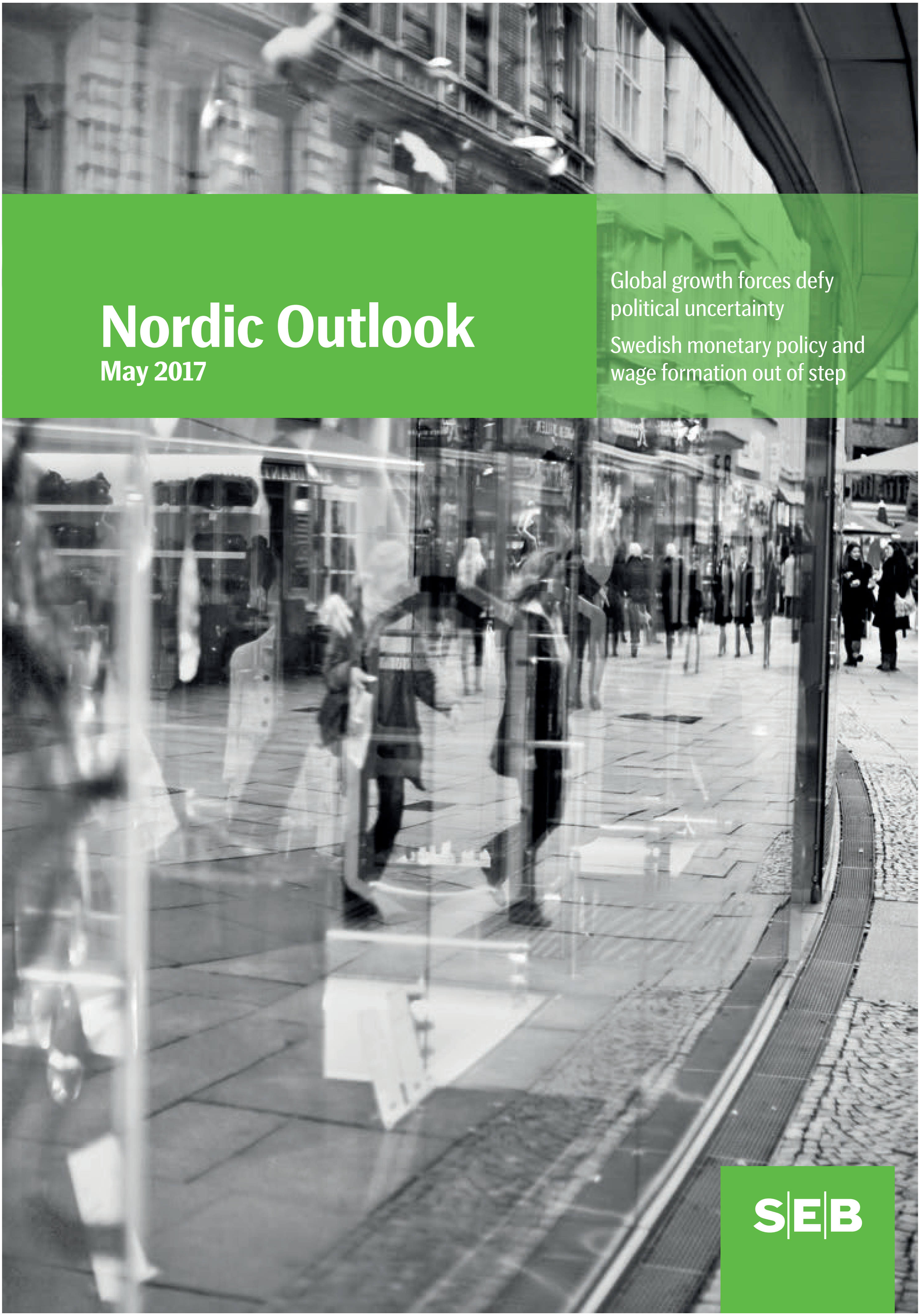

Nordic Outlook

May 2017

Global growth forces defy political uncertainty

Swedish monetary policy and wage formation out of step

SEB

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This report was published on May 9, 2017.

Cut-off date for calculations and forecasts was May 3, 2017.

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Late-cycle GDP surge may lead to record-long recovery

- **Rising global optimism across a broad front**
- **Unexpectedly passive Trump administration**
- **Post-election relief, but EU project in danger**
- **Signs of EM strength and better balance**
- **Long-term yields continue their cautious rise**
- **Higher earnings support late-cycle stock rally**
- **High growth + low inflation=Swedish dilemma**

The global economy has continued to improve. Economic actors are signalling strong optimism, while first quarter 2017 corporate reports have mainly been surprisingly positive. Hard macroeconomic data have also improved, though not as much as sentiment indicators suggest. Disappointing Q1 growth in the United States is one important exception to this upbeat picture. Several underlying factors explain strong world economic growth. For example, industrial capacity utilisation has finally moved up to levels that will trigger new investments on a broader scale. Emerging market (EM) economies have also undergone adjustment processes that have improved their balance situation, while rising commodity prices have brought relief to previously hard-pressed producer countries.

Global GDP growth

Year-on-year percentage change

	2015	2016	2017	2018
United States	2.6	1.6	2.3	2.5
Japan	1.2	1.0	0.8	0.5
Germany	1.7	1.9	2.0	1.9
China	6.9	6.7	6.7	6.3
United Kingdom	2.2	1.8	1.4	0.9
Euro zone	2.0	1.8	2.0	2.0
Nordic countries	2.3	2.0	2.2	2.1
Baltic countries	2.0	2.0	3.1	3.2
OECD	2.4	1.8	2.1	2.2
Emerging markets	4.2	4.3	4.8	4.9
World, PPP*	**3.4**	**3.2**	**3.7**	**3.8**

Source: OECD, SEB * Purchasing power parities

Recent developments have thus provided support for our rather optimistic economic picture, especially concerning the EM sphere and Western Europe. In our own neighbourhood, we have witnessed signs of strength in both the Nordic (especially Swedish) and Baltic economies. Looking at the world economy as a whole, we now believe that **GDP growth will accelerate from 3.2 per cent in 2016 to 3.7 per cent this year and 3.8 per cent in 2018**. Because our earlier forecast was already above consensus, our upward adjustment is only 0.1 percentage points for both years. The weak first quarter has also led to a downward adjustment in our full-year US forecast, although we believe the dip was temporary. **The mood in the Chinese economy has shifted solidly in a positive direction**, but we believe this will actually lead authorities to eventually shift their economic policies in a tightening direction, in part to slow the build-up of imbalances. In the United Kingdom, a weak pound has helped buoy the economy to a greater extent than we had expected. But even if the Tory (Conservative) government and Prime Minister Theresa May can strengthen their position after the June parliamentary election, we still foresee a rather **tough "Brexit" process**.

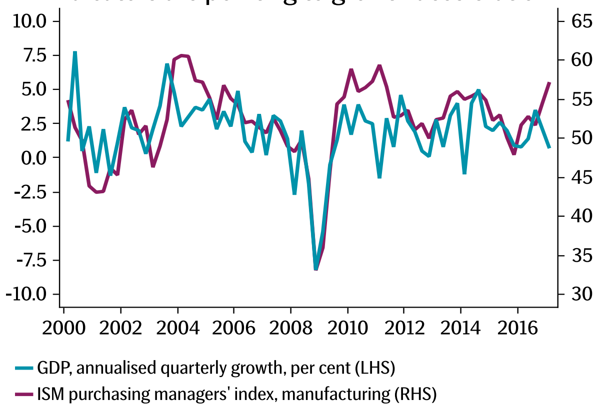
In the last *Nordic Outlook*, we pointed out that rising optimism was due to underlying factors and not so much due to hopes of economic policy changes. This has been confirmed with increasing clarity. We have lowered our expectations further with regard to US fiscal stimulus measures. But the interplay between economics and politics has many facets, and in other respects the political trend has been favourable. **President Donald Trump's administration has been forced to become more pragmatic** on various points and has also proved less dogmatic than feared. Our belief there would be no further elections successes for anti-EU forces was confirmed in the Netherlands and France; there are no indications that the German election in September will change this picture.

This does not mean we can write off all political threats. The level of conflict has escalated in several geopolitical areas, while it remains uncertain to what extent Trump's **protectionist rhetoric in the election campaign will be transformed into actual policy**. Emmanuel Macron, a rather inexperienced French president, will be highly dependent on the parliamentary situation after the June election. Italy increasingly looks like a key country in the euro zone, making political development there especially important. Meanwhile the EU project faces difficult problems and crucial choices in the next few years. This issue of *Nordic Outlook* includes theme articles dealing with Macron's potential after the presidential election, the Brexit process and the EU's future choices.

However, last year's developments showed that both the real economy and financial markets are often rather insensitive to political events. When weighing downside risks connected to political uncertainty against the potential for positive economic surprises, we reach the conclusion that the risk picture for global growth has a certain upside bias. In 2017-2018, the question of what cyclical phase we are actually in will be one focus of attention for financial markets. Continued low price and pay increases look set to give central banks manoeuvring room to normalise monetary policies at a very gradual pace. The US Federal Reserve (Fed) will mainly continue going it alone with key interest rate hikes for another year or so. We believe the European Central Bank (ECB) will soon hike its deposit rate for banks a bit, but central banks in Sweden, Norway and elsewhere will not follow suit until well into 2018. We thus assume that **long-term yields will rise only 70-80 basis points by the end of 2018**. In such an environment, we also believe that **improved prospects for corporate earnings will enable stock markets to climb further**.

The recovery has been under way for eight years, close to a post-war record in terms of duration, which is thought-provoking. The combination of an increasingly strained resource situation, weak price and wage responses and threats of financial imbalances in the form of rising asset prices and debts is confusing to both forecasters and decision makers. Conditions may change quickly, and a tardy policy response would risk making the situation worse.

Indicators are pointing to growth acceleration



Source: US Burea of Economic Analysis (BEA), Institute of Supply Management (ISM)

US acceleration after temporary dip

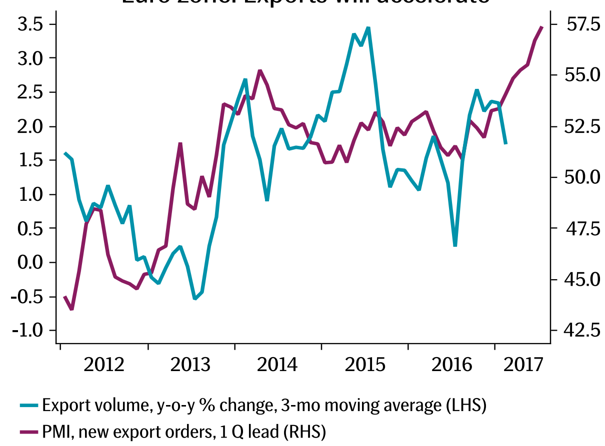
First quarter GDP growth was again disappointing, reaching only an annualised 0.7 per cent rate. As earlier, temporary effects such as weather conditions or technical problems with seasonal adjustments may explain the unexpected slowdown. We have readjusted our 2017 GDP growth forecast from 2.5 to 2.3 per cent, partly based on experience from prior years when a Q1 slowdown has not proved to be the starting point of a lasting weaker trend but has nonetheless contributed to a lower full-year outcome. The main disappointment was private consumption, whose underlying strengths – including a robust labour market – point to a recovery. Sentiment indicators are generally signalling strong GDP growth but will probably fall a bit due to the absence of economic policy reforms. In practice, not much was achieved during Trump's "first 100 days". The administration's inexperience along with unexpectedly tough opposition in Congress have caused us to adjust our already low expectations further downward. Fiscal stimulus effects will be non-existent this year. Certain tax cuts will have a 0.2 percentage point impact on GDP in 2018. This is one reason we have lowered our US growth forecast for 2018 too.

Yet our GDP growth forecast remains above consensus, as well as well above potential. One important reason is a clear recovery in the oil and mining sectors due to a favourable price situation. Looking ahead, the labour supply will be increasingly important to GDP growth, especially since the weak productivity growth trend looks set to continue. Except for a dip in March, job growth has remained good. Unemployment fell to 4.4 per cent in April. Joblessness is now close to equilibrium, but we believe it may fall further to just above 4 per cent in 2018. The labour force participation rate has begun to rise encouragingly but today's 63 per cent level is more than 4 percentage points below its peak in 2000, an indication that there is still plenty of slack in the economy. This strengthens the potential for more sustainable growth, among other things by decreasing the risk that the Fed will need to speed up the pace of rate hikes in a way that would lead to a USD that is so strong as to create problems for manufacturers.

Euro zone GDP confirms strong indicators

In the euro zone, economic signals have rather consistently continued improving. We have adjusted our **GDP growth forecast upward to 2.0 per cent both in 2017 and 2018**. This is a few tenths of a point higher than in February's *Nordic Outlook*. Signs of strength are broad-based in both sectoral and regional terms. Sentiment indicators point to significant acceleration, signalling an upside risk to our forecast.

Euro zone: Exports will accelerate

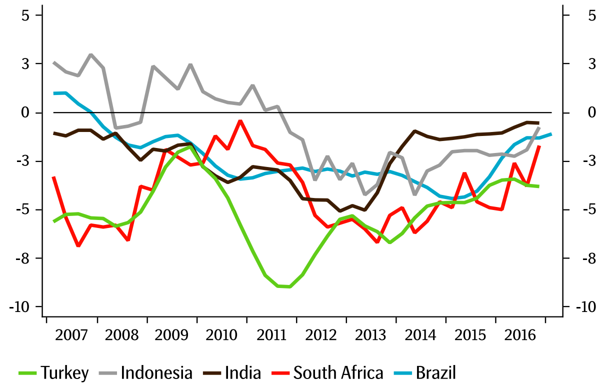


Source: Eurostat, Markit

The political currents manifested in 2016 by the UK's Brexit referendum and the US elections also quickened the political pulse in the euro zone, raising important questions about openness and cohesion both in individual countries and the region as a whole. Political uncertainty diminished, however, after anti-EU forces were less successful than expected in the Dutch and French elections. There is no indication that the German parliamentary election in September will change this, since the anti-immigrant Alternative for Germany (AfD) is shaken by internal conflicts. The centre-right CDU and Angela Merkel are still favoured to keep the post of chancellor. **But it would not be especially dramatic if Martin Schulz and his Social Democrats (SPD) were to become the biggest party.** The SPD would probably pursue a more expansionary fiscal policy and push for higher pay increases. Such a policy would facilitate euro zone recovery and address both external and internal criticism of Germany's current account surpluses. The European Commission's attempt to force EU member countries to choose a strategy (see theme article) reflects Brussels' serious concerns about long-term strategies for the Union. The Commission presents several alternatives: **1. Carrying on (business as usual); 2. Nothing but the single market; 3. Those who want more do more; 4. Doing less more efficiently; and 5. Doing much more together.** The easiest choice among these alternatives is probably some version of alternative 4, with future EU cooperation focusing on more limited areas that can enjoy greater popular support.

EM current accounts approach equilibrium

Per cent of GDP



Source: Central Bank of Brazil, Reserve Bank of South Africa (SARB), Bloomberg, Macrobond, SEB

EM economies are showing resilience

The outlook for emerging market economies has recently become much brighter. Despite threats of protectionism, world trade is growing again, boosting economic activity in often export-dependent EM economies. China's role is pivotal, and although optimism has increased greatly, we are sticking to our cautious growth forecast of a gradual GDP deceleration. This is because the authorities will probably utilise signs of economic strength to implement monetary policy tightening, among other things in order to cool off the credit market. The slowdown in **India's economy** due to last autumn's currency ("demonetisation") reform was smaller than feared. The governing Bharatiya Janata Party (BJP) has also succeeded in pushing through several key reforms without being punished by voters in the state elections that have been held. We believe **growth will accelerate gradually to 8.0 per cent in 2018**. Overall GDP growth in the EM sphere will speed up from 4.4 per cent in 2016 to almost 5 per cent both in 2017 and 2018.

In recent years, current account deficits have narrowed greatly in some of the most vulnerable EM economies. This has mainly been because of two factors: 1) Domestic demand in countries such as Russia, Brazil and South Africa has taken a major beating and 2) currencies have fallen sharply against the US dollar (USD). **Stronger EM current accounts increase these countries' economic policy manoeuvring room and reduce their vulnerability to Fed key rate hikes.** Their currencies have also partially rebounded, partly due to higher commodity prices, but these economies have improved their competitiveness and can thus take advantage of higher global growth. Countries like Russia and Brazil still have big structural problems but have now emerged from their recessions.

GDP growth, BRIC countries and EM sphere

Year-on-year percentage change

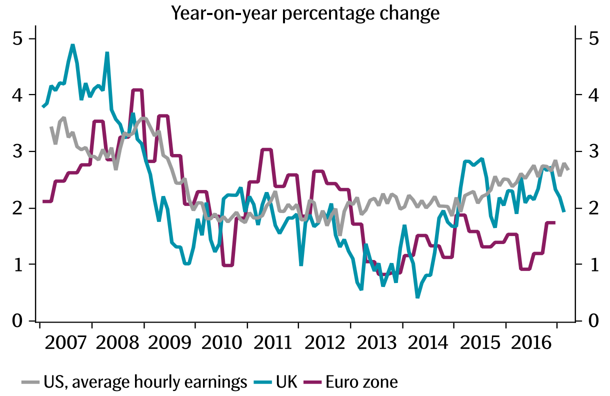
	2015	2016	2017	2018
China	6.9	6.7	6.7	6.3
India	7.9	7.5	7.7	8.0
Brazil	-3.8	-3.6	0.7	2.0
Russia	-2.8	-0.2	1.0	1.5
Emerging markets, total	4.2	4.3	4.8	4.9

Source: OECD, SEB

Our oil price forecast (Brent) is unchanged at annual **averages of USD 55/barrel in 2017 and USD 60 in 2018, but we see obvious downside risks**, especially for 2018. Productivity improvements and expansions in US shale oil production are continuing. The OPEC oil cartel's production cap agreement with other major producers (such as Russia) has thus not led to as large a downturn in stockpiles as expected. Consequently, our assumption of an average supply shortage of about 0.5 million barrels per day in 2018 is also highly uncertain.

Stable low pay increases in the West

Year-on-year percentage change



Source: Macrobond

Hesitant inflation upturn

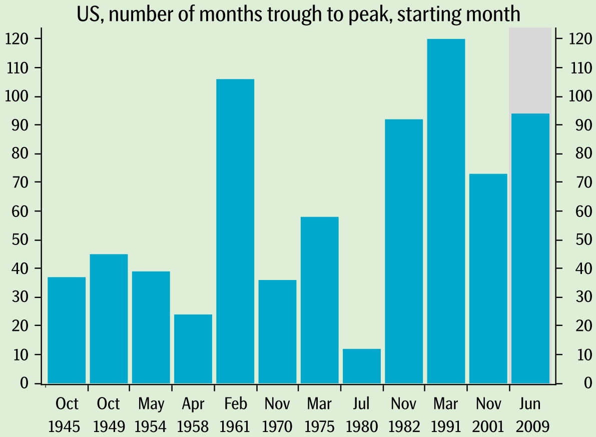
Inflation has generally risen in the past six months mainly due to base effects, as earlier energy price declines have vanished from 12-month figures. In addition, new energy price increases are one reason why headline inflation (the consumer price index, CPI) is now above core inflation for the first time in years. A rising trend in inflation expectations in most countries also **confirms that we have moved a bit away from a zero inflation environment**, but the most recent signals have been mixed. In March, inflation fell significantly both in the US and the euro zone. Inflation expectations according to the index-linked bond market have also fallen a bit, after a sharp upturn following the US presidential election in November. This trend shows that although deflation risks appear increasingly distant, the inflation upturn is still vulnerable as long as pay increases remain historically low. The US pay upturn looks rather stable. If it persists, it will soon reach levels that will give the Fed room to continue its gradual key interest rate hikes.

Can the recovery die of old age?

Worries that the US economy is again starting to sputter, after eight years of recovery, is raising the question of whether a new recession is imminent. During the post-war period we have had four US recoveries comparable in length to this one, but if it continues according to forecasts, **the records from the 1960s and 1990s will be surpassed in 2019**. The pattern of US recessions spreading around the world is so clear that this analysis can represent the entire industrialised world.

The economic cycle has become longer

US, number of months trough to peak, starting month



Source: National Bureau of Economic Research (NBER)

The recovery is not likely to die due to age alone, **but the more time that passes, the greater the risk that some of the factors that have triggered earlier recessions will reassert themselves**. The first post-war quarter century was dominated by somewhat shorter inventory and investment cycles, while the period after financial market deregulation in the early 1980s was characterised by longer recoveries that ended because excesses in special sectors led to burst bubbles. Via subsequent balance sheet adjustments, contagious effects were dramatic.

Given the special characteristics of the current recovery, the next recession might conceivably be triggered in an unusually large number of ways. Growth has been so anaemic and fragile that it raises the question of whether the economic cycle has completely disappeared. Growth has repeatedly lost momentum, leading to ever more powerful official economic stimulus measures. **This fragility has also inspired the thesis that we are in the midst of a period of chronically weak demand.** Such *secular stagnation* might, for example, be due to underlying factors in the economy that increase people's inclination to save while reducing their desire to invest.

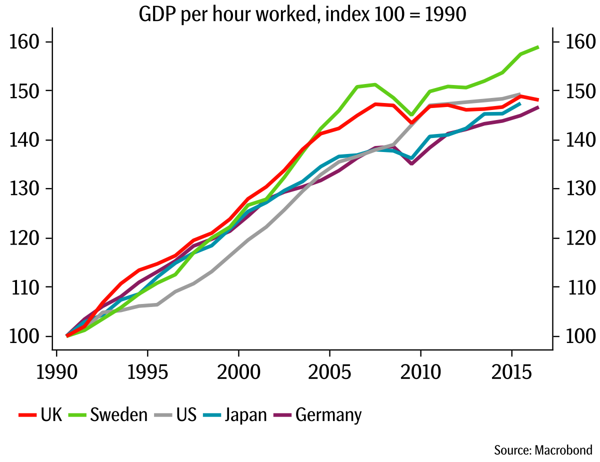
The labour market shows a different picture than GDP, There has been a clear cyclical improvement, with a continuous downturn in US unemployment. The jobless rate has also fallen to historically low levels in Japan, Germany and the UK: close to equilibrium. This is one reason why output gaps in many countries are now small. This implies that in the not too distant future, bottleneck problems may halt the recovery. **It has been possible for anaemic growth to coexist with strong labour markets because productivity growth has weakened since the financial crisis (see chart on next page).** This has initiated a policy discussion about the extent to which ever-lower key interest rates have weakened reform pressure in a way that hampers efficiency improvements in the economy. A closely related discussion concerns the risks that exceptional stimulus measures will again lead to excessive asset prices and debt. Brutal balance sheet adjustments due to burst bubbles are a recession catalyst that might make itself felt again.

The environment of recent years has thus provided a lot of room for different diagnoses of the problem. Perspectives have shifted rapidly over time; about a year ago, worries that the forces behind secular stagnation would be so strong that not even extreme monetary policies could prevent a recession were dominant. **During the latest period of increased optimism, there has seen more focus on the threat that supply-side restrictions might halt the upturn.** It is thus becoming more and more important to track how prices and wages react to higher resource utilisation. At present, it looks as if the forces behind the prevailing "lowflation" environment have the upper hand, but they are increasingly being challenged by growing bottleneck problems and protectionist tendencies.

It currently appears that the Fed and other central banks have enough manoeuvring room to launch normalisation policies that can neutralise harmful overheating effects in time. Signals from most central banks also indicate that they perceive the situation in this way. Bubble tendencies in financial market pricing are not so alarming either. **In such a situation, it is a bit speculative to believe in recession as a main scenario.** This is only relevant when we discern intractable policy dilemmas or when, for other reasons, central banks signal austerity plans that seem excessively tough. The feeble inflation response that we are now seeing may eventually become a trap for central banks. Without a fairly clear Phillips curve correlation, there are also increasing risks that an interest rate policy governed by an inflation target will become pro-cyclical and destabilising. This is especially true in a situation where coordination with fiscal policy and macro-prudential supervision are not working satisfactorily, as is now the case in Sweden, for example. If we make a narrower comparison with recent economic cycles in terms of the resource situation, **we reach the conclusion that today we are at the same level as in 1998 and 2005**. A mechanical calculation thus indicates that we have three years left until the next recession. But things are not that simple, of course. During the last two recoveries, various financial market bubbles burst before we actually tested how low unemployment could go before inflation took off.

Productivity growth has lost momentum

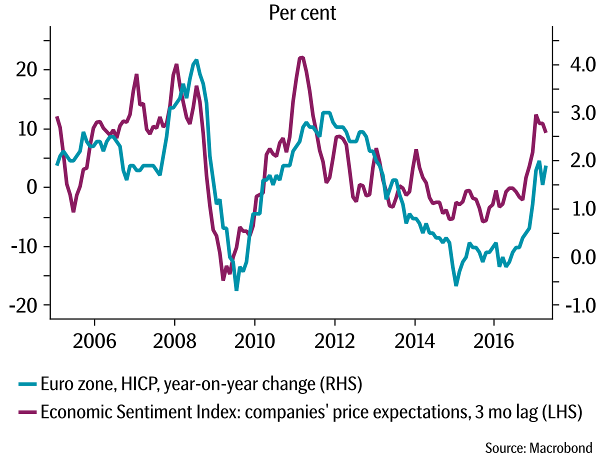
GDP per hour worked, index 100 = 1990



In Western Europe, the weak wage response to stronger labour markets is more problematic for central banks. Not even in Germany – where a record-high percentage of companies report that labour shortages are hampering production – are wages rising by more than 2 per cent a year. This is not far above the euro zone average of 1.5 per cent. Looking ahead, we expect a slight upturn but the rate of increase will not reach 2 per cent even in 2018. Such modest pay increases in nearby countries were one reason why this year's Swedish wage round ended with 3-year contractual pay hikes of a mere 2.3 per cent, despite a strong labour market.

HICP and manufacturers' price expectations

Per cent



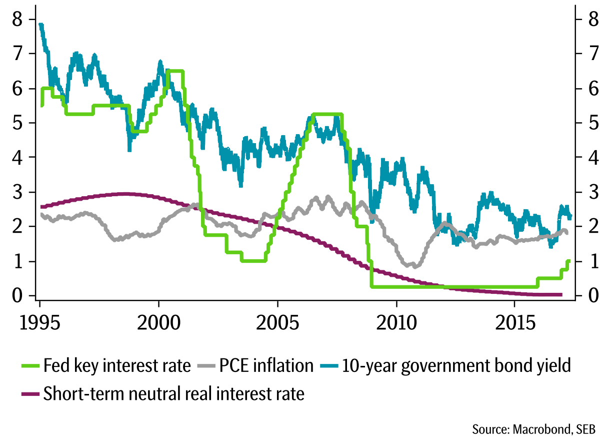
In the euro zone, we expect inflation to trend downward towards 1 per cent in mid-2017. As annual averages, inflation will fall **from 1.5 per cent this year to 1.1 per cent in 2018**. In the US, a persistent inflation upturn will not occur until well into 2018, once pay increases have accelerated more clearly. Average CPI **inflation will end up at 2.1 per cent in both 2017 and 2018**. The risks are on the upside, though. The broad commodity price upturns we have seen recently may have a bigger impact on consumer prices than we had anticipated. So far we have seen their effect on food prices, but core inflation may also be affected in the coming months, especially in Western Europe. It is also possible that cyclical inflationary forces may generally strengthen to a rather great extent. Companies are signalling that they have growing opportunities to push through price hikes. This usually manifests itself in higher inflation, with a slight lag (see chart). Pay hikes may also accelerate a bit faster than expected as shortages increase, in an environment with more protectionist headwinds.

Expansionary policy, but new risk situations

There are still good reasons to pursue expansionary monetary policy, but it is becoming increasingly difficult to find arguments for its more extreme expressions such as negative and zero interest rates and large securities purchases. Various central banks are grappling with the challenge of achieving their inflation targets without the support of robust pay increases, but the risk picture has changed. The deflation risk has become smaller, manifested in such events as rising and/or more stable inflation expectations. Meanwhile the risk picture for growth has become more symmetric, in some cases with mainly upside risks. Overall, these are situations that various central banks also confirm.

Neutral real interest rate remains close to zero

Per cent



But the policy environment in which central banks operate remains complex, and their policies must evolve cautiously. Transformative technologies and globalisation are reinforcing the "lowflation" environment, and changed conditions affecting savings and investment patterns are pushing down the neutral price of money (interest rate). This, in turn, modifies and reduces the actual expansiveness of monetary policy (see above chart). Protectionism is also threatening to spread, while geopolitical risks are increasing. These are other background factors to take into account, although as expected they have not had any major impact on financial markets or the real economy so far. For example, there is continued great uncertainty about US trade policy, although until now strong rhetoric has predominated rather than concrete policies. The conditions for growth and inflation have thus not changed either. For a number of central banks, **the currency remains a strong focus of monetary policy**.

The **Fed** seems to have been taken by surprise when overall **financial conditions** – share prices, the US dollar, long-term yields and credit spreads – became more expansionary despite its rate hikes and signals about shrinking its monetary policy portfolio (SOMA). The Fed is also drawing the conclusion that the **global economy**, especially the EM sphere, is showing greater resilience to changes in US monetary policy. This gives the Fed **room to continue normalising its policy**. The **latest signs of weakness** in the US economy are expected to have a marginal effect on the Fed's main strategy of **hiking its key interest rate three times each in 2017 and 2018 to 2.25 per cent and reducing its SOMA portfolio**. Pay increases have shown an accelerating trend for about two years, and inflation is now close to the 2 per cent target for the personal expenditures consumption (PCE) deflator, the Fed's favourite inflation metric. There is now less risk that the Fed will face pro-cyclical US fiscal policies, for example tax cuts and infrastructure projects that will force it to make new rate hikes, but the consequences will not be very great because the Fed has not previously made allowances for fiscal policy changes.

Central bank key interest rates
Per cent

	Today	Dec 2017	Dec 2018
Federal Reserve (Fed)	1.00	1.50	2.25
ECB (deposit rate)	-0.40	-0.25	-0.25
Bank of England (BoE)	0.25	0.25	0.25
Bank of Japan (BoJ)	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.70	4.70
Riksbank (Sweden)	-0.50	-0.50	0.00
Norges Bank (Norway	0.50	0.50	0.75

Source: Central banks and SEB

ECB will hike deposit rate by 15 basis points

In March the ECB further revised its economic risk picture. Having decided in December to reduce monthly securities purchases starting in April 2017, the ECB now **views the risk of deflation as marginal**. We now believe that as part of its major forecast revision in September, the ECB will provide new policy signals that pave the way for a **15 bp hike in its deposit rate to -0.25 per cent**. We expect no further adjustments in ECB interest rates during our forecast period. This hike will ease pressure on earnings in the banking system, especially in Germany, where about 60 per cent of the euro system liquidity surplus ends up. This autumn we also expect the ECB to announce that it will extend securities purchases for six months but reduce them further to EUR 40 billion per month in January 2018.

Because of troublingly low inflation pressure, the **Bank of Japan** will continue its JPY 90 trillion per year securities purchases and keep pursuing its objective that 10-year government bond yields should be close to zero. Its key rate will remain at -0.10 per cent throughout our forecast period. This policy will help push down the yen. In the UK, we expect the **Bank of England** to leave its key rate at 0.50 per cent throughout our forecast period but there is great uncertainty, partly due to the Brexit process.

Divergent policies in Norway and Sweden

Improved global demand is helping the internationally dependent Nordic economies, and our GDP forecasts have been adjusted upward to varying degrees in all these countries.

In **Denmark**, the lingering effects of earlier credit tightening will hamper consumption in the short term, but the economy will rebound as domestic headwinds fade and foreign demand gains momentum, GDP will grow by 2.0 per cent this year and by 2.4 per cent in 2018. In **Finland**, indicators are signalling multi-year highs after a long-awaited acceleration in growth. Weak incomes due to low pay increases and slightly higher inflation are causing consumption to decelerate, despite record optimism among households. GDP will grow by 1.6 per cent this year and 1.7 per cent in 2018.

The **Swedish** economy continues to grow rapidly, partly due to a great need for housing and public services. Industrial production is also accelerating now, driven by increased international demand and to some extent by the weak currency. **GDP growth will be 3.1 per cent this year and 2.6 per cent in 2018**. Rapid job growth is again pushing down unemployment, but despite increasingly apparent supply-side restrictions the wage response has remained very weak. Our cautious pay forecast is not enough to bring CPIF inflation (CPI excluding interest rates) up to the 2 per cent target when temporary effects of earlier energy price changes and exchange rates fade.

In **Norway**, strong capital spending in the mainland economy – excluding offshore oil and gas – has contributed to a turnaround, and the recovery will broaden this year as private consumption and traditional goods exports rebound. **Growth in mainland GDP will accelerate to 1.7 per cent this year and 2.0 per cent in 2018**. Inflation has fallen quickly since it peaked last year. The main driver has been lower goods inflation, as the effects of earlier currency depreciation fade. Due to falling import prices combined with historically low pay hikes, **inflation will remain low and downside risks will predominate**.

Nordics, GDP growth
Year-on-year percentage change

	2015	2016	2017	2018
Sweden	4.1	3.3	3.1	2.6
Norway	1.6	1.0	1.4	1.4
Denmark	1.6	1.3	2.0	2.2
Finland	0.3	1.4	1.6	1.7

Source: OECD, SEB

The **Riksbank** and **Norges Bank** are thus squeezed by the same dilemma, as low inflation is combined with tight labour markets and rising home prices. Both are expressing a clear desire to hold off on monetary policy normalisation due to low inflation pressure. Both also focus strongly on exchange rates and are thus dependent on ECB policy. In April, a divided Executive Board surprised markets by extending Riksbank purchases of government bonds by six months and SEK 15 billion. Given resource utilisation at historically high levels, the **Riksbank is closer to a rate hike**. We have changed our **forecast of the first hike from December 2017 to April 2018**. At the end of 2018, the Riksbank's repo rate will be 0.00 per cent. **Norges Bank will hike its key rate only in late**

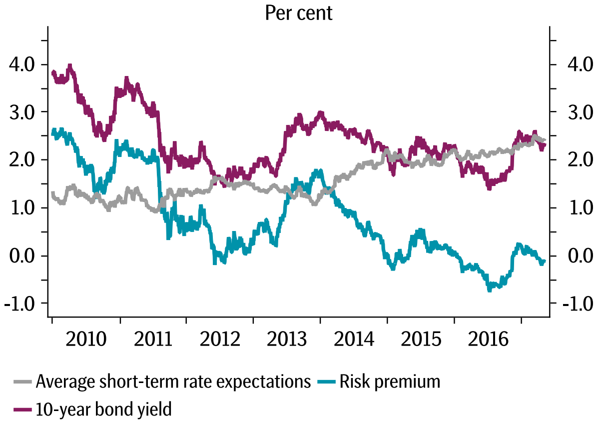
2018, to 0.75 per cent. By keeping its key rate unchanged despite a rapid drop in inflation, the bank is confirming that it also considers financial imbalances important – in contrast to Sweden, where the Financial Supervisory Authority's appeals that interest policymakers should pay heed to financial stability are ignored.

Temporary pause in yield upturn

The upturn in long-term bond yields halted this spring. Although the Fed has delivered two interest rate hikes within only four months, 10-year US Treasury yields today are slightly below their levels at the end of last November. Investors have dialled back their expectations of US fiscal stimulus measures, easing worries about upward pressure on yields driven by an increased supply of bonds and faster Fed rate hikes. In Europe, a search for safe investments ahead of the French presidential election also occasionally helped push German long-term yields lower. In addition, new data have calmed worries about a more aggressive inflation upturn.

Low risk premium in US Treasury yields

Per cent



Source: Federal Reserve Board

The changed approach to various supply and inflation risks is reflected in a renewed downturn in estimated term premiums both in the US and Europe. The chart shows a breakdown of 10-year US Treasury yields into short-term rate expectations and a term premium, according to a model developed by the Fed. We see few reasons for the market to resume flirting with deflation risks. We are thus sticking to our earlier forecast of slowly rising long-term yields, driven by gradual Fed rate hikes and an upturn in risk premiums from today's low levels. **The Fed's plans to gradually begin reducing its balance sheet late in 2017 may lead to upward pressure on long-term yields.** But this effect will be limited – **equivalent to around 10-20 basis points per year** – since the Fed is likely to be aiming at a larger balance sheet total than before the 2007 crisis and will probably take plenty of time, in an effort to ease upward pressure on long-term yields. Since the Fed has progressed further in its rate hiking cycle, this means the yield curve measured as the spread between 10-year Treasury yields and the US key interest rate **will gradually flatten, while the German yield curve will continue to steepen until the ECB begins its rate hikes**.

Our forecast is that 10-year US Treasury yields will rise to 2.65 per cent at the end of 2017 and 3.00 per cent at the end of 2018. Equivalent German bonds will trade at 0.60 per cent by the end of 2017 and 1.15 per cent by the end of 2018. **This represents an upturn of about 70-85 basis points from today's levels: somewhat more in Germany and less in the US**. The 10-year spread between the two countries will remain around 200 basis points this year, in line with the widest spreads since the late 1980s. After that the spread will narrow slowly as the ECB ends bond purchases in mid-2018 and as its first refi rate hike approaches. Compared to February**, we have lowered our long-term yield forecast** by 20 basis points for US yields and 10-15 points for corresponding German yields.

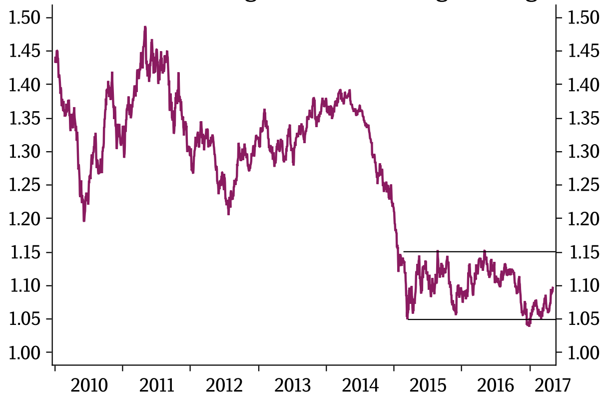
The spread between 10-year Swedish and German bond yields has been largely unchanged in the past six months. Sweden's National Debt Office reduced its bond issues in February and further cutbacks are likely in June, which will exert downward pressure on Swedish yields. Meanwhile the Riksbank is having an increasingly hard time finding sellers in its bond purchasing programme, which will continue during the second half. In the short term, **these factors will narrow the spread to German yields**. Looking further ahead, expectations of Swedish key interest rate hikes may still help push up long-term yields more than German ones. We expect 10-year Swedish yields to **climb from 0.60 per cent today to 0.80 per cent at the end of 2017 and nearly 1.50 per cent at the end of 2018**.

Rising international yields will also affect Norwegian bond yields. Since Norges Bank is unlikely to change its key rate this year, Norway's yield curve will probably steepen, though not as much as in Germany. The supply of long-term bonds will ease after the successful introduction of a new 10-year bond earlier this year. Inflation is also expected to fall, making it unlikely that markets will price in expectations about Norges Bank hikes during the coming year. An attractively valued NOK may generate currency-related interest for Norwegian government bonds, although some investors will probably be a little more cautious after recent NO weakness. **At the end of 2017, we expect the 10-year spread against Germany to have shrunk to 105 basis points, for a yield of 1.65 per cent.** The spread will then stabilise at around 90 points by the end of 2018, when the market begins to expect cautious rate hikes by Norges Bank.

Low interest rates = trendless FX market

The absence of durable trends in the foreign exchange (FX) market is increasingly evident; many currency pairs fluctuate back and forth within wide ranges. The EUR/USD exchange rate is the most important example; sideways range-bound movements have now been under way for more than two years. The continued depreciation of the British pound after last June's Brexit referendum is a clear exception. Range trading can be connected to the strong interplay between monetary policies and currency movements in recent years. A weak currency has been desirable in order to push up inflation in a global "lowflation" environment. Central banks have then driven each other towards ever-lower and sometimes negative interest rates in order to avoid currency appreciation. During 2014-2015 the Fed experienced the consequences of diverging from the policies of other central banks; sharp USD appreciation forced it to slow the pace of interest rate hikes. **The lack of trends, combined with narrow interest rate spreads between many currencies, makes it difficult to generate returns in the FX market.** This is undoubtedly the main reason why FX trading volume is now trending downward. Meanwhile there are signs of significantly worsened liquidity in minor currencies.

EUR/USD exchange rate stuck in range trading



Source: Bloomberg, SEB

After the US presidential election there was potential for renewed USD appreciation, partly due to expectations of powerful fiscal stimulus measures and promises of lower corporate taxation in order to attract company profits home. These hopes have gradually been lowered, while expectations of aggressive Fed rate hikes have also faded. In such an environment, it becomes more important that the dollar, according to our calculations, is cautiously overvalued. Anti-EU forces in European elections have lost momentum and the ECB is expected to take further steps towards normalisation this autumn, which will also benefit the euro. Overall, we believe this will allow the sideways movement that has dominated the FX market for so long to continue. **We expect EUR/USD exchange rates to fluctuate around 1.10 during 2017 and then move upward towards 1.14 by the end of 2018.**

Political uncertainty due to the Brexit process has squeezed the pound, which is clearly undervalued today. Now that the UK's has submitted its formal application for withdraw from the EU, there will be an intensive period of negotiations, first about the divorce and then about the future UK-EU relationship. A quick and simple solution seems distant, and political uncertainty is likely to persist. Meanwhile there are signs of a UK economic slowdown, which will probably continue. Because of persistent political uncertainty and weaker growth, the pound will remain clearly undervalued. **The EUR/GBP exchange rate will reach 0.90 towards the end of 2017, after which the pound will recover a bit in 2018.** Signals of harmonious negotiations, with an increased probability of a softer Brexit, might lead to a substantial appreciation in the pound, given its low valuation.

The krona is still trading at historically weak levels due to exceptional Riksbank monetary policy. After the bank's April statement, it is hard to foresee a quick krona rebound; **in a foreign exchange (FX) market dominated by low volatility and a search for returns, negative interest rates are an extra big handicap**. As we approach a Riksbank policy shift, there are reasons to expect decent-sized krona appreciation. According to our recent *Kronsyn* survey, a more hawkish Riksbank is the single most important factor behind krona purchases by market players. The government has proposed that the Riksbank should repay the SEK 250 billion it borrowed from the NDO to strengthen the currency reserve, which may also be important. If such a decision is actually made this autumn, Riksbank interventions in the FX market would be prevented since they would lead to a growing currency reserve. Although it has become more difficult to determine when the policy shift will occur, **we expect the EUR/SEK exchange rate to reach 9.30 at the end of 2017 and continue to 8.95 at the end of 2018**. Meanwhile we expect the USD/SEK rate to be 8.45 and 7.85 on these respective dates.

Partly due to stable, higher oil prices, the once significantly undervalued **Norwegian krone appreciated greatly during 2016 and early 2017**. This upward movement went a bit too far, however, and has now been followed by a downward correction, although there is still a clear connection between krone movements and oil prices. NOK appreciation is now dampening inflation but the Norwegian economy is continuing to bounce back, while home prices keep climbing. This makes it hard for Norges Bank to ease monetary policy further. Meanwhile the flow situation remains favourable to the krone. The oil-adjusted deficit in the government budget exceeds NOK 250 billion this year, generating large net inflows into the krone. **We expect the EUR/NOK exchange rate to fall to 8.80 by the end of 2017** and believe that the krone will continue appreciating to 8.50 per euro by the end of 2018.

Earnings-driven stock market strength

The cheerful stock market mood of late 2016 has persisted. Strong economic conditions will remain the most important stock market driver. Positive signals about corporate financial results are offsetting various sources of concern, such as political risks and relatively high share valuations. More than halfway through the Q1 2017 report season, sales and earnings have beaten expectations. In addition, forecasts of future earnings have been adjusted upward: an important change compared to previous years. **Q1 reports from US-based S&P 500 companies show an increase in overall sales by around 8 per cent while earnings have climbed more than 15 per cent.** The recovery of the energy sector after its problems early in 2016 plays a large part in this, but virtually all sectors show upturns in both sales and earnings. Signs of improved pricing power are contributing to this positive picture. Companies' price hikes are still not large, but the negative price pressure of recent years has definitely faded and can be expected to turn positive if growth continues.

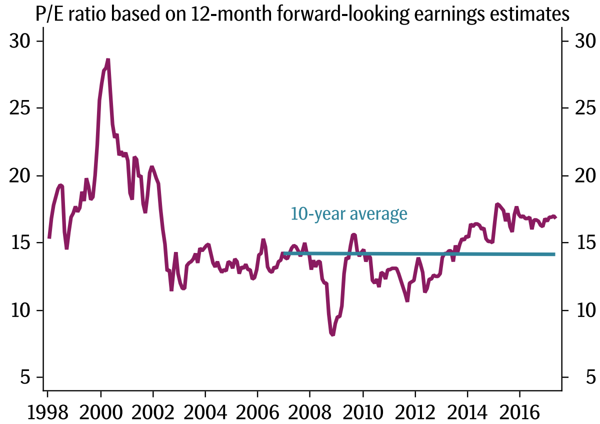
Among sources of concern is political uncertainty on both sides of the Atlantic, but political processes rarely impact corporate earnings in the short and medium term. Nor is it any obstacle that the upturn has already lasted for several years, provided that earnings forecasts are favourable. **As long as interest rates remain low, it is unusual for stock markets to fall for long periods while earnings are rising.** Although the upturn has lasted a long time, that is not unique either. During the past 60 years, three periods of stock market upturns have been both longer and bigger – most recently in the 90s.

Relatively high valuations, combined with an investment community that is already clearly overweighted in equities, may have a dampening effect on share prices. We still believe that the potential in Europe is better than in the US, given a less challenging starting point with both lower profit margins and lower earnings valuations. The outlook for emerging markets, especially in Asia, and for the Nordic countries is also relatively good.

Q1 reports are reflecting sharply improved economic indicators in the Nordic countries. In the US, 80 per cent of S&P 500 companies surpassed market earnings forecasts, by an average of 6 per cent. In Nordic stock markets, the corresponding share was only 70 per cent, yet earnings were 13 per cent higher than forecast. Meanwhile sales were only about 1 per cent above forecast. **This shows that the long-term task of cost-cutting and streamlining has enabled higher sales to have a big impact on the bottom line.** Given the positive macro forecast, rising sales should result in good future earnings growth as well. Last year, earnings of Nordic listed companies fell by more than 3 per cent. This year we expect a 12 per cent upturn in earnings. But one company, Norway's Statoil, will contribute 5 percentage points to the earnings surge after completing its cost-cutting programme and due to higher oil prices. In 2018 the forecast is a broader 14 per cent earnings upturn.

Nordics: Valuations a bit above historical average

P/E ratio based on 12-month forward-looking earnings estimates



Source: SEB

Nordic stock markets are now valued at a price/earnings ratio of 16.8, based on our earnings forecasts looking ahead 12 months. This is somewhat above our estimate of a long-term equilibrium P/E ratio of 16.4. **Given our optimistic view of the earnings trend even in a longer time perspective, there is room for the stock market to climb another 5 per cent** and still close at our long-term equilibrium valuation by the end of 2017. In addition, there is the possibility that the market will overshoot, since it is not unusual for share prices to "run ahead of" earnings. Offsetting such a scenario, however, there will still be many future risk factors to keep track of, especially in light of the mature economic expansion, which increases vulnerability to shocks.

Acceleration after temporary dip early in 2017

- **Passive fiscal policy due to inexperience**
- **Households holding off despite optimism**
- **Tight labour market but late wage response**
- **Fed's normalisation combo: key rate hikes and reduction in the balance sheet**

Hopes of major fiscal stimulus that existed early in 2017 have been dashed. The Trump administration seems incapable of delivering particularly forceful actions this year and probably not in 2018 either. In other ways, too, the start of the year was disappointing. First quarter GDP growth reached only an annualised 0.7 per cent, well below our estimate in February. The main disappointment was household consumption, which decelerated sharply and showed annualised growth of a mere 0.3 per cent. As on several occasions in recent years, this dip seems to have been caused by weather effects and is thus expected to be temporary. Continued labour market improvement and an ever-brighter capital spending outlook suggest continued recovery. Yet due to the weak first quarter, combined with the absence of previously announced tax cuts, we are adjusting our growth forecast downward compared to February's *Nordic Outlook*. **We expect GDP to climb by 2.3 per cent in 2017 and by 2.5 per cent in 2018.**

Indicators are pointing to growth acceleration

Source: US Bureau of Economic Analysis (BEA), Institute of Supply Management (ISM)

Strong sentiment data are also contributing to our optimism about the next few quarters. In March, the Conference Board's Consumer Confidence Index reached its highest level since the dotcom (IT) boom in 2000. Indicators are generally at levels that signal a major acceleration in GDP growth. But the wide divergence between soft and hard data is causing uncertainty, resulting in caution. Indicators will probably fall a bit again in the near future as hopes of stimulus measures start to fade.

The Federal Reserve is continuing its monetary policy normalisation. Our main scenario is that **the Fed will hike its key interest rate twice more in 2017, followed by three hikes during 2018**. This implies a federal funds rate of 2.0-2.25 per cent at the end of our forecast period. These rate hikes will probably be combined with a simultaneous **unwinding of its bond holdings**; we believe that the Fed will begin reducing its balance sheet in December 2017. A number of other combinations of rate hikes and balance sheet reductions are conceivable, however.

No growth stimulus from fiscal policy 2017

Over time it has become increasingly evident that the Trump administration is having major difficulties in pushing through its promised policies. The president and many of his staff members lack political experience, making it hard to interact with Congress. Appointments to numerous positions in the administration are also taking a long time, further hampering efficiency. In practice, not much was achieved during the president's first 100 days in office, despite Trump's ambition to demonstrate his resolve. The biggest failure was his attempt to repeal and replace the Affordable Care Act (Obamacare), but it is becoming increasingly unlikely that any large-scale tax cuts can be pushed through during 2017.

In the February issue of *Nordic Outlook*, we estimated that the impact of fiscal stimulus on growth would be small, totalling only 0.2 per cent of GDP in 2017 and 0.3 per cent in 2018. It now looks as if even this cautious forecast was too optimistic. **The stimulus effect of fiscal policy measures will be non-existent in 2017.** However, certain tax cuts will probably take effect at the beginning of 2018. These are likely to be much less far-reaching than what has been promised, and the growth effect will probably be only 0.2 per cent of GDP.

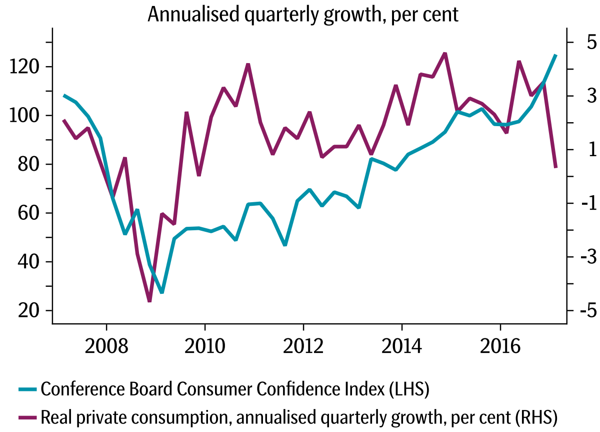
Worries about strongly protectionist US trade policies have subsided somewhat, at least in the near term. The Trump administration has adopted a more conciliatory tone towards Mexico and China and we do not expect any protectionist measures in 2017. But depending on Trump's approval ratings, there is a risk of measures being introduced in 2018, ahead of the mid-term elections.

Temporary dip in private consumption

Private consumption decelerated sharply in the first quarter, increasing by a weak 0.3 per cent annualised rate, but this slowdown is largely explained by temporary factors. Recordwarm temperatures in January and February reduced the need for space heating, which explains the weak figure. Delays in tax refund payments also partly explain this weakness. There is thus **good potential for consumption to take off soon**. Aside from elevated consumer confidence indicators, there are more concrete factors that suggest an acceleration. The labour market is continuing to strengthen, while pay increases are expected to speed up this year. Even if the promised tax cuts do not materialise in 2017, household wealth is increasing because of rising home prices and record-high stock markets. Meanwhile household debt has decreased significantly in recent years, and borrowing costs are low.

Private consumption decelerated in the first quarter

Annualised quarterly growth, per cent



Source: BEA

But the question also remains: **Will households actually increase their consumption, rather than their savings?** The household savings ratio has fallen a bit from a peak of around 6 per cent during 2016. **We believe that the savings ratio will also fall slowly in 2017 and 2018**, driven by labour market improvement. This will enable a **consumption increase of 2.3 per cent in 2017 and 2.4 per cent in 2018**.

Capital spending will take off

The outlook for business investments has improved further in recent months. The ISM index of manufacturing sentiment has fallen from its recent high in February but is still at a level historically consistent with 3 per cent GDP growth. **Capital spending** has also been a bright spot among hard data, **helping keep first quarter GDP growth from slowing even more** thanks to an increase of more than 9 per cent in annualised quarterly growth. The strong rebound is mainly a result of **a clear recovery in the petroleum and mining sectors**, thanks to commodity prices well above last year's. Oil drilling activity has picked up significantly, thus stimulating investments. Given our forecast that oil and other commodity prices will remain close to current levels, there is potential for continued expansion in these sectors.

Meanwhile, industrial production has increased strongly for several months and capacity utilisation continues to creep higher. Utilisation is now just above 76 per cent, closer to the 80 per cent level at which investments usually take off. **The construction sector also saw investments rising sharply in the first quarter.** There is good potential for continued strong growth. The supply of homes is limited, while demand is good because of population growth and low interest rates. Since residential investments are historically low as a share of GDP, we expect an increase during the next few years.

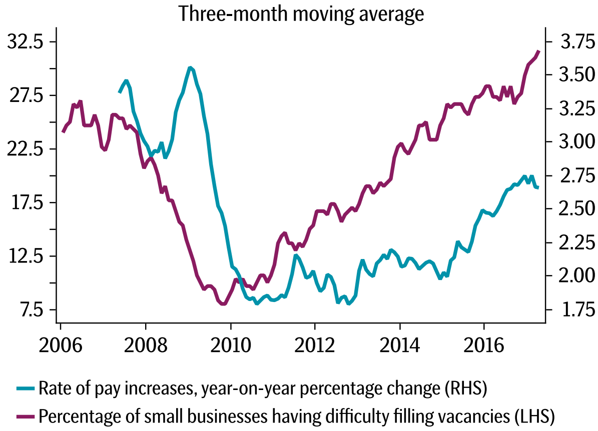
Our forecast is that **business investments will increase by 5.0 per cent in 2017 and 4.5 per cent in 2018**, which implies that they will contribute substantially to GDP growth in both years. There are sources of concern, however. A US dollar appreciation would hamper industrial production, and any attempts by the Trump administration to help manufacturers by means of protectionism will risk having the opposite effect. Another risk is that the weak productivity trend reflects a shortage of investment opportunities.

Increasingly tight labour market

The labour market keeps getting stronger. Except for a dip in March, job growth has continued at a healthy pace, with average payroll increases of 185,000 in the first four months of the year. Unemployment dropped to 4.4 per cent in April and is expected to continue falling further, before levelling out at just above 4 per cent during 2018. The participation rate has been around 63 per cent in recent months. This is still more than 4 percentage points below its peak in 2000, but the recent combination of falling unemployment and a stable participation rate is a sign of strength.

Tighter labour market expected to push up pay

Three-month moving average



Source: National Federation of Independent Business (NFIB)

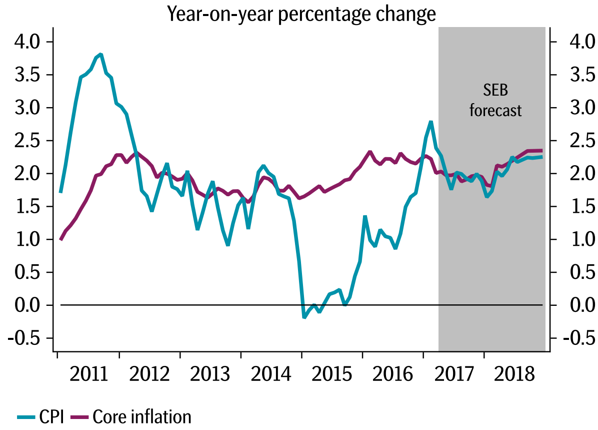
So far, the strong labour market has not affected wages and salaries very much. During 2016 the rate of pay increases accelerated, but in recent months it has again stagnated. In April the rate of increases was 2.5 per cent. This levelling out is partly due to base effects, and several factors suggest that **pay hikes will again accelerate during 2017**. A growing percentage of companies are reporting difficulty in recruiting employees; this is especially clear among small businesses (see above chart). Company compensation plans also indicate upward pressure. As the labour market tightens further, the effects of rising demand for labour will shift from increasing employment to rising wages and salaries. **We are sticking to our forecast that the rate of pay increases will accelerate during 2017, reaching around 3.5 per cent by year-end.**

Inflation will not accelerate until 2018

Last autumn, inflation rose because earlier energy price declines disappeared from the 12-month figures, but this trend has now reversed. In March, the inflation rate fell to 2.4 per cent from 2.8 per cent the previous month. The downturn was partly explained by weather factors. Core inflation (CPI excluding food and energy) also fell and in March was at 2.0 per cent, its lowest level in 17 months. In a broader perspective, we are maintaining our assessment that it will take a little more time before wages and salaries take off. **A sustained upturn in the inflation rate will thus not occur until early 2018.** The lack of fiscal stimulus also suggests that it will be a while before inflation accelerates, and the upside risk in our inflation forecast has eased. **We expect average annual inflation to end up at 2.1 per cent in both 2017 and 2018.** The Fed's main metric, core inflation using the personal consumption expenditures (PCE) deflator, remains below the 2 per cent target but is expected to accelerate to around 1.9 per cent by the end of 2018. **Our full-year forecast is that core PCE will grow by 1.4 per cent in 2017 and by 1.7 per cent in 2018.**

Inflation will speed up in 2018

Year-on-year percentage change



Source: US Bureau of Labor Statistics, SEB

Household inflation expectations according to the University of Michigan consumer sentiment survey are now 2.5 per cent in a one-year perspective, or somewhat lower than at the start of 2017. Inflation expectations measured as break-even inflation rose rapidly after the presidential election but have now levelled out at close to 1.7 per cent looking ahead five years. We believe inflation expectations will rise slowly in 2017.

Fed normalisation uses two different tools

Because the Fed's key interest rate hike in March was well communicated, market turbulence was largely avoided both domestically and in emerging economies, which are normally sensitive to tightening American monetary policy. This increases the Fed's chances of implementing a gradual normalisation of its key rate without creating market volatility and capital outflows from emerging economies.

The Fed has now clearly communicated that **it intends to combine future rate hikes with a reduction in its balance sheet**. Given these two independent policy tools, there are numerous potential combinations for continuing the Fed's normalisation. Our **main scenario** is that the **key rate will be hiked in June and September** and that **reduction in the balance sheet will begin in December 2017**. Because several members of the Federal Open Market Committee (FOMC) have noted the difficulties in predicting market reaction to a phase-out of the Fed's large-scale bond holdings, there are indications that this will also occur at a relatively slow and gradual pace in order to avoid market turbulence. During 2018 we expect three more key rate hikes, in line with FOMC members' own forecasts. This implies a federal funds rate of 2.00-2.25 per cent at the end of 2018.

At present, the Fed's monetary policy portfolio (System Open Market Account, SOMA) is equivalent to some USD 4.2 trillion. So far the Fed has not communicated in great detail how it will reduce this balance sheet but has declared that this process will be "conducted in a passive and predictable manner". It is thus **likely that the Fed will not use the reduction in its balance sheet as a policy tool** and that the proportion of maturing government securities that the central bank re-invests will decrease. Management of its holdings of mortgage-backed securities (MBS) is more complicated. The Fed has communicated that its MBS holdings should also be wound down concurrently with its holdings of Treasury securities. But the maturities of SOMA's MBS holdings are substantially longer. During the next 10 years, only slightly more than 1 per cent of these holdings will mature. If the Fed intends to reduce its MBS holdings at the same pace as its Treasury securities, it may be forced into directly selling MBS holdings.

The reduction of the balance sheet will generally be a function of the intended end-point for its size. There are strong reasons to believe that the balance sheet will not revert to its pre-crisis size, since both the economy and the amount of US currency in circulation is substantially larger today than before the crisis. A reasonable assumption is that by 2027, the SOMA portfolio might be around USD 2.4 trillion. Combined with an assumption that the share of Treasury securities in this portfolio will remain at 60 per cent in the long run, the target would be Treasury holdings of USD 1.4 trillion. Based on this, **the reduction in Treasury securities would end up around USD 7 billion per month**. This can be compared to the size of purchases when the balance sheet was being expanded. The pace varied over time. Most of these securities were bought at a pace of USD 45-50 billion/month.

When the Fed was expanding its balance sheet, long-term yields were pushed down. Now that the balance sheet will be decreased, the effect should be the opposite. Studies show that a reduction in Treasury holdings by USD 7 billion/month would increase average maturities, creating upward pressure on long-term yields of around 10 basis points, approximately **corresponding to one key rate hike per year**. Our main scenario of three key rate hikes during 2018 would thus also include a normalisation of the balance sheet equivalent to one additional rate hike.

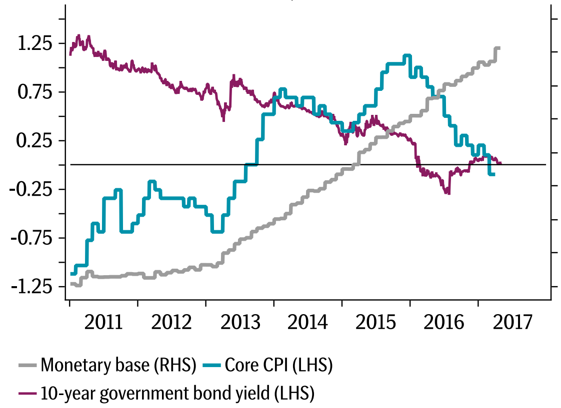
Meagre outcome despite favourable conditions

- **Industry contributing to modest growth**
- **Households hesitant, despite better outlook**
- **Continued ultra-expansionary BoJ policy**

Japan is showing signs of increasingly stable growth. There was rising economic activity in all four quarters of 2016. **Full-year GDP growth was 1.0 per cent**. This was above the historical average of 0.5 per cent since 1980. In the absence of policies that can boost long-term production capacity, potential growth is currently estimated at 0-0.5 per cent, but the short-term growth climate remains favourable. Monetary and fiscal policy remain expansionary, the yen is weak, global economic conditions are strengthening, companies are showing higher earnings and unemployment is falling. But households seem to remain doubtful about the future, and deflation worries persist. Structural factors are also hampering the economy's production capacity. We thus choose to stick to our earlier modest growth forecast: **GDP will increase by 0.8 per cent this year, then reach 0.5 per cent in 2018**. The most important driver of growth somewhat above potential in 2017-2018 will be companies, which will lift GDP by means of both increased exports and increased capital spending.

Japan: Continued rapid monetary expansion

Per cent, JPY trillion



Source: SEB, Macrobond

It is clear that domestic demand will continue to be **hampered by a persistently deflationary environment, high public sector debt and long-term structural problems**. An ageing population that is adding to its savings is one factor behind our cautious consumption forecast. It is also of little help that the government and Bank of Japan (BoJ) are trying to encourage an expanded labour supply (focus on social insurance systems) and higher pay increases. Wage and salary growth remains surprisingly low despite a strong labour market: **unemployment** has fallen as expected and we believe it **will remain below 3 per cent during 2017 and 2018**.

Japan reported **0.1 per cent deflation in 2016**. Although the deflation risk has decreased, **price pressure remains weak**. The **output gap** has apparently closed, while **energy prices** have stopped falling and the **yen** has weakened. **Inflation expectations** are about 1 per cent (below the 2 per cent target). But companies seem to have little pricing power, contributing to low wage growth. We forecast **CPI inflation of 0.6 per cent in 2017 and in 2018**. The risk picture is asymmetric, with a higher probability of new reversals. Since the BoJ's policy framework states that inflation must "*exceed the... target of 2 per cent in a stable manner*", the bank is forced to maintain its current monetary policy strategy.

This implies that the **key interest rate will remain at -0.10 per cent** throughout our forecast period, while the BoJ buys about JPY 90 trillion worth of securities yearly (as earlier). Its aim is thus to keep **10-year government bond yields close to 0 per cent**. The fact that global long-term yields are expected to climb in 2017-2018 will contribute to a more negative yield spread and help push down the yen. **We expect a USD/JPY exchange rate of 120 at the end of 2017 and 124 at the end of 2018**.

Today the BoJ owns **more than 40 per cent of all Japanese government bonds**. Although the BoJ can – in technical terms – essentially buy an unlimited quantity of additional securities, regulations requiring banks, insurance companies and others to hold a certain amount of government securities will place obvious limits on how big future BoJ bond purchases can be.

In the absence of any credible strategy for a sustainable fiscal policy, **Japan's current public sector debt, 240 per cent of GDP**, is also a risk factor for the world economy. The impact of three large fiscal stimulus packages during 2016 on economic growth has been comparatively weak so far, despite front-loaded measures. The public sector is expected to show deficits of 3-4 per cent of GDP in 2017 and 2018. Our forecast is **that public debt will climb to above 240 per cent of GDP next year**. As the economy stabilises, Prime Minister Shinzo Abe's administration will be under increasing international pressure to enact the consumption tax hike postponed from April 2017 and now scheduled for implementation no later than October 2019. Since private consumption is still weak, however, our main scenario is that the consumption tax hike will be delayed.

Every BRIC is growing again, but disparities are large

- **China: Slowdown due to policy tightening**
- **India: A rebound after the currency reform**
- **Russia: Rising confidence in the economy**
- **Brazil: End of the tunnel is discernible**

China: Tightening credit conditions

China began 2017 with very robust growth. First quarter GDP was up 6.9 per cent year-on-year, somewhat higher than the 6.7 per cent outcome in 2016 and within the government's 6.5-7.0 per cent target interval for last year. **Stronger exports** due to increased global activity are a key driver. **Construction** and **private consumption** are also benefiting from favourable credit conditions, which are pushing up home prices and boosting household wealth. Because of the better economic outlook, Beijing is also abstaining from letting the currency continue its weakening trend from 2016; so far this year, the yuan has largely remained flat at around 6.90 per US dollar.

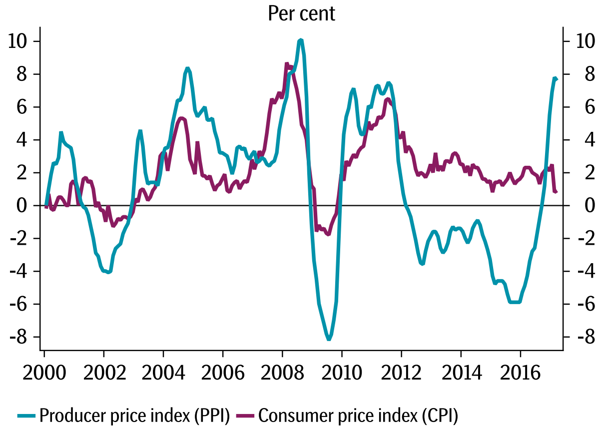
During the rest of our forecast period, we expect a controlled deceleration. **GDP growth will be 6.7 per cent in 2017**, in line with the revised target of "around 6.5 per cent", falling to **6.3 per cent in 2018**. In recent months, the government has revised its economic policy with the aim of slowing growth. Such measures as limits on home mortgage lending – initially intended to cool off the housing market mainly in large cities – have now also begun to affect smaller cities. In addition, increased inflation pressure and Fed rate hikes have forced the People's Bank of China (PBoC) to tighten monetary policy.

The risk picture for GDP growth is balanced this year, among other things because 2017 is a politically important year. In October the Chinese Communist Party's top leadership will be reshuffled, something that occurs every five years. President Xi Jinping is seeking stable growth and limited financial market volatility during 2017 in order to ensure a smooth political transition. Signs of undesirable deceleration would lead to a resumption of more expansionary monetary policy.

Once the new political leadership has settled in, we expect the **implementation of reforms that will contribute to a deceleration in GDP growth to 6.3 per cent in 2018**. For example, tightening of credit conditions is likely, in order to slow the increase in debt. Beijing is also expected to take steps to reduce surplus production capacity in the coal, cement and base metal sectors. This is in line with the country's goal of moving higher in the value-added chain for production of goods and services. Exactly how these reforms will look will be unveiled when Chinese officials announce their GDP growth target for 2018.

During the rest of 2017, the **main task will be to manage monetary aggregates** in order to lower inflation risks. In March, producer prices showed a 7.6 per cent year-on-year increase: the highest level in nearly a decade. Historically, this has had clear secondary effects on consumer prices. Higher inflation might push up interest rates and thus increase the burdens on highly indebted households and businesses. Meanwhile there is a greater risk of bankruptcies and an upturn in the percentage of doubtful loans, which might destabilise both the financial system and the entire economy.

China's CPI is expected to rise by 2.3 per cent



Source: Macrobond

We estimate that **CPI inflation will be 2.3 per cent in 2017 and 2.5 in 2018**: an upturn from 2.0 per cent in 2016. Inflation will thus end up **below the PBoC's 3 per cent target**, partly due to the beginnings of monetary tightening. The PBoC has already hiked its repo rate twice, by a total of 20 basis points, and we expect a **35 bp hike in the benchmark lending rate to 4.70 per cent late in 2017**. To further limit inflation pressure, fiscal policy is also expected to be unchanged, with a government budget deficit of about 3 per cent of GDP.

Our forecast is that the **yuan will weaken a bit to CNY 7.05 per USD by year-end**. This cautious movement is likely a consequence of Beijing's desire to ensure a smooth political transition. The yuan's weakness reflects the relatively vigorous US growth picture and continued Fed key rate hikes. Capital controls imposed late in 2016 will remain in place, since Beijing fears new destabilising capital outflows. Only in 2018 do we expect these controls to be eased. At the end of next year, the yuan will trade at 6.80 per USD, among other things because the dollar is expected to weaken against other currencies.

India: Successful reforms for BJP government

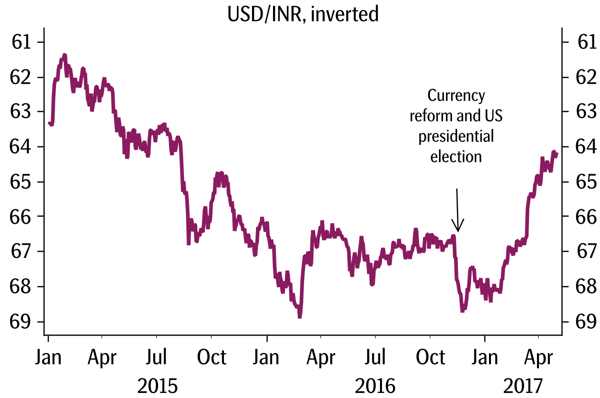
The **currency (or "demonetisation") reform** launched in November **hampered growth to a lesser extent than feared** despite flawed implementation and acute cash shortages that hurt retailers and other sectors. The fourth quarter slowdown was mild and GDP grew 7.0 per cent year-on-year. The effects of the reform have now largely faded. Purchasing managers' indices (PMIs) fell sharply in December but rebounded quickly. The same is true of car sales, which serve as an important consumption indicator in the absence of retail sales statistics.

But other statistics point to weaker growth than indicated by GDP figures. Industrial production is sluggish, and capital spending is still hampered by heavily indebted companies and banks. Steps have now been taken to deal with the weak balance sheets at banks. State-owned banks are being recapitalised, and commercial banks are being forced to set aside resources to cover their high percentage of bad loans, but it will take time before these steps have a positive impact on lending and capital spending. Exports have surged, however, and private consumption is expected to increase at a healthy pace. **GDP growth will accelerate from 7.5 per cent in 2016 to 7.7 per cent in 2017 and 8.0 per cent in 2018**.

The currency reform temporarily drove down price pressure due to discounts. Inflation slowed to a mere 3.2 per cent in December. But inflation has accelerated again, reaching 3.8 per cent in March. Looking ahead, rising food prices and unfavourable base effects will push inflation somewhat higher, but because of low inflation early in the year, our 2017 forecast still needs to be revised downward. As an annual average, we expect **inflation** to end up at **4.4 per cent in 2017 and 5.2 per cent in 2018**. We believe that because of rising inflation pressure, the Reserve Bank of India will leave its **key interest rate unchanged at 6.25 per cent throughout 2017** and then raise it to **6.75 per cent at year-end 2018**.

Quick rupee rebound after currency reform and Trump victory

USD/INR, inverted



Source: Macrobond

Expectations that the currency reform would harm the governing Bharatiya Janata Party (BJP) in the important **Uttar Pradesh state election** proved incorrect. The **strong pro-BJP outcome** indicates **clear support for Prime Minister Narendra Modi's reform-minded policies**, strengthening the BJP's position in the upper house of parliament, although unlike the lower house it is far from enjoying its own majority.

The Modi government's **most important reform success** is the **national goods and services tax**, which has now been approved by the upper house. Implementation of the tax is planned for July 1 but will probably take longer. The tax replaces a crazy-quilt of state taxes and is **expected to have a positive impact on economic growth starting in 2018**, but achieving the official target of 8-10 per cent GDP growth will require reforms of politically sensitive labour market and land purchase laws. Although reform chances have clearly improved since the BJP's state election success, Modi is expected to proceed cautiously and focus on more uncontroversial reforms.

The **rupee** is one of the emerging market currencies that has performed the best since Donald Trump's election victory. Strong fundamentals in the form of decent growth and smaller current account and budget deficits make it **resilient**. The rupee has appreciated clearly against the US dollar so far in 2017. India is also a relatively closed economy, and its currency is not affected especially much by worries about increased protectionism. The weakening of the rupee will thus be mild in 2017 despite Fed rate hikes. **We expect a USD/INR exchange rate of 69.0 at the end of 2017 and 67.0 at the end of 2018**.

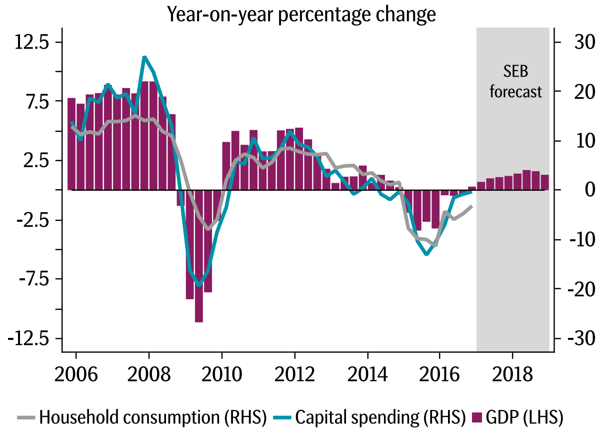
Russia: Oil gets the wheels spinning again

The recession that began in 2015 is now over. Russian GDP fell by about 0.2 per cent in 2016, but this **full-year figure conceals a significant upturn in the fourth quarter**, when the economy grew by 0.3 per cent year-on-year. Ultimately, the rebound is being driven by a recovery in oil prices and higher oil production, but the agricultural and manufacturing sectors have also taken off. The depreciation of the rouble since 2014 has provided an extra push for exports of both energy and other products, helping Russian PMIs climb well above 50.

Investment appetite has been cautious, however, which **will limit GDP growth to 1.1 per cent in 2017 and 1.5 per cent in 2018**. Another factor restraining growth will be fiscal austerity, but the economy will benefit a bit from monetary easing. Inflation fell sharply to 4.3 per cent in March and we expect the central bank to reach its 4 per cent target by mid-2017, which seemed impossible only a year ago. **It will, however, be difficult to keep inflation down** due to imminent value-added tax hikes and pent-up wage and salary demands. Inflation expectations remain high, suggesting that key interest rate cuts will be implemented at a cautious pace from today's 9.25 per cent. Our forecast is that the **key rate will stand at 8.0 per cent at the end of 2017 and 7.25 per cent at the end of 2018**, while annual average **inflation** will end up at **4.3 per cent in 2017 and 4.2 per cent in 2018**.

A tug-of-war is under way between the central bank and the Finance Ministry. The central bank is currently prevailing, thanks to support from the Kremlin for a tight monetary policy aimed at bringing down inflation expectations. High inflation combined with increased poverty could potentially be politically explosive even in Russia. But high interest rates also mean a strong rouble, which hurts government finances since each dollar of Russian oil that is sold brings in fewer roubles.

Gradual increase in Russian growth is expected
Year-on-year percentage change



Source: Russian Federal State Statistics Service (Rosstat), SEB

The Finance Ministry aims to bring the federal budget deficit down to 1.0 per cent of GDP in 2019 from last year's 3.4 per cent. This plan is ambitious, and the March 2018 presidential election (which Vladimir Putin is virtually certain to win) will make budget targets tough to achieve, especially if the rouble keeps appreciating. The deficit will probably shrink to about 3.0 per cent of GDP in 2017 (in line with the ministry's sub-target) and 2.5 per cent in 2018 (0.5 points above target). **As inflation expectations fall** and pressure on the budget increases, however, the central bank will ease monetary policy and the **Finance Ministry will gain increased influence over the currency**. The **rouble** now stands at 58.3 to the dollar, but **we expect it to weaken to RUB 62.0 to the dollar at the end of 2017 and 64.5 at the end of 2018**.

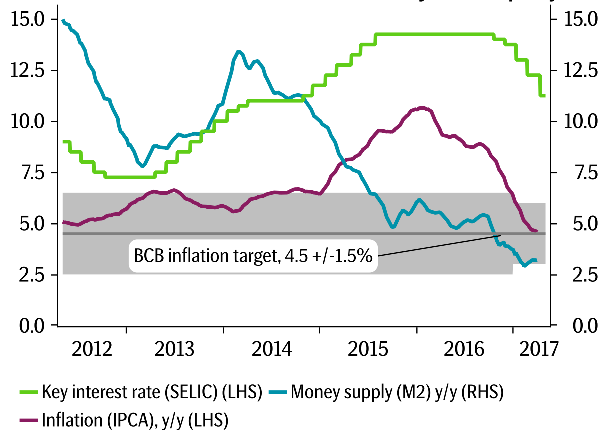
Hopes that American and European sanctions against Russia will be removed have been crushed, and **we expect no easing until 2018 at the earliest**. Europe will not change its mind without first renegotiating the Minsk II agreement on Ukraine, which will not happen until after the German election in September. President Trump is also unlikely to roll back US sanctions, in light of suspicions of Russian interference in the US election and increased geopolitical tensions.

Brazil: Slow-motion recovery

The Brazilian economic recovery has been delayed but it now seems under way. **GDP fell by 3.6 per cent in 2016**. Exports rose by 1.7 per cent, driven by a weaker currency, but that was not enough to offset the sharp downturn in private consumption and capital spending. **During the first quarter of 2017, however, the trend reversed**. The central bank's economic activity index rose by 1.3 per cent in February, its largest upturn since 2010, driven by exports. The economy has bottomed out, but **remains in a deep hole that it will take time to climb out of** – due to weaknesses in government finances, infrastructure and the business climate.

We estimate that Brazil's **GDP will climb by 0.7 per cent in 2017 and 2.0 per cent in 2018**. The most important drivers will be exports of agricultural products, which will rebound after last year's drought, and of iron ore. Year-on-year inflation fell from 10.7 per cent in January 2016 to 4.6 per cent in March 2017 due to currency appreciation and weak domestic demand. We expect an **inflation rate of 4.2 per cent in 2017 and 4.8 per cent in 2018**, well in line with the central bank's 4.5 ± 1.5 per cent target. This will enable the bank to cut its key rate significantly: from today's 11.25 per cent to 8.25 per cent by the end of 2017 and 7.75 per cent in 2018. A lower key rate is important in order to stimulate lending and capital spending, as well as to maintain export competitiveness. The Brazilian **real is thus likely to weaken** from today's 3.20 **to 3.40 per USD at the end of 2017 and 3.60 at the end of 2018**.

Banco Central do Brasil will cut key rate rapidly



Source: Brazilian Institute of Geography & Statistics (IBGE), Central Bank of Brazil, SEB

The need to consolidate Brazil' public finances will hamper growth for years. **The budget deficit** was 9.7 per cent of GDP in 2016 and **is expected to shrink slowly to around 8.0 per cent** in 2017 and 7.0 per cent in 2018. Lower interest rates on government debt and a cyclical economic upturn will help, but the government will need to cut spending since the tax burden is already one of the highest among emerging market countries. But this will take time, since about 80 per cent of spending is governed by rules written into the constitution.

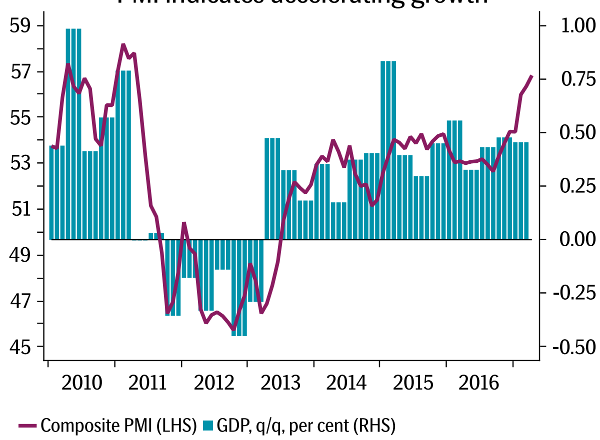
Political developments over the next few years are very uncertain. President Michel Temer's administration enjoys congressional support for extensive reforms. Most important will be cost-cutting in the pension system and a liberalisation of the labour market. Temer will probably be able to remain in office until the October 2018 election, although various ministers in his government may be forced to resign due to involvement in the far-reaching Car Wash corruption case. Temer may have to resign if his and former President Dilma Rousseff's candidacies in the 2014 election are declared invalid, but the Electoral Court appears unwilling to worsen the political situation as long as reform efforts are progressing.

GDP will accelerate, confirming strong indicators

- **Households are cautious, despite optimism**
- **Reassuring election results during 2017, but the EU faces an uncertain long-term future**
- **Inflation will remain below the ECB target…**
- **…but high enough to allow further ECB stimulus reduction in September 2017**

Euro zone growth has markedly improved. Employment and household optimism are rising, while decently high capacity utilisation is helping to speed up the growth in capital spending. Sentiment indicators point to a significant acceleration, but some indicators are so strong that they are difficult to trust completely. Political uncertainty has decreased, after anti-EU and anti-euro candidates were less successful than expected in the Netherlands and France. Yet the remaining question marks about the EU's long-term development and its ability to deal with problems will have only marginal negative effects on growth. **We expect GDP to climb 2.0 per cent both in 2017 and 2018**, which means our scenario remains a bit brighter than consensus. Despite low inflation, we believe that the European Central Bank (ECB) will trim its stimulus measures further in September 2017.

PMI indicates accelerating growth



Source: Markit, Eurostat

Less political uncertainty after the elections

The political currents manifested in 2016 by the UK's Brexit referendum and the US elections also quickened the political pulse in the euro zone, by raising important questions about openness and cohesion both in individual countries and the region as a whole. In itself, there is nothing new about dissatisfaction with established political parties; new parties have previously been successful in Greece, Spain and elsewhere. However, our assessment in the February issue of *Nordic Outlook* that **the influence of EU- and euro-sceptical parties would be limited** is supported by the election outcomes in the Netherlands and France. Although it remains to be seen how vigorously the relatively inexperienced Emmanuel Macron will be as president, he will at least guarantee pro-EU actions by France. The large support for EU-sceptical candidates has made also Macron bring up the need for EU reforms. Now the parliamentary election in Germany remains, but at present the battle for the office of chancellor between Angela Merkel (CDU/CSU) and Martin Schulz (SPD) does not appear especially crucial to financial markets and growth (see box). But even if the 2017 election results do not lead to any major drama, large question marks remain about the EU and euro projects in an environment where polarisation on important issues is greater than for years, both inside and between countries. The European Commission's attempt to force EU member countries to choose a strategy (see theme article) is raising the temperature. There are several alternatives, but the most convenient path may ultimately be a multi-speed Europe, in which some countries may receive opt-outs of the kind that the UK negotiated with the EU before the Brexit referendum.

GDP forecasts

Year-on-year percentage change

	2015	2016	2017	2018
Germany	1.7	1.9	2.0	1.9
France	1.3	1.2	1.4	1.4
Italy	0.8	0.9	1.0	1.2
Spain	3.2	3.2	3.0	2.8
Euro zone	**2.0**	**1.8**	**2.0**	**2.0**

Source: Eurostat, SEB

Fiscal policies will be weakly expansionary

Most euro zone countries are weighed down by large deficits and/or high public sector debt, although stronger economic conditions and low interest rates are easing their situation. There is heavy spending pressure, for example due to ageing populations, refugee resettlement and increased security tensions. In this environment, we expect fiscal policies to be weakly expansionary in 2017-2018. Because many governments are under pressure from the success of populist parties, Brussels will adopt a gentler attitude towards how quickly budget deficits must be pushed below 3 per cent of GDP. Yet public sector **deficits in the euro zone as a whole may fall towards 1 per cent of GDP in 2018**, while government debt, now at just below 90 per cent of GDP declines slowly. The biggest risks are in Italy, where a high percentage of bad loans in the banking sector, slow growth, political uncertainty and already heavy government debt are an unmanageable set of problems.

German election: Slight edge for Merkel?

With Martin Schulz as their new party leader, Germany's Social Democrats (SPD) have boosted their voter support. Merkel now has a challenger for her position as chancellor, opening the way for a number of possible coalitions. The governmentally experienced liberal party (FDP) looks set to break back into the Bundestag, where it would be a coalition partner for either the CDU/CSU or SPD. The anti-immigration Alternative for Germany (AfD) is shaken by internal conflicts between an extreme-right and a more pragmatic wing – contributing to such a big drop in public support that AfD is hardly going to gain any real power as long as other parties do everything they can to avoid collaborating with it. Because the CDU/CSU has performed well in recent state elections, Merkel remains the favourite, but the May 14 vote in Germany's most populous state, North Rhine-Westphalia, will provide further indications of party strengths.

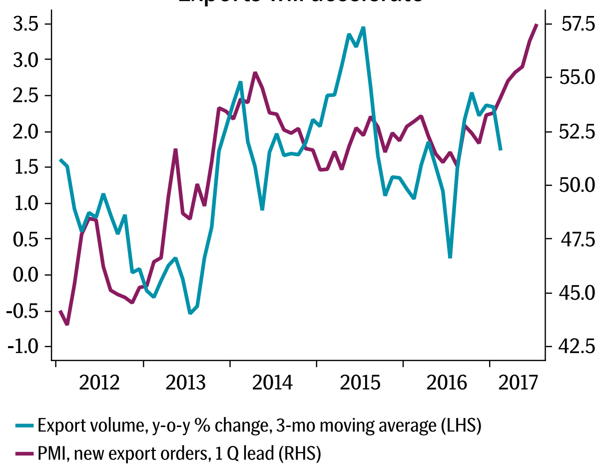
From a financial market perspective, both major parties have strengths and weaknesses. Merkel would provide continued stability and predictability, while Schulz has signalled that he is willing to reverse portions of the important labour market reforms implemented over a decade ago by Gerhard Schröder's SPD government. On the other hand, a change of chancellor may inject new energy into Germany and Europe. Schulz is pro-EU and has extensive experience in Brussels, including as president of the European Parliament. He would probably pursue a more expansionary fiscal policy, push for faster pay hikes and establish a more pragmatic and gentle attitude towards resolving the problems of crisis-plagued countries, especially compared to Wolfgang Schäuble, the CDU finance minister. Such policies would further stimulate euro zone recovery and soften both external and internal criticism of Germany's historically high current account surpluses of 8 per cent of GDP.

Strong indicators = higher capital spending

Sentiment indicators are currently strong, pointing to a clear acceleration in economic activity. Euro zone purchasing managers' indices (PMIs) are at their highest since 2011 and the upturn is broad-based, both in geographic and sectoral terms. PMIs for the four largest countries (Germany, France, Spain and Italy) are in the 54-57 range, where 50 is neutral. The manufacturing and service sectors are roughly in line with composite indices, while the construction sector – despite improvements – lags somewhat behind. The order situation is good in both domestic and export markets, and companies are also beginning to see opportunities to raise prices, but because actual industrial production has shown sluggish growth – especially around year-end – we should interpret the indicator situation with some caution. Export figures have strengthened, however. Based on the indicators as well as improved international economic conditions, we anticipate that **exports will accelerate to an annual growth rate of around 4 per cent in 2017-2018**. However, the increase in **industrial production will reach only about 2 per cent**.

Despite an upturn in recent years, capital spending is about 10 per cent lower than in 2008. A speed-up is now likely, since investment activity benefits from better economic conditions, rising production, low interest rates and greater demand for loans. Companies are satisfied with their order bookings and foresee greater potential for raising prices, which points in the same direction. Housing construction is also benefiting from rising prices for existing homes in most countries. Meanwhile there are factors holding back capital spending growth: strong indicators need to be confirmed by additional hard data, and it is uncertain to what extent companies are actually expanding within the euro zone. The problems of southern Europe's banking sector also remain a constraining factor. Although ECB studies indicate that southern European companies pay interest rates on a par with the euro zone as a whole, less willingness to lend money is hampering the effectiveness of ECB policies. Overall, however, we have adjusted our forecast somewhat higher. We predict that **total capital spending will increase by more than 4 per cent yearly in 2017 and 2018**.

Exports will accelerate



Source: Eurostat, Markit

Households hesitant, despite confidence

Various factors now suggest a stronger consumption increase; consumer confidence has improved, employment is rising, interest rates are low and fiscal policy headwinds have eased. Higher car sales confirm the optimistic picture, but meanwhile relatively weak retail sales show that households remain cautious. Because of low nominal income increases, even an upturn in inflation as moderate as we have now seen hurts purchasing power. The household savings ratio has also fallen since 2008 due to economic recovery and is now at 6 per cent. Such a depressed level makes households especially sensitive to the political uncertainty lingering in many countries. Overall, we thus foresee a **yearly upturn of less than 2 per cent in household consumption in 2017-2018**.

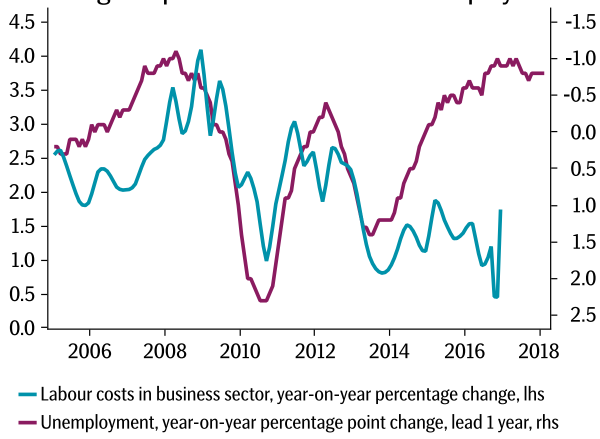
Stronger labour market, but weak pay hikes

The labour market shows continued strength. The jobless rate was 9.5 per cent in March: its lowest level since 2009.

Compared with the peak in 2013, the number of unemployed has fallen by 4 million. The trend is positive in most countries, although the picture is divergent. In Germany and Spain, the jobless rate is falling clearly, while little has changed in Italy and France. **Business hiring plans according to PMIs are at high levels** that have only been achieved a few times since 2000, and job growth has historically followed this indicator relatively well. **We expect unemployment to fall slightly below 9 per cent by the end of 2018**. This means it will stay a bit above equilibrium, which we estimate at about 8 per cent.

Despite the ever-stronger labour market, there are **no signs that pay hikes will accelerate**. Although a record-high percentage of German businesses (according to the EU index) state that labour shortages are hampering production, for the euro zone as a whole this is not an imminent problem. Yet the gap between actual pay hikes is not so wide; German wages and salaries are rising at a 2 per cent yearly pace, compared to 1.5 per cent for the overall euro zone. In Spain, pay levels are largely constant. Looking ahead, we expect pay increases to accelerate somewhat to nearly 2 per cent by the end of 2018.

No wage response to downturn in unemployment



Source: Eurostat

Limited inflation upturn

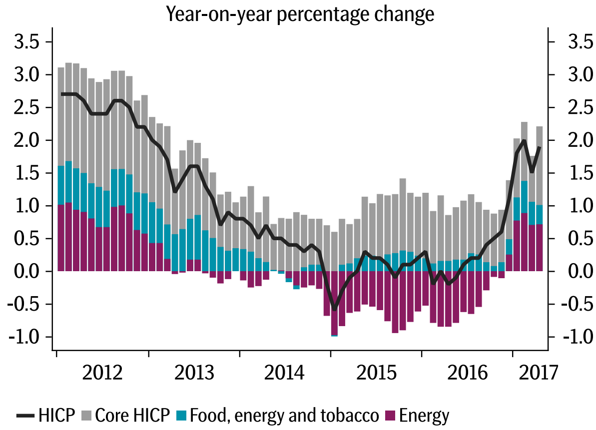
Driven by temporary surges in energy and food prices, inflation according to the harmonised index of consumer prices (HICP) temporarily reached 2 per cent, the highest reading since January 2013, in early 2017. The peak is now already past, however. We expect slightly falling inflation this spring and summer, then a clearer downturn to **about 1 per cent. This is also consistent with the underlying price pressure that has largely prevailed for the past 3 years** in an environment of low pay increases. At present there are gaps between countries; in March, inflation varied between 0.6 per cent (Netherlands) and 3.3 per cent (Latvia). In 8 of the 19 euro zone countries, inflation exceeded 2 per cent. Slightly higher inflation has left its mark in higher inflation expectations. According to ECB, inflation is expected to reach some 1.5 per cent looking ahead a few years, while financial market pricing indicates levels of 1-1.5 per cent depending on the time horizon. Although this is a bit below the ECB's target of close to but below 2 per cent, deflation worries have greatly eased. We expect **inflation of 1.5 per cent in 2017 and 1,1 per cent in 2018**. Core inflation will end up near 1 per cent in both years.

Further ECB stimulus cut in September

Ultra-loose monetary policy will continue, although the **tug-of-war between ECB doves and hawks is likely to escalate ahead**. A number of factors indicate that the **ECB will take additional steps during 2017 to phase out its stimulus measures**. The economic outlook has gradually improved, while the political risks that some members of the Governing Council have highlighted will become less important if election results follow our main scenario. Inflation is likely to fall again to levels that are uncomfortably low to the ECB, as the temporary effects of energy and food prices fade. But the risk of deflation has meanwhile decreased, and we expect both HICP and core inflation to stabilise at 1-1.5 per cent. For another while, the ECB will also probably stick to its **higher forecast of stable HICP around 1.75 per cent and gradually rising core inflation**, making it easier for the bank to advocate somewhat less expansionary monetary policies. As early as last December, the ECB also showed that in the prevailing environment it is ready to take small steps away from **exceptional crisis policies** when it announced a cutback in monthly bond purchases from EUR 80 to 60 billion starting in April 2017. The US Federal Reserve is continuing to hike its key interest rate, confirming the impression that central banks generally will begin taking small steps towards less extreme monetary policies, which will marginally also affect the ECB.

Energy and food are driving up inflation

Year-on-year percentage change



Source: Eurostat

We now expect the ECB to hold off until its **September policy meeting, when it will 1) raise its deposit rate for banks by 15 basis points** to -0.25 per cent; **2) reduce monthly bond purchases** to EUR 40 billion starting in January 2018; and **3) extend these purchases** to the entire first half of 2018. This combination of measures is in line with ECB President Mario Draghi's "recalibration" at the December meeting and means that the Governing Council is giving with one hand and taking back with the other. Yet several Council members have signalled that interest rates should not be touched before ECB bond purchases end. An alternative scenario may thus be that the September meeting approves a cutback in bond purchases starting by October 2017 and an end of purchases by spring 2018, after which the first deposit rate hike will occur.

- **En Marche untested in legislative elections**
- **Weak economy will force compromises**

After two dramatic election rounds, **Emmanuel Macron** has now won the French presidency. With Socialist and Republican candidates failing due to their own errors, **French politics now faces an uncertain period**. The Fifth Republic has its first president from outside the two major parties, reflecting tensions in French society that Macron must now deal with. In his campaign, he proclaimed himself an outsider, despite having attended elite French schools and served as economy minister in François Hollande's Socialist government. His party, En Marche! (EM), styles itself as a progressive alternative in the political mainstream, with ambitions to unite the right and left.

One crucial question is how large support Macron gets and how he will work with parliament. **A president is powerful only if parliament accepts his policies**. The National Assembly election resembles the one for president, with two rounds in single-deputy constituencies. If no candidate wins a majority on June 11, there is a second round on June 18 for candidates who received more than 12.5 per cent. Since the Fifth Republic began in 1958, the president and prime minister (PM) have normally represented the same political camp. With presidential and legislative elections falling so close in time, outcomes have largely reflected the same political currents. Only three times have the president and PM come from different political camps. The experience of such "cohabitation" has been generally negative. There were Republican governments in 1986-88 and 1993-95 under Socialist President François Mitterrand and Socialist ones under President Jacques Chirac in the early 2000s.

Seats in the current National Assembly (lower house)

	Number	Per cent
Socialists	295	51
Republicans (conservative)	196	34
National Front (right-wing populist)	2	<1
Others: Centre-right	29	5
Centre-left	15	3
Greens	18	3
Extreme left	15	3
Miscellaneous	7	1

With both **Socialists and Republicans in deep crisis** after the defeat of presidential candidates Benoît Hamon and François Fillon, their parliamentary position is also likely to weaken. But EM will find it **tougher to perform well in the National Assembly election** though some polls now surprisingly show that they will reach a majority. EM was founded as recently as April 2016. Aside from the presidential election it has not taken part in elections. Its organisational shortcomings are likely to be obvious. EM will have difficulty recruiting enough candidates to stand in all constituencies.

If EM still manages to win a decent minority of seats, this will strengthen Macron's position. The outcome for other parties is also important, since the **National Assembly can overthrow a government in a vote of no confidence**. The National Front (NF) is also likely to gain seats. In the past, its opponents have withdrawn from the second round to stop NF candidates. Today NF has only two deputies. But after Marine Le Pen attracted 34 per cent of votes in the second presidential round, an increase in the number of NF seats seems inevitable.

Our main scenario is thus that **Macron must deal with a parliament where EM has only a minority of seats:** it will need to work with one or more other parties. There are many scenarios for how such cohabitation may look. Macron is likely to start by trying to launch an EM or independent prime minister. If this is impossible, he will likely have to appoint a PM from the biggest party: probably the Republicans, considering the Socialists' even bigger collapse in the presidential election. Macron will be dependent on **how the established parties deal with their frustration** after a crushing presidential election defeat. **The Fifth Republic was largely designed to enable two major parties to fight for power** and stable majorities. If the parties are unable to adapt to the new situation, **French politics may deadlock, causing major problems for both the economy and EU cooperation**. Since the established parties must also avoid internal disunity and devise strategies to stop the NF's long-term rise, cohabitation may prove complicated.

Yet Macron's potential should not be underestimated. He enjoys a political tailwind and should initially have a strong mandate as an independent, enabling him to work with both right and left. Since the French economy is having difficulty keeping up with the euro zone recovery, it should be possible for several parties to agree on steps to improve optimism, job creation and growth. **There are similarities between Macron's and Fillon's programmes** that might create the basis for collaboration. For example, both advocate trimming public sector costs to finance tax cuts as well as increased security and defence spending. Both also agree that France should be proactive in deepening EU cooperation in general.

But **Macron must quickly spell out much more concrete policies** than he has done so far. Earlier experience indicates that the first period of a presidency is important; the reforming power of both Nicolas Sarkozy and Hollande quickly waned as their popularity figures fell and opponents organised strikes and other protests. If Macron moves clearly to the right, the left will eventually revolt, but the Socialist Party's deep crisis implies that it will need to tend to its wounds for a while after the election before regaining the strength for such a fight.

- **EU's future being reassessed – unclear how**
- **Multi-speed union in 2025 logical, but risks splitting EU and jeopardising euro stability**
- **Beginning of reform work also provides an opening for UK to reconsider Brexit**

The European Union is at a critical, existential crossroads. This conclusion is confirmed in the *White Paper on the Future of Europe* unveiled by the European Commission on March 1, 2017. For example, the EU is challenged by globalisation, economic inequality, populism, a new security policy agenda and transformative technologies that affect societies and labour markets. Together with background studies (see below), the "Book" is intended to generate public debate on the **EU's main issues and possible future scenarios**. In September, Commission President Jean-Claude Juncker will summarise and present conclusions about the future of the EU in an address to the European Parliament.

EU 2025: Important dates during 2017

Apr	Report: The social dimension of Europe
May	Report: Harnessing globalisation
May	Report: Deepening the economic and monetary union
Jun	Report: The future of European defence
Jun	Report: The future of EU finances
Sep	Speech: Juncker's "State of the Union" in Parliament
Oct	**Decision**: Social summit
Dec	**Decision**: European Council (EU27 summit meeting)

Source: SEB, European Commission

The debate and decisions may be crucial in three areas:
I. Dealing with anti-establishment forces in many EU countries.
II: Impact on the euro project and the stability of the euro.
III: Brexit and the probability that the UK may remain in the EU.

Years of euro crises and attempts to move towards political union with increased supra-nationalism have hit a brick wall, contributing to anti-establishment forces in the EU. Meanwhile the euro project still lacks necessary infrastructure such as common fiscal, tax and pension policies that might give the euro long-term stability. If the EU debate also allows new ideas on the immigration issue, the concept of free labour mobility, greater national self-determination and limited access to national welfare systems, the Brexit process may end up in a new situation. The EU that the UK voted in June 2016 to leave may look different when the EU completes its discussions.

The Commission's timetable is ambitious. Its objective is for the EU27 to "decide on a course of action to be rolled out in time for the European Parliament elections in June 2019." Depending on the path chosen, these decisions are expected to trigger changes in EU treaties. This, in turn, implies a new round of national parliamentary decisions and in some cases referendums. It would probably **take five years to ensure full support for these decisions** and to launch the **new EU in 2025**.

The White Paper offers five alternatives:

The European Commission presents five different scenarios for how the EU27 may look in 2025. They are:

1. Carrying on – business as usual
The EU sticks to its course and focuses on implementing and upgrading its current reform agenda.

2. Nothing but the single market
The EU is trimmed down and focuses on deepening certain key aspects of the single market; less cooperation in several areas.

3. Those who want more do more
EU allows willing member states to do more together in specific areas – a "multi-speed EU".

4. Doing less more efficiently
The EU focuses on delivering more and faster in selected policy areas – while doing less elsewhere.

5. Doing much more together
The EU decides to do much more together across all policy areas – federalism and a "United States of Europe".

At present, alternatives 1 and 5 are unrealistic: EU needs rethinking and renewal, but taking the step towards a political union is currently not in the best interest of EU citizens and would generate further populist forces. Choosing alternative 2 would be a reversal – there is room for European cooperation in more areas, which is an argument for alternative 4. These key areas may include common security, defence and foreign policies. **Worryingly, such countries as Germany, France, Italy and Spain have already said that they would like to pursue alternative 3, that is, a multi-speed EU**.

Given the big differences between EU countries, a multi-speed EU is appealing, but there is a risk that tensions within the EU27 would increase. A number of Eastern European countries are expected to oppose such a development. A multi-speed EU also throws a spotlight on the obvious weaknesses of the euro project. There is a risk of growing pressure to create a multi-speed euro zone in which some countries take new steps to establish a fiscal union, for example, which would add new uncertainty to the euro as it looks today.

The *White Book on the Future of Europe* creates both opportunities and threats to the EU, the euro zone and the Brexit process. It marks the beginning of a multi-year process whose final results are far from certain. At present, **alternative 4 appears to be the most reasonable way forward** for the EU27. It is an alternative that should be attractive to most EU countries – including the UK.

Election will strengthen dominance of May and Tories

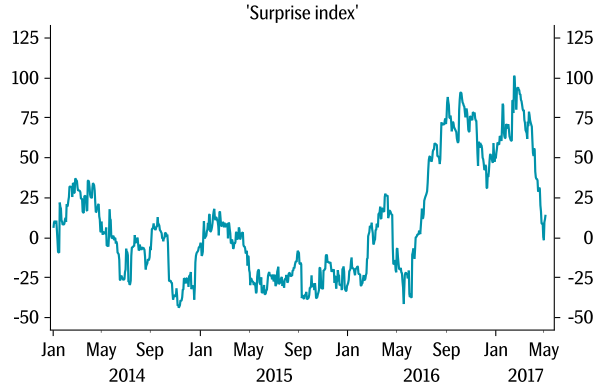
- **Weak pound softens negative Brexit impact**
- **Consumption growth engine is sputtering**
- **Unchanged key interest rate in 2017-2018**

On March 28 the UK government sent in its official application to leave the EU, beginning a two-year period of negotiations on withdrawal and future relations. Prime Minister Theresa May has also called a snap election for June 8. Support for the incumbent government is strong and the opposition is in poor shape. There are many indications that the election will strengthen May's position in Parliament. A strengthening of her mandate as prime minister and of the Tory government could make the coming negotiations with the EU easier.

So far the British economy has shown few signs of the slowdown feared after the Brexit referendum. Significant currency depreciation has helped. Early 2017 also looked stable, but we believe **political uncertainty will increasingly hamper future economic growth** via weaker capital spending and consumption. In Q1 2017 **growth slowed to 0.3 per cent compared to the preceding quarter**. As the chart shows, more and more recent data that no longer meet expectations point in that direction. **This year growth will fall to 1.4 per cent, and in 2018 GDP will increase by only 0.9 per cent**: a forecast that is somewhat below consensus. Given such slow growth, we expect **rising unemployment**, reaching 5.2 per cent by the end of 2018 compared to 4.7 per cent today.

Harder for economic statistics to meet expectations

'Surprise index'



Source: Bloomberg

Growth in 2017-2018 will be greatly affected by what future relationship the UK and the EU can agree on. The **British government's policy is to withdraw completely from the EU**, among other things because the UK's demands for controlled immigration and full influence on legislation are incompatible with "limited membership" such as in a European Economic Area (EEA) treaty. It is thus out of the question that British companies can enjoy unlimited access to the EU single market. Instead, the government's goal is **to negotiate a free trade agreement that can maintain commercial relations with the EU to the greatest possible extent**. But EU leaders have made it clear that a partnership can never give the UK the same benefits as membership. A lot is at stake for the UK, since 44 per cent of its exports go to other EU countries.

In recent years, household consumption has been the engine of UK economic growth, but we now fear a deceleration. Wage growth looks set to remain weak and the savings ratio is at historically low levels, **limiting the potential for further reductions**. Meanwhile **higher inflation and future weakness in the labour market are undermining household purchasing power**. Year-on-year inflation will peak at 2.9 per cent in 2018 and **annual average inflation will reach 2.5 per cent in 2017 and 2018**. A continued weak currency and strong international conditions **will soften the slowdown**, however. The depreciation of the pound has helped keep export order bookings stable, but we still see signs of slowing business investments. The latest statistics show unchanged investments compared to last year, and spending plans fell in the second half of 2016. Withdrawal from the EU will also make fiscal tightening hard. The government has abandoned its ambition to achieve a budget surplus by the end of its term. Instead it will implement aggressive measures such as **cutting corporation tax to 17 per cent by 2020** and **new investments in research, development and infrastructure**.

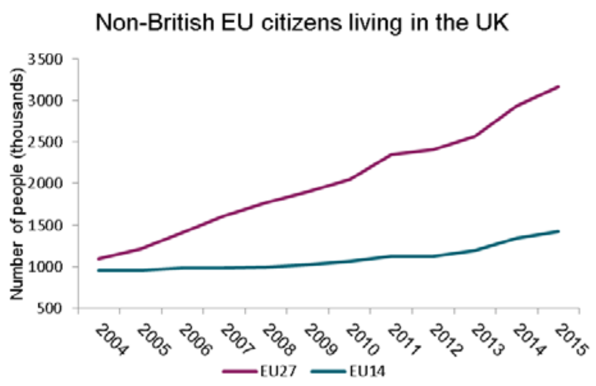
Economic growth has not been as weak as the Bank of England (BoE) feared last summer when it cut its key interest rate to a record-low 0.25 per cent. At the BoE's March meeting, one policy committee member voted to hike the key rate. Several others also indicated a shift in views. Although inflation is expected to exceed the BoE's target in 2017-2018, due to weaker growth **we expect the BoE to leave its key rate unchanged during our forecast period**. After last year's depreciation, the pound is undervalued in a long-term perspective, but its outlook is uncertain and will be determined by Brexit negotiations and the resilience of the economy. **We believe the pound will remain weak for another while, however**. If negotiations prove difficult, there is a risk of further weakening. Given its current valuation, it should nevertheless recover slightly towards the end of our forecast period. **The GBP/USD exchange rate will reach 1.30 and the EUR/GBP rate 0.88 at the end of 2018**.

- **Withdrawal negotiations begin this summer**
- **Talks will occur in two phases**
- **Free movement for people main challenge**

On March 29 the European Union finally received the United Kingdom's formal withdrawal request in compliance with Article 50 of the Lisbon Treaty. The clock began ticking, and British EU membership will end on March 29, 2019, but formal negotiations will be delayed until after the UK parliamentary election on June 8. However, both the UK and the EU have published guidelines detailing how they wish to organise the talks and their basic negotiating positions.

Achieving full sovereignty is the UK's fundamental ambition. Important related issues are future **control of all British laws** and **the right to control immigration**, including from EU countries. The EU's ambition is for the UK to remain a close partner of the union. Its strategy is to first negotiate British withdrawal and only after that begin negotiations on the terms of the future relationship. But the EU clearly states that as a partner, the UK can never enjoy the same rights it had as a member; **cherry-picking is thus out of the question**.

The terms of British withdrawal must be decided by the autumn of 2017 so negotiators will then have time to reach agreement on the new relationship. The main item is agreeing on the status of the roughly 3.2 million non-British EU citizens living in the UK and 1.2 million Britons living in other EU countries. Immigration to the UK has increased rapidly in recent years, especially from Eastern Europe.



The EU and the UK must also reach agreement on the amount the UK will pay for its existing obligations as a member. There is a wide gap between their starting positions; the EU side has mentioned a level of about EUR 60-100 billion while the UK estimates the amount at roughly EUR 9 billion.

As for future relations, the objective will be to achieve a free trade treaty that can enter into force after British withdrawal. Such an agreement cannot be activated as long as the UK remains a member. The intention is thus to negotiate a declaration of intent in the trade field that can then be transformed into a new treaty. In a number of other areas, such as crime-fighting and security policy, transitional solutions will also be needed before new rules definitively take effect.

Time pressure will be intense; two years is a very short time in this context. For example, the free trade treaty between the EU and Canada that went into effect earlier this year took seven years to negotiate. If negotiators fail to reach an agreement, there are only two real alternatives: **either all EU countries approve an extension of the two-year withdrawal deadline or the UK leaves the EU without a new treaty**. This means EU-UK trade may be saddled with tariffs, which would hurt the British economy. Although it is not clear from the Lisbon Treaty, the UK can probably stop the withdrawal process if it wishes, but this must happen no later than March 29, 2019 when membership ends – with or without a new agreement.

Another question is how the Brexit process will be affected by Prime Minister Theresa May's decision to call a snap election to the UK House of Commons on June 8. Opinion surveys indicate that the election will strengthen her position as well as that of her Conservative government, while the election will be a disaster for Labour. Because of the snap election, the next regular election will be delayed until 2022, three years after Brexit, thus creating political stability. The election is likely to strengthen the government's mandate to some extent and might open the way for May to be a bit more flexible in the coming negotiations with the EU, but it is **hard to believe that this will play a major role in how the final agreements will look**.

The biggest challenges in the negotiations are related to future labour mobility between the UK and the EU. To achieve progress, the two sides must first reach a consensus on the rights of the non-British EU citizens who are UK residents, and the British government seems unwilling to compromise on this matter. A restrictive British attitude on the issue will be hard for poorer Eastern European members of the EU to accept; their citizens are heavily overrepresented among non-British EU citizens in the UK. This might very well delay a future trade treaty until long after the UK has left the EU, leading to major risks of economic damage.

High growth and low inflation create tensions

- **Indicators at historical peaks**
- **Home building and public sector activity drive GDP growth as households hesitate**
- **Rapid job growth, but a rising participation rate is keeping unemployment up**
- **Inflation will fall as temporary drivers fade**
- **Riksbank will hike its key rate in April 2018**

Strong sentiment indicators and, to an increasing extent, better hard data on production and the labour market have confirmed our forecast that GDP growth will be well above trend and consensus. We are sticking to our estimate that **GDP will grow by 3.1 per cent this year but are revising our 2018 forecast slightly higher to 2.6 per cent**. The need for housing and public services, due to such factors as the recent refugee crisis, remains an important driving force. Meanwhile manufacturing activity is strengthening significantly.

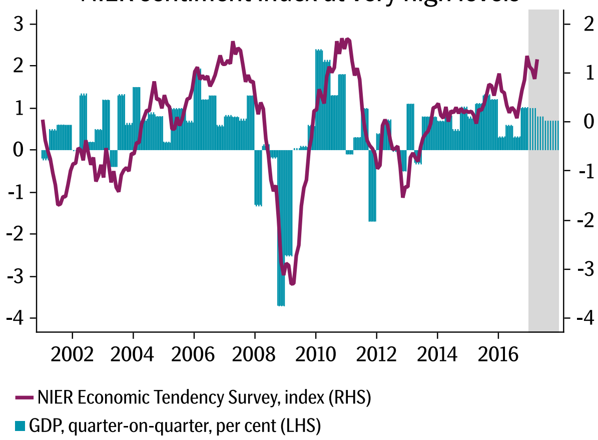
Risks to growth are instead on the upside, among other things because sentiment indicators are signalling much stronger growth. In addition, trade organisations in such major sectors as construction and private services maintain that much faster expansion would be possible based on demand, but that supply-side restrictions – mainly in the labour market – are posing obstacles. Yet contradictory signals from the labour market make the situation hard to interpret from a forecasting standpoint. Employment is climbing rapidly, but population growth and higher labour force participation are slowing the unemployment downturn. Large-scale matching problems are one reason why shortages are already close to historical peaks. All indications are that they will keep climbing.

Meanwhile the wage response to this tight resource situation is very weak. The ongoing national wage round looks set to end up with contractual pay increases of around 2.3 per cent a year in 2017-2019, although there is still some uncertainty about the impact of extra wage hikes for low-income employees. The growing labour shortage in many sectors suggests higher non-contractual "wage drift", but as long as this has not appeared in the statistics we choose to make **cautious forecasts that total wage and salary increases will be 2.7 per cent this year and 3.1 per cent in 2018**. Slightly larger pay hikes along with higher international prices will contribute to a certain inflation upturn in 2018. Yet this is **still not enough to bring CPIF (CPI with fixed interest rates)** up to **the Riksbank's 2 per cent target in 2018**, once the temporary effects of earlier energy price increases and krona depreciations fade.

Despite an ever-tighter resource situation, renewed home price acceleration and rising inflation expectations, at its April policy meeting the Riksbank chose to further expand its already exceptional dose of economic stimulus, among other things by postponing its first key interest rate hike until mid-2018. **We have thus changed our forecast of the first rate hike from December 2017 to April 2018**. Arguments in favour of a less expansionary monetary policy will both broaden and strengthen ahead, but after the Riksbank's statement that its inflation target must be reached at any price, it is not possible to believe the bank will change its monetary policy soon.

The temperature is also rising when it comes to fiscal policy. Rapidly rising tax revenue will enable the government to present an expansionary budget for the election year 2018. Additional spending for core public sector activities, on top of already heavy spending pressure on local governments in particular, will only be partly financed by higher taxes. The failure to create a government that commands a parliamentary majority **has had a paralysing effect on Swedish politics since 2010**. Somehow we believe this will change after the September 2018 election. Despite internally divergent views on strategy and the formation of a future government, we believe that the Alliance parties will block some of the Social Democratic-Green Party minority government's tax hikes. With only a year left until the scheduled election, all parties probably want to avoid a government crisis and an extra election.

NIER sentiment index at very high levels



Source: National Institute of Economic Research (NIER), Statistics Sweden, SEB

Manufacturing sentiment at earlier peaks

The upturn in sentiment indicators has been more dramatic in Sweden than in most countries. Purchasing managers' indices (PMIs) in recent months have been on a par with peak levels during the past 20 years. This is partly due to a relatively weak krona, but it also confirms the historical pattern of a cyclically sensitive Swedish export industry. Merchandise exports and industrial production have risen in the past 3-4 months, but as in other countries the upturn has been modest so far. **Our export forecast is cautious compared to PMIs**, although our upward adjustment to a 6 per cent increase this year and 4 per cent in 2018 implies the fastest upturn since 2011.

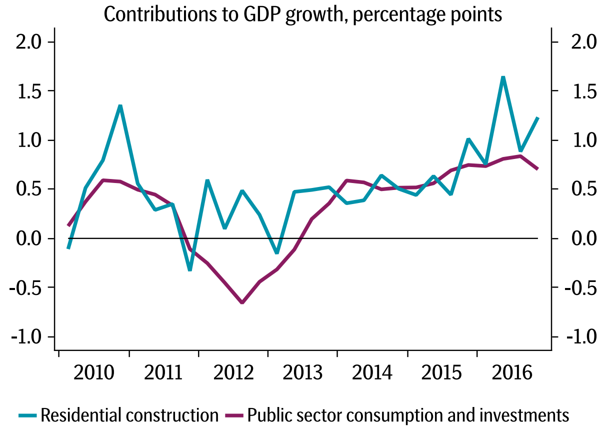
Home building will continue to drive GDP

Residential investments rose rapidly throughout 2016, and the number of housing starts points to a continued upturn. Their contribution to GDP looks set to be as high as in 2016: 0.8 percentage points. **In 2018 supply-side restrictions will slow this growth**, although it is uncertain to what extent foreign-based builders can help sustain the expansion. New home prices are also starting to be troublingly high, which will have a cooling effect as lenders and builders become more uncertain about the payment capacity of potential buyers.

In contrast to their survey responses, **industrial companies** cut their capital spending during the second half of 2016. Their plans for this year are cautious, but experience indicates that they often launch investment projects quickly once their production plans expand. **Public sector investments accelerated gradually** during 2016 and reached a year-on-year growth rate of nearly 15 per cent in the fourth quarter. Sharply rising demand for public services in health care, social welfare and schools suggests continued strong increases both this year and next. **Overall capital spending will increase by 8 per cent this year and then slow to 5 per cent in 2018**.

Home building and public sector are driving growth

Contributions to GDP growth, percentage points



Source: Statistics Sweden, SEB

Hesitant recovery in consumption

Both public and private consumption were unexpectedly weak in the second half of 2016. As projected, central government spending fell when direct refugee resettlement costs declined compared to 2015, but the upturn in local government consumption once refugees who receive residence permits need to be provided with education, health care and housing has proved smaller than we anticipated. This is a bit hard to interpret since employment, which should be a good proxy for consumption, has risen by nearly 3 per cent. **The impact on public consumption will probably occur after some delay**.

We have adjusted our 2017 forecast downward to 2.5 per cent while adjusting our 2018 forecast upward to 1.0 per cent.

Household consumption has also recently been weaker than expected, mainly due to anaemic retail sales. The NIER Economic Tendency Survey indicates that households are uncertain about the future, as reflected in a continued upturn in saving. Yet rising incomes and wealth combined with an increasingly strong labour market suggest that consumption will recover a bit this year and that the household savings ratio will not rise further. **We predict an increase of 2.5 per cent both this year and next, which translates to very moderate per capita growth**.

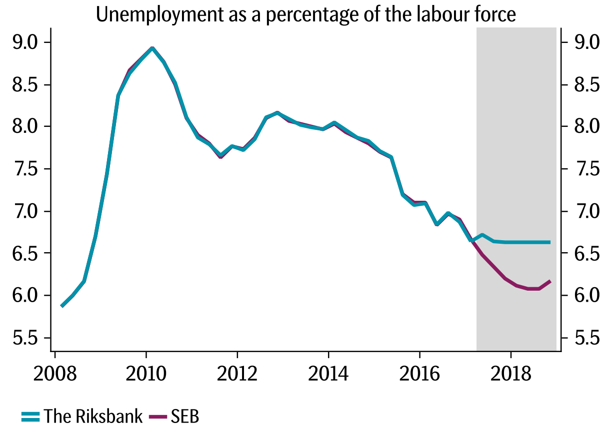
Renewed upturn in home prices

After a brief slowdown due to the loan repayment requirement that took effect in June 2016, home prices have regained their upward momentum. Meanwhile other lending to households appears to have accelerated as well. Most indications are that this upturn will gain strength in the near future. Despite rapidly rising construction, supply still cannot keep up with rapid population growth. The long period of low construction also created pent-up demand for homes. Also fuelling the current trend is that the Riksbank, despite appeals from the Financial Supervisory Authority (FSA), **sees no room to factor in the risks of housing market excesses**. For example, household expectations of a depressed repo rate have helped lift the SEB Housing Price Indicator close to historical peaks.

The FSA may be planning to introduce a ceiling on the household debt/income ratio starting early next year, aimed at slowing the current trend. If its proposal can be designed in a way that does not categorically exclude low-income earners from the housing market, there is a good chance it will be approved by Parliament. Yet generally, the weak minority government finds it **hard to win parliamentary support for large-scale measures aimed at strengthening financial stability**. The FSA is thus very likely to continue appealing to the Riksbank to weigh housing market risks into its interest rate decisions.

Unemployment is falling faster again

Unemployment as a percentage of the labour force



Source: Statistics Sweden, Riksbank, SEB

Strong job growth squeezes unemployment

Labour market indicators are also showing strength. Company hiring plans, normally a reliable indicator, are close to historical peaks, while public sector expansion is the strongest since the 1970s. Because of a robust start to the year, we have raised our job growth forecast by a few more tenths and **now expect employment to increase by more than 2 per cent this year**. Short-term indicators also show that upside risks dominate.

As expected, the downturn in unemployment has slowed because of rising labour supply due to population increase, but labour force participation has also risen. This is a bit surprising, considering the increase in the population of immigrant groups with low average participation rates. One explanation may be that those who obtain residence permits are being referred to the Swedish Employment Service to a greater extent than previously for training. But in March, unemployment fell substantially. Although it is too early to draw conclusions based on this, **we believe that unemployment will continue falling to a much greater extent than the Riksbank predicts**, reaching levels close to 6 per cent early in 2018.

Resource utilisation at historical highs

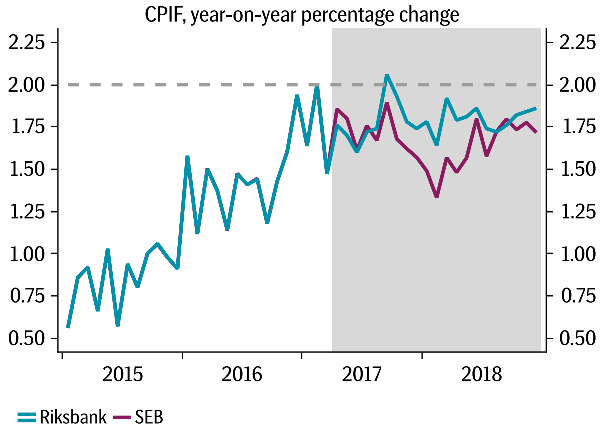
A growing number of unemployed belong to groups defined by the Employment Service as having weak ties to the labour market (born outside Europe and/or having little formal education). **This suggests that equilibrium unemployment is high and also rising**, which is confirmed by the growing proportion of firms that cite recruitment problems as their main obstacle to expansion. In Q1 2017, the Riksbank's resource utilisation indicator continued to climb. It is now on a par with the peak levels of the past 20 years, but this does not seem to have affected the 2017 wage round, which ended with contractual pay hikes of a mere 2.3 per cent yearly. Despite anecdotal information to the contrary, there are no signs that labour shortages have led to higher wage drift. In a theme article on page 32, we analyse in more detail where this may conceivably lead and why we believe **total pay increases will reach only 2.7 per cent this year and 3.1 per cent in 2018**. These forecasts are unchanged from February, but represent slow increases compared to earlier economic boom periods.

Inflation temporarily close to target

CPIF inflation retreated to 1.5 per cent in March after reaching the Riksbank's 2 per cent target in February for the first time since 2011. Lower price increases for energy and vegetables explain some of the decline, but a temporary drop in travel prices made the downturn bigger than expected. The inflation rate is expected to rebound in April, and **during the next six months CPIF is likely to be only marginally below target**. However, this will be due to renewed energy price increases and the effects – mainly on goods – of last year's krona depreciation. Most indications are that **inflation will fall again late in 2017 when these temporary forces fade**. To some extent we are counting on strong economic conditions to push pay levels higher, but the acceleration we predict in 2018 is probably not enough to bring inflation back up to 2 per cent, though risks – especially pay-related ones – are on the upside.

High inflation this year, but temporary driving forces

CPIF, year-on-year percentage change



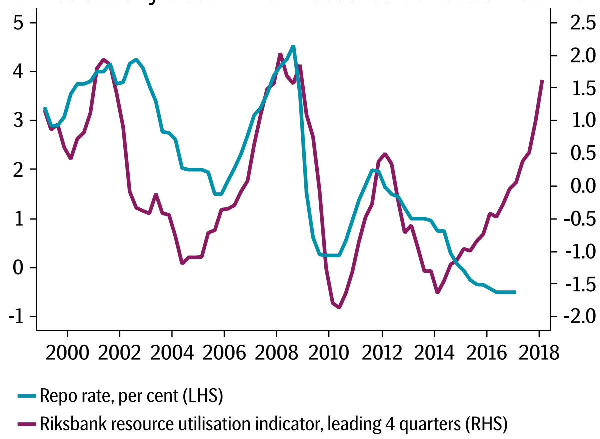
Source: Riksbank, SEB

Delayed rate hike despite tight resources

In spite of the booming economy, the Riksbank decided at its April policy meeting to postpone its first repo rate hike until mid-2018, among other things as a response to unexpectedly low contractual pay increases. At the same time, a very divided Executive Board expanded asset purchases by SEK 15 billion in the second half of 2017, split evenly between nominal and index-linked government bonds. However, the Riksbank reduced the likelihood of further rate cuts in the near term.

This further intensifies the paradoxes in Swedish economic policy. Increasingly obvious supply-side restrictions, higher inflation expectations and inflation close to target call for some modification of Sweden's extremely expansionary monetary policy. These arguments have gained additional strength due to renewed acceleration in home prices and household borrowing, which has also contributed to the Financial Supervisory Authority (FSA)'s appeal to the Riksbank to weigh financial stability into its interest rate decisions, in the same way as its Norwegian counterpart is already doing.

Hikes usually occur when resource utilisation climbs



Source: Riksbank, SEB

Yet given the Riksbank's clear message in April, **we have changed our forecast of the first rate hike from December 2017 to April 2018**. We expect a further repo rate hike to 0 per cent by the end of 2018. For various reasons, we continue to predict a somewhat earlier hike than the Riksbank's rate path indicates. For example, we believe the bank will need to adjust its growth and employment forecasts higher. Although it is not our main forecast, upside wage and price risks in 2018 are somewhat larger than before. Another factor is the Fed, which is leading an international trend towards less expansionary policies. Re-introducing an inflation tolerance range might also allow greater flexibility, though the Riksbank will undoubtedly play down the significance of any change. Switching the target variable to the CPIF would also have a marginal effect. When the bank has time to ponder the outcome of the 2017 wage round, it may possibly conclude that the costs of diverging from the inflation target have fallen now that employers and unions have concluded such low long-term agreements based on international pay increases. Finally the historical pattern is that the **Riksbank has actually begun tightening earlier than it signalled 6-12 months before the first hike**.

The spread between 10-year Swedish and German government yields changed very little in the past six months. The National Debt Office (NDO) cut its bond issues in February. Further cuts are likely in June, pushing yields lower. Meanwhile the Riksbank is having an increasingly hard time finding sellers in its weekly reverse auctions, which will continue during the second half of 2017. In the short term, we still believe **these factors will narrow the yield spread against Germany**. Looking further ahead, stronger economic conditions in Sweden will probably create expectations of rate hikes, helping Swedish long-term yields rise more than German ones. We expect 10-year Swedish yields to **climb from today's 0.60 per cent to 0.80 per cent at the end of 2017 and 1.45 per cent at the end of 2018**.

Stronger krona as key rate hikes approach

The krona is still trading at historically weak levels due to exceptional monetary policy. After the Riksbank's April statement, it is hard to foresee a quick krona rebound; **in a foreign exchange (FX) market dominated by low volatility and a search for returns, negative interest rates are an extra big handicap**.

As we approach a Riksbank policy shift, there are reasons to expect decent-sized krona appreciation. According to our recent *Kronsyn* survey, a more hawkish Riksbank is the single most important factor behind krona purchases by market players. The survey also showed that Swedish firms have already begun positioning themselves for this, but exposure to foreign currencies is still high among both companies and institutions. Moreover, foreign market players have not yet begun to position themselves for a stronger krona. The government has proposed that the Riksbank should repay some SEK 250 billion it borrowed from the NDO to strengthen the currency reserve, which may also be important. If such a decision is actually made this autumn, Riksbank interventions in the FX market would be prevented since they would lead to a growing currency reserve. Although this will be more difficult to determine when the bank's policy shift occurs, **we expect the EUR/SEK exchange rate to reach 9.30 at the end of 2017 and continue to 8.95 at the end of 2018**. Meanwhile we expect the USD/SEK rate to be 8.45 and 7.85, respectively.

Election budget will pass despite Alliance

Swedish public finances remain solid, with higher revenue due to expansion in such important tax bases as employment, household consumption and construction. The government has again tended to underestimate the cyclical sensitivity of taxes and will probably need to revise its tax forecasts further. Its spring budget included additional spending on core public sector activities, only partly financed by tax hikes. Combined with underlying pressures on public sector consumption and investments, **this means fiscal policy will be clearly expansionary in 2017 and 2018**. The public sector will show stable surpluses in both years, and government debt will fall below 40 per cent of GDP. In an interview, Finance Minister Magdalena Andersson has said it may be necessary to maintain a certain level of government debt in order to ensure liquidity, in which case a fund may need to be built up. But this falls outside our forecast period.

Public finances

Per cent of GDP

	2015	2016	2017	2018
Net lending	0.3	0.9	0.6	0.6
Borrowing req., SEK bn	33	-85	-26	-26
Gen. gov't gross debt	43.9	41.6	39.7	37.7

Source: Statistics Sweden, SEB

The parliamentary budget process this autumn will be a kind of preview of next year's election campaign. Backed by a strong economy, the finance minister has a good chance of success with her balancing act: **appearing fiscally responsible while presenting an aggressive election budget**. Given declining public support for the Alliance as a whole, the four parties now agree on the need to end their passivity but disagree on the mechanism for doing so. The dominant Moderates want to present a joint Alliance budget, while the Center only wants to vote down portions of the government budget. The difference may seem technical but is based on different strategies for forming a government after the 2018 election. Due to the lingering paralytic effects of the now-defunct December Agreement of 2014, under which the Alliance had pledged not to vote down the minority government's budgets, the need for a stable, proactive government is greater than for years. The Moderates already want to pave the way for an Alliance government with some form of support from the right-wing populist Sweden Democrats, while the Centre and Liberals want to avoid such commitments before the election. **This close to the regular election, all parties probably want to avoid a government crisis**. Thus our main scenario is that the opposition will block certain tax hikes, but not to such an extent that the government will resign or call an extra election, which would make fiscal policy even more expansionary. In this way, the opposition can demonstrate how weak the government is while the prime minister can accuse opposition parties of being quarrelsome and unprincipled by acting in ways they had once criticised the Social Democrats for doing when the Alliance was in power. It remains to be seen which of these aspects is most important to voter opinion.

Theme: Wage formation and monetary policy

- **Low wage drift despite tight labour market**
- **4 per cent pay hikes needed to hit target**
- **Both wages and prices in step with Europe?**

This year's Swedish wage round will end up with unexpectedly low and long-lasting collective agreements. With contractual pay increases of 2.3 per cent annually in 2017-2019, the Riksbank faces further difficulty in pushing inflation up to its 2 per cent target. The following is a discussion of wage formation and inflation processes in a situation of low international pay hikes but increasingly evident domestic resource restrictions.

Low international pay increases

Despite rising resource utilisation and near-equilibrium employment in countries like the US, Japan and Germany, pay increases remain low. Slower productivity growth has decreased the room for pay hikes since the financial crisis. But as a share of GDP, labour costs have fallen for a long time, while **productivity gains due to technical advances and global integration have largely gone to rising profits**. An even tighter resource situation will lead to slightly higher pay pressure in 2017-2018, especially in the US. But from a Swedish perspective the change is likely to be marginal. Many EU countries still have a lot of economic slack; for example, this will hold back German pay hikes despite low unemployment.

Low wage drift in recent years

Contractual and total pay in the Swedish economy, y-o-y % change

Source: Swedish National Mediation Office, SEB

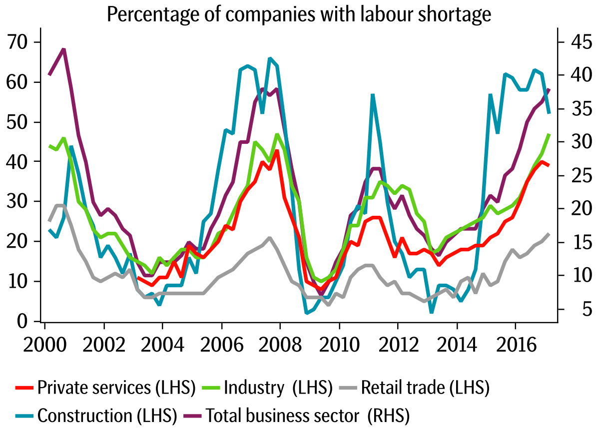
Faster pay hikes in a tighter labour market?

But Sweden diverges from the international pattern, since **pay as a share of GDP has climbed for a long time**. This is one factor behind modest demands. Union members have become used to higher purchasing power even with small nominal pay hikes; in the past 20 years, average real wages have risen nearly 2 per cent annually. Another reason for caution is that the Swedish Trade Union Confederation (LO) wishes to coordinate pay demands. This is facilitated by setting demands even sectors facing tough competitive pressure can manage.

How will an even stronger labour market affect wage formation? Economic and job growth show no signs of slowing. Our 3.1 per cent GDP growth forecast for 2017 is well above trend but is held down by supply-side restrictions. Construction and private service firms say **much higher growth is possible if they can find suitable employees**. Public sector shortages are even worse. Due to low pay, experienced employees are leaving health care, teaching and police work. In such a situation, employers should be prepared to offer higher pay, but there are few signs this is happening; non-contractual pay increases ("wage drift") have been record-low in recent years.

Growing shortage in many sectors

Percentage of companies with labour shortage



Source: National Institute of Economic Research (NIER)

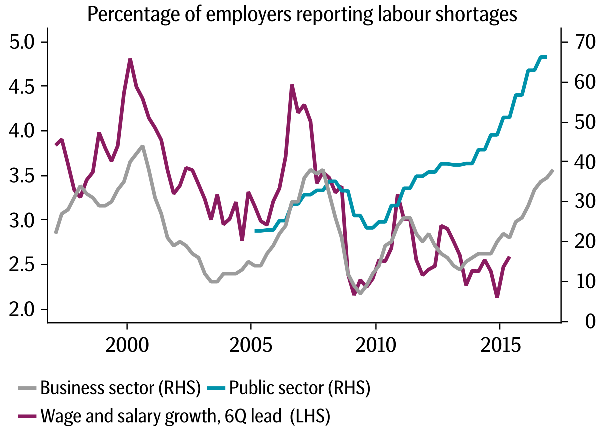
Budget restrictions are holding back public sector pay hikes, but shortages in core public activities may become so severe as to **threaten the social contract unless vigorous action is taken**. The ability of private firms to pass on higher labour costs by raising prices will determine their long-term payment capacity. Such pricing power has been weak for some time, but we are now seeing signs that it is increasing in many sectors. This is apparent in construction, but also in portions of industry and such service sectors as hotels and restaurants. In retailing, however, prices remain squeezed, due to factors like greater price transparency in online sales. Yet the gaps between sectors in official pay hike statistics are surprisingly small.

Greater opportunities for foreign companies to work in Sweden have weakened the wage response to the tight labour market. Immigration has pushed wages lower, especially in low-paid jobs. Despite high unemployment and long adjustment periods for new arrivals and the foreign-born, these groups account for most job growth. Since their educational level and productivity tends to be relatively low, this has also helped lower average pay hikes. Meanwhile there are **signs that the price- and wage-dampening effect of foreign construction firms is fading**. The government plans to strengthen the role of collective agreements by removing the previous government's

"Lex Laval" allowing these firms to pay imported workers less than Swedish ones. Although the labour market has performed better than expected, due to international conditions and low agreements, **we are sticking to our forecast that pay hikes will total 2.7 per cent in 2017 and 3.1 per cent in 2018**.

Delayed wage response to labour shortage

Percentage of employers reporting labour shortages



Source: National Institute of Economic Research (NIER), Riksbank

Low pay hikes make it harder to hit target

Looking at historical trends the Riksbank has no easy task, given the prevailing pay increases. It is especially interesting to see how inflation dynamics have changed since the financial crisis. In the past 20 years, pay hikes have averaged 3.2-3.5 per cent depending on what measure is used. Meanwhile CPIF (CPI less interest rates) has risen 1.5 per cent in the same period and core CPIF (ex food, energy etc.) by 1.2 per cent. **Wages would need to increase by at least 4 per cent yearly to be compatible with 2 per cent inflation**: somewhat higher than the NIER) estimates and well above the increases we predict.

Wages, labour costs and productivity

Average annual change over period

	1997-2016	1997-2007	2012-2016
Wages, negotiated	2.4	2.5	2.3
Wages, total*	3.2	3.7	2.6
Wages, total**	3.5	4.1	2.8
Productivity (GDP)	1.7	2.9	1.0
Unit labour cost	1.9	1.2	2.1

Source: Statistics Sweden, *Mediation Office **National Accounts

But the inflation target is not so distant. Because productivity growth has slowed in the past five years, there is less room for pay hikes. Unit labour cost (ULC) has risen 2.1 per cent yearly: higher than average for the past 20 years. This is reflected by an increase in pay as a percentage of GDP. The Riksbank has viewed the ULC increase as **a signal of a pent-up need for price hikes, which may materialise if demand becomes stronger**. In their survey responses, companies are fairly satisfied with their profitability. This contradicts any ULC-driven squeeze on margins. The slowdown in Swedish productivity growth is amplified by major fluctuations in the IT sector – another reason for cautious interpretations.

Underlying trends in the CPI basket may also shed some light. During 1997-2007, energy prices rose relatively fast. CPIF thus averaged 1.6 per cent even though core CPIF was only 1.3 per cent. In the past five years, energy prices have instead had a negative impact on CPIF, which has thus averaged a bit below core inflation. Looking ahead, both energy prices and indirect taxes may contribute slightly positively to CPIF, but **core CPIF will probably have to reach about 1.7-1.8 per cent in order for CPIF to hit 2.0 per cent**.

inflation metrics and selected sub-items

Average annual change over periods

	1997-2016	1997-2007	2012-2016
CPIF	1.5	1.6	0.9
CPIF, core	1.2	1.3	1.0
Energy	3.0	5.0	-1.5
Food	1.6	0.9	1.5
Alcohol and tobacco	2.2	1.9	2.6

Source: Statistics Sweden

Is the Riksbank running out of patience?

When the Riksbank adds further stimulus measures in response to low pay agreements, this implies that it will continue to rely on cyclical inflation forces to grow so strong that its own target will be reached within a year or so. This might very well prove true. Our own CPIF forecast is only 3-4 tenths of a point below target, indicating that the margins are not so wide. Nor can we rule out a bigger wage response as labour shortages continue to worsen. But if our analysis is correct, with international conditions and low agreements leading to pay increases too low to be compatible with the target, the **Riksbank risks having to postpone its interest rate hikes repeatedly**. The question is how long that can continue without harming credibility and economic stability.

Does the Riksbank's approach to the labour market need to be reassessed? Since it launched the inflation target in the mid-1990s, we have seen a tug-of-war between those who believe international pay hikes or the inflation target should be the anchor for collective agreements. The NIER and mainstream academicians have argued that the inflation target should take precedence. The National Mediation Office, industrial unions and employers have meanwhile supported letting industry set the pace of pay increases, thus also following international trends. The latter system now seems to predominate, which is mainly justified by the Swedish economy's dependence on international markets and uncertainty as to whether exchange rate movements can correct divergences with other countries after the fact. But if unions and employers today largely behave as if Sweden were part of the euro zone, it would be **logical for the Riksbank to be more willing to accept an inflation rate in line with that of the euro zone**. The cost of minor divergences from the target should at least have decreased now that 3-year agreements are in place and there is no risk of throwing a spanner into the negotiating system. Merely reverting to the Riksbank's standpoint before its summer 2014 policy shift would allow greater flexibility. And with inflation expectations back at higher levels, the most important argument for this policy shift has already been eliminated.

Tightening of credit affects labour market

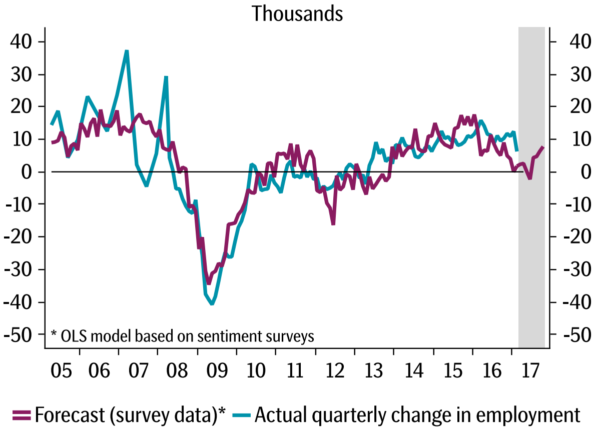
- **Solid 2017 GDP growth despite weak H1**
- **Job creation slows temporarily as economy shifts to foreign demand**
- **The krone will remain strong**

The Danish economy grew by 1.3 per cent in 2016, slightly above expectations. We expect the upswing to continue and forecast **2.0 per cent growth this year** and **2.4 next year,** as domestic headwinds fade and global demand picks up.

Since the end of 2015, the financial sector has been tightening the credit standards faced by households. In our view, this has been a severe but prudent headwind for private consumption, consumer sentiment, credit creation and the housing market. For now, the weakness of last year is likely to spill into **lower employment growth in the first half of 2017** and the economy will shift from domestic to foreign demand, the latter having a very positive outlook. Hence, looking ahead, we are more upbeat for the Danish economy in H2.

Temporary setback for employment growth in H1

Thousands



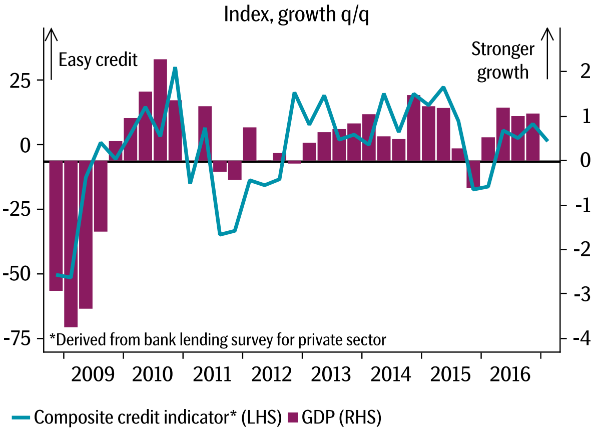
Source: Statistics Denmark, SEB

Concerning Q1, a pronounced weakness in retail sales due to warmer-than-average weather suggests downside risks to consumption estimates. Broadly, slower income growth, rising inflation and toughening credit standards imply that private consumption is likely to face significant headwinds during 2017. **Consumer spending** grew by 1.9 per cent in 2016 and we forecast **1.5 per cent growth in 2017, increasing to 2.3 in 2018.**

By standard measures, Denmark's competitiveness is good and the outlook for its main trading partners is increasingly favourable. We therefore expect an **acceleration in exports from 1.8 per cent in 2016 to 4.7 per cent in 2017**. The pick-up in exports and weak private consumption suggest that net exports will contribute strongly to GDP growth this year. The shift in drivers is also clear from business sentiment. Export-oriented sectors have been more upbeat in recent months, whereas optimism among firms in domestically-oriented retail and service sectors has declined.

Tight credit is hampering growth

Index, growth q/q



Source: Statistics Denmark, SEB

Within our forecast horizon, we see little risk of an overheating economy and few warning signs. As such, credit growth remains broadly subdued, unemployment is high at 6.5 per cent, industrial capacity utilisation is low and wages are likely to grow at less than 2 per cent annually. Danish inflation is expected to be broadly in line with our euro area forecast. Hence, the drag from declining oil prices seems to be fading and underlying price pressures are strengthening, albeit slowly. We expect annual growth in **consumer prices to increase gradually from 0.0 percent in 2016 to 1.4 percent in 2018**.

Limited domestic imbalances and strong exports imply that the current account surplus will continue to remain historically high, around 7 per cent of GDP. The difference in fundamentals for Denmark and the euro zone suggests the **krone will continue to be under pressure to appreciate**. However, in the near term, a revival of optimism about euro zone growth and politics could offset this upward pressure somewhat. In our view, the main play would be in interest rates where some of the negative risk premium could be unwound.

The main risks to our current forecast remain changes in the international outlook and stronger-than-expected consumption and/or credit growth.

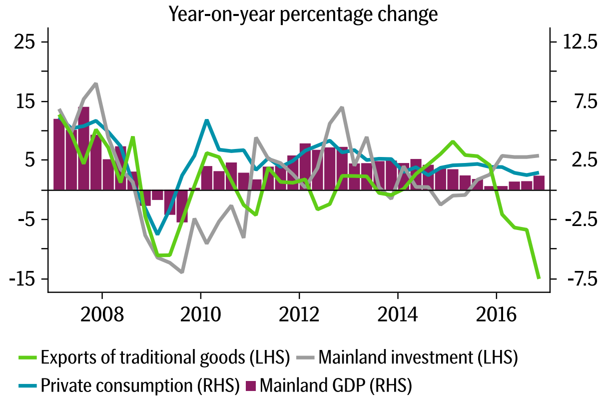
Economic recovery on track

- **Mainland GDP growth to accelerate in 2017**
- **Downside risks to inflation dominate**
- **Norges Bank in no hurry to hike rates**

The Norwegian economy reached a trough last year with mainland GDP growing a modest 0.8 per cent, the lowest annual rate since the financial crisis. The slowdown in growth was curbed by a solid upturn in mainland capital spending, in addition to a strong monetary and fiscal policy response. The outlook is positive and the broad contours from the February issue of *Nordic Outlook* remain intact. Rising optimism according to various sentiment indicators suggests improved growth momentum at the start of 2017 (the Q1 GDP report will be published on May 16). Continued high investment activity in the mainland economy will underpin growth, while stronger private consumption and rebounding exports of traditional goods are expected to broaden the economic recovery. Our growth **forecast for mainland GDP has been lifted marginally to 1.7 per cent in 2017**, while the **2018 forecast is unchanged at 2.0 per cent**. Total GDP should be up 1.4 per cent in both 2017 and 2018.

Recovery led by domestic demand

Year-on-year percentage change



Source: Statistics Norway

Changes in the economic policy mix

The fiscal policy rule, which states how much petroleum revenues can be spent each year, shields the central government budget from short-term volatility in oil prices and thus lets automatic stabilisers work, which has been an important offset in the recent economic downturn. The rule ties the non-oil budget balance to the size of the Government Pension Fund Global (GPFG), by in effect stipulating that over a full cycle the structural deficit shall be limited to the expected real return of the fund, estimated at 4 per cent. While the rule itself has an expansionary bias, growth in the GPFG (and thus petroleum revenue spending) has been even stronger than assumed when the rule was introduced in 2001. The government has recently lowered estimated real return to 3 per cent, resulting in **smaller fiscal leeway and a neutral policy over a full cycle**. However, the rule still allows for extraordinary stimulus in case of a severe economic downturn. The government's budget for 2017, which was published before the rule was revised, implies a fiscal contribution to mainland GDP of 0.4 per cent, corresponding to 3 per cent of the fund (the revised budget is due May 11). We assume no contribution from fiscal policy in 2018.

The Norwegian inflation target was introduced in parallel with the fiscal policy rule in 2001. It was assumed that phasing in petroleum revenues to the economy would create higher cost pressure and weaken competitiveness. Consequently, the target of 2.5 per cent was set slightly higher than international practice. Since the target was set in relation to the fiscal policy rule, **it is not unreasonable that the inflation target will also be revised lower**. Adjusting the inflation target in line with Norway's main trading partners would also facilitate the restructuring of the Norwegian economy towards a greater reliance on traditional exports. A committee was appointed by the Ministry of Finance in 2015 to review the Central Bank Act. The committee's work will be published by June 30, but any possible substantial changes to the target would likely be announced by the government in advance.

Strong investments underpin growth

The sharp contraction in capital spending in the petroleum sector has been a drag on growth since 2014, but the investment cycle has taken a turn for the better. Higher – and stable – oil prices have improved project economics and triggered more final investment decisions. Moreover, companies have boosted their capital spending plans for 2017. We now **expect a 7.0 per cent drop in oil sector investment in 2017** compared to -14.7 per cent in 2016, while maintaining our **3.0 per cent forecast for 2018**.

The turnaround in private mainland capital spending has been vital for the rebound in domestic demand. Residential investments increased a solid 9.9 per cent in 2016 from a year earlier, and the strong increase in home prices and housing starts supports the notion that capital spending should continue to underpin aggregate growth. While such investments relative to GDP are not alarming at 7 per cent, the historically high level suggests investment activity will moderate from 2018. After having been a drag on mainland GDP growth in the past three years, business investment rebounded in 2016 and showed sequential year-on-year gains in each quarter, reaching a 2.8 per cent increase from 2015. The recovery has been broad-based among sectors. Both increased profitability and sharply higher investment plans according to the Business Tendency Survey suggest such capital spending will accelerate further in 2017 and 2018.

Growth in mainland exports disappointing

Exports of traditional goods were weak in 2016 and posted a 15 per cent year-on-year decline in Q4. This is surprising, considering improved competitiveness and stronger profitability. Some of the decline is related to supply-side disruptions and should therefore recover in early 2017. The cyclical turnaround taking hold among Norway's trading partners also suggests that export growth is about to resume, and export orders according to the Business Tendency Survey have returned to more normal levels. Non-oil imports should also start to recover, implying that **net trade will have a neutral effect on mainland GDP in 2017 and 2018**.

Consumption to rebound with real income

Private consumption has been weak over the past year amid stalling growth in household real disposable income. Nominal wage growth slowed from 2.8 per cent in 2015 to 1.7 per cent last year. This decline likely reflects structural effects as layoffs in the oil sector have resulted in fewer people working in high-paid jobs. Combined with surprisingly high inflation, real wage growth was severely negative in 2016. Household income should recover this year. The negotiations between the dominant trade union organisation (LO) and the main private sector employers organisation (the Confederation of Norwegian Enterprise) covering blue-collar workers in manufacturing reached an agreement expected to lift wages by 2.4 per cent in 2017. Lower inflation, improved job growth and tax cuts will contribute to a recovery in household real disposable income growth. Meanwhile, a continued (albeit more moderate) rise in home prices will support consumer confidence further. **We expect private consumption growth of 2.0 per cent in 2017 and 2.3 per cent in 2018.**

Unemployment past the peak

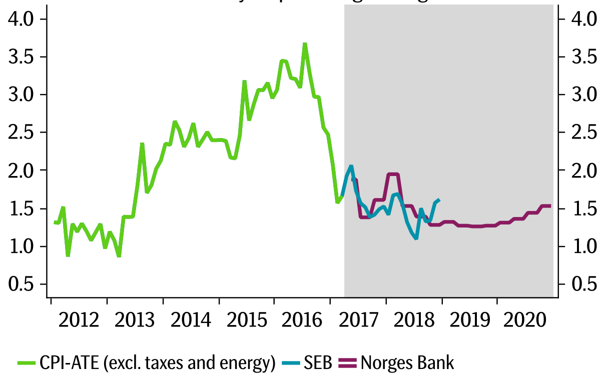
Labour market conditions have improved so far in 2017. Registered unemployment has declined moderately in line with lower trending layoffs. Unemployment according to the Labour Force Survey (LFS) has reversed the sharp upturn seen in 2015 and in the first half of 2016. Part of the decline reflects a fall in the participation rate. The labour force tends to vary with the business cycle, suggesting that the decline is a delayed response to deteriorating economic growth in recent years. With economic activity now picking up, we expect the labour force to gradually normalise. Job growth according to the LFS showed a slight decline in 2016, though it held up better as measured in the national accounts (which include employees not registered as residents of Norway). Employment has been weaker than we foresaw in February's *Nordic Outlook*, yet the unemployment rate has dropped more than projected. Better growth in the mainland economy is expected to boost job growth ahead, in line with signals from Norges Bank's regional network report. We expect **LFS unemployment to average 4.3 per cent in 2017 and 4.2 per cent in 2018**.

Downside risk to inflation dominates

Inflation adjusted for energy and taxes (CPI-ATE) began to fall rapidly late last summer and is now two percentage points below its peak of 3.6 per cent last July. Part of the decline is explained by a temporary fall in air fares, but the main driver is lower inflation on goods. The latter falls when earlier price increases from a weaker exchange rate disappears from 12-month figures. Despite the recent decline, prices of imported goods are still rising much faster than the historical average and we expect the annual rate of change to fall to zero towards the end of the year. After a rebound when air fares normalise, we expect the downward trend to resume, resulting in **CPI-ATE rising by less than 1.5 per cent by the end of the year**.

Core inflation to fall further

Year-on-year percentage change



Source: Statistics Norway, SEB, Norges Bank

Domestic inflation has fallen slightly over the past six months and historically low pay increases suggest that domestic inflation will remain low in the coming year. Despite upward pressure from higher international prices, most factors suggest inflation will remain low also next year and we expect **CPI-ATE inflation to average 1.4 per cent in 2018**. Risks are skewed to the downside and are related to the possibility of a faster and deeper fall in prices of imported goods.

Norges Bank's tug-of-war

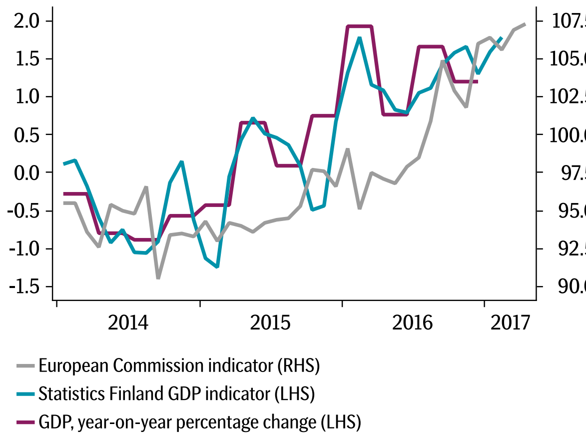
Norges Bank has kept its key interest rate at 0.50 per cent since the economic recovery gained a footing early last year. Rapidly falling inflation and pronounced uncertainty associated with inflation and wage developments ahead have thus not persuaded the central bank to lower rates. This sends a strong signal that any rate cut is highly unlikely as long as financial imbalances are growing. Moreover, inflation expectations remain well-anchored and the real economy is recovering. We reiterate our expectation that the key rate has bottomed out. Our expectations of lower-trending core inflation and a still-negative output gap imply that Norges Bank will be in no rush to hike rates and the normalisation of the key rate will be very gradual by historical standards. We forecast **a first hike in December 2018.** (See the "International overview" for implications on the NOK and Norwegian bonds).

Broad-based recovery as export volume rises

- **Indicators at multi-year highs**
- **Industry and capital spending drive growth**
- **Record-high household optimism, but consumption growth is decelerating**

The Finnish economy provided upside surprises in 2016. The outlook has become even brighter this year. In line with the rest of the euro zone, **sentiment indicators are now at their highest levels for years**. Employment is increasing and capital spending is trending upward as business confidence, production and exports accelerate. Meanwhile the investment climate has improved, driven by both housing construction and corporate capital spending. The mood of households has improved greatly, with indicators close to historical peaks, but consumption is being squeezed by low income increases as inflation climbs. **GDP will grow by 1.6 per cent in 2017 and 1.7 per cent in 2018**, a bit above our last *Nordic Outlook* forecast.

Growth will accelerate further



Source: Statistics Finland, European Commission

Overall, indicators are at multi-year highs, **signalling a broad-based acceleration in economic activity**. Although the outlook has improved, we believe the upturn partly reflects a widespread sense of relief that the period of recurring recessions is over. After four years of falling industrial production, output rose slightly in 2016. According to business sentiment surveys, order books have improved markedly in the past six months. This is also apparent from better production figures, and the outlook for 2017 is good. Export performance early this year also points to a clearer upturn, although volatile monthly figures must be interpreted cautiously. Service exports in particular have accelerated, but merchandise exports are expected to follow suit and show a stronger upturn in 2017-2018. Competitiveness is slowly improving, among other things due to agreements between labour unions, employers and the Finnish government. Under these pacts, the government offers lower income taxes as compensation for low collective pay hike agreements and a shift in certain social insurance fees from employer to employee. Imports have also accelerated in response to higher domestic demand, leaving Finland's current account deficit at about 1 per cent of GDP: largely unchanged from 2016. We expect overall industrial production to grow by 2.5 per cent while **the yearly export upturn will accelerate to nearly 3.5 per cent in 2017-2018**.

Capital spending rebounded in 2016 after several weak years; it is still about 10 per cent below the pre-crisis level. Residential investments are being driven by a supply shortage, especially in major cities, as well as low interest rates. Rising capacity utilisation and higher order bookings at companies will also contribute to a broad increase in business investments ahead. Total **capital spending will increase by 3.0-3.5 per cent yearly in 2017-2018**, but there is an upside risk in case the good business outlook has a bigger impact than expected.

The labour market is improving, but the decline in unemployment has been slower than predicted in recent months. In March, the jobless rate was 8.7 per cent for the eighth (!) straight month. Employment rose about 0.5 per cent during the first quarter of 2017 compared with Q1 2016. But its level is only about 0.5 per cent higher than the average since 2000, indicating that there is not so much labour market slack. Looking ahead, we foresee a slow **unemployment downturn to just above 8 per cent by the end of 2018**.

Household optimism is record-high according to the European Commission's survey, yet consumption growth is decelerating. Despite increasing employment and slightly rising home prices, consumption is being squeezed by low wage and salary increases. Meanwhile inflation has climbed, although the upturn (to 0.9 per cent in March) was not, and will not be, as high as the euro zone average. To maintain their consumption, households have cut back on saving, and their savings ratio has already fallen from 9 per cent in the 2000s to just above 6 per cent last year. **Household consumption will thus increase by only about 1.5 per cent yearly in 2017-2018**.

Public sector finances remain squeezed but have improved more than expected. Cost-cutting continues to hold back demand, but better economic conditions will decrease the need for further government austerity. **The budget deficit will fall to 1.5 per cent of GDP in 2018**, while gross government debt as a percentage of GDP will increase slightly.

Lithuania

Economic upturn, but continued high emigration

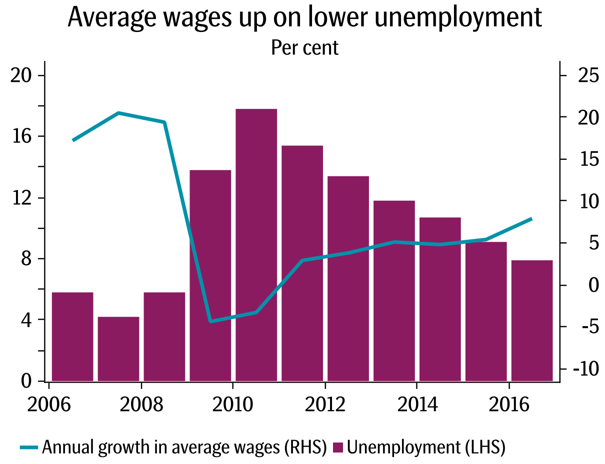
- **Exports will drive growth higher**
- **Inflation expectations are rising**
- **Government budget shows strength**

Several indicators confirm that the acceleration in GDP growth that started late in 2016 has spilled over into early 2017. However, the general mood among the people remains rather sceptical due to still-increasing emigration and higher inflation. **We are nevertheless increasing our GDP growth forecast for 2017 from 2.5 to 3.2 per cent**, mainly due to improving exports. In addition, base effects from public spending will have a positive impact on the annual growth rate. Meanwhile, the increase in private consumption will slow down from 5.6 per cent to 4.2 per cent in 2017 and to 4.0 per cent in 2018 as real income growth and the number of consumers fall.

Unemployment keeps falling and shortages of skilled labour are becoming a huge problem in some regions. Taking into account that inflation is accelerating, current unemployment is already near its natural level. We believe that the improving economy will force the **unemployment rate down to 7.5 per cent in 2017 and to 7.2 per cent in 2018**.

Average wages and salaries increased by a full 8.7 per cent year-on-year in the last quarter of 2016. Pay rises will slow down slightly this year but will certainly exceed 6 per cent. Average pay in Lithuania is still the third lowest in the EU and growth in recent years has lagged the upturn in the other Baltic countries, thus the catch-up effect was long-awaited. Pay rises are faster in the private sector, which has managed to increase its productivity faster than the public sector. **However, the fact that the public sector is overstaffed and some employees such as teachers are greatly underpaid will require radical public sector reforms**, which are usually very difficult for Lithuanian governments to implement.

We believe that companies will keep increasing their investments in machinery and equipment in an effort to take advantage of favourable conditions in export markets and the still-low interest rate environment. Industrial confidence indicators have improved in recent months and support the positive short-term trend in output. **We forecast that exports will increase by 3.7 per cent in 2017**, largely due to higher foreign sales of food, plastics, steel products and electronic equipment. In 2018 exports will go up by 5 per cent.



Source: Statistics Lithuania

Inflation has risen to over 3 per cent in the first quarter of 2017 due to higher prices for oil products, food, alcoholic beverages and services. The sharp hike in excise duties for alcohol in March alone added nearly 1 percentage point to the annual inflation rate. Expectations of higher inflation have also increased recently. **We are raising our forecast of average growth in prices from 2.5 to 3.3 per cent for this year**, and from 2.4 to 2.8 per cent for next year.

Higher inflation is providing more incentives to search for cheaper goods in neighbouring Poland, where food prices are lower even though average wages are higher. A lower VAT rate, greater support to agricultural producers and keener competition in the retail sector are among the reasons that favour purchases in Poland. Although shopping in Poland still accounts for a minor share of total retail sales to Lithuanians, major retailers are starting to feel more pain, aggravating current tensions in the sector.

The **general government budget surplus of 0.3 per cent of GDP in 2016 was the first ever achieved** in Lithuania's history. Budget revenue so far in 2017 is 3.4 per cent above the government's projection. Stronger-than-expected economic growth, higher inflation and the implementation of a smarter tax administration system have had the largest positive impact on tax revenues. The new government has not yet revealed its plans for future tax reforms but will be forced to take active measures to keep pace with Latvia and Estonia, which are closer to ambitious reforms. The 2017 government budget will show a deficit of around 0.5 per cent of GDP due to the implementation of new "social model" in the second half of this year, while next year the budget will be balanced.

Global tailwinds strengthening growth prospects

- **Tax system overhaul should boost competitiveness and growth**
- **Inflation surges above euro zone average**

Although there was some recovery late in the year, GDP growth slowed from 2.7 per cent in 2015 to 2.0 per cent in 2016. Household and public sector consumption were growth engines, rising 3.5 and 2.7 per cent, respectively, while capital spending fell by 11.7 per cent. Despite strong headwinds, exports were also up, contributing positively to GDP.

The near-term prospects for the Latvian economy look favourable. The situation in the euro zone is slowly improving and EU structural funds are starting to pour in again. This will lead to a rebound in capital spending and construction, boosting sentiment across the economy. We expect a bit more domestic consumption, which is already reflected in retail sales growth of 2.5 per cent in the first two months of this year. There will be a gradual upturn in service sectors, especially the real estate market, hotels and restaurants. Meanwhile, uncertainty will persist in the transit sector. The main threats to the Latvian economy are associated with political risks in the EU and global geopolitical tensions. **We expect GDP to grow by 3.5 per cent both this year and next**.

Manufacturing is another bright spot, with a 6.6 per cent year-on-year increase in the first two months of 2017. We expect industrial production to grow by 5.0 per cent as a full-year average, driven by both exports and domestic demand, but increased capital spending is essential in order to maintain such a rapid expansion rate. Meanwhile demand in key export markets has improved and will continue to keep exports strong. Export statistics may be volatile, but the 9.5 per cent year-on-year upturn early in 2017 indicates a sustainable positive trend that we believe will lift exports by 6 per cent in 2017. **Such a strong trend in the vital export sector will create good momentum for a healthy recovery in domestic consumption as well.**

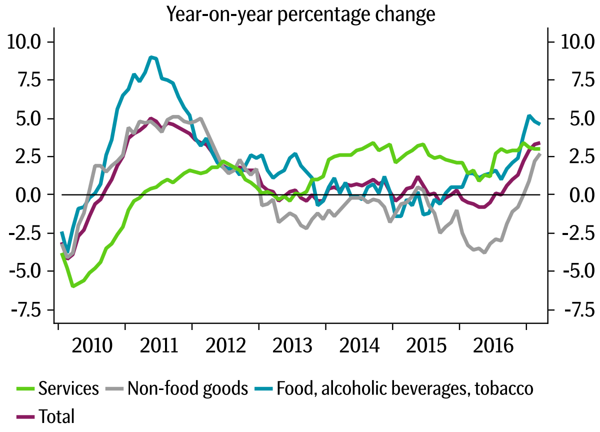
Average wage and salary growth fell from 6.8 per cent in 2015 to 5 per cent in 2016. Pressure for higher wages is very strong, especially in public administration, which risks stimulating pay increases in the private sector as well. Minimum wages look set to be raised, but since productivity gains remain slow, businesses will continue to focus on controlling costs and will limit wage growth to 5.5 per cent this year and next.

As expected, improvements in the labour market last year were insignificant. Unemployment fell somewhat to 9.3 per cent in 2016 but remained the highest in the Baltic countries. We expect the labour market to strengthen gradually, although employers will still be cautious about hiring. The nationwide unemployment rate will remain high, but with major regional differences. Labour emigration will continue, especially among younger people. Together with low birth rates, this will contribute to the ageing of the population. An older workforce decreases labour market flexibility and may soon become a serious obstacle to growth. We believe that average **unemployment will fall to 8.9 per cent in 2017 and 8.2 per cent in 2018**.

In March 2017, year-on-year inflation surged to 3.4 per cent, its highest level since 2012. The main contributing factors were food and energy prices, as well higher housing costs. Inflation looks set to level out in the next few months, though in the autumn it may resurge again since service prices will probably increase again. However, the main trend will depend on food and energy prices. Overall, we expect **CPI to increase by 3.0 per cent this year and 2.0 per cent in 2018**.

Inflation has surged but will stabilise

Year-on-year percentage change



Source: Statistics Latvia

In order to boost competitiveness and improve growth potential, the Ministry of Finance has finally announced a fundamental tax reform starting as early as 2018. The main purpose is to lower the labour tax wedge and stimulate capital spending. One proposal envisages cutting personal income tax from 23 to 20 per cent. The minimum wage will be raised to EUR 430 a month. The capital gains tax and share dividend tax will be set at 20 per cent, while the tax on reinvested profit will be eliminated. So far, VAT is planned to remain at 21 per cent, but since the current proposals will probably lead to a revenue shortfall of EUR 450 million, a VAT increase will probably be necessary. The European Commission will not accept as large a deviation from fiscal targets as the current proposals imply. Increases in indirect taxes are likely. This is one reason why inflation next year could be higher than our current forecast.

Short-term growth, long-term questions

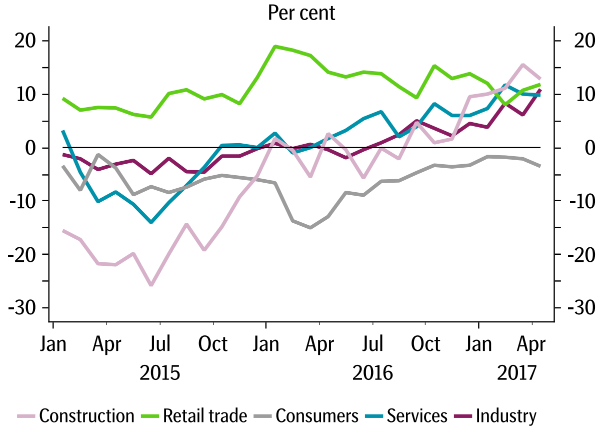
- **Surge in exports will drive growth**
- **More expansionary fiscal policy expected**

After **seven quarters of anaemic growth**, in Q4 2016 the Estonian economy expanded by 2.7 per cent. The last time year-on-year growth was higher was exactly two years earlier, in Q4 2014. Growth was boosted by a large added-value increase in the IT sector, but also by retail and wholesale trade. Yet we remain cautious, sticking to our forecast of **2.2 per cent GDP growth in 2017** and **3.1 per cent in 2018.**

Growth in private consumption, a driving force in the economy during the last couple of years, will decelerate in 2017. While gross wages are still increasing fast, growth in real wages will be much slower due to **rebounding inflation**. HICP surged by 3.1 per cent in Q1 2017. In addition to higher energy prices, an increase in excise duties and rapidly rising food prices also fuelled inflation. We have lifted our **HICP forecast** to **3.2 per cent in 2017**. However, since households only gradually adjust to higher inflation, we expect private consumption to expand by a hefty 3 per cent this year. Due to the exceptional **increase in tax-exempt minimum income** from the current EUR 180 to EUR 500 **starting next year**, in 2018 private consumption is expected to surge by 4 per cent.

Sentiment indicators are improving

Per cent



Source: European Commission

In services, industry and construction, **business sentiment has strengthened**, but in the retail sector higher inflation seems to have soured the mood in recent months. Yet households do not seem to mind higher prices, since consumer confidence remains solid. Much of this household optimism is due to the rapid decrease in unemployment expectations. In 2016 employment among 15-74 year olds stood at 65.6 per cent, which is the highest recorded level. At the same time the unemployment rate is increasing due to an ambitious reform which aims to bring non-active people with reduced working ability back into the labour market. As there is a lack of suitable jobs for people with disabilities, they mostly join the ranks of the unemployed. Due to this reform **we expect the jobless rate to reach 7.5 per cent in 2017 and 8.0 per cent in 2018**.

Capital investments, which have been declining since 2013, **are bound to surge this year**. In a small country one-time events can have a significant impact on statistics. Due to a purchase of a large passenger vessel, gross fixed capital spending is expected to increase by more than 9 per cent in 2017. Yet this tells little about the economy as a whole. When excluding transport equipment, imports of capital goods, a proxy for capital expenditures, decreased by 10 per cent during the first two months of 2017 year-on-year.

Estonian exports improved markedly in January and February, reaching double-digit growth. The main drivers have been the recovery in shale oil and metal structure exports, while foreign sales of timber products have been good for many years. Since the outlook in Estonia's main export markets is favourable, we expect exports to surge by 3.8 per cent in 2017 and 4.0 per cent in 2018.

The new government, in office since November 2016, is on a **fast track to introduce new taxes** to compensate for the loss of revenue from the large increase in the tax-exempt income threshold. This mostly comprises increases in some excise duties and introduction of smaller levies, but also a corporate income tax for banks and a reduction in the income tax on dividends to encourage pay-outs. As expected revenues from these changes are limited, the budget deficit will increase to around 0.5 per cent of GDP.

While the economy is expected to improve in the short term, the **long-term outlook remains bleak**. The big question is what will drive future growth. According to a consensus of long-term projections, the economy will expand at an annual rate of around 3 per cent, which implies that the convergence with Nordic countries could take more than a generation. While the thriving IT sector has been the main driver of growth in recent years, upward movement in the value chain has been moderate in manufacturing, which is dominated by traditional industries and companies. Faster growth requires more ambition and risk appetite by existing companies, but also the birth on new high value-added firms. While the government is trying to accelerate short-term growth, investments in research and development and higher education, which could spur long-term growth, remain scarce.

GLOBAL KEY INDICATORS

Yearly change in per cent

	2015	2016	2017	2018
GDP OECD	2.4	1.8	2.1	2.2
GDP world (PPP)	3.4	3.2	3.7	3.8
CPI OECD	0.6	1.1	2.0	1.8
Export market OECD	3.0	2.1	3.0	3.6
Oil price, Brent (USD/barrel)	53.4	45.2	55.0	60.0

US

Yearly change in per cent

	2016 level, USD bn	2015	2016	2017	2018
Gross domestic product	18,223	2.6	1.6	2.3	2.5
Private consumption	12,439	3.2	2.7	2.3	2.4
Public consumption	3,245	1.8	0.8	0.2	1.0
Gross fixed investment	3,060	3.9	0.6	5.0	4.5
Stock building (change as % of GDP)		0.2	-0.4	-0.1	0.0
Exports	2,212	0.1	0.4	3.6	3.2
Imports	2,733	4.6	1.1	4.0	2.9
Unemployment (%)		5.3	4.9	4.4	4.1
Consumer prices		0.1	1.3	2.1	2.1
Household savings ratio (%)		3.2	5.8	5.7	5.6

EURO ZONE

Yearly change in per cent

	2016 level, EUR bn	2015	2016	2017	2018
Gross domestic product	10,461	2.0	1.8	2.0	2.0
Private consumption	5,743	1.8	2.0	1.6	1.7
Public consumption	2,165	1.3	1.9	1.3	1.0
Gross fixed investment	2,066	3.2	3.7	4.3	4.0
Stock building (change as % of GDP)	0	-0.1	-0.1	0.1	0.0
Exports	4,832	6.5	2.9	3.7	4.4
Imports	4,358	6.5	4.0	4.3	4.7
Unemployment (%)		10.9	10.0	9.3	9.0
Consumer prices		0.0	1.8	1.5	1.1
Household savings ratio (%)		6.0	6.2	6.3	6.2

OTHER LARGE COUNTRIES

Yearly change in per cent

	2015	2016	2017	2018
GDP				
United Kingdom	2.2	1.8	1.4	0.9
Japan	1.2	1.0	0.8	0.5
Germany	1.7	1.9	2.0	1.9
France	1.3	1.2	1.4	1.4
Italy	0.8	0.9	1.0	1.2
China	6.9	6.7	6.7	6.3
India	7.3	7.5	7.7	8.0
Brazil	-3.8	-3.6	0.7	2.0
Russia	-2.8	-0.2	1.1	1.5
Poland	3.6	2.8	3.2	3.4
Inflation				
United Kingdom	0.1	0.4	2.5	2.5
Japan	0.8	-0.1	0.6	0.6
Germany	0.2	0.8	1.9	2.0
France	0.3	0.8	0.7	0.7
Italy	0.1	-0.1	0.7	0.7
China	1.4	2.2	2.3	2.5
India	4.9	5.0	4.4	5.2
Brazil	9.0	8.8	4.2	4.8
Russia	15.6	7.1	4.3	4.2
Poland	-0.9	-0.6	2.1	2.2
Unemployment (%)				
United Kingdom	5.4	4.9	4.9	5.2
Japan	3.4	3.1	2.9	2.8
Germany	4.6	4.1	4.1	4.2
France	10.2	10.1	9.6	9.5
Italy	11.9	11.7	12.0	12.0

FINANCIAL FORECASTS

Official interest rates		03-May	Sep-17	Dec-17	Jun-18	Dec-18
US	Fed funds	1.00	1.25	1.50	1.75	2.25
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.25	0.25	0.25	0.25	0.25
Bond yields						
US	10 years	2.31	2.50	2.65	2.80	3.00
Japan	10 years	0.02	0.10	0.10	0.10	0.10
Germany	10 years	0.33	0.50	0.60	0.85	1.15
United Kingdom	10 years	1.15	1.30	1.40	1.75	2.05
Exchange rate						
USD/JPY		112	118	120	122	124
EUR/USD		1.09	1.10	1.10	1.12	1.14
EUR/JPY		123	130	132	137	141
EUR/GBP		0.85	0.90	0.90	0.89	0.88
GBP/USD		1.29	1.22	1.22	1.26	1.30

SWEDEN

Yearly change in per cent

	2016 level, SEK bn	2015	2016	2017	2018
Gross domestic product	4,181	4.1	3.3	3.1	2.6
Gross domestic product, working day adjustment		3.9	3.1	3.4	2.7
Private consumption	1,884	2.7	2.2	2.4	2.5
Public consumption	1,086	2.5	3.1	2.5	1.0
Gross fixed investment	989	7.0	5.9	7.7	4.7
Stock building (change as % of GDP)	23	0.3	0.1	0.0	0.0
Exports	1,906	5.6	3.4	5.8	3.9
Imports	1,708	5.5	3.7	7.6	4.0
Unemployment, (%)		7.4	6.9	6.4	6.1
Employment		1.4	1.5	2.2	1.4
Industrial production		3.3	2.7	3.7	3.0
CPI		0.0	1.0	1.6	1.6
CPIF		0.9	1.4	1.7	1.6
Hourly wage increases		2.5	2.4	2.7	3.1
Household savings ratio (%)		16.2	16.5	16.4	15.8
Real disposable income		2.4	3.0	3.2	2.1
Current account, % of GDP		4.7	4.7	4.3	3.8
Central government borrowing, SEK bn		33	-85	-26	-26
General government net lending, % of GDP		0.3	0.9	0.6	0.6
General government gross debt, % of GDP		43.9	41.6	39.7	37.7

FINANCIAL FORECASTS	**03-May**	**Sep-17**	**Dec-17**	**Jun-18**	**Dec-18**
Repo rate	-0.50	-0.50	-0.50	-0.25	0.00
3-month interest rate, STIBOR	-0.48	-0.50	-0.55	-0.20	-0.05
10-year bond yield	0.57	0.65	0.80	1.15	1.45
10-year spread to Germany, bp	24	15	20	30	30
USD/SEK	8.82	8.59	8.45	8.08	7.85
EUR/SEK	9.62	9.45	9.30	9.05	8.95
KIX	114.0	111.1	109.3	106.2	104.9

FINLAND

Yearly change in per cent

	2016 level, EUR bn	2015	2016	2017	2018
Gross domestic product	218	0.3	1.4	1.6	1.7
Private consumption	119	1.5	2.0	1.5	1.5
Public consumption	52	0.1	0.5	0.0	0.0
Gross fixed investment	46	1.1	5.2	3.0	3.5
Stock building (change as % of GDP)		-0.3	-0.1	0.1	0.0
Exports	76	2.0	0.5	3.2	3.4
Imports	78	3.1	2.5	3.0	3.1
Unemployment, OECD harmonised (%)		9.3	8.9	8.6	8.3
CPI, harmonised		0.0	0.4	1.5	1.5
Hourly wage increases		1.5	1.5	1.7	1.7
Current account, % of GDP		-0.6	-1.1	-0.9	-1.0
Public sector financial balance, % of GDP		-2.7	-1.9	-1.7	-1.5
Public sector debt, % of GDP		63.7	63.6	63.2	63.0

NORWAY

Yearly change in per cent

	2016 level, NOK bn	2015	2016	2017	2018
Gross domestic product	3,191	1.6	1.0	1.4	1.4
Gross domestic product (Mainland)	2,561	1.1	0.8	1.7	2.0
Private consumption	1,311	2.1	1.6	2.0	2.3
Public consumption	706	2.1	2.3	1.7	1.5
Gross fixed investment	711	-3.8	0.5	2.5	2.1
Stock building (change as % of GDP)		0.2	0.3	-0.1	0.0
Exports	1,266	3.7	-1.2	0.9	1.3
Imports	956	1.6	0.3	2.1	2.8
Unemployment (%)		4.4	4.7	4.3	4.2
CPI		2.2	3.5	2.0	1.4
CPI-ATE		2.7	3.1	1.7	1.4
Annual wage increases		2.8	1.7	2.5	2.8

FINANCIAL FORECASTS	**03-May**	**Sep-17**	**Dec-17**	**Jun-18**	**Dec-18**
Deposit rate	0.50	0.50	0.50	0.50	0.75
10-year bond yield	1.57	1.60	1.65	1.75	2.05
10-year spread to Germany, bp	124	110	105	90	90
USD/NOK	8.62	8.18	8.00	7.68	7.46
EUR/NOK	9.41	9.00	8.80	8.60	8.50

DENMARK

Yearly change in per cent

	2016 level, DKK bn	2015	2016	2017	2018
Gross domestic product	2,061	1.6	1.3	2.0	2.4
Private consumption	985	2.0	1.9	1.5	2.3
Public consumption	526	0.6	-0.1	0.5	0.7
Gross fixed investment	1,094	2.5	5.2	2.6	2.9
Stock building (change as % of GDP)		-0.3	-0.4	-0.1	0.0
Exports	1,094	1.8	1.8	4.7	3.6
Imports	953	1.3	2.4	3.9	3.2
Unemployment, OECD harmonised (%)	6.2	6.5	6.4	6.1	5.8
CPI, harmonised	0.2	0.0	1.1	1.4	1.4
Hourly wage increases	1.5	1.7	1.7	1.8	1.9
Current account, % of GDP	7.0	6.0	6.0	6.0	6.0
Public sector financial balance, % of GDP	-1.7	-0.6	-1.6	-1.1	-1.1
Public sector debt, % of GDP	40.2	40.4	40.8	40.5	40.5

FINANCIAL FORECASTS	**03-May**	**Sep-17**	**Dec-17**	**Jun-18**	**Dec-18**
Lending rate	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.49	0.65	0.75	1.00	1.30
10-year spread to Germany, bp	16	15	15	15	15
USD/DKK	6.82	6.76	6.76	6.64	6.53
EUR/DKK	7.44	7.44	7.44	7.44	7.44

LITHUANIA

Yearly change in per cent

	2016 level, EUR bn	2015	2016	2017	2018
Gross domestic product	39	1.8	2.2	3.2	3.0
Private consumption	25	4.1	5.6	4.2	4.0
Public consumption	7	0.9	1.3	1.5	1.3
Gross fixed investment	7	4.7	-0.5	5.0	6.0
Exports	29	-0.4	2.9	3.7	5.0
Imports	28	6.2	2.6	5.7	6.1
Unemployment (%)		9.1	7.9	7.5	7.2
Consumer prices		-0.7	0.7	3.3	2.8

LATVIA

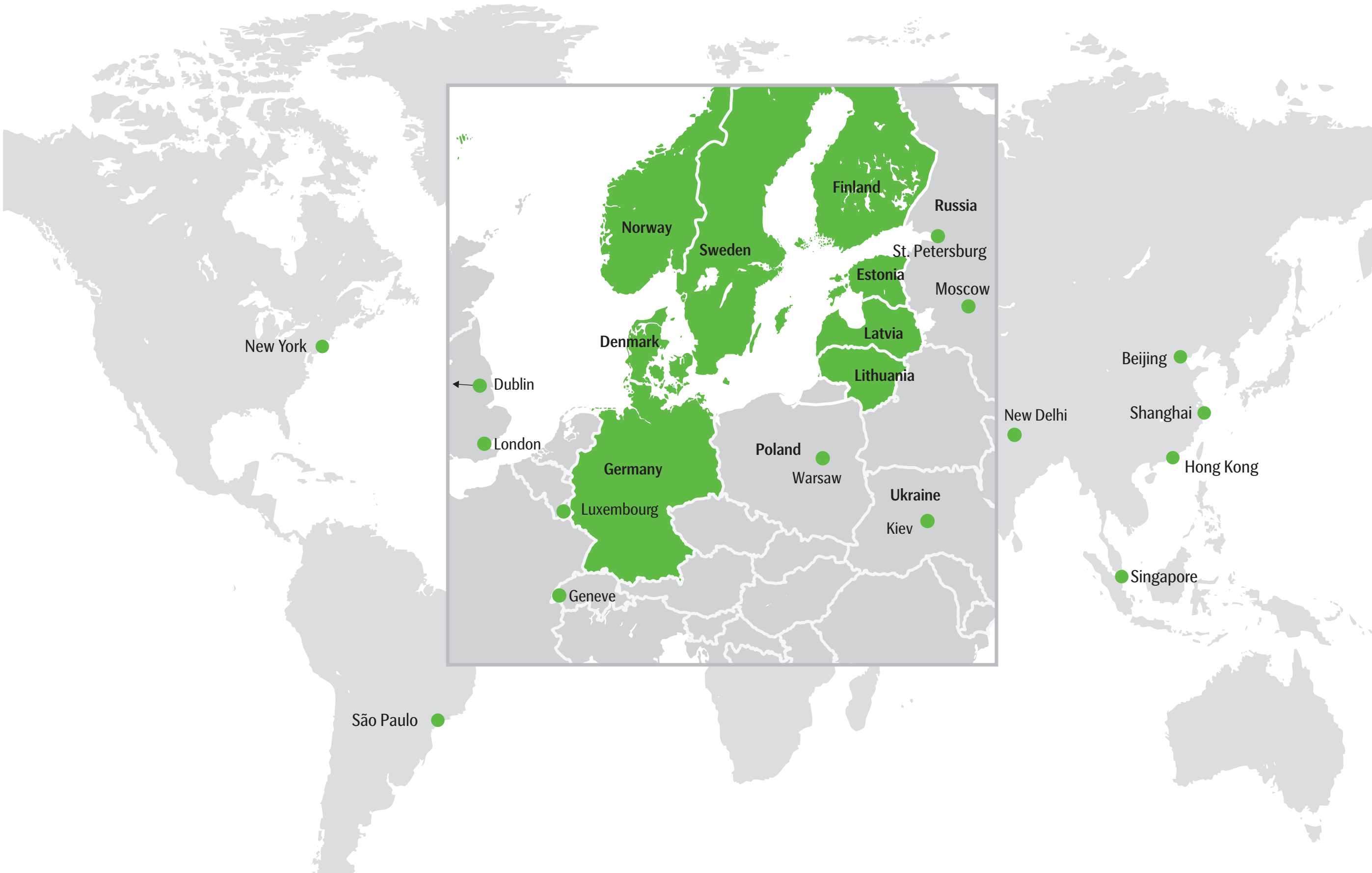
Yearly change in per cent

	2016 level, EUR bn	2015	2016	2017	2018
Gross domestic product	25	2.7	2.0	3.5	3.5
Private consumption	15	3.7	3.5	3.9	4.2
Public consumption	4	3.1	2.7	2.9	2.9
Gross fixed investment	5	-1.8	-11.7	6.8	8.5
Exports	15	2.6	2.8	4.5	5.0
Imports	14	2.1	4.6	5.1	5.5
Unemployment (%)		9.9	9.6	8.9	8.1
Consumer prices		0.2	0.1	3.0	2.0

ESTONIA

Yearly change in per cent

	2016 level, EUR bn	2015	2016	2017	2018
Gross domestic product	21	1.4	1.6	2.2	3.1
Private consumption	11	4.6	4.0	3.0	4.0
Public consumption	4	3.4	1.0	2.5	1.8
Gross fixed investment	5	-3.4	-2.8	9.2	-0.2
Exports	17	-0.6	3.6	3.8	4.0
Imports	16	-1.4	4.9	5.8	2.8
Unemployment (%)		6.2	6.8	7.5	8.0
Consumer prices		0.1	0.8	3.2	2.7



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SEGR0113 2017.05