP in 2009 to about 2.5 per cent of GDP today. **Tight fiscal policy is thus one reason for consistently lower GDP growth** compared to the historical pattern in recoveries; in 2011-2014 fiscal policy headwinds resulted in one percentage point lower annual GDP growth, according to our calculations.

The political winds that contributed to this tight budget policy culminated in a partial shutdown of public sector activities in October 2013. Above all, such budget battles proved politically costly for the Republicans, and since then the budget deficit has become a less heated political issue. This laid the groundwork for last year's broad economic policy agreement to raise both the federal discretionary expenditure ceiling and the defence budget. The debt ceiling issue will thus not be back until March 2017. Further defence appropriations are also close at hand due to international threats, especially in the South China Sea and Russia. Overall, **we expect fiscal policy to contribute positively to growth in both 2016 and 2017**.

President Barack Obama will thus be handing over a rather favourable budget situation to his successor after the November 8 election. But **long-term budget challenges are likely to grow over time as the population ages**. Last year people aged 65 or older numbered one fourth as many as those aged 20-64, a figure expected to climb to nearly 40 per cent by 20 years from now. Public finances will thus be squeezed both from the expenditure and revenue side. On the expenditure side, Medicare costs are expected to climb especially fast.

Neither Hillary Clinton nor Republican presidential candidate Donald Trump has shown any great enthusiasm for dealing with long-term budget challenges. Both have announced that they will not cut back the social insurance systems now in place. Clinton wants to expand these systems further and finance the expansion with tax hikes for high income earners. Trump wants to make the systems more efficient, while ensuring their long-term financing by means of faster economic growth. Independent estimates show that **Clinton's proposals are largely budget-neutral** and will thus not change the debt curve appreciably compared to the Congressional Budget Office's main scenario, in which federal debt will gradually increase from 76 to 86 per cent of GDP in 2026.

If Trump wins the presidential election, however, estimates show a sharp erosion in public finances; Trump's budget proposal is expected to push up federal debt to 127 per cent of GDP by 2026. But we believe there is little risk that Trump's economic proposal will become a reality. First, the Republicans will probably retain control of the House of Representatives. This suggests that there will be no sweeping expenditure increases. Second, we believe **the probability that Trump will win the presidential election is a low 15 per cent**. Looking at how the states have voted in modern times, it is difficult to see how Trump could win the election without capturing Florida, where ethnic minorities are dominant voter groups. **Both among blacks and Hispanics, Trump's confidence figures are record-low**. The reason why Trump cannot be entirely discounted as the future president is that American voters are tired of the political establishment and the status quo, symbolised by Clinton. Studies also show that 75 per cent of voters rank classic Republican issues such as security and economic growth as the most important, which may also benefit Trump.

Key interest rate hikes at a cautious pace

The temporary drop in job growth during May persuaded the Fed to postpone its planned June key interest rate hike, after which the Brexit referendum probably extended the central bank's policy tightening pause. The Fed has also lowered its rate forecasts. Its median forecast now indicates that the federal funds rate will stand at 2.4 per cent by the end of 2018. The Fed is predicting a **historically flat rate hiking cycle, mainly because it believes that the real-term neutral key interest rate has been pushed lower in recent years**. This implies that only a few rate hikes are required to bring the key rate up to a neutral level and then give monetary policy a tightening direction. Another restraining factor is that international considerations and financial market stability are playing a large role in the Fed's reaction function. The central bank also wants to avoid excessive US dollar appreciation in a situation where most other central banks are still easing their monetary policies.

Meanwhile the latest monetary policy meeting in July showed that the Fed is keeping the door open to a rate hike and that its **December meeting is the most probable date for such a hike**, which is also our forecast. After that, we expect two 25 basis point hikes per year in 2017 and 2018, which means that **the most important key interest rate will stand at 1.50-1.75 per cent by the end of our forecast period**. We also believe that a tighter monetary policy will be justified; the economy will continue to strengthen in a situation where the labour market already has nearly full employment. **To prevent overheating risks and thereby lengthen the economic upturn, gradual rate hikes are a natural recipe**. The market does not share this assessment; futures pricing shows only two rate hikes during the next couple of years.

- **Hillary Clinton: Tax hikes for the rich and wage hikes for the poor**
- **Donald Trump: Big emphasis on tax cuts for both businesses and households**
- **US more protectionist, regardless who wins**

Economic policy has not played as prominent a role in this presidential campaign as usual, but the reason it has been overshadowed so far by other issues is not because the gap between the candidates' proposals is narrow. On the contrary, it is record-wide. Below is a comparison of Clinton and Trump's economic policy plans for some key groups and areas.

The poor

Clinton wants to raise the national minimum wage from today's USD 7.25 to USD 12/hour and expand various benefits for the poor. Those earning less than USD 9,275 would avoid federal income tax. *Trump*, who previously opposed a higher minimum wage, has now changed his mind but does not want to specify any level. Currently, it's unclear whether his plan to exempt anyone earning below USD 29,000 from paying federal income tax is still valid (they now pay 10-15 per cent).

The rich

Clinton wants to raise taxes on high income earners and close loopholes to ensure that everyone pays a reasonable tax. The ultra-rich (with incomes above USD 5 million) would pay a surcharge of 4 per cent, thereby raising the highest federal tax bracket from 39.6 to 43.6 per cent. She supports the "Buffett rule" that no multimillionaire should occupy a lower tax bracket than his secretary (implying in practice that anyone with an income in the millions should pay at least 30 per cent). *Trump's* plan caps federal income tax at 33 per cent and gives ultra-wealthy people the biggest tax cuts, both in percentage and absolute terms, but closes tax loopholes they enjoy. Estate tax, which today only affects the very rich, would be abolished.

Households in general

Clinton's plan implies that a majority of households would pay roughly unchanged federal tax, but she wants to introduce a lot of new tax breaks for child care, medical expenses etc. *Trump's* proposal would give all households big tax cuts and greatly simplify the system, with only three tax brackets (12, 25 and 33 per cent) compared to seven today. He wants to introduce a new deduction that would make child care cheaper, while "Obamacare" would be scrapped.

Business

Clinton wants to penalise companies that move their domicile abroad for tax reasons, by levying a special "exit tax". She would simplify tax laws for small businesses but tighten the Dodd-Frank financial market regulations, including higher fees for big banks. She would promote investments that facilitate the transition to renewable energy. *Trump* wants to cut corporate taxes, with no company having to pay more than 15 per cent (compared to 35 per cent today). Firms that choose to repatriate funds from abroad should only have to pay a one-time tax of 10 per cent. Numerous "unnecessary" regulations that create obstacles to business should be abolished, and there should be a temporary moratorium on new regulations. Trump has said he will "dismantle" Dodd-Frank. His energy reform would ensure cheap power for industry, and he would restore the role of coal as an important energy source.

Trade

Clinton helped negotiate the Trans-Pacific Partnership (TPP) while secretary of state but has changed her views on this trade agreement, saying the government must now focus on ensuring more and higher-paid jobs in the US. She also wants to renegotiate the North American Free Trade Agreement (NAFTA) but opposes new tariffs and would prefer giving tax breaks to companies that locate factories in the US. *Trump* wants less free trade and more "fair trade". He wants the US to withdraw from the TPP and renegotiate NAFTA. New tariffs should be imposed on countries that manipulate their currencies and use illegal trade subsidies (read: China, South Korea and Mexico). China should immediately be labelled a currency manipulator. Tariffs on goods from Mexico should rise to 35 per cent and on goods from China to 45 per cent.

National debt and federal budget

Clinton's plan (according to the nonpartisan Committee for a Responsible Federal Budget in late June) would boost revenue by USD 1.2 trillion over the next decade, which would largely cover her proposed spending increases. *Trump's* original plan, would have reduced federal revenue by a whopping USD 10.5 billion. Changes in the plan since have reduced this shortfall but it is unclear by how much. His revised plan still lacks sufficient details needed assess its overall impact on tax revenue. Trump is still relying heavily on positive dynamic growth effects to make ends meet but most independent observers believe these effects are greatly exaggerated. Neither candidate has proposed significant cuts in America's large and increasingly costly social insurance "entitlements". Under current law, the national debt (excluding debt held by federal agencies) is expected to climb from 76 to 86 per cent of GDP during the next decade. Clinton's plan would boost it marginally – to 87 per cent – while Trump's original plan would have increased the debt to 127 per cent of GDP.

The same policies, but with bigger numbers

- **New stimulus package will lift 2017 growth but not provide the desired inflation surge**
- **"Passive helicopter money" possible as an emergency response to any new slowdown**

Japan's **growth is sluggish**, due to disappointments connected to both international and domestic demand. The government's latest fiscal stimulus package will push growth higher, mainly in 2017. **GDP will increase by 0.5 per cent both this year and next** (unchanged forecast); **2018 GDP growth will be 0.5 per cent**. This is at or above 2016-2018 potential growth. Absence of structural reforms, and demographic headwinds, will eventually squeeze potential growth towards zero. We foresee a balanced risk picture for growth during the period.

Unemployment will drop **below 3 per cent by 2018**. This is close to equilibrium (NAIRU) for Japan. The number of working-age people will keep shrinking by about 1 per cent yearly, but one positive sign is a cautious upturn in female labour force participation. This will boost the labour supply and may offset the downturn in Japan's long-term potential growth.

Putting record corporate liquidity to use

Company earnings are at near-record levels, and corporate liquidity is equivalent to 60 per cent of GDP, boosting potential for **capital spending growth**. But manufacturers remain squeezed by the past year's 20 per cent **yen appreciation** (in effective terms) and global and regional surplus capacity.

The outcome of this year's wage round was meagre, despite government and central bank calls for higher pay. The government is sticking to its 3 per cent yearly minimum wage hike target, while the IMF and others would like it to enact measures that improve wage dynamics through both political sticks and carrots aside from current fiscal, monetary and restructuring policies (adding a "fourth arrow" to Abenomics). **We expect yearly nominal pay hikes of 0.5 per cent in 2017 and 2018**, providing marginal real wage growth.

Due to Japan's long-standing deflationary environment, expectations of continued slow price increases are deeply rooted in the economy. This has an adverse impact. Even though the output gap is closing, a stabilisation of oil prices and the yen is not expected to help push up prices much in the absence of higher pay increases. **CPI inflation will be -0.3 per cent this year**, rising marginally to **0.2 per cent in 2017** and **0.6 per cent in 2018** – still **well below the Bank of Japan (BoJ)'s 2 per cent target**. The consumption tax hike from 8 to 10 per cent planned for April 2017 will now occur in October 2019, also delaying its impact on the CPI.

Shinzo Abe's political position is secure

The July upper house election strengthened Prime Minister Abe, giving him a two-thirds **supermajority** in both the upper and lower houses of Parliament. Economic weakness and questions about the effectiveness of "Abenomics" have thus not undermined voter confidence in the country's leadership. The supermajority will enable the administration to propose constitutional amendments, such as military reforms, that can later be approved by referendums. **The political situation will not significantly change Japan's economic outlook**.

Abe's 275 billion dollar stimulus package

The package, dubbed *"Realizing Investment for the Future"*, totals 28 trillion yen or 6 per cent of GDP. It consists mainly of previously announced measures; about 25 per cent is "new" money. USD 45 billion or about 1 per cent of GDP will be used in the current fiscal year ending in March 2017. The focus is on labour force participation, infrastructure projects, business investments and higher grants for children and the elderly.

The BoJ left its policy nearly unchanged at the July meeting: a key interest rate of -0.1 per cent and yearly asset purchases of JPY 80 trillion. Its balance sheet has grown by USD 2,925 billion since 2007, with a bit over half these asset purchases occurring in the past three years. We believe that in practice, BoJ monetary policy is near the end of the road. **We foresee a key rate cut to -0.20 per cent, with an unchanged QE programme**. The value of the yen seems relatively reasonable; we expect a **USD/JPY** exchange rate of **105** this December, **110** at the end of 2017 and **115** at the end of 2018.

Japan's increased emphasis on fiscal stimulus, and on avoiding steps that influence yen exchange rates, is **consistent with G20 strategy to boost global growth**. Public debt is now expected to swell to more than 255 per cent of GDP from 250 per cent today. The country's economic goals – stabilised public debt by 2020, surpluses in the government's primary budget balance and 2 per cent inflation – will not be achieved in the near term. Low interest expenses and good tax revenue will allow room for expansionary fiscal policies, but Japan's high and growing public debt entails increasing credibility risks. The debate on alternative policies has intensified due to the IMF's latest evaluation and commentary on Japan. The country appears to be the **most likely candidate to consider passive helicopter money** (see the theme article on page 14).

Little Brexit vote impact, but plenty of other challenges

- **China: Policy actions provide growth floor**
- **India: Patel to replace Rajan as RBI head**
- **Russia: Downward pressure has eased**
- **Brazil: Clearer signs of a turnaround**

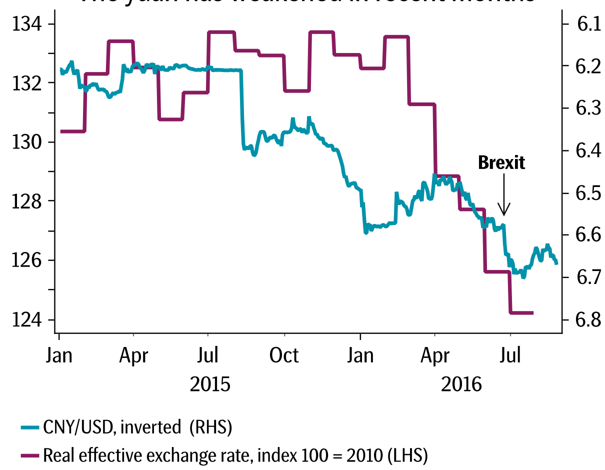
China: Reforms more vital than stimulus

In the second quarter, China's GDP rose by 6.7 per cent year-on-year: the same pace as in Q1. The discrepancy between the service and manufacturing sectors persists, although manufacturing growth accelerated a bit in Q2. The housing market has continued to improve, with rising prices and an increased number of sales. The near-term risks of a serious deceleration are small, but **growth has not speeded up despite large-scale policy actions**. This raises questions about long-range trends. Stimulus measures have provided a floor for growth but have not made it take off. Earlier monetary policy easing will help sustain growth for a while, but its effects will fade during 2017. Fiscal policy may take over the initiative temporarily via expanded government capital spending, but after that we expect growth to decelerate again. Our forecast is that **GDP will increase by 6.6 per cent in 2016** and **6.3 per cent in 2017. In 2018**, growth will slow to **6.0 per cent**.

Inflation stood at 1.8 per cent in July and is expected to remain around 2 per cent during the rest of 2016: clearly below the 3 per cent target, which in practice is a ceiling. **We expect full-year average inflation of 2.2 per cent in 2016** and **2.5 per cent in 2017 and 2018**. Widespread flooding will reduce harvests, creating some upside risk for food prices.

China's economy is only weakly connected to the UK. The real economy will be only marginally influenced by Brexit as long as the EU as a whole is not harmed. Financial markets have also generally reacted calmly to the UK vote. The yuan has fallen both against the USD and in trade-weighted terms, but unlike last summer and early 2016 this has not led to financial market turmoil. Capital outflows from China have stabilised in recent months and investors now seem less worried about yuan depreciation. The People's Bank of China has improved its communication and markets have started to become accustomed to a more volatile yuan, contributing to the relative calm. If the dollar keeps climbing significantly, the PBoC will probably intervene to keep prevent movements from again causing market turbulence and dramatically rising capital outflows. We expect the **USD/CNY** to be **6.80 at the end of 2016, 6.70 at the end of 2017 and 6.60 at the end of 2018**.

The yuan has weakened in recent months



Source: BIS, Macrobond

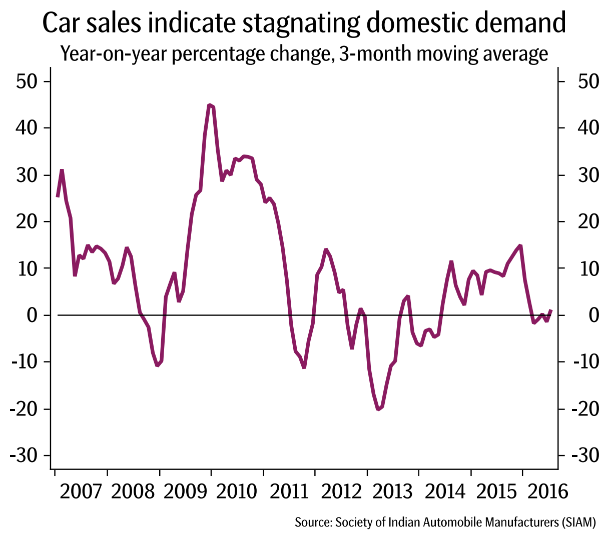
Although the near-term growth outlook has stabilised, there is reason for concern about long-range trends, among other things because official actions aimed at meeting **growth targets are hampering long-term reform efforts**. For example, rapidly expanded lending helps sustain short-term growth but meanwhile worsens debt problems and increases the risks connected to the banking system. A growth target of 6.5 to 7.0 per cent is also very ambitious for an economy at China's development level, and it would thus be natural to adjust it further downward. Small steps have been taken in that direction, for example by formulating the target as an interval, but there is also underlying potential to move towards less ambitious targets. GDP growth per se such is actually not as crucial to the authorities as labour market stability. There are still no clear signs of labour market deterioration, even though GDP growth has already decelerated greatly. This indicates that **to a greater extent than before, growth is driven by increased employment** and to a lesser extent by rising productivity. This reduces the risk that lower growth might trigger labour market turmoil.

China needs to intensify its economic policy reform efforts in various fields. This applies above all to the management of state-owned enterprises (SOEs), whose influence on the economy is admittedly decreasing gradually but is still having a restraining effect. **Their productivity is significantly lower than in the private sector, and a disproportionately large share of bank lending goes to large SOEs.** This hampers the ability of small and medium-sized businesses to borrow. Overcapacity in the Chinese economy is also concentrated in state-owned heavy industry and mining. The government has begun taking **steps to reduce overcapacity** in these sectors, and a large number of jobs will disappear in the next few years.

Yet fears that such changes will lead to sharp labour market deterioration in the short and medium term will probably continue to slow the pace of reform policies.

India: Patel to replace Rajan

First quarter GDP growth accelerated unexpectedly to 7.9 per cent, thereby widening the discrepancy between GDP and other data that point to significantly slower expansion. Industrial production has cooled, while exports and imports remain sluggish. Car sales, a vital piece of the puzzle in the absence of broader consumption indicators, have slowed.



Weak capital spending will keep GDP growth from reaching the government target of 10 per cent. Investment activity is hampered by heavy debt among banks and many businesses. **Lending is very weak**, while in 2017 businesses will again be focusing on debt reduction. It will take time before new competition legislation and other measures will have a positive impact on capital spending. Because of the central government's ambition to decrease its budget deficit, it cannot use fiscal policy to stimulate the economy. GDP increased by 7.3 per cent in 2015. We foresee an acceleration to **7.6 per cent in 2016** and **7.8 per cent in 2017**. We expect GDP growth to reach **8.0 per cent in 2018**.

The term of office of Raghuram Rajan, current governor of the Reserve Bank of India, expires in early September and **will not be extended**. Since he took over in 2013, Rajan has built up a monetary policy framework with inflation targeting as its central anchor. The RBI has tightened policy. Along with lower oil prices, this has helped to essentially halve inflation since 2013. Rajan has also initiated steps to bring order to the balance sheets of banks and resolve problems caused by the high percentage of bad loans. Rajan's reforms and interest rate hikes, combined with his candid style, have led to criticism and probably explain why his term is not being extended.

Rajan will be replaced by Urjit Patel. Patel is RBI deputy governor in charge of monetary policy and headed the committee that in 2014 recommended the central bank to adopt inflation targeting. We believe that **the current monetary policy framework will remain in place**. Similarly to Rajan, Patel is considered hawkish and no major change in the direction of monetary policy is expected. The change of governor coincides with an increase in underlying inflation risks connected to sharp pay hikes for public sector employees. However, a bountiful monsoon is expected to put downward pressure on food prices. We expect full-year **inflation** to average **5.4 per cent in 2016, 4.7 per cent in 2017** and **4.5 per cent in 2018**.

Inflation targeting, combined with smaller current account and budget deficits, has made the **rupee** less volatile. This summer's uncertainty about who would replace Rajan and speculation about looser monetary policy weakened the currency slightly, but the Brexit referendum had little impact since economic and financial links between India and the UK are weak. **At the end of 2016 we expect an USD/INR exchange rate of 68.5, and at year-end 2017 a rate of 65.0.** At the end of **2018**, we expect a rate of **64.0**.

The much-delayed **national goods and services tax (GST)**, which will integrate India's states into a single market, was approved by Parliament in August and will now be ratified by the individual states. The nationally ruling Bharatiya Janata Party has gained strength in local elections, and together with local parties it looks likely to push through the tax, which is expected to have **positive growth effects** in 2018 if it is introduced as planned on April 1, 2017. The Narendra Modi government has also introduced a deregulation package for foreign direct investments.

Russia: Downward pressure has eased

The deep recession in the Russian economy is now over, and the slightly higher global oil prices that have now become established are helping to stabilise growth. The purchasing managers' index has strengthened, while industrial production has recovered. The sharp declines in real wages have faded as inflation has slowed, contributing to the current slowing of the decline in retail sales, but growth is not being helped along by fiscal policymakers. We estimate that the **federal budget deficit** will end up **around 4 per cent of GDP**. This tight situation will mainly hurt public sector investments. **In 2016** as a whole, **we estimate that GDP will shrink by 0.4 per cent, after a dramatic slide of nearly 4 per cent in 2015**. We expect GDP to climb cautiously in **2017** and **2018**: by **1.0** and **1.5 per cent**, respectively. In July, inflation slowed to 7.2 per cent. Measured as annual averages, we expect **CPI inflation** to end up at **7.3 per cent in 2016**, then slow to **6.0 per cent in 2017 and 5.0 per cent in 2018**.

In mid-June the central bank lowered its key interest rate to 10.5 per cent after leaving it unchanged since July 2015. The rate cut was a result of falling inflation expectations and rouble appreciation. The expected inflation slowdown this autumn will allow further rate cuts. We expect **a key rate of 9.0 per cent at the end of 2016 and 6.0 per cent at the end of 2017**.The correlation between oil prices and the rouble remains strong; the rouble appreciated this past spring as oil prices recovered. Its appreciation has levelled out, but the rouble is one of the fastest-rising emerging market currencies this year. We **expect**

the USD/RUB exchange rate to be 61.0 at the end of 2016, 66.0 at the **end of 2017** and **70.0** at the **end of 2018**.

EU sanctions against Russia have been extended until January 31, 2017. The measures outlined in the Minsk 2 agreement in February 2015 that were aimed at ending sanctions have not been implemented. Meanwhile support for the sanctions has eroded in various EU countries. The failure to fulfil the Minsk 2 agreement is also due to lack of action by the Ukrainian government. One possible scenario is thus that the EU will conclude that some of the blame for the non-fulfilment of Minsk 2 rests with Kiev and will state this as a reason for gradually beginning to ease the sanctions. Tensions between Russia and Ukraine have recently increased, reducing the probability that sanctions will be eased. We expect **US sanctions** to remain **in place for the foreseeable future**; unlike EU sanctions, they require no periodic renewal votes. Russia, in turn, has extended its own sanctions against food imports from certain Western countries until the end of 2017.

Public support for Putin remains above 80 per cent

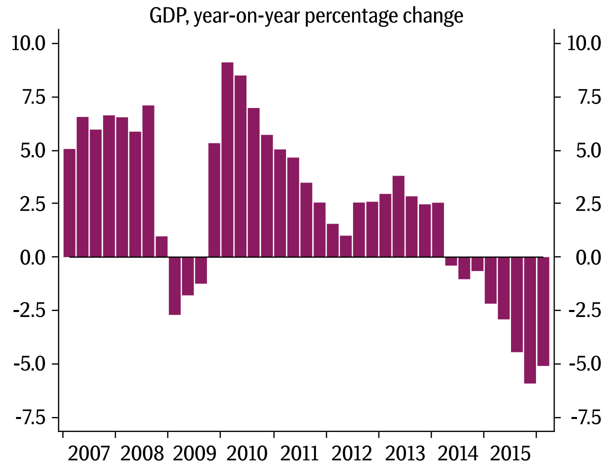
Source: Levada Centre

The State Duma election on September 18 will hardly result in any major political changes. Despite the economic downturn and decline in living standards, **President Vladimir Putin enjoys strong public support**. This support has fallen a bit from its peak but remains above 80 per cent. Putin and his government have shown great skill in handling the state-owned media and using Western sanctions as a scapegoat for Russia's economic problems. Putin's party, United Russia, is not as popular as he is and the party is expected to lose parliamentary seats, but the opposition is weak and United Russia is expected to remain in power.

Brazil: Signs of a turnaround

There are increasingly clear signs that the economy has passed its worst downturn. GDP declined less than expected in the first quarter of 2016. Consumer and business confidence have recovered, although they remain at very low levels. The purchasing managers' index for the manufacturing sector has begun to gain strength but remains far below the 50 mark that indicates expansion. On a monthly basis industrial production and retail sales have begun to rise cautiously. Exports are recovering and the current account deficit has decreased substantially. Although the worst is probably over, **we expect GDP to decline by 3.5 per cent in 2016**. In **2017** GDP will **increase by 0.5 per cent** and in **2018** by **2.0 per cent**.

Sharpest GDP decline is past



Source: IBGE

The domestic political situation has become less turbulent since President Dilma Rousseff stepped aside in May while awaiting the Senate vote in late August that will determine whether she will be forced to leave office permanently. Rousseff was replaced by Vice President Michel **Temer**, whose new government has exceeded expectations and launched various market-friendly reforms. **Its focus is on dealing with very weak government finances**, including a budget deficit of more than 10 per cent of GDP. The new government has a high ambition level, but ultimately the **implementation of its reforms** will be decisive. Fiscal austerity measures will require constitutional amendments and at least a 60 per cent majority in the National Congress. A large-scale **pension reform** is vital if the government's austerity plan is to succeed.

The central bank's monetary policy committee decided in late June to **leave the current inflation target of 4.5 per cent in place during 2017 and 2018**, but narrow the tolerance range from ±2 to 1.5 percentage points starting in 2017. Looking ahead, the most important monetary policy factor is how well the government succeeds in reducing the budget deficit. According to the central bank, there is no room for key interest rate cuts as long as budget-cutting has not been implemented. Inflation has fallen from its peak of 10.7 per cent in January. We believe that it will continue to slow as last year's regulated prices hikes fade from the 12-month statistics and low capacity utilisation pushes down underlying inflation pressure. **We expect full-year 2016 inflation to end up at 8.6 per cent**, then slow to **6.0 per cent in 2017** and **5.0 per cent in 2018**.

Both the stock market and the **real** have rebounded strongly this year, driven by rising commodity prices as well as expectations of more reform-oriented, market-friendly economic policies. The currency has shown good resilience to Brexit-related market turbulence, and the central bank has intervened to prevent appreciation. **At the end of 2016 we expect the USD/BRL rate to be 3.05. At the end of 2017 it will be 3.50 and by the end of 2018 at 3.75.**

- **Purge of officials raise questions about Turkey's continuity and predictability**
- **Strained relations with West, but NATO membership is not threatened**
- **Relatively minor negative economic impact**

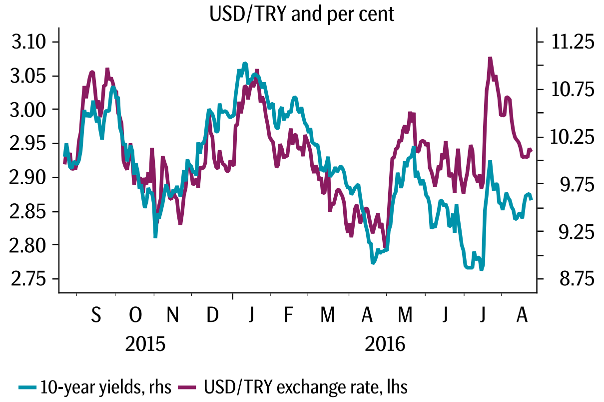
Far-reaching political effects in Turkey

President **Recep Tayyip Erdoğan**'s powerful reaction to the July 15 coup attempt risks undermining Turkey's public sector functions. Turkish authorities have fired – or removed – some 70,000 public employees. This purge is one reason why S&P has downgraded Turkey's credit rating. Moody's and Fitch have chosen to retain their "BBB" ratings, but Moody's is expected to lower its rating in the coming year due to a weakened government system (such as the courts and police) and the ongoing concentration of power around Erdoğan.

Even before the coup attempt, the president planned to introduce an executive presidency. These plans were highly controversial and it was uncertain whether he would achieve his goal. Today the situation is different. Major opposition parties have condemned the coup attempt. Meanwhile cross-party cooperation and dialogue have increased. This is expected to result in a transition to **a strong presidency**.

Fixed income market recovery will take time

USD/TRY and per cent



Source: Macrobond, SEB

The negative effects on Turkey's international relations will be most apparent in the short term. Ankara has demanded the extradition of cleric Fetullah Gülen from the United States. Whether this will happen is uncertain, but it will lead to US-Turkish tensions. Despite sharp exchanges of words, **nothing currently suggests that Turkey's status as a NATO member will be affected**. Turkey has the second-largest army in NATO after the US, and the country's geo-strategic position creates a mutual dependence that is too big to allow NATO's cooperation with Turkey to be jeopardised.

Relations with the EU will also be tense, due to EU criticisms of Turkey's restrictions on freedom of expression, but neither the EU nor Turkey wants to jeopardise the refugee agreement they reached in March. **However, the probability that the EU will resume membership talks with Ankara in the near future has decreased further**. Relations with Russia, on the other hand, are expected to improve, but this is mainly a matter of restoring previously interrupted trade ties and resuming work on the Turkstream gas pipeline**. It is unlikely that Turkey will politically orient itself more generally towards Russia**, since they are far apart on such issues as the war in Syria.

Little economic impact

The Turkish lira has recovered and is trading at around 2.93 to the US dollar, only 1.5 per cent weaker than before the coup attempt. **We expect the lira to recover further**, thanks to a strong global risk appetite and political stabilisation. Due to the risk of new credit downgrades, it will probably take longer for both the stock market and fixed income market to regain strength; a 10-year government bond yields 9.6 per cent today, reflecting the political and economic challenges Turkey faces.

The economic impact of the coup attempt is expected to be relative small. A diminished propensity to invest will push down GDP growth a tenth of a percentage point or so, but increased government spending and lower interest rates will stimulate domestic consumption (about 3.3 per cent growth this year). Ankara is also likely to ease its budget discipline to maintain public support for the government but will limit the budget deficit to 1.3 per cent of GDP. The government can manage its finances since debt is a low 33 per cent of GDP.

For some time, the central bank and commercial banks have been subject to political pressure to lower interest rates and relax lending standards. **Erdoğan has even accused the opponents of rate cuts of being traitors**. The rhetoric has intensified, and despite higher inflation expectations the central bank has continued last spring's monetary policy easing. Various banks have also apparently listened to Erdoğan and lowered their home mortgage and consumer loan rates.

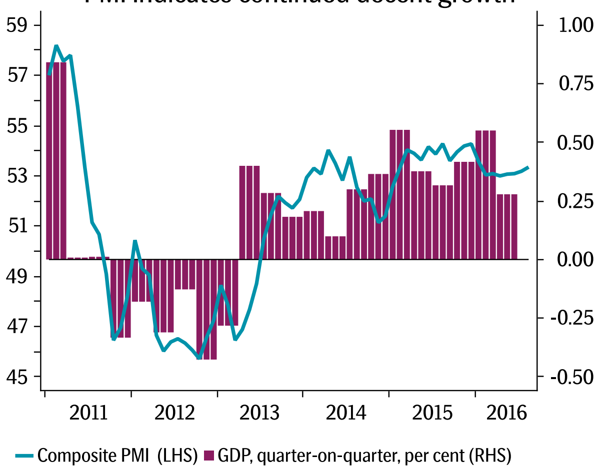
The current account deficit has narrowed to about 4 per cent of GDP thanks to lower oil prices, but **Turkey needs to reduce its deficit further**. The root of the problem is excessively low gross saving of about 15 per cent of GDP. The most obvious solution is to hike interest rates and thereby decrease domestic economic pressure, but as mentioned Erdoğan opposes that alternative because it would hurt consumption. Turkey also needs to implement labour market reforms, but a liberalisation is controversial and would probably lead to protests – something the administration wants to avoid at any price.

Strong domestic demand despite shaky banking sector

- **Indicators are resilient to Brexit worries**
- **Employment will drive consumption**
- **Inflation stuck below target in 2016-2018**
- **ECB will extend its bond purchases**

The euro zone economies continue to move in the right direction, despite various sources of concern. Job growth, consumption and capital spending are giving domestic economies underlying stability, although weak industrial production and exports will **limit yearly GDP growth to a modest 1.7 per cent or so from 2016 to 2018**. This still represents above-trend growth. Unemployment will gradually fall from today's 10.1 to 9.0 per cent by the end of 2018. Unlike most other major economies, resource utilisation in the region as a whole will remain relatively low throughout our forecast period, giving the European Central Bank room to maintain highly expansionary monetary policies for a long time.

PMI indicates continued decent growth



Source: Markit, Eurostat

Meanwhile there are various questions and risks, both short- and long-term. **GDP growth decelerated in the second quarter after a strong start to the year**, yet the 0.3 per cent quarter-on-quarter growth rate is consistent with averages in recent years. Both Italy and France slowed to zero growth, but the French economy was hampered by temporary factors such as strikes and de-stocking. German and Spanish growth remained relatively healthy: 0.4 and 0.8 per cent, respectively. **Growth rates will continue to diverge**, although due to supply restrictions the German economy will not grow faster than the euro zone average.

The Brexit outcome involves both political and economic risks, considering the euro zone's close relations with the UK in various respects, but so far indicators have not shown any significant negative reaction. Given our scenario of a rebound in UK growth, the economic impact on the euro zone should be minor over the next couple of years, **but the political risks may eventually become hard to manage**. Exit negotiations are likely to be complex, and although our main scenario implies that constructive solutions will be achieved, euro zone political leaders will be under pressure. There will be continued focus on the future and the crisis management capacity of the EU and the euro zone. Many signs point to a conflict between Brussels-based institutions wishing to deepen integration and national political leaders wishing to distance themselves from supranational ambitions. Next year, France and Germany hold elections. Anti-EU protest parties are expected to gain ground, especially in France, where Marine Le Pen of the National Front is likely to dominate the agenda in the presidential election even though she will probably not make it to the Elysee Palace.

The ECB's exceptionally loose monetary policy is not risk-free either. Conditions in euro zone economies differ fundamentally, creating dilemmas. In addition, record-low interest rates are squeezing the banking system. Although European Banking Authority (EBA) stress tests showed that banking sector capitalisation has improved in recent years, there is lingering uncertainty. The high level of bad loans, especially in Italy, is hampering monetary policy effectiveness.

GDP forecasts

Year-on-year percentage change

	2015	2016	2017	2018
Germany	1.7	1.7	1.6	1.6
France	1.3	1.3	1.3	1.2
Italy	0.8	0.9	1.0	1.2
Spain	3.2	3.1	2.8	2.8
Greece	-0.2	0.0	2.7	3.0
Portugal	1.5	1.7	1.8	1.8
Ireland	26.3	4.8	3.8	4.0
GIPS countries	6.3	3.0	2.9	3.0
Euro zone	**1.7**	**1.6**	**1.7**	**1.7**

Source: Eurostat, SEB

Gentler fiscal policy on the way

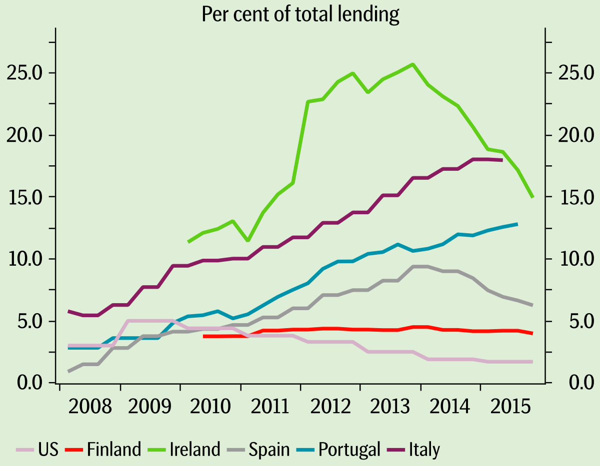
As room for further **monetary stimulus shrinks, the focus of attention is shifting towards fiscal policy**. Earlier belt-tightening and low interest rates have helped create clear improvements in government finances.

Bad loans hampering ECB's effectiveness

The euro zone banking sector remains under pressure. Its **problems are economic** – ECB policies do not have a full impact due to bad loans – **and political**: Will the bail-in principle hold up, or do governments need to prop up banks? The volume of bad loans in the banking systems is high, while mutual dependence between governments and banks is a concern. Total bad loans are estimated at nearly EUR 1,000 billion, of which 360 in Italy. These problems do not apply to southern Europe only; Germany's Centre for European Economic Research (ZEW) indicates in a recent report that German and French banks are also vulnerable according to Fed stress test methodology. The stress test results published in late July by the European Banking Authority (EBA) provided a temporary respite. But after critics argued that the EBA had been too lenient, not examining vulnerability over a long period of negative interest rates, market mistrust returned. European banking shares have slid nearly 40 per cent since July 2015, far more than US bank shares, which have lost almost 15 per cent. European bank valuations are also lower at 0.67 of book value (US 0.95 and Europe about 2 before the financial crisis).

Continued high percentage of bad loans

Per cent of total lending



Source: IMF

Restoring confidence in the banking sector is important for ECB policy impact. About 85 per cent of corporate credit in the region is supplied via banks (about 15 per cent in the US). ECB actions push down interest rates and supply cheap loans to banks, while boosting demand for loans according to its surveys. But bank lending is increasing only slowly; in Spain and Italy we even see continued downturns. IMF studies show that bad loans are a crucial reason why lending is not accelerating despite decent demand for loans, low interest rates and good liquidity.

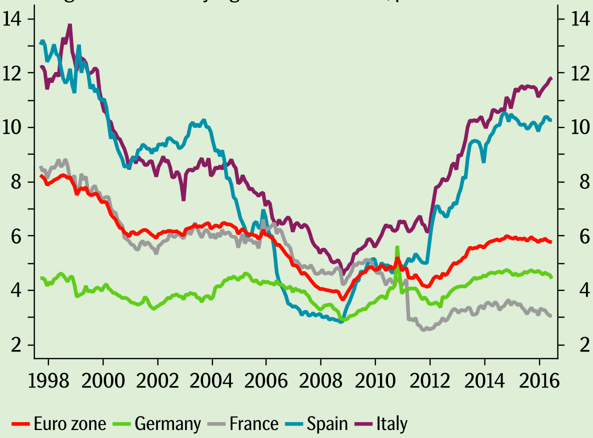
Mutual dependence between governments and banks is also a source of concern. Low risk weighs for sovereign debt lead banks to buy government securities. Further purchases may then be motivated when banks want to help governments with large deficits avoid failed bond issues, with falling values in their bond portfolios as a consequence.

There are major differences in banks' holdings of their own country's government securities; Spain and Italy stand out with especially large holdings. Germany has, for example, exerted pressure for differentiation of risk weightings for government bonds in order to prevent banks in southern Europe from buying their own country's bonds to an excessive degree.

The most common way of solving bad loan problems is to transfer doubtful assets to a "bad bank", which has been done to varying degrees. An alternative is government loss guarantees. Although EUR 260 billion has been supplied to the banking sector since 2011 (according to EBA estimates), more will be needed. One important question is how to deal with bank losses and how to supply them with more capital. New EU rules mean that not only shareholders, but also bond holders, must take losses (bail-ins) before a government may intervene. Government capital (bail-outs) must also be approved by Brussels, since it is regarded as state aid. We are seeing steps being taken in the right direction in Italy, but the amounts set aside so far are too small, and the bail-in principle is sensitive – it is politically and economically sensitive to allow small savers in particular to take losses. As the IMF has highlighted, another problem is that legislation on bad loans varies between euro zone countries. We expect that more will be done, but as in many other respects, institutional sluggishness will delay the process.

Bank holdings of government bonds vary

Holdings of own country's government bonds, per cent of total assets



Source: ECB

Overall, there are many indications **that bad loans in the banking system hamper the effectiveness of monetary policy**. A high percentage of bad loans lowers profitability, for example via increased funding costs, while locked-in bank capital has an adverse impact on the credit supply and economic growth. Small businesses, which rely more on bank financing, are most vulnerable. Developments in the US show that a solution to banking sector problems is vital to economic recovery. The situation in the euro zone is more serious – with many countries, the European Commission and the ECB involved. It is difficult to foresee how the banking sector can quickly deal with the debt situation by using private capital alone. In choosing between a lengthy crisis in which the bail-in principle is applied and a faster bail-out, we believe that in those countries that have the biggest problems, Brussels will finally approve letting governments absorb part of the blow despite new EU regulations.

Last year, euro zone budget deficits totalled 2.1 per cent of GDP, down from 6.2 per cent in 2010. Gross public debt fell in 2015 for the first time since 2007. But the budget situation remains tight in those countries in greatest need of stimulus. In countries like France, Italy and Spain, deficits are 2-4 per cent of GDP with only a weak downward trend. For the past two years, Germany has shown surpluses; despite refugee resettlement expenditures, these surpluses will continue in the next couple of years. But there are currently no signs that the German government is prepared to use this room for major fiscal policy easing.

The European Commission recently decided not to fine Spain and Portugal for exceeding deficit limits, indicating a growing acceptance of looser fiscal policies. In the short term, this will help create a better policy mix, while there may be long-term risks because **EU common rules are again not being applied despite actual violations**. We expect the trend towards looser fiscal policy to continue and that no new belt-tightening will be considered over the next couple of years. Aside from economic arguments, general political trends point in this direction, since austerity measures are a convenient target for anti-EU and nationalist parties. After a long period of belt-tightening, **fiscal policy will be largely neutral in 2016-2018**. Net lending will improve a bit, falling from 2.1 per cent of GDP in 2015 to 1.5 per cent in 2018. Public debt will fall marginally.

Indicators defy Brexit worries

Broad indicators such as composite purchasing managers's indices (PMIs) have been relatively stable during 2016. **So far, no Brexit effect has been discernible**; in July, all four large euro zone countries (Germany, France, Italy and Spain) were again over the neutral 50 mark. But differences persist: Spain and Germany hover around 54-55 while business confidence in Italy and France is around the 50-52.

Exports and industrial production still slowed somewhat in the first half of 2016, but order bookings look relatively stable according to various indicators and have not fallen along with production statistics in recent months. We expect a slight acceleration this autumn, although the Brexit process and a weaker pound are creating uncertainty. The euro zone has a relatively large exposure to the UK, which accounts for some 13.5 per cent of its exports and 9 per cent of imports. But given our forecast that there will be no recession in the UK, it is difficult to foresee any significant disruption to the euro zone. Overall, **we expect euro zone exports to increase by 2 per cent yearly in 2016 and then climb by about 4 per cent in 2017-2018**.

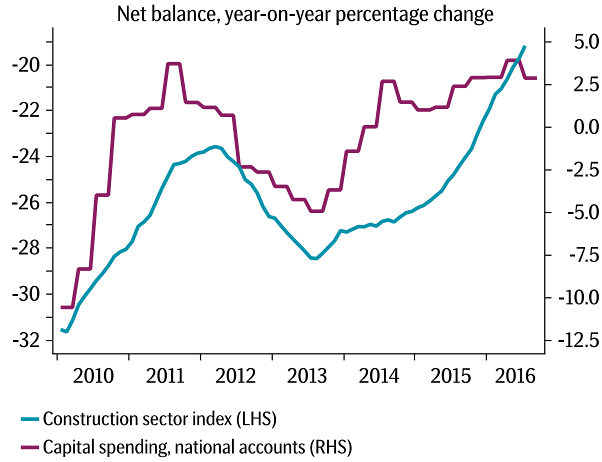
The euro zone's current account surplus will shrink somewhat from 3.5 to 3.0 per cent of GDP during our forecast period, primarily driven by major Germany surpluses (8.5-9.0 per cent of GDP). Spain has also greatly improved its current account balance since the recent crisis and is now showing a surplus (about 1.5 per cent of GDP). Consumption and capital spending growth will drive up euro zone imports in the next couple of years, and the current account surplus will thus not keep increasing. In the absence of domestic stimulus measures, Germany's surplus may climb a bit further, which will increase international criticism. Since Germany does not control its currency, it is hard to take American signals that the country should be labelled a currency manipulator seriously.

Capital spending will continue to increase

Total capital spending is still more than 10 per cent below its pre-crisis peak. As the recovery matures, investments are slowly strengthening. Capacity utilisation is rising and business investment plans, according to the European Commission's index, look more positive in 2016 than in 2015. The outlook seems especially good in the automotive and investment goods sectors. The ECB's bank survey shows continued healthy demand for loans, although continued banking sector problems hamper lending, especially in southern Europe. Overall lending to non-financial companies will continue to climb weakly, mainly driven by an expansionary trend in Germany. We expect a **capital spending upturn of 3-3.5 per cent annually 2016-2018.**

Capital spending will continue to increase

Net balance, year-on-year percentage change



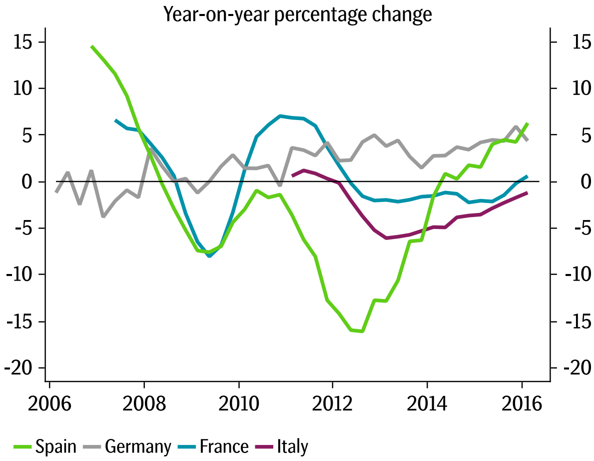
Source: Eurostat, DG Ecfin

Temporarily weak Q2 consumption

Retail sales growth slowed in the second quarter, when the upturn was the weakest for several years, but this deceleration occurred after a number of strong quarters. General economic developments in the region indicate that the dip was temporary. The receding effects of earlier belt-tightening programmes combined with **rising employment suggest a positive income and consumption trend**. Household optimism has also rebounded. Rising home prices in most countries (with Italy as a key exception) will strengthen household balance sheets. This is one reason why we believe that the household savings ratio will now stabilise after rising in recent years, although it remains below its pre-crisis level. Yet underlying economic policy uncertainty and the gradual fading of the stimulus effect from lower oil prices will slow the upturn. **Overall euro zone consumption will increase by more than 1.5 per cent annually in 2016-2018**.

Home prices on their way up

Year-on-year percentage change



Source: Eurostat

Employment will continue to rise

The labour market is moving in the right direction. Unemployment was reported at 10.1 per cent in June, its lowest level in nearly 5 years and almost 1 percentage point lower than a year earlier. The positive trend, with job growth and falling unemployment, will continue in most countries even though there are major differences in levels and the pace of change. **By the end of our forecast period, unemployment in the region as a whole will be 9 per cent**.

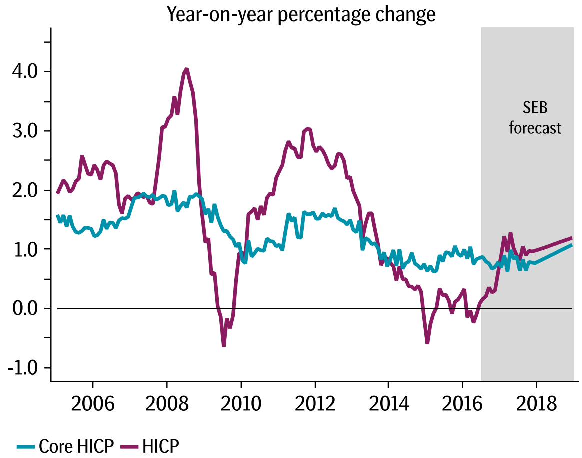
Equilibrium unemployment climbed during the lengthy crisis. We estimate that it is now at about 8-8.5 per cent for the euro zone as a whole. **This means that in 2018 there will still be a way to go before reaching equilibrium**. But there is great uncertainty about the equilibrium level after the economic shocks of recent years and sizeable migration flows into some countries. Wide gaps in unemployment between countries also make interpretation difficult. Differences in resource utilisation naturally show up through varying pay increase rates in the region, but despite Germany's tight labour market, wages there are currently rising by a modest 2.5 per cent yearly. In Spain the level is just above zero, while in the overall euro zone it is somewhat over 1 per cent. Meanwhile low inflation means that real wages in many countries are increasing at a decent pace. The upturn in pay increases will probably be modest in 2017-2018. German wage and salary hikes will accelerate to 3 per cent in 2017, while the pace of increase in the overall euro zone will stay at just above 1 per cent, since high unemployment in many countries is continuing to have a braking effect.

Rising inflation, but far from the ECB target

In recent months, inflation has hovered around zero. In July, the harmonised index of consumer prices (HICP) rose 0.2 per cent, while core inflation was 0.9 per cent. As base effects from falling energy prices vanish from year-on-year figures this autumn, inflation will slowly rise. But this upturn will be moderate, and levels will be well below the ECB target of close to 2 per cent throughout our forecast period. In the spring of 2017, HICP and core inflation will be at around 1 per cent and then climb a few tenths by the end of 2018. Due to low global price pressures combined with weak pay increases, the ECB will have difficulty reaching its inflation target in 2016-2018.

Rising inflation but well below target

Year-on-year percentage change



Source: Eurostat, SEB

ECB: More QE, but no interest rate cuts

The ECB's expansionary policy pushes down lending rates and eases general financial conditions. Government bonds of various euro zone countries are being traded at negative rates far out on the yield curve; for example in Germany, France, the Netherlands, Belgium and Finland the yield on 5-year bonds is below -0.40 per cent. Yield spread to Germany is at its lowest level for more than a year. Meanwhile ECB policy is leading to **increased monetary policy tensions in the region** because of varying structural and cyclical situations. Exceptionally low interest rates are also squeezing the banking system.

There are many indications that monetary policy will become even more expansionary in the near term, but **we expect the ECB's refi and deposit rates to remain unchanged throughout our forecast period**. The focus will instead be on **adjusting the QE programme**. Given its current principles, the ECB is being forced to go further and further out on the yield curve in order to complete its bond purchases. We thus believe that various adjustments are on their way. At the ECB's October policy meeting, we expect that: 1) **the interest rate floor (i.e. deposit rate, -0.40 per cent) for bond purchases will be** adjusted downward or **removed**; 2) the ECB will be allowed to buy a **larger percentage of the outstanding supply of corporate bonds from individual companies**; 3) the earliest closing date of the QE programme will be extended by six months to September 2017; 4) new cheap TLTROII loans will be offered to the banking sector throughout 2017-2018.

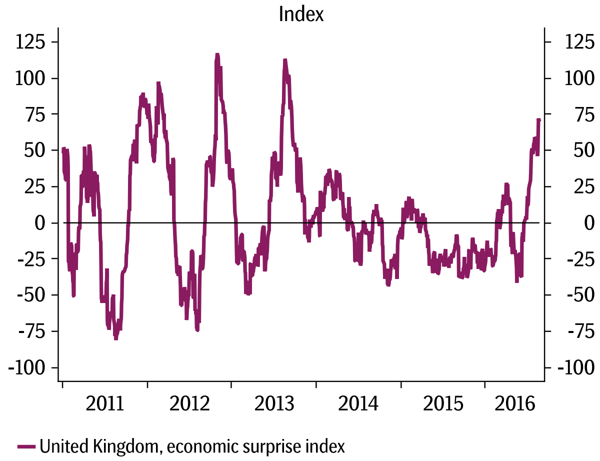
Our forecast of very cautious Fed interest rate hikes starting in December 2016, as inflation gradually creeps upward, implies less pressure on the ECB to deliver further easing. Signals of cutbacks in the QE program are nevertheless likely to be delayed. **Not until the second quarter of 2017 do we expect the ECB to begin communicating that it will reduce its bond purchases**. Our forecast assumes a cutback of EUR 20 billion per quarter, starting in the fourth quarter of 2017. Proceeds from maturing bonds will be reinvested, but net purchases will reach zero in mid-2018.

British economy losing momentum after Brexit vote

- **Autumn stagnation due to lower confidence**
- **Weak pound and stimulus will ease shock**
- **UK will activate exit clause after New Year**

The shocking outcome of the referendum on continued EU membership is shaking up the UK economy. Both household and business indicators point to steep declines. There is an **intensified risk of recession in the short term**. Looking further ahead, developments will depend greatly on the shape of the Brexit agreement. But new stimulus measures, the rapid appointment of a new prime minister and the weaker pound suggest there will be no lengthy recession scenario. **GDP will grow by 1.7 per cent this year, 0.9 per cent next year and 2.0 per cent in 2018**. The economy will thus barely avoid a technical recession during the second half of 2016. Our forecast is a bit above consensus, but **unemployment will rise** due to the growth slump. By the end of 2018, the jobless rate will be one percentage point higher than today. **Inflation**, which was zero last year, will rise to **0.4, 1.8 and 2.2 per cent, respectively, from 2016 to 2018**. Although inflation will end up above the Bank of England's target, overheating risks are small. We expect the BoE to lower its key interest rate further to **0.05 per cent in the autumn and maintain this record-low rate during 2017**.

British data topping expectations



Source: Bloomberg, SEB

Business indicators show a broad-based decline after the referendum. Following the biggest drop during a single month in the 20-year history of the index, **the composite PMI is compatible with a quarter-on-quarter GDP decline of 0.5 per cent**, but we believe that this gloomy projection will not materialise. Retail sales indicate that the household sector is resilient, and statistics have generally far exceeded the market's low expectations. GDP growth proved unexpectedly resilient in the second quarter. **A precipitous fall similar to the one after the Lehman Brothers crash is improbable**; both hiring and investment plans were unchanged in two thirds of companies, according to a BoE survey. Instead of continuing to fall towards 40 as in 2008, business confidence indicators are expected to stabilise this autumn as the initial shock fades. The hardest-hit sector is commercial property, and indicators point to a 10 per cent drop in construction. Office space in London especially is in danger of sizeable price slides, but **the risk of a real estate-driven banking crisis like that of the 1990s is considered small**. Bank lending for real estate has halved since 2008 and banks are highly resilient to price slides, according to the stress tests conducted as recently as last year.

The falling pound and looser economic policies will help prevent a deeper downturn, and a **tentative recovery will begin in 2017**. The government is expected to soften fiscal austerity when it unveils its autumn budget. Lower corporate taxes and new infrastructure investments will be in the cards, decreasing headwinds by GBP 5-10 billion per year. Since the Brexit referendum, the pound has lost 11 per cent in trade-weighted terms. It is at its weakest level against the dollar since the mid-1980s, giving British exporters a strong competitive position. With currency depreciation having a temporary rather than a permanent impact on inflation, the BoE has room to launch whole-hearted economic stimulus measures. **This autumn the BoE will cut its key interest rate to a record-low 0.05 per cent and leave it untouched until mid-2018, when it will begin cautious rate hikes**. Meanwhile its asset purchases will continue until 2017. Ultra-loose monetary policy will keep squeezing the pound: **The EUR/GBP rate will be 0.79 and the GBP/USD rate 1.42 at the end of 2017**.

The big question is what kind of withdrawal the UK is aiming for. The most important consideration is how much influence it wants over immigration in exchange for restrictions in access to the EU single market. Our forecast is based on a scenario where the UK activates the EU exit clause after New Year and important non-EU trading partners signal their willingness to sign mutually beneficial trade agreements with the UK. **Formal withdrawal from the EU will thus occur no earlier than January 2019**. We expect the country's new relationship with the EU to follow the Swiss model, rather than the Norwegian one. This implies a comparatively high degree of independence, in which the UK chooses to prioritise control of immigration ahead of full access to the single market.

- **Pragmatic negotiations will ease the economic effects – political risks remain**
- **EU withdrawal by 2019 is unrealistic – many political and legal obstacles lie ahead**

On June 23, the British people surprised the world by **voting 52 to 48 per cent to leave the European Union**. Turnout was 72 per cent, making the outcome fairly clear. In **Scotland** and **Northern Ireland**, a majority voted to remain in the EU.

	Leave	Remain	Voter turnout
United Kingdom	51.9%	48.1%	72.2%
England	53.4%	46.6%	73.0%
Northern Ireland	44.2%	55.8%	62.9%
Scotland	38.0%	62.0%	67.2%
Wales	52.5%	47.5%	71.7%

"Brexit means Brexit…"

The message from the new British government headed by Prime Minister Theresa May is unmistakable: the result of the referendum *"must be respected."* The government has also made clear its intention not to invoke the **"exit clause"** (Article 50 of the Lisbon Treaty) **until after the end of 2016**. Several factors will determine the date: 1. Other countries and British companies want **fast, clear information** but it is the government that decides the timetable; 2. Withdrawal should preferbly occur at the turn of a year; 3. A withdrawal by January 1, 2019 at the earliest – after the stipulated two-year negotiations – will enable the **May 23-25, 2019** EU election to be held without the UK; 4. France is afraid that negotiations will coincide with its **spring 2017 presidential election**. But until it withdraws, the UK will be a **full-fledged EU member**.

The referendum has left behind a **divided people and country**, as well as **splitting political parties** down the middle. The Leave side has faced criticism for its lack of objectivity and aggressiveness during the campaign and for its absence of realistic impact assessments and unwillingness to assume responsibility and leadership. Xenophobia in the UK has also gained a nasty tailwind.

Three scenarios with varying probabilities

London has begun exploratory talks with the EU and other countries in order to get some idea of its negotiating situation. Three scenarios are conceivable:

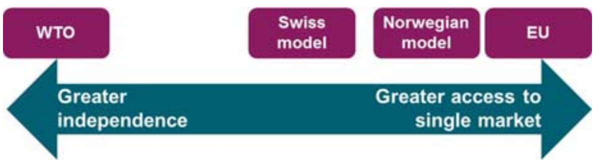
1. Brexit – positive (70 per cent probability)
Implications: The UK activates the exit clause after the end of 2016, while starting discussions with other countries. Early signals from countries like the US and China indicate a desire to conclude **mutually beneficial trade agreements**. The UK is a G20 country, which should make discussions easier. Pragmatic negotiations will enable the country to leave the EU, but not before January 1, 2019. The process will likely take longer: an EU agreement with the UK must also be approved by all 27 other EU countries. The British may be able to vote on this new pact – an exit fast-track would imply a referendum in the autumn of 2018. Agreements with other countries will go into effect only after UK withdrawal from the EU, since having double agreements is not possible for an EU member.

2. Remain (20 per cent probability)
Implications: Accusations of bad faith triggered by the EU referendum campaigns and signals that Brussels is willing to discuss immigration trigger a **new UK election**. Alternatively, the UK Parliament – depending on Supreme Court rulings – may turn out to have the right to vote to activate the exit clause. Since two thirds of current MPs support EU membership, **Parliament may vote not to proceed**. In such a situation, it would be hard for the government to carry out Brexit. Prime Minister Theresa May would then have to **decide whether to call a new election before the end of 2016**.

3. Brexit – negative (10 per cent probability)
Implications: Negotiations become lengthy and create tensions both in the UK and the EU generally, hampering growth and triggering financial market volatility.

Swiss model is the most likely

Only by early 2017 do we expect to have a clear picture of what relationship the UK will seek with the EU, for example on trade and immigration. There are many signs that the EU agreement will follow **the Swiss model, not the Norwegian one**. The main reason is that the UK is not likely to accept all of the EU's four freedoms: that is, freedom of movement for goods, services, capital and – now the most important – people.



Norwegian model: Member of the European Economic Area (EEA), which provides nearly full access to the single market, but Norway must fully accept the EU's four freedoms while also contributing to the EU budget.
Swiss model: Various bilateral trade agreements provide partial access to the single market in exchange for a small contribution to the EU budget.
WTO model: Member of the World Trade Organisation (WTO).

Four key issues are vital in shaping an EU agreement:
1. In what areas will the UK have **access to the EU economy?**
2. What will be the UK's **financial contributions** to the EU?
3. To what extent will EU **laws and regulations** apply?
4. How large an influx of **EU immigrants** will the UK have?

The British government's strategy is to make the economy **"super-competitive"** in order to support manufacturers, attract foreign investment capital and make the UK stronger in its negotiations with other countries. The autumn budget is expected to show how this strategy looks in detail. There are many indications of a continued focus on a corporate tax cut (to no more than 15 per cent), more infrastructure investments around cities and in the north and measures to boost productivity growth. Talk of fiscal austerity and achieving a balanced budget by 2020 is now gone. The Bank of England's strategy is expected to focus on trying to keep the pound weak for a while and making more funds available for lending; the BoE has lowered countercyclical capital buffer requirements from 0.5 per cent to zero. Economic policy shifts and international conditions will ease the adverse impact of Brexit on the UK.

Can Scotland leave the United Kingdom?

Scotland and the three other "states" that make up the UK **have no formal legal authority to block** the decision of the UK government and Parliament to begin withdrawal negotiations and eventually leave the EU. However, if these states can prove that the Parliament's EU decision changes the balance of power among the states, the decision must be jointly approved. The potential for stopping the withdrawal process is mainly **political rather than legal**.

Scotland is signalling its strong readiness to hold a new referendum on independence. The Scottish National Party (SNP) will announce its position in the spring of 2017 after the situation during early Brexit negotiations becomes clearer. But it is the UK Parliament that authorises its Scottish equivalent to organise such a vote. In the 2014 referendum, 55 per cent of Scots opted to remain in the UK. New **opinion polls show that the outcome of the recent Brexit vote has not changed their position**. It is reasonable to assume that in any new referendum, a clear majority – at least 60 per cent – will be required in order for the outcome to be considered valid, and that voter turnout must be high.

However, **the EU is unlikely to accept parallel negotiations with the UK (out) and Scotland (in)**. Becoming an EU member requires forming a country, enjoying national independence and gaining the approval of all the remaining 27 EU countries. Statements by Italy, Spain and others indicate an unwillingness to accept Scotland as an EU member, since this would increase the risks that Italy might split up or that Catalonia and the Basque region would achieve independence. Such developments are associated with risks that most EU countries would like to avoid. It would thus be time-consuming for Scotland to become a member of the EU. The alternative of creating a fast-track by letting Scotland simply "take over" the UK's membership does not appear especially likely either.

The EU needs to adopt new strategies

The outcome of the Brexit referendum has created the EU's worst political crisis to date. **The extra EU summit** in mid-September will be an attempt to find a common platform to address the major challenges the EU must deal with. As for the coming negotiations with the UK, the other EU countries face a difficult balancing act. All the parties have a fundamental interest in retaining a good working relationship and avoiding trade disruptions. On the other hand, there may be concerns that the UK's actions could be too attractive an example to other EU countries. One central issue is whether the EU can accept the UK strategy of **retaining free trade in goods and services but introducing restrictions on labour mobility**.

Refugee crises and terrorist threats also urgently require constructive cooperation, but the governments of many EU countries have limited manoeuvring room because of domestic public opinion and the current wave of success for EU- and immigration-critical parties. In the background are the threats posed by long-term economic problems: weak growth, low capital spending levels and ageing populations. In this environment, the EU's process for finding a new identity is not easy. The French presidential election (April-May) and Germany's federal parliamentary election in the autumn of 2017 also risk paralysing decision-making at a time when the UK's negotiations with the EU will be fully under way.

Areas in which the EU has good potential to deepen cooperation among its members are security and defence policies, in light of increased geopolitical uncertainty and heightened terrorism risks. In the economic policy field, most indications are that the EU's June 2015 roadmap to create a full-fledged economic and monetary union will be shelved. In choosing between greater integration and "more EU", on the one hand, and greater national self-determination, on the other hand, the EU establishment must become more responsive to public opinion in member countries. In practice, this means that **the euro currency project will remain without a completed infrastructure that would give the euro zone long-term stability**. Looking ahead, the conclusion that is starting to become discernible is that the euro needs a strong EU but the EU does not need the euro in order to evolve into a stronger union.

Key events to watch during autumn 2016

Date	Events
Sep 4-5	G20 summit: Heads of state and government
Sep 5	New referendum debate, UK Parliament
Sep 15	Bank of England – interest rate announcement
Sep 16	Extra EU summit on Brexit, the EU's future etc
Oct 2	Hungarian referendum: EU refugee quotas
Oct 2	Austrian presidential election
Oct 2-5	UK Conservative Party Conference
Oct 15-16	UK Supreme Court to hear Brexit challenge
October	Italian referendum on the constitution

Source: SEB

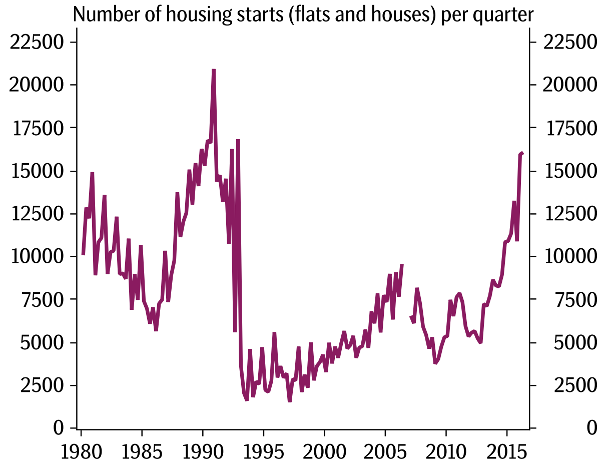
Continued strong growth but major political challenges

- **Housing construction reaching record levels**
- **Slower growth but stronger labour market**
- **High resource utilisation but low inflation**
- **Key rate hikes will start in autumn 2017**
- **Major political challenges around the corner**

The Swedish economic growth outlook remains good. The most important underlying forces are sharply increasing residential investments and public sector consumption driven by resettlement of the many refugees who arrived in 2015. Due to weak exports during the first half, however, we have adjusted our 2016 GDP growth forecast to 3.7 per cent, down from 4.0 per cent in May. **Growth will gradually slow to 2.8 per cent in 2017 and 2.3 per cent in 2018**. Public sector consumption will level out as refugee resettlement decreases, while the rate of increase in housing construction will slow.

Housing starts on their way to record levels

Number of housing starts (flats and houses) per quarter



Source: Statistics Sweden, SEB

Despite some growth disappointments, labour market performance has been stronger than expected. The job upturn is accelerating, while the unemployment downturn is more and more evident. This is reflected in an increasingly tight resource situation and means that **supply-side restrictions will also contribute to a deceleration in GDP growth**. On the other hand, there is relatively good potential for recruiting labour from other European countries, which – along with low global inflation pressure – will hold down inflation. Because of the slow upturn, CPIF (CPI minus interest rate changes) will not reach the Riksbank's two per cent target during our forecast period. Yet we believe that **Riksbank will initiate cautious key interest rate hikes next autumn**. The repo rate will still be as low as 0.25 per cent at the end of 2018.

Although the number of new refugee arrivals has now declined sharply, integration issues will dominate economic policy in the next couple of years. The many political challenges that await as asylum seekers who have received residence permits are absorbed into the educational system and the labour and housing markets are now starting to become evident. Political tensions between the political blocs are likely to intensify as pressure for decisive action increases. Although government crises cannot be ruled out during the next couple of years, our main scenario is still that the ruling red-green government will muddle through until the September 2018 election. The opposition Alliance parties, dominated by the Moderates, are not especially eager to take over before the election, but they will not be inclined to reach major agreements between the blocs. Without political breakthroughs, we will probably see higher medium-term unemployment plus major strains on public core activities and eventually government finances.

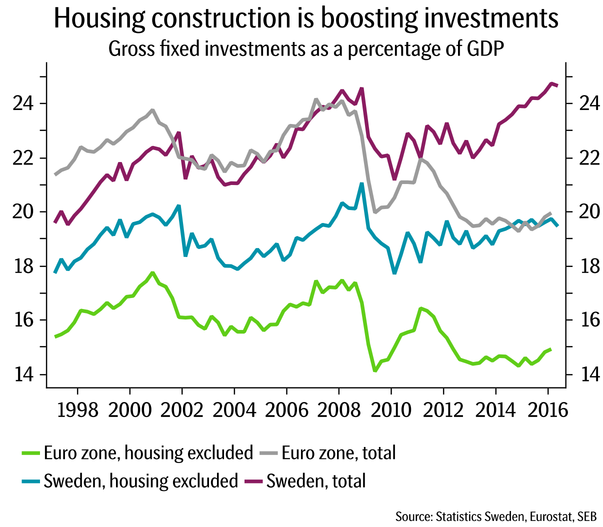
Service exports are rebounding

Industrial production has been weak over the past two years. A slight improvement is now on the way as merchandise export growth rebounds to its historical average, but more slowly than normal in recovery phases. This reflects, among other things, the anaemic growth of world trade. Exports will continue to benefit from the weak krona, although this effect will gradually fade as the currency recovers. Despite a modest upturn in merchandise exports, total exports rose 6 per cent in 2015, **thanks to a 12 per cent surge in service exports**. This is on par with records set during the late-1990s IT boom. Although 2015 stands out, service exports rose sharply over a long period, but plunged early in 2016. Our interpretation is that this was a response to an exaggerated upturn late in 2015 and that service exports will continue to expand fast. The significant upward revision of an initially similar trend in Germany, when second quarter results were published, supports this conclusion. Our forecast is that **total exports will increase by 3.6 and 4.6 respectively in 2016 and 2017**.

Housing construction boosting investments

Although industrial investments are now slowing, there are many indications that total **capital spending will continue to increase at a healthy pace**. The main driver is **sharply higher housing construction**, with housing starts during the first half of 2016 on a par with the construction boom around 1990. Despite political deadlock at the national level, strong demand is now persuading many municipally owned housing companies to speed up construction activities, with more land being made available for housing. We expect housing investments to climb by nearly 20 per cent in both 2016 and 2017, **contributing nearly one percentage point to yearly GDP growth** and a full 4 percentage points to the total upturn in capital spending. This building boom is logical in light of population growth and housing shortages, but it increases the risk of a sharper price downturn once the housing market eventually cools off. By the end of 2018, we expect housing investments to reach 7 per cent of GDP. This is on par with pre-crisis peaks in countries like Denmark and the Netherlands, but still well below the levels reached in Spain and Ireland.

To an increasing extent, public sector investments will also contribute to the capital spending upturn, since refugee resettlement will also create a need for expansion and new investments in fields like education and health care. Overall fixed investments as a share of GDP have climbed to their highest level since 1990. Because this upturn is occurring at a time when the current account surplus totals more than 5 per cent of GDP, gross savings (investments + current account surplus) are record-high. In this respect, the situation **differs radically from the early 1990s, when the construction boom helped create large current account deficits**.



Public consumption strongest since 1991

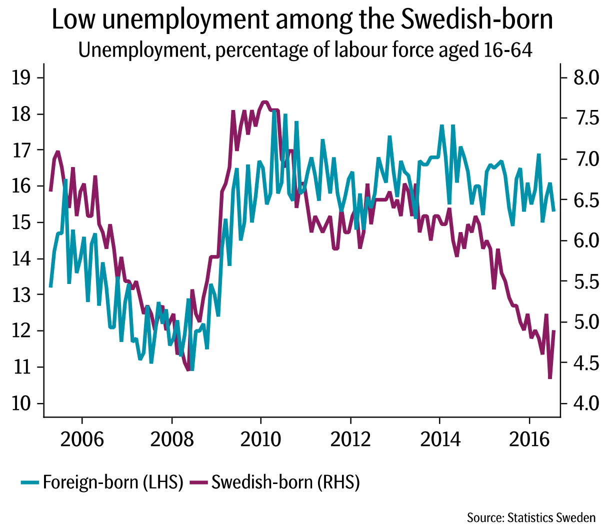
Our forecast of 4 per cent growth in public consumption this year is well on its way to materialising. Although new refugee arrivals have decreased sharply, municipal governments will remain under pressure for a long time. **The upturn will continue in 2017, though somewhat more slowly**. In 2018 there will be a clearer levelling out as the Swedish Migration Agency's direct spending for refugee resettlement decreases.

The upturn in **household consumption has gradually accelerated recently**, and the growth rate during the past three quarters averages more than three per cent: the highest level since 2010. Rising incomes, driven by increasing real wages and robust job growth, suggest a continued strong upturn in consumption in 2017 and 2018. Because households feel uncertain about the sustainability of public social insurance and services and the future housing situation, however, **saving remains high**. We thus believe that **consumption growth will slow from 3.1 per cent in 2016 to 2.8 per cent next year and 2.5 per cent in 2018**.

After increasing by 15 per cent in 2015, home prices stabilised this past spring and summer and even fell slightly according to some indices. This deceleration coincides with the introduction in early June of the long-planned principal repayment requirement on home mortgage loans. It is too soon to determine how big an impact the new rules will have, and the inflated home price level implies latent downside risks. Yet the most likely explanation is that the summer slowdown was largely a reaction to earlier accelerated home purchases to avoid being affected by the new rules. **Due to major housing shortages and low interest rates, prices will remain resilient**. We thus believe that the housing market will stabilise this autumn, which is supported by a slight recovery in the SEB housing price indicator in August. However, we foresee increasing downside risks to our forecast of a 5-10 per cent price upturn in 2016. After that, we foresee a levelling out of home prices.

Clear downturn in unemployment

Despite marginally weaker GDP growth, the labour market has performed unexpectedly well so far this year. Job growth is approaching 2 per cent year-on-year, and the downturn in unemployment has intensified. Short-term indicators suggest that this strength will persist during the second half, when the number of public sector employees will increase even faster. **Our forecast implies that unemployment will continue downward to 6.0 per cent in early 2018**, then rebound as the influx of new arrivals into the labour market begins in increase in volume while GDP growth is slowing.

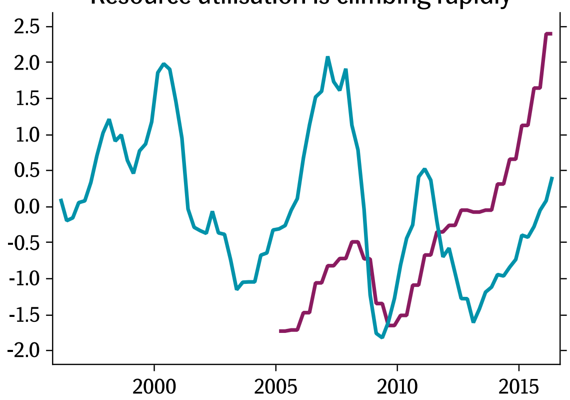


The downturn in unemployment is driven entirely by Swedish-born people, whose jobless rate has now fallen to 4 per cent. For the foreign-born, unemployment is stuck at a level of around 16 per cent, despite increasing employment. Of those enrolled as job seekers at the Swedish Employment Service, the share of foreign-born people has risen rapidly to 42 per cent for people born outside Europe, which underscores the major political challenges. There are big ideological differences between the political blocs when it comes to integration policy. The minority Social Democratic-Green Party government will probably launch a combination of educational and training programmes and subsidised jobs in its budget bills for 2017 and 2018. Although the opposition would like to emphasise other measures, it is unlikely that these proposals provide sufficient reason to provoke a government crisis.

Little slack, but low wage pressure

Although unemployment is still relatively high, more and more companies are signalling that they are having difficulty finding suitable job applicants. This is reflected in the Riksbank's resource utilisation indicator, which has climbed faster and faster so far this year. In the business sector, it is now at about the same level as during the strong recovery following the 2011 financial crisis, but well below its peaks in 2000 and 2007. However, the shortages reported by public sector employers are now at their highest level since measurements were introduced in 2005. **The tighter resource situation increases the probability that pay and inflation will eventually rise**, but this effect is likely to be delayed somewhat. Experience from other countries suggests that the association between resource situation and wage pressure has weakened. Swedish companies probably also have good potential to recruit employees from nearby countries that have significantly weaker labour market situations.

Resource utilisation is climbing rapidly



— Riksbank resource utilisation indicator (LHS)
— Percentage of public sector entities with a labour shortage (RHS)

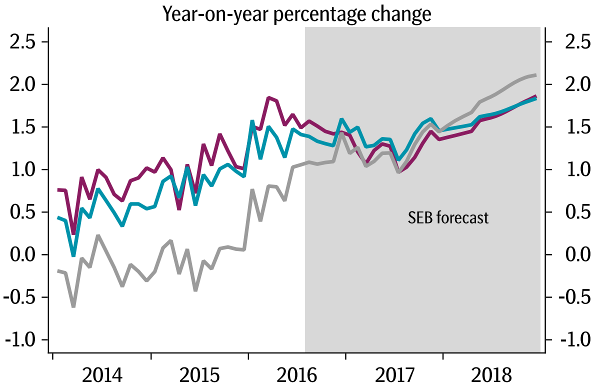
Source: Swedish Employment Service, the Riksbank

The weakness of this association is confirmed by pay increases this past year, which have provided downside surprises. Preliminary estimates indicate a slowdown in pay hikes during the second quarter. This is partly because the collective wage agreements signed last spring have not yet fully impacted the statistics, but even adjusted for this, pay hikes have been unexpectedly low. **We have adjusted our forecast of average 2016 pay hikes from 2.7 to 2.5 per cent**.

Although the ink has hardly dried on this year's labour agreements, the next wage round is fast approaching. The Trade Union Confederation (LO) is again likely to have difficulty achieving any formal coordination among its member unions. Given the success of the Municipal Workers in single-handedly negotiating a special pay package for assistant nurses in its three-year pact, one contentious issue has disappeared from the agenda. But LO unions outside the manufacturing sector, led by construction and transport workers, are likely to try to achieve higher pay agreements than the customary industrial benchmark, emboldened by the strong labour market. The experience of last year, however, shows that it is difficult for individual unions to pull this off. Although the 2017 wage round may be messy, we expect two-year collective agreements with yearly pay hikes of 2.4 per cent or somewhat more than this year's 2.2 per cent. **We expect total pay hikes to accelerate from 2.5 per cent in 2016 to 2.9 per cent in 2017 and 3.1 per cent in 2018**.

Higher inflation, but below target

Year-on-year percentage change



— CPI — CPIF
— CPIF, excluding energy, food, alcoholic beverages and tobacco

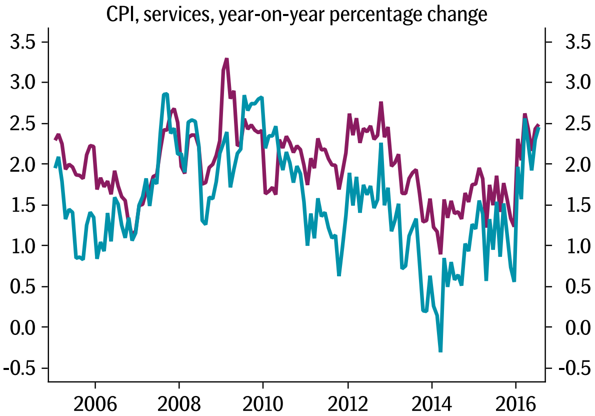
Souirce: Statistics Sweden, SEB

Inflation will remain below target

After climbing sharply early this year, CPIF inflation stabilised between 1.0 and 1.5 per cent, but some interesting underlying trends are concealed behind this movement. Core inflation measured as CPIF excluding energy gradually slowed this past spring and summer from a peak of 1.9 per cent in March to about 1.5 per cent. The main driver was the diminishing effect of an earlier krona depreciation, which mainly affected goods inflation. The slightly falling trend for CPIF excluding energy is expected to continue during the coming year. **Total CPIF will instead flat-line, since base effects from earlier oil price declines will offset the decline in core inflation**.

Higher domestically generated inflation

CPI, services, year-on-year percentage change



— Services excluding housing — All services

Source: Statistics Sweden

One central issue over the next couple of years will be how much the tighter resource situation will affect inflation. Although inflation due to pay hikes will occur after a time lag, we can already see that **prices of services have climbed greatly so far during 2016**. This is partly due to higher indirect taxes (lower renovation and repair deductions) and higher public sector fees (congestion taxes and health care co-pays), but other service prices have also climbed faster. Although our forecast implies that service inflation will slow early in 2017, due among other things to base effects from indirect taxes and fees, service inflation will remain significantly higher than in 2015. In 2018 we expect service inflation to accelerate further as wage and salary hikes accelerate, but because of weak international goods prices, CPIF inflation will remain below the 2 per cent target even at the close of our forecast period.

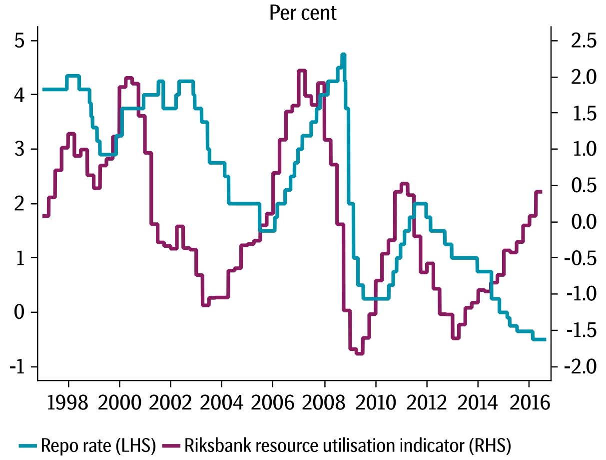
CPI inflation will approach CPIF during the coming year due to base effects for home mortgage interest expenses. When the Riksbank gradually begins raising its key interest rate towards the end of next year, CPI inflation will reach 2.0 per cent.

Extended QE programme, but 2017 rate hike

Our view this past year has been that the strong economic situation will help the Riksbank gradually retire from its aggressive stimulus strategy. Although Swedish growth, resource utilisation and inflation have largely followed – and in some respects exceeded – our expectations, the prospects of near-term rate hikes have decreased. **One reason is that international monetary policy seems likely to become more expansionary**, among other things because of the Brexit vote. Both we and the market have lowered our expectations about the Fed, while the ECB and Bank of England are expected to add to their expansionary measures this autumn. Nor has the Riksbank clearly signalled so far that Sweden's generally strong economic situation – combined with the acceleration in borrowing – will be factored into its monetary policy to any great extent.

Resource utilisation suggests higher key rates

Per cent



Source: The Riksbank

Yet a speech in August by Deputy Governor Kerstin af Jochnick signals that this autumn (probably as early as September), the Riksbank will publish studies about changing target variables and introducing a tolerance range around its two per cent target. Her speech also hinted that the Riksbank is considering changes in methodology for calculating its repo rate path. These measures are among proposals presented by the King-Goodfriend (K-G) report early in 2016. Although these changes will not affect our monetary policy forecast in the short term, it is clear that that K-G report is increasingly influencing the Riksbank's thinking. This increase the probability that the Riksbank will eventually also follow the advice of the K-G report to be more tolerant of divergences from its inflation target and focus less on short-term exchange rate movements.

Because we expect the ECB to announce an extension of its QE programme this autumn, and given the Riksbank Executive Board's continued ambition to keep the value of the krona down, we foresee an overwhelming likelihood that **the Riksbank will extend the bond purchase programme until mid-2017**. However, its volume will be reduced to SEK 30 billion from SEK 45 billion during the second half of 2016.

Looking a bit further ahead, we believe that the more strained resource situation will assume a larger role. Several Executive Board members have also hinted that it suffices if inflation approaches the Riksbank's target and that exact target fulfilment is not required before cautiously starting to tighten monetary policy. **We believe that the bank will raise its key rate in October 2017**. This is roughly in line with the rate path in its latest monetary policy report in July. According to our forecast, by then the Fed will have hiked its key rate two more times, making it easier for the Executive Board to shift its monetary policy even though inflation is expected to be lower than its target on that date. **In 2018 we expect two more hikes, bringing the repo rate to 0.25 per cent** by year-end.

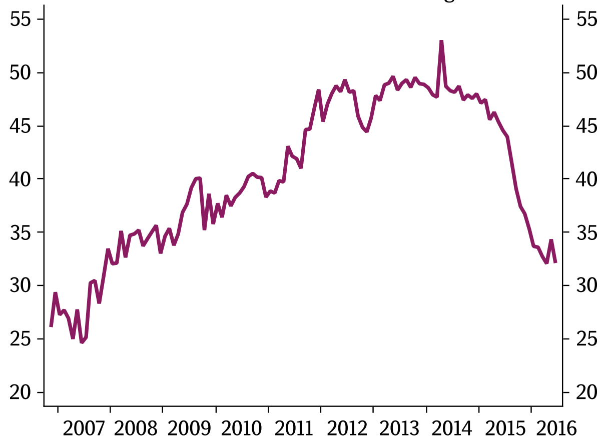
Risk of liquidity problems further ahead

In line with the international trend, Swedish bond yields have been pushed down significantly this summer, but in Sweden the downturn has been bigger than in nearly all other countries, with the UK as an important exception. The spread against Germany on 10-year government bond yields has shrunk from more than 50 basis points to about 10. Expectations of gentler Riksbank policy due to the Brexit vote have played a role, but this movement began before the referendum. Our interpretation is that the Riksbank's bond purchases are starting to exert increasing downward pressure on yields. **One sign of this is that foreign market players have now stopped lowering their holdings**, after a period when they sold bonds on about the same scale as the Riksbank's holdings increased. We are now seeing the bank being forced to pay more and more to carry out its reverse auctions, thus squeezing yields. The National Debt Office announced in June that due to stronger government finances, it has decide to reduce issue volumes. This intensified the yield movement. Although the Riksbank has slowed the pace of its bond purchases, we believe that downward pressure on yields will persist in the second half of 2016 and that the yield spread against Germany will fall to zero during the coming months.

A bit further ahead, however, we expect bond yield spreads against Germany to widen. The most important reason is our forecast that during the second half of 2017 the Riksbank will decouple its policy from the ECB and cautiously begin raising its key interest rate. There is a risk of rather large rate hikes initially, **since liquidity in the Swedish bond market will be very depressed** in a market where the Riksbank owns more than 35 per cent of an already small bond supply in relation to GDP. Because strong government finances will force the National Debt Office to decrease its issue volumes further next autumn, the situation may become worse and there is a risk of increased volatility in the Swedish bond market.

Stabilisation of foreign holdings, government bonds

Per cent of total volume outstanding



Source: Statistics Sweden

Public finances are continuing to improve

The strong economic situation is now clearly benefiting public sector finances. The expansion is being driven by tax-heavy demand components such as household consumption and housing construction. Meanwhile it is also employment-intensive. As a result, the ratio between GDP growth and net lending is currently very favourable. Public finances improved by a full 1.6 per cent of GDP in 2015 compared to 2014 and achieved balance for the first time since 2010.

Public finances

Per cent of GDP

	2015	2016	2017	2018
Net lending	0.0	0.3	0.2	-0.1
Borrowing req., SEK bn	33	-36	-21	0
Gen. gov't gross debt	43.4	40.7	38.8	38.0

Source: Statistics Sweden, SEB

During 2016-2018, various factors will pull in different directions. Continued good growth, though gradually slowing, will enable revenue to keep rising at a healthy pace, which is clearly reflected in monthly statistics from the National Debt Office. Meanwhile there is upward pressure on various public expenditure items. Although new refugee arrivals have decreased sharply, central and local government spending for migration, integration, social services, health care, education and training etc. will remain high for a long time and lower immigration will not lead to lower spending. Additional resources will have to be appropriated for education, training and integration, as confirmed by the priority areas unveiled after the government's internal budget meeting in Harpsund in late August. Our overall assessment is that revenue will increase at such a good pace that **public sector net lending will continue improving to 0.3 per cent of GDP in 2016** and then remain at about that level in 2017. General government gross debt will continue falling to 38 per cent of GDP in 2018. The new surplus target level will be reached this year but net lending will in 2018 deteriorate and debt will still be somewhat too high. **This will limit room for unfunded reforms.** We believe that the 0.33 per cent surplus target, together with the 35 per cent debt anchor, will be a tougher restriction than the previous one per cent target.

Adjustment of the surplus target starting in 2019

After a review of the official surplus target in force since the mid-1990s, last summer all parliamentary parties except the right-wing populist Sweden Democrats approved a number of adjustments that will go into effect in 2019: 1) the surplus target will be lowered to 0.33 per cent of GDP; 2) Sweden will introduce a debt anchor: 35 per cent of GDP; 3) there will be tougher monitoring of the surplus target and any divergence from the debt target, including evaluations by the Swedish Fiscal Policy Council; 4) surplus target and debt anchor levels will be reassessed every second parliamentary term of office.

Tricky political choices

This autumn's budget bill will focus on major social challenges such as integration of immigrants into Swedish society, employment and housing construction. Various other areas that are highly topical include increasing sick leaves and the need to strengthen the police and defence systems. Local government finances have improved in recent years due to central government grants and rapidly rising tax revenue. Despite strains on local government operations, we thus do not believe any new extra central government grants will be considered in addition to the 10 billion already promised.

Due to spending pressure from migration and housing market imbalances, fiscal policy will be rather expansionary in 2017-2018. The recent agreement between the two blocs may increase the political price of not taking the budget targets seriously, but we believe the government is prepared to pay that price instead of enacting large tax hikes that give the Alliance an opportunity to make tax policy a main issue in the 2018 election campaign. If there are no shifts in public opinion, it is increasingly likely that the government will try to show even greater initiative by presenting a more active political agenda and an even more expansionary policy in the two budget bills it will submit in 2017. **More expansionary, leftist policies may boost political tensions**, but the closer we get to the 2018 election, the less motivation the Alliance parties will feel to try to take over power. Thus our main scenario is that the government will succeed in manoeuvring through its full term of office, ending late in 2018.

Theme: Undervalued krona in Riksbank's grip

- **Aggressive Riksbank policy forces market to accept undervalued krona**
- **Record-low interest rates weaken market players' incentives to hedge and buy SEK**
- **Neutral positioning – when Riksbank shifts strategy, EUR/SEK rate will drop below 9.20**

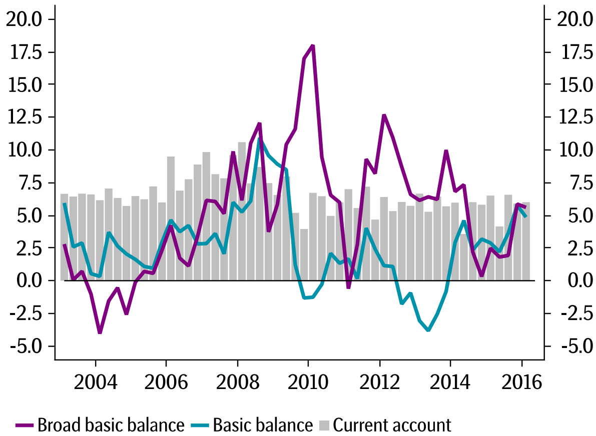
The renewed Swedish krona depreciation of recent months has created attractive buy levels from a long-term perspective, but the foreign exchange (FX) market is still missing the triggering factor that will enable the krona to take back lost ground. This theme article consists of two parts: 1) an analysis of the rather dramatic krona-related developments of the past 3-4 years, with the Riksbank playing a key role, and 2) a forward-looking analysis that is based on the SEB FX Scorecard and that structures the krona's potential over the next 1-2 years.

Large current account surpluses not enough

Sweden's large, stable current account surpluses (6-8 per cent of GDP) are regarded by many observers as one main reason why the krona seems undervalued. Although the IMF has pointed out that national saving is probably overestimated, since the statistics include an unexplained residual item that often totals about 50 per cent of the current account surplus, the organisation believes the krona is undervalued. Meanwhile a current account surplus in itself is not enough to push the krona higher. **The export flows that are generated today are not large enough to drive the exchange rate to any great extent.** The role of Sweden's external balance is instead to be an important background factor in analysing valuations.

Current account and portfolio flows

Per cent of GDP



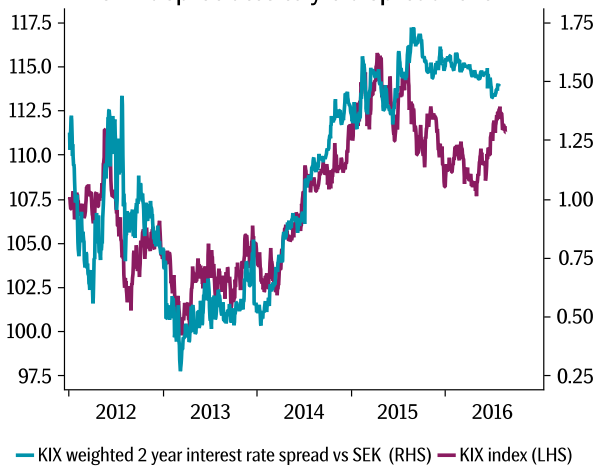
Source: OECD

For nearly 20 years, Sweden's current account surplus has been stable at 4-8 per cent of GDP, while the krona has fluctuated within a broad range. This pattern ended in 2012-13 when Swedish macroeconomic fundamentals (growth trend, budget and current account balances) were impressive. Meanwhile, Swedish economic policy looked successful in a Europe shaken by the euro crisis. In this environment, the savings surplus was a signal to the world that Sweden was a stable country to invest in. It also gave the krona "safe haven" status. The krona appreciated, due to capital flows by both long-term portfolio managers and more short-term speculative investors. This type of flows often plays a role in the krona's movements, since it is significantly larger than trade-driven capital flows and also tends to move in the same direction.

The Riksbank's increasing credibility

Since the Riksbank changed its strategy in the summer of 2014 and began actively using the currency as a means of achieving its inflation target, various phases in the krona's performance are visible. The SEK depreciated until February 2015 in line with the Riksbank's intentions. The weak krona became attractive in an environment where Sweden's economic growth outlook seemed far better than that of other countries. Economic drivers such as expansionary economic policies, record-high housing construction and rising private consumption looked robust, and second half 2015 GDP growth was about 5-6 per cent. Krona buyers wanted to believe that these positive prospects would **sooner or later undermine the Riksbank's desire to emulate the ECB's monetary expansion.**

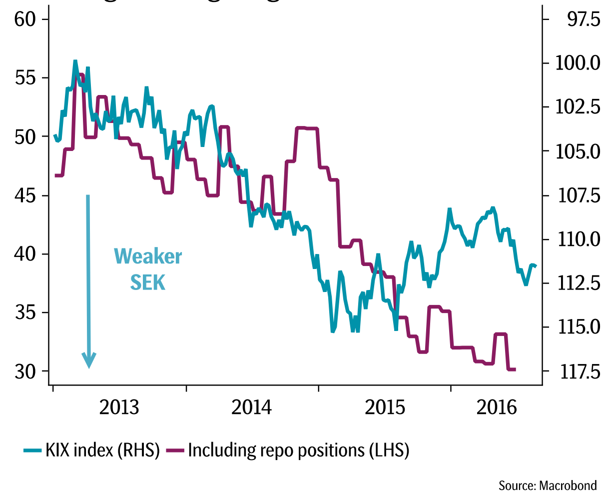
SEK depreciates to yield spread level



Source: Macrobond, Bloomberg

During 2016 the Riksbank has demonstrated greater determination than expected. During the spring and summer, foreign investors in particular have unwound their krona positions and assets. Our flow indicators for trading by foreign institutions show net SEK sales during 2016. After the krona depreciation that followed the Riksbank's April decision to extend its QE programme to the end of 2016, the krona has traded more in line with what relative monetary policy directions stipulate (see above chart). The gap that began to open in mid-2015 has thus nearly closed. One conclusion we can draw is that **the Riksbank has gained credibility for its implicit exchange rate target**.

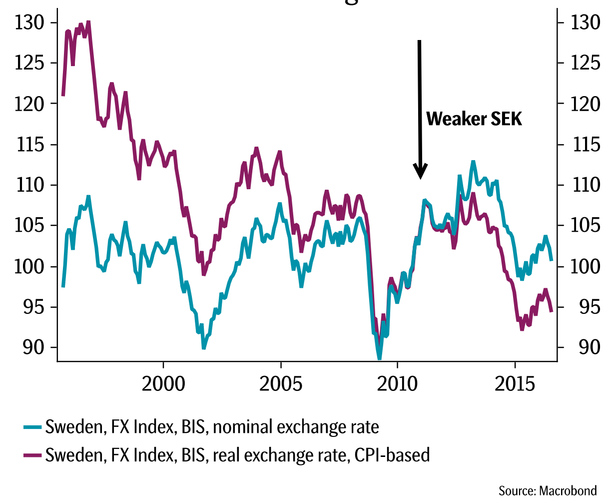
Foreign holdings of government bonds and KIX



Unconventional monetary policy has **weakened interest in the krona as a "safe haven" currency**. This is illustrated by the decline in foreign ownership of outstanding Swedish government bonds from a 2014 peak of 50 per cent to just above 30 per cent today. As the Riksbank increases its ownership share by means of QE purchases, market liquidity risks being adversely affected as fewer sellers are available. This is a probable factor behind this summer's rapidly falling long-term yields in Sweden; the krona rarely thrives during periods of poorer liquidity.

SEB will publish *Currency Strategy* in early September. Our SEB FX Scorecards examine various currency performance drivers. This article focuses on four of these: **"Fundamentals"**, "**Valuation"**, **"Monetary policy"** and **"Flows"**.

Sweden: Trade-weighted krona



1. Fundamentals = still positive for SEK
Sweden's economy is performing strongly. Growth is higher than in most other developed economies, while central government finances stand up very well in an international comparison. Although global investors have unwound some of their positions in Swedish assets, the country's AAA rating is not threatened.

2. Valuation = still positive for SEK
The SEB FX Scorecard uses various metrics, with SEB's model and the deviation from the nominal trend in the trade-weighted exchange rate clearly showing an undervalued krona (about 5-10 per cent). A third metric – the real exchange rate – is more difficult to interpret, since over time the inflation-adjusted krona shows a falling trend that is not reasonable in a longer-term perspective (should be trendless). If the thesis **about the relative strength of Swedish fundamentals is correct, valuation will be an important reason why the krona will find more notable buyers again in 2017.**

3. Monetary policy = no SEK support
The Riksbank has achieved confidence in its monetary policy, and the FX market is meanwhile showing clear signs of liking "carry": currencies with low or negative interest rates become borrowing currencies and weaken in relation to high-interest currencies. Countries that can offer returns on securities will have strong currencies (which apply especially to emerging markets). This theme becomes particularly clear when market volatility is generally low and small currency movements are expected. **Since this environment will persist in the coming months, it will create a negative environment for SEK.**

4. Flows = positive for SEK in the long term
The Riksbank's record-low repo rate and QE programme have pushed the entire Swedish sovereign yield curve, except for the very longest bonds, into negative levels. Hedging a foreign currency exposure is costly in such an environment and implies that export firms may possibly hold off on hedging their export flows (buying SEK futures). Meanwhile foreign speculative investors have already drawn down their krona holdings to such low levels that the process should be over. Nor do we believe that reserve managers (central banks and sovereign wealth funds in oil-exporting countries, for example) are likely to continue selling Swedish government bonds at the same pace as previously. **This is positive for SEK in the long term.**

Conclusion: No krona appreciation soon
To summarise, let us note that the krona appreciated after the global financial crisis of 2008-2009. The combination of a euro crisis and strong Swedish fundamentals led to a sharp and justifiable krona upturn in 2012/2013. But the Riksbank has helped force the krona downward, in the pursuit of its inflation target. Despite risks in the Swedish economy, mainly connected to imbalances in the housing market and the strains from refugee resettlement, **Swedish fundamentals look significantly stronger than those in the euro zone. The trigger that will release SEK-positive flows will be monetary policy, when it finally becomes tighter than in other countries. The flows that may be generated at that time will justify an upswing for the krona and a stabilisation at 100 to 110 in KIX terms.** But as reported in the Sweden section of this *Nordic Outlook*, a shift of monetary policy will not occur in the near term. There is thus no potential for the EUR/SEK exchange rate to fall below 9.20. Further ahead, the Riksbank's motives for holding down the value of the krona will weaken, enabling the currency to return to its "equilibrium range" of 8.50-9.00 per euro.

More capital spending needed for complete recovery

- **GDP growth rebounded in early 2016**
- **Strong consumption, lagging investment**
- **Government to unveil 2025 fiscal plan**

Denmark's GDP growth rebounded from below zero in the fourth quarter of 2015 to a quarterly rate of 0.7 per cent in Q1 2016, and recent indicators point to continued decent growth over the summer. **This suggests that growth is on track to improve on 2015's paltry 1 per cent rate** as capital spending catches up with consumption, which is already increasing at a robust pace of more than 2 per cent.

Denmark's recovery has been unexpectedly slow. Private consumption has risen at an annualised 2 per cent rate for almost two years, but sluggish fixed investments and public consumption kept overall growth at just 1 per cent in 2015. Q1 data suggest that this was due to delays in spending, not cancellations. Still, the slump in the second half means **we only expect growth of 1.4 per cent in 2016, accelerating to 2.3 percent in 2017 and 2018** (a downgrade of 0.1 percentage points in 2016).

Private consumption remains the key growth driver and recent data suggest that the fundamental outlook continued to improve in the first half of 2016, although confidence has not yet recovered from last summer's decline. Employment growth reached 1.5 per cent in Q1, and real wages continue posting strong gains – aided by low CPI inflation and more recently also by stronger wage and salary gains. House prices have continued rising, and apartment prices are now clearly above their 2007 peak. Altogether, this suggests that **consumption growth will remain in the 2-2.5 per cent range**.

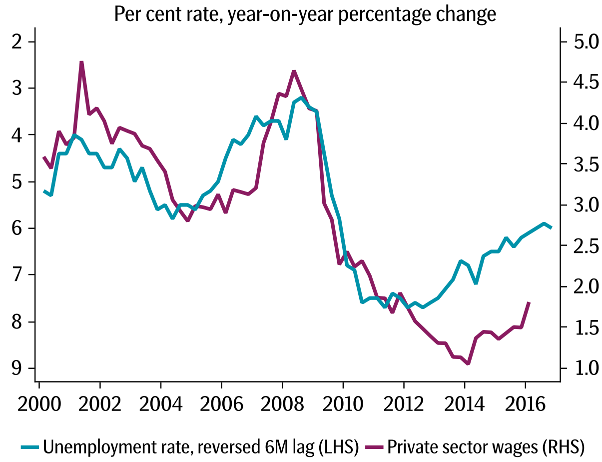
Fixed investment growth came in at 1 per cent in Q1 and remains conspicuously slow. However, Q3 2016 data show capacity utilisation rising to the highest level since the financial crisis, and this is likely to push business investment higher in the coming quarters. In construction, the puzzling gap between building permits and housing starts has not closed, but rising home prices should eventually lead to higher activity. We expect total **investment growth of 3.2 per cent in 2016 and more than 4 per cent in 2017 and 2018**.

Both export and import volumes were stagnant in 2015. Exports to the UK may weaken after the Brexit referendum, but we **expect both exports and imports to return to growth in 2016**. The current account surplus has come down to around 7 per cent of GDP but remains robust.

Inflation dynamics are starting to look interesting. CPI inflation fell at the start of the year and remains close to zero, but wage inflation is starting to pick up after failing to respond to declining unemployment for several years. At 1.8 per cent, private sector wage inflation is well below its level during periods of similar unemployment in the past, but at least the direction is there. In the near term, this is unlikely to have a major effect on core CPI numbers, but next year we expect to see a gradual rise in core inflation. Headline CPI will accelerate from a marginally lower 0.4 per cent this year to 1.2 per cent next year and 1.5 per cent in 2018.

Wages begin to respond to low unemployment

Per cent rate, year-on-year percentage change



Source: Macrobond, SEB

Denmark's centre-right minority government is planning a new fiscal plan running until 2025 to replace its old 2020 plan. Orthodoxy is to be expected, and early hints suggest it will include another round of cuts in taxes, spending and transfers, based on a conservative assessment of fiscal policy constraints. The Social Democrats have invited the right-wing populist Danish People's Party to join forces to block a cut in the top income tax rate, but the latter will probably stick with the government. **Fiscal policy is likely to stay tight.**

Denmark's krone-euro peg briefly came under pressure around the time of the Brexit referendum, and the central bank was forced to intervene to keep the EUR/DKK exchange rate above 7.435, but the past month has seen this pressure ease in line with the general trend of worries about political risks.

The tide is turning

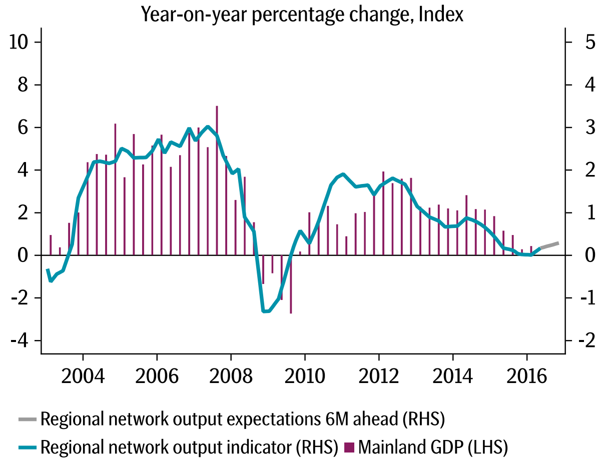
- **Indicators suggest improving momentum**
- **Slow consumption growth partly offset by rising non-oil investments**
- **Norges Bank near the rate trough**

The Norwegian economy has been heavily affected by extensive cutbacks in the petroleum sector, resulting in slower growth over the past two years. The downturn has been asymmetric, with oil-related counties and sectors being hit the hardest. Fears of even more severe secondary effects have lingered, but various sentiment indicators and real economic data have recently supported our projection from the May issue of *Nordic Outlook* that **the low point in terms of economic momentum was passed last winter**.

The fallout has been mitigated by lax monetary policy including a sharply weaker exchange rate and a more expansionary fiscal policy. In this regard, it is worth noting that the step-up in fiscal stimulus worth 1.1 percentage points of mainland GDP in 2016 should be felt in the second half of the year.

Brighter growth prospects

Year-on-year percentage change, Index



Source: Statistics Norway, Norges Bank

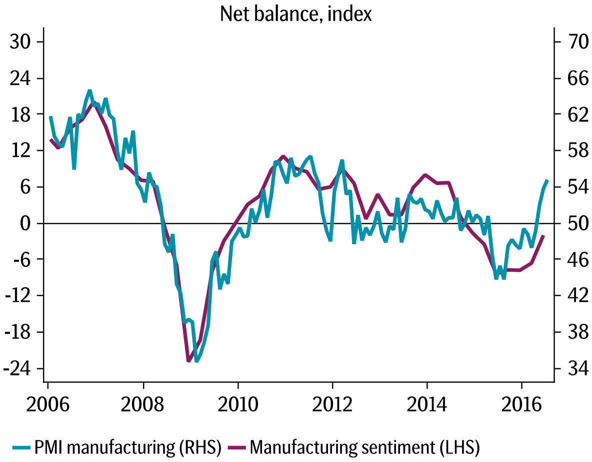
The recovery will be modest in the light of a continued negative contribution from falling petroleum investments and private consumption being squeezed by weak real disposable income growth. Yet mainland GDP – excluding petroleum and shipping – should benefit from healthy non-oil domestic demand as mainland capital spending gains further traction. We have **lowered our growth forecast for mainland GDP to 0.9 per cent in 2016 and 1.8 per cent for 2017** (from 1.1 and 2.0 per cent respectively in May's *Nordic Outlook*), accelerating further to 2.1 per cent in 2018. **Total GDP should be up 1.2 per cent in 2016 and 1.4 per cent in 2017**.

Drag from plunging oil investments fading

Capital spending in the petroleum sector will remain a drag on the Norwegian economy. As measured by the national accounts (i.e. adjusted for price changes for goods and services, rig rates etc.), such spending plummeted 20 per cent in the year to the first quarter, which by itself subtracted almost a full percentage point from the annual change in GDP. Operators on the Norwegian continental shelf continue to slash investment plans, though the decline should be much smaller next year and the negative demand impulses to the rest of the economy should wane accordingly. We expect **capital spending in the petroleum sector to decline by 14.7 per cent in 2016**, and a **less steep 6.5 per cent next year**. As several new projects, including the large Johan Castberg field, will probably be approved late in 2017, petroleum investments **should turn positive in 2018**.

Rising business sentiment

Net balance, index



Source: Statistics Norway

The manufacturing sector (excluding energy and mining), which has been hit the hardest, seems now past its worst period. Overlooking an exaggerated drop in production in June, short-term momentum has improved – as suggested by various sentiment indicators. Manufacturing output should continue to recover, albeit from weak levels, contributing positively to mainland GDP growth from the second half of the year (but keep in mind that it only makes up some 10 per cent of gross value added excluding oil, gas and shipping).

High inflation squeezing spending

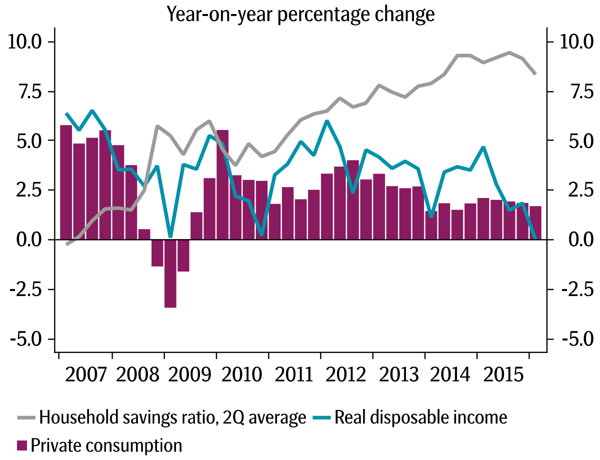
We have previously singled out private consumption – not oil – as the main downside risk to overall growth in 2016.

Momentum in private consumption has indeed slowed but only modestly so, since trend-like spending on services has made up for sluggish goods consumption. The 1.7 per cent year-on-year growth rate in Q1 for overall private consumption was well above what depressed sentiment would suggest.

While the benchmark quarterly confidence survey improved in the third quarter from weak levels, uncertainty still lingers on household fundamentals: First, households' purchasing power is being squeezed by rising prices, since overall CPI inflation averaged 3.5 per cent in the first half of the year and was thus more than a percentage point above the 2015 average of 2.2 per cent. At the same time, wage growth should be slightly less in 2016. Second, employment growth has slowed and is trailing last year's modest gain of 0.5 per cent on the Labour Force Survey (LFS) metric. Combined, higher inflation and slower job growth have been instrumental in stalling growth in real household disposable income over the first half of the year.

High inflation squeezes real income

Year-on-year percentage change



Source: Statistics Norway

The high savings ratio (up more than 3 percentage points in three years to 9.1 percent in 2015) should provide some cushion. Moreover, household disposable income should receive some support ahead from the step-up in fiscal stimulus. **We have nudged our 2016 consumer spending forecast lower to 1.6 per cent**. In 2017 and 2018, we expect the same two factors to become more supportive as inflation eases and employment picks up in tandem with reaccelerating economic momentum. We expect annual averages of 2.0 and 2.5 per cent in 2017 and 2018, respectively.

Labour market surprisingly resilient

Labour market indicators have been unexpectedly benign in the first half of the year. This stabilisation adds to other evidence suggesting that risks of more severe secondary effects from the oil-related downturn have eased. Registered unemployment declined in the first six months of 2016, although developments remain divergent between petroleum-related counties and the rest of Norway. The largest cutbacks in the petroleum sector are likely behind us, but rising temporary layoffs at the start of the year will gradually affect the jobless rate. Unemployment, including people enrolled in various labour market programmes, should thus creep higher in the second half of the year from 3.7 per cent in July. The rise in unemployment according to the LFS metric has slowed, since the labour force has shrunk simultaneously with slower employment growth. We are maintaining our forecasts for **LFS unemployment of 4.8 per cent in 2016 and 2017**.

Inflation downturn has been delayed

Norwegian inflation has continued to post large upside surprises, with CPI-ATE (excluding taxes and energy) averaging 3.3 per cent so far this year – 0.6 percentage points above the average in 2015. Recent data suggest more upward pressure on imported goods, with the year-on-year change currently running at 4.6 per cent. The long period of a weakening trend for the krone seems to be affecting long-term exchange rate expectations, thereby changing many companies' pricing behaviour. The impact of the exchange rate is thus turning out to be significantly larger than indicated by historical correlations. Eventually goods inflation should come down, and low wages and service prices will push the inflation rate below Norges Bank's target. We have **lifted our forecast for CPI-ATE to 3.3 per cent in 2016 but still expect slower core inflation starting next year, averaging 2.8 per cent in 2017 and 2.1 per cent in 2018.** Overall CPI should average 3.7 per cent this year before slowing in 2017 and 2018.

Norges Bank moving to neutral

High inflation has not swayed Norges Bank, which has maintained a growth-oriented policy. The key rate has thus been cut to a record-low 0.50 per cent and the central bank has committed to lowering it further this autumn. However, such a move is uncertain given waning downside risks to growth as portended in rising sentiment indicators. Moreover, there are growing concerns about financial instability, as home prices in particular are rising much more than projected by Norges Bank. The risk of a rapid, speculation-driven krone appreciation nonetheless renders a cautious rate outlook. A final reduction to 0.25 per cent in September is thus still likely, while the **first rate hike is not expected until June 2018.**

The NOK exchange rate will benefit from a more neutral monetary policy stance by Norges Bank and improving growth momentum. With the krone still closely tied to oil prices, our oil price forecast implies a positive environment for the krone. Its valuation remains attractive, although we expect Norges Bank's currency focus to prevent the EUR/NOK exchange rate from reaching our estimated long-term fair value level of 8.35 anytime soon. We expect **the EUR/NOK rate to reach 9.20 and 8.90 by the end of 2016 and 2017, respectively**.

Norwegian government bonds (NGBs) trade with a large discount to their German peers. Normally there is a high degree of FX-related positioning in NGBs, suggesting that a gradually stronger krone next year will make them more attractive. With yield-seeking demand expected to increase, the market should be able to digest upcoming supply in coming years. We thus expect the 10-year yield spread against Germany to **tighten from around 115 bps to 70 bps by the end of 2017** for a yield of 1.00 per cent. The yield spread will stabilise around 80 bps in late 2018 when Norges Bank cautiously starts raising rates.

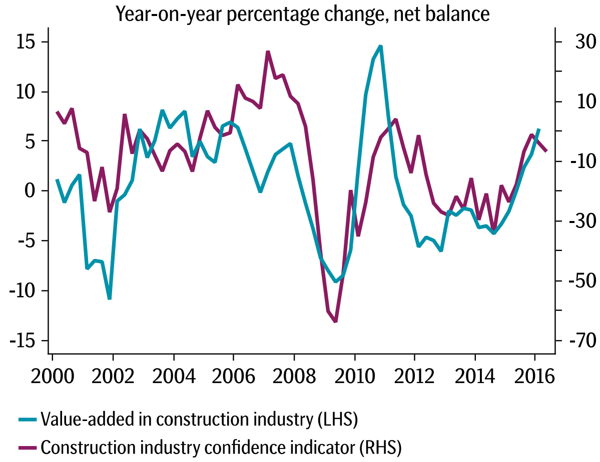
Weak growth, but small steps in the right direction

- **Indicators showing some improvement**
- **Consumption the most important driver**
- **Construction investments are accelerating**
- **Broad agreement to boost competitiveness**

Finland is continuing to struggle against economic headwinds, although the worst seems to be over. After two straight quarters of positive growth, something that had not happened since 2013, the labour market is now improving and consumer confidence has rebounded. Construction activity also appears somewhat brighter, although overall capital spending remains weak. Manufacturing and exports are still sputtering but will improve during 2017-2018. The recent pact between the government, employers and unions may eventually boost Finland's competitiveness and growth, but near-term fiscal belt-tightening will hamper growth. Overall, **we expect GDP to increase by 0.7 per cent in 2016, gradually accelerating to 1.0 per cent in 2017 and 1.2 per cent in 2018**.

Capital spending has accelerated

Year-on-year percentage change, net balance



Source: Eurostat, DG Ecfin

Indicators remain at low levels, although some improvement is visible in the comprehensive surveys by the OECD and the European Commission. There is a persistent divide in the economy: headwinds for the manufacturing sector, especially in terms of order bookings, while the service sector is more optimistic. But manufacturing seems to have bottomed out and production volume has risen three months in a row, for the first time in years. Although exports are continuing to shrink, given **stabilisation in Russia and good growth in Sweden and Germany, we foresee prospects of an improvement** during the second half. **Exports will climb by 0.5 per cent in 2016 as a whole and accelerate a bit more in 2017-2018.**

Domestic demand will remain the biggest growth force during the next couple of years. Households, which have been squeezed by high unemployment and public sector austerity for a long time, foresee some improvement. A better labour market situation has had a positive impact on both household confidence indicators and consumption. Consumer confidence has reached a five-year high, and retail sales rose by 1.6 per cent in May and 1.7 per cent in June. The competitiveness pact will be largely neutral for households. Among other reforms, certain social insurance fees will be paid directly by employees, who on the other hand will be compensated by tax cuts. Despite moderate pay increases, low inflation is allowing real wage increases, but real incomes will be squeezed as inflation slowly rises ahead. Meanwhile home prices seem to have stabilised and are now increasing again. **Household consumption will increase by about 1 per cent yearly in 2016-2018**.

Finland's lengthy economic slump has deeply affected the labour market, but the outlook has improved. The downturn in unemployment from 9.5 per cent in mid-2015 to 8.9 per cent in July was unexpectedly large. Job growth is an economic driver, but labour force participation has decreased. Pay increases remain moderate and will continue to be squeezed by idle resources in the economy and the competitiveness pact. **Annual average unemployment will stand at 8.9 per cent in 2016**. The jobless rate has recently declined more than the economic growth rate would indicate, and the pace of this decline is expected to slow ahead as the labour market activity rate stabilises. We expect unemployment of 8.4 per cent in 2018.

Pay increases are at around 1 per cent in the Finnish economy as a whole and will accelerate only marginally in 2017-2018. Price pressures are also low; HICP inflation in recent months has been at a 0.3 per cent rate, and low global price pressures as well as low domestic pay increases suggest a continued price squeeze. **Inflation will stand at 0.3 per cent in 2016, climbing to 1 per cent year-on-year in 2017-2018**.

Public finances remain squeezed, leaving no room for any fiscal stimulus measures. Weak growth and a rather slowly improving labour market will provide little help. The public budget deficit will fall slightly but remain above 2 per cent of GDP in 2018, while gross government debt will climb from 63.1 per cent of GDP in 2015 to 67.5 per cent in 2018.

Strong labour market is supporting growth

- **Sluggish growth in the first half of 2016**
- **Exports are improving**

According to the first estimates, the economy grew only by **1.1 per cent** in the first half of 2016. Growth has been restrained by sluggish capital spending and weak exports, but there are signs of an economic pick-up and the second half of the year should produce better results. Yet because of sub-par performance in the second quarter, yearly GDP growth will remain lower than previously expected. We estimate that the Estonian economy will grow **1.7 per cent** this year, **followed by an acceleration in both 2017 and 2018** with GDP growth of **2.4** and **3.0 per cent**, respectively.

Trade remains at the core of the economy, with exports equivalent to 80 per cent of GDP. Conditions seem to have improved in recent months, with Q1 2016 merchandise exports largely unchanged from year-earlier levels. In **Q2**, **exports increased 5 per cent** in real terms, with the biggest gains in the wood and furniture industry. Export growth has been outpaced by **higher imports**, which **widened the trade deficit** and thus contributed negatively to GDP. We expect trade to grow moderately during our forecast period.

Capital spending continued to decrease in Q1, with **gross fixed capital formation dropping by 5.8 per cent** — for the 7th consecutive quarter in a row. Although private demand for housing continues to be solid, companies see few incentives to expand. Business investments tend to be concentrated in construction of commercial real estate. At the same time, increased imports of capital goods and lending by non-financial companies imply that the previous trend may be turning and that **capital spending will pick up in the second half of the year**. Similarly to other Baltic countries, government investments have been held back by the transition from one European Union structural funds period to another. Some **70 per cent of public investments are funded by the EU**. The low tide in government tenders has been especially troublesome for the construction sector. Public investments are expected to gain momentum in 2017. To tackle sluggish growth, the government has been planning to pursue a more expansionary fiscal policy by allowing a budget deficit of up to 0.5 per cent of the GDP in coming years. However, the fiscal stance will remain very conservative compared to the rest of Europe, with public debt below 10 per cent of the GDP.

In **Q1 2016, the average gross wage increased 8 per cent**, propelling fears of layoffs due to companies' need to cut costs. Yet the labour market has remained solid, with a jobless rate of 6.5 per cent and employment and activity levels climbing. In Q2, labour force participation reached 71.5 per cent, one of the highest levels in the EU. Another positive change has been the **reversal in migration** patterns; last year more people settled in Estonia than left the country. Yet the shortage of qualified labour and the rapid growth of unit labour costs remain a key challenges. To boost the labour supply, the government is pursuing a reform to increase employment among people with reduced working ability. Due to the reform and companies' need to cut costs, the **unemployment** rate will climb to **7.2 per cent** in **2017** and **7.8 per cent** in **2018**. Strong demand for qualified labour means that **wage growth** will remain around **5 per cent** throughout our forecast period.

Strong labour market performance

Per cent

Source: Statistics Estonia

High employment and rapid wage growth have been a boon for **private consumption**, which **rose by 5.5 per cent** in Q1. Detailed national accounts for Q2 will be published in September, but it is likely that a hike in excise duties, which took place in February, may have shifted some consumption earlier. Part of these expenditures may now appear in Latvia's accounts, since cross-border shopping gained in popularity after the tax hike. Private consumption will remain one of the main drivers of economic growth in 2017 and 2018.

Consumers continue to enjoy the benefits of **low inflation**. During the first half of 2016, HICP rose 0.2 per cent. Inflation has been pushed down by falling energy prices, which reduce transport and housing costs. Low food prices have also contributed. We expect inflation to be very limited this year, with **HICP increasing only 0.5 per cent**. Over the next couple of years, HICP will surpass the 2 per cent threshold next year: totalling **2.4 per cent in 2017** and **2.8 per cent in 2018**.

Sluggish acceleration in growth – mounting challenges

- **GDP growth defies international factors, rising towards 3.5 per cent potential pace**
- **Mounting challenges to competitiveness – increased pressure for necessary reforms**

Latvia's economy remains **squeezed by international factors and a decline in EU funds**, which primarily have a negative effect on construction and manufacturing investments. A gradual improvement in sentiment about the economy, now at a two-year high, suggests a cautious acceleration in growth during the second half. The outlook for 2017 and 2018 is mainly supported by a strong labour market and real wage hikes, but also expectations of better export and investment prospects. GDP growth in 2016 will be 2.4 per cent (revised from 2.7 per cent in the May *Nordic Outlook*). **Next year and in 2018, GDP will grow by 3.5 per cent**, or close to potential. Downside risks predominate, due to continued uncertainty about Russia and negative contagious effects from Brexit.

The export outlook is uncertain in the short term but is expected to strengthen in 2017. Exports are largely influenced by Latvia's role as a transit country for exports to other countries. Exports to Russia have fallen from 10.7 per cent in 2014 to 7 per cent, implying that Latvia is taking further steps to reduce its dependence on Russia.

Inflation pressure is weak but is expected to rise in 2017 and 2018. This summer's statistics will hopefully confirm that Latvia has left behind its deflationary period. **We expect CPI inflation this year of 0.1 per cent, rising to 2.1 per cent in 2017 and then falling to 1.8 per cent in 2018**.

Low interest rates and a weak euro generally benefit Latvian competitiveness, but many businesses are being squeezed by sluggish retail sales, low price hike expectations and employee pay demands. Wage increases have slowed, but productivity growth has been weak. Overall, this has **worsened Latvia's competitiveness**. After **wages and salaries rose** by 6.8 per cent, there will now be a **deceleration** in pay hikes to 5.1 per cent this year, 4.0 per cent in 2017 and 3.8 per cent in 2018.

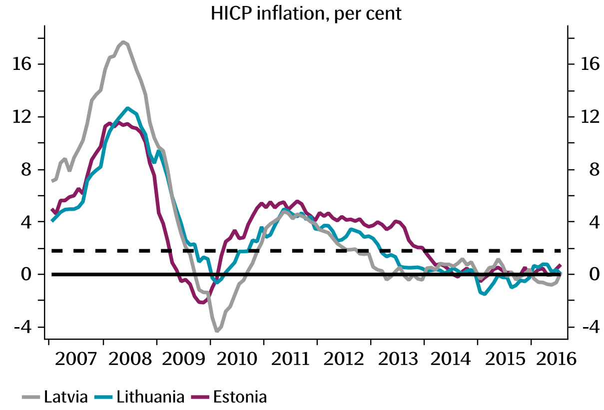
Slower pay increases may be related to a somewhat weaker labour market situation, especially in certain regions. During the first half, unemployment rose above 10 per cent, in line with the EU average, but the jobless rate is likely to fall as economic activity accelerates. This year, average unemployment will exceed 10 per cent, falling to 7.7 per cent in 2017 and 7 per cent in 2018. Demographic trends represent major challenges to Latvia, leading to a smaller future labour supply. This increases the need for restructuring policies, among other things to offset falling productivity. These policies need to focus, for example, on infrastructure investments, a re-assessment of the operations of state-owned companies and steps to stimulate innovation in the economy.

Fundamentally, Latvia has a **relatively strong economy**, but public finances have been weaker than expected even though the strength of the domestic economy has led to upside surprises regarding tax revenue so far in 2016. The government needs to prepare for a post-2020 situation in which EU grants will gradually decrease and it needs to implement an economic policy that will attract foreign investment capital to Latvia.

The European Commission has **authorised the government to increase its 2017 budget deficit in order to implement reforms in the health care sector**, but Latvia's long-term objective is to generate budget surpluses that allow room for necessary reforms. We forecast a budget deficit of 1.3 per cent of GDP this year, 1.2 per cent next year and 1.0 per cent in 2018. Public debt will fall to about 33 per cent of GDP in 2018.

Latvian inflation expected to rise from low levels

HICP inflation, per cent



Source: Macrobond

The Brexit-vote outcome poses a growth risk to Latvia, for three reasons. First, Latvian exports have lost competitiveness to British companies as the pound has weakened sharply; the UK is Latvia's seventh largest market (5.1 per cent of total exports). Second, Brexit may affect the **flow of money** from people who have left Latvia to work in the UK, totalling about EUR 300 million yearly according to the World Bank. Third, Brexit may affect the EU budget and thus Latvia's chances of gaining **access to various EU funds**. During 2014-2020 Latvia is expected to receive about EUR 7.5 billion from the EU, roughly equivalent to one year of its own government budget. This sum may decrease if the EU budget shrinks.

Back to inflation due to faster wage growth

- **GDP forecast slightly lowered**
- **Labour market keeps improving**
- **Higher inflation expected**

The Lithuanian economy showed year-on-year GDP growth of 2.1 per cent in the first half of 2016. Although this was faster than the 1.6 per cent increase in 2015, it was a little bit lower than we expected. The drop in capital spending put pressure on GDP growth, but we foresee an upturn in private investment during the second half and a higher impact from upcoming public infrastructural projects starting the next year. **We are lowering our GDP forecast to 2.2 per cent in 2016 and 2.5 per cent in 2017** (from 2.8 and 3.2 per cent, respectively). **In 2018 we expect an acceleration to 3.0 per cent.**

Economic sentiment figures remain similar to last year's levels. **There is some lack of optimism among exporting enterprises and construction companies.** Relatively slow growth in the EU and the unclear consequences of the Brexit vote are forcing manufacturers to remain cautious. Although businesses operating in the service and retail sectors are more positive, rapid growth in labour costs is adding more stress.

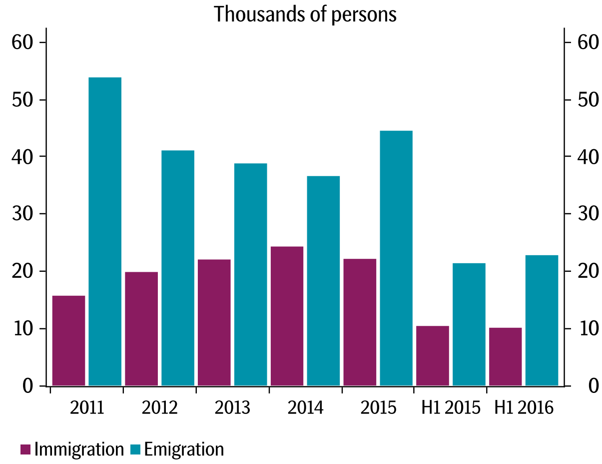
The value of exported goods has dropped so far this year due to lower prices, especially for refined oil products and fertilisers. Export volume has been increasing and we expect modest growth in the EU, Lithuania's main export partner. the weaker GBP lowered the values of remittances and exports in euros. In contrast, **the strong US dollar is benefiting exporters and the US is already Lithuania's fifth largest export partner**.

Capital expenditures in the private sector are expected to end this year higher. Bank loans to companies have been recovering rapidly, since companies understand the necessity of investments in order to remain competitive globally. **Besides, both the commercial property and housing markets have been steadily improving on cheap financing**, but their fundamentals are still rather healthy.

The labour market has been improving at a rapid pace. However, this is largely due to unfavourable demographic trends as the number of 15-29 year old residents rapidly declines and the number of 50-64 year olds sharply increases. Besides, the scale of emigration has been expanding, putting pressure on the long-term potential of the labour force. A decision to ease the terms of employment for citizens from countries outside the EU was thus adopted this summer. The effect on the expansion of the economy cannot be underestimated. Our **unemployment forecast is unchanged at 8.0 per cent in 2016 and 7.7 per cent in 2017**. **In 2018, average unemployment rate will be 7.2 per cent.**

Scale of emigration does not shrink

Thousands of persons



Source: Statistics Lithuania

The decrease in unemployment, the shortage of skilled labour and a new increase in the minimum wage from July 1 have had a positive impact on average pay, **which is expected to go up by 7 per cent in 2016 and 6 per cent in 2017**. Although wages keep increasing, income inequality is not shrinking and the risk-of-poverty rate is one of the highest in the EU. Taking into the account the ageing population and the lack of innovation, income inequality is not helping the long-term growth of the economy. Although the government is taking short-term actions such as minimum wage hikes and higher tax exemptions for low wage earners, the country still lacks a strategy for improving the quality of education and skills.

Higher labour costs have started outweighing the effect of lower energy prices than a year ago. We believe that such tendencies will remain intact. **Inflation will increase gradually to 0.8 per cent this year and accelerate further to 1.5 per cent in 2017 and 2.5 per cent in 2018.** Statistics do not reveal unusual price increases but some citizens are out-raged by rising prices, and boycotts of the largest retail chain stores began this year. However, the entry of foreign retailers to Lithuania has improved competition and reduced tensions.

Less than two months remain before **parliamentary elections** on **October 9**. It is very likely that the current ruling coalition will split up after the elections, but no radical or economically harmful parties will join Parliament.

GLOBAL KEY INDICATORS

Yearly change in per cent

	2015	2016	2017	2018
GDP OECD	2.3	1.7	2.0	2.0
GDP world (PPP)	3.1	3.1	3.5	3.6
CPI OECD	0.6	0.9	1.5	1.8
Export market OECD	3.4	2.4	4.0	4.0
Oil price. Brent (USD/barrel)	53.4	45.0	55.0	60.0

US

Yearly change in per cent

	2015 level. USD bn	2015	2016	2017	2018
Gross domestic product	18,223	2.6	1.6	2.4	2.0
Private consumption	12,439	3.2	2.8	2.8	2.4
Public consumption	3,245	1.8	0.9	-0.1	0.0
Gross fixed investment	3,060	3.9	1.0	5.0	5.2
Stock building (change as % of GDP)		0.2	-0.4	0.0	0.0
Exports	2,212	0.1	0.3	5.5	6.1
Imports	2,733	4.6	1.3	6.4	8.2
Unemployment (%)		5.3	4.8	4.5	4.2
Consumer prices		0.1	1.2	2.0	2.2
Household savings ratio (%)		5.8	5.7	5.0	5,0

EURO ZONE

Yearly change in per cent

	2015 level. EUR bn	2015	2016	2017	2018
Gross domestic product	10,407	1.7	1.6	1.7	1.7
Private consumption	5,738	1.7	1.8	1.8	1.8
Public consumption	2,169	1.3	1.7	1.3	1.0
Gross fixed investment		2.9	3.5	3.2	3.5
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	4,770	5.3	2.0	3.9	4.4
Imports	4,308	6.1	3.3	4.7	5.2
Unemployment (%)		10.9	10.1	9.6	9.1
Consumer prices		0.0	0.1	1.0	1.1
Household savings ratio (%)		6.4	6.7	6.6	6.5

OTHER LARGE COUNTRIES

Yearly change in per cent

	2015	2016	2017	2018
GDP				
United Kingdom	2.2	1.7	0.9	2.0
Japan	0.5	0.5	0.5	0.5
Germany	1.7	1.7	1.6	1.6
France	1.3	1.3	1.3	1.2
Italy	0.8	0.9	1.0	1.2
China	6.9	6.6	6.3	6.0
India	7.3	7.6	7.8	8.0
Brazil	-3.7	-3.5	0.5	2.0
Russia	-3.7	-0.4	1.0	1.5
Poland	3.6	3.6	3.5	3.4
Inflation				
United Kingdom	0.1	0.4	1.8	2.2
Japan	0.8	-0.3	0.2	0.6
Germany	0.2	0.8	1.9	1.9
France	0.3	0.2	0.7	0.7
Italy	0.0	0.2	0.7	0.7
China	1.4	2.2	2.5	2.5
India	4.9	5.4	4.7	4.5
Brazil	9.0	8.6	6.0	5.0
Russia	15.6	7.3	6.0	5.0
Poland	-0.9	0.0	1.8	2.2
Unemployment (%)				
United Kingdom	5.4	5.2	5.7	5.8
Japan	3.4	3.2	3.0	2.8
Germany	4.3	4.3	4.5	4.7
France	10.2	9.8	9.6	9.5
Italy	12.4	12.2	12.0	11.8

The Baltics

	2015	2016	2017	2018
GDP, yearly change in per cent				
Estonia	1.1	1.7	2.4	3.0
Latvia	2.7	2.4	3.5	3.5
Lithuania	1.6	2.2	2.5	3.0
Inflation, yearly change in per cent				
Estonia	0.3	0.5	2.4	2.8
Latvia	0.2	0.1	2.1	1.8
Lithuania	-0.7	0.8	1.5	2.5

FINANCIAL FORECASTS

		24-Aug	Dec-16	Jun-17	Dec-17	Jun-18	Dec-18
Official interest rates							
US	Fed funds	0.50	0.75	1.00	1.25	1.50	1.75
Japan	Call money rate	-0.10	-0.20	-0.20	-0.20	-0.20	-0.20
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.25	0.05	0.05	0.05	0.05	0.50
Bond yields							
US	10 years	1.57	1.60	1.75	2.00	2.10	2.30
Japan	10 years	-0.09	-0.15	-0.15	-0.15	-0.10	0.00
Germany	10 years	-0.09	-0.05	0.05	0.30	0.40	0.60
United Kingdom	10 years	0.66	0.60	0.65	0.90	1.20	1.60
Exchange rate							
USD/JPY		101	105	108	110	112	115
EUR/USD		1.12	1.08	1.10	1.12	1.14	1.15
EUR/JPY		113	113	119	123	128	132
GBP/USD		1.32	1.29	1.34	1.42	1.48	1.53
EUR/GBP		0.85	0.84	0.82	0.79	0.77	0.75

SWEDEN

Yearly change in per cent

	2015 level. SEK bn	2015	2016	2017	2018
Gross domestic product	4,159	4.2	3.7	2.8	2.3
Gross domestic product, working day adjustment		4.0	3.4	3.1	2.4
Private consumption	1,879	2.7	3.1	2.8	2.5
Public consumption	1,084	2.6	3.8	2.5	0.0
Gross fixed investment	1,007	7.0	6.7	6.0	4.2
Stock building (change as % of GDP)	15	0.1	0.3	0.0	0.0
Exports	1,878	5.9	3.6	4.6	3.0
Imports	1,704	5.5	5.7	6.4	3.0
Unemployment (%)		7.4	6.7	6.1	6.1
Employment		1.4	1.7	1.5	1.2
Industrial production		2.9	3.0	3.5	3.0
CPI		0.0	0.9	1.2	1.9
CPIF		0.9	1.4	1.4	1.7
Hourly wage increases		2.6	2.5	2.9	3.1
Household savings ratio (%)		15.7	16.0	15.9	15.3
Real disposable income		2.8	3.4	2.9	2.5
Current account, % of GDP		5.9	5.5	5.2	4.8
Central government borrowing, SEK bn		33	-36	-21	0
Public sector financial balance, % of GDP		0.0	0.3	0.2	-0.1
Public sector debt, % of GDP		43.4	40.7	38.8	38.0

FINANCIAL FORECASTS	24-Aug	Dec-16	Jun-17	Dec-17	Jun-18	Dec-18
Repo rate	-0.50	-0.50	-0.50	-0.25	0.00	0.25
3-month interest rate, STIBOR	-0.55	-0.60	-0.50	-0.30	0.05	0.25
10-year bond yield	0.09	-0.05	0.35	0.90	1.10	1.40
10-year spread to Germany, bp	18	0	30	60	70	80
USD/SEK	8.42	8.61	8.32	7.99	7.72	7.61
EUR/SEK	9.47	9.3	9.15	8.95	8.8	8.75
TCW	130.4	128.9	126.6	124.1	122.0	121.2
KIX	111.3	110.0	108.1	105.9	104.2	103.5

NORWAY

Yearly change in per cent

	2015 level. NOK bn	2015	2016	2017	2018
Gross domestic product	3,189	1.6	1.2	1.4	1.8
Gross domestic product (Mainland)	2,498	1.0	0.9	1.8	2.1
Private consumption	1,279	2.0	1.6	2.0	2.5
Public consumption	684	1.9	2.8	2.5	2.5
Gross fixed investment	687	-4.2	-1.4	1.1	2.7
Stock building (change as % of GDP)		0.3	0.0	0.0	0.0
Exports	1,273	3.4	0.8	1.3	1.2
Imports	898	1.1	0.2	2.5	3.1
Unemployment (%)		4.4	4.8	4.8	4.6
CPI		2.2	3.7	2.7	2.2
CPI-ATE		2.7	3.3	2.8	2.1
Annual wage increases		2.8	2.5	2.8	2.9

FINANCIAL FORECASTS	**24-Aug**	**Dec-16**	**Jun-17**	**Dec-17**	**Jun-18**	**Dec-18**
Deposit rate	0.50	0.25	0.25	0.25	0.50	0.75
10-year bond yield	1.05	0.90	0.90	1.00	1.10	1.40
10-year spread to Germany, bp	114	95	85	70	70	80
USD/NOK	8.24	8.52	8.32	7.95	7.63	7.70
EUR/NOK	9.26	9.20	9.15	8.90	8.70	8.85

DENMARK

Yearly change in per cent

	2015 level. DKK bn	2015	2016	2017	2018
Gross domestic product	1,986	1.0	1.4	2.3	2.3
Private consumption	958	2.3	2.4	2.6	2.7
Public consumption	519	-0.7	0.4	0.9	0.8
Gross fixed investment	389	1.1	3.2	4.2	4.1
Stock building (change as % of GDP)		-0.3	-0.1	0.0	0.0
Exports	1,061	0.3	1.2	4.4	4.6
Imports	936	0.0	2.0	5.0	5.3
Unemployment (%)		4.6	4.4	4.1	3.8
Unemployment, OECD harmonised (%)		6.2	6.0	5.6	5.2
CPI, harmonised		0.5	0.4	1.2	1.5
Hourly wage increases		1.4	1.6	1.9	2.2
Current account, % of GDP		7.0	7.0	6.8	6.3
Public sector financial balance, % of GDP		-2.1	-2.0	-1.5	-1.0
Public sector debt, % of GDP		41.9	41.0	40.0	40.0

FINANCIAL FORECASTS	**24-Aug**	**Dec-16**	**Jun-17**	**Dec-17**	**Jun-18**	**Dec-18**
Lending rate	0.05	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.01	0.00	0.05	0.30	0.40	0.60
10-year spread to Germany, bp	10	5	0	0	0	0
USD/DKK	6.62	6.90	6.77	6.65	6.54	6.48
EUR/DKK	7.44	7.45	7.45	7.45	7.45	7.45

FINLAND

Yearly change in per cent

	2015 level. EUR bn	2015	2016	2017	2018
Gross domestic product	211	0.2	0.7	1.0	1.2
Private consumption	116	1.5	0.9	0.9	1.1
Public consumption	51	0.4	-0.5	-0.3	-0.2
Gross fixed investment	43	0.7	0.4	1.0	1.0
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	77	-0.2	0.5	1.5	2.5
Imports	78	1.9	0.0	0.5	1.5
Unemployment (%)		9.3	8.9	8.6	8.4
CPI, harmonised		0.0	0.3	1.0	1.0
Hourly wage increases		1.5	1.5	1.7	1.7
Current account, % of GDP		-1.0	-0.9	-0.9	-1.0
Public sector financial balance, % of GDP		-2.7	-2.5	-2.5	-2.2
Public sector debt, % of GDP		63.1	64.5	66.0	67.5

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