

Press release

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Nordic Outlook: Trumpism will have an uncertain impact Swedish economic optimism, Riksbank done with rate cuts

As we approach 2017, the world has become both more exciting and more frightening from an economic and political standpoint, according to SEB's economists in the November issue of the quarterly Nordic Outlook report. With the United States preparing to test a new fiscal stimulus strategy, there is new hope for economic growth now that monetary policy has reached the end of the road. But strong and growing anti-establishment forces are changing the domestic and foreign policy playing field in troublesome and unpredictable ways. SEB's forecast scenario confirms stronger, but far from impressive, global economic expansion – hampered by such factors as inequitable wealth distribution and heavy debt. In Sweden, domestic driving forces – including residential construction and public sector consumption, combined with somewhat stronger exports – will lead to continued robust growth in 2017. The Riksbank is finished with its key interest rate cuts, but the bank will be forced to buy government securities for another while.

Our picture of the international economic outlook has not changed especially much since our last Nordic Outlook in August. Sentiment indicators have rebounded, and financial markets have reacted in an unexpectedly positive way to the possibility of more growth-oriented economic policies in the wake of Donald Trump's US presidential election victory. The outlook for emerging market (EM) economies will improve somewhat, as Russia and Brazil emerge from recession and Chinese growth decelerates at a controlled pace. **Average economic growth in the 35 mostly affluent 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 GDP growth in the OECD countries will be 2.0 per cent.** Considering that many central banks are maintaining historically low key interest rates and are making large-scale purchases of securities (quantitative easing or QE policies), this is a rather mediocre growth rate.

Yet political conditions have changed dramatically since the United Kingdom's "Brexit" referendum on withdrawal from the European Union and the US presidential election. Anti-establishment forces are ascendant and may become even stronger in the important elections that will take place in Western Europe during 2017. A general shift among established parties towards prioritising national considerations – at the expense of international obligations – is likely. Fiscal stimulus measures may gain a more prominent role in the economic policy framework, and this may improve growth potential. But large and growing uncertainty about global trade and security policies is opening the way for completely new scenarios, which may have major negative economic consequences in the long term.

American fiscal “battering ram” will have global impact

The election of Donald Trump as the next president of the United States is expected to lead to more expansionary US fiscal policies – a yearly dose of stimulus equivalent to some 0.5-1.0 per cent of GDP in 2017 och 2018 – based on tax cuts equally divided between households and businesses, as well as infrastructure investments. This is well below the dose of stimulus that Trump announced during his election campaign. We are uncertain about the coming administration's actual ambitions and about its chances of piloting these policies through Congress. Because of heightened political uncertainty and the potentially negative effects of various Trump proposals on international trade, we are making minor adjustments in our US forecast: **GDP will increase by 1.6 per cent this year, accelerate to 2.3 per cent growth in 2017 and**

expand by 2.2 per cent in 2018. This is somewhat higher than the potential rate of about 2 per cent. The expansion is being held back by weak productivity growth, which hampers capital spending, and by demographic headwinds that slow consumption. Unemployment will fall to 4.5 per cent (below equilibrium) by the end of 2018, and the increase in average hourly earnings will accelerate to 3.5 per cent in 2018: a level that is compatible with the Federal Reserve (Fed)'s 2 per cent inflation target.

EU political map being redrawn – stability of euro may be undermined

The power and momentum of populism is expected to be confirmed by the 2017 elections in the Netherlands, France and Germany, and perhaps also in Italy in the aftermath of its December 2016 constitutional referendum. Governments and established political parties will eventually be under pressure to pursue more expansionary fiscal policies, for example by boosting defence expenditures due to the changing security policy situation. In March 2017, we expect the contours of the European Union's new roadmap to be unveiled during celebrations of the 60th anniversary of the Treaty of Rome. In our assessment, the advocates of EU federalism will be forced to lower their voices so as not to provoke public opinion in member countries in a risky way. Established political parties, especially on the left, will be forced to find new strategies and alliances in order to slow the advance of new populist parties. EU economic policy regulations and cooperation will be under stress, with the risk of escalating tensions – for example between Germany and various other euro zone countries. Despite political anxiety, Brexit uncertainty and weaknesses in their banking systems, **we expect the euro zone economies to grow by 1.8 per cent this year and then decelerate cautiously to 1.6 per cent both in 2017 and 2018.**

The Brexit process is surrounded by big question marks. The British economy has been resilient – in line with our expectations – but we expect a slowdown in GDP growth to 1.4 per cent next year (compared to 2.0 per cent this year and 1.7 per cent in 2018). New legal proceedings will take away the UK government's power to activate the EU "exit clause" by itself. This leads to three conclusions: the country's withdrawal from the EU may be delayed, a "soft Brexit" is more likely and the possibility of a new British election in 2017 will open up.

Our earlier forecast scenario for several major EM economies is proving correct. Their economic growth bottomed out last spring. In **Russia and Brazil** the worst GDP declines are now past, and both economies will return to positive growth in 2017. **India** remains the bright spot among the BRIC economies. **We also expect China to deliver good annual growth of 6-6.5 per cent**, but high indebtedness, a shaky housing market and industrial overcapacity will continue to challenge economic policymakers in Beijing.

Fiscal policy may ease burden on monetary policy, but shift is complicated

Various elements of Trump's economic policies are well in line with what economists and international organisations have called for over a long period. New fiscal and structural policies may **increase demand and boost potential US growth capacity**. This may ease the burden on central banks, in a situation where the effectiveness of monetary policy is becoming weaker and weaker, while its disadvantages – greater economic inequality, weaker reform pressure and risks of increased financial market instability – are becoming increasingly evident.

But shifting the policy mix towards fiscal and structural measures is far from unproblematic; political decision-making processes take time and the independence of central banks is being questioned in countries like the US, the UK and to some extent Sweden. Some central banks may also be forced into further extending their QE programmes in order to soften the threat of rising long-term bond yields in countries with weak government finances, such as Italy. The Bank of Japan's new tools for directly controlling the entire yield curve may also be adopted by other central banks. Our main scenario is that **in December the European Central Bank (ECB) will extend its securities purchases** by six months until September 2017, later providing cautious signals that it plans to phase them out during 2017. The Bank of Japan will not change its current sharply expansionary monetary policy.

The international low-inflation environment will be tested during 2017-2018 as resource utilisation reaches relatively high levels. Meanwhile the UK and the US are on their way towards becoming more closed economies. This will tend to weaken global disinflationary forces and cause national conditions to have a greater impact on inflation. Inflation expectations in financial markets have already climbed a bit. **The Fed will hike its key interest rate in December and then carry out rate hikes every six months during 2017 and 2018 to a level of 1.50-1.75 per cent.** Global concerns, the risk of a

stronger dollar and a downward adjustment in the neutral key interest rate will hold back the Fed. The Bank of England and Norges Bank in Norway will hike their key rates during 2018, while the ECB will keep its refi rate unchanged. We expect US and German government bond yields to climb by 60-90 basis points, reaching higher levels than we had previously anticipated. The EUR/USD exchange rate will move close to parity during 2017 and later rebound towards 1.10 by the end of 2018.

Sluggish economic recovery in several Nordic and Baltic countries

The expansionary economic policies that have been employed to ease the negative effects of falling oil prices **will contribute to a modest recovery in the Norwegian economy, but Norway's dual-track GDP growth will reach only 1.3 per cent this year and 1.4 per cent in 2017**. In 2018 growth will reach 1.8 per cent, aided by stronger private consumption. Norwegian inflation will fall when currency rate effects fade. **Finland will also experience weak growth**, although its outlook has improved. **GDP will increase by 0.8 per cent this year, accelerating to a 1.0 per cent rate next year and 1.2 per cent in 2018** – supported by increased capital spending and other factors. Fiscal austerity will continue. **In Denmark the recovery will broaden. GDP will increase by only 1.4 per cent this year but then climb to a 2.1 per cent rate in 2017 and 2.4 per cent in 2018**. Growth will be supported by a stronger labour market that will improve consumer purchasing power, while higher capacity utilisation and rising home prices will boost capital spending.

Economic trends in the three Baltic countries will also point in the right direction, with household consumption as the most important driving force, but challenges to the competitiveness of these countries – due to such factors as high pay increases and demographic headwinds – will limit their growth potential. **Estonia's GDP will increase by only a weak 1.3 per cent this year but accelerate to a 2.2 per cent rate in 2017 and 2.8 per cent in 2018**. In **Latvia**, too, current growth is unsatisfactory, but we expect EU funds and private consumption to push GDP growth from **1.6 per cent this year to 3.5 per cent in 2017, followed by a 3.0 per cent expansion in 2018**. In **Lithuania**, lower public sector investments are hampering economic growth, but the commercial real estate market is stable and the country will show the **strongest economic expansion in the region at 2.2 per cent this year**. After that, there is good potential for Lithuanian growth to end up at **2.5 per cent in 2017 and 3.0 per cent in 2018**.

Swedish GDP growth will remain well above trend – households hesitant

Although forecasters have lowered their estimates of Sweden's economic outlook in recent months, we are sticking to a more optimistic view. **We expect GDP to increase by 3.7 per cent this year. Next year, too, the economy will grow at well above trend, with GDP gaining 2.8 per cent. In 2018 various bottleneck problems will contribute to a slowdown to 2.3 per cent**. The foremost GDP drivers are public consumption (due to refugee resettlement) and capital spending (due to the housing shortage). An undervalued krona will gradually provide support to exports. Mixed signals about household consumption are a downside risk: despite strong job growth, good real wage increases and positive wealth effects, the savings ratio is at a record-high 16 per cent of disposable income. Households seem to be sceptical about the future, due to uncertainty about international conditions, Sweden's domestic political situation and the Riksbank's negative interest rates.

Swedish inflation has stabilised at a higher level – between 1 and 2 per cent – but underlying cyclical forces are not yet strong enough to result in stable inflation of 2 per cent. We expect next year's collective labour agreements to run for two years and lead to wage and salary increases 0.2 percentage points higher than the 2016 agreements. Including wage drift, pay hikes will be 2.9 per cent in 2017 and 3.1 per cent in 2018, up from this year's 2.6 per cent. At the end of 2018, unemployment will stand at 6.5 per cent. **We expect CPIF inflation (consumer price index minus interest rate changes) to end up at 1.6 per cent in 2017, in line with the Riksbank's latest forecast. CPI inflation is expected to reach 2 per cent at the end of our forecast period, while CPIF will remain below this target**. The foreign exchange market, which at present is underweighted in the Swedish krona, is awaiting the Riksbank's signal that it will be shifting its monetary policy; we believe this signal will come in late spring 2017. This will strengthen the krona despite its near-term weakness: **at the end of 2017 the EUR/SEK exchange rate will be 9.30 and the USD/SEK rate will be 8.80**; at the end of 2018 these rates will be 9.05 and 8.25, respectively.

Fiscal stimulus – key interest rate hike late in 2017

Swedish public finances are continuing to provide upside surprises, helped by large tax revenues in a domestically driven economy. Looking ahead, however, public finances will be squeezed as economic growth decelerates while strains caused by demographics and migration/integration expenditures grow. We expect public finances to be close to balance throughout our forecast period. Meanwhile general government gross debt will fall to 38 per cent of GDP. Increased expenditure pressures on local governments will increase tensions between them and the central government, and we expect further central government grants aimed at avoiding large local income tax hikes. This will help boost the dose of stimulus in the budget for 2018, which is an election year.

Continued low inflation and the ECB's extension of its QE programme **suggest that the Riksbank will extend its own programme of government securities purchases by another six months until June 2017, but reduce its scale** (SEK 30 billion, compared to SEK 45 billion during the second half of 2016). A further key interest rate cut is unlikely, however, among other things because it would divide the bank's Executive Board. Although CPI inflation will not quite reach 2 per cent by the end of 2018, we expect the Riksbank to hike its key rate in late 2017. The main reasons for such hikes are that the level of inflation will have stabilised, credit growth will be high and central banks in other countries will be phasing out their asset purchases and/or hiking their key interest rates. **New Riksbank rate hikes during 2018 will bring the repo rate to 0.25 per cent by the end of 2018.**

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

International economy, GDP, year-on-year changes, %	2015	2016	2017	2018
United States	2.6	1.6 (1.6)	2.3 (2.4)	2.2 (2.0)
Eurozone	2.0	1.8 (1.6)	1.6 (1.7)	1.6 (1.7)
Japan	0.6	0.5 (0.5)	0.5 (0.5)	0.5 (0.5)
OECD	2.3	1.7 (1.7)	2.0 (2.0)	2.0 (2.0)
China	6.9	6.7 (6.6)	6.4 (6.3)	6.0 (6.0)
Nordic countries	2.2	2.0 (2.1)	2.0 (2.0)	2.0 (2.0)
Baltic countries	1.8	1.8 (2.2)	2.7 (2.8)	3.0 (3.1)
The world (purchasing power parities, PPP)	3.1	3.1 (3.1)	3.5 (3.5)	3.6 (3.6)
Swedish economy. Year-on-year changes, %				
GDP, actual	4.1	3.7 (3.7)	2.8 (2.8)	2.3 (2.3)
GDP, working day corrected	3.9	3.4 (3.4)	3.1 (3.1)	2.4 (2.4)
Unemployment, % (EU definition)	7.4	6.9 (6.7)	6.3 (6.1)	6.2 (6.1)
CPI	0.0	0.9 (0.9)	1.2 (1.2)	1.9 (1.9)
CPIF	0.9	1.4 (1.4)	1.4 (1.4)	1.7 (1.7)
Government net lending (% of GDP)	0.0	0.3 (0.3)	0.2 (0.2)	0.0 (-0.1)
Repo rate (December)	-0.35	-0.50 (-0.50)	-0.25 (-0.25)	0.25 (0.25)
Exchange rate, EUR/SEK (December)	9.19	9.75 (9.30)	9.30 (8.95)	9.05 (8.75)

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