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Press release

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Nordic Outlook: Crucial choices for global economic policy experiments – new stimulus measures despite signs of Swedish overheating

Global financial markets are proving resilient to an environment with a clearly heightened political risk level. Monetary policymakers seem to be benefiting from confidence in their ability to prevent share and bond price declines. But the effectiveness of monetary policy is increasingly being questioned. There have been various growth reversals during the first half of 2016, but more recent economic signals have been predominantly positive.

Despite significant domestic policy uncertainty, important emerging market (EM) economies such as Russia and Brazil are now past their worst downturns, partly due to more stable energy and commodity prices. India is continuing its rapid growth, while China's economy is expected to decelerate in a controlled way. Overall, the growth outlook for 2016-2018 is not impressive and lacks clear cyclical patterns – with risks of worse growth outcomes continuing to outweigh upside risks. GDP growth for the mainly affluent 35 member countries of the Organisation for Economic Cooperation and Development (OECD) will be 1.7 per cent this year, down from 2.3 per cent in 2015. In 2017 and 2018, annual growth in the OECD will be 2.0 per cent.

Monetary policy at end of road – ideas being tested ahead of next downturn

On the whole, monetary policy will be more expansioary over the coming year as several central banks, such as the European Central Bank (ECB), the Bank of Japan (BoJ) and Sweden's Riksbank, extend their bond purchasing (quantitative easing, QE) programmes. The British, Japanese, Chinese and Norwegian central banks will cut their key interest rates further. The United States Federal Reserve (Fed) will move in the opposite direction, hiking its key rate this coming December, twice in 2017 and twice in 2018 to 1.75 per cent. The low inflation environment will be tested as output gaps in various countries now close and policymakers increasingly intervene in wage formation, while commodity prices stabilise at somewhat higher levels. We expect Brent crude oil prices to be at USD 55-60 per barrel until the end of 2018, with a downside risk. The connection between resource utilisation and inflation is unclear, however; this connection is almost essential if the system of inflation targeting and independent central banks is to work reasonably well. Our main scenario is that disinflationary forces will continue to dominate the global economy.

A high propensity to save and low investment appetite are continuing to push down real global short-term interest rates, forcing central banks to adjust their estimates of a neutral key interest rate downward. This implies that today's monetary policies are not quite as expansionary as previously assumed, which in turn will slow future key rate hikes. The risks connected to further driving up asset prices and private debts, with little or no impact on growth and inflation, will increase the pressure for fiscal stimulus measures. In addition, weaknesses in the banking systems in the euro zone, Japan and elsewhere impose restrictions on monetary policy. Yet the build-up of public sector debt in recent years limits the manoevring room of governments. Various blockages increase the need for fresh thinking about the interactions between fiscal and monetary policy. Automatic discretionary fiscal stimulus packages may be a possibility, which in exceptional cases can be funded via "helicopter money".

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Brexit at least 80 per cent political – London strengthening immune system

We are maintaining our conclusion that the economic effects of the Brexit process (United Kingdom withdrawal from the European Union) are manageable, but the political risks are serious – for both the UK and the EU. Our main scenario, which has a 70 per cent probability, implies that the "exit clause" in the EU's Lisbon Treaty will be activated early in 2017. Negotiations with the EU and non-EU countries will then occur in a constructive way, but it is highly doubtful that the UK can leave the EU after only two years and before the next election to the European Parliament in May 2019. The British government and the BoE are aiming at making the UK economy "super-competitive" by means of a weaker pound (down 17 per cent in the past year), key interest rate and corporate tax cuts, cheap loans and infrastructure investments, which will also soften the short-term consequences of Brexit. Contagious economic effects in the EU and elsewhere will thus be minor. British GDP will grow by 1.7 per cent this year, 0.9 per cent in 2017 and 2.0 per cent in 2018, but the Brexit referendum outcome makes our forecasts especially uncertain, both in the short and long term.

The political future of Europe will be in focus during the coming year as important elections are held in France and Germany. Euro zone economic growth diverges from country to country but is decent overall, despite weaknesses in banking systems and lingering questions about how banks that need fresh capital should receive support. GDP growth in the euro zone will be 1.6 per cent in 2016, then 1.7 per cent yearly in 2017 and 2018. Our conclusion is that the EU establishment will choose not to move in a more federalist direction. In practice, this means that the euro project will remain without an infrastructure and economic policy integration that can give the euro long-term stability, but heightened political uncertainty is not expected to worse the euro zone growth outlook perceptibly. Domestic demand will be strengthened by falling unemployment, while capacity utilisation in a number of countries has now reached levels where capital spending normally takes off.

Although Chinese housing market indicators have rebounded, there is lingering uncertainty about debt and overcapacity in the economy. Beijing's 2016-2020 GDP growth target of 6.5-7.0 per cent yearly is not credible without further stimulus measures. We anticipate a shift in the balance between monetary and fiscal policy; a necessary slowdown in credit growth will put heavier demands on fiscal policymakers. China's economy will show a controlled deceleration, growing by 6.6 per cent this year. GDP growth will slow to 6.3 per cent in 2017 and 6.0 per cent in 2018.

Rising political temperature in the US – Clinton victory our main scenario

The US economy lost momentum during the first half, affecting our full-year 2016 GDP forecast. Recent indicators – combined with underlying strong consumption growth and clearly expansionary financial conditions – are supporting the real economy. Our GDP growth forecast for 2016 is 1.6 per cent (previously 1.9 per cent). Next year, growth will accelerate to 2.4 per cent (2.5). Certain supply-side restrictions will push growth down to 2.0 per cent in 2018, in line with potential growth. Unemployment will continue to fall, reaching 4.2 per cent by the end of 2018 compared to 4.9 per cent today. The pace of wage and salary increases will move cautiously higher, providing the Fed with reasons for gradually hiking its key rate. We estimate that the probability of a Hillary Clinton victory in the November presidential election is 85 per cent. Such an outcome would not change the US economic outlook to any great extent, despite some protectionist elements in Clinton's campaign statements. If Donald Trump wins, this will boost foreign and security policy uncertainty, but the Congressional mill will largely grind down any odd economic policy proposals.

In the Nordic economies, growth will average 2 per cent annually during our forecast period. We expect the recovery to be moderate due to continued negative contributions from falling oil sector investments, while houshold consumption will be squeezed by weak real income increases. Norway's GDP growth this year will be 0.9 per cent, then accelerate to 1.8 per cent in 2017 and 2.0 per cent in 2018. Norges Bank will carry out one more key rate cut this autumn, and we expect the first Norwegian rate hike in mid-2018. This will strengthen the krone: the EUR/NOK exchange rate will be 8.85 at the end of 2018. In Finland there are certain signs of improvement, although the economy faces continued strong headwinds. Consumption is the most important driving force, but construction investments are also starting to accelerate. We expect confidence to climb, now that the country has managed to

reach a consensus on measures to strengthen its competitiveness. Finland's GDP growth this year will be 0.7 per cent, accelerating cautiously to 1.0 per cent in 2017 and 1.2 per cent in 2018. In Denmark, too, we expect capital spending growth to strengthen, with private consumption as another important driver, but the recovery has been unexpectedly slow. The government is now preparing a long-term fiscal policy plan looking ahead towards 2025. We expect Danish GDP growth to reach 1.4 per cent this year, increasing to 2.3 per cent annually during the following two years.

The three Baltic countries are expected to show gradually accelerating growth, still mainly driven by private consumption. This, in turn, will be driven by strong labour markets and good wage and salary growth. On the whole, the Baltics have healthy economic fundamentals but are vulnerable to accelerating pay increases, which risk lowering their competitiveness. Continued restructuring policy measures will be needed to improve the strength of Estonia, Latvia and Lithuania in relation to other countries and to make the region less economically dependent on Russia, for example. The three countries will benefit from low interest rates, but the international situation is troublesome for them and the weakness of the Swedish krona is a challenge. Growth in the Baltics will accelerate. By 2018, on average it is expected to be close to its potential level of 3-3.5 per cent yearly.

Deceleration in Swedish growth during 2017-2018

In Sweden, the economic growth outlook remains good – thanks to record-level housing construction, high public sector consumption due to large-scale refugee arrivals especially during 2015 and a strong labour market. Both fiscal and monetary policy will be expansionary during our forecast period. GDP growth will reach 3.7 per cent this year (a downward adjustment from our 4.0 per cent forecast in May). Next year, GDP will increase by 2.8 per cent and in 2018 by 2.3 per cent. The economy is split down the middle, though: domestic sectors are showing impressive strength, while the export-oriented sector is feeling international headwinds despite a greatly undervalued krona. Sweden's growth deceleration will occur undramatically, however. It will be due to a declining rate of increase in housing construction and somewhat lower government spending pressure due to a downward revision in projected immigration, along with growing supply-side restrictions.

Despite the slower economic growth rate the labour market will continue to perform strongly, although the unemployment gap between Swedish- and foreign-born people will widen. Unemployment will fall from today's 7.0 per cent to less than 6 per cent by mid-2018. After that, slower growth and a growing labour supply as recently arrived immigrants increasingly move into the labour market will lead to a somewhat higher jobless rate. Wage and salary increases in 2016 appear likely to be slightly below expectations, but a new wage round is already imminent. Our forecast is that two-year collective labour agreements will be reached early in 2017, with contractual pay hikes averaging 2.4 per cent yearly (0.2 percentage points higher than today's agreements). Overall pay increases will climb from 2.5 per cent this year to 2.9 per cent in 2017 and 3.1 per cent in 2018. This remains somewhat below the level that is compatible with the Riksbank's 2.0 per cent inflation target. CPIF inflation (the consumer price index excluding interest rate changes) will climb by the end of 2018 but fall short of the target. CPI inflation, however, will end up slightly above 2 per cent.

Halfway through its four-year term, the Social Democratic-Green Party minority government can focus greater attention on reform policies now that the most acute phase of the refugee crisis appears to have passed. Public sector finances are continuing to improve, thanks to job-heavy expansion driven by such tax-rich demand components as consumption and housing construction. Sweden's revised official fiscal policy framework – with a budget surplus target of 0.33 per cent of GDP and a government debt anchor of 35 per cent of GDP – is expected to constrain reform fever ahead of the September 2018 election. As a result of the fiscal framework, which was recently agreed upon by both the red-green bloc and the opposition Alliance parties and takes effect in 2019 – any signs that the framework is being violated are expected to become weapons in the election debate on fiscal policy credibility. Public sector net lending is expected to be a few tenths of a percentage point above zero 2016 and 2017. Because of spending pressure in areas like migration and imbalances in the housing market, fiscal policy will be fairly expansionary during the next couple of years.

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Other countries forcing Riksbank to buy bonds – autumn 2017 rate hike

Continued loose global monetary policy is forcing the Riksbank to continue its expansionary policies despite strong credit growth, cautiously rising inflation and higher resource utilisation, as well as increased inflation risks ahead. Today's bond purchasing programme will be extended by six months and SEK 30 billion, ending on June 30, 2017. This will increase the risk of liquidity problems in the Swedish bond market. We do not expect new macroprudential tools to be launched during our forecast period; even the politically sensitive mortgage loan interest deduction will be left untouched. Home prices will level off during 2017 and 2018 due to an increased market focus on the Riksbank's coming rate hikes (starting in the autumn of 2017). As earlier, we expect the Riksbank to make adjustments in its monetary policy framework, among other things re-introducing the tolerance range in its inflation target and changing its preferred inflation metric to the EU's harmonised index of consumer prices (HICP). This will give the Riksbank a greater degree of freedom and reduce pressure for further monetary stimulus measures. By the end of 2018, the repo rate will stand at 0.25 per cent. In the short term, the krona is expected to remain fairly flat, at a continued weak level. During 2017 and 2018 we expect the krona to appreciate against the euro and the dollar, with the EUR/SEK exchange rate reaching 8.75 and the USD/SEK rate 7.60 by the end of 2018.

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

International economy, GDP, year-on-year changes, %	2015	2016	2017	2018
United States	2.6	1.6 (1.9)	2.4 (2.5)	2.0
Euro zone	1.7	1.6 (1.7)	1.7 (1.8)	1.7
Japan	0.5	0.5 (0.5)	0.5 (0.5)	0.5
OECD	2.3	1.7 (1.9)	2.0 (2.3)	2.0
China	6.9	6.6 (6.5)	6.3 (6.3)	6.0
Nordic countries	2.2	2.1 (2.2)	2.0 (2.0)	2.0
Baltic countries	1.8	2.2 (2.6)	2.8 (3.1)	3.1
The world (purchasing power parities, PPP)	3.1	3.1 (3.1)	3.5 (3.7)	3.6
Swedish economy. Year-on-year changes, %				
GDP, actual	4.2	3.7 (4.0)	2.8 (2.8)	2.3
GDP, working day corrected	4.0	3.4 (3.8)	3.1 (3.0)	2.4
Unemployment, % (EU definition)	7.4	6.6 (6.9)	6.0 (6.5)	6.0
Consumer Price Index (CPI) inflation	0.0	0.9 (0.9)	1.2 (1.4)	1.9
Government net lending (% of GDP)	0.0	0.3 (0.4)	0.2 (0.1)	-0.1
Repo rate (December)	-0.35	-0.50 (-0.50)	-0.25 (0.25)	0.25
Exchange rate, EUR/SEK (December)	9.19	9.30 (9.00)	8.95 (8.70)	8.75

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