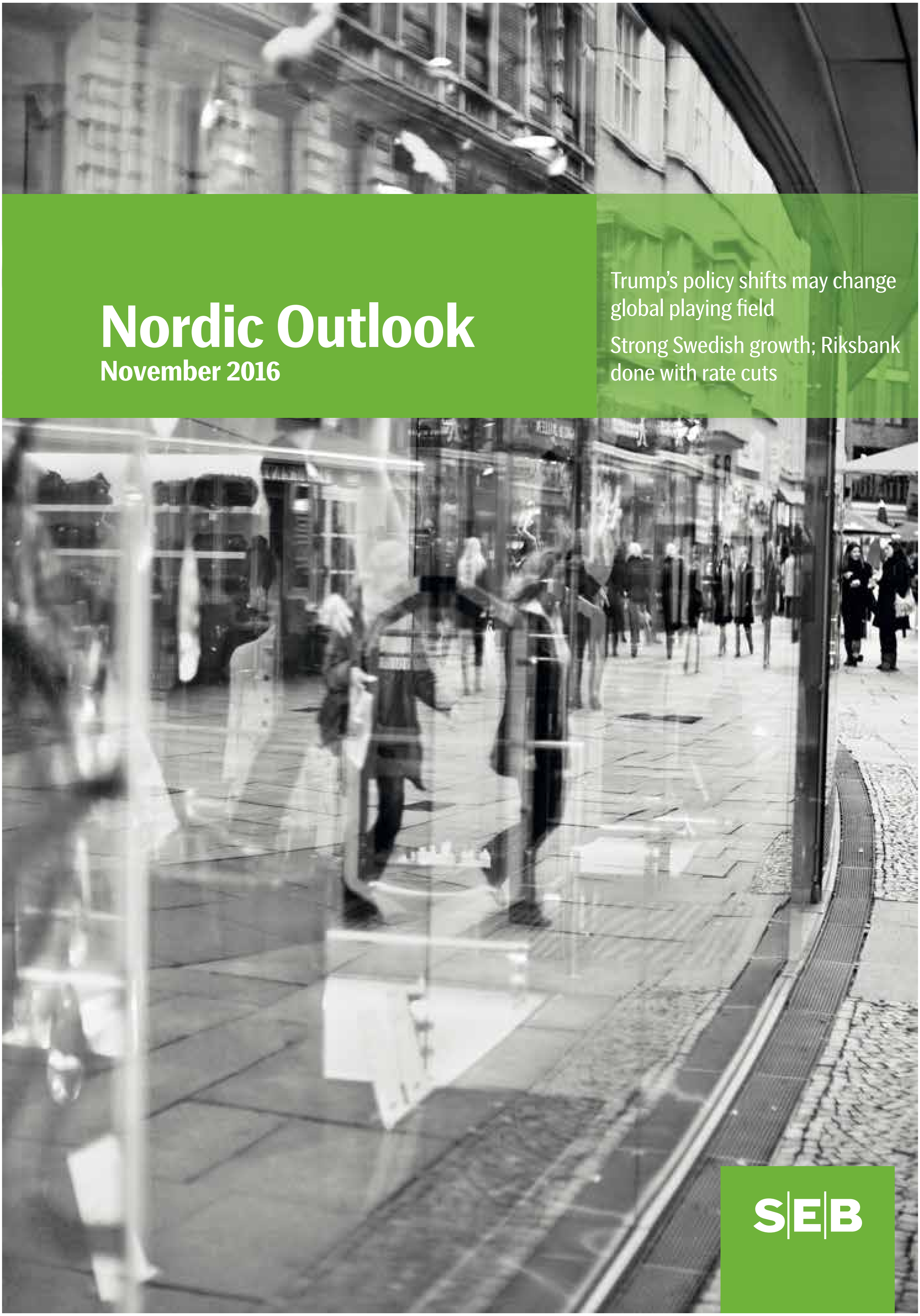
Nordic Outlook

November 2016

Trump's policy shifts may change global playing field

Strong Swedish growth; Riksbank done with rate cuts



Contents

International overview	5
Theme: Mixed effects from Trump's economic policies	13
The United States	14
Theme: Demographics one reason behind gentle Fed	17
Japan	18
Theme: BoJ is breaking new monetary policy ground	19
The BRIC countries	20
The euro zone	22
The United Kingdom	25
Sweden	26
Theme: Growing central-local government tensions	29
Denmark	30
Norway	31
Finland	33
Estonia	34
Latvia	35
Lithuania	36
Economic data	37

Boxes

Continued uncertainty about Brexit process	6
New perspectives on the risk picture	9
Japan's neutral interest rate about 0 per cent	18
Important but non-crucial vote in Italy	23

This report was published on November 22, 2016.

Cut-off date for calculations and forecasts was November 16, 2016.

Robert Bergqvist
Chief Economist
Japan
+ 46 8 506 230 16

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

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

Erica Blomgren
SEB Oslo
Norway
+47 2282 7277

Mattias Bruér
US, United Kingdom
+ 46 8 506 23294

Ann Enshagen Lavebrink
+ 46 8 763 80 77

Dainis Gaspuitis
SEB Riga
Latvia
+371 67779994

Per Hammarlund
+46 8 506 231 77

Carl Hammer
+46 8 506 23128

Olle Holmgren
Sweden
+46 8 763 80 79

Johan Javeus
+46 8 506 23019

Andreas Johnson
China, India, Russia, Brazil
+46 73 523 77 25

Elisabet Kopelman
+ 46 8 506 23091

Mihkel Nestor
SEB Tallinn
Estonia
+372 6655172

Tadas Povilauskas
SEB Vilnius
Lithuania
+370 68646476

Lars Sparresø Merklin
SEB Copenhagen
Denmark
+45 3124 6759

Thomas Thygesen
SEB Copenhagen
Denmark
+45 3328 1008

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

Financial markets at new crossroads after Trump victory

- **US fiscal stimulus foreshadows policy shifts**
- **Major emerging markets have bottomed out, but EM sphere is sensitive to US policies**
- **Trump trade policies biggest downside risk**
- **Central bank stimulus at end of road**
- **Strong Swedish growth, no more rate cuts**
- **Higher inflation expectations will drive up bond yields and US dollar**

After the UK's Brexit referendum and Donald Trump's victory in the US presidential election, political conditions in the Western world have changed dramatically. **In areas like global trade and security policy, there is great uncertainty.** Completely new scenarios have suddenly opened up which may eventually have negative economic effects. In Western Europe, we are facing several key elections of various kinds as voters in Austria, Italy, the Netherlands, France and Germany cast their ballots. If the winds from major English-speaking countries also blow across the Continent, the political map of the entire European Union may be redrawn.

Yet financial market reactions after the Brexit vote, and so far since Trump's victory, have underscored that it may be **tricky to draw quick, far-reaching negative economic conclusions from the results**. Because of Trump's recent shifts towards less disruptive positions on several issues, we know little about how his policies will actually end up. Considering that his election campaign was so clearly run as a protest against various parts of the establishment, it is a bit paradoxical that it seems to include several expansionary fiscal policy elements that are **well in line with what many economists and international organisations have called for**. This also has a bearing on the discussion about the need for changes in the economic policy framework and the role of monetary policy, which is becoming more and more intensive alongside the political drama. The disadvantages of unconventional monetary policy – widening economic gaps, the risk of new financial bubbles and weaker reform pressure – are becoming ever clearer, while many observers also increasingly question the effectiveness of such policies.

Our picture of the international economy in terms of growth and inflation prospects **has not changed especially much since our last *Nordic Outlook*** in August. This is another reason to focus extra attention on economic policy issues in this report. After plunging during the summer months, sentiment indicators have rebounded. In particular, purchasing managers' indices (PMIs) have climbed sharply. Preliminary third quarter GDP figures **for the United States and the United Kingdom** have been surprisingly positive as well. We also believe that during 2017-2018, more expansionary fiscal policies will provide some support. Despite increasing uncertainty about the UK's long-term relationship with the European Union, the weak British pound has helped sustain near-term economic activity. Our view in the August issue of *Nordic Outlook* that Brexit and a weak pound would not worsen the **euro zone** economic outlook especially much has also been supported by incoming data. Despite political worries and weaknesses in the banking system, we are thus sticking to a euro zone forecast above the market's consensus estimate. **Swedish** data, too, have confirmed our view that increased residential construction and public sector consumption due to the refugee crisis will enable the economy to grow at an above-trend rate for another while. The ever-weaker Swedish krona is also beginning to have a clearer impact on export figures.

Global GDP growth

Year-on-year percentage change

	2015	2016	2017	2018
United States	2.6	1.6	2.3	2.2
Japan	0.6	0.5	0.5	0.5
Germany	1.7	1.8	1.5	1.6
China	6.9	6.7	6.4	6.0
United Kingdom	2.2	2.1	1.4	1.7
Euro zone	2.0	1.8	1.6	1.6
Nordic countries	2.3	2.1	2.0	2.0
Baltic countries	2.0	1.8	2.7	3.0
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

Our earlier forecast scenario for major emerging market (EM) countries is also holding up nicely. Their economic growth probably bottomed out last spring and is now rebounding. In **Russia** and **Brazil**, the worst GDP declines are now past and both economies will return to positive growth in 2017. In **China**, activity has stabilised with the help of expansionary economic policies, but growth is expected to resume its deceleration in 2017, though gradually. **India** remains the bright spot among major EM economies; looking ahead, growth will accelerate somewhat but will have difficulty exceeding 8 per cent as long as reform efforts do not make further progress in the right direction.

Overall, this means that **our global GDP forecast is unchanged since August**. We predict that GDP growth will climb from **3.1 per cent this year to 3.5 per cent in 2017 and 3.6 per cent in 2018**. But even if political uncertainty does not prevent such acceleration, this is not an impressive in light of today's extremely loose monetary policies. It remains clear – especially in the US – that the transmission mechanism has weakened – among other things because widening gaps are driving up the household savings ratio, thereby weakening the correlation between increased wealth and consumption.

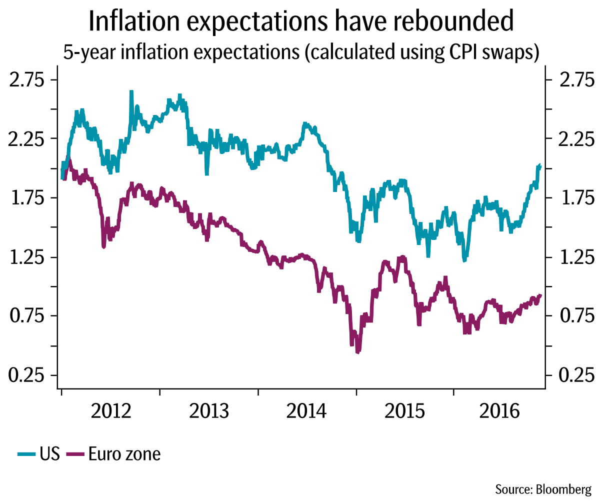
GDP growth, BRIC countries and EM sphere

Year-on-year percentage change

	2015	2016	2017	2018
China	6.9	6.7	6.4	6.0
India	7.3	7.6	7.8	8.0
Brazil	-3.8	-3.2	1.0	2.0
Russia	-3.7	-0.6	1.0	1.5
Emerging markets, total	3.9	4.2	4.7	4.8

Source: OECD, SEB

The international low-inflation environment will be tested during 2017-2018 as **resource utilisation reaches relatively high levels**. Meanwhile the UK vote in favour of leaving the European Union (Brexit) and Trump's election victory indicate that we are moving towards more closed economies. This will tend to weaken global disinflationary forces and instead **cause national conditions to have a greater impact on inflation**. We can already see that US inflation expectations have recently rebounded quite clearly.



But although the risk picture has changed, it is still too early to fundamentally change our forecast scenario. This implies that most central banks will have to continue their battle against uncomfortably low inflation. It is also a bit too early to attach much importance to the signs of greater responsibility among fiscal policymakers that are discernible, **but they have marginally affected our central bank forecasts**. We are sticking to our assessment that the US Federal Reserve will hike its key interest rate in December and then carry out further hikes at six-month intervals, thereby reaching a federal funds rate of 1.50-1.75 per cent by the end of 2018. Other central banks are close to the end of the road in terms of stimulus measures; we are not expecting any further rate cuts, although both the European Central Bank (ECB) and Sweden's Riksbank are likely to extend their bond purchase programmes for 6 months.

The changed outlook after the presidential election has already led to a clear upturn in long-term yields both in the US and elsewhere. Expected policy shifts have caused the market to adjust its Fed expectations upward, but the yield upturn is also driven by rising inflation expectations. **We believe that this re-pricing, to a greater extent than earlier yield rebounds, is supported by underlying fundamentals.** We have thus adjusted our bond yield forecast 60-70 basis points higher to the August issue of *Nordic Outlook* and, for example, now expect a 10-year US Treasury yield of 2.65 per cent by the end of 2017. Threats of withdrawal from trade agreements and wall-building will weaken EM currencies, while the expected Fed rate hike and **political uncertainty ahead of coming European elections will strengthen the dollar towards parity with the euro** for some months into 2017. Further ahead, however, we do not believe the dollar can remain this far from fundamental equilibrium levels. The prospect of stimulus measures and partial deregulation, along with improved economic data, has lifted Western share prices. Our future stock market scenario is also cautiously optimistic, but prices will be sensitive to rapidly rising interest rates and yields as well as increased political uncertainty. Meanwhile valuations are starting to become troublingly high, especially in the US.

Continued uncertainty about Brexit process

The Brexit process is still surrounded by major political questions on both sides of the English Channel. Today there are no signs that either side has a realistic plan as to when, where and how negotiations will begin. The situation is characterised by a lot of political rhetoric but little action or concrete information. There are many indications that the UK's Supreme Court will ultimately rule that Parliament must decide when the EU exit process should begin (such a ruling is expected by mid-January). Our main forecast is that the exit process will begin before March 31, 2017, as Prime Minister Theresa May has stated, but the latest legal proceedings will mean three things: that there is a greater probability that exit negotiations will begin later, that Parliament will try to impose a "soft Brexit" (since 2/3 of its members are pro-EU) and that there is an increased probability of a new British election during 2017. Although uncertainty has increased, we are sticking to our main scenario – that an EU-UK agreement can be reached without excessively negative effects on trade between the two.

Many unknowns in new political landscape

In a number of ways, Donald Trump's unexpected victory in the US presidential election is plunging the world into unknown territory. Many of his statements during the campaign about international trade and foreign policy, for example, indicated rather extreme views that would create major economic and security policy risks. But because of Trump's post-election ambition to build bridges and distance himself from tough campaign rhetoric, the negative stock market reaction that many observers predicted has not materialised at all. But it is still too early to relax; **the playing field may change quickly** as the coming administration begins to provide clearer signals about its policies in various fields.

Both the presidential election and the Brexit referendum have shown that voters in the two biggest English-speaking countries want a shift in policy towards greater emphasis on national issues and lower priority for international commitments and ambitions. **Big post-war policy changes in the US and the UK have had a major effect on the whole Western world, with a certain time lag.** It is naturally difficult to draw historical parallels, but in 1980 – when Ronald Reagan campaigned against high taxes, swelling bureaucracy and intrusive economic policies – he was portrayed for years as an extremist, especially in Europe, but his policies ultimately had a global impact that lasted for decades. Nor were Bill Clinton and Tony Blair initially viewed so favourably by many leftist European political parties, but their policies eventually served as models for other countries. Trump's campaign behaviour is unprecedented, but most observers would certainly agree that the underlying political currents that have sustained him are rather well-represented in Europe as well. We can also draw a more ominous parallel to the years after the First World War, when US President Woodrow Wilson led efforts to establish guidelines for a future international security system. But in the end, there was no support for his ideas at home. After a big Republican victory in the 1920 election, **the US entered a period of isolationism and remained outside the League of Nations**, with devastating consequences for the world, especially Europe.

The question today is what the established political parties in Europe can do to prevent cataclysmic populist successes in the elections scheduled during the coming year, with the French presidential election and the German federal parliament (Bundestag) election as the most important. In the UK, we have seen how the Tory (Conservative) party has shifted clearly from economic liberalism towards greater emphasis on safeguarding the national welfare state. **A similar strategy is also likely among major non-socialist parties on the Continent**, though for example Germany's CDU/CSU adopted such a position many years ago. Perhaps the most important question is how the political left will act. In many European countries, the left has been weakened as populist parties have made major inroads in its traditional voter base. Yet to a great extent, social democratic parties have stuck to a fundamentally positive, idealistic view of globalisation and the strengthening of supranational institutions. Trump's success in mobilising similar groups in the US is now bringing strategic issues to a head. **Is greater focus on the sustainability of national welfare systems the only way of winning back the groups the left has lost to populist parties?** In any case, the latest political developments have reinforced our belief that **the EU establishment will not dare challenge public opinion by forcing through the federalist ambitions** expressed in documents like the Five Presidents' Report published in 2015. This, in turn, means that the infrastructure for a stable euro will remain conspicuously absent. The question is instead whether EU integration efforts must be reversed further in response to public opinion in member countries.

Trump as a fiscal policy battering ram?

In a slightly narrower economic policy perspective, we can be a bit more optimistic about what changes may occur. With Republican majorities in both the Senate and House of Representatives, most indications are that US fiscal policy will move in a more expansionary direction (see theme article, page 13). Important elements of such a policy are **infrastructure investments and tax cuts for both businesses and households**. The proposals unveiled in the election campaign total roughly 2-2½ per cent of GDP yearly but will probably be trimmed by Congress, especially in light of the traditional Republican aversion to increased public debt. Also offsetting the expansionary effect of these policies will be greater uncertainty in many areas, which may hamper economic activity. Nor can we rule out the possibility that rising national debt may push long-term bond yields higher. However, **Trump's victory has contributed marginally to a slightly more positive view of the US economy.**

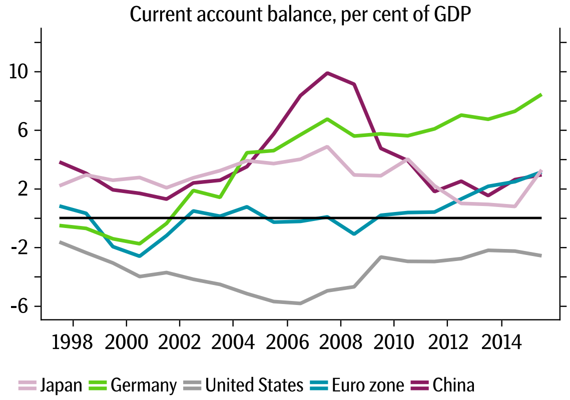
Such policies are quite consistent with the increasingly predominant view that fiscal and structural policy needs to play a more important role in both **helping sustain short-term economic growth and boosting potential long-term growth**. This will ease the burden on monetary policy and allow it greater manoeuvring room, while helping deal with demographic headwinds in a longer perspective. But **shifting the policy mix towards more reliance on fiscal stimulus is far from unproblematic**. First, political decision-making processes take time and are hardly likely to occur without conflicts both at the national and supranational levels. There are also risks that credibility problems will lead to rising long-term bond yields in countries that already have weak government finances to begin with.

A number of factors will determine how large the secondary effects of this shift in US economic policy might be. **Infrastructure investments and tax cuts in the US would be consistent with the conclusions reached by the International Monetary Fund (IMF) and the Group of 20 (G20)**. However, Trump's large proposed tax cuts for high income earners go completely against the IMF's recommendations that tax policy should be used for redistributive purposes. In Europe it is also difficult to imagine gaining widespread support for Republican-style tax policies. But the most important question is how much room there is for unfunded stimulus measures. Many countries and regions, especially the euro zone, have invested a lot of political capital in fiscal tightening. If Trump's policies are embraced by populist parties in Europe, the established parties may face difficult choices, especially in the important elections due in

2017. They may thus also change the EU economic policy landscape – for both better and worse. The right reform policy can stimulate economic growth and improve production capacity, but this policy may also cause various countries to choose programmes that may **undermine EU and euro zone economic policy regulations and cooperation**.

German surplus illustrates global imbalances

Current account balance, per cent of GDP



Source: IMF

Germany's fiscal policy actions will be important in several respects. While global imbalances have generally decreased, especially current account figures from the US and China, Germany's current account surplus just keeps growing. **It is now close to 9 per cent of GDP**, reflecting Germany's strong competitive situation within the euro zone but also in relation to other countries via a relatively weak euro. There is thus growing pressure by both international organisations and the US for Germany to enact fiscal stimulus measures. For example, the future Trump administration is rather likely to cite the surplus as a reason why **Germany should assume greater responsibility for financing common NATO defence expenditures**. Germany will undoubtedly continue to express a defiant attitude towards proposed stimulus measures and point to the rules in the EU's Stability Pact, which limit its degree of freedom. Although we do not believe there will be a drastic change in the next couple of years, the probability of a shift in German fiscal policy has undoubtedly increased.

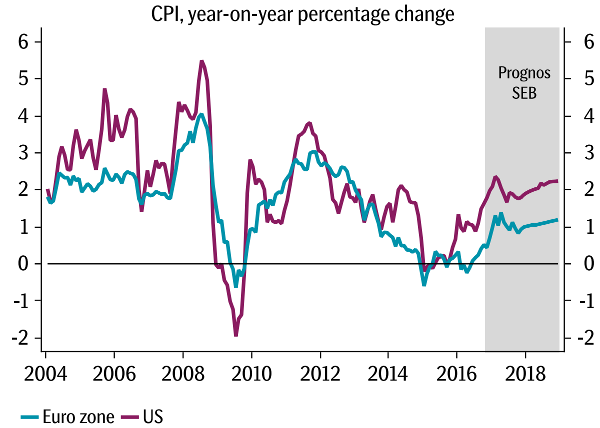
Low-inflation environment will persist

Inflation is now climbing in most countries, driven by base effects from energy prices. In recent months, the upturn in the consumer price index (CPI) in both the US and the euro zone has been somewhat faster than expected. In the UK the weak pound has started to push inflation higher, and this effect will culminate during 2017. But we do not foresee upturns as dramatic as in 2009-2010, when the effects of exchange rate shifts were amplified by value-added tax (VAT) hikes. In Sweden, exchange rate effects have decreased so far this year, but renewed weakness in the krona will again provide an extra inflation impulse in the course of 2017.

During 2017-2018, the low inflation environment of the past decade will be tested as the output gap closes in advanced economies. Meanwhile political decisions will have more effect on wage formation – for example, by means of minimum wage hikes in some countries. **The trend towards limitations on mobility, especially for labour**, that is discernible partly due to the Brexit decision may cause the national resource situation to have a bigger impact on price and wage formation. In addition, there will now be **growing trade restrictions due to the US presidential election**. Yet it is too early to change our basic view that disinflationary forces will continue to predominate. The above structural changes are still uncertain and might have mainly long-term effects. Historical experience also indicates that the effects of tighter resource utilisation on inflation appear only after a time lag. Inflation will thus remain uncomfortably low for many central banks in 2017-2018, especially the European Central Bank (ECB), which must continue to fight for the credibility of its inflation target. In the US, unemployment at or below equilibrium level will exert some upward pressure on wages and salaries, but the moderate inflation upturn that we foresee will still give the Federal Reserve (Fed) a great degree of freedom.

Low but rising inflation

CPI, year-on-year percentage change



Source: Eurostat, BLS, SEB

Unburdening questionable monetary policy

Conditions for pursuing monetary policy are changing. More and more observers share the belief that monetary policy is close to the **"end of the road"**. This is because its effects on growth and inflation are shrinking and may even vanish. Unconventional monetary policy can still drive up asset prices, but its disadvantages in the form of widening gaps and negative effects on pension and banking systems are hobbling its impact on the real economy. Together with risks of new asset bubbles, this implies a greater need to factor in the consequences of monetary policy on **financial stability**.

Developments in the US suggest that **more expansionary fiscal policy, and possibly also structural policy, will increasingly "ease the burden" on monetary policy**, which has affected our central bank forecasts to some extent. However, it is uncertain to what extent this will occur, and the consequences are not obvious either. For example, if long-term bond yields climb too fast as a reaction to rising public sector deficits, financial conditions will tighten. In a situation of continued anaemic growth, this may force central banks to continue their unconventional policies. Also limiting the manoeuvring room of central banks is the fact that neutral global real interest rates have been in a downward trend for a long period (see *Nordic Outlook*, August 2016). Another trend that should be factored in when assessing the monetary policy outlook is the criticism that politicians are increasingly aiming at central banks in the US, the UK, the euro zone (certain countries) and elsewhere. In some cases, central bank independence is being questioned, though we do not expect any rapid near-term changes in the laws that determine the national mandates of central banks. But increased **criticism by politicians** may influence decision making as well as the appointment of new central bank governors and monetary policy committee members.

To summarise, central banks face various complex challenges and must respond to a number of questions, such as:

- Assessing to what degree fiscal and structural policy will actually undergo a shift. In countries with high resource utilisation such as the US, it is also important to estimate the supply-side effects of policies, since pure demand stimulus measures risk arriving too late in the economic cycle.
- Analysing how monetary policy normalisation processes should be shaped, in an environment where depressed real equilibrium interest rates and high indebtedness may have increased sensitivity to key interest rate hikes, compared to earlier economic cycles.
- Analysing the advantages and disadvantages of further QE programmes; in particular, the ECB must factor in the risk of negative effects from additional stimulus measures on the functioning of euro zone banking systems.
- The need to develop new policy tools (see theme article, page 19) in order to give central banks greater manoeuvring room in the future, for example changes in inflation targets and/or nominal interest rate management.

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	0.25	0.25	0.25
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10
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	0.50	0.50	0.75

Source: Central banks and SEB

We are maintaining our forecast that the **Fed will hike its key rate in December** by 0.25 percentage points to 0.50-0.75 per cent. A tighter resource situation, which will gradually accelerate pay increases and inflation, is among the factors behind our forecast that the Fed will carry out further rate hikes at six-month intervals during 2017 and 2018. This implies that the federal funds rate will be 1.50-1.75 per cent at the end of 2018. This cautious pace in historical terms is attributable to a gradual decline in the neutral interest rate. Meanwhile the Fed must take into account the risks of negative secondary effects on global financial markets and of an excessively strong dollar.

Late this year, we expect the **ECB** to announce an **extension of its quantitative easing (QE) programme** for six months after March 2017 but **reserve the right to gradually lower ("taper") its bond purchases** during 2017-2018. The ECB's key rate will remain at 0.00 per cent. We do not expect the Bank of Japan (BoJ) to cut its key interest rate, now -0.10 per cent, but it will continue its QE programme and its new yield curve control system.

New perspectives on the risk picture

In the situation the world has now ended up in, it is natural for political factors to dominate risk analysis. A number of positions that Trump expressed during the presidential election campaign – for example, about withdrawing from trade agreements or changing security policy systems – **undoubtedly have potentially major economic consequences, in part by boosting uncertainty**. Yet there are still so many unclear points about how his policies will actually look that we have chosen not to let this dominate our main forecast. In many cases, these changes also have double-edged economic consequences. For example, a reduced US military commitment in Europe would create greater uncertainty, thus inhibiting investment, but it might also provide a stimulus effect via increased military investments by European countries. A shift in US policy towards Russia, for example, might also lead to the cancellation or at least the easing of sanctions. As for trade policy, there are also reasons to adopt a wait-and-see approach in our forecasts. First, negotiations are likely to be rather lengthy. Second, it is reasonable to believe that the risk of negative effects on the US itself will be accorded greater weight the more concrete the negotiations become. These considerations are among the reasons for our assessment that **the probability of a low-growth scenario will be no more than 25 per cent** (up from 20 per cent in the last *Nordic Outlook*).

As for the upside risk picture, the shift towards more expansionary fiscal policies may be even larger than we had expected. It is also possible that later in our forecast period, households will lower their savings ratio and that the historical relationship between consumption, wealth and employment, especially in the US, will make itself felt. **As in the last *Nordic Outlook*, we estimate the probability of a higher growth scenario at 15 per cent**.

Riksbank is done with rate cuts

Macroeconomic developments in Sweden pose continuing dilemmas for the Riksbank. GDP will continue to grow well above trend in 2017, driven by higher residential construction and public consumption due to the refugee crisis. Meanwhile inflation has remained lower than expected. We predict that the bank's target variable, CPIF (CPI minus interest rate changes) will not quite reach 2 per cent during our forecast period. We still believe that given rising resource utilisation, somewhat higher inflation and a weak krona, at its next monetary policy meeting in December the Riksbank will settle for a slight extension of its QE programme but will refrain from a further interest rate cut. Looking further ahead, we believe that the Riksbank is underestimating GDP growth. In an increasingly tight resource situation, it is reasonable to expect that the bank will be less fixated on minor divergences from its inflation target. **This will be enough to persuade the Riksbank to carry out an initial rate hike in December 2017**, about four months earlier than its own rate path indicates. In 2018, we predict two additional rate hikes to a level of 0.25 per cent at year-end.

Nordics, GDP growth

Year-on-year percentage change

	2015	2016	2017	2018
Sweden	4.1	3.7	2.8	2.3
Norway	1.6	1.2	1.4	1.8
Denmark	1.6	1.4	2.1	2.4
Finland	0.2	0.8	1.0	1.2

Source: OECD, SEB

The Norwegian economy is gradually emerging from its slump, with a powerful fiscal and monetary policy response having limited the secondary effects of low oil prices. Domestic demand is now driving a still-fragile recovery. A brighter growth outlook and surprisingly high inflation have decreased the need for further key interest rate cuts. But given a stronger currency, below-trend growth and inflation that will fall during 2017-2018, Norges Bank can maintain its dovish policy. No key rate hike will occur until the autumn of 2018.

Trump gives yield rebound an extra push

The presidential election was followed by a rapid upturn in US long-term bond yields, also pushing yields higher in other countries, but global long-term yields had already started climbing earlier this autumn from historical lows just after last June's Brexit vote. Recurring forecasts of a trend shift in the fixed income market during the prolonged recovery of recent years had proved wrong every time. A number of interacting forces suggest that this time around, the rebound will be more long-lasting and also occur faster than we had anticipated. One fundamental reason is that **there is no room for further monetary easing**.

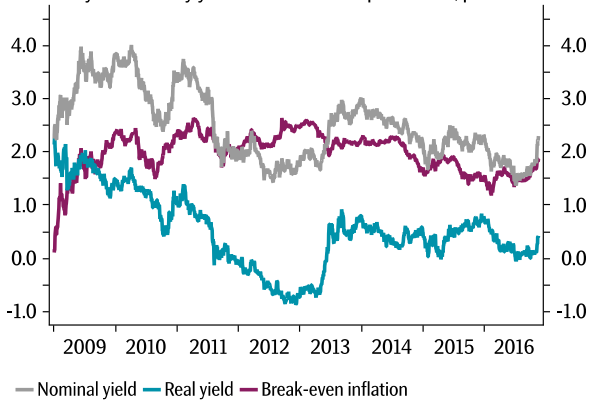
The US now appears likely to lead the way in a shift from monetary to fiscal stimulus. This is one reason why after the election, the market has adjusted its expectations of future key interest rate hikes higher – more in line with our forecast. The upturn in interest rates and yields has also been driven by rising inflation expectations that have been priced into markets, reflecting the **new inflation risk scenario in a situation of rising resource utilisation and threats of restrictions on foreign trade and migration**. A third driving force behind higher US bond yields is the prospect of increased federal borrowing, especially if this is not offset by looser monetary policy as earlier.

Our forecast is that 10-year US Treasury yields will be 2.30 per cent at the end of this year, gradually rising to 2.65 per cent at the end of 2017 and 2.85 per cent at the end of 2018. The equivalent German government bonds will trade at 0.40 per cent at the end of 2016, 0.80 per cent at the end of 2017 and 1.20 at the end of 2018. **The spread between 10-year US and German yields will thus remain around 190 basis points**, at least during the coming year, **consistent with the widest spreads since the late 1980s**. Compared to the August issue of *Nordic Outlook*, we now foresee a steeper yield curve since **our Fed forecast is unchanged while we have revised our long-term yield forecast upward** by 0.60 points.

There is a more two-track risk picture for yields than before, since **our previous disinflationary scenario is being challenged by possible reflation or stagflation scenarios**. On the upside is a faster upturn in inflation expectations, less confidence in US fiscal sustainability and a tighter key interest rate policy once the Republicans have been able to appoint new Fed policymakers. On the downside are risks of financial market turbulence and new economic reversals, for example driven by an escalation of trade wars or geopolitical crises. Because of a stronger dollar, a larger share of tightening effects in the US may come via the currency instead of interest rates and yields alone. In Europe, efforts by the ECB to counter the effects of rising US interest rates and yields may lead to a further widening of spreads against the US. In this respect, the Bank of Japan is a pacesetter because of its new policy of setting a yield ceiling.

US: Trend shift in the fixed income market

10-year Treasury yield and inflation expectations, per cent



Source: Macrobond

The Riksbank's bond purchases combined with smaller issuance volumes have squeezed the spread between 10-year Swedish government bonds and German ones to about 10-15 basis points. **We expect the Riksbank to extend its QE programme in December, while strong government finances will force the National Debt Office to reduce its bond issues further.** This will squeeze bond yields during the first half of 2017 and help narrow the yield spread against

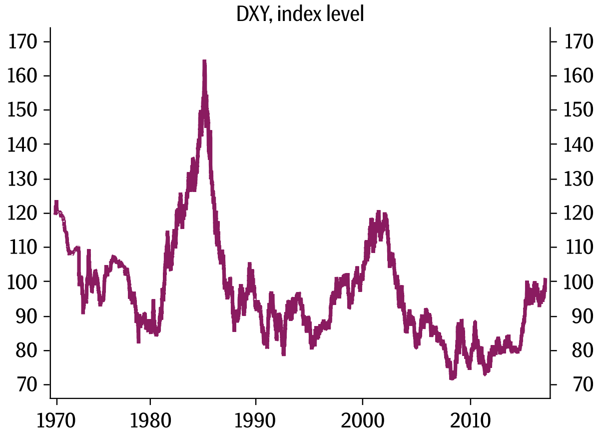
Germany close to zero, but during the latter part of 2017 the spread will widen substantially as the Riksbank's first key interest rate hike approaches. We also believe that Swedish bonds will carry a liquidity premium at that time. Our forecast of a **50-point spread against Germany at the end of 2017 and 70 points at the end of 2018**. Swedish 10-year yields will thus climb from 0.50 per cent at the end of 2016 to 1.90 at the end of 2018.

Foreign exchange market driven by politics

The recent political upheavals could potentially have a major impact on the foreign exchange (FX) market. Although there is great uncertainty about US President-elect Trump's policies, investors have focused so far on the reflationary elements of his tax cut and infrastructure investment proposals. But Trump's agenda also includes potentially growth-inhibiting and inflationary proposals, such as US withdrawal from trade agreements and wall-building. **This part of his policies is reflected in the weakening of emerging market (EM) currencies**, and more of this can be expected. The FX market is likely to be largely driven by political events, at the expense of economic data. This will create uncertainty and rising volatility.

Dollarindex at strongest level since 2003

DXY, index level



Source: Bloomberg

We view the US dollar as overvalued at present, but **a Federal Reserve key rate hike in December and an initially favourable interpretation of Trump's policies** will affect the dollar in an upward direction during the next six months. Now that the event risk level has subsided in the US, the FX market will also shift its focus towards Europe, where uncertain election outcomes during the coming year will boost the political risk premium, putting further pressure on demand for the euro. Partly due to Fed rate hikes, our main forecast is that the EUR/USD exchange rate will drop towards parity by the end of June 2017. Political events, for example if Marine Le Pen becomes president of France, would drive the EUR/USD rate far lower, especially in the short term. Further ahead, we forecast that the EUR/USD rate will move towards levels more justified by fundamentals: around 1.10 towards the end of our forecast period.

The pound has depreciated sharply this autumn, due to complications in the Brexit process and an increased risk that the UK will not enjoy access to the EU single market. The currency is likely to remain weak as long as uncertainty about future EU-UK relations persists, but our assessment is that both sides are dependent on a constructive solution. **The pound is already greatly undervalued against most currencies, which is justified at present.** But the UK economy has not yet been adversely affected to a significant degree, and if there are signals that the political process is moving in the right direction, the pound has major appreciation potential. The timing of such an event is very uncertain, however. We expect the pound to remain weak, with the EUR/GDP exchange rate in the 0.85-0.90 range at least until mid-2017.

The recent aggressive Swedish krona depreciation has several explanations, but the Riksbank's monetary policy is the most important factor. So far during 2016, foreign asset managers have reduced their krona exposure as the Riksbank's ambitions to weaken the krona have gained strong credibility. But EUR/SEK exchange rates close to 10.00 are not sustainable as long as Sweden avoids being drawn into a financial crisis. Both positioning and eventually also the macro situation suggest a stronger krona. Foreign investors have a low exposure to Sweden, while Swedish asset managers and companies have an abnormally large currency exposure. We believe that the EUR/SEK rate will fall towards 9.50 during the next six months. **In order for this movement to continue downward towards 9.00, however, a shift in monetary policy will be required.** We believe that the Riksbank will give the market that signal during the second half of 2017. The USD/SEK rate may test the 9.50 level during the next six months before falling.

Norwegian krone appreciation will also occur gradually. Norges Bank has signalled that further key interest rate cuts are unlikely, although the bank will probably continue threatening to implement them. But fundamental factors such as interest rate margins and valuations unambiguously suggest a stronger NOK. Meanwhile the flow situation is positive, with Norges Bank buying NOK 900 million worth of local currency per day. Assuming that oil prices do not fall sharply again, **we expect the EUR/NOK rate to drop towards 8.50 within 12 months**.

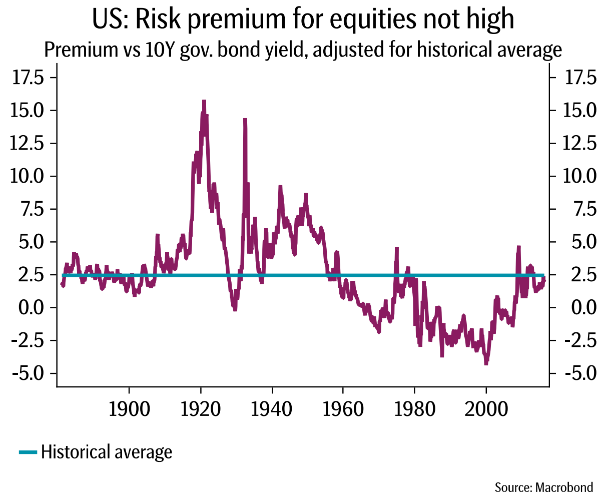
US policy shift boosts stock market outlook

The stock market downturn that investors feared after a Trump victory did not even last for one day. On the contrary, expectations of more expansionary US fiscal policy and easing of regulations in the financial service, oil, pharmaceutical and other sectors have led to renewed energy in Western stock markets. In addition, partly due to the uncertainty that preceded the US election, the improved macroeconomic indicators of recent months were previously not reflected in stock market performance. Third quarter corporate reports also point to a certain global stabilisation, with a recovery for financial service companies in particular. This reduces the risk of downward earnings revisions ahead, **although the**

market's forecasts for the next couple of years are still somewhat overly optimistic in our view.

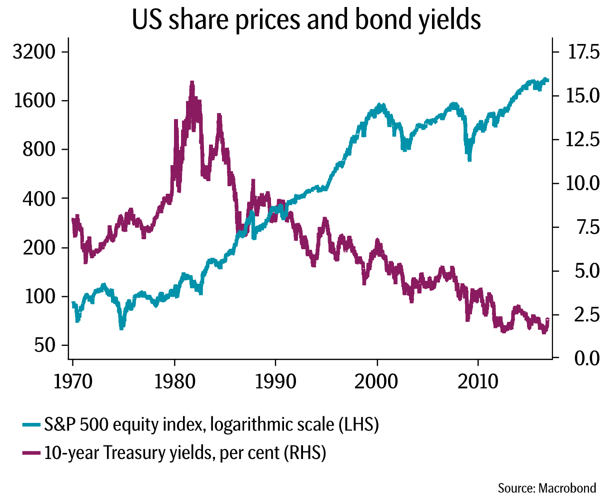
All else being equal, more fiscal stimulus and the accompanying inflation impulses are good for the stock market. Our forecast of a slight acceleration in global economic growth next year supports a cautiously positive stock market scenario. **On the downside are uncertainty about world trade and questions about future risk premiums**, that is, the extra compensation investors will demand to buy equities rather than risk-free fixed income assets. The implicit US risk premium is in line with the historical average and may climb in a politically unpredictable and thus more volatile environment.

A continued sharp upturn in bond yields is another factor that may disrupt our stock market scenario. Higher yields need not be a problem for the stock market if this trend is driven by expectations of stronger economic growth, and so far the stock market has proved resilient. But the correlation between the stock market and bond yields has recently been unusually low, creating a risk of reversals if yields continue to climb rapidly. In addition, stock market valuations remain troublingly high – especially in the US.



Among advanced economies, we foresee a **better outlook for European stock markets than for American shares** due to more attractive valuations, a somewhat stronger earnings outlook and help from a more favourable fixed income and currency trend than in the US. The prospects of somewhat better global economic growth will especially benefit EM stock markets, but offsetting this is that after the US election these markets carry the greatest risk from potential trade restrictions and the adverse impact of higher US interest rates and a stronger USD. Among EM equities, we still see the greatest potential in Asia.

The OMX Stockholm exchange occupies a middle position in terms of the prospects for Nordic equities in 2017. **We predict a 10 per cent increase in corporate earnings next year**, compared to a more moderate 6 per cent in Denmark. Norwegian and Finnish equities will transition from clear declines in earnings this year to upturns of nearly 30 per cent and 14 per cent, respectively, in 2017. This is mainly due to the shifting fortunes of two companies, Statoil in Norway and Nokia in Finland, which represent the two sectors (energy and IT) expected to show the strongest earnings rebound next year. The weakest earnings performance is expected in the financial sector and in commodities, but the outlook may need to be reassessed if Trump's infrastructure investments become a reality.



Valuations on the Stockholm exchange are still somewhat lower than we estimate to be a long-term equilibrium level. Together with good expected earnings increases, this would normally lead to a rather positive future scenario, but the risk connected to earnings forecasts is on the downside. It is also possible that investors will demand a higher risk premium, given the prevailing global political situation, which might very quickly offset both valuations and the earnings outlook.

Mixed effects from Trump's economic policies

- **Health care reform will be reformed**
- **Tax cuts and infrastructure investments are likely**
- **Political uncertainty and trade restrictions will offset fiscal stimulus measures…**
- **… but the net effect will be growth-positive**

Donald Trump's presidential election victory, combined with the Republican majority in Congress, will lead to major changes in US economic policy. Now that the executive and the legislative branch of the federal government are controlled by the same party, the polarisation in Congress it is less important. President Barack Obama's administration had the same golden opportunity during its first two years in office. **But there is still great political uncertainty, for various reasons**. Which policy areas will enjoy priority, and to what extent will Trump try to push through his most outrageous and harmful proposals? Other questions are to what extent Trump can hope for the support of Congress, and to what extent he will actually need it.

During the election campaign, there was a focus on such policy areas such as large-scale tax cuts for private individuals and businesses and more restrictive trade and immigration policies. The Republican fixation on tearing up President Barack Obama's health care reform also played a key role, along with a conviction that the regulatory burden on companies should be eased. For many congressional Republicans, tax cuts, deregulation and the dismantling of "Obamacare" are closest to their hearts; early statements from Congress have indicated that both deregulation and reforming the health care reform are top priorities. Trump's anti-free trade campaign promises have no support from traditional Republicans, however, while the attitude of Congress towards immigration is mixed. **But Trump will have wide-ranging authority to take action in the field of trade without congressional approval**. In other fields, he will need support from some Democrats in the Senate. The Republicans' simple majority in the Senate will thus not be enough in every situation; amending laws and regulations generally requires having at least 60 Senators on board. In order to enact deregulation in the energy and financial sectors, Trump will thus need broader congressional majorities.

As for fiscal policy, the Republican Party's simple majorities in the House of Representatives and Senate will go a long way. The same applies to amendments in the health care reform, but in that field the president-elect now suddenly seems far more willing to compromise, meaning that Obama's signature political legacy appears likely to survive at least in part. Changes in federal expenditures, including Trump's proposed infrastructure programme, can also become law with simple congressional majorities, but it is uncertain whether he can persuade Republicans to back these proposals whole-heartedly. Yet the probability of infrastructure investments is high, since such a programme is generally supported by Democrats. Infrastructure investments were among the few proposals that Trump mentioned in his victory speech. His most recent infrastructure proposal would cost USD 1 trillion over a ten-year period, **equivalent to about 0.5 per cent of GDP yearly**. We believe that such investments are probable, though in a trimmed-down version.

Generally speaking, most indications are that US fiscal policy will be looser than we had previously anticipated. Trump's proposed tax cuts will cost at least an estimated USD 4.4 trillion over a ten-year period, or nearly 2 per cent of GDP annually. The proposed cuts would benefit households and businesses in roughly equal amounts. Trump's tax reform resembles the proposal from the House of Representatives, but the latter is estimated to cost only half as much. We believe that **there is a good chance of tax cuts as early as 2017, but they will be on a substantially smaller scale** than the above figures indicate. Many Republicans want budget discipline and can thus be expected to object to tax cuts that would cause the national debt to skyrocket; Trump's proposal will probably fail if a few Republicans in the Senate vote against it. Moreover, the **debt ceiling, which has to be raised again in March 2017, will act as a constraint**. A trimmed-down version similar to House Speaker Paul Ryan's tax proposal is thus a more likely compromise, since it also includes offsetting expenditure cuts. At present, we expect tax cuts that may provide a fiscal tailwind equivalent to 0.25 per cent of GDP in 2017 and 0.5 per cent in 2018.

The above reasoning indicates that **fiscal stimulus from tax reform and infrastructure spending may total between 0.5 and 1 per cent of GDP in 2017 and 2018**. Since a reform of the tax system is complicated and it may take time before the infrastructure programme gets off the ground, the impact of these measures is likely to be smaller in 2017 and larger in 2018. Their net effect on the economy will also depend on what happens in the trade field and to what extent political uncertainty lowers consumption and capital spending. However, **we expect their net effect to be marginally positive**.

Fiscal stimulus will offset political uncertainty

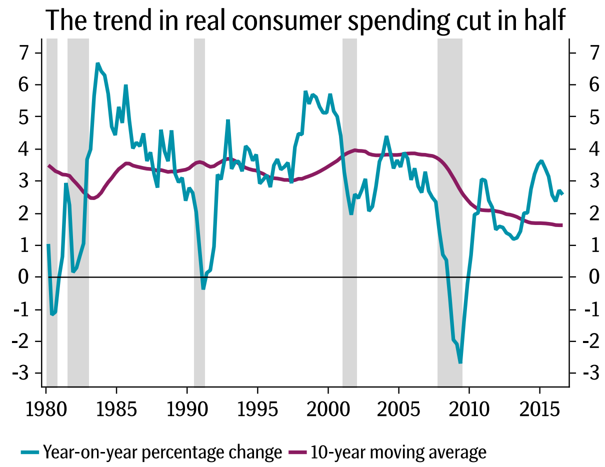
- **Households are saving more**
- **Record-weak productivity growth is holding back capital spending**
- **Unemployment will drop below equilibrium**
- **Gentle Fed will hike its key rate in December**

Donald Trump's unexpected presidential election victory is not a deathblow to the economy, which will instead continue to expand over the next few years. Heightened political uncertainty and negative trade effects will be offset by more expansionary fiscal policies; both tax cuts and infrastructure investments are on the agenda. Meanwhile the US economy has struggled to show persuasive growth. When business confidence indicators lost ground earlier this autumn, the economy came worryingly close to the brink of recession. But the worst headwinds have calmed and business indicators have recouped their losses. Growth will reach only a modest 1.6 per cent this year. **GDP will accelerate to 2.3 per cent in 2017 and reach 2.2 per cent in 2018**. The economy is thus growing somewhat faster than its underlying trend, which we estimate at 1.8 per cent. **Unemployment** has trended flat during 2016 but will resume its **gradual decline to 4.5 per cent by the end of our forecast period**. An ever-tighter labour market will set the stage for faster pay increases. Wages and salaries will gradually take over as a driver of consumption as job growth decelerates. Rising pay levels are another reason why core inflation will be close to the Federal Reserve (Fed)'s 2 per cent inflation target. Headline inflation, which hovered around zero as recently as 2015, has also climbed noticeably.

With the economy approaching the Fed's labour market and inflation targets, the conditions for resuming its key interest rate normalisation are in place. **The next rate hike will occur in December, according to our forecasts**. After that, the Fed will move very cautiously, and the most important **key rate will reach the 1.50-1.75 per cent range at the end of 2018**, unchanged compared to our earlier estimate.

Consumption is growing at a leisurely pace

Household consumption will grow by 2.6 per cent this year – somewhat more slowly than in 2015, when the rate of increase was the fastest since 2005. Consumption remains the most important engine of the recovery, yet it is **trending weaker than fundamental factors justify**. With household net worth at near-record levels, historically low interest rates and new unemployment benefit claims at a 43-year low, the conditions are obviously favourable. But although the labour market is generating job and income growth, household confidence indicators have fallen this autumn. Instead of consuming, **households have increased their saving**. We foresee no strong reasons why this behaviour should change over the next couple of years and predict that the household savings ratio will continue to climb, reaching **6.4 per cent by the end of 2018: somewhat higher than in earlier forecasts**. Although incomes will benefit from various tax cuts and faster pay increases, this means that **consumption will continue to rise at a sedate 2.5 per cent on average in 2017 and 2018**.

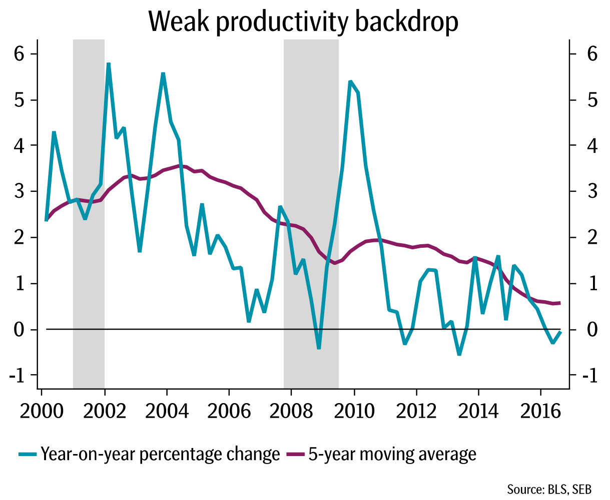


Source: BEA, SEB

In a longer-term perspective, too, household consumption has been far weaker than in earlier cycles; **ten-year trend growth today is less than half its pre-crisis level**. In contrast to the pattern after earlier recessions, the latest downturn in 2008-2009 had a major impact on the long-term trend, as the above chart shows. There are several possible reasons why consumption is reluctant to take off. According to the life-cycle hypothesis, households want to allocate their consumption evenly over their lifetimes. With an ageing population and the big post-war baby boomer generation approaching or having reached retirement age, **an ever-larger share of households are focusing on saving for their old age**. Aggregated metrics also conceal widening income and wealth gaps; a growing share belongs to the rich, who have the lowest inclination to consume. More households may perhaps also be feeling uncertain about the long-term US economic outlook; weaker growth ahead will mean less favourable conditions for both future income and social safety net systems.

Weak manufacturing hampers investments

In recent months, business confidence indicators have recovered after a sharp decline in August. **Our composite ISM indicator is compatible with about 2.5 per cent real GDP growth**, but the relatively strong dollar is still hampering exports. Industrial production today is at the same level as in 2007. Measured year-on-year, production has shown negative growth for 14 consecutive months, which is remarkable in a recovery phase. Although the manufacturing sector represents a rather small percentage of the US economy nowadays, **the correlation between industrial production and business investments is a high 80 per cent**. Weak manufacturing activity is thus one reason why business investments are not really taking off. Nor do order bookings and capacity utilisation indicate an imminent upswing in capital spending. Manufacturing capacity utilisation is around 75 per cent. Historically, only when it exceeds 80 per cent will capital spending show robust growth rates. But with the steep decline in oil-related investments behind us, there is reason to expect a certain rebound. After this year's stagnation, **we expect business investments to increase by 4 per cent in both 2017 and 2018**. With the presidential election now past, an upswing is also likely. According to the Fed's Beige Book, uncertainty ahead of the election held back investments, especially in commercial real estate construction.



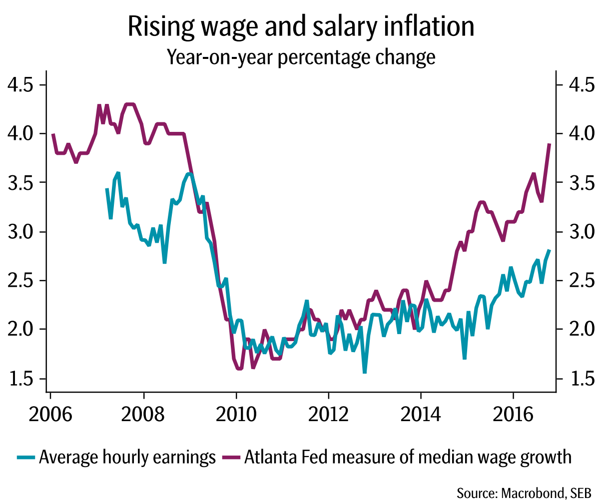
Weak productivity may dampen demand

The US economy is showing signs of demand-side secular stagnation. At the same time, it is beginning to encounter supply-side restrictions. This is related to weak productivity growth after the Great Recession. Over the past five years, corporate sector productivity has risen by an annual average of 0.5 per cent, compared to an average of 2 per cent in 1976-2005. This has enabled moderate growth to be combined with a surge in employment and a rapid decline in the jobless rate. We can also ponder whether there are other types of inter-dependence between slow productivity growth and weak demand. If weak productivity reflects fading innovative power, this may also hamper investment demand due to a shortage of profitable investment opportunities. In addition, weak productivity may affect households' plans to save because of a subdued income growth outlook. **Persistently weak productivity growth may thus lead to both lower capital spending and a high savings ratio in the economy**.

Looking a bit further ahead, there are reasons to believe that productivity growth may accelerate. After all, capital spending is on its way up, while demographically driven labour shortage symptoms may force streamlining of the kind we have seen in Japan. Many observers also hope that technological advances due to digitisation will boost productivity after a certain time lag. But we do not expect these forces to have very much impact during our forecast period.

Labour market will continue to strengthen

Despite weak growth, the US economy is continuing to generate jobs, though at a somewhat slower pace than in 2015. So far during 2016 monthly job growth has averaged 180,000, compared to 230,000 last year. Employment is thus still rising at about twice the pace that is compatible with constant unemployment. Yet joblessness has remained flat this year, reflecting an **upturn in labour force participation**. Compared to September 2015, the participation rate has risen by 0.5 percentage points. There is probably room for a further increase, although the **ageing population is still causing structural pressure**; since 2007, retirements have accounted for two thirds of the fall in the participation rate. There are thus many indications that unemployment will slowly shrink again, reaching a projected **4.5 per cent by the end of 2018**. This matches the bottom of the previous cycle, which was 4.4 per cent.



The increasingly tight labour market is beginning to have some impact on wage formation. The rate of increase in average hourly earnings – the highest-profile metric – has accelerated in 2016. This upturn will probably continue, although the correlation between resource utilisation and pay increases has probably weakened a bit, compared to the historical pattern. **By the end of 2017, we predict that average hourly earnings will be climbing by 3.5 per cent year-on-year**.

Faster inflation trends

Having remained at around zero last year, inflation curves are pointing upward again. The Consumer Price Index (CPI) rose to a two-year high of 1.5 per cent in September. The impact of earlier energy price declines is disappearing from the 12-month figures, thus driving the upturn. Base effects suggest further inflation increases in the coming months; oil prices bottomed out at USD 26/barrel in February 2016 and today's levels are about twice as high. Measured as annual averages, we predict that **inflation will climb from 1.3 per cent this year to 2.1 per cent in 2017 and 2.3 per cent in 2018**.

Slightly higher CPI inflation will make it easier to justify a cautious tightening of US monetary policy, but core inflation is also a vital element of key rate hikes. Core inflation – measured as CPI excluding food and energy – has trended flat at just above 2 per cent since the end of 2015. During the first half of 2017 we now foresee a slight downturn, but then pay increases will contribute to a rebound to above 2 per cent. The Fed's main metric – core inflation measured using the CPE deflator – remains 3/10 of a point below target. The gap between the two core inflation metrics is unusually wide, but we expect it to shrink towards its historic average in the next couple of years. Long-term inflation expectations of households fell to record lows in October, according to the University of Michigan consumer sentiment survey. Break-even inflation expectations are still low, but the trend is rising fast after the election. It is possible that **market pricing still underestimates future inflation**. In an environment where actual inflation is rising as the Fed moves in a less accommodative direction, inflation expectations are likely to move higher too. A lot will also depend on economic policy; **fiscal stimulus combined with any trade restrictions may push up inflation more** than our current forecasts indicate.

More fiscal stimulus with Trump

After the dirtiest presidential election campaign in American history, it is time to focus instead on how fiscal policy will affect the future economy. When Donald Trump takes office in January, he will have the same golden opportunity that Barack Obama had during his first two years as president: his party will enjoy majorities in both the Senate and the House of Representatives. While there will thus not be a polarised Congress that blocks his proposals outright, we expect budget discipline to be significantly stricter than Trump's campaign promises have indicated. Many Republicans in Congress will want a balanced budget. This is totally contrary to Trump's broad unfunded tax cuts and major infrastructure investments, which would boost federal debt by at least USD 4.4 trillion over a ten-year period. Our forecast assumes a substantially smaller fiscal tailwind than this; **we are projecting yearly stimulus doses equivalent to 0.5-1 per cent of GDP in 2017 and 2018**. Fiscal stimulus will thus offset the negative impact of the new president's trade policies on the US economy.

As for Trump's proposed trade restrictions, it is naturally difficult to assess what will end up being implemented, especially in light of the conciliatory tone in his victory speech. As an initial step, however, the Treasury Department is expected to single out China as a currency manipulator. Trump's other hobby-horses – such as punitive tariffs on Chinese and Mexican imports – may become a reality at a later stage. Meanwhile free trade treaties with Pacific Rim countries (TPP) and with the European Union (TIPP) will be buried. We assume that the North American Free Trade Agreement (NAFTA) will survive, however. Obama's legacy may be undermined; his health care reform may undergo a makeover and the US may withdraw from the promising Paris Agreement on climate change. Given Republican majorities in Congress, there is potential to tackle the long-term budget challenges connected to an ageing population, but it remains to be seen whether the new administration will take the chance.

Gentle Fed will hike key rate in December

Unless financial conditions tighten dramatically during the next few weeks, we continue to believe that the Fed will hike its key rate in December. When economic statistics have provided weaker arguments for a rate hike, the central bank has instead focused on other factors. According to a recent policy speech by Fed Vice Chair Stanley Fischer, today's ultra-low interest rates may be problematic for several reasons. They make it harder for financial institutions to build capital buffers. The banks' interest rate margins are also being squeezed, while the likelihood of financial instability increases when investors are forced to search for returns from riskier instruments. **The Fed also believes its credibility will be endangered** if it again backs away from the rate hiking plans it has already announced. Furthermore, the Fed wants to create enough room to ease monetary policy when the next recession hits. There is also speculation that Fed Chair Janet Yellen will submit her resignation once the new administration takes office. If true, it is one more reason to expect a December rate hike.

Looking ahead, stepped-up fiscal stimulus suggests that monetary policy may be normalised at a somewhat faster pace. This is especially true if Yellen's successor advocates a more rule-based monetary policy – which many Republicans support. On the other hand, the central bank seems to have learned a lesson from the fact that for many years, it has been overestimating both the growth outlook and inflation. Nowadays the Fed is **embracing a modified version of secular stagnation** in its forecasts. It has significantly lowered its median forecasts of both GDP growth and the key interest rate, meanwhile describing today's low interest rates as only moderately expansionary. According to the Fed's latest forecasts, its key rate will stand at 1.875 per cent in December 2018, compared to 3.4 per cent on the same date in its forecast of one year ago. There may also be room for the Fed to make further downward adjustments in its estimate of a neutral key rate, from today's figure of nearly 3 per cent. This, in turn, indicates that the Fed may continue flattening its rate path in future forecasts. Overall, **we predict that the federal funds rate will be in the 1.50-1.75 per cent range at the end of our forecast period**, unchanged from our August forecast. As before, we foresee a rate hike at the Fed's policy meetings in June and December of both 2017 and 2018. The market still believes that the Fed's rate hikes will be substantially more modest; market pricing indicates three hikes during 2017-2018.

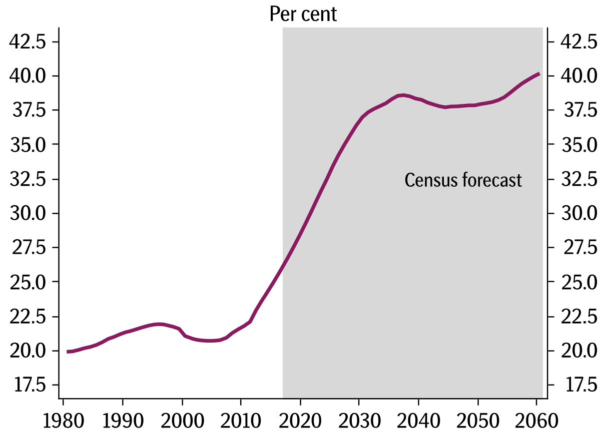
- **Demographic factors are pushing down the neutral interest rate by 100-125 basis points**
- **Model estimates point to further downward adjustments in the neutral rate by the Fed**

According to the Federal Reserve's latest forecasts, the central bank will hike its main key interest rate at a leisurely pace over the next couple of years. At year-end 2018 the rate will be 1.875 per cent, according to its latest estimate – compared to a Fed forecast of 3.4 per cent a year ago. New analyses of demographic effects have played a major role in this change.

The neutral (or natural) interest rate is a rate that creates a long-term equilibrium between savings and investments; **if the inclination to save exceeds investment appetite, the neutral interest rate falls, and vice versa**. Population structure, in turn, is a key factor in household saving. The large US baby boom generation born in the decades after the Second World War is approaching (or has reached) retirement age. According to the life-cycle principle, this boosts household saving, in turn pushing down neutral interest rates. Population structure also has an impact via other channels; both longer life expectancy and changes in the share of working-age people compared to pensioners are important. Given today's population structure, it may take at least 20 years before the share of working-age people begins to increase again.

A Bank of England study indicates that overall demographic changes may explain a one percentage point lower neutral interest rate today than in 1980. According to the Fed's analyses, this effect is somewhat larger: **125 basis points via lower trend growth** than in 1980.

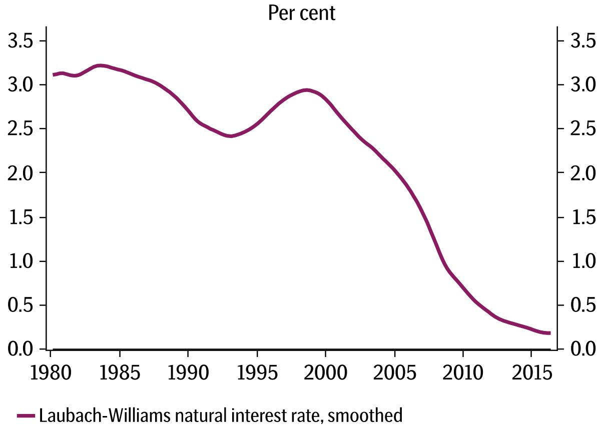
Ratio of people aged 65+ to those aged 20-64



Source: Census Bureau, SEB

However, an ageing population will probably not have permanent effects on the savings ratio and the neutral interest rate. Once most of the baby boom generation has retired – its members now range from their early 50s to early 70s – from a life-cycle perspective we can expect the aggregate savings ratio to fall. This, in turn, suggests that the neutral interest rate will eventually rise, but the overall picture is that the neutral interest rate will continue to be pushed down during the foreseeable future because other factors, including productivity, will exert downward pressure. **After several years of meagre productivity growth, the Fed is inclined to believe that the trend can be expected to persist for some time**. The combination of slow productivity growth and a smaller labour supply, when a larger percentage of the population is retired, are powerful factors behind a dramatic lowering of the long-term growth trend, according to the bank's forecasts. **The Fed now expects long-term GDP growth to end up at a modest 1.8 per cent yearly**, compared to an average of 3 per cent in 1990-2005. With the long-term growth outlook also looking weaker than in earlier estimates, the neutral interest rate is also being pushed down via both lower capital spending and a higher savings ratio.

The natural interest rate is trending down



Source: Macrobond, SEB

According to the latest Fed forecasts, **the nominal neutral interest rate today is 2.9 per cent**. Given the Fed's 2 per cent inflation target, this is equivalent to a 0.9 per cent real neutral interest rate. Meanwhile the central bank's own model-based estimates indicate that the neutral interest rate may be even lower than this: less than 0.5 per cent. If the Fed also applies this to its official forecasts, there is thus **room to make its expected key rate path flatter**. The Fed's interest rate forecasts remain well above those of the market, but the divergence is not as spectacular as about a year ago. Because structural, slow-moving factors underlie the central bank's latest shift, there is less risk of a hawkish swing in monetary policy over the next couple of years.

Digging deeper in the economic policy toolkit

- **GDP growth near or just above potential**
- **New stimulus measures have weak impact**
- **Monetary policy enters uncharted territory**
- **Much of the yield curve is below zero**

Despite new economic **stimulus measures** (see *Nordic Outlook*, August 2016) in the past six months, we see no reason to change our GDP forecast: **annual growth of 0.5 per cent in 2016, 2017 and 2018**, which is below consensus. The risk picture is balanced for both the inflation and growth outlook. Despite a slow growth rate, the economy will expand at near or just above potential (0-0.5 per cent). **Japan will not achieve its main targets** – stabilisation of public sector debt, budget surpluses and 2 per cent inflation **– in the near future**.

Softening the demographic headwinds

Unemployment will fall below 3 per cent by 2018, mainly because the working-age population is shrinking by some 1 per cent yearly: part of the ongoing demographic headwinds. The government continues to take new steps to increase **female labour force participation**, make it **easier** for **older people** to stay in the labour force and **deregulate markets**. It hopes these policies will boost Japan's potential growth and neutral interest rate, thereby also making current monetary policies more expansionary (see below).

Today unemployment is at a 21-year low. Meanwhile companies are reporting historically high earnings. These forces together set the stage for both higher private consumption and investments, but manufacturers remain squeezed by the past year's 20 per cent yen appreciation (in effective terms) as well as global and regional surplus capacity.

We expect nominal pay to grow by 0.5 per cent yearly in 2017 and 2018, providing marginal real wage growth. The government is sticking to its 3 per cent yearly pay hike target, while the IMF and others would like it to enact measures that improve wage dynamics through "political sticks and carrots", aside from fiscal, monetary and restructuring policies (adding a "fourth arrow" to Prime Minister Shinzo Abe's "Abenomics").

Due to Japan's long-standing deflationary environment, expectations of continued slow price increases are deeply rooted in the economy, hampering growth. 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 Consumer Price Index.

Japan's neutral interest rate about 0 per cent

The task of monetary policy is to push the real bond yield below (or above) a neutral rate in order to make policy more expansionary (or contractive). According to new BoJ estimates, the neutral real rate is about 0 per cent. Given today's -0.10 per cent key rate, **monetary policy viewed only from a key rate standpoint is neither expansionary nor contractive**, shifting the focus towards unconventional monetary policy – and the amount of room for further expansionary fiscal policy.

The BoJ's yield curve control

Japan's monetary policymakers have broken new ground (see theme article), adding two new elements to their framework:
1. Increased control/management of the yield curve;
2. A call for inflation to *exceed* the BoJ's 2 per cent target.

The motives behind these new measures are to a) push down **real interest rates/yields for various maturities**, thus boosting capital spending and consumption, b) stimulate Japanese investors to **buy assets abroad** and thereby weaken the yen, and c) to some extent, **protect the financial sector** against rising interest rates and squeezed profitability. Meanwhile the BoJ continues to **expand the monetary base**, which now totals 100 per cent of GDP: five times larger than the Fed's and ECB's balance sheet expansion. Since the BoJ recently announced greater tolerance about when the inflation target is achieved, we expect it to **abstain from further key interest rate cuts.** Today we believe that the yen's value is relatively reasonable, but our main scenario is that it will weaken against the dollar due to Fed key rate hikes. The **USD/JPY** rate will be 108 this December, 113 at the end of 2017 and 115 at the end of 2018. Japan is clearly afraid of international/G20 accusations of exchange rate manipulation; when the BoJ's various analyses evaluate monetary policy, they almost never mention the yen or the exchange rate channel.

The Abe administration's promise to the G20 to pursue credible fiscal consolidation still rings hollow, and Japan's public sector debt would be a risk factor in the world economy in case of credibility problems. Over the next couple of years **we expect public finance deficits to reach 4-5 per cent of GDP**. This implies that **public sector debt will climb from 248 to 255 per cent of GDP** during out forecast period.

- **Japan tests lowering all real bond yields up to 10 years – but with doubtful results**
- **New tools aim to protect financial sector against low interest rates and weaken yen**
- **Invoking the spirit of Bernanke on how to increase central bank manoeuvring room**

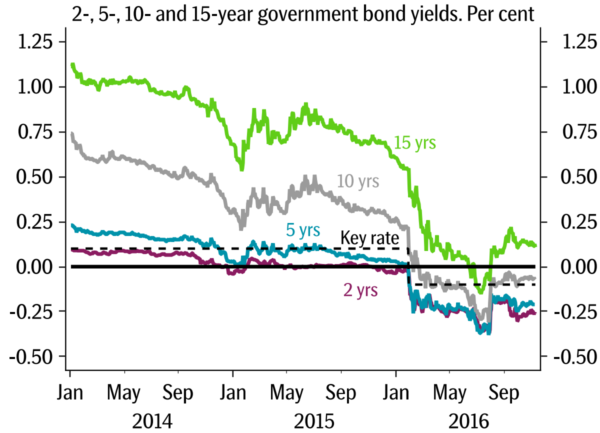
This October's IMF annual meeting in Washington lent growing support to the perception that **monetary policy is at "the end of the road"** – with **diminishing** or largely **absent** effects on growth and inflation, while **boosting risks** to the financial system. The focus of most central banks is thus on a) possibly **phasing out ongoing bond purchases**, b) in some cases, **launching normalisation processes** and c) determining what **manoeuvring room** will exist when the next downturn hits.

Yet Japan's unique situation seems to be taking that country in a different direction. In September the Bank of Japan (BoJ) approved important changes in its policy framework, thereby breaking new ground. The BoJ is likely to be watched with great interest by other central banks looking for new future tools.

The BoJ's previous policy framework included these elements:
1. A 2 per cent **inflation target**, measured using the CPI
2. Quantitative and qualitative easing (QQE) with yearly securities purchases of JPY 80 trillion (USD 780 billion), including JPY 6 tr (USD 60 bn) in ETFs, plus a **negative key interest rate, currently at -0.1 per cent**.

Japan squeezing bond yields below zero

2-, 5-, 10- and 15-year government bond yields. Per cent



Source: Macrobond

Yield curve control one of two new tools

As part of its reform, the BoJ is adding **two new elements**:
1. **Yield curve control** up to 10 years out on the yield curve;
2. A commitment to ***exceed*** the inflation target of 2 per cent.

The first element, ***yield curve control***, is the more interesting from an operational standpoint. It implies that the BoJ will now ensure that the entire yield curve for government securities with maturities of up to 10 years will be at or below zero per cent. The BoJ has declared that **10-year government bond yields will be close to zero per cent until further notice**. Combined with a negative key interest rate, this will push the entire yield curve downward. As needed, the BoJ may change both the level (in per cent) and maturity target (in years). Remarkably, the BoJ now has both a yield and expansion target; in practice, one of them is superfluous.

The second element, a ***pledge to exceed the 2 per cent inflation target***, will be achieved through continued sharp expansion of the monetary base by purchasing assets. The aim is to increase inflation expectations and thus lift pay hike expectations. The desired overall effect of these two new steps is to ensure that the **real yield curve, at least out to 10 years, will be pushed downward as future inflation rises**.

Invoking the spirit of Bernanke at the BoJ

Former Fed Chairman Ben Bernanke is probably one of the architects behind the BoJ's new measures. Unlike former Fed colleagues and other central bankers, he seems to believe that it is **more effective to control** (i.e. to lower) **nominal yields than to change** (i.e. to raise) **inflation targets**, for example when creating greater manoeuvring room in a new world.

The debate on whether this is the best way forward for renovating monetary policy frameworks is likely to continue and intensify as the risk of secular stagnation rises. But for Japan, it is highly **doubtful whether the BoJ's recent steps are really the solution for boosting growth and inflation**.

These monetary policy changes imply both **protection and vulnerability** for Japan's financial sector. The BoJ is trying to achieve an upward-sloping yield curve and ease the negative effects of its low interest rate policy on bank profitability. The BoJ is also protecting the Japanese bond market from rising international yields, something that many observers fear may be the result of expected rate hikes in the US and elsewhere.

The question is whether Japan is still trying to weaken the yen, despite the G20's conclusions, in order to give exporters an even better chance to hike wages and boost capital spending. The BoJ's desire to create negative real yields of up to -2 per cent on long-term investments – provided the inflation target is regarded as credible – while global yields rise, will motivate Japanese investors to increase their foreign exposures.

In practice, the BoJ has now taken a step towards "helicopter money", by enabling the government to borrow at 0 per cent for 10 years. Since this policy is expected to have a time limit, the helicopter will not take off until the BoJ agrees to write down the value of its Japanese government bond holdings.

Growth will rebound next year, except in China

- **China: Near-term stabilisation**
- **India: Cautious acceleration is expected**
- **Russia: A slow turnaround**
- **Brazil: Government finances a big challenge**

China: Faster reforms are needed

Growth has now remained at 6.7 per cent year-on-year for three quarters. The manufacturing and construction sectors appear to have contributed less to third quarter growth, but this was offset by faster service sector expansion. Exports remain sluggish, hampered by weak global demand, while the Chinese housing market saw an upswing in 2016 as higher residential sales led to a decline in the supply of unsold homes. Local authorities have nevertheless begun taking steps to slow price increases by banning sales of multiple homes to the same buyer in major cities and by requiring larger down payments. Housing policy has thus shifted from supportive measures to tightening, which will cool future growth.

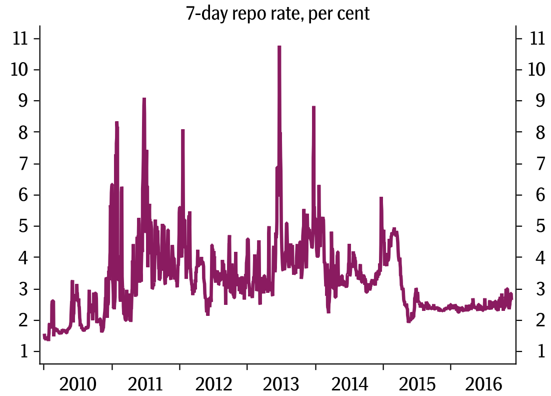
Overall **economic activity has stabilised**, largely thanks to stimulus measures. Next year, we expect growth to slow again as the effects of earlier monetary policy stimulus fade and reform efforts weigh down manufacturing performance. But the government probably wishes to keep growth stable ahead of the important meetings late in 2017 at which numerous members of the political elite will be replaced. We thus expect expansionary fiscal policy to help keep deceleration moderate. **We predict GDP growth of 6.7 per cent in 2016** and **6.4 per cent in 2017**. In **2018**, growth will slow further to **6.0 per cent**.

Inflation remains far below the 3 per cent official target; in October it stood at 2.1 per cent. Producer prices are again showing positive 12-month figures after having fallen since early 2012. **We expect full-year average CPI inflation of 2.2 per cent in 2016 and 2.5 per cent yearly in 2017 and 2018.**

Chinese monetary policy has shift in a conventional direction. The People's Bank of China previously tried to control the money supply directly, which resulted in a highly volatile interbank rate, but since 2015 this rate has stabilised – probably because the PBoC has begun to use it as a target variable. The central bank is now using open market operations and other interventions as policy instruments. This shift decreases the need to make adjustments in reserve ratios and benchmark rates. China's monetary policy tools have thus become more like the ones that advanced economies use.

China: Monetary policy shift

7-day repo rate, per cent



Source: ChinaMoney

Reform efforts are moving slowly. Measures to shrink industrial overcapacity have been limited so far, and there has been no clear deceleration in lending. The authorities are worried that rapid reforms might weaken the labour market and trigger social unrest, but a change in official communication is discernible. An extra Politburo meeting in late October **signals that the focus of policy is now shifting from growth support to curbing asset bubbles**. This change is consistent with steps being taken to slow home price increases, reinforcing the impression that fiscal policy is the remaining official stimulus tool.

After having kept the **yuan** stable ahead of its inclusion in the IMF's Special Drawing Rights (SDR) basket starting October 1, the central bank has let the currency depreciate. US dollar appreciation following the Trump victory and ahead of the Fed's rate hike in December together with continued capital outflows and worries about future US trade policy creates downward pressure on the yuan. However, we expect only a mild depreciation with a **USD/CNY** exchange rate of **7.05** at the **end of 2017** and **6.80** at the **end of 2018**.

India: Questions about monetary policy

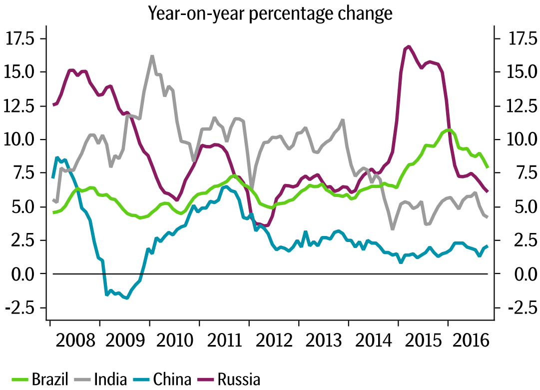
Second quarter GDP growth slowed to 7.1 per cent year-on-year, thereby narrowing the discrepancy with other economic data which point to significantly more sluggish expansion. In the near term, weak capital spending represents the biggest obstacle to a surge in growth. Investment activity is hampered because of structural problems and because heavy debt among state-owned banks and many private companies is limiting both the supply and demand for loans. A number of steps have been taken, and attempts are being made to build up a corporate bond market, but large-scale capital injections in banks will probably be needed in order to boost lending activity.

We expect GDP to accelerate gradually from **7.6 per cent in 2016 to 7.8 per cent in 2017 and 8.0 per cent in 2018**. The national goods and services tax (GST) is an important reform measure. This tax may possibly be ready for implementation on April 1, 2017, as planned, but due to obstacles in important reform areas like the labour market and land purchase laws, it will be difficult to reach the 8-10 per cent GDP growth target.

Inflation has decelerated and is well below the official target of 5 per cent at the end of the current fiscal year in March 2017. We expect annual average **inflation of 5.2 per cent in 2016, 4.7 per cent in 2017 and 4.5 per cent in 2018**.

BRIC countries: Low or falling inflation

Year-on-year percentage change



Source: National statistical offices

The Reserve Bank of India has now ended the old system of letting the governor personally set the key rate. Such decisions are instead made by a monetary policy committee. Like Sweden's Riksbank, it has six members including the governor, who has a tie-breaking vote. At its first meeting in October, the committee voted unanimously to cut the key rate by 25 basis points. Combined with the RBI's downward revision in its estimate of the long-term neutral real rate, this has raised **questions about monetary policy**, but it is too early to say that the RBI has shifted its focus back to stimulating growth. The rupee has weakened somewhat on the Trump victory following a period of stability but strong fundamentals provide resilience. We expect a **USD/INR** exchange rate of **69.0** at the **end of 2017** and **67.0** at the **end of 2018**.

Russia: The recovery will be slow

Because of higher oil prices and improvements in the manufacturing sector, the worst of the recession is now past. Private consumption remains squeezed but there are signs of resurgence. EU and US sanctions against Russia are expected to continue, although Donald Trump's election victory has boosted uncertainty. Combined with structural problems, this means that the recovery will be weak. **GDP is expected to fall by 0.6 per cent in 2016**, followed by a weak recovery. We predict **1.0 per cent growth in 2017** and **1.5 per cent in 2018**.

There is little room for fiscal stimulus. The 2016 federal budget deficit is expected to be nearly 4 per cent of GDP. The government has been using the Reserve Fund to cover its deficit, and if the fund continues to shrink at the same pace it will be empty next autumn. Using the National Welfare Fund, the deficit can be funded until early 2019. Before then, the government must take steps to increase taxes and borrowing.

Inflation has fallen, and the downturn is expected to continue. We predict **average annual inflation of 7.1 per cent in 2016, slowing to 5.5 per cent in 2017 and 5.0 per cent in 2018**. In mid-September, the central bank cut its key interest rate by 50 basis points to 10.0 per cent, but its press release was hawkish and we expect the key rate to remain unchanged for the rest of 2016 before the bank resumes rate cuts in 2017.

The result of the **parliamentary election** was that President Vladimir **Putin** and his **United Russia** party further **strengthened their grip on domestic politics**. Due to changes in election laws and a tough approach to Russia's divided opposition, United Russia expanded its number of parliamentary seats despite weak economic growth. This election outcome is not expected to affect economic policy and reinforces the impression that no extensive reforms will occur before the **March 2018 presidential election**.

The **rouble** has appreciated sharply during 2016; this trend continued during the autumn, driven by more stable oil prices and improved sentiment. The currency depreciated after Trump's victory along with oil prices but by less than most EM currencies and we expect a **USD/RUB exchange rate of 66.0** at the **end of 2017** and **70.0** at the **end of 2018**.

Brazil: Government finances a big challenge

Like Russia, Brazil has passed its worst GDP downturn. The turnaround is being driven by net exports and capital spending. Due to high household debt, combined with a rising proportion of bad loans and weak lending, private consumption will not be a driving factor – unlike earlier recoveries. **We expect GDP to decline by 3.2 per cent in 2016 and then increase by 1.0 per cent in 2017 and 2.0 per cent in 2018.**

The recovery is gaining some support from looser monetary policy. In October the Brazilian central bank cut its key rate for the first time in four years, to 14 per cent. Inflation has fallen sharply to 7.9 per cent year-on-year in October. We **expect 2016 inflation to average 8.7 per cent**, slowing to **6.0 per cent in 2017** and **5.0 per cent in 2018**. Falling inflation and the government's ambition to restore fiscal order will allow further monetary easing, but key rate cuts will be gradual.

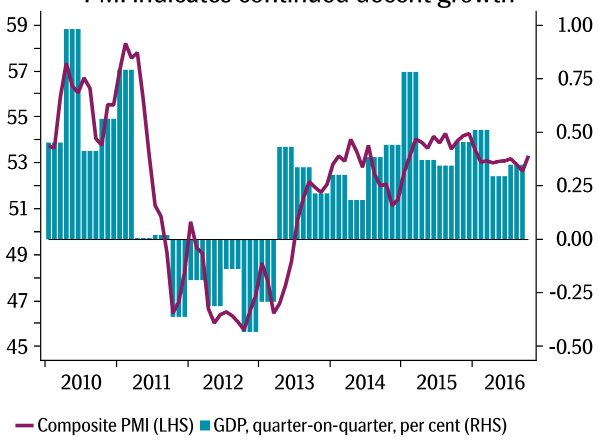
The domestic political scene has stabilised since Dilma **Rousseff was forced to resign as president**. The Michel Temer government will probably survive until the 2018 election and can intensify its focus on reforms. Aside from structural problems, the budget **deficit** of 10 per cent of GDP is the **biggest near-term challenge**. Temer's proposed public expenditure ceiling will probably win final approval in December, but the fiscally crucial **pension reform** will be more difficult to push through. So far this year, the **real** has gained close to 20 per cent against the dollar; it risks becoming a threat to the recovery but is expected to weaken in 2017 driven by higher American interest rates in the wake of the Trump victory. We predict a **USD/BRL** rate of **3.50 at the end of 2017** and **4.00 at the end of 2018**.

Indicators signalling some acceleration in growth

- **Increased employment driving consumption**
- **Inflation is rising but remains low**
- **Political uncertainty due to elections soon**
- **ECB will extend QE programme in December**

The euro zone economic outlook has recently stabilised. Various forward-looking indicators are now pointing to some acceleration in GDP growth. An upswing in manufacturing will help create **more balanced expansion** between service and goods production. Rising employment is driving consumption, while higher capacity utilisation is stimulating capital spending, although problems in parts of the banking sector are hampering this development. **GDP will grow by 1.8 per cent in 2016 and 1.6 per cent yearly in 2017-2018. In December 2016 the European Central Bank (ECB) will decide to extend its bond purchases**. The question of phasing out these purchases (tapering) will emerge early in 2017.

PMI indicates continued decent growth



Source: Markit, Eurostat

Several large euro zone countries will be going to the polls in late 2016 and during 2017. Most indications are that populist and EU/euro-sceptical parties will increase their support. In Italy, Prime Minister Matteo Renzi is facing headwinds ahead of his December 4 referendum on a new constitution. A loss may topple or at least weaken his government (see box). It is hardly likely that National Front leader Marine LePen will be elected president of France or that nationalist parties will be successful enough in Germany's Bundestag election to threat the dominant role of the CDU/CSU. But these confrontations will still require a lot of energy, thereby dimming the possibility of breakthroughs on key future-oriented EU and euro issues. The Netherlands, where members of parliament have questioned whether the ECB has an actual mandate for its unconventional monetary policy, also faces a divisive election in March. Meanwhile the Brexit issue will generate uncertainty for years to come. The experience of the past few years, most recently the CETA trade negotiations with Canada, has underscored how hard it is for the EU to reach a consensus. But as long as these problems are of a more low-intensity nature, it is unlikely that a lack of resolute decision-making will have such big negative economic effects during our forecast period.

GDP forecasts
Year-on-year percentage change

	2015	2016	2017	2018
Germany	1.7	1.8	1.5	1.6
France	1.3	1.3	1.1	1.3
Italy	0.7	0.9	0.8	1.2
Spain	3.2	3.3	2.7	2.8
Greece	-0.2	0.0	2.7	3.0
Portugal	1.6	1.0	1.5	1.5
Ireland	26.3	4.8	3.6	3.5
GIPS countries	6.3	3.0	2.8	2.9
Euro zone	**2.0**	**1.8**	**1.6**	**1.6**

Source: Eurostat, SEB

Economic policy at a crossroads

Both fiscal and monetary policymakers are facing difficult choices. The ECB and other central banks are more and more clear in appealing for help from fiscal policymakers, but a number of euro zone countries are still struggling with large budget deficits and debts. For example, Spain and Portugal have failed to reduce their deficits in compliance with the guidelines established by Brussels, although they have not been penalised. Due to their limited manoeuvring room, a major change is hardly likely even though the toughest phase of fiscal austerity is over. **Looking ahead, the EU will adopt a largely gentler approach to enforcing its budget rules**. Certain German stimulus measures are likely. Overall, **fiscal policy will be largely neutral or only slightly stimulative in 2016-2018**. The euro zone public deficit will **fall from 2.1 per cent of GDP in 2015 to 1.5 per cent in 2018**. Public sector debt will stop rising this year, but because of low nominal GDP growth the downturn in debt will occur at a slow pace.

Slight improvement in indicator data

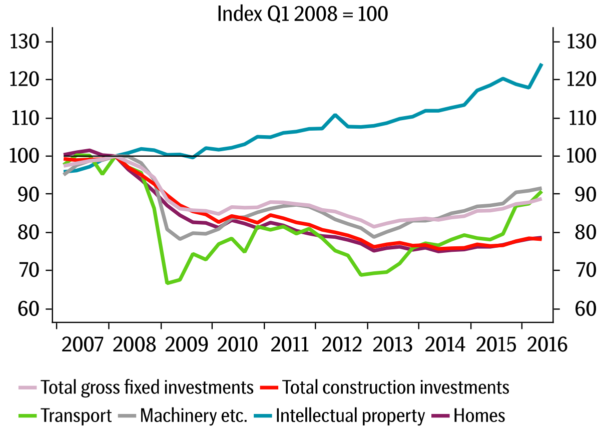
Purchasing managers' indices (PMIs) rose in October and **indicate some acceleration in the growth rate early in the fourth quarter**. The gaps between major euro zone countries have narrowed somewhat, although Germany and Spain continue to show a more expansive trend than France and Italy. In sectoral terms, we are also seeing a more balanced trend, with the situation in the manufacturing sector having recently improved; October manufacturing PMIs were the strongest since April 2014. After a weak start to the year, **exports and industrial production have slowly improved**. The order situation is decent, according to both PMIs and the EU's Economic Sentiment Indicator (ESI), and the positive trend is continuing during the autumn. The downturn following the UK's Brexit referendum bottomed out in August, and exports are expected to continue increasing. Industrial production will climb by 1-2 per cent yearly in 2016-2018 and **export growth will speed up from 2.5 per cent in 2016 to 4.5 per cent in 2018**. Current account surpluses will shrink slightly in 2017-2018 as imports grow faster than exports. International pressure on Germany to deal with its external imbalances (excessive domestic saving) will increase, but it will probably remain difficult for the US or others to single out one country in the currency union as a currency manipulator.

Capital spending will accelerate

Capital spending has been low for years, and its weakness has been broad-based. This is one reason why capacity utilisation in manufacturing has climbed a bit above its historical average, despite a weak economic recovery. New investment needs are thus gradually increasing, and the demand for loans is already at a decent level. Overall, we expect euro zone capital spending to **increase by 3-3.5 per cent yearly in 2016-2018**, but problems in the banking sector, especially in southern Europe (see the box in *Nordic Outlook*, August 2016) continue to hold back lending and capital spending. Although there is widespread willingness – and attempts are being made – to recapitalise the weakest banks, the process is moving sluggishly in Italy and elsewhere. Banking sector problems are not unique to southern Europe, as illustrated by the fines that the US Justice Department is demanding from Deutsche Bank. In terms of stock market performance, European banks remain depressed; the European banking share index is now about 10 per cent lower than it was at the beginning of 2016 after improving from its summer lows.

Low capital spending over a long period

Index Q1 2008 = 100



Source: Eurostat

Important but non-crucial vote in Italy

Unlike other southern European countries, Italy has managed to avoid bail-out packages, but it still faces major challenges. After two prolonged recessions since 2008, GDP is nearly 10 per cent below pre-crisis level. Persistent competitiveness problems are one reason why our growth forecast for Italy is around only 1 per cent annually over the next couple of years, which will not allow any significant improvement in the labour market situation. Meanwhile the government is grappling with banking sector problems and difficult refugee flows.

To some extent, political uncertainty is helping hold back the Italian economy. The increasing worries connected to developments in Italy are illustrated by the recent increase in government yields, rising faster than in other countries in the region. Renzi has carried out various reforms over the past two years, and the next crucial event will be the December 4 referendum on a new constitution. Put simply, the proposed changes in the constitution would improve the ability of the government to run the country and enact reforms, among other things by curtailing the power of the Senate. The opposition, however, sees a risk in putting too much power in the hands of the prime minister and his government. Renzi initially put his entire political future on the line by declaring he would resign in case of a No vote, but now that the No side has opened up a lead in opinion polls, Renzi has backed away from this threat. A Yes vote would signal support for Renzi's continued reform policies. In case of a No vote, political uncertainty would increase further. Renzi's main opponent, the anti-EU Five Star movement led by Beppe Grillo, would gain a tailwind and could then push through a referendum on Italy's EU membership. At present, opinion polls point to a No vote. This would risk destabilising the government, increasing the probability of a new election in the spring of 2017. Due to political uncertainty, the downside risks in our already weak Italian forecast are already dominant. In the unstable situation now prevailing in the overall EU project, a No vote and triumphs for the Five Star movement would further strengthen the momentum behind EU-sceptical parties in other countries.

Consumption will continue to climb

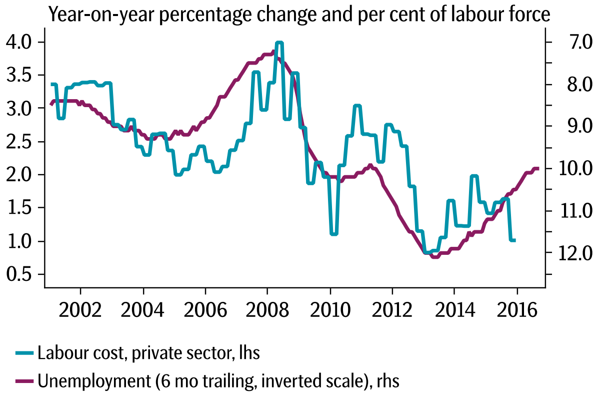
Euro zone household consumption has risen at a relatively stable pace over the past year and has been one of the main drivers of economic growth. Retail sales have recently slowed a bit, but car sales continue to climb at a healthy pace. The retail sector seems to have a relatively stable view of the future, according to forward-looking indicators (PMIs). **Several factors suggest that consumption will keep rising**, although somewhat higher inflation will squeeze real incomes to some extent. Job growth is continuing, fiscal policy is largely neutral and home prices are climbing in three of the four largest euro zone economies (Italy being the exception). **Consumption will rise by 1.8 per cent in 2016 and 1.6 per cent yearly in 2017-2018**.

Employment will continue to increase

The positive labour market trend is continuing. In the second quarter of 2016, the number of people with jobs was 2.5 million higher than in the same period of 2015. In spite of this, **unemployment has levelled out at 10.1 per cent for five months in a row**. This partly reflects the fact that labour force participation has now gained back much of its decline during the economic crisis. According to the European Commission index, hiring plans indicate a continued upturn in employment, which will lead to a renewed downturn in the jobless rate ahead. **Measured as annual averages, unemployment will fall to 9.6 per cent in 2017 and 9.1 per cent in 2018**. We estimate that structural equilibrium unemployment for the euro zone is 8-8.5 per cent. Idle labour market resources and the need to restore competitiveness in many countries will continue to slow pay increases. Also worth noting is wage and salary restraint even in countries with a tighter resource situation. For example, in recent years German wages have risen by only about 2.5 per cent yearly despite historically low unemployment. This is one factor behind our forecast of a very cautious acceleration in euro zone pay increases: from just above 1 per cent this year to 1.5 per cent in 2018.

Falling unemployment will eventually push wages and salaries slowly higher

Year-on-year percentage change and per cent of labour force



Source: Eurostat

Rising inflation, but below the ECB target

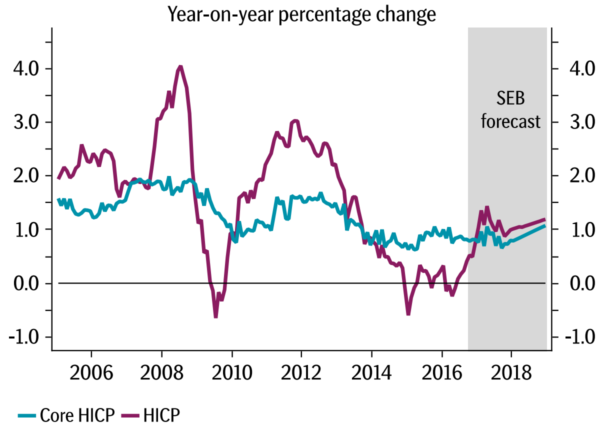
After hovering around zero for a couple of years, the harmonised index of consumer prices **(HICP) has now started to climb**. The October figure (0.4 per cent) was the highest year-on-year rate of increase since June 2014, and the upturn is continuing. This is mainly driven by fading base effects from energy prices, while underlying inflation is stable at around 1 per cent. Inflation will be well below the ECB's target of close to 2 per cent in 2017-2018. Continued low pay increases are one reason why core inflation will remain low throughout our forecast period. Our inflation forecast does not diverge so much from the ECB's in the near term, but the gap will widen in 2018; we thus believe that the ECB will eventually revise its forecast downward. Annual average **inflation will be 0.2 per cent in 2016 and 1.1 per cent yearly in 2017 and 2018**.

Continued bond purchases for a while

Our main forecast is still that **in December the ECB will decide to extend its QE programme for another six months** until September 2017. Its bond purchases will continue on the same scale as before (EUR 80 billion per month), while the **yield floor will be removed** and the key rate will be left unchanged. The yield floor (a restriction stating that the ECB will buy no bonds with yields below its own deposit rate for banks, currently -0.4 per cent) has led to increasing problems for the ECB in buying bonds of countries with negative yields that dominate far out on the yield curve. For example, the ECB cannot buy bonds with shorter maturities than 5 years in Germany. Removing the yield floor is probably the most effective step to enable the ECB to enlarge its bond purchase universe in a credible way, although the recent upturn in yields somewhat has reduced the pressure. We thus believe that this change will be approved at the December policy meeting, based on recommendations from the committees that are now studying the matter. Once the yield floor is removed, the ECB can focus more of its purchases on shorter maturities, which will lead to a steeper yield curve.

Rising inflation but well below target

Year-on-year percentage change



Source: Eurostat, SEB

But a continued and even more expansionary monetary policy is not problem-free. The credibility of QE policy and negative interest rates is being threatened, among other things by mounting concerns about the liquidity situation in Germany and elsewhere and its political consequences for financial stability. Politicians are also raising the question of **how far the mandates of central banks actually extend.** As monetary policy approaches the end of the road, however, the ECB leadership is increasingly frustrated that politicians are not using the time that monetary policy is buying them to implement the necessary fiscal stimulus and structural reforms. But at present, the ECB has hardly any choice but to continue its bond purchases. We thus believe that discussion about when bond purchases will decrease will be kept out of official ECB communications, but that various test balloons will be dispatched to gauge the market's reaction. We believe that **late in the first quarter or early in the second quarter of 2017, the ECB will begin to communicate that its next step will be to cut back its monthly purchases by EUR 20 billion per quarter, starting in Q3**. This means that purchases will continue throughout 2017, but at a declining level.

Greater uncertainty, but Brexit is not killing the economy

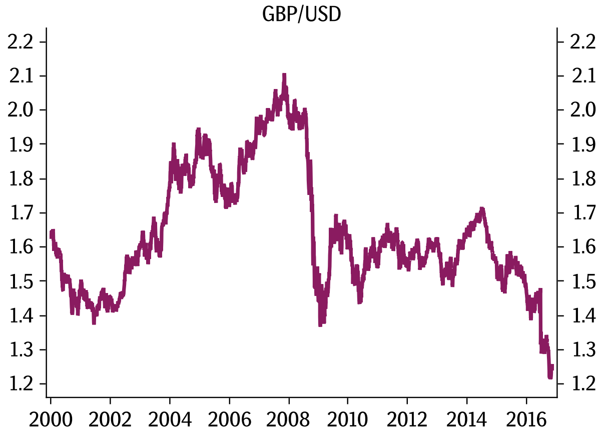
- **EU exit clause will be activated in the spring**
- **Political uncertainty will slow GDP in 2017**
- **Pound slide and fiscal policy ease the shock**
- **Gentle BoE approach, despite high inflation**

So far, Brexit has not killed the British economy. On the contrary, economic statistics have topped expectations, in turn justifying a slightly **more optimistic growth outlook**. After traumatic initial declines, indicators have rebounded and are suggesting that fourth quarter 2016 economic growth will match the robust trend of the preceding quarter. In 2016 the economy will grow by 2.1 per cent. **We predict a bit of a hangover in 2017, when growth decelerates to 1.4 per cent**. In 2018, GDP will grow by 1.7 per cent and our forecast exceeds the 2016-2018 consensus. **Unemployment**, which has continued to fall this year, **will be 4.7 per cent at the end of our forecast period**. This is in line with the lows during the last economic cycle. The fall of the pound will boost exports and inflation; year-on-year inflation will peak at 2.5 per cent in 2018. Measured as annual averages, **inflation will be 2.1 in 2017 and 2.3 per cent in 2018**. Although inflation will end up above the Bank of England (BoE) target, we expect the bank to leave its key rate at the current record-low level throughout 2017.

In an October policy speech, Prime Minister Theresa May said that **Article 50 of the Lisbon Treaty (the "exit clause") will be activated no later than the end of March 2017**. By not postponing the issue, the government was hoping informal talks with EU leaders could begin immediately, but signals from Germany's Angela Merkel, France's François Hollande and the European Council's Donald Tusk indicate that they are not prepared to give the UK special treatment, out of **fear that other countries may follow the British example and apply for withdrawal**. It is difficult to see how May's belief that the UK should have great influence on immigration can be combined with access to the EU single market. The recent High Court ruling that Parliament, not May's government, should be in charge of the process will probably not stop the UK's withdrawal, but it increases the chances of a gentler Brexit that includes more British concessions in order to maintain single market access. These developments have fuelled speculation about a new election; **the probability of such an election in 2017 is about 40 per cent, according to betting firms**.

The May government would like to shift the focus of economic policy towards **allowing fiscal policy to assume a larger share of stimulus measures**. Although investors are demanding more compensation for the inflationary effects of the weaker pound – as recently as August the yield on 10-year sovereign bonds was 0.60 per cent, compared to 1.48 per cent today – the government's borrowing costs are still low. This opens the way for infrastructure projects when the autumn budget is unveiled on November 23; the weak opposition in Parliament is unlikely to create obstacles. This will ease the pressure on the BoE to stimulate the economy**; its key interest rate will remained unchanged at a record-low 0.25 per cent until mid-2018**, when the bank will begin cautious rate hikes. PM May's criticisms of today's ultra-low interest rates and bond purchases are marginally eroding the BoE's independence but do not affect actual monetary policy.

Fast pound depreciation against the dollar



Source: Macrobond, SEB

Once the exit clause has been activated, **we expect political uncertainty to have a greater impact on growth**, especially via weaker capital spending amid falling order bookings. We also expect job growth to slow, while higher inflation will undermine purchasing power. Another sign of UK economic weakness is that third quarter growth was driven entirely by the service sector; both industrial production and the construction sector contributed negatively. Yet we believe that a combination of the weak pound and looser fiscal policy will soften any economic downturn; so far during 2016, the pound has fallen sharply against most currencies, **losing slightly less than 20 per cent against both the euro and the US dollar**. This is benefiting exporters, whose order bookings have rebounded dramatically. Currency trends are uncertain and are likely to be driven in the short term by political events, but at present the pound is clearly undervalued, especially against the dollar. We thus believe the pound will eventually appreciate. **The GBP/USD exchange rate will reach 1.38 at the end of 2018; meanwhile the EUR/GBP rate will be 0.80**.

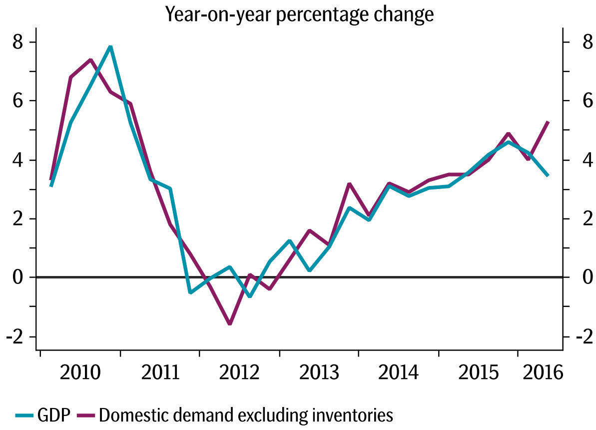
Growth will remain well above trend

- **Broad-based GDP growth**
- **Manufacturers will benefit from weak krona**
- **High resource utilisation will cause inflation**
- **Riksbank will abstain from further rate cuts**
- **Major structural and political challenges**

Although forecasters have generally adjusted their GDP estimates lower after a disappointing first half, we are continuing to predict that **in 2017 the Swedish economy will keep growing at well above its long-term trend**. We expect GDP to grow by 3.7 per cent in 2016 and 2.8 per cent in 2017, then decelerate to 2.3 per cent in 2018. **Growth will continue to be driven by domestic demand**, with public sector consumption and housing investments making especially large contributions. Household consumption will slow somewhat, partly offset by more expansionary public sector investments and stronger exports due to the weak krona. One sign that underlying strength still remains is that final domestic demand (excluding inventories) continued to accelerate during the first half of 2016, even though GDP growth slowed.

Final domestic demand is gaining strength

Year-on-year percentage change



Source: Statistics Sweden

A weaker krona combined with higher electricity prices will drive up CPIF (CPI minus interest rate changes) to nearly two per cent in early 2017. When these temporary effects fade, inflation will again fall somewhat, since underlying cyclical forces are not strong enough to fully resist. This means that at the end of 2018, inflation will remain below the Riksbank's 2 per cent target, though partly due to temporary effects. We believe that **the Riksbank will extend its QE programme in December**, but that the higher 2017 inflation outlook combined with still-climbing resource utilisation will be among the reasons why it will **abstain from further key rate cuts**. We expect an initial rate hike in December 2017 and a year-end 2018 repo rate of 0.25 per cent.

Looking ahead, fiscal policy will be dominated by efforts to deal with the very large refugee inflows of recent years. But as refugees are granted residence permits, responsibility shifts from the central government to local (municipal and county/regional) authorities, which are responsible for supplying the new arrivals with housing, health care and education. The result will be **a surge in local government consumption and investments**, but also **increased tensions between the central and local government sectors about how they should share these cost burdens**.

Manufacturers will benefit from weak krona

Manufacturing sector indicators have improved this autumn. The latest purchasing managers' index (PMI) showed **a clear upturn in optimism**, probably reflecting both a somewhat better world economic situation and a weak krona exchange rate. According to our estimates, the 10 per cent depreciation since the summer will provide an export stimulus equivalent to 3 per cent over a three-year period. We have thus adjusted our export forecast, though the past few months' performance has not been impressive. Also contributing to a brighter outlook is that final service exports have been adjusted much higher, compared to earlier worrisome reports of a decline. **We expect total export growth to climb from 4.2 per cent this year to 4.6 per cent in 2017**. Due to a slightly stronger krona, this growth will slow to 3.0 per cent in 2018.

Housing investments will continue upward

Capital spending has been an upside surprise so far this year, and there are many indications that it will keep growing at a healthy pace. **The most important driver is residential construction**, with housing starts climbing to the same levels as during the latest boom around 1990. Housing investments will contribute 0.7 percentage points to GDP growth in 2016 and 0.8 points in 2017. By the end of our forecast period, residential construction will reach 7 per cent of GDP, which is in line with pre-financial crisis peaks in Norway, Denmark and elsewhere. Capital spending activity is also rather expansive in other areas, but with wide variations between sectors. Manufacturing investments have provided an upside surprise this year, although indicators suggest they will slow down in 2017. However, there are many indications that **local government investments**, which have been largely unchanged so far, **will take off precipitously during 2017**.

Total capital spending growth will nevertheless slow to 6.0 per cent during 2017, from about 8 per cent in 2016.

Household incomes and consumption

Year-on-year percentage growth

	2015	2016	2017	2018
Consumption	2.7	2.7	2.7	2.5
Incomes	2.2	3.1	2.5	2.4
Savings ratio, %	15.7	16.2	16.3	15.9

Source: Statistics Sweden, SEB

Mixed signals about private consumption

Despite rapid job growth, a healthy increase in purchasing power and rising wealth, **private consumption is climbing at a rather moderate pace** – especially considering population growth. Instead, **households are choosing to increase their savings**. Low confidence in the general economic trend, according to National Institute of Economic Research (NIER) confidence surveys, suggests that households are sceptical about whether the good times will last. This, in turn, may help explain why concerns about the long-term housing situation, for example whether one's children will be able to find housing, or worries about a low pension may drive up saving. **The future outlook is mixed** but generally suggests relatively good consumption growth figures of around 2½ per cent. The SEB Housing Indicator points to continued price increases next year, while the labour market will gain further strength. Although the upturn in real incomes will slow down, partly due to an import price-driven upturn in inflation, the rate of increase will still be higher than the historical trend. Short-term indicators are mixed, with increased uncertainty in the retail sector, whereas October consumer confidence was at the highest level since 2010.

Rapid expansion in public consumption

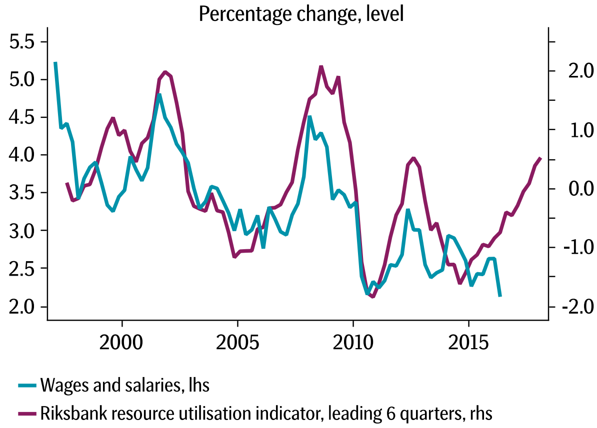
Last year's large refugee inflow is now putting increased pressure on local governments. As the number of approved residence permits increases, responsibilities are shifting from the Swedish Migration Agency to local governments. Because of continued heavy demand for health care, social services and schooling, the growth in consumption will remain high for a number of years to come – although this growth will soon culminate. **Total public sector consumption contributed one percentage point to GDP growth in 2016**. Although local government consumption growth will slow to 2.5 per cent next year, its contribution will remain substantially above the average of the past 20 years.

Strong job growth is speeding up

Job growth has accelerated greatly this autumn, after a slowdown this past summer. Hiring plans according to the NIER's Business Tendency Survey suggest even stronger near-term growth. Furthermore, **public sector employment** (which is not included in the NIER survey) **is growing ever faster**, contributing nearly half of the total increase in the second quarter of 2016. Unemployment is trending downward, although monthly figures are volatile. A rapid increase in the labour supply will keep the downturn slow, however. Because the decline in unemployment is concentrated among people born in Sweden, while the jobless rate among foreign-born people remains high, there is a major risk of structurally higher unemployment, **accentuating the major integration challenges faced by policymakers**.

Rising resource utilisation but sluggish pay increases

Percentage change, level



Source: The Riksbank

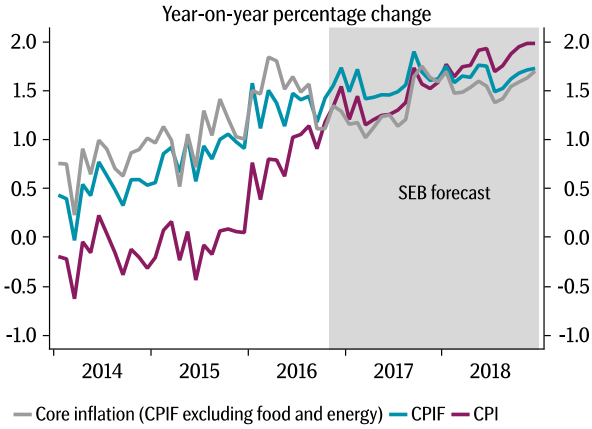
The strong labour market is also reflected in **the continued upturn in resource utilisation**. The percentage of companies stating that they are having trouble recruiting suitable employees is approaching **the peak levels of the past 20 years**. A tighter labour market supports our scenario that the ongoing wage round will end up with somewhat higher contractual pay hikes than the latest round. As in the last round, industrial unions will demand 2.8 per cent increases, but extra programmes for low-wage earners will make total demands somewhat higher. **We expect two-year collective agreements with yearly pay increases of 2.4 per cent:** about 0.2 points higher than in 2016. Because companies have ample opportunities to import labour from other EU countries, pay increases above the collective agreements will be moderate in a historical perspective. **We expect total pay hikes to accelerate from 2.6 per cent this year to 2.9 per cent in 2017 and 3.1 per cent in 2018**: lower than the Riksbank's forecast.

Inflation will rise in 2017 but fall in 2018

Expectations of weak underlying inflation pressure have become well-established in recent months, but in the near term sharply rising electricity prices will drive up CPIF inflation to nearly two per cent early next year. Combined with a major slide in the krona, CPIF inflation appears likely to end up averaging 1.6 per cent next year. This is in line with the Riksbank's latest forecast. Electricity prices will begin falling again in the second half of 2017, however, and upward pressure from the weaker krona will ease during 2018. Offsetting these trends will be gradually intensifying, cyclically underlying inflation pressure driven by higher pay and slightly rising international prices. Yet our view for a long time has been that the impact of resource utilisation on inflation will arrive with a lag of 1-2 years and may also have weakened compared to historical patterns. **The result will be that CPIF inflation will again remain a bit below target in 2018**.

CPIF will not quite reach 2 per cent

Year-on-year percentage change



Source: Statistics Sweden

Riksbank is done with rate cuts

Despite unexpectedly low inflation in recent months, at its latest policy meeting the Riksbank chose to await further information before enacting more stimulus. Since October inflation stayed below the Riksbank's forecast, though marginally, **an extension of its quantitative easing programme at the December meeting appears likely**. However, we still believe there is a high probability that **the Executive Board will abstain from further key rate cuts**. Although no Board members publicly dissented, the October minutes shows that Board members are starting to diverge in their opinions both about the need for new measures and the risks of adverse side effects. If Governor Stefan Ingves would really like to push through further rate cuts, there is every indication that this would lead to a divided Executive Board.

The Riksbank's inflation forecast for 2017 is closely in line with ours, but the central bank meanwhile expresses a far less optimistic growth and labour market outlook. If we are right, incoming data will thus not support further stimulus measures during the coming year. The unexpected depreciation of the krona in recent months – unexpected by the Riksbank, too – points in the same direction. Although CPIF inflation will not quite reach 2 per cent during our forecast period, we still believe that high resource utilisation and a shift towards less fixation on minor divergences from targets are sufficient to persuade to Riksbank to hike its key rate in December 2017. This implies a rate hike about four months earlier than in the Riksbank's October rate path.

Narrow near-term spread again Germany

Because of the combination of Riksbank bond purchases and reduced issue volumes, the spread between 10-year Swedish government bond yields and their German equivalents has narrowed to about 10-15 basis points. We believe that the Riksbank's extension of its QE programme will include a larger proportion of inflation-linked bonds, but we also expect nominal government bonds to be part of the programme. We also believe that either in February or June 2017, the National Debt Office will be forced to further reduce its bond issues. This will put yields under continued heavy downward pressure during the first half of 2017. We thus foresee the possibility that the yield spread against Germany will fall to zero early in 2017, but when the Riksbank eventually ends its purchases we believe that Swedish sovereign bonds will still trade with a liquidity premium. Combined with approaching Riksbank rate hikes, this suggests that the spread against Germany will widen substantially during the latter part of 2017. **Our forecast of a 50 basis point spread against Germany at the end of 2017 and a 70 point spread at the end of 2018** is relatively unchanged from the previous *Nordic Outlook*.

Continued weak krona for another while

The recent aggressive Swedish krona has several explanations, but the Riksbank's monetary policy is the most important factor. So far during 2016, foreign asset managers have reduced their krona exposure as the Riksbank's ambitions to weaken the krona have gained strong credibility. But EUR/SEK exchange rates close to 10.00 are not sustainable as long as Sweden avoids being drawn into a financial crisis. Both positioning and eventually also the macro situation suggest a stronger krona. Foreign investors have a low exposure to Sweden, while Swedish asset managers and companies have an abnormally large currency exposure. We believe that the EUR/SEK rate will fall towards 9.60 during the next six months. As Riksbank rate hikes draw closer, the krona may strengthen further with the EUR/SEK rate reaching close to 9.00 at the end of our forecast period. As for the USD/SEK rate, we believe it will rise during the next six months and test the 9.50-level before gradually decline to levels more justified by fundamentals, around 8.20-8.30 at the end of 2018.

Public finances

Per cent of GDP

	2015	2016	2017	2018
Net lending	0.0	0.3	0.2	0.0
Borrowing req., SEK bn	33	-65	-5	-20
Gen. gov't gross debt	43.4	40.7	38.8	38.0

Source: Statistics Sweden, SEB

Stable public finances

Despite rising expenditure pressures due to the refugee crisis, public sector finances have recently provided upside surprises as tax revenues are driven higher by strong economic conditions. But challenges will gradually increase over the next couple of years as economic growth and tax revenues slow, while migration- and integration-related expenditures persist. Yet we believe that **public finances will remain relatively healthy in 2017-2018**, with net lending close to balance and public sector debt that will shrink as a percentage of GDP. The government budget will show a surplus or close to balance throughout our forecast period, The National Debt Office appears increasingly isolated in its prediction of large deficits as early as 2017, but increasing local government spending pressure (see theme article) will lead to growing tensions between the central and local government sectors.

- **Growing local government burdens**
- **SEK 20+ billion in new national grants**

Swedish municipal and county/regional finances look relatively sound today, thanks to rising tax revenues. Last year 266 out of 290 municipalities reported budget surpluses, excluding extraordinary items. As central government and Swedish Migration Agency refugee resettlement costs decrease, **pressure on local governments will grow**. Our forecast already points to a sharp increase in local government consumption. Looking ahead, there will be growing tensions between central and local governments about financing issues.

Growing expenditure-driving factors

Local governments are already squeezed by an ageing population. **They now also face a need to expand public activities** like as health care, schools and social services due to large migrant inflows. Growing population also **requires major capital spending** on homes, schools, roads etc. Meanwhile **the shortage of trained staff** in such activities is increasingly noticeable, not only threatening quality but putting pressure on budgets due to rising labour costs. Although the sector is covered by a 3-year collective agreement stipulating that pay hikes will follow those in the private sector, **higher "wage drift" will probably lead to faster-than-average increases**. These problems also have a regional dimension: local governments are now under pressure to make very long-term investments but cannot be sure that new arrivals in Sweden or other inhabitants will continue living in their territories. A bit oversimplified, **there is a great risk that few people want to live where there is room, while most people want to live where there is neither room nor a desire to build**. This dilemma delays investment decisions and causes some local governments to limit capital spending.

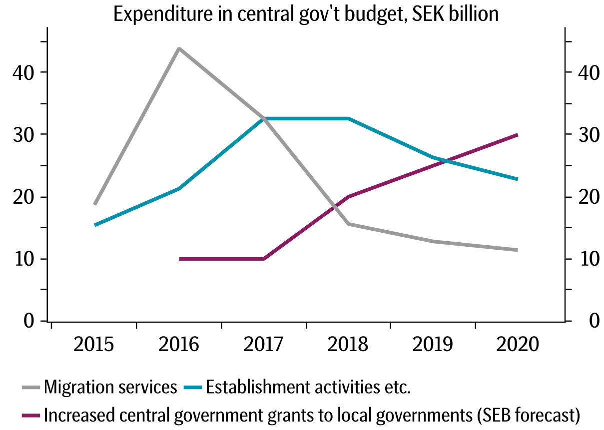
Increased grants and borrowing expected

Due to large refugee inflows late in 2015, the Swedish government boosted its local grants by SEK 10 billion in 2017. But **the financial burden on local governments looks set to increase by more than this**. Central government funding for migration services and establishment activities etc. have increased by SEK 30 billion in 2016 and 2017 compared to 2015. Direct central government costs will fall by SEK 15 and SEK 25 billion in 2018 and 2019, respectively, according to the latest budget bill. This downturn is relatively modest compared to the large projected decline in the number of asylum seekers. Immigration by relatives of existing migrants etc. will thus keep costs high for the central government as well for a long time.

Most indications are that **local government costs will rise more than central government costs fall over** the next five years. Calculations by the Swedish Association of Local Authorities and Regions (SKL) indicate that local income tax may need to be raised 2-4 percentage points by 2020 (1 point equals a revenue increase of about SEK 20 billion). Without a drastic improvement in job creation and integration of migrants into Swedish society, this implies a tug-of-war between central and local governments. So far SKL's political leaders have maintained a rather low profile and avoided alarmist statements, but as these problems become more acute it is reasonable to believe that calls for increased central grants will become clearer. Aside from migration, the general demographic trend and quality shortcomings in health care and the schools will further intensify the need for more resources. The chart below shows a scenario in which central grants rise by another SEK 20 billion yearly in 2018-2020. This should probably be viewed as a minimum, considering the great risks associated with breaching the social contract due to sharply deteriorating quality in core public sector activities. We expect grants to be raised by a further SEK 10 billion in the 2018 central government budget. It is also reasonable to believe that extra funding will be targeted in the future to those local governments that actually welcome new arrivals, in light of the ongoing tug-of-war between the central government and recalcitrant local governments.

More grants to local governments in the future?

Expenditure in central gov't budget, SEK billion



Source: Swedish government, SEB

Ultimately, the pressure on local governments must also be dealt with in other ways besides more central grants. Local income tax will probably be raised, while cutbacks and lowering of ambitions in some fields are likely. The capital spending upturn will probably be financed by more borrowing, as local governments themselves predict in an SKL survey. In 2015 the local government sector invested SEK 70 billion. Local government-owned companies invested another SEK 63 billion (2014). In 2015, the sector's debts rose by 10 per cent to SEK 674 billion. Increased borrowing by local governments themselves is possible, but other solutions may be needed if they are unable or unwilling to increase long-term debt: for example central government loans or loan guarantees.

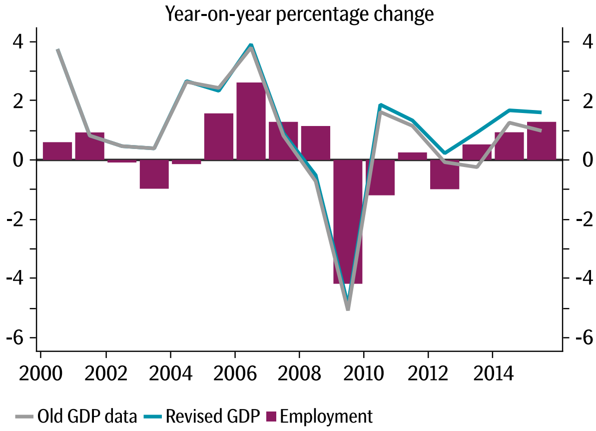
Foundation for more broad-based recovery in place

- **GDP growth expected to gradually pick up**
- **Strong employment growth supports consumption**
- **Capacity utilisation and home prices underpin future investments**
- **Wage growth to rise but remain low**

The third quarter will probably show weak growth, since car sales, consumer confidence, retail sales, PMIs and trade data have dipped recently. Nonetheless, long-term drivers of major GDP components remain well anchored. We are thus sticking to our forecast of above-trend growth; **GDP will increase by 2.1 and 2.4 per cent respectively in 2017 and 2018,** up from 1.4 per cent in 2016.

Revised national accounts solves growth puzzle

Year-on-year percentage change

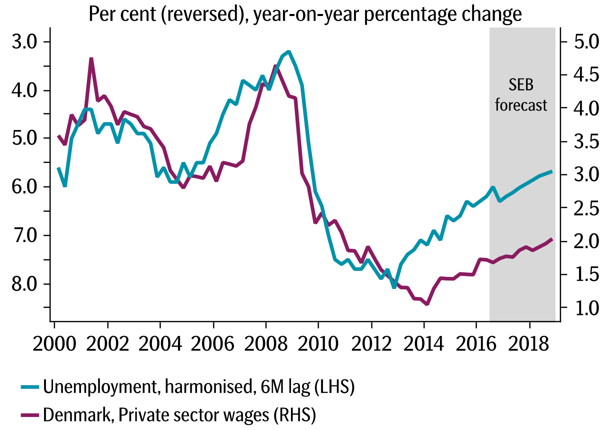


Source: Statistics Denmark, SEB

Real disposable income is increasing on the back of rising employment and low inflation, favouring a positive trend in **private consumption**; **we foresee growth of 2.1 and 2.2 per cent in 2017 and 2018**, respectively. Further, low interest rates are easing the debt burden of households. Home prices have rebounded in recent years but we regard fears of a new bubble in major cities as exaggerated. Revised national accounts show better performance for exports in recent years compared to earlier data, more in line with developments in foreign demand, and exports should pick up further going forward. We also expect capacity utilisation to pick up gradually as demand rises and slack disappears. Together with rising home prices, this will support capital spending.

Structural shift in Danish NAIRU?

Per cent (reversed), year-on-year percentage change



Source: Statistics Denmark, SEB

Revised annual GDP numbers up to 2015 suggest the Danish recovery may have been stronger and faster than previously thought and more in line with the observed employment. Strong job growth should continue to lower the unemployment rate. The data suggest that reforms, among other things, may have lowered the non-accelerating inflation rate of unemployment (NAIRU) in the Danish economy. On the back of this, we expect wage inflation to pick up slowly over our forecast horizon but to a lower level than previously associated with the current Danish unemployment rate. As the drag from energy prices fades and wages continue to pick up, we expect **HICP to lift from 0.1 per cent in 2016 to 0.8 per cent and 1.2 per cent in 2017 and 2018**, respectively.

Fiscal policy is mildly contractive and gross public debt is expected to keep a sound distance to the 60 per cent limit as stipulated in the EU's Stability and Growth Pact.

We foresee the DKK trading at the strong end of its peg range against the EUR in the coming year given a strong current account surplus and expected developments for monetary policy both home and abroad. ECB is likely to further extend its QE programme in December of 2016, while the Danish central bank seems reluctant to cut interest rates due to financial stability concerns and the absence of a strong trigger.

Major risks to the current forecast include any negative surprises affecting world growth and risks connected to labour market dynamics if, contrary to our expectations, current job growth either ends or results in higher-than-projected wage growth due to bottlenecks. Consumer confidence has been dropping during the past year and the savings ratio has climbed; we expect a modest reversal for both measures.

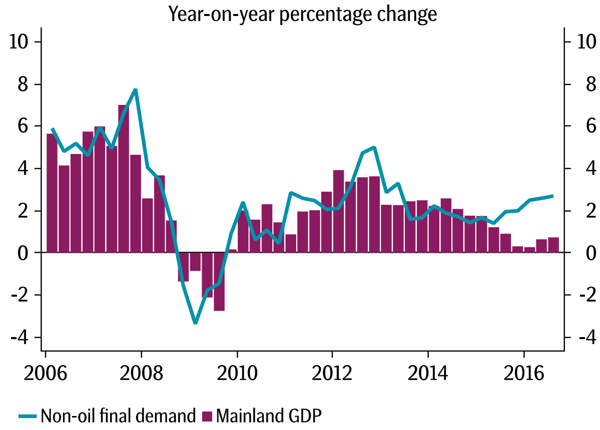
An uneven recovery

- **Ongoing but weak recovery driven by domestic demand**
- **Core inflation will trend lower**
- **Norges Bank's key rate on hold until 2018**

After decelerating growth in recent years due to plunging oil prices and extensive cutbacks in the petroleum sector, the tide turned last winter. A strong fiscal and monetary policy response has helped to contain negative secondary effects in the overall economy. The broad contours of Norwegian economic recovery remain intact since the August edition of *Nordic Outlook*. The economic upswing is being led by non-oil final domestic demand, especially capital spending and private consumption. However, a continued contraction in petroleum investments – with negative implications for output and employment in the supply industry – will dampen the general upturn. In the same way that the downturn showed divergent trends between oil-related sectors and the rest of the economy, the recovery will thus be uneven.

Growth driven by domestic demand

Year-on-year percentage change



Source: Statistics Norway

Growth in mainland GDP – excluding petroleum and shipping – was a lacklustre 0.2 per cent from the second to the third quarter. However, the composition of growth was encouraging. Adjusting for a weather-related drop in electricity output, momentum slowed only marginally from spring. We are nonetheless nudging our **growth forecast for mainland GDP** slightly lower to 0.8 per cent for 2016 and are **slicing one tenth off our 2017 forecast to 1.7 per cent,** due to minor tweaks to public consumption and slower export growth. The **2018 forecast is left unchanged at 2.1 per cent. Total GDP should be up 1.4 per cent in 2017 and 1.8 per cent in 2018**.

Fiscal policy will turn less expansionary next year as the economy recovers from the oil slump. The government's 2017 budget bill implies a 0.4 percentage point contribution to mainland GDP, compared to 1.1 percentage points in the current year. Lower corporate taxes, increased spending on infrastructure and additional employment measures will help sustain the recovery.

Non-oil capital spending on the mend

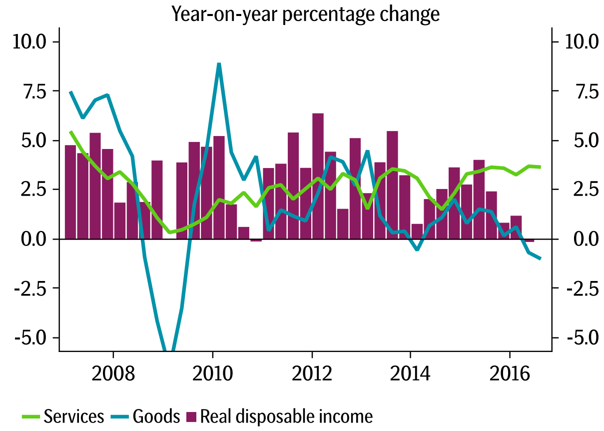
Mainland private investment should gain speed in the coming year. Residential investment has already rebounded sharply, led by a strong upturn in home prices and housing starts. Non-oil business investment, which has been a drag on mainland GDP in the past three years, was up 5.1 per cent in Q3 from a year earlier. The dominant service sector and other goods-producing industries are leading the recovery. The lack of timely indicators makes it hard to judge the near-term outlook, but higher activity in the broader economy suggests capital spending in those sectors will increase further. The manufacturing sector is lagging, but according to the most recent Business Tendency Survey manufacturers were less negative about their capital spending expectations.

Consumption will recover

Private consumption has not been stellar this year, but surprisingly resilient considering deteriorating household fundamentals. Stalling growth in household real disposable income has weighed on domestic consumption of goods, which posted sequential declines in both Q2 and Q3. Overall private consumption has nonetheless been firm due to continued strong spending on services.

Weak real income weighs on goods consumption

Year-on-year percentage change



Source: Statistics Norway, SEB

Looking ahead, consumption will be supported by several fundamental factors and rising consumer confidence. Fiscal stimulus and recovering employment growth will lend support to household disposable income. Simultaneously, household purchasing power should improve following a year of substantial negative real wage growth; inflation will ease and some compensation in nominal wages is likely.

Private consumption has tended to be sensitive to developments in home prices. Although there are large geographical divergences, existing home price increases have accelerated to 12 per cent at the national level in October from a year ago. While prices seem somewhat inflated, there is nothing suggesting a near-term trend shift. We have kept our **forecast for overall private consumption in 2017 and 2018 unchanged at 2.0 per cent and 2.5 per cent, respectively**.

Divided labour markets

The labour market shows signs of improvement, but there is a large discrepancy between measures which raises some questions about the underlying trend. The seasonally adjusted registered jobless rate has trended lower this year to 2.9 per cent in October. However, this metric probably underestimates the number of unemployed people, since it excludes those who are not entitled to unemployment benefits or are otherwise not registered with the Norwegian Labour and Welfare Administration. Unemployment according to the Labour Force Survey (LFS) has surged, averaging 4.9 per cent in Q3. This upturn is likely exaggerated, since the phone-based survey is notoriously volatile and tends to amplify changes in youth unemployment. While the overall impression is that the labour market is stabilising earlier than expected, we expect unemployment to remain at high levels. Somewhat stronger job growth will broadly match the increase in the labour force, and the **LFS unemployment rate should average 4.7 per cent in 2017 and 4.6 per cent in 2018**.

Cross-currents for the recovery

The government's aggressive policy response has boosted mainland domestic demand, but oil-related sectors are still struggling. The decline in petroleum investments has been roughly as expected this year, with such spending during Q3 being a full 10.8 per cent lower than a year earlier. Operators on the Norwegian continental shelf have slashed capital spending plans further, but the decline should be smaller measured in volume terms. We have maintained our forecast for a further **6.5 per cent decline in 2017**, and we still expect **petroleum investments to turn positive in 2018**. Hence, the drag from petroleum investments will gradually diminish.

Suppliers to the oil industry still face headwinds. The petroleum-related portion of the manufacturing sector, which is negatively affected by the global capital spending cycle, is still in deep contraction. Other sectors are performing better, although not strongly. Considering that cutbacks in global petroleum investments have further to go, industrial production (excluding energy) is likely to continue lagging behind what various sentiment surveys suggest.

There are widening discrepancies among exporters of traditional goods as well. Such exports have declined by 7.3 per cent so far this year, which is surprising given the previous depreciation of the krone. This lacklustre trend is partly due to plunging shipments of petroleum-related goods such as machinery and equipment and refined petroleum products, which make up roughly one third of the total. We have assumed a broadly neutral contribution to mainland GDP from net foreign trade in 2017 and 2018.

Inflation falling to below target

Inflation has been surprisingly high during 2016. Adjusted for energy and taxes, it rose to above 3.5 per cent during the summer. The upturn can be almost entirely attributed to the recent weakening of the krone. Price increases for imported goods accelerated during this period to 4.5 per cent, compared to an underlying trend of slightly falling prices. Imported goods inflation started to move lower after the summer, and the historical pattern suggests that this downward trend will continue. We expect such inflation to fall to just above zero in 2017-2018. There may be a larger and even faster downturn due to the appreciation of the krone in recent months.

Prices of domestic goods are rising in line with the historical trend of nearly 2.5 per cent. There is currently nothing to indicate a faster price increase. Wage increases in 2016 were the lowest since 2000, and although we expect some acceleration, the risks are even greater on the downside. We expect **CPI-ATE (which excludes taxes and energy) to fall below 2 per cent next year and remain below target in 2018.** CPI inflation will remain high during the winter due to soaring electricity prices.

Norges Bank in a waiting mode

While the key interest rate has been held at 0.50 per cent since March, Norges Bank made a subtle shift towards a neutral monetary policy stance at its September meeting. Brighter growth prospects and surprisingly high inflation have reduced the need for lower key rates. Moreover, the vulnerability of the financial system remains considerable since the rise in home prices has continued to exceed Norges Bank's projections. Although we believe **the rate trough has been reached**, the central bank will maintain a dovish bias throughout most of 2017 due to the stronger krone and more expansionary policy abroad. Moreover, the economic recovery is still in an early phase and thus fragile. With growth below trend and inflation expected to ease in coming years, we expect **Norges Bank to remain on hold until autumn 2018.**

NOK and NGBs – best together

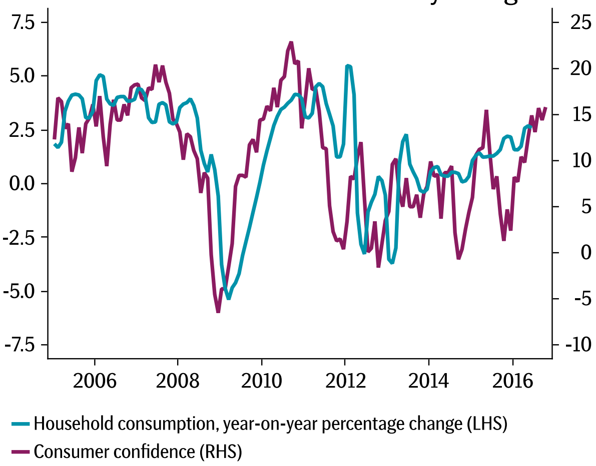
The outlook for the NOK is positive due to 1) a more neutral policy stance by Norges Bank, 2) higher oil prices, 3) a still-undervalued krone and 4) continued positive capital flows. We expect the **EUR/NOK exchange rate to reach 8.70 and 8.50 by the end of 2017 and 2018, respectively**. In addition to negative net supply next year, the constructive outlook for the krone should in itself support the outlook for government bonds. We expect **the 10-year yield spread against Germany to tighten to 100 bps by the end of 2017.**

Economic expansion, but with continued headwinds

- **Consumer confidence at multi-year high**
- **Capital spending is picking up**
- **Continued fiscal austerity**

Finland is continuing to lose some ground compared to euro zone averages, although **growth is taking small steps in the right direction**. Exports will recover somewhat in 2017-2018, but domestic demand remains the engine of economic expansion. Despite weak growth in recent years, households are in good spirits; in October, consumer confidence rose to its highest level in five years. Capital spending continues to climb, but because of idle capacity the upturn is slow. **GDP will increase by 0.8 per cent this year, 1.0 per cent in 2017 and 1.2 per cent in 2018.** Despite the recovery, the GDP level in 2018 will be about 3 per cent below that of early 2008.

Consumer confidence is at a five-year high



Source: Statistics Finland, European Commission

Indicator readings have improved in recent months. The European Commission's Economic Sentiment Index (ESI) has climbed significantly since July. Above all, service sectors indicate an improved outlook, but the manufacturing and construction sectors are also more optimistic. In spite of this, the economy remains divided: with weak exports and manufacturing. Although industrial production has increased during 2016, the year-on-year growth rate is only slightly above zero. Exports have fallen so far this year, but some improvement is expected in the near future as international demand benefits from the end of the recession in Russia while Germany and Sweden continue their above-trend expansion. The government's programme to improve competitiveness, among other things through low labour cost increases, is helping sustain exports. On the other hand, the weak Swedish krona will undermine near-term competitiveness. Rising consumption and capital spending are nevertheless driving up imports. Finland showed a current account surplus in 2015 for the first time since 2010, but it is reverting to a deficit. So far this year, inventory drawdowns have held down economic expansion, but a shift this autumn will help drive growth.

Capacity utilisation remains low in the manufacturing sector, after falling in 2016. In spite of this, **business investments are pointing higher**; the second quarter of 2016 was the strongest in several years. Business lending has increased, while the number of building permits indicates a slight uptick for residential investments too. **Capital spending will increase by about 1.5-2.0 per cent yearly in 2016-2018.**

Unemployment remains high – 8.6 per cent in September – but is falling. During the past year, the jobless rate has decreased by 0.8 percentage points, and the number of jobs is rising despite weak economic growth. We expect unemployment to continue falling, though at a diminishing pace since the labour force is meanwhile expanding. **Annual average unemployment will be 8.3 per cent in 2017 and 8.0 per cent in 2018.** We estimate that equilibrium unemployment is around 7.5 per cent, which means that there is still slack in the labour market. Wage pressures will thus remain low, although certain regional labour shortages will increase.

Consumer confidence has rebounded and was at its highest level for more than five years in October. Falling unemployment and a growing number of jobs are important pieces of the puzzle behind rising optimism and consumption. Meanwhile real incomes are being held back by moderate pay hikes and tight fiscal policy. The household savings ratio is trending downward, which has helped keep consumption up in recent years, but it is difficult to foresee it falling much further from today's depressed level of nearly -1 per cent. The housing market has been a source of concern, but prices have levelled out and are sustained by low interest rates and a somewhat stronger labour market. Overall, we predict that **consumption will climb by about 1 per cent yearly in 2016-2018**.

The public budget deficit will continue to shrink slightly, from 2.5 per cent of GDP in 2016 to 2.2 per cent in 2018. Because of low inflation and slow growth, gross government debt will climb further to 67.5 per cent of GDP in 2018. Fiscal policy remains tight, including an extension of the temporary surtax on high incomes and an increase in indirect taxes.

Economy is chugging along

- **Growth has remained subdued**
- **Possible changes in economic policy**

GDP growth has remained subdued for the second year in a row. During the first half of 2016, the economy grew by a paltry 1.1 per cent, putting Estonia right ahead of Portugal in the EU growth table. In the third quarter, growth was expected to accelerate, but according to the flash estimate it remained unchanged at 1.1 per cent. Thus we have **lowered our forecast for this year's GDP growth to 1.3 per cent**. Due to somewhat reduced expectations for euro zone growth, we have also lowered our forecasts for **2017** and **2018** and expect the economy to grow by **2.2** and **2.8 per cent**, respectively.

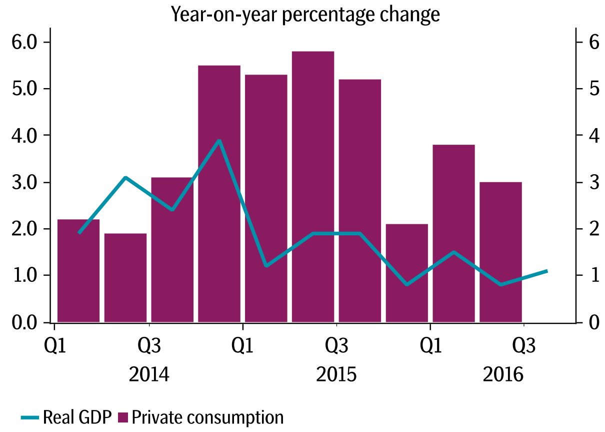
While **manufacturing has been recovering** from previous year's decline, value added dropped significantly during the first half of 2016 in the energy sector. Much of this reflects cyclical weakness in the shale oil industry, which was hampered by the previous drop in oil prices but has started to recover in recent months. In manufacturing, solid growth in the wood processing industry has been supporting growth, while metal industry orders are dwindling due to **low capital expenditures**. At the same time there are very few sectors which have experienced strong growth. Industrial production is expected to slowly increase due to higher export demand.

Domestically, there are signs that investments are picking up. **Capital spending increased by 5.4 per cent in Q2.** This is very welcome, since aside from having one of the most export-based economies, Estonian GDP growth is also more investment-dependent than most other European countries. **Higher corporate lending** and an expected **upturn in public investments** imply that growth should continue. However, some observers wonder whether more capital spending is enough to sustain long-term economic growth. A recent analysis by the central bank shows productivity and investment growth to be nearly perfectly correlated, while **total factor productivity has not increased** at all.

The labour market remains solid, but compensation to employees has surged to around 50 per cent of GDP from 45 per cent in 2014. With unemployment at 7.5 per cent and both employment and labour market participation already very high, there are **no quick fixes to increase labour supply**. The government recently decided to lower the wage employers must pay to workers from outside of the EU. Previously, 1.24 times an average Estonian salary was required to hire a non-EU employee; now the national average will do. The wage requirement will be suspended for seasonal employees, who may now be paid minimum wage in sectors like agriculture that have a temporarily high demand for labour. **The need to adjust Estonia's very conservative immigration policy is imminent**, since the number of people aged 25-64 is expected to drop by 10 per cent or around 70,000 people by 2025.

After two consecutive years of deflation, **inflation has returned**. August was the first month since mid-2014 when prices increased. This year the domestic consumer price index should stay roughly at its 2015 level, but it will grow more than 2 per cent next year. Our **forecast for the harmonised consumer price index** (HICP) is **2.4 per cent 2017** and **2.8 per cent in 2018**. This will also have an impact on **private consumption**, which has been previously been the main driver of economic growth. **During the first half of 2016, private consumption surged by 3.4 per cent.** It should also remain brisk next year, due to continuingly strong wage growth.

Growth has been dependent on private consumption



Source: Statistics Estonia

The **governing coalition unexpectedly fell apart**. A new coalition will be formed by two left-leaning parties and conservatives. This is the first time for 17 years that the Reform Party (liberals) will not be part of the government and the first time in almost 12 years that it is not supplying the prime minister. Exact policies remain vague but the new government has vowed to end the current impasse in economic policy. The introduction of a progressive income tax instead of the current flat tax, and taxing corporate earnings in addition to dividend pay-outs, have been discussed but seem unlikely to be enacted. All parties seem open to increasing today's ultra-low public debt in order to stimulate capital spending. With **municipal elections coming up in 2017**, there is a danger that politicians will prefer quick fixes to long-term solutions.

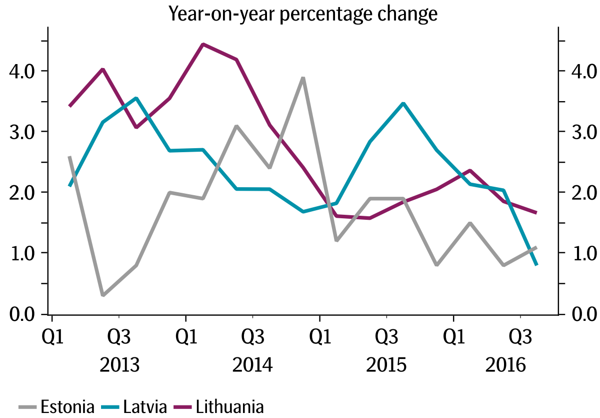
Unsatisfactory growth, but better outlook

- **Disappointing short-term growth – EU funds will boost GDP and thus inflation**
- **Ambitious plans for stronger government finances – increased focus on vital reforms**

From a growth standpoint, Latvia's current situation is **far from satisfactory**. In the third quarter of 2016, year-on-year GDP growth reached only a surprisingly low 0.8 per cent, due to new disappointments in private consumption, construction and other sectors. This will affect the full-year outcome. **We are now forecasting a 2016 GDP increase of 1.6 per cent** (2.4 per cent in August). **Next year GDP growth will accelerate to 3.5 per cent and in 2018 it will total 3.0 per cent**, thanks to EU-financed projects. Important challenges for Latvia will be to ensure that it preserves or improves its competitiveness, implements structural reforms and gradually makes its economy less dependent on EU funds beyond 2020.

GDP, constant prices

Year-on-year percentage change



Source: National statistical offices

Downside risks to growth predominate, due to continued uncertainty about the impact of Brexit and the geopolitical situation of the Baltic countries. Big question marks related to key national elections in Europe during 2017 will also increase the risk of lower capital spending and consumption.

So far during 2016, hopes that increased access to EU funds would lead to greater momentum in construction and other capital spending have been dashed. Private consumption has also been weaker than expected. Mediocre international growth and heightened geopolitical uncertainty have contributed to the downturn in Latvia's economic growth rate.

Inflation will creep upward

Latvia has left deflation behind, and the pace of price increases will trend higher in the next few months. Early in 2017, we expect inflation to reach about 2 per cent. **CPI inflation will be 0.1 during 2016 as a whole, climbing to 2.1 per cent in 2017 and reaching 1.8 per cent in 2018** – partly due to rising service sector inflation.

There is persistent pressure for higher wages and salaries, which employers find it difficult to resist. **We expect annual pay growth of 4-5 per cent** over the next couple of years. The labour supply is worsening, due to such factors as demographics (ageing population) and emigration, which increase total economic strains on social insurance systems. **We expect unemployment to fall from 8.9 per cent this year to 7.2 per cent by the end of 2018**. Labour market trends combined with expected real wage hikes will help sustain a recovery in private consumption during 2017-2018.

Latvian companies are struggling with **weak productivity growth** and the resultant increase in cost pressure, but so far they can show good performance; production is increasing in such key sectors as wood and wood products, fabricated metal products and electronic goods.

Lower economic activity so far during 2016 is at odds with Latvia's **continued positive trend of tax revenue**. During the first nine months of 2016, authorities collected 7.4 per cent more taxes than a year earlier. One reason is their actions to prevent tax evasion and to curtail the unofficial economy. In the best case, public finances may be an indication that in practice, GDP growth is higher than reported so far.

The government budget showed a deficit of 1.3 per cent of GDP last year. We expect the deficit to stay at this level 2016 and then gradually decrease to 1 per cent in 2018. Latvia has the potential to achieve a balanced budget. Public debt is expected to fall slightly from today's 36 per cent of GDP. The government's main priorities during 2017 will be health care, defence and education. In a medium-term perspective, demographic challenges must be addressed. Achieving healthy public finances will require a balancing act. There is thus a lingering **risk that tax hikes may be necessary**.

Credit growth is slowly accelerating. This is expected to help sustain economic expansion. Loans outstanding to both households and businesses are now growing at about 2 per cent yearly. This slow pace reflects a continued debt restructuring process, while demand for loans according to various metrics is relatively low. Looking ahead, ECB's expansionary monetary policy is expected to boost credit growth.

Lower public capital spending is hampering growth

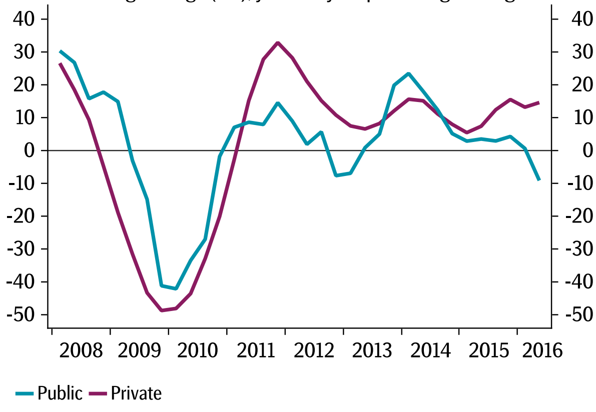
- **Sluggish public capital spending**
- **Vibrant real estate market**
- **Cautious look at new leading party**

Lithuanian economic growth has been losing momentum. GDP expanded by only 1.7 per cent in the third quarter of 2016. A smaller grain harvest and lower construction output due to lower public capital spending were the biggest factors. Slow growth may also **represent the** "**new normal**", given deeply negative population changes and the lack of innovation. Despite this, **we are sticking to our GDP forecast of 2.2 per cent growth in 2016** and believe that expansion will accelerate to 2.5 per cent in 2017 and 3.0 per cent in 2018.

In 2016 the abrupt downturn in public fixed investments was caused by a gap between the end of strategic projects completed in 2015 and preparations for projects co-financed by EU funds that will start in the next few years. Meanwhile **companies are investing more this year**. First, they are forced to invest in order to remain competitive in the region. Second, capacity utilisation among manufacturers is record-high, making capacity expansion necessary.

Public and private fixed investments are diverging

Moving average (4Q), year-on-year percentage change



Source: Statistics Lithuania

The real estate market in Vilnius, the capital of Lithuania, is vibrant. An oversupply of new space is possible in some market segments. The supply of office space will increase by a third during a two-year period. Occupancy will thus depend on the expansion of new shared service centres. Historically high occupancy rates at hotels encouraged large investments in this segment. The residential market remains very strong, with **near-record demand** and healthy price increases.

Export growth has been hampered by lower sales of such goods as oil products and fertilisers this year. Fears of a possible decline in exports to United Kingdom after the Brexit referendum materialised. However, we believe that 2016 exports will be slightly higher year-on-year if there is no unexpected drop in demand for Lithuanian goods among the main export markets in the fourth quarter. In contrast, service exports – sustained by the expansion of road cargo transport and financial services – are demonstrating solid growth and **will achieve a new record this year**.

Private consumption rose **by 5.8 per cent in the first half of 2016** due to a jump in average real wages, lower unemployment and relatively stable consumer confidence. **The shortage of qualified labour and the very high level of emigration are forcing companies to compete more fiercely for employees**. Surveys also reveal that companies expect to hire people at an even faster pace in 2017. The only relief for businesses next year will be that the minimum monthly wage was left unchanged at EUR 380. We expect gross pay to go up by 7 per cent in 2016 and by 6 per cent in 2017 and in 2018.

Average inflation will remain below 1.0 per cent this year even though service prices keep climbing due to higher labour costs. However, the fading effects of low energy prices, along with higher food prices and more growth in service prices, will push inflation to 1.5 per cent in 2017 and 2.5 per cent in 2018.

The drama surrounding Lithuania's more flexible new Labour Code continues. The newly elected Parliament will reverse some changes and **delay the entry into force of the new Code for six months.** This will certainly not please investors, who usually point out that the labour market is more strictly regulated than in other countries. That is one reason why Lithuania lags behind neighbours in foreign direct investments.

The Peasants and Greens Union, led by wealthy agri-businessman Ramūnas Karbauskis, convincingly won the parliamentary elections and formed a coalition with the Social Democrats. The successful party became a major political force only one year ago, so its actions remain highly unpredictable. Although it won the elections based on some highly populist proposals, including a bigger State role in business, we doubt that it will maintain these beliefs.

We forecast that the budget deficit will total 0.3 per cent of GDP this year, due to **better tax revenue than expected**. However, next year the deficit will most likely be larger because of higher expenditures on pensions and defence.

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	1.6	1.8
Export market OECD	3.1	2.5	3.3	4.0
Oil price, Brent (USD/barrel)	53.4	44.0	55.0	60.0

USA

Yearly change in per cent

	2015 level, USD bn	2015	2016	2017	2018
Gross domestic product	18,223	2.6	1.6	2.3	2.2
Private consumption	12,439	3.2	2.6	2.6	2.4
Public consumption	3,245	1.8	0.8	0.2	1.4
Gross fixed investment	3,060	3.9	0.6	3.5	4.9
Stock building (change as % of GDP)		0.2	-0.4	0.0	0.0
Exports	2,212	0.1	1.0	6.2	2.6
Imports	2,733	4.6	1.0	5.2	5.1
Unemployment (%)		5.3	4.8	4.5	4.2
Consumer prices		0.1	1.3	2.1	2.3
Household savings ratio (%)		5.8	5.9	6.0	6.3

EURO ZONE

Yearly change in per cent

	2015 level, EUR bn	2015	2016	2017	2018
Gross domestic product	10,456	2.0	1.8	1.6	1.6
Private consumption	5,744	1.8	1.8	1.6	1.6
Public consumption	2,164	1.4	1.7	1.3	1.0
Gross fixed investment		3.2	3.5	3.2	3.5
Stock building (change as % of GDP)		-0.2	0.0	0.0	0.0
Exports	4,832	6.5	2.5	3.9	4.4
Imports	4,357	6.4	3.3	4.7	5.2
Unemployment (%)		10.9	10.1	9.6	9.1
Consumer prices		0.0	0.2	1.1	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	2.1	1.4	1.7
Japan	0.6	0.5	0.5	0.5
Germany	1.7	1.8	1.5	1.6
France	1.3	1.3	1.1	1.3
Italy	0.7	0.9	0.8	1.2
China	6.9	6.7	6.4	6.0
India	7.3	7.6	7.8	8.0
Brazil	-3.8	-3.2	1.0	2.0
Russia	-3.7	-0.6	1.0	1.5
Poland	3.6	2.9	3.5	3.4
Inflation				
United Kingdom	0.1	0.4	2.1	2.3
Japan	0.8	-0.3	0.2	0.6
Germany	0.2	0.8	1.9	2.0
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	5.2	4.7	4.5
Brazil	9.0	8.7	6.0	5.0
Russia	15.6	7.1	5.5	5.0
Poland	-0.9	-0.4	1.8	2.2
Unemployment (%)				
United Kingdom	5.4	5.1	4.8	4.8
Japan	3.4	3.2	3.0	2.8
Germany	4.6	4.1	4.0	4.2
France	10.2	9.8	9.6	9.5
Italy	12.4	12.2	12.0	12.0

The Baltics

	2015	2016	2017	2018
GDP, yearly change in per cent				
Estonia	1.4	1.3	2.2	2.8
Latvia	2.7	1.6	3.5	3.5
Lithuania	1.8	2.2	2.5	3.0
Inflation, yearly change in per cent				
Estonia	0.1	0.7	2.4	2.8
Latvia	0.2	0.1	2.1	1.8
Lithuania	-0.7	0.8	1.5	2.5

FINANCIAL FORECASTS

		16-Nov	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	-0.10	-0.10	-0.10	-0.10	-0.10
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.25	0.25	0.25	0.25	0.25	0.25
Bond yields							
US	10 years	2.24	2.30	2.60	2.65	2.75	2.85
Japan	10 years	0.02	-0.05	-0.05	-0.05	-0.05	0.00
Germany	10 years	0.31	0.40	0.70	0.80	1.00	1.20
United Kingdom	10 years	1.41	1.50	1.80	1.90	2.10	2.30
Exchange rate							
USD/JPY		110	108	112	113	115	115
EUR/USD		1.07	1.06	1.03	1.06	1.08	1.10
EUR/JPY		117	114	115	120	124	127
GBP/USD		1.24	1.20	1.18	1.28	1.33	1.38
EUR/GBP		0.86	0.88	0.87	0.83	0.81	0.80

SWEDEN

Yearly change in per cent

	2015 level, SEK bn	2015	2016	2017	2018
Gross domestic product	4,181	4.1	3.7	2.8	2.3
Gross domestic product, working day adjustment		3.9	3.4	3.1	2.4
Private consumption	1,884	2.7	2.7	2.7	2.5
Public consumption	1,085	2.5	3.8	2.5	0.0
Gross fixed investment	991	7.2	8.0	6.0	4.2
Stock building (change as % of GDP)	23	0.3	0.3	0.0	0.0
Exports	1,906	5.6	4.2	4.6	3.0
Imports	1,708	5.5	6.5	6.4	3.0
Unemployment (%)		7.4	6.9	6.3	6.2
Employment		1.4	1.5	1.4	1.2
Industrial production		2.9	2.8	3.5	2.5
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	16.2	16.3	15.9
Real disposable income		2.2	3.1	2.5	2.4
Current account, % of GDP		5.2	4.9	4.7	4.5
Central government borrowing, SEK bn		33	-65	-5	-20
Public sector financial balance, % of GDP		0.0	0.3	0.2	0.0
Public sector debt, % of GDP		43.4	40.7	38.8	38.0

FINANCIAL FORECASTS	16-Nov	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	-0.56	-0.60	-0.50	-0.30	0.05	0.25
10-year bond yield	0.51	0.50	0.95	1.30	1.60	1.90
10-year spread to Germany, bp	20	10	25	50	60	70
USD/SEK	9.21	9.20	9.32	8.77	8.47	8.23
EUR/SEK	9.83	9.75	9.60	9.30	9.15	9.05
TCW	136.3	135.0	133.8	129.7	127.6	126.0
KIX	116.5	115.4	114.4	110.9	109.0	107.7

NORWAY

Yearly change in per cent

	2015 level, NOK bn	2015	2016	2017	2018
Gross domestic product	3,191	1.6	1.3	1.4	1.8
Gross domestic product (Mainland)	2,561	1.1	0.8	1.7	2.1
Private consumption	1,311	2.1	1.7	2.0	2.5
Public consumption	706	2.1	2.2	1.9	1.7
Gross fixed investment	711	-3.8	0.3	1.2	3.0
Stock building (change as % of GDP)		0.2	0.3	0.0	0.0
Exports	1,266	3.7	-1.5	0.8	1.4
Imports	956	1.6	-1.1	1.5	3.1
Unemployment (%)		4.4	4.8	4.7	4.6
CPI		2.2	3.7	2.9	2.0
CPI-ATE		2.7	3.2	2.5	2.0
Annual wage increases		2.8	2.5	3.0	3.1

FINANCIAL FORECASTS	**16-Nov**	**Dec-16**	**Jun-17**	**Dec-17**	**Jun-18**	**Dec-18**
Deposit rate	0.50	0.50	0.50	0.50	0.50	0.75
10-year bond yield	1.65	1.65	1.80	1.80	1.90	2.10
10-year spread to Germany, bp	133	125	110	100	90	90
USD/NOK	8.50	8.58	8.54	8.21	7.96	7.73
EUR/NOK	9.08	9.10	8.80	8.70	8.60	8.50

DENMARK

Yearly change in per cent

	2015 level, DKK bn	2015	2016	2017	2018
Gross domestic product	2,027	1.6	1.4	2.1	2.4
Private consumption	962	2.2	2.0	2.1	2.2
Public consumption	521	0.6	1.0	0.5	0.9
Gross fixed investment	390	2.5	1.8	1.8	2.8
Stock building (change as % of GDP)		-0.3	-0.4	-0.1	0.0
Exports	1,120	1.8	1.8	2.3	3.2
Imports	970	1.3	0.9	1.1	1.9
Unemployment (%)		4.6	4.5	4.2	4.0
Unemployment, OECD harmonised (%)		6.2	6.1	5.8	5.6
CPI, harmonised		0.2	0.1	0.8	1.2
Hourly wage increases		1.5	1.7	1.8	1.9
Current account, % of GDP		7.0	6.0	5.7	4.6
Public sector financial balance, % of GDP		-1.7	-0.6	-1.6	-1.1
Public sector debt, % of GDP		40.2	40.4	40.8	40.5

FINANCIAL FORECASTS	**16-Nov**	**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	0.41	0.50	0.80	0.90	1.10	1.30
10-year spread to Germany, bp	10	10	10	10	10	10
USD/DKK	6.97	7.02	7.22	7.02	6.89	6.76
EUR/DKK	7.44	7.44	7.44	7.44	7.44	7.44

FINLAND

Yearly change in per cent

	2015 level, EUR bn	2015	2016	2017	2018
Gross domestic product	211	0.2	0.8	1.0	1.2
Private consumption	116	1.5	1.2	1.2	1.0
Public consumption	51	0.4	-0.2	0.0	0.0
Gross fixed investment	43	0.7	1.2	1.5	2.0
Stock building (change as % of GDP)		0.0	-0.1	0.0	0.0
Exports	77	-0.2	0.0	1.5	2.5
Imports	78	1.9	0.0	1.5	2.0
Unemployment (%)		9.3	8.8	8.3	8.0
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		-2.8	-2.5	-2.5	-2.2
Public sector debt, % of GDP		63.6	64.5	66.0	67.5

SEB is a leading Nordic financial services group. As a relationship bank, SEB in Sweden and the Baltic countries offers financial advice and a wide range of financial services. In Denmark, Finland, Norway and Germany the bank's operations have a strong focus on corporate and investment banking based on a full-service offering to corporate and institutional clients. The international nature of SEB's business is reflected in its presence in some 20 countries worldwide. At 30 September 2016, the Group's total assets amounted to SEK 2,851bn while its assets under management totalled SEK 1,758bn. The Group has around 15,300 employees. Read more about SEB at www.sebgroup.com.

With capital, knowledge and experience, we generate value for our customers – a task in which our research activities are highly beneficial.

Macroeconomic assessments are provided by our SEB Research & Strategy unit. Based on current conditions, official policies and the long-term performance of the financial market, the Bank presents its views on the economic situation – locally, regionally and globally.

One of the key publications from the SEB Research & Strategy unit is the quarterly Nordic Outlook, which presents analyses covering the economic situation in the world as well as Europe and Sweden.

SEGR0109 2016.11