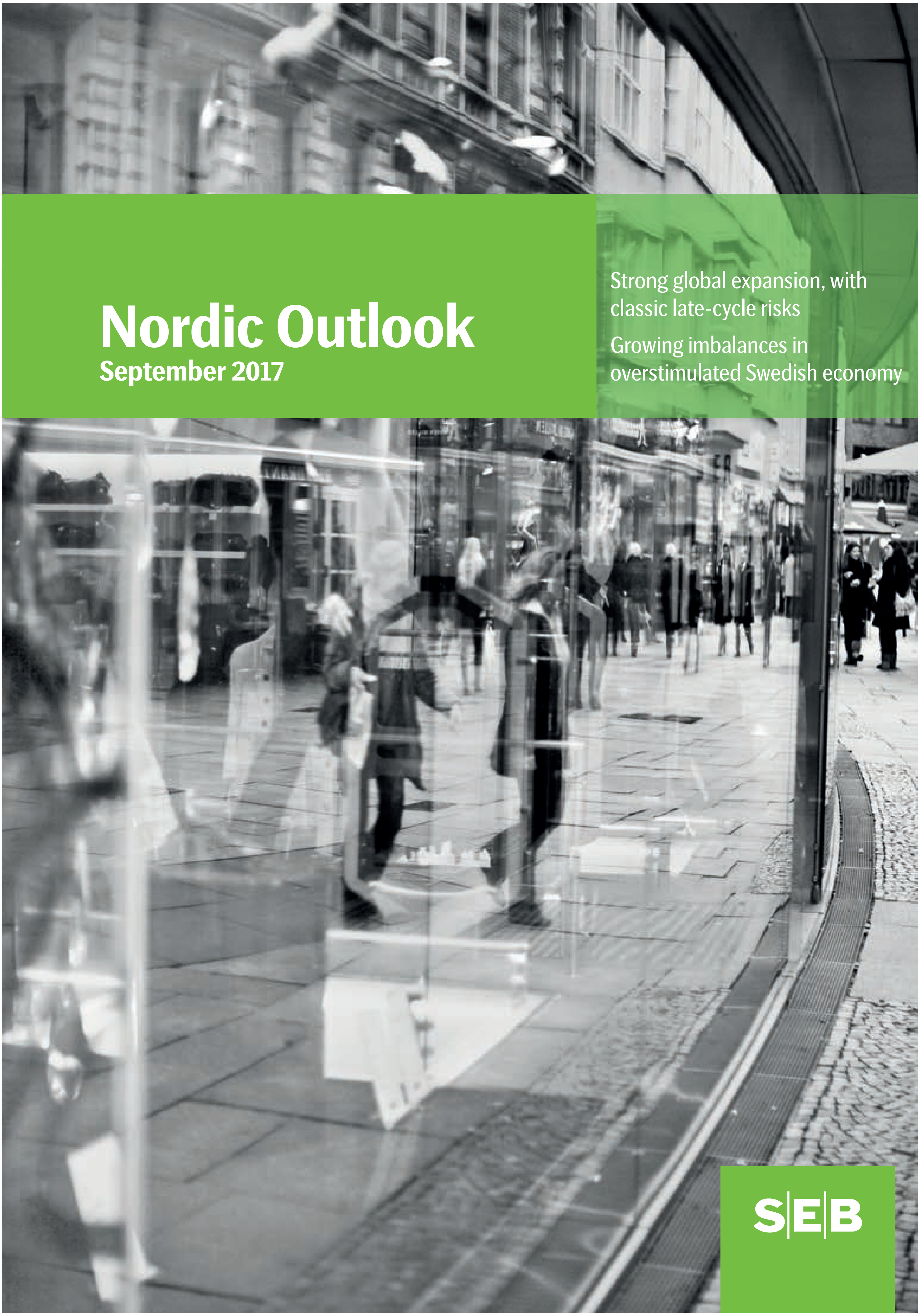

Nordic Outlook

September 2017

Strong global expansion, with classic late-cycle risks

Growing imbalances in overstimulated Swedish economy

SEB

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Boxes

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Late-cycle growth forces resilient to political uncertainty

- **Shift of focus from US to EM sphere and euro zone => stable 2017-2019 GDP growth**
- **Ultra-loose monetary policy fading despite low inflation; Fed will hike to 2.50 per cent**
- **Steps towards euro integration and strong expansion will drive EUR/USD rate to 1.25**
- **Growth and central bank liquidity drive equities higher despite high valuations**
- **Swedish economy accelerating further, but lack of policy coordination increases risks**

The global economy has continued to perform favourably in recent months. **The strength of sentiment indicators has increasingly been confirmed by hard data**, especially in the euro zone, China and Japan. The Swedish economy is also impressive, with a strong GDP rebound in the second quarter of 2017. In the United States, however, GDP seems unwilling to take off in earnest despite continuing labour market improvement. Falling indicators and lowered expectations of fiscal stimulus measures also suggest modest growth ahead. The British economy faces uncertainty ahead of crucial Brexit negotiations, reflected so far in an inflation-driven squeeze on incomes due to a weakening pound.

Economic performance over the next couple of years will be determined by a mix of unusually dramatic political events, on the one hand, and classic cyclical issues on the other. A lack of clarity about the United Kingdom's future relationship with the European Union and the Trump administration's changeability represent **a clear heightening of political uncertainty, especially in foreign policy**. The quarrel with North Korea has been in the headlines recently, but if President Donald Trump's aggressive foreign policy rhetoric continues, new crises may flare up quickly. In the euro zone, however, the political worries of early 2017 have been replaced by **hopes that President Emmanuel Macron will deliver structural reforms in France**. We have also seen greater hopes that euro zone integration plans might be revived post-Brexit, now that France has an EU-friendly, federalist-oriented president. This generally implies that both political opportunities and risks are greater than usual, but experience shows that their short- and medium-term economic impact is not usual so large.

The **cyclical perspective is dominated** by a global recovery that has been under way for nearly a decade and shows typical signs of maturity. Capacity utilisation has reached levels that require broad-based capital spending, while strong labour markets and rising asset price are generating optimism among households. This suggests robust global demand over the next couple of years. With unemployment close to, or even below, equilibrium in most industrialised countries, **the supply side of the economy will instead determine the duration of the recovery**. Towards the end of our forecast period, we also expect bottleneck problems to contribute to slower GDP growth, especially in the US. Meanwhile earlier experience shows that the supply side often tends to surprise on the upside late in the economic cycle, which suggests a mild slowdown. Another reason why global GDP growth will remain relatively high throughout our forecast period is that emerging market (EM) economies are now also accelerating their expansion. This year and in 2018 **we expect global GDP to increase by 3.8 per cent**: a relatively sharp acceleration since 2016. In 2019 there will be a slight deceleration, mainly due to weak US growth. Overall, the risks are on the downside.

Global GDP growth

Year-on-year percentage change

	2016	**2017**	**2018**	**2019**
United States	1.5	2.2	2.4	2.0
Japan	1.0	1.3	0.8	0.7
Germany	1.9	2.1	2.0	1.8
China	6.7	6.8	6.4	6.1
United Kingdom	1.8	1.5	1.0	1.2
Euro zone	1.8	2.1	2.2	2.0
Nordic countries	2.1	2.5	2.3	2.2
Baltic countries	2.0	3.5	3.3	3.1
OECD	1.8	2.1	2.1	1.9
Emerging markets	4.3	4.9	5.0	5.0
World, PPP*	**3.1**	**3.8**	**3.8**	**3.7**

Source: OECD, SEB * Purchasing power parities

Continued low inflation, but clear downside surprises in the US, **will give central banks the flexibility to retain expansionary policies** that will enable the chronically unemployed and other marginalised groups to return to the labour market. But **central banks must also balance various threats**. On the one hand, there is a risk of underestimating the economy's sensitivity to interest rates, thus tightening monetary policy too soon. On the other hand, they must bear in mind the risks of inflating asset prices further and being affected at a later stage by unpleasant inflation surprises when the economy is already on its way down. Recently central banks have mainly confirmed that they will change strategy when **stronger economic conditions and waning**

deflationary risks weaken the justification for the prevailing ultra-loose monetary policies. But there are major differences between them. We expect that because of the strong labour market, **the US Federal Reserve (Fed) will resume its key interest rate hikes in December**, then follow this up with hikes that will result in a key interest rate of 2.50 per cent at the end of 2019. The Fed will begin reducing its balance sheet as early as October 2017. This autumn the European Central Bank (ECB) will decide to **decrease its monthly purchases** of securities during the first half of 2018. **The ECB will hike the deposit rate for banks from -0.40 per cent to -0.25 per cent in June 2018, while raising its refi rate in two steps to 0.5 per cent during 2019.**

We can also foresee an interesting **difference in the behaviour of central banks with inflation targets in smaller economies**. Despite low inflation, the **Bank of Canada** unexpectedly hiked its key interest rate in July, in light of high resource utilisation and risks in the housing market. In Norway, Norges Bank has also explicitly begun to factor in the risks of soaring asset prices in its interest rate decisions. Sweden's **Riksbank, however, will continue to focus intensively on inflation**, but we believe that strong economic growth and increasingly serious labour shortages will lead to **an initial rate hike as early as April 2018**: three to six months earlier than signalled.

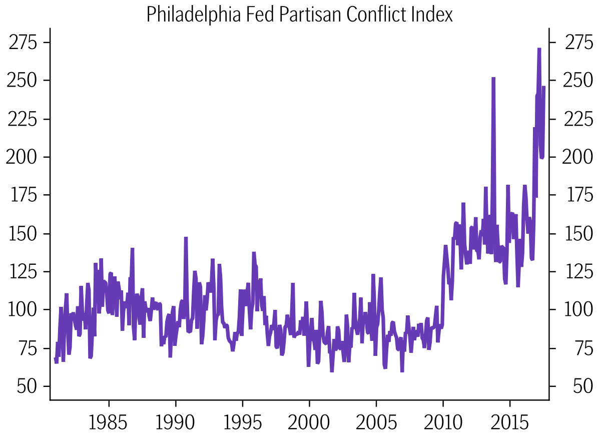
As central banks on both sides of the Atlantic retreat from ultra-loose monetary policy, this will push long-term yields higher. But given continued subdued inflation, low key rates and lingering effects from earlier asset purchases, it is hard to foresee any dramatic upturn. Ten-year government bond yields with climb by 90 basis points both in the US and Germany during our forecast period. **This will bring US Treasuries to 3.10 per cent and German yields to 1.30 per cent**. In a historical perspective, the yield gap will thus remain relatively wide. The dollar will regain some lost ground this autumn, but **further ahead the EUR/USD exchange rate will climb towards a new interval, 1.20-1.25**. Meanwhile the euro project will take some steps forward, while economic recovery will enable the ECB to begin hiking interest rates. Political disarray in the US and higher geopolitical tensions have had no major impact on the risk climate. **Stock markets are enjoying support from continued improvements in earnings**. But efficiency measures rather than rising sales have driven earnings – **a downside risk for the stock market, while share valuations remain at historically high levels**.

US: Lower expectations of fiscal stimulus

So far in 2017 year, GDP growth in the US has been weaker than expected, although the second quarter represented something of a rebound. The main source of disappointment is consumption, while exports and capital spending are rising at a healthy pace – driven by such factors as a weaker dollar and a revival of interest in new oil investments. We expect further recovery in the second half, enabling **continued above-trend GDP growth: 2.2 per cent in 2017 and 2.4 per cent in 2018, followed by a slowdown to 2.0 per cent in 2019**. Despite disappointing growth, the labour market has remained strong. So far this year, job growth has averaged 184,000 per month. This has pushed unemployment down to 4.3 per cent: below equilibrium. Despite an increase, the labour force participation rate remains about 4 percentage points below its peak in 2000, indicating that there is still some labour market slack. Unexpectedly low recent inflation also confirms the impression that troubling bottleneck symptoms are conspicuously absent.

US: Higher level of conflict in Congress

Philadelphia Fed Partisan Conflict Index

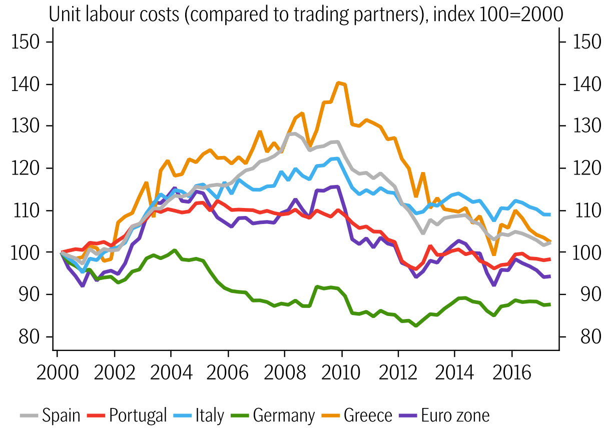


Source: Federal Reserve Bank of Philadelphia , Macrobond, SEB

The turbulence surrounding the Trump administration has continued, for example with arbitrary foreign policy statements and a continuously changing cast of key individuals. This affects decision making capacity, and despite all the political capital invested in such ventures as replacing "Obamacare" with a new health insurance system, these initiatives appear to have failed. The above chart also shows how **the conflict level in US domestic politics has risen in recent years**. We have further lowered our expectations of stimulus measures, although some tax cuts are likely to be enacted in 2018. The need to raise the federal debt ceiling will be a new test this autumn. Although it will probably be raised in the end, there may be tough battles in Congress, leading to new conflicts – especially within the Republican Party. The administration's weakening domestic decision making capacity might be offset by protectionist actions in the trade policy field.

Competitiveness improving, but a way to go

Unit labour costs (compared to trading partners), index 100=2000



Source: OECD, Macrobond, SEB

Euro zone accelerating, but UK stagnating

The euro zone economy has been the clearest exclamation point in the global picture, with hard data confirming earlier strong indicator signals. GDP growth reached 2.2 per cent in the second quarter, which means that the region grew faster than both the UK and the US, especially in per capita terms. The upturn is broad-based; the German economy is showing continued strength while southern European countries have strengthened their competitiveness. Because the budget situation has improved after earlier belt-tightening, slightly expansionary fiscal policies are now possible. We are revising our optimistic view further upward and now predict **GDP growth a bit above 2 per cent both in 2017 and 2018, then a marginal slowdown to 2.0 per cent in 2019**.

All indications today are that **Angela Merkel's CDU will continue to lead the German government**, although the shape of her coalition may change after the September parliamentary election. With Macron and Merkel in leading roles, the euro zone countries will enjoy a far more stable political landscape than widely feared early in this super-election year. We believe that Macron can push through certain reforms, especially in the labour market, which may improve the functioning of the French economy. But expectations should not be too high, since there are many examples of a president's reform agenda losing momentum as his popularity falls and the "parliament of the street" begins asserting itself in the form of strikes and protests. There is also uncertainty as to whether Macron's new political movement (LREM) is really mature enough to carry out controversial reforms.

This autumn, attention is shifting from national elections to an intensive calendar of meetings concerning EU and euro zone reforms. The European Commission's *White Paper* last spring, which presented five possible EU scenarios (see the theme article in *Nordic Outlook*, May 2017) will force member countries to adopt positions on big issues affecting future cooperation. **France, and to some extent Germany, are expected to pursue a multi-speed EU policy**. Although the outcome will perhaps not be so concrete, the trend towards greater power for the Eurogroup is likely to intensify. This may eventually put pressure on non-euro countries like Sweden and Denmark to join the common currency project in order to avoid marginalisation. With the UK on its way out of the EU, the non-euro zone group is losing its dominant member.

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

	2016	2017	2018	2019
China	6.7	6.8	6.4	6.1
India	7.9	7.1	7.8	7.8
Brazil	-3.6	0.7	2.0	2.2
Russia	-0.2	1.9	2.0	1.9
Emerging markets, total	**4.3**	**4.9**	**5.0**	**5.0**

Source: OECD, SEB

EM economies speeding up after slump

Over the past three years, emerging market (EM) economies have slowed, but their economies are now accelerating again. We expect GDP growth in SEB's **EM index to climb from 4.3 per cent in 2016 to 4.9 per cent this year and 5.0 per cent next year and in 2019**, but the trends for major EM economies are divergent. **The Chinese economy** has surprised on the upside this year, but in 2018 and 2019 GDP growth will slow in a controlled way. This will, however, be offset by accelerating growth in other BRIC countries**. India** will again reach growth of slightly below 8 per cent in both 2018 and 2019. The Narendra Modi government has managed to implement important tax reforms but will have difficulty in making progress in such fields as the labour market before the 2019 election. **Brazil and Russia** can expect a cyclical recovery, but due to a large budget deficit and debt burden in Brazil and continued low oil prices combined with a lack of reforms in Russia, their growth rates will be mediocre: around 2 per cent.

One important downside risk is connected to the Fed and ECB normalisation processes. Historically, monetary policy tightening has hurt capital inflows to EM economies, leading to rising interest rates and falling stock markets. The EM economies remain dependent on capital from the US and Europe, but given the very slow pace of normalisation that appears likely, the disruptions should not be so great. **The risks that geopolitical tensions and crises will disrupt EM economies have increased recently**. The crises in Syria and Ukraine, for example, may lead to a flare-up in tensions between Russia and Western powers. Border disputes between China and India are fairly inconspicuous but could potentially have economic consequences for these countries. It is also difficult to foresee any solution to the conflict with North Korea. Unless North Korea and the US are willing to negotiate, the crisis will probably escalate during the next couple of years. China and Russia are likely to gradually distance themselves from North Korea's nuclear weapons development, but this will make the regime even more dependent on these weapons to ensure its survival. Meanwhile experience from the 1962 Cuban crisis, for example, shows that financial markets have great difficulty pricing risks of this type, with catastrophic potential but very low probability.

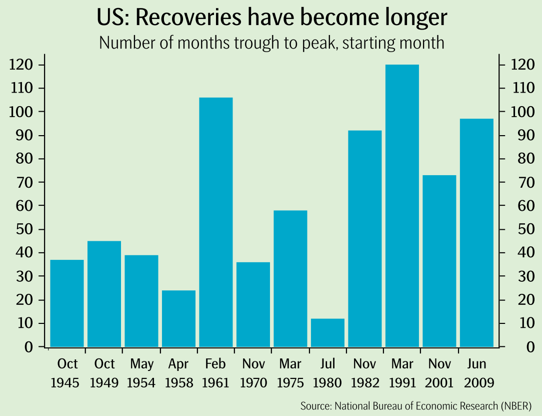
Broad upturn in the Nordic economies

The upswing in continental Europe has helped to further improve the growth outlook in the Nordic countries. **Finland** is also benefiting from a slightly more stable outlook in Russia and has left behind a period of recurring recessions. We have adjusted our forecast significantly and **now foresee robust yearly GDP growth of more than 2 per cent in 2017-2019**. In **Denmark**, household consumption is an increasingly important economic engine as earlier tight credit market conditions have been loosened. Healthy demand from nearby countries is lessening the impact of a stronger currency. This will help the **Danish economy expand by more than 2 per cent a year as well**: a bit above trend growth. **In Norway, too, GDP growth intensified during the first half of 2017**. The upturn is broad-based, with generally positive expectations in various sectors. Traditional exports rebounded sharply after falling in 2016, while oil sector investments seem to have recovered. Looking ahead, an income-driven revival in household consumption will offset a slowdown in housing investments. We expect overall GDP to **increase by 1.7 per cent in 2017, after which oil investments will help speed up growth to 1.9 per cent in 2019**.

Type scenarios in a mature expansion

The US recession after the financial crisis ended in June 2009 (according to the NBER), which means that the recovery has now been under way for more than 8 year. Our forecast implies that a new "length record" will be set in mid-2019. The box entitled "Can the recovery die of old age?" in our last *Nordic Outlook* discussed the potential for predicting the outbreak of a recession. Our conclusion was that this is difficult as long as economic conditions do not confront decision makers with insoluble dilemmas or as long as decision makers do not signal strategies that we, as forecasters, perceive as obvious policy mistakes. During the next couple of years, market players and decision makers will constantly need to evaluate the risks of our ending up in such situations. Below is a discussion of four type scenarios that are often relevant in a mature expansion.

1) Policy errors amid fragile secular stagnation
The recovery has long been characterised by anaemic, fragile growth, inspiring the thesis that we are in the midst of a period of chronic weak demand (*secular stagnation*). The background may be that various underlying factors have boosted people's inclination to save while reducing their motivation to invest. Despite recent global growth acceleration, this is still a topic of public debate: The newly published annual report of the Bank of International Settlements (BIS) highlights this as an important downside risk to the world economy. In order for the forces behind secular stagnation to actually trigger a recession, central banks – especially the Fed – must **underestimate the sensitivity of the economy to interest rates and carry out overly aggressive rate hikes**. Geopolitical uncertainty, for example connected to the Korean crisis, which might disrupt global trade and discourage capital spending, may also be covered by such demand-driven downside risks.



2) Ketchup-effect inflation creates a dilemma
So far, inflation is conspicuously mild, suggesting that the correlation between labour market resource utilisation and pay and price increases has been interrupted or at least weakened**. But we cannot rule out that inflation may suddenly take off.** Synchronised high resource utilisation in the world economy, for instance combined with commodity price hikes and protectionist tendencies, could create such an environment, forcing central banks to raise interest rates in a way that would end the expansion and lead to tumbling prices for shares and other assets. Central banks may signal a certain acceptance of inflation that overshoots their targets, but considering that we lack experience of phasing out exceptional monetary policies, price stability would likely be questioned in a more fundamental way and inflation expectations would surge in such a scenario. This, in turn, may lead to such a significant upturn in long-term yields that plunging asset prices will be inevitable. The more pumped-up share and home prices are at the outset, the deeper the downturn may be.

3) Supply-side slowdown amid low inflation
Yet the dominant perception today is that disinflationary forces are so strong that rising resource utilisation will not have much upward effect on pay and prices during the next couple of years. This enables central banks to keep their expansionary monetary policy, **yet labour shortages and other bottleneck symptoms may slow economic growth**. Most observers now believe that output gaps are largely closed, which suggests such a supply side-driven slowdown. But GDP growth can still remain at a decent level, somewhat above trend, which is compatible with a relatively good stock market climate.

4) Elastic supply side, leading to a longer recovery
An even more positive scenario, in which the supply side of the economy proves more elastic than expected, cannot be ruled out. For example, labour force participation may begin to creep upward as a long-lasting expansion creates opportunities for people who were previously far removed from the labour market to find their way back. Productivity may also climb in a situation where recruitment problems force companies to search more actively for efficiency improvements. Another possibility is that technological advances that have not greatly affected the economy so far may, after a certain time lag, achieve broader commercial breakthroughs and thereby boost productivity. A scenario of supply-side surprises would be very beneficial to stock market performance.

Our main forecast most closely resembles scenario 3. There are strong reasons for believing that disinflationary forces will remain dominant, although they may look different from one country to another. But over the next couple of years, we believe **we will also see certain elements of scenario 4**. The long recovery periods of recent decades were characterised by upside surprises on the supply side, especially in the US. As a result, forecasts of slowdowns repeatedly proved incorrect. These experiences may be worth bearing in mind. Nor can we ignore the downside risks in scenarios 1 and 2. Although we currently do not foresee such major risks of aggressive policy errors or sudden inflation surges, **we still know rather little about how interest rate-sensitive economies actually are**, in a situation of pumped-up balance sheets and high asset prices. Although we do not believe that powerful inflationary impulses are imminent, we have seen many **examples of inflation showing up in a stage of the economic cycle that is inconveniently late** for central banks. Trying to limit the risks of ending up in a precarious situation, with an inflation surge at a stage when GDP growth is falling and asset prices are greatly overblown, appears to be a wise central bank strategy.

Robust second quarter GDP figures and an even stronger labour market **have confirmed our view of very rapid Swedish growth**. A continued weak currency is providing extra help to exports, while the domestic economy is mainly driven by housing construction. Expansionary monetary and fiscal policies are also helping boost consumption. Households are relatively cautious, however, while the record-high increase in public sector employment due to the recent refugee crisis is not fully reflected in measurements of consumption volume. We expect **GDP to grow by 3.2 per cent this year and by 2.8 and 2.4 per** cent in 2018 and 2019, respectively. While growth and the labour market are impressive, there are increased risks ahead as weak decision making power in the political system combined with poor coordination between different policymaking bodies contribute to growing imbalances.

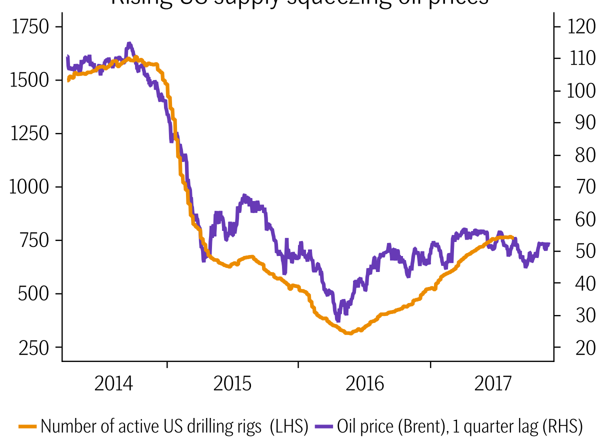
Nordics, GDP growth

Year-on-year percentage change

	2016	2017	2018	2019
Sweden	3.2	3.2	2.8	2.4
Norway	1.1	1.7	1.6	1.9
Denmark	1.7	2.3	2.4	2.4
Finland	1.9	2.5	2.2	2.2

Source: OECD, SEB

Rising US supply squeezing oil prices



Source: Bloomberg, SEB

Stable oil prices of USD 50-60/barrel

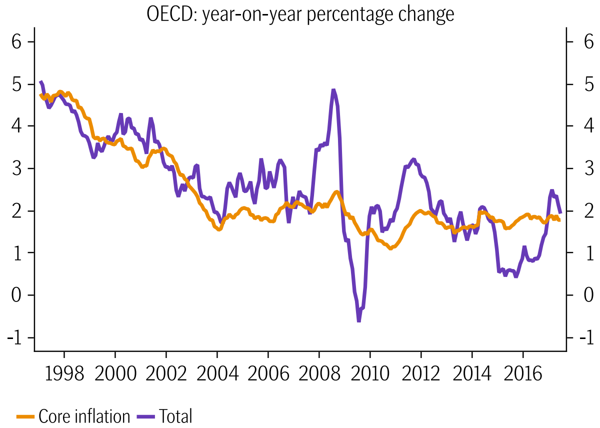
Rising global growth and production limits by "OPEC+" (the Organisation of the Petroleum Exporting Countries plus mainly Russia) have stabilised oil prices during 2017. These forces will continue to operate during 2018-19. Diminishing oil production in countries like China and Brazil will also contribute to better balance. Offsetting this is an increased shale oil supply in the US after a rebound in the number of active drilling rigs this past year. This places a ceiling on how much oil prices can rise. Overall, **we expect an average price of USD 55/barrel for Brent crude during 2018, roughly unchanged from 2017, followed by a cautious upturn to USD 60 during 2019**. Downside risks dominate and are connected to the rapid development of other energy types and the threat of a collapse in OPEC+ cooperation. Possible upside risks are connected to a sharp reduction in supply from Venezuela due to unrest and shortages of capital spending as well as a collapse in Libya's recently resumed production. Such a price upturn would be softened to some extent by such factors as large oil stockpiles, OPEC's reserve production capacity and very elastic US shale oil output.

Unexpectedly low inflation figures

Inflation in most countries has fallen below the levels prevailing at the outbreak of the 2007-2008 financial crisis, but so far this has not had any major impact on price and wage formation. The question of how the Phillips curve (which posits an inverse relationship between the unemployment level and the inflation rate) looks is analysed in various places in this *Nordic Outlook*, but short-term inflation movements are dominated by other forces. After a fairly sharp commodity-driven upturn in the overall consumer price index (CPI) during the second half of 2016, we have seen a downward trend since March. Total CPI in the 35 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) is now very close to core inflation, somewhat below 2 per cent. The perception that we have moved away from a zero inflation environment and deflation risks continues to be confirmed, **but cyclical wage-driven acceleration in inflation remains conspicuously absent**.

CPI and core inflation converging at close to 2 per cent

OECD: year-on-year percentage change



Source: OECD, Macrobond, SEB

Inflation has surprised on the downside mainly in the US, reaching a 2-year low in May. Expectations based on the inflation-indexed bond market have also fallen. The main Fed metric – core inflation using the personal consumption expenditures (PCE) deflator – has fallen especially far and is now at 1.5 per cent, but we believe this is partly due to temporary effects such as an intensive mobile phone service price war. We thus predict a rebound this autumn. After that, we are sticking to our **forecast that the increasingly hot labour market, with unemployment levels a bit below equilibrium, will lead to a gradual acceleration in pay increases** and set the stage for a broader upturn in inflation.

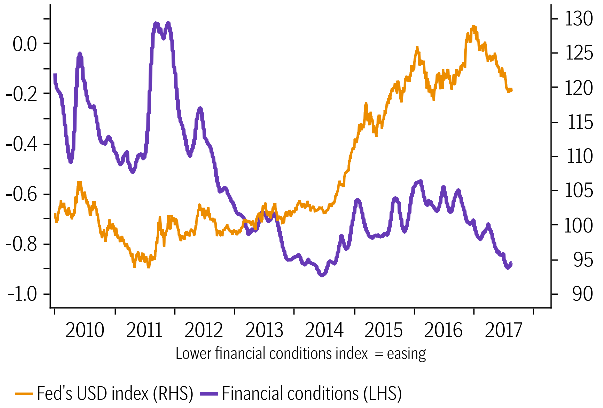
Euro zone inflation has also fallen. The harmonised index of consumer prices (HICP) reached 2 per cent for a couple of months, but fell to 1.3 per cent in July. Despite historically low unemployment in Germany, pay increases remain stable at around 2.5 per cent. In southern Europe, competitiveness continues to improve. In Spain, for example, pay increases are marginal. The year-on-year rate of pay increases in the euro zone as a whole is thus unlikely to exceed 2-2½ per cent towards the end of our forecast period. **We believe this will lead to an inflation rate of around 1 per cent**, which is in line with the level of underlying inflation in recent years.

Is the Phillips curve still alive?

In recent months a number of central banks have, with varying transparency (see earlier issues of *Nordic Outlook*), confirmed a **shift in monetary policy strategy**. This is because **the risk picture has changed**, mainly due to diminishing deflation and recession risks. There are reasons to keep pursuing expansionary monetary policy (see theme article: *"A very full punch bowl – the party continues"*, p. 16), but it is becoming ever harder to justify its more extreme forms. Yet central banks still face many difficult choices, due among other things to uncertainty about how well forecasting models can capture today's inflation processes. This increases the need for a more flexible interpretation of successful inflation targeting (see box). **The key role of the Phillips curve** as a policy anchor is often discussed; studies by BIS and the International Monetary Fund (IMF), like our own estimates, conclude that the link between unemployment and inflation/pay growth persists – though weakened. This gives central banks reasons to try to normalise their policies in **cautious steps. The real neutral short-term interest rate will remain low** during our forecast period as structural forces in the economy drive up the desire to save, suggesting cautious rate hikes. We also expect central banks to be **sensitive to currency appreciation**, which makes it harder for them to meet their inflation targets.

Fed monetary policy out of sync with its effects

USD and financial conditions. Index



Source: Federal Reserve Bank of Chicago, Federal Reserve, Macrobond, SEB

Impact of Fed policy is opposite of intention

The Fed will have to continue moving ahead with rate hikes on its own for an unusual long period. So far it has not been so easy for the Fed to evaluate the impact of the hikes it has implemented. The effects of monetary policy on the real economy occur via its impact on **financial conditions**, i.e. the yield curve, credit spreads, the stock market and exchange rates. After the Fed began hiking in December 2015, **financial conditions have instead – somewhat paradoxically – become more expansionary**. This is probably due to lagging effects from earlier expansionary policy, but also continued balance sheet expansion by central banks elsewhere. Despite recent low inflation figures, the strong labour market suggests that the Fed will continue its normalisation. In October it will begin a reduction of its USD 4.2 trillion monetary policy portfolio that is expected to continue for about four years. This will initially occur at a very cautious pace, then gradually speed up. In addition, the Fed will **hike its key rate again in December this year, carry out three further hikes in 2018 and one in 2019, which means that we will reach a federal funds rate of 2.50 per cent** at the end of 2019.

Central bank key interest rates

Per cent

	Today	Dec 2017	Dec 2018	Dec 2019
Federal Reserve (Fed)	1.25	1.50	2.25	2.50
ECB (refi rate)	0.00	0.00	0.00	0.50
Bank of England (BoE)	0.25	0.25	0.25	0.50
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.60	5.10
Riksbank (Sweden)	-0.50	-0.50	0.00	0.75
Norges Bank (Norway)	0.50	0.50	0.75	1.25

Source: Central banks and SEB

ECB will tighten policy despite low inflation

This month the ECB will approve a **reduction in its monthly purchases** of securities during the first half of 2018. Bond-buying will end in mid-2018, when the ECB also **hikes its deposit rate for banks from -0.40 per cent to -0.25 per cent (June 2018)**. During 2019 the ECB will take another step by **hiking its refi rate twice to 0.50 per cent**. If euro zone countries successfully increase their policy integration, it will decrease pressure on the ECB to hold a large securities portfolio. The **Bank of Japan** will be forced to continue bond purchases at an unchanged level of about JPY 90 trillion per year and keep its key interest rate at -0.10 per cent, since Japan is failing to reach its inflation target. In the UK, the **Bank of England** will keep its key rate unchanged at **0.25 per cent** until mid-2019, due among other things to great uncertainty about British withdrawal from the European Union (Brexit).

The motives for normalising Swedish monetary policy are becoming stronger, but so far the **Riksbank** continues to focus entirely on ensuring a sustained upturn in inflation. Although the bank is facing a need for large upward revisions in its forecasts of GDP, the labour market and to some extent inflation, a shift from its extreme policy is likely to take time. We are sticking to our forecast of a **first interest rate hike in April 2018**. We expect **two more hikes in 2018 and three in 2019, bringing the repo rate to 0.75 per cent at the end of 2019.** Partly due to a stable core inflation outlook, **Norges Bank** has now removed its easing bias. But limited long-term inflation prospects and a clear slowdown in housing prices are giving the Norwegian central bank room to await normalisation by its peers elsewhere in Europe. We believe that **its first interest rate hike will not occur until December 2018** and that the key rate will then be raised to 1.25 percent during 2019.

Rapid strategy shift by Bank of Canada

The July 12 key interest rate hike by the Bank of Canada (BoC) provided an interesting example of how rapidly a central bank can change its monetary policy strategy. The BoC cut its key rate to 0.5 per cent in 2015 but maintained an easing bias as late as last spring. But in June came an announcement that the housing market and rising household debt were growing sources of concern. **Risks of financial instability were highlighted, despite record-low inflation figures close to 1 per cent**. The dangers of uncomfortably low inflation were meanwhile downplayed. BoC Governor Stephen Poloz declared that the 2015 rate cuts had completed their job. Forecasts at the time of the rate hike indicated that the output gap will close as early as this year – a clear signal that more rate hikes in the footsteps of the Fed can be expected.

Comparisons between Canada and Sweden may be interesting since there are many similarities between the two countries, for example in terms of social welfare systems and export dependence. They also have in common the challenge of managing their own similar inflation targets in the shadow of dominant southern neighbour: the US and the euro zone/Germany. Since the financial crisis, there has been strong recovery.

In both countries the resource situation is now tight, and home prices have increased in a similar way over a long period. On the inflation front, the differences are bigger at the moment; while Canadian inflation has declined, Swedish inflation is showing an upward trend and has passed the 2 per cent target. **From a domestic perspective, Sweden's Riksbank should thus have greater motivation than the BoC to change its strategy**. On the other hand, the actions of the Riksbank can be defended because its large neighbouring central bank, the ECB, is behaving in an entirely different way than the Fed is doing at present. But the big question is whether the Riksbank has time to wait for the ECB or whether domestic conditions will become too extreme before that.

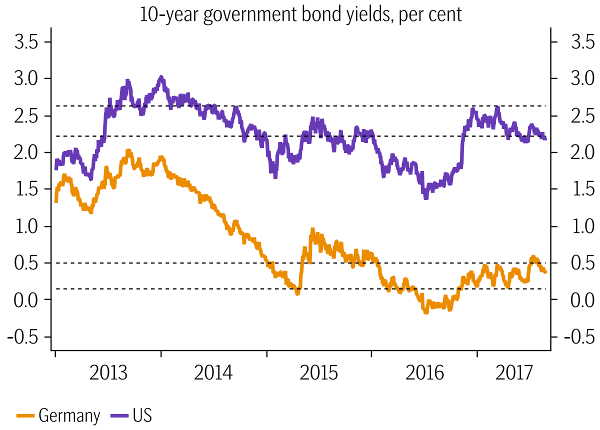
Yield upturn will resume this autumn

During most of 2017, long-term bond yields have moved within a limited range in an environment of above-trend growth but continued low inflation. However, recent movements have been affected by the reversal that has occurred in market perceptions about the euro zone and the US, respectively, in terms of political risk and relative growth and inflation outlook.

In the US, a renewed downturn in inflation has caused long-term yields to fall, even though the Fed has delivered key rate hikes. Lower expectations of fiscal stimulus measures, and to some extent the turbulence in the White House, have contributed to downward pressure. But as long as this does not interrupt the economic upturn, we expect the Fed to continue its gradual tightening.The Fed's focus today is on starting to shrink its balance sheet, but our forecast of Fed rate hikes is well above market consensus, which only discounts about two hikes until the end of 2019. This excessively cautious pricing suggests that US long-term yields will move upward as new key rate hikes approach. Looking ahead, downsizing the balance sheet will also help push yields higher. Fed studies indicate that the bank's bond purchases **pushed down 10-year yields by a total of 100-120 basis** points by the end of 2013, and we can expect some of this effect to be reversed during our forecast period. **By the end of 2019, we predict that 10-year US Treasury yields will be 3.10 per cent**, an increase of around 90 basis points from today. The yield curve, measured as the spread between 10-year yields and the key interest rate, will flatten further but remain positive throughout the forecast period.

Long-term US yields have fallen

10-year government bond yields, per cent



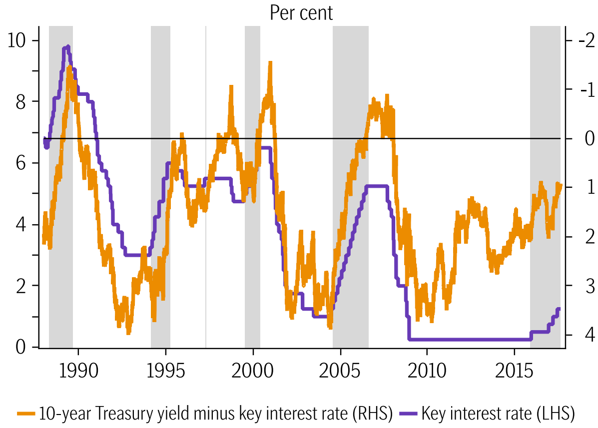
Source: Bloomberg, SEB

Because of robust economic growth, a more stable political landscape after the French presidential election and changing signals from the ECB, **in recent months 10-year German government bond yields have climbed to multi-year highs**. After the recent surge in the value of the euro, however, the ECB has had to take a step back, but the reasons why the bank should cautiously and gradually decrease its dose of stimulus during our forecast period remain in place. This suggests that bond yields will gradually move higher from today's extremely depressed levels. The yield curve (measured as the spread between a German 10-year bond and the key interest rate) is extremely flat in historical terms. This reflects the impact of the ECB's bond purchases and the mounting shortage of government securities available to buy. Decreased issuance requirements due to improved government finances are further helping to limit the supply of long-term government securities, especially in Germany. According to our forecast, ECB bond-buying will end in mid-2018, but the ECB's large balance sheet will continue to push down market yields even after that. **Ten-year German yields will climb to 0.90 per cent at the end of 2018 and 1.30 per cent at the end of 2019**: up 90 basis points from today's levels. This forecast implies that the 10-year spread against the US will remain historically wide, but down from a peak of nearly 240 points at the end of 2016.

Swedish government bond yields have remained low and the spread against their German equivalents has narrowed somewhat, despite Sweden's strong economic growth and relatively high inflation. The Riksbank's bond purchases combined with new cuts in National Debt Office issue volumes will further limit the supply of Swedish government securities this autumn, putting further downward pressure on bond yields. We believe the 10-year government bond yield spread against Germany will shrink to 25 bps late in 2017, then rebound as Swedish key rate hikes approach in the spring of 2018. As the Riksbank narrows the key rate gap with the ECB, yield spreads against Germany will increase to 60 bps by the end of 2019. **Ten-year bond yields will thus increase to 1.90 per cent in 2019, from just over 0.7 per cent today**.

Our forecast of higher global yields should support the outlook for Norwegian government bonds (NGBs) on a relative basis. The 10-year yield spread against Germany tends to tighten when yields are rising. NGBs are also attractive for yield-seeking investors, since they trade with a large discount to their German peers. We expect **the 10-year yield spread against Germany to narrow by about 20 bps by the end of 2017** before it **stabilises around 85-90 bps** as Norges Bank starts to normalise interest rates.

US: Flatter curve as Fed resumes rate hikes



Source: Federal Reserve, Macrobond, SEB

EUR/USD rate will eventually approach 1.25

The significant upturn in the EUR/USD exchange rate during the past 4-5 months to current levels of around 1-17-1.18 has occurred in phases. Early in 2017 the market focused on the low euro zone resource utilisation and political risks related to European elections, but in the US hopes about "Trumponomics" helped drive exaggerated expectations of continued Fed rate hikes. Emmanuel Macron's victory in the first round of the French presidential election in late April **marked a turning point by largely eliminating the euro's political risk premium**. Quite soon after that, the ECB also began laying the groundwork for a less expansionary monetary policy, so the first phase was dominated by euro-positive changes. In the past few months, dollar-negative factors have dominated, despite the Fed's rate hike in June. Above all, because of low US inflation figures the market is now expecting only about two more Fed rate hikes during 2017-2019, but diminished hopes of fiscal stimulus measures have also played a part. However, the general turbulence surrounding the Trump administration has been less important, as indicated by the apparent lack of any confidence effects on the stock or credit market. In general, we believe that the **"carry" theme (buying high-interest currencies and selling low-interest currencies) is now on its way back** into the foreign exchange (FX) market to some extent, given a macro environment with good growth, decent risk appetite, low volatility and a surfeit of liquidity. This favours various emerging market (EM) currencies at the expense of funding currencies like the EUR and Swiss franc. **In such an environment the USD is also likely to regain lost ground against the euro.** Fundamentals such as central bank expectations (2-year spreads) and relative stock market performance still favour the USD. When the market again begins to boost its Fed expectations in line with our forecast, we also believe that the EUR/USD rate will move down towards 1.14 next spring. Because the current strength of the euro comes primarily from speculative flows, profit-taking this autumn will also have a positive impact on the USD.

But further ahead we expect the EUR/USD rate to continue towards 1.25. Although we have rather modest expectations about Macron's delivery of structural reforms, France – along with various southern European countries – is still on the right track. Combined with the powerful German economy, euro zone fundamentals seem relatively strong compared to the US and UK. **A lower trend in the inflation rate compared to the US also suggests that the EUR/USD equilibrium exchange rate is on its way up to 1.20**. When the ECB more clearly signals that the key rate hikes are starting to move closer in mid-2018 the EUR/USD rate will begin climbing, reaching 1.20 at the end of 2018 and 1.25 at the end of 2019. Considering the strong external balance of the euro zone, especially Germany, we believe that the ECB will accept such a movement.

Strong euro out of sync with rate expectations

Source: Bloomberg, SEB

The British pound is clearly undervalued in the long term, but the Brexit process still makes its future trend uncertain. **We believe that the pound will remain weak for another while**. If EU withdrawal negotiations run into severe trouble, a further depreciation is likely. Given its valuation, the pound should nevertheless recover a bit further ahead. Our forecast is that **the EUR/GBP exchange rate will be 0.89 at the end of 2018 and 0.85 at the end of 2019**. The pound's recovery against the dollar will be more noticeable, with the GBP/USD rate moving towards 145-1.50 at the end of 2019.

Sweden's economic strength and higher inflation have contributed to a slight krona appreciation, but so far market players seem to be relying on the Riksbank to stick to its ultra-loose monetary policy. Assuming above-target inflation in the immediate future combined with increasingly evident bottleneck problems, expectations of a policy change relatively soon will make the krona stronger. **We believe the EUR/SEK exchange rate will be around 9.30 at the end of 2017** as the market begins in earnest to ramp up its expectations of key rate hikes, but because the SEK has appreciated a lot in terms of the KIX trade-weighted index – mainly due to dollar and pound weakness – this will slow downward potential for the EUR/SEK rate. We believe that **the EUR/SEK rate will reach 9.00 by the end of 2018 but then climb to 9.20 by the end of 2019 as the euro strengthens on the global scene**. Given our long-term forecast of a weaker dollar, the USD/SEK rate will fall as low as 7.50 at the end of 2018, then decline a bit further in 2019.

The Norwegian krone has depreciated a bit so far this year, despite strong fundamentals. We expect the more robust economic outlook to help bring about a gradual rebound ahead, but a cautious outlook by Norges Bank combined with relatively low oil prices suggest that the recovery will be gradual. **We expect the EUR/NOK exchange rate to reach 9.15 and 8.80 by the end of 2017 and 2018, respectively**.

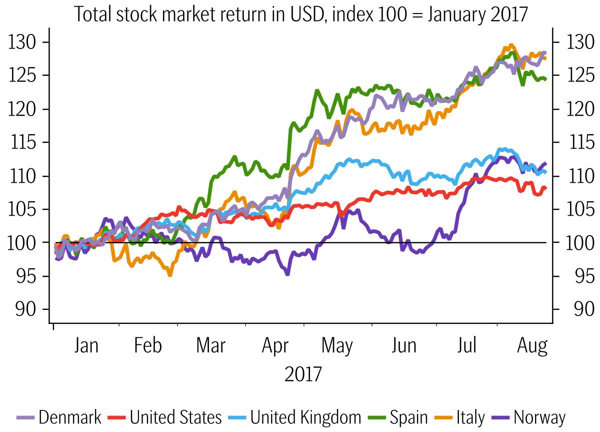
Rising profits continue to sustain shares

Accelerating economic growth and central banks providing large quantities of cheap liquidity are creating a continued favourable stock market climate. In the US, share prices set new historical records this summer. **Decreasing political risk premiums after the French presidential election and positive macroeconomic data have breathed new optimism into the European stock market**. Large exchange rate movements are affecting equity indices. The MSCI World index has returned more than 10 per cent so far this year, but translated into euros instead of USD, returns fall to a couple of per cent. Euro appreciation has pulled down European indices compared to American ones, but translated into the same currency, US stock exchanges have lagged behind so far this year. In particular, stock exchanges in the euro zone periphery have benefited from reduced political risk premiums.

Second quarter corporate reports generally surpassed high expectations, most clearly in the US. Share price upturns are thus being sustained by good earnings growth. **Improved margins have been the main factor behind better earnings, while sales are growing at a modest pace**. US profit margins are now at a record-high 11 per cent, while European companies have a bit further to go before reaching earlier peaks. Because sales growth has not really been persuasive, full-year 2017 earnings expectations have been dialled back a bit in Europe, while American expectations have been stable. In both regions, earnings growth of 11 per cent is expected in 2017. Along with geopolitical tensions on the Korean peninsula and political turbulence in the US, this has led to a slight downturn in share prices in recent weeks. If the situation deteriorates, the stock market will have difficulty ignoring these sources of concern, at least in the short term.

Reduced political risk premium helps European periphery

Total stock market return in USD, index 100 = January 2017



Source: MSCI Barra, Macrobond, SEB

In light of our robust growth scenario, we believe that corporate sales volume will have the potential for upside surprises. Rising profits combined with more subdued share price performance have also caused valuation figures to fall somewhat from historically high levels. We thus anticipate rising equity prices for some time ahead. **Given the degree of maturity in the economic and stock market cycle, valuations should still lead to caution**. During the next few quarters, share price increases in line with or just below earnings growth appear reasonable.

In the Nordic countries, **the stock markets in Denmark and Finland have been especially strong**. The Finnish market has benefited because the economic has now put the recession years behind and because the Russian economy is showing some stabilisation. In Denmark, the health care and transport sectors, which weigh heavily in the stock market, have recovered well during 2017. Shipping and transport, along with telecoms and technology, are the Nordic sectors that have provided the best returns so far this year, while consumer goods and especially oil have lagged behind.

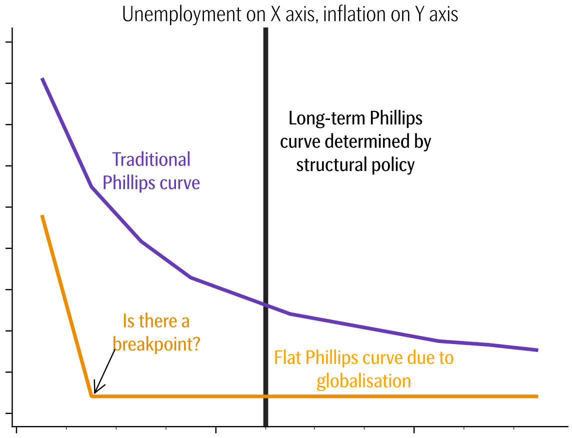
Nordic stock market valuations are 12 per cent higher than their 10-year historical average, but this can be explained by very low interest rates. SEB's aggregate Nordic earnings estimate **indicates that nearly 10 per cent earning growth this year will be followed by more than 14 per cent growth next year and around 10 per cent in 2019**. Combined with valuations in line with long-term equilibrium, this suggests a continued upturn in prices, but individual companies may have a large impact on aggregate earnings. A single company, Statoil, accounts for nearly half of expected earnings growth this year.

- **The Phillips curve has often been controversial in economic policy discourse**
- **Lower sensitivity to tighter labour market situations, especially for wages and salaries**
- **In Sweden, the Phillips curve broke down after recent financial crises**
- **Closed labour market gaps will open the way for real-life tests, especially in Sweden**

The Phillips curve has been a key concept in both theory and practice since it was introduced in the 1950s. It shows how inflation changes when unemployment changes. Its logic is simple: when the labour market tightens, companies are forced to pay higher wages and salaries to attract labour, which in turn leads to higher inflation in the economy. Wage growth is also expected to accelerate in earnest when unemployment is below equilibrium (NAIRU). Historically, that is also the time when central banks tighten their monetary policy in earnest, to keep a wage-price spiral from taking hold in the economy.

Shape of Phillips curve is one focus of policy debate

Unemployment on X axis, inflation on Y axis



Source: Macrobond, SEB

Controversial as early as the 70s

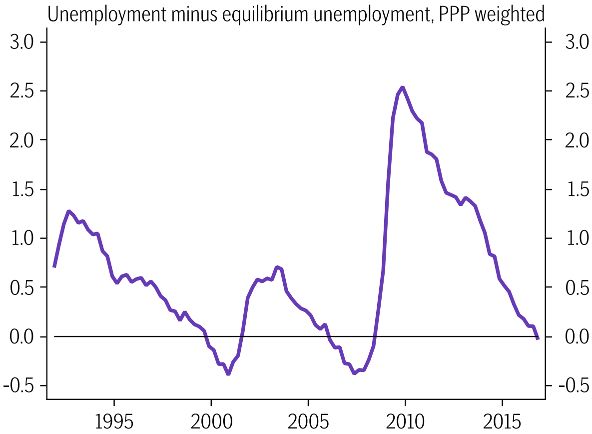
The Phillips curve has repeatedly been a focus of economic policy discourse and has had to withstand various kinds of attacks. In the 1970s and 80s the question concerned whether a lasting reduction in unemployment was possible in exchange for higher inflation, as the traditional Phillips curve indicated. Critics maintained that expansionary and ambitious fiscal policies could only temporarily push down unemployment. When economic players learned to see through the effects, inflation expectations rose in a way that made the policy ineffective. In the long term, the Phillips curve was vertical at the "natural" unemployment level determined by structural factors and could thus only be affected by structural policy. A period of both high unemployment and high inflation ("stagflation") was interpreted as the result of a fruitless struggle to push down unemployment with the help of stimulus measures and acceptance of inflation.

Closed labour market gaps test relationship

After the economic policy framework was reformed in the 1980s and 1990s, with the creation of independent central banks and inflation targets, the situation changed. Inflation has gradually fallen and central banks have generally been so successful in creating confidence in their targeting that fluctuations in inflation have nearly disappeared. This has again raised the question of whether the relationship between unemployment and price and wage formation has changed. But today the question is instead whether the Phillips curve has become horizontal, firmly nailed to the inflation target. Now that a weighted average shows that the labour market gap is now closed in the G7 countries, we are facing **the true test of whether historical relationships still apply**.

The labour market gap is closed in the G7

Unemployment minus equilibrium unemployment, PPP weighted

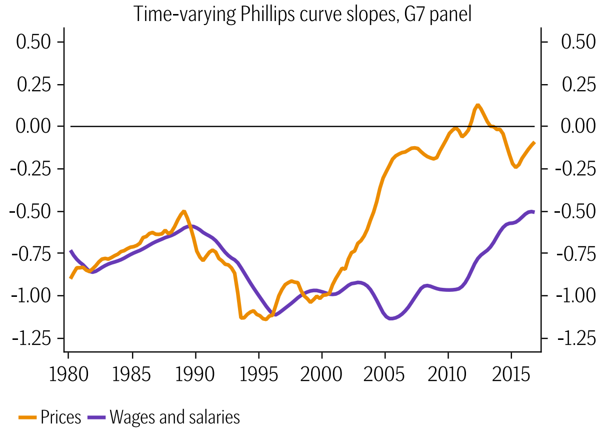


Source: Macrobond, SEB

Our empirical estimates also indicate that the relationship has clearly weakened. Looking at a panel of G7 countries, the relationship between labour market slack and inflation has almost been wiped out in the past 20 years. **The relationship between (productivity-adjusted) pay and unemployment gaps** has also decreased over the same period but **is still statistically significant** according to our calculations. In other words, the Phillips curve is flatter nowadays. The chart below shows that when the unemployment gap shrinks by 1 percentage point, pay (measured as unit labour costs adjusted for productivity) rises by about 0.5 percentage points. Around the turn of the millennium, the effect between wages and unemployment gaps was about twice as large. There are many explanations for the above result. As already mentioned, the increased credibility of central banks may have led to inflation targets becoming self-fulfilling and classical relationships may have lost their relevance. Secular deflationary forces have probably also assumed a more prominent role due to globalisation; studies show an **ever-increasing correlation between global and country-specific unit labour costs**. Greater global labour market mobility and the increased supply of labour in emerging market (EM) economies are one explanation. Technological advances, with trends towards increased robotisation and digitisation as prominent examples, may also have contributed to reducing both the negotiating strength of labour and the pricing power of companies.

Wages more sensitive than prices as unemployment falls

Time-varying Phillips curve slopes, G7 panel



Source: Macrobond, SEB

In light of this, **our forecast is that pay will rise more rapidly within the G7 as labour markets continue to tighten**. Since wages and salaries are such a major part of production costs, especially in the service sector, it is natural to assume that rising pay levels will also push inflation somewhat higher. **But it is not set in stone that pay rises wages will also cause prices to increase faster**. If pay levels can be justified by rising productivity, unit labour costs need not increase in a way that forces companies to raise prices in order to remain profitable. It is also conceivable that competitive pressure is so keen that companies will find it hard to pass on their cost increases in the form of higher prices. At least for a while, we would then see margins being squeezed, with negative consequences for share prices.

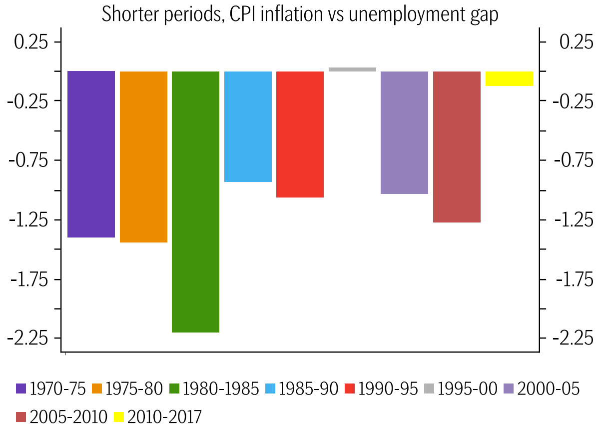
Weakened relationship in Sweden, too

We have also looked closely at the pattern in Sweden. Viewed over the past 30 years, we actually find a fairly strong relationship between inflation and unemployment in the Swedish data, although there are big differences between time periods. When Sweden introduced its inflation target in the mid-1990s, for example, the relationship broke down for a while. This is because it took time for the Riksbank to achieve credibility; the 1995 wage round also resulted in high pay increases even though unemployment remained high after the deep crisis of the early 1990s. When wage formation was then reformed in the late 1990s, among other things due to the 1997 Industrial Cooperation and Negotiation Agreement and the expanded remit of the National Mediation Office, the relationship reappeared.

Since 2010, the relationship again seems to have been interrupted. The ever-tighter resource situation – both according to the labour market gap and the Riksbank's RU indicator – has not led to any significant acceleration in pay increases and inflation. There may be several reasons for this. The Swedish labour market has become more open. In particular, the **influx of labour from European countries with higher unemployment and/or lower pay levels** has been rather extensive. Meanwhile the climate of Sweden's wage rounds has changed. During the preceding decade the level of pay increases agreed in collective contracts was affected to some extent by the economic situation. This was especially clear from the relatively high pay hikes achieved in the 2007 wage round. But in recent years, contracts with low pay increases have been concluded amid fairly overheated labour markets. Even though the Riksbank, at least during one period, appealed to labour and management to respect the role of its inflation target as an anchor for wage formation, the two sides have attached ever-greater importance to following the low rate of pay increases in other countries.

Sweden: Big variations in Phillips relationship over time

Shorter periods, CPI inflation vs unemployment gap



Source: Macrobond, SEB

But Sweden, too, will now enter a crucial test situation as bottleneck problems grow, especially labour shortages. Among private employers, this is especially true in the construction and information technology (IT) sectors. Meanwhile the public sector has difficulty recruiting employees in most of its key areas. The country's highly centralised wage formation makes the situation worse by blocking relative wage and salary changes that might increase labour mobility and improve the potential for recruiting people to overheated sectors. The question is now to what extent the red-hot labour market will lead to higher wage drift (pay hikes above contractual levels). Most forecasts imply a cautious acceleration in pay increases, but it is difficult to completely ignore the structural changes that our estimates of a flatter Phillips curve clearly demonstrate. Although the margins are small, pay increases over the next couple of years will probably not reach a level that is fully compatible with the Riksbank's 2 per cent inflation target.

Theme: A very full "punch bowl" – the party continues

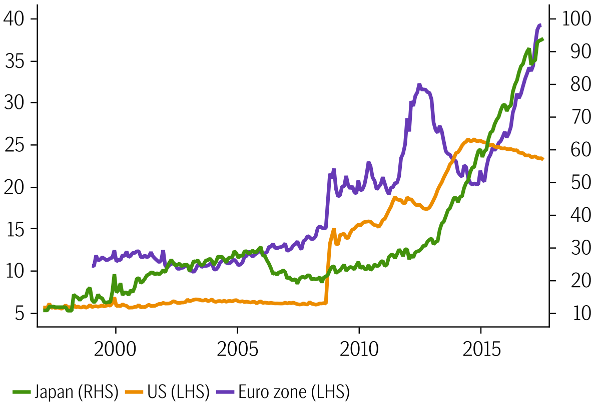
- **New strategies for money-printing policy, but gigantic liquidity surplus persists**
- **Monetary policy will not jeopardise economic growth or asset prices**

The world is swimming in money. After the 2008 Lehman Brothers collapse, central banks have "printed money" and created a gigantic surplus[1] of about **15 trillion dollars**, equal to **20 per cent of global stock market capitalisation**.

There are good reasons to pursue expansionary monetary policy, but it is increasingly hard to justify its more extreme forms, such as negative or zero interest rates and large bond purchases (= money-printing). This is because **the risk picture has shifted**: the risk of deflation and recession has decreased to a minimum in many economies, and thus also globally.

Large asset purchases and sharp monetary expansion

Central bank balance sheets. Per cent of GDP



Source: Bank of Japan, Fed, ECB, Macrobond, SEB

At last, a change in monetary policies

In 2017 it has become increasingly clear to markets that several central banks are on their way towards **changing monetary policy strategy**. This situation actually began emerging as early as 2016 (see earlier editions of *Nordic Outlook*) but has now strengthened. Sweden's Riksbank, Norges Bank in Norway and the ECB have chosen to declare that new interest rate cuts are unlikely. The Bank of England is buzzing about a rate hike, and the Bank of Canada has already raised its key rate.

This change of strategy is **not** – as many want to believe – **centrally orchestrated**. The explanation is simply that the risk picture has simultaneously changed in many economies and the global economy: in a number of major economies, there is full employment today. But three central banks continue to print money: aside from the **Riksbank** also the **European Central Bank** and **Bank of Japan**. The Riksbank is expected to end its securities purchases in December 2017 while the ECB will continue them in 2018, though at a slower pace. The BOJ will continue purchases in 2019 as well, due to difficulty pushing inflation above 2 per cent for a sustained period.

[1] We have calculated the surplus as the difference between the total change in global central bank balance sheets, for example due to purchases of securities, and the bank reserves growing economies need.

Central banks, punch bowls and monetary policy

The simile between a punch bowl and expansionary monetary policy goes back to a speech by then-Fed Chairman William McChesney **Martin** in late 1955. His message was that the often unpopular task of a central bank is to take away the punch bowl (stimulus policy) just as the party is really warming up. The current head of the New York Fed, William **Dudley**, referred to Martin's simile in a March 2017 speech describing US monetary policy thusly: *"I don't think we are removing the punch bowl, yet. **We're just adding a bit more fruit juice**."*

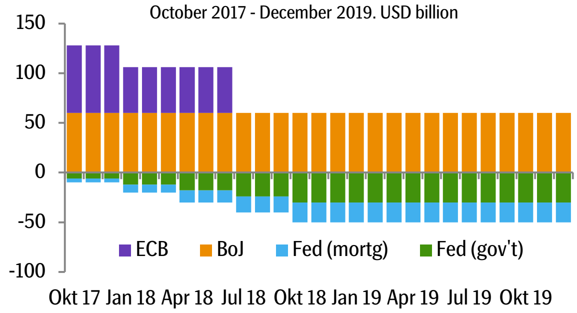
Nervous, volatile asset markets

The idea that central banks will provide less money (ECB) or empty the system of surplus money (Fed) has made stock markets more volatile and has occasionally pushed long-term yields higher, but there are **three good reasons to try maintaining a sober view of what is happening**:

1. The Fed is set to reduce its bond portfolio by **USD 10 billion per month** in October-November; this is 0.7 per cent of its USD 4.2 trillion portfolio and 0.2 per cent of global money-printing in recent years. Meanwhile, the Bank of Japan and ECB will add new liquidity equivalent to more than USD 400 billion. **Net global liquidity will thus increase by a full USD 355 billion** during the fourth quarter of 2017, even though the Fed will begin trimming its balance sheet in October after a decision at its September policy meeting.

Forecast: Changes in central bank liqudity

October 2017 - December 2019. USD billion



Source: ECB, Bank of Japan, Fed, Macrobond, SEB

2. The market should instead focus more on how monetary policy **changes financial conditions**: its overall impact on interest rates and yields, exchange rates, stock markets, credit spreads etc., as well as how **the real economy reacts** and strengthens. Despite four rate hikes so far and signals that it will decrease its monetary policy portfolio, **events so far have**

gone against the Fed's policy intentions: a weaker dollar, higher share prices, low long-term yields and depressed credit spreads. In practice this gives the Fed power, arguments and opportunities to continue its normalisation process, thus making room for rate cuts in the next recession, for example.

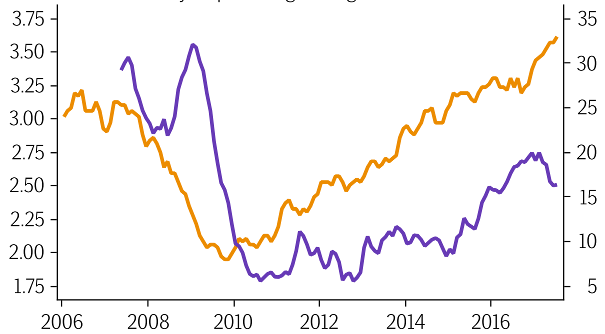
3. Although it will be a **long time before** much **net shrinkage** in balance sheets occurs – see above chart – the money supply in the system does not need to decrease. If central banks decrease total bank reserves, that also reduces the "monetary base", but the banking system can offset this by increasing its deposits and lending, via the **multiplier effect**. This **reduces the decrease in liquidity** that central banks initiate, and thus also the impact on financial conditions and asset markets.

Complex situation confuses central banks

An increasing number of labour markets around the world appear to have **full or near-full employment**, yet wage hikes show few signs of acceleration. There are also few indications of commodity and energy price upturns, though it is positive from an inflation perspective that a growing number of businesses now seem to see greater potential to raise prices.

Tightening labour markets, but sluggish pay increases

Year-on-year percentage change and net balance

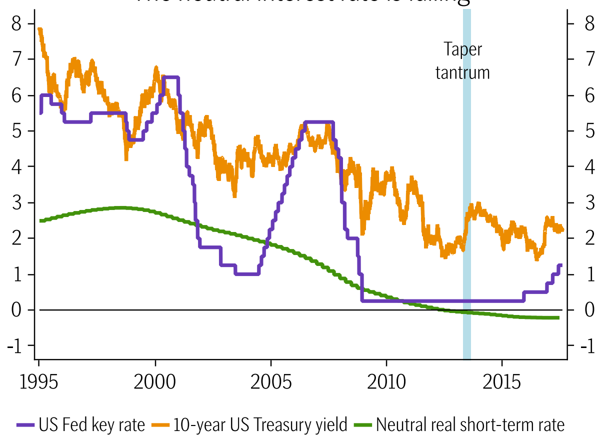


Source: National Federation of Independent Business, U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

Policy challenges		Comments
1	Excessively crude, mechanical monetary policy behaviour rules	For example, Taylor rules and Phillips curves no longer seem to work as policy benchmarks
2	Asymmetric risk: hard to reverse course if normalisation moves too fast	Monetary policy manoeuvring room is sharply limited in case of any policy mistakes
3	The independence of central banks is under scrutiny by politicians	Discussion is under way in some countries on central bank mandates and post-2008 policy
4	Relationships and interaction with other economic policy fields	Uncertain fiscal/macroprudential policies also create uncertain monetary policies
5	The Fed's monetary policy is the epicentre of global economies as well as financial markets	US monetary strategy plays a major role for the manoeuvring room of other central banks

Transformative technologies – such as digitisation and automation – along with globalisation are entrenching "lowflation". Meanwhile changing conditions for saving and investment patterns are pushing down the neutral price of money/interest rate. This has been a recurrent theme in *Nordic Outlook*. One policy conclusion from this ongoing phenomenon is that the actual expansiveness of monetary policy (see chart) is decreasing, becoming a drag on central bank normalisation steps. But some central banks, especially the Fed, foresee a gradual rise in the neutral price of money.

The neutral interest rate is falling



Source: Macrobond, SEB

A strongly dependent world

In recent years, monetary policy in many countries has been a **giant experiment on the way to zero and negative interest rates** and swelling balance sheets. And it will **remain an experiment on the way out** of this unconventional policy. Our assessment is that the global economic recovery will continue, but it is worth remembering that only when monetary policy has reached a more normal situation and when the economy is self-sustaining can we definitively declare the global recession and its severe repercussions over.

Milton Friedman's ideas seen in a new light

Central banks enjoy being monetarists. They have embraced renowned economist Milton Friedman's thesis that "*inflation is always and everywhere a monetary phenomenon*". This partly explains why they have been printing money at top speed in recent years. But more and more economists and central bank representatives now seem prepared, if not to reject, at least to qualify the idea that money leads to inflation.

Despite all the challenges reported above, our main scenario is still that **the world's central banks will continue to slow down and reverse their extreme policies**. As at all turning points, there is a risk of increased uncertainty and volatility. But we must keep cool and see the forest for all the trees: global monetary policy will remain sharply expansionary for a long time to come. In other words: **the party will continue – the punch bowl is out there, filled with USD 15 trillion**, but now small splashes of fruit juice are being added. This will hopefully reduce the risk of a hangover. Looking ahead, monetary policy cannot be blamed for poorer growth or falling share prices. If these things occur, we must find other explanations.

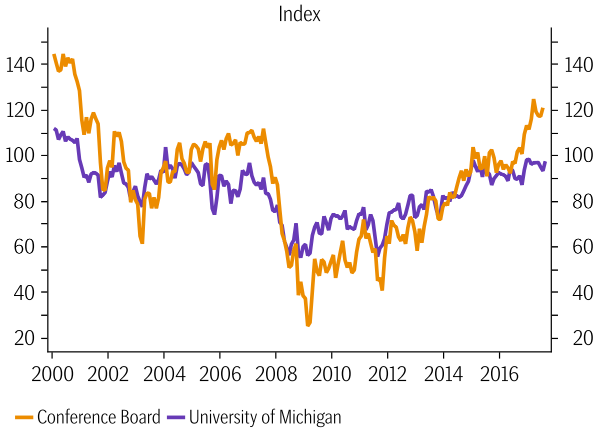
Decent growth despite political turbulence

- **Economy is resilient to political turbulence, but no tax cuts will be enacted in 2017**
- **Recovery after a weak start**
- **Labour market is increasingly tight…**
- **…but low inflation is a Fed dilemma**
- **One more Fed hike this year, three in 2018**

The continued **political turbulence surrounding the Trump administration is not significantly affecting the economy**. As expected, growth accelerated in the second quarter after a weak first quarter, when GDP grew at a 1.2 per cent annualised rate. This Q2 rebound was largely driven by private consumption, and growth accelerated to 2.6 per cent. There are many indications that the economy will keep growing at a decent pace in the next few quarters. Most sentiment indicators have retreated from last spring's peaks but remain at historically high levels. Because of the growth rebound, combined with somewhat weaker indicators, the earlier wide divergence between soft and hard data has narrowed. **We expect GDP to increase by 2.2 per cent in 2017 and by 2.4 per cent in 2018**, but we foresee a deceleration in **2019** due to rising interest rates and worsening bottleneck symptoms. GDP growth will reach only **2.0 per cent**, a bit above trend.

Consumer confidence remains high

Index



Source: University of Michigan, Conference Board, Macrobond, SEB

The Federal Reserve (Fed) will continue its monetary policy normalisation. Our main scenario is **one more key interest rate hike in 2017**. We also expect the central bank to begin decreasing its balance sheet and phasing out its bond holdings, starting in the fourth quarter. During **2018 we expect three key rate hikes**. When growth decelerates **in 2019**, we believe that the Fed will be content with one hike, with the key rate standing at **2.5 per cent** by year-end.

Political turbulence stopping fiscal stimulus

Our view in the May issue of *Nordic Outlook* that expansionary fiscal stimulus would be almost non-existent in 2017 has received further support. Although the Trump administration sacrificed much political capital in efforts to replace the Affordable Care Act (Obamacare), it appears to have failed. The administration is also still hampered by lack of political experience, slowness in filling key positions and legal disputes related to Russia's interference in the US presidential election. Another source of concern is that the federal **debt ceiling** soon needs to be raised. Despite Republican majorities in Congress, tough negotiations seem likely since conservative Republicans oppose raising the debt ceiling in the absence of spending cuts. Democrats seem determined to take advantage of the situation in order to push through their own policies. We believe the debt ceiling will ultimately be raised, but the conflict will cause **further difficulties for the administration in pushing through its political programme**.

It is now very unlikely that any **tax cuts** will be enacted during 2017. There is also a great **risk that they will also fail to materialise during 2018** as the November 6 congressional election moves closer. Donald Trump's inability to push through reforms increases the risk that he will implement protectionist measures in order to demonstrate his capacity for action and strengthen his popularity and that of the Republicans ahead of the autumn 2018 vote. There may be some indications of what may happen when the US ramps up its negotiations with Canada and Mexico on the North American Free Trade Agreement (NAFTA) this month.

Consumption not dependent on tax relief

Several interdependent factors are helping to sustain household consumption. Given continued labour market improvement, more and more people have jobs, though pay increases remain moderate. Meanwhile household wealth is growing as share prices reach new records and home prices climb at a healthy pace. We predicted earlier that the household savings ratio would fall in 2017 and 2018. As part of the yearly review of the US national accounts, household incomes were revised lower while consumer spending was revised higher. This led to a **significant downward revision of the savings ratio**, from just below 6 per cent to 4.9 per cent in 2016. However, this will not necessarily have a major negative impact on household consumption. Reduced saving is probably a consequence of low interest rates, while household assets are at record levels. The savings ratio is now slightly below 4 per cent. Though room for further declines has decreased, we believe the savings ratio will bottom out at around 3 per cent in 2018. Overall, there is potential for household consumption growth to remain healthy even if the Trump administration fails to push through tax cuts. Our forecast is that **consumption will increase by 2.5 per cent in 2017 and by 2.7 per cent in 2018**, but due to rising interest rates and a stagnating labour market, the increase in consumption will slow to **2.1 per cent in 2019**.

Capital spending will help sustain growth

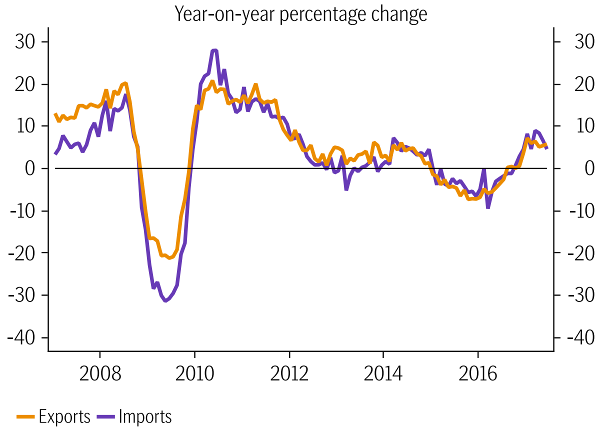
Capital spending was a bright spot in the weak first quarter but slowed down in the following quarter due to a fall in housing investments. These are expected to rebound, however, and further ahead demographics will generate good demand for housing. A sharp rise in activity in the oil and mining sectors provided support to investments during the first half of 2017 but lower oil prices are now expected to curb future commodity company investments.

Trump's efforts to strengthen US manufacturing will not have much impact, but industrial production is benefiting from the weaker dollar and stronger global economic conditions. Since industrial production has generally been robust, capacity utilisation continues to climb slowly, thus also stimulating capital spending. We believe business investments will increase by **3.8 per cent in 2017 and 3.1 per cent in 2018**.

The depreciation of the dollar and the improvement in global economic conditions have also helped sustain **exports**, which have **climbed significantly during 2017**. Imports have also recovered. We expect exports to continue improving strongly. We believe that net exports will make a neutral contribution to GDP growth in 2017 after having been negative in recent years.

Exports and imports have accelerated

Year-on-year percentage change



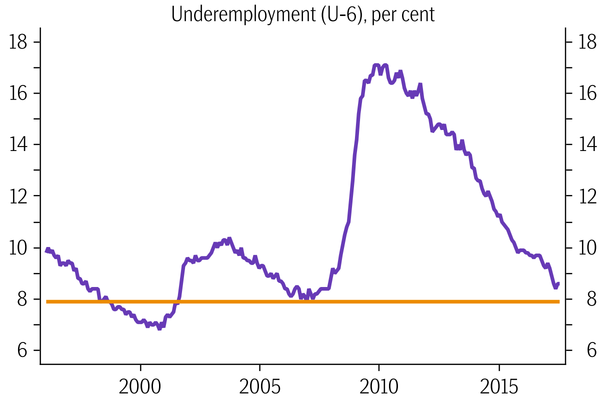
Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

More jobs but no wage acceleration

The labour market keeps getting stronger and job growth is continuing at a brisk pace, especially in light of the already tight situation. During 2017 payrolls have climbed by an average of about 184,000 per month, well above the roughly 70-100,000 jobs needed to keep pace with population growth. Unemployment has fallen to a level below most estimates of a long-term equilibrium rate; in July it was 4.3 per cent, compared to 4.9 per cent a year earlier. **Unemployment has fallen faster than anticipated** and is expected to drop to 4 per cent by the end of 2017. It will thus fall further below the non-accelerating inflation rate of unemployment (NAIRU), which the Fed estimates at 4.6 per cent. Indicators such as new vacancies and "quits" show continued labour market improvement. The situation resembles the one prevailing before the financial crisis. The broadest unemployment metric, U-6, has fallen sharply to 8.6 per cent but is still above its low of 7.9 per cent in December 2006, signalling that there is still a certain amount of slack. Meanwhile the participation rate has remained close to 63 per cent, about 4 points below its peak in 2000. This indicates that the rate has some potential to rise. At the same time, demographic headwinds and exclusionary tendencies caused by the economic crisis suggest it will hardly be possible to achieve earlier peak levels again. Although the supply side has provided upside surprises during earlier long US expansionary phases, especially in the 1990s, our overall view is that **the amount of slack is now small**.

The broadest unemployment metric indicates some degree of idle resources

Underemployment (U-6), per cent



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

Wage formation remains relatively insensitive to the strong labour market. Despite low unemployment and a rising share of businesses reporting difficulty filling vacancies, the rate of pay hikes has not accelerated much since 2015. Yet we are sticking to our view that a continued strengthening of the labour market will gradually begin **showing up in rising pay as room for job growth becomes smaller and smaller**. We expect the rate of pay increases to rise gradually to 3.0 per cent in 2018 and 3.5 per cent in 2019.

Temporary factors have slowed inflation

Unexpectedly weak inflation in recent months has increased market scepticism that the Fed will continue to hike its key interest rate. After an acceleration around the end of 2016, CPI inflation has again slowed in recent months, reaching 1.7 per cent in July. The main explanation is falling energy prices. As full-year averages, **we expect inflation to end up at 2.0 per cent in 2017, 1.8 per cent in 2018 and 2.1 per cent in 2019**.

But more worrisome for the Fed is that **core inflation has also fallen**, reaching a two-year low in May. Temporary factors explain a relatively large proportion of the downturn. For example, an intensive mobile telephone service price war had a clear impact. The Fed's main metric, core inflation using the personal consumption expenditures (PCE) deflator, assigns a relatively high weight to drug prices and health care, so a sizeable inflation slowdown in these fields has had a big impact. There is now a risk that this slowdown in price increases will spread more widely, but our assessment is still that a tighter resource situation will create upward pressure on both wages and prices. It will take until 2018, though, before core inflation has recovered. **Our forecast is that core PCE will climb by 1.6 per cent in 2017, 1.7 per cent in 2018 and 1.9 per cent in 2019.** In June, the Fed revised its PCE inflation forecast for 2017 lower but left its 2018 forecast unchanged.

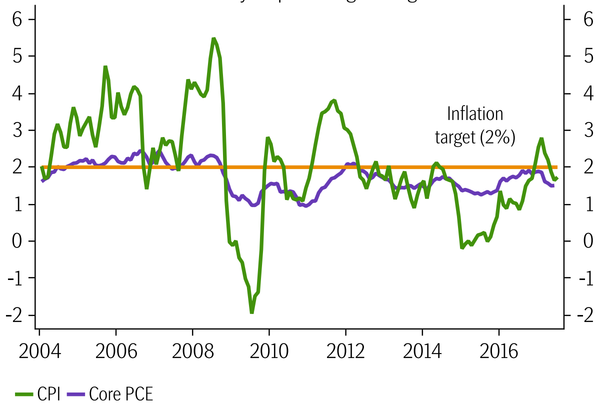
Inflation expectations according to the University of Michigan survey have been relatively stable in 2017 at around 2.5 per cent in a one-year perspective, which is somewhat lower than in 2016. But measured as **break-even inflation**, inflation expectations have fallen since the beginning of 2017 and in July stood at **1.6 per cent in a five-year perspective**.

Fed's dilemma is low inflation

The Fed's dual mandate related to inflation and employment is now creating both dilemmas and flexibility. The **Fed** has clearly communicated that it **believes it has now achieved its employment target**, but after declining in recent months, inflation has created a dilemma. Although most Federal Open Market Committee (FOMC) members express confidence in the Phillips curve's association between a tighter labour market and higher inflation, there **is increased uncertainty about achieving the inflation target**. But our own assessment is that although the Phillips curve has become flatter, it is still consistent with a continued tightening of American monetary policy (see "The US Phillips curve is consistent with the Fed's monetary policy normalisation", *Economic Insights*, July 11, 2017). Also affecting the situation is that some FOMC members have expressed concern that a tighter labour market may eventually result in sharply rising inflation.

Fed's inflation metric is below target

Year-on-year percentage change



Source: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS), SEB

Despite the Fed's four interest rate hikes since December 2015 and the announcement that its balance sheet will be reduced, US financial conditions have instead become more expansionary. This decreases the risk that a tightening of monetary policy will hurt US economic growth and gives the Fed room to continue hiking interest rates and reducing its balance sheet. **The Fed will hike its key rate a fifth time in December 2017** and will carry out **three more hikes in 2018 and one hike in 2019, to 2.50 per cent**. The nominal key rate will thus end up below 3 per cent, which according to the Fed now represents a neutral monetary policy. One reason why the key rate will remain low and less than 3 per cent is that for structural reasons the neutral real short-term interest rate is expected to remain close to zero per cent longer than the Fed now expects, and that the balance sheet is also being reduced.

The Fed's monetary policy portfolio (System Open Market Account, SOMA) totals **USD 4.2 trillion**. In September we expect the Fed to formally decide to **reduce its government and mortgage backed securities holdings starting in October** by USD 6 billion and 4 billion/month, respectively, during the fourth quarter of 2017. The total amount of USD 10 billion will then be adjusted upward on a quarterly basis until it reaches USD 50 billion/month. According to New York Fed calculations, the entire adjustment process may be completed in about four years, that is, by 2021. The objective is **high predictability** and for **no adjustments** to be made in this plan unless economic and financial conditions radically change. Although its impact should not be exaggerated, we expect some tightening effect via long-term yields.

Uncertainty about Fed's future leadership

The seven members of the Federal Reserve's **Board of Governors** are appointed by the president of the United States and confirmed by the US Senate. The president also appoints the **Chair** and **Vice Chair** from among the Board and the Senate must confirm them. The Federal Open Market Committee (**FOMC**) consists of the Board, the head of the New York Fed district and four heads (rotating) from among the Fed's other 11 districts. **Today the Board has three vacancies,** while Chair Janet **Yellen's term expires on February 3, 2018** and Vice Chair Stanley **Fischer's ends on June 12, 2018**.

There is **great uncertainty** about what **high-level changes** can be expected. The White House has both criticised and praised Yellen's leadership this year. **There has been criticism of excessively loose monetary policy** and **too much regulation**. The White House has expressed some preference for increasing the role of **simple rules** (à la Taylor) in formulating monetary policy. The president has nominated **Randal Quarles** to the Board, and **Marvin Goodfriend** is a possible candidate; both are **"Taylor rule" advocates**, which confirms the thinking in the White House. The Fed has tried recently, in speeches and its *Monetary Policy Report* to Congress in July, to show the shortcomings of a Taylor-based policy.

Fed policy is already in a normalisation stage. **If it leans more towards the Taylor rule, this implies faster key rate hikes**, thereby risking a stronger dollar and falling stock markets. But on the other hand, even new members of the Fed leadership are likely to be eager to avoid a **monetary policy that generates volatility**.

- **Despite Chinese and euro zone efforts, the USD remains the global reserve currency**
- **The world, especially EM economies, will benefit from a weaker US dollar**
- **Swedish equities less USD-dependent than thought, but fund exposure affects the SEK**

In the past 4-5 months, the US dollar has weakened rather sharply, ending several years of very stable exchange rates with the euro trading in the USD 1.05-1.15 range. Although a minor EUR dip is likely in the near term, we believe that a bit further ahead the EUR/USD rate will again climb towards 1.25 and that the dollar will also weaken against most other currencies. This largely assumes that euro zone economic policy cooperation will keep moving in the right direction, making it easier for the European Central Bank (ECB) to take cautious steps away from today's ultra-loose monetary policy. Though such a forecast includes many uncertainties, large USD movements usually have far-reaching global consequences. This theme article discusses various issues surrounding the role of the USD in the world economy and some aspects of the Swedish economy's dollar dependence.

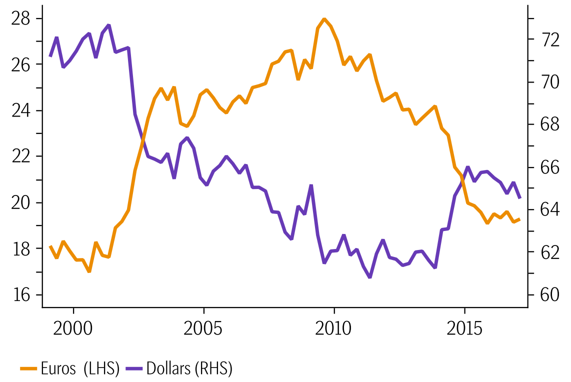
Still the world's reserve currency

Today's global monetary system was created when the Bretton Woods system collapsed in the early 1970s. This system was based on currencies having a fixed exchange rate against the US dollar, whose value was in turn linked to gold. When the US could no longer guarantee the dollar's fixed conversion price in gold, partly due to large budget and current account deficits in the wake of the Vietnam War, the system fell apart. But the role of the US as the world's dominant economic power has largely endured, even under a floating exchange rate regime. This includes its dominant role in world trade, with commodities priced in USD. Because the US has also continued to run more or less chronic current account deficits, there have been sizeable "exports" of dollars. It is estimated that more **than half of all USD** banknotes in circulation are found outside the US (more than USD 500 billion worth). Nearly 90 countries representing more than **30 per cent of global GDP** have a **direct link to the dollar**. The dollar's dominance as a global means of payment is clear from Bank for International Settlements (BIS) statistics showing that dollars are part of nearly 9 out of 10 foreign exchange transactions. The USD's role as a reserve currency has also been ensured by the dominance of the US capital market, with 4**0 per cent of the world's debts denominated in dollars**. All this has led, in turn, to a **need to hold dollar reserves**.

When the euro was launched in the late 1990s, some observers asked to what extent it might challenge the dollar and reduce global USD dependence. **The euro's role as a reserve currency** in fund managers' portfolios rose gradually in the 2000s **from below 20 per cent to nearly 30 per cent**. But the threat of a collapse during the **euro crisis effectively ended this diversification**. The euro is now back at 20 per cent (see chart). It has proved difficult to specify an optimal level for the USD's share of reserves. Studies indicate that it is unnaturally high. **All indications are that it will remain far higher than the US share of the world economy, 18 per cent.**

The euro has lost ground as a reserve currency

Per cent of total allocated reserves



Source: International Monetary Fund (IMF), Macrobond, SEB

New challenges to USD dominance may emerge, however. If the trend towards euro zone policy integration persists, the euro's share of reserves will probably rebound, especially since **global reserve managers are now underweighted in euro-denominated assets**. This would also **improve flows, benefiting the euro's exchange rate**. Further ahead, the Chinese yuan (renminbi) is a threat. In 2016 it joined the IMF's Special Drawing Rights (SDR) currency basket. This is not so important to the flow situation but is a clear sign of China's ambition to strengthen its role in world trade and global capital markets. **Deregulation of China's capital markets is proceeding sluggishly, though.** The authorities seem to prioritise control over flexibility and convertibility, which are necessary if the yuan is to achieve a role as a reserve currency. Our conclusion is that although long-term forces will reduce dollar dependence, it may well take **10-20 years before any currency can seriously threaten USD dominance.**

The world will benefit from a weak USD

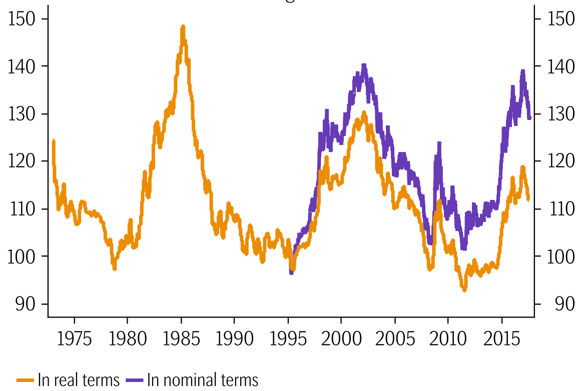
Given the USD's role as a global reserve currency and means of payment, its value is always highly interesting whether rising or falling. **Our SEBEER equilibrium model indicates that the dollar is about 4-8 per cent overvalued**, which IMF models also support. Historically (see chart) the dollar has fluctuated within a broad range. In relation to currencies of advanced economies, including the euro, it has had a surprisingly stable equilibrium value over time (for EUR/USD around 1.15-1.20). At present, most G10 currencies are also trading relatively close to estimated equilibrium exchange rates and historical average rates. As for the **value of the dollar**, our assessment is that the overall global economy **benefits more from a weak dollar than a strong one**. There are several reasons for this:

1) For many EM countries, there is a perceptible loss of income if commodity prices fall, which they usually do when the dollar appreciates (commodities are priced in USD). IMF studies also show that a strong dollar leads to slower EM economic growth.

2) With the dollar accounting for 40-50 per cent of global debts, many companies and EM countries are vulnerable to USD appreciation. Unhedged debts become larger in local currency, and since USD appreciation often coincides with rising US interest rates, strains increase from two directions. According to BIS, USD-denominated debts of EM countries in 2015 totalled nearly USD 4 trillion. **When the Fed began its normalisation process in 2013-2014, there were also large capital flows from EM countries.** For example, Chinese companies had previously taken advantage of the opportunity to borrow at low USD interest rates at a time when the dollar was also falling. When the Fed shifted policy, they were under pressure to pay off USD debts, which totalled nearly USD 1.2 trillion according to BIS. This, in turn, put great pressure on the People's Bank of China to intervene vigorously to stabilise its own currency, which led to a shrinking currency reserve.

Historically large USD fluctuations

Fed's trade-weighted USD index



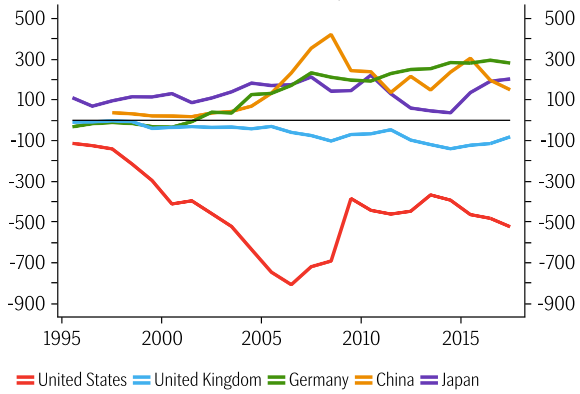
Source: Federal Reserve, Macrobond, SEB

Weaker USD will ease global imbalances

The dollar has long played a key role in discussions of global imbalances. America's ambition to constantly monitor its trading partners to determine whether they are manipulating their currencies to gain competitive advantages is one sign of this. In the mid-2000s the US current account deficit looked unsustainable, but after the financial crisis these imbalances have greatly decreased. The mirror image of lower US deficits is shrinking Chinese surpluses. **Meanwhile Germany has emerged as the country with the biggest surplus**, especially as a percentage of GDP but also in nominal USD terms. President Trump has also singled out the country as a possible "currency manipulator". But now that Germany is part of the euro zone and no longer has its own currency, these surpluses are largely due to the **euro exchange rate being pushed down in recent years by a political risk premium and ECB efforts to keep the currency union together**. Although a more expansionary fiscal policy and faster pay increases in Germany may contribute to lower surpluses, the most important things is still whether euro zone economic and political cooperation can be intensified in a way that might reduce the euro risk premium and lead to a stronger currency. **Our forecast that the EUR/USD rate will reach 1.25** within a few years also implies that both Germany's current account surpluses and overall global imbalances will thereby decrease.

Diminishing global imbalances

Current account balance, USD billion



Source: Macrobond, SEB

Role of USD for Swedish shares overstated

The dollar plays an important role for Swedish listed companies, but the net impact of big USD exchange rate movements is less than one might think. **Seventy per cent of Swedish merchandise exports stay within Europe.** Less than 10 per cent go directly to the US; even counting markets with USD pegs, the total is only around 15 per cent. Yet many companies sell in USD and have costs in SEK. Recent USD depreciation and a lower degree of currency hedging have worsened their earnings outlook, especially in manufacturing. But many Swedish firms also import USD-priced input goods, including commodities, so a weaker USD lowers their costs and thus benefits their earnings. SEB's equity analysts estimate that the total impact of a 10 per cent USD depreciation is a 1.5 per cent decrease in earnings. The impact may be somewhat larger if the volume effects of exchange rate changes are factored in.

Sweden's high USD exposure via funds

Since 2014 US equity indices have performed better than European ones. Because the USD also appreciated in 2014-2016, **Swedish investments in dollar-denominated US mutual funds have shown very high returns when translated to kronor**. Such savings in US mutual funds are at historically high levels, but today's dominant recommendations call for investors to switch from US to European exposures. If such a re-weighting occurs, currency flows may come back to Sweden or else be converted to euros or other European currencies. A major US stock market correction or recession would probably speed up such a process, thereby making the SEK less pro-cyclical: that is, decreasing the krona's tendency to appreciate during economic boom periods and depreciate during economic slowdowns.

Abenomics will celebrate five years of mixed success

- **More stable GDP growth close to low trend**
- **Economy with long memory of deflation**
- **Japan's monetary expansion will continue, contrary to rest of central bank world**

Better **global economic conditions** this past year, especially in Asia**, four fiscal stimulus packages** in 18 months plus **exceptional monetary policy** have improved Japan's growth, at least in the short term. **This year we expect GDP growth of 1.3 per cent**, up from 1.0 per cent in 2016. Even though monetary policy will be more expansionary during our forecast period and the yen will weaken, growth will slow due to fading fiscal stimulus effects, a consumption tax hike and lower capital spending as preparations for the 2020 Tokyo Olympics are completed. **GDP growth will fall to 0.8 per cent next year**, and further to **0.7 per cent in 2019**. Overall, growth will be **near or somewhat above its potential rate** of 0.5-1.0 per cent and above a historical average of 0.5 per cent since 1980.

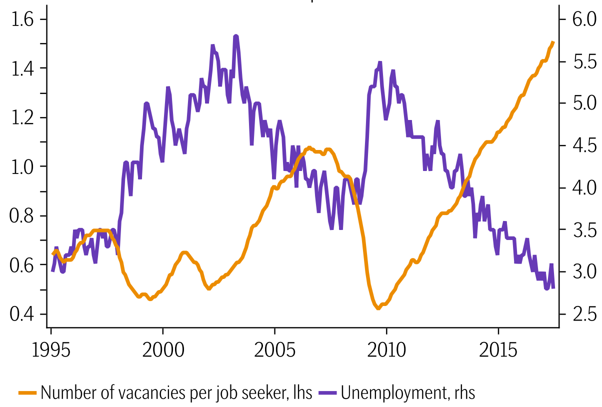
Late in 2017, **Abenomics will "celebrate" its fifth birthday**. Prime Minister Shinzo Abe's economic policy has been both extreme and forceful, but its results are mixed. **Deflation risk has diminished**, but inflation is still conspicuously absent. With **public debt at 240 per cent of GDP** and **budget deficits reaching 3-4 per cent of GDP in 2017-2019** – a direct effect of the many fiscal stimulus packages – there is an increased risk of credibility problems. The Bank of Japan (BoJ) currently holds 40 per cent of all central government bonds. Given the inflation outlook, this holding will increase further during our forecast period as the BoJ continues its stimulus.

Looking ahead, Japan's challenges will be to broaden growth and make the economy less dependent on exceptional stimulus programmes and exports. The country also needs measures to ease demographic headwinds and boost the labour supply. Some steps have been taken, but far more is needed to raise GDP growth. This includes greater labour market mobility through legislative reforms, improved social insurance systems that enable women and others to expand their participation as well as various training programmes.

Unemployment today is somewhat below 3 per cent: the lowest level since the 1990s. We forecast that it will **fall another couple of tenths of a point by the end of 2019**. But despite increasing labour shortages, historically high corporate profit levels and the BoJ's attempts to boost inflation expectations by expanding its balance sheet, pay increases remain troublingly low from an inflation targeting perspective. During 2017 inflation expectations have been almost unchanged, at a bit above 1 per cent.

Record-strong Japanese labour market

Ratio and per cent



Source: Japanese Statistics Bureau, Japanese Ministry of Health, Labour & Welfare, Macrobond, SEB

Inflation continues to disappoint. Although deflation risk has diminished, price pressure remains weak. The output gap is closed, energy price have stopped falling and the yen is weak, but companies still lack the determination to raise prices and employee pay demands are moderate. **We predict CPI inflation of 0.5 per cent in 2017 and 0.4 per cent in 2018**, well below the BoJ's 2 per cent target and far from its *"inflation-overshooting commitment"*. An expected autumn 2019 consumption tax hike from 8 to 10 per cent will result in total **CPI inflation of 1.2 per cent in 2019**. Domestic demand clearly remains hampered by a persistent deflationary environment, high public debt and long-term structural woes.

Given our forecast that the BoJ will fail to lift inflation above its 2 per cent target, the central bank will be forced to continue buying **about JPY 90 trillion worth of securities per year to fulfil its ambition to keep 10-year government bond yields close to 0 per cent**. We also expect the key interest rate to stay at -0.1 per cent during our forecast period. As other central banks end their QE programmes and also decrease their enormous monetary policy portfolios, the effectiveness of Japanese policy measures will increase indirectly, while the potential investment returns of life insurance companies improve. The fact that global long-term yields will climb during our forecast period will contribute to a more negative yield gap and help weaken the yen. We forecast a **USD/JPY exchange rate of 115 at the end of 2017. The USD/JPY rate will reach 122 at the end of 2018 and 120 at the end of 2019**.

BRICs still the engine of the world economy

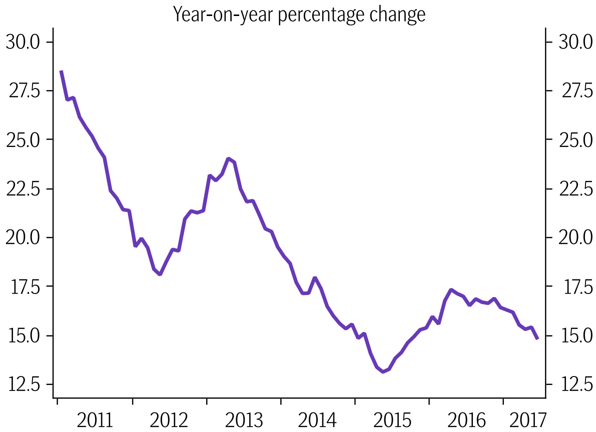
- **China: Partly credit-related deceleration**
- **India: Weak GDP, closer to other data**
- **Russia: Low oil prices limit growth rate**
- **Brazil: Reforms despite political storm**

China: Stable economy eases reshuffle at top

China's economy is showing its muscles. In the first half of 2017, growth accelerated. It is currently a couple of tenths **above the government's GDP growth target of around 6.5 per cent**. There are two drivers. One is stronger global economic conditions, which in July stimulated 10 per cent year-on-year export growth to both Europe and the US, compared with falling exports a year earlier. The other is looser credit conditions, stimulating mortgage loan activity and home prices, which in turn have helped boost construction and have had a positive wealth effect on households. The economic expansion has also strengthened the yuan.

China: Beijing to cut credit growth further

Year-on-year percentage change



Source: SEB

Our forecast is that the Chinese economy will decelerate in a controlled way. **This year GDP growth will be 6.8 per cent, slowing to 6.4 per cent in 2018 and 6.1 per cent in 2019.** Government policy is now aimed at decelerating growth. Strong export conditions give Beijing manoeuvring room to bring about more controlled domestic development that is not driven by increased debt. President Xi Jinping views China's rising indebtedness as a potential threat to political stability. Debt reduction has not begun but debt growth has decreased, which is now expected to slow the domestic economy.

Political events will affect economic growth during part of 2018 as well; the seven-man leadership of the Communist Party may be reshuffled in October-November 2017 in order to pave the way for a change of president in 2022. Before this reshuffle, Xi would like calm, positive and controlled economic growth.

The next president in 2022: Chen Min'er?

President Xi's term of office expires in 2022. Our main scenario is that he will step down. **The most likely candidate to succeed him is Chen Min'er**, who has advanced with Xi's help. Chen, born in 1960, is expected to "shadow" Xi over the next five years in order to become president during 2022-2032. It is too early to say what policies Chen would pursue, but there are many indications that they would closely resemble those of Xi. If Chen does not land a seat in the top leadership this autumn, this increases the likelihood that Xi will stay on as president even beyond 2022.

Despite rapid growth, inflation has been low – partly due to a drop in food prices resulting from favourable weather. We believe **CPI inflation will fall to 1.8 per cent in 2017** from 2.0 per cent in 2016. **Inflation will bounce back to 2.5 per cent next year and to 2.8 per cent in 2019.** Inflation will thus stay somewhat below the informal 3 per cent target. We expect the People's Bank of China to raise its repo rate cautiously; **the key rate will remain at 4.35 per cent this year, be hiked to 4.60 per cent in the second half of 2018 and then reach 5.10 per cent by the end of 2019**. Government measures to decelerate credit growth will make this slow rate hiking cycle possible. We expect the government budget deficit to be 3-4 per cent of GDP, which represents an unchanged fiscal strategy.

The yuan is expected to appreciate slowly. Our forecast is that **the USD /CNY rate will be 6.70 at the end of 2017, 6.50 at the end of 2018 and 6.40 at the end of 2019**. China's currency policy is aimed at trying to keep the yuan stable, with a slight appreciation tendency, thereby increasing global interest in China's stock and bond markets. Nor will slight yuan appreciation have any significant impact on exports to the US or Europe while underlying demand is increasing.

One risk facing China is whether global inflation will spread to internal price and interest rate developments. China needs to decrease its total debt, which is 250 per cent of GDP. Given its prevailing debt situation, rising interest rates and bond yields would pose a major challenge to Chinese borrowers and increase the number of bankruptcies in the country.

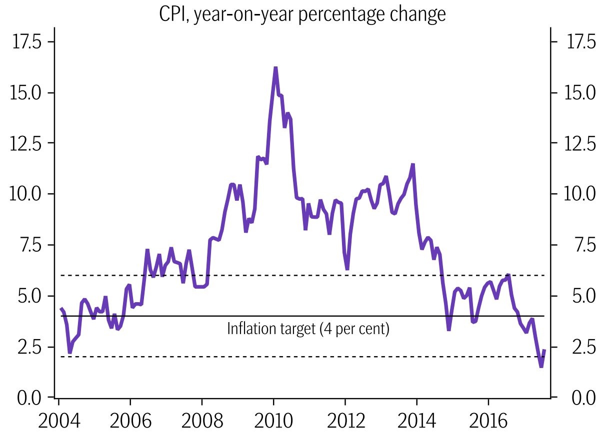
India: Low inflation expected to accelerate

GDP growth was unexpectedly weak in the first quarter, ending up at 6.1 per cent year-on-year, a clear deceleration from 7.0 per cent in the fourth quarter of 2016. The currency (or "demonetisation") reform launched last November severely hurt both retailers and other sectors, but these effects have now faded. **Because of unexpectedly slow growth, the discrepancy between GDP and other statistics that point to a significantly weaker performance has narrowed.** Purchasing managers' indices (PMIs) recovered after their decline following the currency reform. Industrial production has decelerated, along with exports and imports, and car sales are also sluggish. Although we expect a recovery after this year's weak start, we need to revise our GDP forecast downward. **We expect GDP to increase by 7.1 per cent in 2017 and by 7.8 per cent in 2018 and 2019.**

Inflation has decelerated sharply during 2017 and has remained well below the 4 per cent inflation target. This downturn has been driven by falling food and fuel prices. Today most indications are that inflation has bottomed out, and in July it accelerated to a 2.4 per cent year-on-year rate. Food prices are beginning to rebound and capacity utilisation is relatively high, but because of recent low final figures we also need to revise our inflation forecast lower. Measured as annual averages, we expect **inflation** to end up at **3.4 per cent in 2017 and around 4.5 per cent in 2018 and 2019**.

India's inflation has bottomed out

CPI, year-on-year percentage change



Source: Indian Ministry of Statistics & Programme Implementation, Macrobond, SEB

Low inflation has put pressure on the Reserve Bank of India. At its policy meeting **in August, the RBI lowered its key interest rate by 25 basis points to 6.0 per cent**. However, the minutes indicated that there is little room for further cuts. Our forecast is that **the key rate will be left unchanged until the end of 2018**, when the RBI will again begin hiking it. We expect the key rate to be **6.25 per cent at the end of 2018 and 6.50 per cent at the end of 2019**. The **rupee** has appreciated in 2017, driven by strong fundamentals and capital inflows into equity and bond markets. Our forecast is that **the USD /INR rate will be 64.5 at the end of 2017, 62.0 at the end of 2018 and 60.0 at the end of 2019**.

The central bank will continue its efforts to clean up the banking sector, where problems with **bad loans** are holding back lending and harming business investments. State-owned banks have been recapitalised and insolvency processes will be initiated against companies that account for a large proportion of the banks' bad loans. These measures will strengthen the balance sheets of banks, but it will take time before they have an impact on lending.

Prime Minister Narendra **Modi** visited US President Donald **Trump** in June to seek expanded cooperation, but this is likely to focus mainly on military matters. Trump wants India to support the US struggle against the Islamic State and serve as a counterweight to China, while Modi is courting American support for his harder line against Pakistan. US and Indian positions are more rigid on economic issues. Neither country has shown much interest in pursuing a free trade agreement.

India implemented its **national goods and services tax** on July 1. It is the Modi government's **most important reform**. The GST replaces numerous state taxes, creating a single market, but due to implementation problems and compromises its positive impact on economic growth will not materialise until 2018 and risks being smaller than previously estimated. In the two remaining major reform areas – the labour market and land purchase laws – we believe that the government will remain passive. It is expected to focus on smaller, uncontroversial reforms ahead of the 2019 parliamentary election.

Russia: Lack of reforms holding back GDP

After having shrunk by 2.8 per cent in 2015 and 0.2 per cent in 2016, the Russian economy is growing again – though at a leisurely pace. GDP expanded by 1.5 per cent year-on-year during the first half of 2017. Growth was driven mainly by private consumption, which has benefited from receding inflation and lower interest rates as well as falling unemployment. A slight increase in lending to households is a clear sign of gradually rising optimism. Capital spending also contributed a bit to the expansion, although businesses are still cautious about borrowing. Unlike 2016, net exports have contributed negatively to growth, since imports have increased faster than exports this year.

The international agreement on oil production caps – with the OPEC oil cartel and Russia as its chief actors – has had a limited impact on **oil prices**. We have adjusted our forecast downward and now foresee an average price of **USD 53 per barrel in 2017 and USD 55 in 2018**, then an upturn to **USD 60 in 2019**. This moderate price increase will keep Russia's GDP growth below the 3-4 per cent level that the authorities are aiming at. In May, industrial production grew at its fastest rate in more than five years, but maintaining this momentum will require labour market reforms, privatisations and a strengthening of the legal system. President Vladimir Putin will probably unveil an economic reform programme after being re-elected on March 18, 2018. His proposals will be inspired by his economic advisor and former finance minister Alexei Kudrin, but implementation will be slow and probably insufficient. We thus believe that **GDP growth** will be limited to a weak **1.9 per cent in 2017 and roughly 2.0 per cent in 2018 and 2019**.

Russia's federal **budget deficit** looks set to end up **just below 3 per cent of GDP** this year, thanks to comparatively restrained spending policies and somewhat higher oil prices than expected. **The Kremlin is sticking to a policy of minimising government debt increases** and will be able to limit the deficit to about 2 per cent of GDP in 2018 and 1.5 per cent in 2019, helped by the cautious economic recovery.

As early as July, inflation fell below the Central Bank of Russia (CBR) target of 4.0 per cent by the end of 2017. This gives the CBR room to cut its key interest rate from today's 9.0 per cent, but the bank has shown a strongly orthodox approach and also wants to bring down inflation expectations and budget deficits before relaxing up its tight monetary policy. We believe that the **key rate will be cut** by 25 basis points each in September and December to 8.5 per cent, with **inflation averaging a mere 4.3 per cent in 2017 and 4.1 per cent in 2018**.

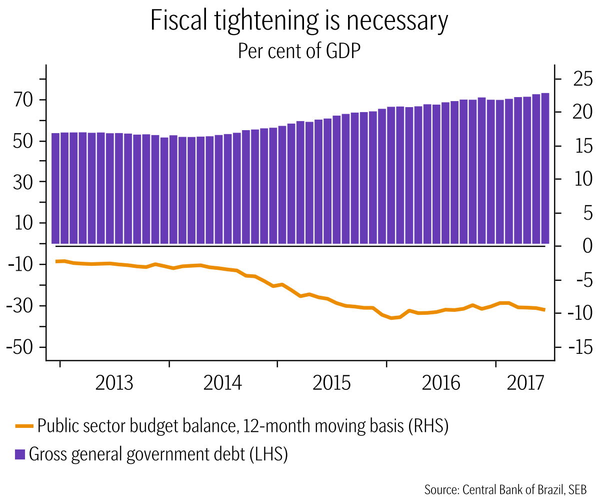
The rouble's correlation with oil prices ended early in 2017 but resumed in mid-year. **We expect the rouble to weaken a bit** to 62.0 per USD by the end of 2017 and then fall further to 64 per dollar in 2018 and 64.5 in 2019, due to narrower interest rate and yield spreads and somewhat higher inflation than in other countries. At present there are **no signs that either the US or EU will ease their sanctions against Russia**, yet their effect on the Russian economy is comparatively small.

Brazil: Weak economy amid political storm

First quarter 2017 Brazilian GDP rose by an annualised 4.3 per cent rate. **The economy has emerged from its deepest recession in modern times, but this has not generated any great optimism.** Growth was driven exclusively by a positive trend in net trade, with exports – especially to China – expanding faster than imports. Both households and the government continue to cut back consumption. In addition, capital spending has trended downward since 2013. GDP figures for the second quarter have not yet been published, but **monthly data point to a slowdown in growth**. The Brazilian economy will keep growing, but heavy household borrowing, rising government debt (now around 73 per cent of GDP) and the corruption scandal surrounding the state-owned oil company Petrobras – the country's largest single source of capital spending – will keep the growth rate slow.

We believe that **GDP will climb by 0.7 per cent this year**, accelerating to a still weak **2.0 per cent in 2018 and 2.2 per cent in 2019**. Exports, especially agricultural products, iron ore and machine parts, will remain the engine of the economy. Due to weak domestic demand and the appreciation of the currency, year-on-year inflation fell to 2.7 per cent in July: the lowest level since 1999 and well below the 4.5 per cent inflation target. In June the central bank announced it will lower its inflation target to 4.25 per cent in 2019 and 4.0 per cent in 2020. We see a pent-up **need to adjust prices and wages upward** as the economy slowly turns around and as the central bank eases monetary policy. **Inflation should thus end up at 3.5 per cent this year**, then rebound gradually to **4.0 per cent in 2018 and 4.3 per cent in 2019**. The key interest rate (SELIC) will be lowered at a rapid pace from its current 9.25 per cent to 7.25 per cent this year and to a record-low 7.00 percent in 2018.

The **Brazilian real** has appreciated by more than 30 per cent since bottoming out in September 2015, but its advance has halted this year and no further appreciation is expected. The export sector is dependent on no more currency appreciation. **Monetary policy easing and slow growth will weaken the real** from its current 3.15 per US dollar to 3.30 at the end of this year, **3.50 at the end of 2018 and 3.60 at the end of 2019**.

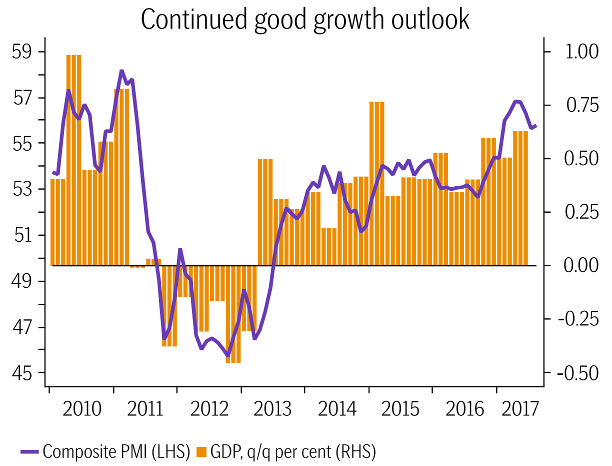


There is no room to stimulate economic growth through expansionary fiscal policy. **The budget deficit in June was 9.5 per cent of GDP** on a moving 12-month basis. Due to unexpectedly slow growth, the administration has been forced to revise its 2017 and 2018 budget targets. In order to prevent runaway government debt, it must rely on spending cuts and temporary revenue such as the sale of oil concessions, since the tax burden is already high. **Far-reaching reforms are under way**. Changes in the pension system have been delayed by accusations of corruption aimed at President Michel Temer, but these reforms look set to be implemented later this year or early in 2018. The government has also announced a reform of Brazil's complex tax system. Time is running out, though, since it will probably be harder to push through unpopular reforms after the October 2018 elections.

Strong indicators confirmed by GDP growth surge

- **Broad-based expansion, with household optimism close to peak level**
- **Falling unemployment, but weak wage response helps keep inflation below target**
- **ECB will soon announce lower bond-buying**

Euro zone GDP growth accelerated to 2.2 per cent year-on-year in the second quarter, the fastest since 2011. Hard data have thus confirmed earlier signals from sentiment indicators pointing to stronger, broader-based **recovery**. Job growth has lifted household confidence to peak levels. Rising capacity utilisation is leading to larger capital spending, and good international economic conditions are boosting exports. So far this year, the region has grown faster than both the UK and the US, especially in per capita terms. We are further revising our "above consensus" forecast for **GDP growth to 2.1 per cent in 2017 and 2.2 per cent in 2018. In 2019, too, we expect growth to surpass the 2.0 per cent trend**. Political uncertainty has diminished. After the German election in September, we expect intensified EU-level attempts to bolster euro zone cooperation. We believe that in September the European Central Bank (ECB) will announce it is **extending its bond purchases for 6 months and will decrease them to EUR 40 billion per month starting in January 2018**.



Source: Markit, Eurostat, Macrobond, SEB

From election focus to more EU cooperation

The German election looks set to be **more about who Angela Merkel's Christian Democrats (CDU/CSU) will govern with – see the box – than about who will win**. There is every indication that the various euro zone elections held during 2017 will lead to a far more stable political landscape than widely feared early this year. After major victories in the French presidential and parliamentary elections, there are now major hopes that President Emmanuel Macron will implement reforms that can improve growth potential, but there are many examples of presidential reform agendas losing momentum as popular support has waned and as the "parliament of the street" has begun asserting itself in the form of strikes and protests. There is also uncertainty as to whether Macron's new political movement (LREM) is really mature enough to push through controversial reforms. At present, we are cautiously optimistic, but we will await concrete decisions on labour market and other reforms before further upgrading our outlook.

The focus of attention is now shifting from national elections to EU and euro zone reforms. This autumn's calendar is full of high-level meetings focusing on decisions and increased integration. The European Commission's *White Paper* last spring, which presented five possible EU scenarios (see the theme article in *Nordic Outlook*, May 2017), will force member countries to adopt more explicit positions on what the EU and euro zone should focus on in the future. Germany and **France are expected to pursue a multi-speed EU policy** that would enable countries that wish to increase cooperation to do so, but on the other hand may generate tensions. The German-French agenda is likely to lead to greater power for the Eurogroup, eventually putting pressure on non-euro zone countries to join the common currency project in order to avoid marginalisation. With the UK on its way out of the EU, the non-euro zone group is losing by far its most important member.

GDP forecasts

Year-on-year percentage change

	2016	2017	2018	2019
Germany	1.9	2.1	2.0	1.8
France	1.2	1.7	1.8	1.8
Italy	0.9	1.4	1.4	1.4
Spain	3.2	3.2	3.1	3.0
Euro zone	**1.8**	**2.1**	**2.2**	**2.0**

Source: Eurostat, SEB

Increasing room for fiscal stimulus

Completion of austerity programmes and improved growth have pushed **public deficits to their lowest level since 2007**. After peaking at 6.3 per cent of GDP in 2009, they have shrunk to 1.5 per cent. Strong economic growth will lead to higher tax revenues, opening the way to cautiously expansionary fiscal policies in 2018 and 2019. This is especially true of

Germany, though a tight resource situation there is starting to place restrictions on stimulus measures. Underlying expenditure pressure in the region, driven by factors like ageing populations and migration, plus the need for added police, defence and infrastructure spending, limit room for new discretionary spending. Yet public deficits continue to fall towards 1 per cent of GDP in 2019, and gross government debt will decrease at a slow pace. Some countries are still grappling with large deficits. Due to high debt levels and crisis-year deficits, Greece, Portugal, Italy and others remain vulnerable. The problems of Italy are especially complex, with heavy debt, numerous bad loans in the banking sector, political uncertainty related to the 2018 election and populist parties enjoying large public support.

German election: Clear Merkel victory seems likely

What seemed an uncertain election (September 24, 2017) last spring now **looks more and more like a triumph for Chancellor Angela Merkel's Christian Democrats** (CDU/CSU). The Social Democrats (SPD) lost ground after an initial surge when Martin Schulz became party leader. Meanwhile the liberal FDP has gained support and is expected to break back into Parliament. A continued CDU/CSU/SPD grand coalition cannot be ruled out, but a government of the CDU/CSU and FDP (similar to their 2009-2013 coalition) appears the most likely alternative given current public opinion. The right-wing populist AfD has lost support after internal conflicts. With a continued grand coalition as one alternative, there is also less chance that smaller parties will enjoy a kingmaker role. One uncertainty factor is that the number of undecided voters is at a 20-year high at about 45 per cent (was one third at the same time before the previous election).

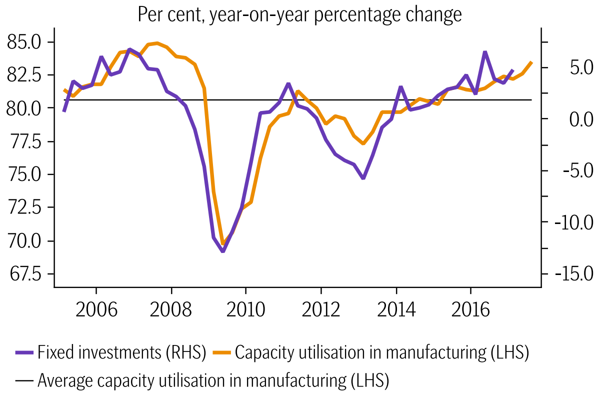
If Merkel remains at the helm, this implies continuity for the euro zone's largest economy, with no major economic policy strategy change expected. Large German budget surpluses make more expansionary fiscal policy possible, as other countries are demanding, but a tight resource situation and deep-seated scepticism among Germans suggest no such major shift is likely. Higher defence spending, which can be largely channelled via higher imports, may be one way to deal with this dilemma. If the German-French axis makes ambitious efforts to increase EU integration again, having the FDP in government may create problems. Since the party wants euro zone countries to assume greater individual responsibility, for example, they might oppose a write-down of Greek debt.

More above-trend growth, indicators say

Indicators continue to paint a bright picture of euro zone growth. Although the surge in indicators that we have seen since the autumn of 2016 has slowed, levels remain high. In July the European Commission's Economic Sentiment Indicator (ESI) was at its highest level in nearly 10 years. The purchasing managers' index (PMI) has fallen slightly but remains close to earlier peaks. **Growth is relatively synchronised** between the large euro zone countries and between sectors. The order situation is good, industrial production is rising and capacity utilisation is at levels implying that businesses will need a greater degree of new investments. In addition, rising home prices and low interest rates are stimulating residential construction. The stronger euro is giving exporters some headaches, but increased international demand is a more important factor and companies foresee greater opportunities to raise prices. **Exports will increase by 4 per cent in 2017 and accelerate to 4.5 per cent growth in 2019**. Capital spending will increase by 4-4.5 per cent yearly in 2017-2019.

Capacity utilisation above historical average, investments accelerating

Per cent, year-on-year percentage change

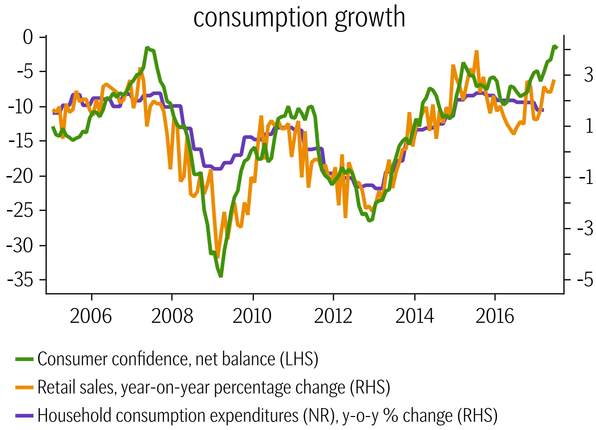


Source: Eurostat, Macrobond, SEB

Households in a very good mood

Household optimism has improved as economic and job growth has accelerated. Consumer confidence is now essentially at the same level as when the 2008 crisis broke out, which is not far from the peak for the past 30 years. In spite of this, consumption has been somewhat weaker than expected. It is clear that households have the problems of recent years in mind. Pay increases are also low, and household incomes are not growing as strongly as the employment trend would normally make possible. In addition, the household savings ratio has fallen for several years and is at a historical low. As incomes improve, households will need to rebuild their buffers, allowing less room for consumption increases. **Measured as annual averages, household consumption will increase by 2 per cent yearly in 2017-2019**.

High consumer confidence and continued good consumption growth



Source: Eurostat, European Commission (DG ECFIN), Macrobond, SEB

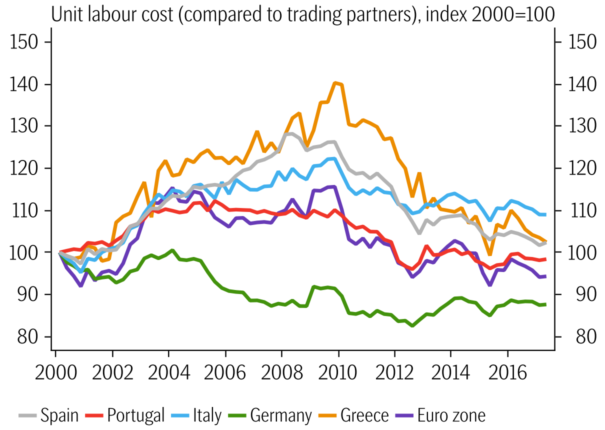
Strong labour market, small pay increases

Good economic growth is continuing to push unemployment lower. **In June, the jobless rate reached 9.1 per cent: 3 percentage points lower than the highest reading** in mid-2013. **Falling unemployment is largely being driven by job creation**. The number of people without jobs has fallen from over 19 million to fewer than 15 million; more than half of the upturn since 2008 has thus been reversed. Meanwhile labour force participation is now higher than before the crisis, due among other things to the strong German labour market. We are also seeing a positive trend in Italy, while participation has fallen in France and Spain. The positive labour market trend is continuing. Business hiring plans indicate that employment will increase by 1-1.5 per cent and growth will remain above trend in the next couple of years. Measured as annual averages, **unemployment will reach 9.1 per cent this year and then fall to 8.5 per cent in 2018 and 8.2 per cent in 2019**. We estimate that structural unemployment is around 8 per cent, which means that at the end of our forecast horizon the euro zone will still have idle labour market resources.

As in many other countries, the connection between unemployment and the pace of pay increases has weakened. At present, wages and salaries in the region are rising at a low 1.0-1.5 per cent yearly. Germany is pulling the average upward, but despite historically low unemployment, a high level of vacancies and initially high union demands, annual pay increases have remained at around 2.5 per cent in recent years. As in various southern European countries, this helps improve competitiveness, though the cost situation is strained in these countries compared to Germany. With the labour market tightening, **we expect pay hikes to accelerate**, but the euro zone average will not exceed **2.0-2.5 per cent in 2018-2019**.

Competitiveness improving, but a way to go

Unit labour cost (compared to trading partners), index 2000=100



Source: OECD, Macrobond, SEB

Rising inflation, but short of ECB target

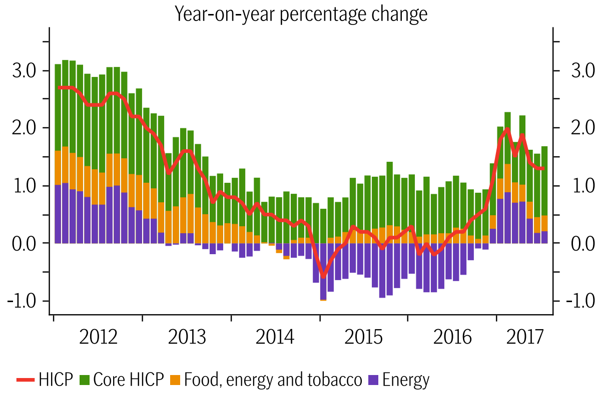
After last spring's upturn, when the harmonised index of consumer prices (HICP) temporarily reached around 2 per cent for a couple of months, inflation has again fallen to 1.3 per cent (July). As **short-term effects** (energy and to some extent food) **disappear, inflation will approach 1 per cent** by the end of 2017. Measured as annual averages, **inflation will fall to 1.1 per cent in 2018 and then climb to 1.5 per cent in 2019**. An HICP level of around 1 per cent in 2018 is consistent with underlying inflation in recent years. Continued low underlying price pressure, low international price increases and weak pay increases will help limit inflation. In a short-term perspective, the appreciation of the euro will also help keep down inflation.

ECB will continue to reduce bond purchases

After 10 years of combating economic crises (in August 2007 the ECB offered its first crisis-related loans to banks), reversing such policies is a difficult process. Although the ECB and its president, Mario Draghi, would like to send gentle signals, the tone has changed and it is now a matter of how quickly the shift to a less expansionary monetary policy will occur. Our forecast is that these changes will occur gradually in small steps and that they will be packaged to provide the gentlest possible impression in order to satisfy both doves and hawks, while avoiding euro appreciation. **The growth acceleration and good outlook are paving the way for new decisions on reduced bond-buying shortly**. Meanwhile the inflation outlook remains weak, creating a tug-of-war between different Governing Council members. We believe that **in September the ECB will announce a reduction in bond purchases to EUR 40 billion per month starting in January 2018, while extending the programme by 6 months**. Our interpretation of recent ECB comments is that the risk of a postponement of the decision until the October meeting has increased but we are sticking to our September forecast. During the spring of 2018 the bank will approve further reductions in purchases, continuing them for the entire first half. We interpret the ECB as preferring to make new decisions on bond-buying cutbacks instead of announcing "tapering" in advance as the Fed did.

Falling inflation as contributions from food and energy prices disappear

Year-on-year percentage change



Source: Eurostat, Macrobond, SEB

The first ECB interest rate hike will occur less than a year from now. Once the bond-buying programme is largely concluded, **at its June 2018 policy meeting the bank will raise its deposit rate for banks by 15 basis points** to -0.25 per cent. After that we expect the ECB to move slowly. If the economy continues to perform in line with our forecast, pressure from the hawks will increase. Even if inflation falls short of the 2 per cent target, economic growth, falling unemployment and inflation that is rising towards target will weigh heavily enough that **in 2019 the ECB will raise the refi rate for the first time since 2011**. The first hike will occur late in the first half of the year followed by a second refi rate hike late in 2019, bringing the key rate to 0.50 per cent by year-end. We expect the ECB to wait until after 2019 to start reducing its bond portfolio.

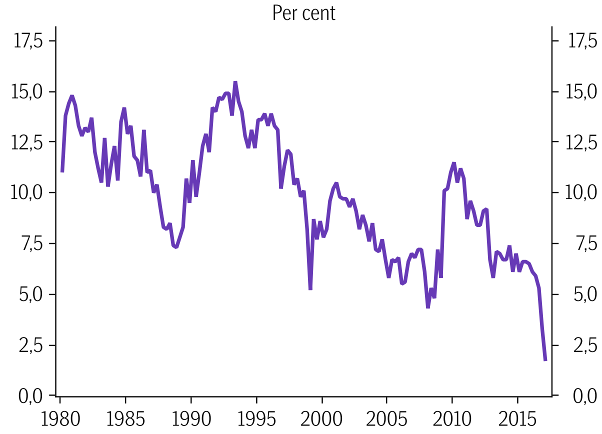
Major challenges in the shadow of EU withdrawal

- **Brexit negotiations creating uncertainty**
- **Weak pay growth despite low jobless rate**
- **No key interest rate hike until 2019**

On June 22 the UK began its negotiations with the EU on withdrawal, which will be held during one week each month for the foreseeable future. In keeping with EU demands the talks will occur in two stages, with withdrawal issues such as the rights of EU and UK citizens and the price for UK withdrawal being resolved first. After that, negotiations will begin on the future EU-UK relationship, including a free trade agreement.

So far the economic impact of the Brexit decision have been relatively small, although GDP growth slowed noticeably in the first half of 2017. Household demand is hampered by rising inflation due to the sharp depreciation of the pound generated by Brexit-related developments, but generally it is hard to determine to what extent the slowdown is a consequence of future EU withdrawal. To date there are no signs of significant adverse effects on capital spending and the labour market, but we expect the withdrawal process to gradually lead to more obvious problems that will pull down UK economic growth during our forecast period. Meanwhile **a continued weak pound and strong global economic conditions should partly offset these negative effects on British expansion**. We are sticking to our pessimistic forecast that **growth will fall a bit to 1.5 per cent this year, while GDP will only climb by 1.0 per cent in 2018. In 2019 we foresee a slight recovery, with growth of 1.2 per cent**. Our forecast is marginally below consensus. But there is great uncertainty. In 2017-2019 growth will largely be determined by Brexit and future UK-EU relations. If the talks fail and the UK leaves the EU without a new agreement in March 2019, we can certainly expect even weaker growth as early as 2018.

The British labour market remains extremely strong. **At 4.4 per cent, unemployment is at its lowest since the early 1970s**. Looking ahead we expect the labour market to be harmed by lower capital spending, with **the jobless rate climbing to 5.2 per cent** by the end of 2019. Household consumption has been by far the most important driver of the recovery since 2013. Aside from EU withdrawal, there are further reasons to expect weaker household demand in the future. Wage and salary growth remains subdued, while household savings have fallen to historically low levels. **Further reductions in saving are no longer sustainable in the long term**, but there are certain indications that the influx of labour into the UK is decreasing. This might possibly contribute to increased wage pressure ahead, but no such tendencies are visible so far.



Meanwhile **high inflation and slow wage growth are helping to undermine household purchasing power**, but we believe inflation has already peaked. **Annual average inflation will be 2.6 per cent in 2017 and 2.2 per cent in 2018, falling to 1.8 per cent in 2019**. The housing market remains stable, with slowly rising prices, but there are some worrisome signs and the home price upturn has gradually lost momentum since late 2015. Brexit has forced the British government to abandon its ambition to achieve a budget surplus by 2020. Instead it will implement various measures as a direct result of EU withdrawal. These include **lowering corporation tax to 17 per cent by 2020** and making **new investments in research, development and infrastructure**.

After cutting its key interest rate to 0.25 per cent in the summer of 2016, the Bank of England (BoE) has revised its economic growth outlook sharply higher. At the central bank's August meeting, two policy committee members out of eight voted for a rate hike due to increasingly tight British labour market conditions. But the BoE has expressed some concern about household demand and future capital spending. Despite above-target inflation in the next couple of years, we expect that due to growth disappointments, **the central bank will leave its key interest rate unchanged until mid-2019**.

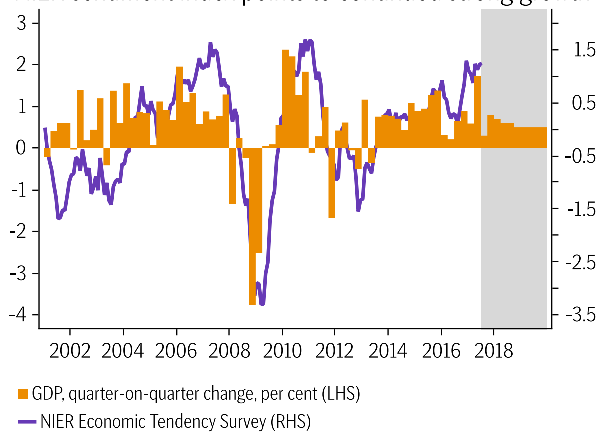
The pound is undervalued in a long-term perspective, but future developments are still hard to assess. The direction of exchange rate movements is likely to be determined by how Brexit talks and GDP growth develop, but **we fear that the pound will remain weak for another while**. If withdrawal negotiations get stuck, further depreciation is likely, yet given its valuation the pound should still recover towards the end of our forecast period. **The GBP/USD exchange rate will be 1.47 and the EUR/GBP rate 0.85 at the end of 2019**.

Continued strong growth but greater risk of overheating

- **Investments drive above-trend expansion**
- **Rapid job growth lowers unemployment**
- **Risk of overheating, but wages lag behind**
- **Higher inflation but still below target**
- **Riksbank will hike its key rate in April 2018**

Weak economic growth early in 2017 was more than offset in the second quarter as fixed investments again rose sharply. Although big differences in the number of working days make year-on-year statistics a bit hard to interpret, first half 2017 GDP figures and strong indicators support our optimistic forecast. We believe **GDP will grow by 3.2 per cent this year**, an upward revision compared to last *Nordic Outlook* above consensus forecast. Growth will remain above the long-term trend in **2018-2019, when GDP will increase by 2.8 and 2.4 per cent**.

NIER sentiment index points to continued strong growth



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

Growth is broad-based, with exports benefiting from a weak krona and greater European economic strength. Meanwhile domestic demand is being stimulated by expansionary fiscal and monetary policies. Housing investments remain the most important driver, while consumption growth is more sedate. Households are behaving cautiously, while new measurement methods show stagnation in public sector consumption at constant prices despite record-high job growth. Labour market signals are generally even stronger than for GDP growth. **Business hiring plans, for example, reached historical peaks this summer**. Despite rapid labour force expansion, the downturn in unemployment is now about to accelerate.

Resource utilisation has now reached historical peaks, but **pay increases have only been marginally affected so far**. The very tight resource situation suggests a **gradual acceleration in hourly wage increases to 3.5 per cent in 2019**, even though the recent national wage round ended up with only 2.2-2.3 per cent yearly pay hikes in 2017-2019. **CPIF inflation (CPI excluding interest rate changes) is now above 2 per cent for the first time in seven years** and will remain close to 2 per cent this coming year. But in the second half of 2018, we believe inflation will fall somewhat, among other things due to the low collective pay agreements and a stronger krona.

Both **fiscal and monetary policy will remain expansionary** throughout our forecast period. We predict that strong growth and slightly higher inflation will help persuade the Riksbank to begin cautious key rate hikes in April 2018: somewhat earlier than it signalled at its July policy meeting. CPIF inflation a bit below the 2 per cent target in 2018 and continued expansionary European Central Bank policy suggest that the hiking cycle will be slow. At the end of 2019 Sweden's repo rate will still be only 0.75 per cent. Continued heavy demand for public services due to the large recent influx of refugees points to continued pressure on public spending. A cyclically driven upturn in tax revenues will also enable the government to unveil an expansionary budget for 2018, with **increased grants to local authorities** as the most important ingredient.

In a way, our main forecast paints a rather bright picture of the Swedish economy. An expanding labour supply will allow a longer period of above-trend growth and create room in the budget for new spending. Meanwhile there are growing long-term risks as ever-larger imbalances build up. Although steps have been taken to slow the upturn in home prices and household debt, a comprehensive strategy in the housing policy field is conspicuously absent. Meanwhile the Riksbank, unlike its peers in countries like Norway and Canada, chooses not to factor these risks into its monetary policy at all. **Housing market imbalances are thus continuing to worsen**. The three-year collective pay agreements now in force are keeping down inflation but also leading to highly centralised wage formation, **blocking relative pay salary changes that might facilitate greater labour market mobility**. For example, this may worsen recruitment problems in the public sector and eventually threaten to undermine the quality of important core public services. A lack of vigorous efforts to integrate new immigrants into Swedish society would also have serious consequences when they are sent out into the labour market.

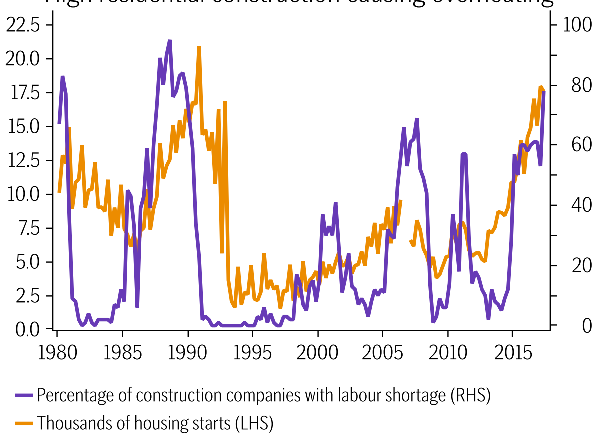
Stronger Europe lifts manufacturing sector

After **confidence indicators** for the manufacturing sector rose sharply late in 2016, they have now **stabilised at a high level**. Their upturn reflects improved international economic performance, especially in Europe, where more than 70 per cent of Swedish exports are sold. The weaker US dollar has squeezed the share prices of important Swedish export companies, but we believe that its impact on export volume will be limited. Hard data also increasingly confirm improved market conditions for manufacturers, and merchandise export forecasts for both 2017 and 2018 have been adjusted upward. But due to unexpectedly weak service exports in the first half, the overall export growth forecast for 2017 is largely unchanged. Because service exports to Germany and other European countries are showing a continued stable upswing and earlier preliminary figures have been revised upward, the slump may have been temporary. Overall, we estimate that exports will increase by 5,3 per cent this year and 3.9 per cent in 2018. When the world economic growth decelerates somewhat in 2019, Swedish export growth will slow to 3.0 per cent.

Record-high growth in housing investments

So far, stronger exports have not led to any increase in industrial capital spending. The Statistics Sweden survey in May also showed that industrial firms have modest investment plans, but experience indicates that these plans may change rapidly as the demand situation shifts. **We expect industrial capital spending to gradually accelerate over the next 12-18 months**. Despite hesitation among manufacturers, overall capital spending rose by 7.7 per cent in the first half of 2017 because **housing investments were up by 24 per cent. This was equivalent to a 4.9 per cent contribution to overall capital spending**. The number of housing starts reached 18,000 during the first quarter of 2017. Despite a minor slowdown in the second quarter, investment activity will remain expansionary throughout the year.

High residential construction causing overheating



Source: NIER, Statistics Sweden

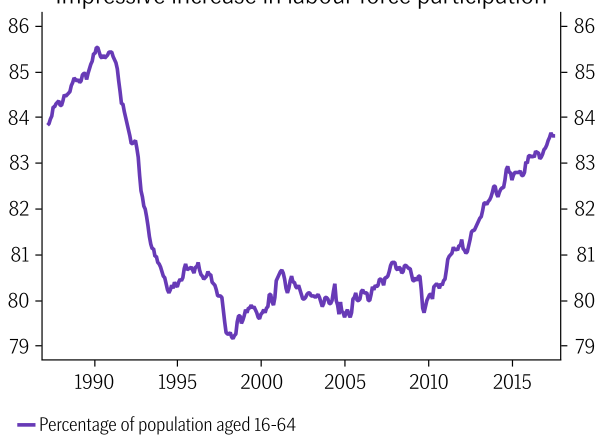
Bottleneck problems in the construction sector are becoming more and more apparent, for example in the form of labour shortages and rising construction costs. However, we believe that a continued influx of foreign labour may allow continued expansion of housing construction in 2017-2019. At the end of 2019, we estimate that **housing construction will account for almost 7.5 per cent of GDP, which is higher than the peak levels in Norway and Denmark** before the financial crisis. The increasingly high level of housing investments, combined with increased financial risk-taking by various participants in the sector, is boosting the probability of a deep economic downturn in the future. When housing construction begins to level out, the rate of increase in overall capital spending will gradually slow during the next two years, even though manufacturers and the public sector will be accelerating their investment activities. We estimate that **overall capital spending will increase by 7.7 per cent this year, 6.5 per cent in 2018 and 4.7 per cent in 2019**.

Unexpectedly weak public consumption

Despite strong fundamentals in the form of rapid job growth, good real incomes and rising asset prices, households are continuing to increase their consumption at a cautious rate, which is consistent with our downwardly adjusted forecast in May. We expect rather stable **growth in private consumption of about 2.5 per cent yearly in 2017-2019**. This is relatively high in an international perspective, but not especially impressive if population growth is taken into account; the per capita rate of increase is actually lower than the average level of the past few decades.

Public sector consumption has been weaker than expected. One reason is that we have misjudged the impact of Statistics Sweden's new methods for measuring public sector consumption. The agency is now attempting to measure actual volumes in such a way that **public consumption in constant prices no longer tracks job growth** (see theme article). Although both job and public consumption growth in constant prices are the fastest since the mid-1980s, the upturn in consumption volume has been very modest and is expected to reach only 1.6 per cent in 2017 and 1.0 per cent in 2018. The productivity downturn that has been recorded is extremely hard to interpret and diverges from the pattern elsewhere in Europe. But the number of public employees will keep growing rapidly in the next 12-18 months, driving up employment and resource utilisation in a way that is not reflected in GDP.

Impressive increase in labour force participation



Source: Statistics Sweden

Rapid job growth, clear drop in jobless rate

Strong GDP growth is confirmed by labour market indicators. For example, **hiring plans in the business sector** – a reliable indicator for the next 3-4 months – **rose to historical highs during the summer**. Actual job growth is also strong. We have adjusted our forecast upward and now foresee an increase of 2.2 per cent this year. Accelerating employment suggests that **unemployment will now begin to fall faster**. A rapid upturn in the labour supply, partly driven by increasing population, is nevertheless slowing the downturn. The increase in labour supply is also due to an unexpectedly large increase in the participation rate, which is now 78 per cent: the highest level since the early 1990s. Our forecast is that unemployment will fall to 5.9 per cent by mid-2018.

Increased share of unemployed with vulnerable position

Thousands of individuals

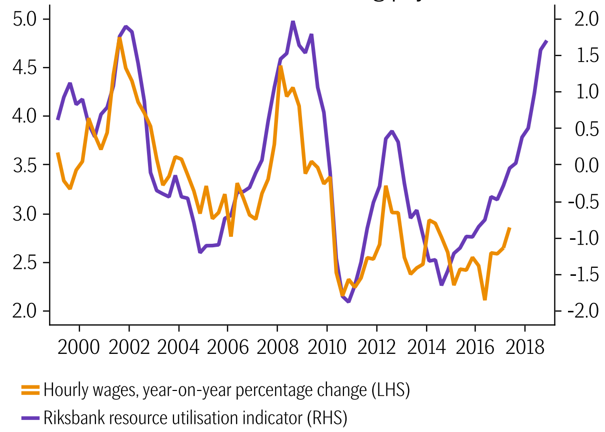
Source: Statistics Sweden, SEB

The number of unemployed, according to statistics from the Swedish Employment Service, has not fallen in line with the Labour Force Survey. This probably reflects the fact that an increasing percentage of the unemployed are more poorly connected to the labour market, especially individuals with little formal education and/or non-European origin. Looking ahead, this tendency will be further reinforced as a large number of recent immigrants join the labour market, which is why we believe unemployment will climb towards the end of our forecast period. This structural problem is likely to persist, implying that equilibrium unemployment will rise towards 7 per cent. We will undoubtedly see various political programmes to lower labour market thresholds, but these reforms will **hardly be far-reaching enough to change the picture much**.

Tight labour market but sluggish pay hikes

The NIER's labour shortage figures and the Riksbank's resource utilisation (RU) indicator are now close to historical highs. Since job growth is about to accelerate, **the RU indicator is soon likely to reach a new record**. As in other countries, the question is to what extent this will spill over into new pay increases. Sweden's resource situation is generally tighter than elsewhere, but the correlation between resource utilisation and pay/inflation has been weak since the mid-1990s, when the inflation target was established and wage formation was reformed. Looking ahead, wages and salaries will be held back by the 3-year collective agreements in place during 2017-2019, with hikes of just over 2 per cent yearly. Because the Swedish labour market is relatively open, imported labour – especially from EU countries with weaker labour markets – also holds back pay increases. Overall, we are sticking to our assessment that **pay increases will gradually accelerate from just over 2.5 per cent this year to 3.5 per cent during 2019**.

Hot labour market, but no big pay increases



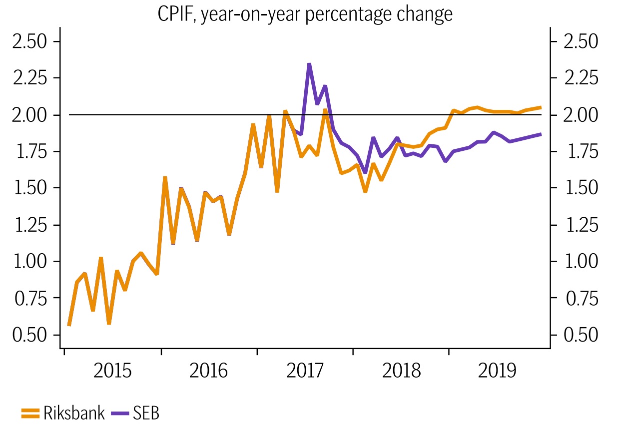
Source: Riksbank, Swedish National Mediation Office, SEB

Inflation close to target

Inflation has surprised on the upside during the past 3-4 months. In July the CPIF reached 2.4 per cent, exceeding the Riksbank's target for the first time since 2010. **The drivers are partly temporary**, mainly in the form of high prices for package holidays that are expected to normalise after summer. However, earlier krona depreciation and higher food prices suggest that inflation will remain largely consistent with the target during the second half. In 2018, though, inflation will fall again as the effects of the weaker krona and high food prices fade. This downturn will be offset by gradually accelerating pay increases and higher international prices. **Inflation will then climb a bit in 2019, but despite the economic boom it will not really reach the 2 per cent target**. So far in 2017, service prices have been higher than expected despite continued low pay hikes. These price increases are partly driven by apparently temporary factors, such as rising bank and health care fees. If less mobile service prices begin to increase faster, however, there is an upside inflation risk. Downside risks will mainly be related to low international prices and a stronger krona.

Inflation close to target

CPIF, year-on-year percentage change



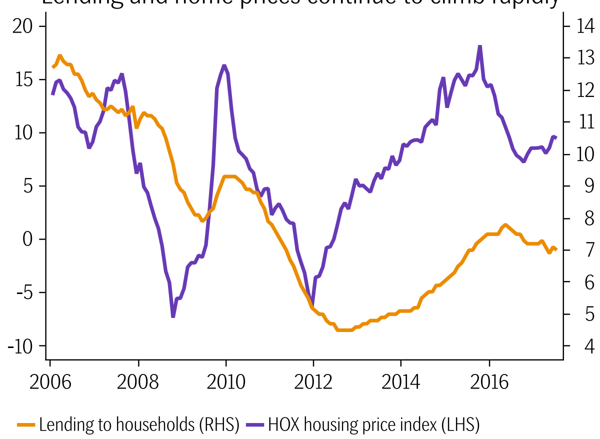
Source: Riksbank, SEB

Slowly less expansionary monetary policy

Sweden's economic performance more and more justifies **a shift in monetary policy**. So far, however, the Riksbank continues to focus entirely on ensuring a lasting upturn in inflation and keeping the krona from appreciating. The minutes of the Executive Board meeting in July showed unexpectedly great unanimity that there is no hurry in changing monetary strategy. Although the Riksbank faces a need for major upward adjustments in its GDP and labour market forecasts, and to some extent its inflation forecast, **the shift from its extremely expansionary policy is likely to take time**. We are sticking to our forecast of a **first key interest rate hike in April 2018**. Aside from domestic economic strength, continued Fed rate hikes and a cautious strategy shift by the ECB are suggesting that the Riksbank will hike its key rate earlier than indicated in its current rate path. Because of low interest rates in other countries and inflation that is not really taking off, the key rate will probably be raised gradually. We expect **two rate hikes per year, which means that the repo rate will be only 0.75 per cent at the end of 2019**.

We believe that the Riksbank will **soon introduce a variance band for its inflation target**. This can be regarded as an opening to decrease the focus on minor divergences from the target, but in the short term it will hardly affect the formulation of its monetary policy. The Riksbank is certain to play down the consequence and argue that the change can occur in both directions; for example, given a variation band the bank will have more room to allow an overshooting of the inflation target, which might even suggest an even more dovish policy. However, changes in the Executive Board, with expiring terms of office for several members – including the Governor – might trigger a somewhat faster and clearer shift in monetary policy.

Lending and home prices continue to climb rapidly



Source: Valueguard Sweden AB, Statistics Sweden (SCB), Macrobond, SEB

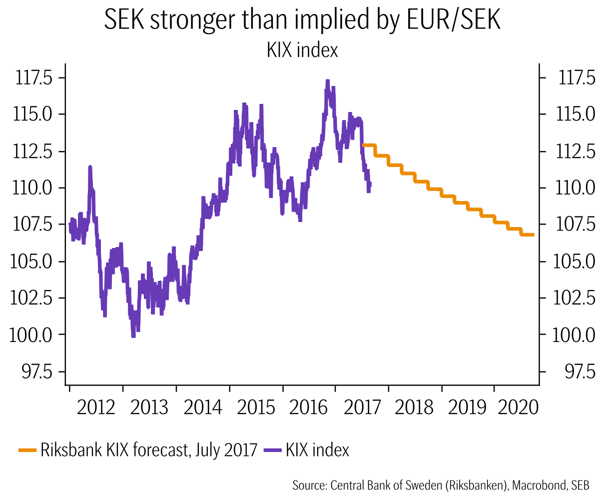
A monetary policy that remains extremely expansionary during a strong economic upturn increases the risks of a deeper future downturn, especially through its effects on property prices and lending. The minimum mortgage principal repayment requirement that was introduced in June 2016 led to a temporary deceleration, but because of heavy demand for housing the growth rate for both lending to households and home prices remains high. An increased repayment requirement related to income level, which probably will go into effect in January 2018, will slow the increase, but we believe that home prices will rise by roughly another 5 per cent in 2018 before prices are expected to level out in 2019.

Shrinking government bond supply

Swedish government bond yields have remained low and the spread against equivalent German bonds has even narrowed somewhat, despite Sweden's strong economic growth and relatively high inflation. Riksbank bond purchases combined with strong government finances have led to a significant decrease in bond supply. Because of surprises in government finances over the past few months, the National Debt Office (NDO) will probably need to adjust projected bond issue volume sharply downward in its October forecast. This autumn, the Swedish Parliament will probably also approve a **reduction in lending to the currency reserve** (see next section). Combined with the Riksbank's short-term maintenance of preparedness for further easing, this will exert continued downward pressure on Swedish bond yields. We thus believe that the yield spread against Germany will narrow to 25 basis points late in 2017. Early in 2018, expectations of Riksbank rate hikes will cause the spread to widen again. As the Riksbank closes its gap against the ECB, yield spreads against Germany will continue to widen, reaching 60 basis points at the end of 2019. **Ten-year Swedish yields will thus climb to 1.90 per cent in 2019 from 0.7 per cent today**.

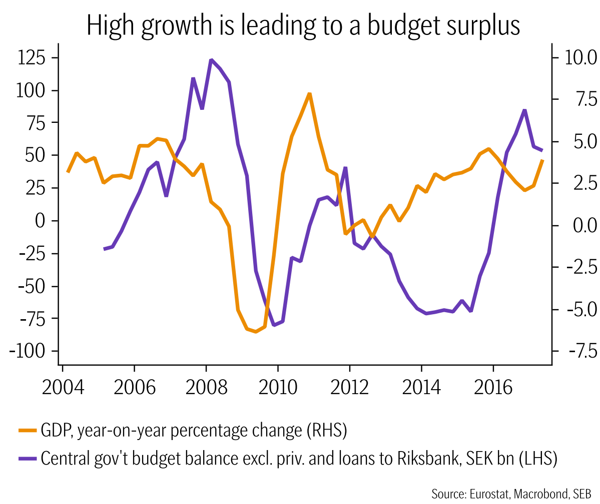
Trade-weighted strength buoying EUR/SEK

Monetary policy and expectations about Riksbank and ECB actions remain the dominant factor for the Swedish krona. Strong economic performance and higher inflation have helped buoy the krona, but so far most market players seem to be relying on the Riksbank to continue on its current path. Negative krona positioning is also strongly connected to monetary policy: at present both domestic and foreign players are influenced by the Riksbank's successful verbal intervention aimed at preventing an excessively strong krona. Conditions will inevitably change, however, as we approach signals of a first key rate hike. **We believe that the EUR/SEK exchange rate will be 9.35 at the end of 2017** when the market begins in earnest to build up its expectations of a rate hike. But because the krona has appreciated quite a lot according to the KIX trade-weighted index – mainly due to dollar and pound weaknesses – this will slow the downward potential of the EUR/SEK rate. We believe that the **EUR/SEK rate will reach 9.00 by the end of 2018 but then climb to 9.20 by the end of 2019** as the euro strengthens on the global scene. Given our long-term forecast of a weaker dollar, the USD/SEK rate will fall as low as 7.50 at the end of 2018, then decline a bit further in 2019. Unexpectedly low inflation figures or signs of an abrupt slowdown in the housing market are the most important downside risks for the krona.



Rapid growth will allow room for stimulus

Due to continued above-trend GDP growth and the expansion of important tax bases such as consumption, construction and employment, Swedish public sector finances will show surpluses throughout our forecast period. **However, the surplus will fall slightly in 2018 and 2019 to a bit below 1 per cent of GDP** due to expansionary fiscal policies each year. In recent months, tax revenues have continued to surprise on the upside. Central government finances are expected to show a surplus this year, albeit lower than in 2016. We believe that **the surplus will end up around SEK 30-40 billion per year in 2017-2019**. During 2017 in particular, this diverges from the NDO's estimate of a deficit of nearly SEK 20 billion. **Public sector debt will continue to fall as a percentage of GDP**. In 2019 it will be slightly above the target (debt anchor) that is part of the new fiscal policy framework that will go into effect at the beginning of 2019. A decision that the Riksbank should repay the loans it raised in foreign currencies in order to strengthen Sweden's currency reserve will decrease both the borrowing requirement and debt by a total of some 5 per cent of GDP, but we believe that such a change would also lead to a corresponding reduction in the debt anchor.



Unexpectedly high tax revenues will enable the government to unveil an aggressive 2018 election budget this September. **We expect stimulus measures worth around SEK 30 billion.**

Spending on core public sector activities will dominate. Local governments, which must bear a heavy burden due to the refugee flows of recent years, are expected to be granted an extra SEK 20 billion or more in 2017-2019. Extra money has also recently been set aside for police and defence spending. To avoid a government crisis, the minority government has now withdrawn most of its tax hike proposals (a new air travel tax, tax hikes on closely-held businesses and a limited upward adjustment of the threshold for paying central government income tax). The centre-right opposition had strongly objected to these proposals and threatened no-confidence votes against individual ministers. Only a scaled-back version of the air travel tax proposal remains, implying that the budget will be more expansionary than otherwise. **In fiscal terms this is no problem**, but it is more doubtful whether it is appropriate considering the strength of the economic cycle.

Public finances

Per cent of GDP

	2016	2017	2018	2019
Net lending	0.9	1.0	0.9	0.8
Borrowing req., SEK bn	-85	-35	-30	-40
Gen. gov't gross debt	41.6	39.5	37.4	35.4

Source: Statistics Sweden, SEB

Although we believe that a Swedish government crisis can be avoided, it has become increasingly clear that positioning ahead of the September 2018 election is starting to paralyse political decision making. The four-party opposition Alliance is moving towards expanding the use of no-confidence votes against individual ministers in the Social Democratic-Green Party minority government, so that such votes will not only be based on incompetence or formal errors, but also from objective disagreements with ministers' policies. To avoid a government crisis, however, the Alliance has declared that it does not wish to call a no-confidence vote against the prime minister or finance minister. **A strategy in which opposition parties are not prepared to take over responsibility for governing but meanwhile do not want to permit the incumbent government to pursue its policies creates a short-term power vacuum** and may worsen the future climate of cooperation. But the actions of Prime Minister Stefan Löfven and his government also include destructive elements. So far, their offers of agreements across the left-right political divide have been conditional on Löfven staying on as PM. By raising the threat of an extra election as the only solution, the Social Democrats **block the alternative of letting the Speaker of Parliament explore the potential for an alternative coalition** that could lead the country until the 2018 election. The latest public opinion surveys show that this chicken race is benefiting the Social Democrats, but there is no indication that either political bloc will be close to enjoying its own majority in Parliament after the election. The path to more stable government thus seems very thorny.

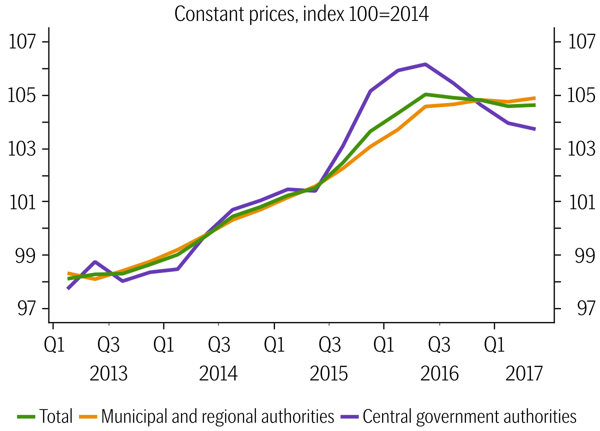
Theme: New metrics understate volume increases in public sector consumption

- **Moderate upturn in consumption despite record-strong public sector employment**
- **Changed measurement methods cause public sector productivity to trend lower**
- **Divergent metrics sabotage comparability between Sweden and rest of EU**
- **GDP, resource utilisation and burden on local government finances understated**

For some time, we have identified public sector consumption as a key driver behind Sweden's rapid GDP growth. We have said that the surge in central government consumption related to large-scale refugee resettlement in 2015 was **followed by greater strain on local governments** as refugees receiving residence permits were shifted to their areas of responsibility. Yet public consumption in constant prices rose far more slowly than expected in the first half of 2017: 0.0 per cent. An upturn is likely in H2, but we are adjusting our 2017 forecast downward from 2.5 to 1.6 per cent. As expected, central government consumption fell when the Migration Agency cut refugee numbers, but **an upturn in local government consumption has been conspicuously absent**.

Levelling-out of public sector consumption

Constant prices, index 100=2014



Source: Statistics Sweden (SCB), Macrobond, SEB

Rapid job growth, yet weak consumption

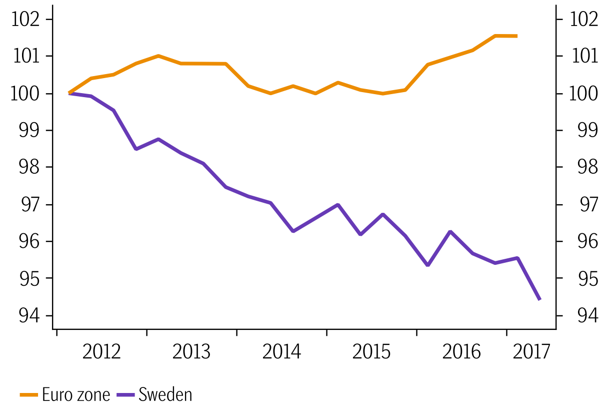
While **consumption has stagnated, employment has increased faster than expected**. Since 2015 public sector employment has increased by nearly 2 per cent yearly, compared to an average of 0.1 per cent in 2005-2014. **During 2016 the number of municipal and county council jobs rose by 3.5 per cent, which is the fastest increase since the current time series started in 1980**. However, public consumption growth has averaged only 1.9 per cent yearly since 2015, or less than half a percentage point higher than the 2005-2014 average. There are various ways of showing how remarkable this trend is. For example, in constant prices Sweden shows slower public consumption growth than the euro zone even though public sector employment has risen more than twice as fast as in the euro zone in recent years.

New metrics show decline in productivity

The explanation for this seems to lie in revised measuring conventions that Sweden implemented a number of years ago. Previous estimates of public sector production were based on hours worked in the public sector, which by definition means a constant productivity level. Now the National Accounts (NA) are instead trying to calculate public sector consumption based on volume estimates of various public services (for example the number of school pupils or number of surgeries performed). Productivity estimates have consequently changed. According to NA, these volume measurements have not increased at the same pace as the number of employees, and **productivity has thus fallen at a rather steady rate**. Other EU countries have not implemented this to the same degree and are thus still showing largely constant productivity levels.

Falling productivity in the Swedish public sector

Index 2012 = 100



Source: Eurostat Database, Macrobond, SEB

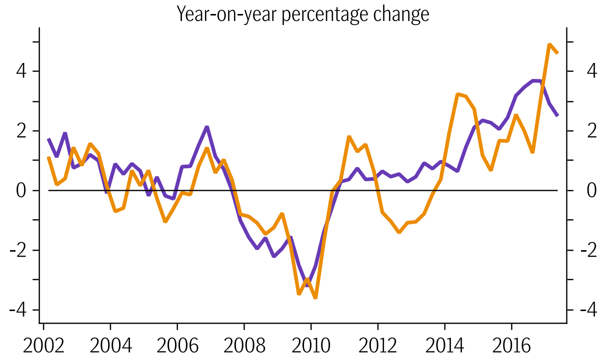
Price and volume measurements in areas where there are no market prices are difficult. The old method did not pay attention to efficiency issues and was thus not entirely satisfactory, but the question is whether the new methods have consequences that create too many interpretation problems. For example, if we boost the number of teachers per pupil or increase the use of educational materials that decline in price, such as computers, productivity falls. In addition, there is a comparability problem because many EU countries have postponed introducing the new methods. It is important to analyse the efficiency of the public sector, but the NR's standardised methods are hardly the right way to go.

GDP and stimulus are understated

We must accept that NR's calculation methods lead to an understatement of public sector consumption and GDP in constant prices, compared to its earlier methodology and compared to other countries. This effect is approximately -0.2 to -0.3 per cent of GDP in 2017. As for strains on public sector finances and the risks of acute staff shortages in vital public sector categories, however, employment is crucial. Additional supporting evidence for this is that during the past few years, **public sector consumption in constant prices – like employment – has increased twice as fast in Sweden as in the euro zone**. The trend of public consumption in constant prices is also a better indicator of overall fiscal expansiveness.

Divergent indicators for local government employees

Year-on-year percentage change



Source: Statistics Sweden

During the first half, local government employment (according to NR) rose by 2.7 per cent. Although some seasonally adjusted levelling out is expected in the second half, the full-year increase is likely to be far higher than the Swedish Association of Local Authorities and Regions (SKL), the government and the Riksbank have foreseen. **The underlying trend may be even stronger**. According to the Labour Force Survey, which is admittedly more volatile, local government employment rose very rapidly in the second quarter.

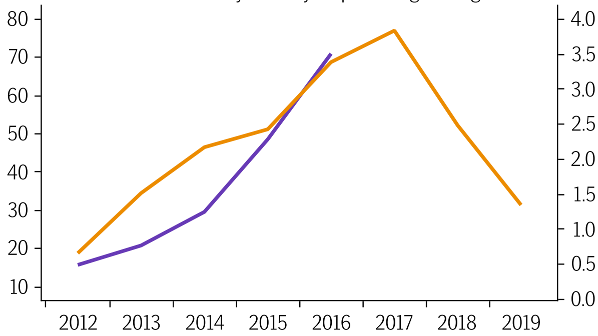
Worsening public sector labour shortages

The number of refugees assigned to local authorities will rise further this year, which is one reason why demand for local government services will continue to grow. In recent years there has been a strong correlation between the number of newly assigned refugees and local government employment (see chart), although there are other important drivers. The question today is how the public sector will cope with its large recruitment needs. According to Statistics Sweden surveys, its **difficulties in finding suitable staff are far greater than at any time** since such measurements began in 2005. Because private sector labour shortages are also close to historical peaks for the past century, competition for staff is even tougher. The problems are acute in most core public sector activities, including the police, health care and schools.

These recruitment problems are due to various factors, including work environment issues and difficulties in expanding the number of openings for training in key occupations. From a macroeconomic perspective, however, wage formation is vital. As early as spring 2016, the local government sector concluded 3-year collective contracts. Except for extra pay commitments for assistant nurses, the sector pledged to follow the level of pay increases that the rest of the labour market negotiated later. The question is now to what extent labour shortages will give rise to wage drift (pay hikes above collective agreements). Looking at teachers, for example, we can see how municipalities are trying to prevent schools from outbidding each other when recruiting. But unless the general pay level rises, the quality of the educational system will probably be undermined.

Refugee assignments will peak in 2017

Thousands and year-on-year percentage change

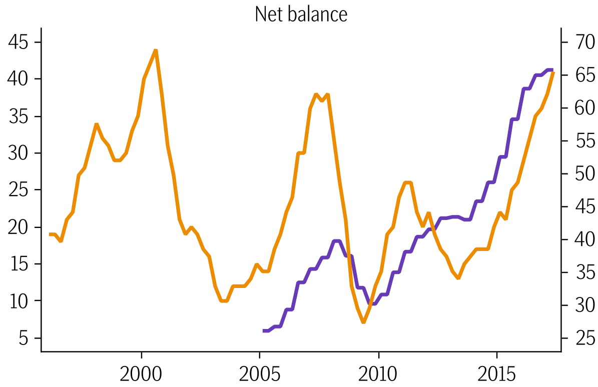


Source: Statistics Sweden (SCB), Macrobond, SEB

Looking ahead, local governments' budget constraints will determine their ability to recruit employees and thereby avoid such serious deterioration in core public activities that the social contract is threatened. Earlier calculations by SKL indicate that **local personal income tax must be raised by 2-4 per cent of income by 2020** (1 per cent equals about SEK 20 billion in additional tax revenue). The needs are probably even larger. SKL's political leaders maintained a low profile for a long time and avoided alarmist statements, but as these problems have become increasingly apparent, their calls for higher central government grants have grown louder. We also expect grants to increase by SEK 20-30 billion yearly in 2017-2019, but there will be a tug-of-war for additional resources. While local government areas such as health care, schools and social services face major strains, more funding is also needed for central government areas such as police and defence.

Labour shortages a major public sector challenge

Net balance



Source: Swedish National Institute of Economic Research (Konjunkturinstitutet, KI)

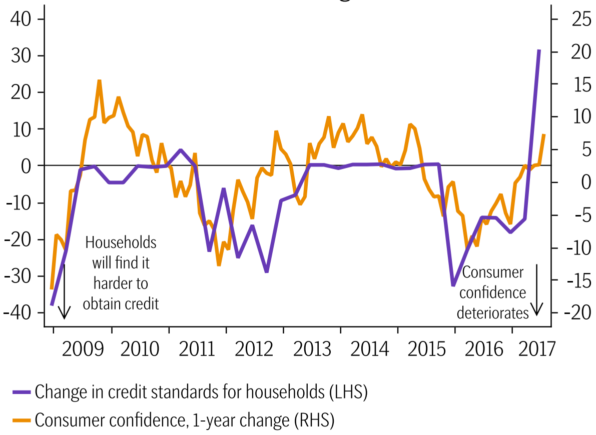
Headwinds holding back domestic demand are fading

- **2017 GDP growth revised to 2.3 per cent**
- **Looser credit standards set to stimulate domestic demand**
- **Limited evidence of imbalances**

Statistics Denmark has released a preliminary estimate of quarterly GDP growth in Q2 of 0.5 percent. If confirmed, this puts the economy at average annual growth of 2.6 per cent for the first half of the year. Since incoming data indicate growth is quite resilient at home and abroad, **we have upgraded our GDP forecast for 2017 from 2.0 to 2.3 per cent, and 2.4 per cent in both 2018** (unchanged from *Nordic Outlook* in May) **and 2019**.

The Danish upswing has been ongoing since 2013. In light of the excesses seen in the mid-2000s, credit standards have been substantially tightened since 2015. In our view, this tightening has been quite efficient in curtailing private consumption, credit growth and the housing market. Likely fuelled by renewed acceleration in home prices and strong income growth, banks have now chosen to loosen credit standards, so headwinds seem to be fading.

Credit standards no longer a headwind



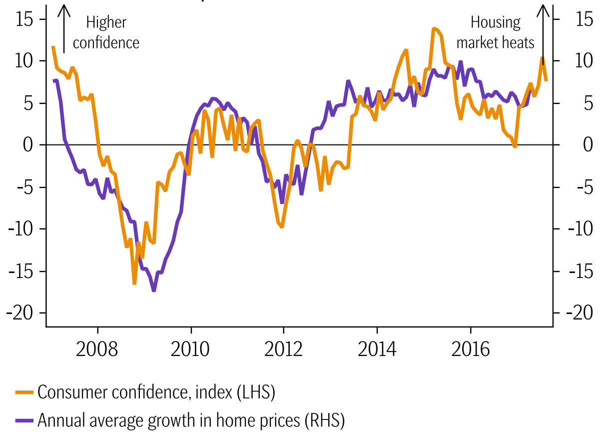
Source: Statistics Denmark, SEB

Looking ahead, we believe credit growth is likely to play an increasing role in supporting private consumption as job creation slows, but in the short term credit growth remains very much subdued by historical standards. Meanwhile, employment growth has been remarkably resilient in the past quarter – sustaining disposable income – and consumer optimism has turned sharply higher during 2017. We have thus **revised our estimate of private consumption growth from 1.5 to 2.3 per cent in 2017**.

The krone has appreciated by 2.4 per cent in 2017, which is likely to dampen exports slightly, but foreign demand is strong and hence the forecast for exports has been broadly unchanged. Over the next couple of years we expect net exports to fade, while higher capacity utilisation and rising home prices support a pick-up in investment activity.

By post-crisis standards, the Danish economy is in stellar shape, so government expenditure is likely to fade via automatic stabilisers. The discretionary part of fiscal policy may well be tightened over the next few years, but political leaders remain divided on the topic and some prefer lowering tax rates for high-income earners.

Consumer optimism has rebounded in 2017



Source: Statistics Denmark, SEB

The economy is in its fifth year of decent growth but capacity utilisation, wages and credit growth all remain at un-alarming levels. Danish CPI surged from 0.6 to 1.5 per cent in June, mainly due to a strong rise in package holiday and hotel prices. In our view, these are transitory changes unrelated to the underlying status of the economy, but inflation is likely to be somewhat elevated for a few months. Broadly, we expect a rather slow move towards **just below 1.5 per cent in 2019**.

The Danish krone faces structural appreciation pressure but given the recent economic rebound in the euro zone, this pressure has faded slightly. On balance, we expect the Danish central bank to mirror the ECB to sustain the EUR/DKK peg.

Risks are balanced. Rising home prices and high savings create scope for even stronger consumption if credit standards are further loosened. On the other hand, both the Fed and ECB are set to tighten policy during our forecast period. For now, Denmark seems to be enjoying a sweet spot.

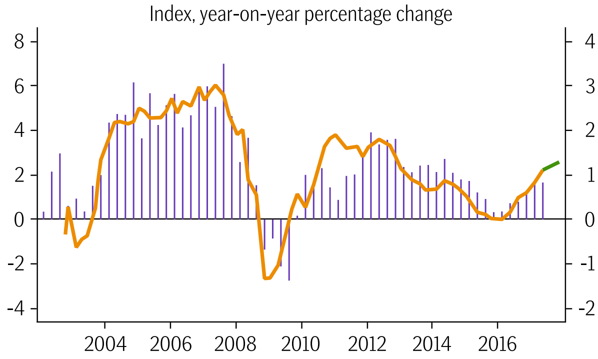
Economic recovery firing on all cylinders

- **A robust economic recovery**
- **Inflation to stabilise below target**
- **Norges Bank hiking rates in late 2018**

The economic recovery which started early last year gained momentum in the first half of 2017. Sequential growth in mainland GDP (excluding petroleum and shipping) was 0.7 per cent in Q2, implying a 1.5 increase in the first half of 2017 from a year earlier. The recovery is seemingly firing on all cylinders; the ongoing upturn in sentiment indicators has been unambiguous, exports of traditional goods have made a strong recovery after a slump in 2016 and capital spending in the petroleum sector has rebounded. An income-led revival in private consumption will counteract a slowing in residential investment, resulting in solid mainland domestic demand. We reiterate our view from the May issue of *Nordic Outlook* that growth in mainland GDP will accelerate in 2017. We have lifted our growth **forecast for mainland GDP to 2.0 per cent in 2017** and **2.3 per cent in 2018 and 2019.** Total GDP should be up 1.7 per cent in 2017. Positive contributions from oil investment will lift growth to 1.9 per cent in 2019.

Growth momentum accelerating

Index, year-on-year percentage change



Source: Statistics Norway, Norges Bank, SEB

Opinion polls suggest a change of government to a centre-left coalition following the September election. We expect fiscal policy to have a broadly neutral impact on mainland GDP in coming years, regardless of the election outcome, as implied by the fiscal policy rule (see Theme: "Norwegian general election", page 41).

Recovery in petroleum-related activity

After years of cost reductions, oil sector investment reached a trough in late 2016. Activity in the sector has picked up, due to lower oil price break-even levels and low reserve replacement ratios. Oil-related capital spending rose in the first two quarters of 2017, and the level is 0.3 per cent above the average in 2016. Statistics Norway's oil investment survey shows that operators on the Norwegian continental shelf have raised capital spending plans for 2017. While the survey still implies a small decline for 2017 and 2018, investment should be higher measured in volume terms. We expect unchanged **capital spending in the sector in 2017** (previously -7.0 per cent). Oil investment is expected to **increase by 2.5 and 5.0 per cent in 2018 and 2019, respectively**.

The cyclical turnaround taking hold in the oil sector is already visible in positive secondary effects. First, manufacturing output has broken a long trend of negative contributions to mainland GDP, with positive sequential growth in the first two quarters. This trend is likely to continue, judging by normalised sentiment and an ongoing recovery in the petroleum-heavy capital goods sector. Second, exports of traditional goods have rebounded strongly after an 8.2 per cent decline in 2016. Part of the rebound relates to previous supply-side disruptions, but a normalisation in expected export orders and a looming recovery in the machinery and equipment sector (partly related to petroleum activity) suggest a trend shift. We expect a **rebound of 1.7 per cent in shipments of traditional goods this year**. However, strong domestic demand will fuel growth in non-oil import resulting in a **slight negative contribution to mainland GDP from net trade**.

Mixed outlook for non-oil investments

The outlook for non-oil investments, which has been vital for the turnaround in the mainland economy, is mixed. Business investment has shown an earlier turnaround than expected by rising 0.3 per cent in 2016, despite capacity utilisation being well below normal levels. Capital spending has been sluggish so far in 2017, but Norges Bank's lending survey indicates rising loan demand from businesses. Investment plans according to the Business Tendency Survey have surged, signalling that the capital spending recovery will resume.

Housing investments are still growing at a brisk pace, rising a solid 11.3 per cent so far in 2017 from a year earlier. However, the home price decline and a pending slowdown in housing starts suggest growing imbalances and an earlier downturn in residential investments than previously expected. We now expect negative investment growth from 2018.

Trend shift in home prices

There is no mistaking the change of trend in the housing market, following the 8.3 per cent annual increase in 2016. Existing home prices have shown sequential declines since April. The initial correction is related to a surge in the supply of new homes, owing to previous strong increases in housing starts. Stricter lending practices have put a lid on credit availability, but existing home sales has been relatively steady. Continued high supply is expected to result in a more unfavourable inventory-to-sales ratio, suggesting prices will drift lower in the coming months. Although home prices seem inflated on various measures, a price collapse is not expected. Fundamentals such as improving labour markets and recovering household income growth are supportive, and the risk of higher interest rates affecting affordability markedly in 2017-2019 is small. A possible psychologically driven supply shock is nonetheless a downside risk to our outlook.

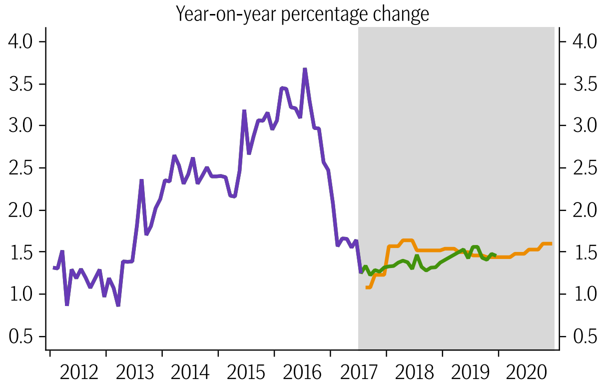
Fundamentals supporting consumption

Private consumption has recovered from the weakness in 2016, particularly due to a revival in domestic consumption of goods. Such spending revived solidly in the second quarter, mirroring improving household fundamentals. Consumer confidence has increased uninterruptedly since reaching a trough in early 2016 and the overall index is now in line with its long-term average, suggesting trend-like spending ahead. Moreover, higher purchasing power owing to higher wage and employment growth and lower inflation should pull up consumption growth in the coming years. We expect **growth in private consumption of 2.4 per cent in 2017**, and 2.3 **per cent and 2.5 per cent in 2018 and 2019, respectively**. Strong consumption supports our notion that growth momentum will become more broadly based.

Stronger household consumption apparently fits well with what seems to have been a modest improvement in labour markets. Both the Labour Force Survey (LFS) and the National Accounts recorded positive job growth in the first two quarters of the year and show tentative signs of accelerating. Positive employment expectations according to sentiment surveys and lower-trending layoffs suggest the labour market will continue to improve. We expect LFS unemployment to decline only gradually**, averaging 4.2 per cent in 2017 and reaching 3.8 per cent in 2019**, reflecting a swelling labour force.

Inflation has bottomed

Inflation has declined rapidly since its peak last summer, after being above or near target for three years. The driving force behind high inflation was almost exclusively the weakening exchange rate between 2012 and 2015, which pushed up prices for imported goods. The combination of a slight krone depreciation during the first half of the year and significantly weaker comparison months than normal from August and onwards suggest the annual inflation rate is now stabilising. It is difficult to pinpoint any triggers for a major rise in inflation. Although some acceleration in wage growth is expected as the economy strengthens, our forecast implies that pay hikes will remain well below the historical average throughout our forecast period. Generally low international price pressure also helps slow inflation. After the recent appreciation of the krone, the expected inflation rate for next year has been lowered by a couple of tenths. Our **forecast for CPI-ATE inflation** (excluding taxes and energy) is now **slightly below Norges Bank's trajectory for 2017 and 2018**. **In 2019**, somewhat higher wage growth will lift core inflation to **1.5 per cent.**



Rate normalisation starting in 2018

Norges Bank has kept its key rate stable at 0.50 per cent for more than a year. The central bank shares our view of an imminent stabilisation in core inflation and consequently removed the easing bias in its rate path at the latest rate decision in June. However, Norges Bank's long-term forecast puts core inflation below target until 2020, signalling no rush to hike rates. Moreover, the need for higher key rates to counteract risks related to the housing market and household debt is fading. The acceleration in growth momentum and closing of the output gap nonetheless suggest that the need for ultra-loose monetary policy is waning. Norges Bank's rate path signals a first hike towards the end of 2019. With inflation expectations well-anchored, Norges Bank can allow itself to cautiously start hiking rates earlier than envisaged, in line with important neighbouring central banks. We reiterate our expectation of **a first hike in December 2018** and that the normalisation will be very gradual by historical standards. We expect the key rate to reach **1.25 per cent by the end of 2019**.

Recovery for NOK and NGBs

After recovering in 2016, the krone has performed poorly so far this year despite supportive fundamentals. We expect a recoupling with underlying positive drivers. A cautious outlook for Norges Bank and oil prices suggests the recovery will be gradual. We expect the **EUR/NOK exchange rate to reach 8.80 and 8.60 by the end of 2018 and 2019, respectively**. Our expectations of higher international yields should support the outlook for Norwegian government bonds (NGBs) on a relative basis. Moreover, NGBs are attractive for yield-seeking investors as they trade with a large discount to their German peers. We expect **the 10-year yield spread against Germany to tighten to 85 bps by the end of 2018** before it stabilises around **90 bps** as Norges Bank starts to normalise rates.

- **A new government is the likely outcome**
- **Bloc structure is still highly uncertain**
- **Fiscal policy should be broadly unaffected**

Norway's long history of minority governments has led to a broad consensus on economic policy across the boundaries between political blocs. Since 1961, only five governments have commanded a majority in the Storting (parliament). Moreover, the past shows that it is unusual for a ruling government to be re-elected, and coalitions are the norm.

In this context, compromises between the two blocs have been a frequent occurrence. These include laws on fiscal policy and on tax and pension reforms. Differences between political parties in Norway mainly concern welfare spending vs. lower taxes and private service providers vs. public services.

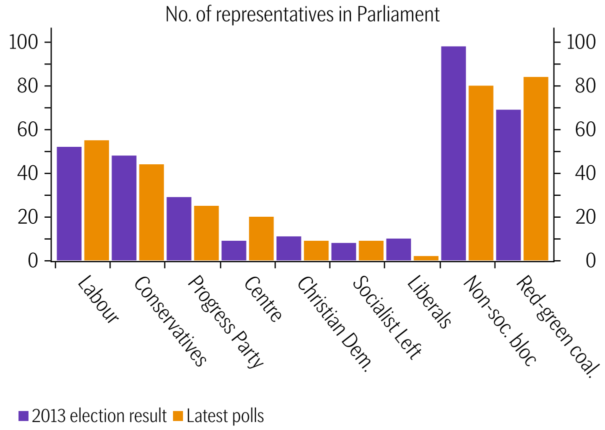
Politics set to turn left

A minority coalition consisting of two non-socialist (centre-right) parties, the Conservatives (H) and the Progress Party (Frp), has been in power since the 2013 general election. In order to command a majority in parliament, they are supported by the Liberals (V) and the Christian Democrats (Krf).

When the centre-right coalition took office in 2013, the economy was doing well by international standards, bolstered by strong growth and record-high oil prices. However, amid contraction in the petroleum sector and the ensuing increase in unemployment, support has been on decline. In the 2015 local elections the ruling parties retreated by 10 per cent combined.

Polls indicate a lead for the red-green coalition

No. of representatives in Parliament



Source: www.pollofpolls.no (Aug. 21, 2017), SEB

Opinion polls ahead of the September 11 general election have, therefore, favoured the red-green (centre-left) coalition. Their lead has mainly been driven by increased support for the Centre Party (SP), which has benefitted from a growing focus on local government politics – one of its top priorities. So in all probability, Norway will have a centre-left coalition led by Labour (AP), although polls diverge greatly.

Uncertainty predominantly relates to which of the smaller parties will support the red-green coalition. The most probable outcome is that the Socialist Left (SV) will join Labour and the Centre Party, as was the case from 2005 to 2013. SV is set to exceed the 4 per cent election threshold, making the party eligible to receive levelling seats. Such seats, which are meant to be distributed to parties which receive insufficient votes in any single constituency to gain representatives in the Storting, will also decide if the coalition may need additional support from the Greens (MDG) or Reds (R), or even the Christian Democrats that currently supports the centre-right bloc.

The fiscal impact is likely to be small

As the blocs broadly agree on the outlines of economic policy, we believe that the impact of shifts in fiscal policy from a change of government will be muted.

What really matters for economic growth is the fiscal contribution to growth, measured as the change in the non-oil structural budget deficit. That is, added petroleum revenue spending from one year to the next. Such spending is unlikely to swell given current estimates of the size of the Government Pension Fund Global, Norway's sovereign wealth fund. Moreover, the need for expansionary fiscal policy has diminished since the worst of the decline in the petroleum sector is over. After the government reduced the fiscal policy rule to 3 from 4 per cent, lowering the cap on petroleum revenue spending, there is also limited fiscal leeway in the state budget (see *Nordic Outlook*, May 2017). This is also a reason why Labour has championed less spending of oil revenues and criticised the government for being incautious with the country's finances.

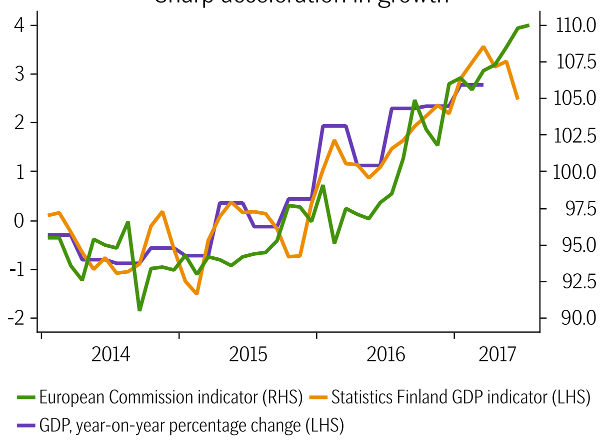
The main disagreement on tax policy concerns the wealth tax, which Labour argues should be raised to reverse previous cuts implemented by the non-socialist parties. As the wealth tax only concerns a small share of the population, we do not expect an increase to significantly affect economic growth. Concerning other taxes, such as corporation and income tax, the Labour Party and Conservatives are in broad agreement. Compromises between the parties were cemented in the 2016 parliamentary tax settlement, building on the work of the Scheel Commission. Regardless of the result, the corporation tax should be reduced to 23 per cent by 2018 and the inheritance tax will not be reinstated.

Growth is surging after a long stagnation

- **Indicators remain at high levels**
- **Production and exports are accelerating**
- **Household optimism is record-high despite a stubborn jobless rate and weak pay hikes**

After four recessions since 2008, the Finnish economy has now clearly bottomed out and is providing upside surprises. **First quarter 2017 growth was among the highest in the EU** and there are many signs that the economy is continuing to strengthen. Sentiment indicators are strong, including record-high household confidence. Meanwhile production and exports are accelerating. So far, unemployment is falling only slowly but GDP growth will lead to job growth ahead. We are making a relatively sharp upward revision in our forecast: **GDP will rise by 2.5 per cent in 2017. The economy will also grow above trend in 2018 and 2019: by more than 2 per cent annually**. For the first time in years, growth is now faster than in the euro zone overall. Finnish GDP will reach the same level as in 2008.

Sharp acceleration in growth



Source: Statistics Finland, European Commission (DG ECFIN)

On the whole, **indicators are at multi-year highs**. Sentiment is especially strong in services, but the mood in the manufacturing and retail sectors has gradually improved recently. Construction has lagged; the recovery will probably have to proceed a bit further before that sector revives. The situation of industrial firms has improved, with higher order bookings from both export and domestic markets. For the first time in some years, more companies are pleased with their order books than displeased. The improvement is also visible in hard data. Industrial production has accelerated, and the rate of increase is expected to rise further. Meanwhile exports have undergone a clear upturn this year. Better international economic conditions and good demand from key export markets like Sweden and Germany are helping. Sanctions are holding back exports to Russia, but that country's recession is over – neutralising a previous negative effect on demand. The 2016 Competitiveness Pact between the Finnish government, employers and labour unions is leading to low pay increases, improving the cost situation of companies and easing the impact of euro appreciation. Overall, **exports will rise by nearly 3.5 per cent in 2017, then climb somewhat faster in 2018 and 2019**. Rising production and capacity utilisation will create a need for business investments. Last year's capital spending surge will not be repeated, but investments will climb by 5 per cent in 2017 and 4 per cent yearly in 2018-2019. Due to rising home prices and supply shortages, especially in major cities, residential construction will increase.

Household optimism is record-high according to the European Commission's survey, despite stubborn unemployment and weak income increases. Because of low pay hikes and an already depressed savings ratio, there is limited room for consumption, but low interest rates and rising asset prices are meanwhile stimulating consumption. Looking ahead, pay increases will also accelerate a bit. Yet inflation will remain low; a 1 per cent HICP increase in 2017 and 2018 will be less than the euro zone average. Due to falling unemployment ahead and continued optimism, **household consumption will increase by about 2 per cent yearly in 2017-2019**.

Despite stronger GDP growth, unemployment has been stuck at a relatively stable level just above 8.5 per cent several months in a row. Meanwhile the number of job vacancies has kept increasing, which indicates labour market matching problems. On the other hand, the jobless rate fell unexpectedly fast in 2015 and 2016 considering Finland's modest economic growth, indicating that companies recruited new staff at an unusually early phase of the recovery. Continued above-trend growth will push down the **jobless rate to 8.3 per cent in 2018 and 8.1 per cent in 2019**.

The economic improvement will ease some of the pressure on Finnish public finances, and **fiscal policy is expected to be largely neutral in the next couple of years**. The budget deficit reached slightly above 1 per cent of GDP in 2016 and is expected to remain at that level throughout our forecast period. If government finances surprise on the upside, steps are likely to be taken to compensate for some of the austerity measures implemented in recent years, but the government's ambition to push its gross debt below 60 per cent of GDP suggests a continued cautious fiscal policy.

Investments and exports drive the economic recovery

- **Exports up on global economic growth**
- **Labour force starts to shrink**
- **Government proposes measures to reduce income inequality**

The economy has been riding a positive trend and jumped by 4 per cent in the first half of 2017. The capital spending recovery and improved trade balance were the main factors boosting GDP growth. Assuming that the economic situation in Lithuania's main export markets remains favourable, compared to *Nordic Outlook* in May **we are raising our GDP forecast for 2017 from 3.2 to 3.7 per cent and in 2018 and 2019 to 3.2 and 3.0 per cent, respectively**.

Private consumption growth has decelerated in 2017 after exceptionally strong figures last year. **Consumer confidence unexpectedly remains disappointing**, unlike business confidence which has been rising. Negative migration tendencies and the jump in inflation are depressing consumers' expectations.

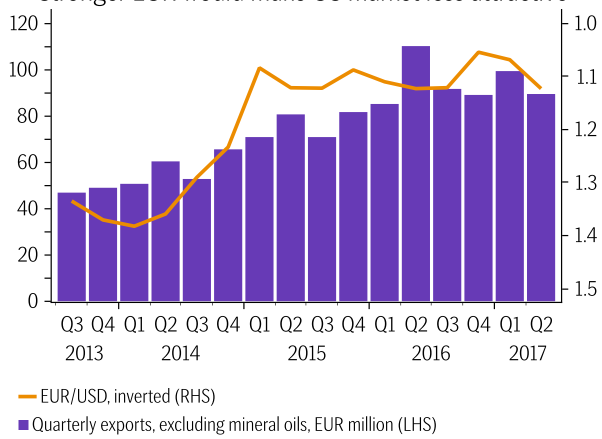
However, hard data indicate that the economic situation of households is improving. Unemployment has fallen rapidly and we expect it to reach 7.3 per cent in 2017. In 2018 and 2019 it will fall further to 7.0 and 6.8 per cent, respectively. The shortage of both skilled and unskilled labour is strengthening the bargaining power of employees. Sadly, our earlier forecasts of a shrinking labour force have started coming true. **The labour force fell by 1.5 per cent year-on-year in the second quarter.** The government will be forced to put more effort into boosting already high labour participation further and getting more people with reduced work ability and pensioners to join the labour market. There is still large potential for private sector employees, since the public sector is overstaffed. An increasing number of immigrants is unavoidable.

Annual growth in average wages accelerated to around 9 per cent in the first half of 2017 due to the labour shortage and a higher minimum monthly wage. Next year, average wages will increase a little more slowly, but much will depend on the decision about the minimum monthly wage in 2018. It currently stands at EUR 380 per month and might be lifted to EUR 420-430 next year. **Although growth in real labour productivity has been improving in recent quarters, labour costs keep rising faster.**

Annual inflation temporarily rose above 4 per cent, boosted by higher excise duties for alcoholic beverages, removal of the reduced VAT rate for heating and higher service prices, which closely correlate to average wages. Assuming that labour costs keep increasing rapidly, inflation will exceed the EU average. **We are leaving our inflation forecast for 2017 unchanged at 3.3 per cent and for 2018 at 2.8 per cent**. In 2019 inflation will fall further but remain above the euro zone average.

Companies demonstrated very solid, broad-based exports in the first half of 2017, **successfully exploiting favourable tendencies in their main export markets.** Re-exports to Russia and Belarus are also recovering due to the stabilising economic situation in those countries. There are signs that a weaker dollar rate against the euro is starting to reduce the attractiveness of US market, but stronger EU economies should offset losses from less exports to the US. Although investments into upgrading and expanding production capacity are steadily increasing, we believe capital spending is still too low. Large companies in particular have excessive cash, which they often distribute to shareholders as dividends.

Stronger EUR would make US market less attractive



Source: Statistics Lithuania, SEB

We hope **the government will be determined to retain a balanced budget this year and will run a 0.3 per cent of GDP surplus next year**. It has proposed changes in the tax system aimed at reducing income inequality and improving Lithuania's competitiveness. These proposals are more technical than structural and still have to be approved in Parliament this autumn. They should not have a negative impact on the budget balance, since they will be partly financed by expected cost-cutting in some areas.

Higher GDP growth may lead to bottlenecks

- **Exports and manufacturing are booming**
- **Mounting wage pressure**

In the **first half of 2017**, Latvia's economic upturn became more pronounced. **Growth reached 4 per cent**, the highest in five years. During the second quarter, GDP was driven by an 8 per cent rise in industrial production, 14 per cent growth in construction and a 3 per cent increase in the service sector.

Many factors are favouring the Latvian economy. Global fundamentals are strengthening exports and industrial performance. EU funds are starting to pour in, boosting construction and other capital spending. For the next 3 years, this will be a significant catalyst for economic activity. It will lift sentiment and sustain consumption growth and demand for loans. Next year, additional stimulus will come from tax reform. Despite this, consumption is expected to improve at a limited pace. A gradual upturn will persist in the real estate market and services. Meanwhile, the transit sector faces a bleak outlook. **We are raising our GDP growth forecast for this year from 3.5 per cent to 4.1 per cent. GDP will expand by 3.7 per cent next year and by 3.2 per cent in 2019.** Due to mounting labour shortages and other factors, bottlenecks are emerging that may start to limit growth potential in 2017-2019.

Reaching 3.4 per cent in March and April, inflation slowed to 2.6 per cent in July. A slight bounce is expected in August, but with HICP reaching just below 3 per cent. At present, no major changes in food prices are expected, though price rises may continue for some food categories. Inflationary pressure in services will strengthen. Our HICP forecast for this year is 3 per cent. **Next year** an excise tax increase will add 0.5 percentage points to **inflation**, yet it will end up marginally lower: **2.7 per cent**, slowing to **2.3 per cent in 2019**.

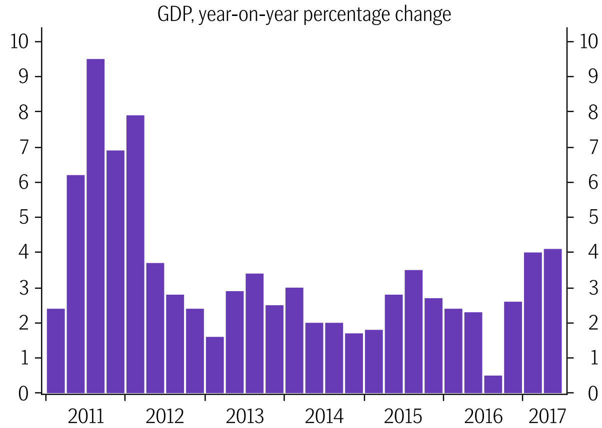
Industrial production and exports are booming. In the first half of 2017, manufacturing output rose by 9 per cent and merchandise exports by 10.3 per cent. We expect industrial growth to endure, driven by both resilient export conditions and domestic demand. The export picture is mixed, with relatively modest expansion in sales to Lithuania and Estonia and strong expansion in exports to Germany, Sweden and even Russia. At the same time sales to the UK fell by 0.5 per cent, with a 8.2 per cent decline in June. With a year-on-year increase of 54 per cent, the US became Latvia's 12th-largest export market. Its share of exports will continue to grow. The issue is, however, the sustainability of export growth to Russia.

In the second quarter, unemployment fell to 8.9 per cent. Over the next couple of years, the jobless rate will keep decreasing. Nevertheless, the situation is still slightly worse than in Lithuania and Estonia, where the unemployment rate has dropped to 7 per cent. Latvia will achieve this level in 2019. Unemployment in some regions will remain relatively high. Since growth is balanced, demand for labour will be broad-based, putting additional pressure on wages. **At the end of this year, unemployment will fall to 8.6 per cent**, next year to 7.4 per cent and to 6.8 per cent in 2019.

In line with macroeconomic trends, **wage and salary growth in the first quarter accelerated to 7.2 per cent**. Pressure for higher wages is very strong, especially in the public sector. Productivity gains are slow and costs are eating into profits, which is why entrepreneurs will continue to focus on costs. Despite this, we are adjusting our pay hike forecasts upward. Pay will grow by 6.5 per cent this year. Due to minimum wage raise next year, average growth forecast is 7.4 per cent and 6.3 per cent in 2019.

Growth expected to accelerate

GDP, year-on-year percentage change



Source: Statistics Latvia

Parliament has passed a **tax reform package** providing a fundamental overhaul starting in 2018. Its main purpose is to lower the labour tax wedge and stimulate capital accumulation. The current 23 per cent personal income tax will be replaced by a progressive tax with 20, 23 and 31.4 per cent brackets. The social security fee will be increased by 1 percentage point to 35.09 per cent. Net income for roughly 99 per cent of employees will increase. The capital tax and corporate income tax on distributed profit will be set at 20 per cent, with 0 per cent tax on reinvested profit. It is difficult to judge whether the reform will succeed, since many details are not clear yet.

Growth spurt fuelled by a surge in exports

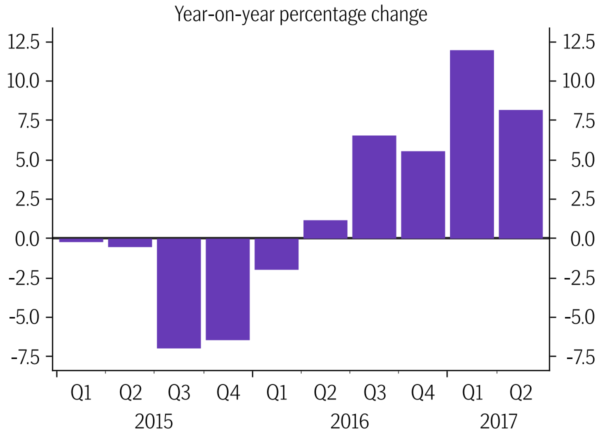
- **Large upward revision of GDP forecast due to a strong first half of the year**
- **Inflation is restraining private consumption**

Although increasing demand in Estonia's main export markets hinted at an acceleration in economic growth, the first half of 2017 exceeded all expectations. In Q1 2017 GDP expanded by 4.4 per cent, the fastest growth rate since 2012, when the economy was recovering from a deep recession. Due to a stronger comparison basis, growth will be slower in the second half of the year, which should result in average GDP growth of **3.6 per cent** in 2017. The economy will adjust to its **long-term growth path** in 2018 and 2019, when we expect GDP to expand by **3.2** and **3.0 per cent** respectively.

In the first half of 2017, **growth has been mainly driven by booming exports**. In Q1 exports of goods and services surged by almost 12 per cent. Exports have flourished thanks to stronger-than-expected growth in two main export markets, Finland and Sweden, while trade with Germany and the other two Baltic countries has also thrived. In addition, stronger capital spending has supported large sectors such as wood and metal product manufacturing. With a positive outlook for Estonia's main trade partners, exporters are expected to do well during the whole forecast period: we estimate export growth of 3.8 per cent in 2018 and 4.0 per cent in 2019.

Merchandise exports are strong

Year-on-year percentage change



Source: Statistics Estonia, Macrobond, SEB

After a long downturn, Estonia's gross fixed capital formation (GFCF) surged by 16.5 per cent in Q1 2017. However, some one-off events seem to have influenced the statistics, so it is too early to proclaim a broad-based recovery. The growth of corporate lending seems to be decelerating, though. Capacity utilisation has been hovering around 75 per cent – historically a very high level for Estonian industry – suggesting that **expanding production capabilities is in order**. The construction sector remains active. In addition to housing, investments in other buildings and structures are also gaining momentum due to higher public sector spending. Because of the large investments made during Q1, we estimate that GFCF will increase by 10.6 per cent this year, followed by a slowdown in 2018 to 1.8 per cent due to base effects.

Private consumption, the main driver of economic growth in recent years, was expected to decelerate due to slower growth in real incomes, but marginal growth of 0.6 per cent in Q1 was a surprise. Surging wages and a strong labour market suggest much higher growth, which is why we expect household consumption to grow by 2.5 per cent this year. Consumption expenditures are being restrained by rebounding inflation. In H1 2017, HICP growth amounted to 3.2 per cent, the highest in the euro zone. We expect average inflation to remain at 3.2 per cent in 2017. The government's decision to raise various **excise duties and the tight labour market will keep inflation far above 2 per cent** in 2018 and 2019 as well.

Sentiment indicators have mainly continued to improve. This is especially visible in the construction sector, where in addition to private sector contracts, public sector commissioned projects have started to flow in. Confidence has also substantially improved in services and manufacturing, the latter at its highest reading since 2011.

Despite an ongoing reform seeking to bring some of the non-active population back into the labour market, the unemployment rate has remained largely unchanged. The reform will lead to a higher unemployment rate, but its impact will be less than previously expected. We forecast an unemployment rate of 6.8 per cent this year and increases to 7.5 per cent in 2018 and 8.0 per cent in 2019. A very high employment rate of 67 per cent translates into strong wage pressure. Average pay has increased by almost 20 per cent in the past 3 years. The yearly growth rate will remain above 5 per cent during our forecast period. However, higher economic growth and recovering business sector profits mean that future growth will be more balanced.

Estonia is looking forward to **municipal elections** in October. In economic terms, this has usually translated into **higher public sector spending**. This time the unknown variable is the ongoing administrative reform, which coincides with the elections and will result in only 79 municipalities instead of the current 213 after the election date.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2016	2017	2018	2019
GDP OECD	1.8	2.1	2.1	1.9
GDP world (PPP)	3.1	3.8	3.8	3.7
CPI OECD	1.1	2.0	1.8	1.9
Export market OECD	2.3	4.1	3.8	3.6
Oil price, Brent (USD/barrel)	45.2	53.0	55.0	60.0

US

Yearly change in per cent

	2016 level, USD bn	2016	2017	2018	2019
Gross domestic product	18,906	1.5	2.2	2.4	2.0
Private consumption	13,057	2.7	2.5	2.7	2.1
Public consumption	3,287	0.8	0.3	0.5	0.4
Gross fixed investment	3,126	0.6	3.8	3.1	2.9
Stock building (change as % of GDP)		-0.4	-0.1	0.0	0.0
Exports	2,242	-0.3	4.1	3.7	2.9
Imports	2,806	1.3	3.5	3.3	2.8
Unemployment (%)		4.9	4.3	3.9	4.1
Consumer prices		1.3	2.0	1.8	2.1
Household savings ratio (%)		4.9	3.8	3.2	3.3

EURO ZONE

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	10,464	1.8	2.1	2.2	2.0
Private consumption	5,750	2.1	2.0	2.1	1.9
Public consumption	2,164	1.8	1.0	1.0	1.0
Gross fixed investment	2,070	4.2	4.2	4.3	4.0
Stock building (change as % of GDP)	0	-0.2	0.2	0.0	0.0
Exports	4,849	3.3	4.1	4.5	4.5
Imports	4,374	4.6	5.0	5.0	5.0
Unemployment (%)		10.0	9.1	8.5	8.2
Consumer prices		0.2	1.5	1.1	1.5
Household savings ratio (%)		6.2	6.3	6.2	6.0

OTHER LARGE COUNTRIES

Yearly change in per cent

	2016	2017	2018	2019
GDP				
United Kingdom	1.8	1.5	1.0	1.2
Japan	1.0	1.3	0.8	0.7
Germany	1.9	2.1	2.0	1.8
France	1.2	1.7	1.8	1.8
Italy	0.9	1.4	1.4	1.4
China	6.7	6.8	6.4	6.1
India	7.9	7.1	7.8	7.8
Brazil	-3.6	0.7	2.0	2.2
Russia	-0.2	1.9	2.0	1.9
Poland	2.7	4.0	3.4	3.2
Inflation				
United Kingdom	0.9	2.6	2.1	1.7
Japan	-0.1	0.4	0.5	1.2
Germany	1.7	1.7	1.4	1.7
France	0.8	1.2	1.0	1.4
Italy	-0.1	1.4	1.0	1.4
China	2.0	1.8	2.5	2.8
India	5.0	3.4	4.5	4.5
Brazil	8.8	3.5	4.0	4.3
Russia	7.1	4.3	4.2	4.5
Poland	-0.6	2.1	2.2	2.5
Unemployment (%)				
United Kingdom	4.9	4.6	4.8	5.2
Japan	3.1	2.8	2.7	2.6
Germany	4.1	4.0	4.1	4.1
France	9.9	9.8	9.5	9.2
Italy	11.7	12.0	11.9	11.7

FINANCIAL FORECASTS

Official interest rates		23-Aug	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19
US	Fed funds	1.25	1.50	1.75	2.25	2.50	2.50
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.25	0.50
United Kingdom	Repo rate	0.25	0.25	0.25	0.25	0.25	0.50
Bond yields							
US	10 years	2.17	2.50	2.60	2.80	3.00	3.10
Japan	10 years	0.03	0.10	0.10	0.10	0.10	0.10
Germany	10 years	0.41	0.60	0.70	0.90	1.10	1.30
United Kingdom	10 years	1.10	1.30	1.30	1.50	1.60	1.90
Exchange rate							
USD/JPY		109	115	119	122	121	120
EUR/USD		1.18	1.14	1.15	1.20	1.23	1.25
EUR/JPY		129	131	137	146	148	150
EUR/GBP		0.92	0.93	0.91	0.89	0.87	0.85
GBP/USD		1.28	1.23	1.26	1.35	1.41	1.47

SWEDEN

Yearly change in per cent

	2016 level, SEK bn	2016	2017	2018	2019
Gross domestic product	4,181	3.2	3.2	2.8	2.4
Gross domestic product, working day adjustment		2.9	3.5	2.9	2.5
Private consumption	1,884	2.4	2.4	2.6	2.2
Public consumption	1,086	2.9	1.6	1.0	0.7
Gross fixed investment	989	5.3	7.7	6.5	4.7
Stock building (change as % of GDP)	23	0.0	0.0	0.0	0.0
Exports	1,906	3.5	5.3	3.9	3.0
Imports	1,708	3.8	6.3	4.9	3.2
Unemployment, (%)		6.9	6.5	6.0	6.1
Employment		1.5	2.2	1.6	1.0
Industrial production		3.3	2.7	3.7	3.0
CPI		1.0	1.8	1.8	2.0
CPIF		1.4	1.9	1.7	1.8
Hourly wage increases		2.4	2.7	3.1	3.5
Household savings ratio (%)		16.1	16.3	16.5	16.7
Real disposable income		2.5	2.4	2.8	2.5
Current account, % of GDP		5,1	5,1	4.3	3.8
Central government borrowing, SEK bn		-85	-35	-30	-40
Public sector financial balance, % of GDP		0.9	1.0	0.9	0.8
Public sector debt, % of GDP		41.6	39.5	37.4	35.4

FINANCIAL FORECASTS	23-Aug	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19
Repo rate	-0.50	-0.50	-0.25	0.00	0.25	0.75
3-month interest rate, STIBOR	-0.44	-0.55	-0.20	-0.02	0.35	0.80
10-year bond yield	0.73	0.85	1.20	1.50	1.70	1.90
10-year spread to Germany, bp	32	25	50	60	60	60
USD/SEK	8.07	8.20	7.91	7.50	7.43	7.36
EUR/SEK	9.54	9.35	9.1	9.00	9.1	9.2
KIX	110.4	108.6	105.7	104.1	105.2	106.4

FINLAND

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	218	1.9	2.5	2.2	2.2
Private consumption	119	1.8	2.3	2.2	2.0
Public consumption	52	1.2	0.5	0.0	0.0
Gross fixed investment	46	7.2	5.0	3.8	4.0
Stock building (change as % of GDP)		0.4	0.0	0.0	0.0
Exports	76	1.3	3.3	3.7	4.0
Imports	79	4.4	3.0	3.1	3.3
Unemployment, OECD harmonised (%)		8.9	8.6	8.3	8.1
CPI, harmonised		0.4	0.8	1.0	1.3
Hourly wage increases		1.5	1.5	2.0	2.0
Current account, % of GDP		-1.1	-0.9	-1.0	-1.0
Public sector financial balance, % of GDP		-1.9	-1.7	-1.5	-1.3
Public sector debt, % of GDP		63.6	63.2	63.0	62.0

NORWAY

Yearly change in per cent

	2016 level, NOK bn	2016	2017	2018	2019
Gross domestic product	3,191	1.1	1.7	1.6	1.9
Gross domestic product (Mainland)	2,561	0.9	2.0	2.3	2.3
Private consumption	1,311	1.6	2.4	2.3	2.5
Public consumption	706	2.3	1.8	1.6	1.6
Gross fixed investment	711	0.3	4.0	2.4	2.8
Stock building (change as % of GDP)		0.3	-0.1	0.0	0.0
Exports	1,266	-0.5	0.9	1.3	1.5
Imports	956	0.8	2.9	2.4	2.5
Unemployment (%)		4.7	4.2	4.0	3.8
CPI		3.6	1.8	1.4	1.6
CPI-ATE		3.0	1.5	1.3	1.5
Annual wage increases		1.7	2.4	2.8	3.1

FINANCIAL FORECASTS	**23-Aug**	**Dec-17**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Deposit rate	0.50	0.50	0.50	0.75	1.00	1.25
10-year bond yield	1.57	1.55	1.55	1.75	2.00	2.20
10-year spread to Germany, bp	116	95	85	85	90	90
USD/NOK	7.87	8.03	7.83	7.33	7.10	6.88
EUR/NOK	9.30	9.15	9.00	8.80	8.70	8.60

DENMARK

Yearly change in per cent

	2016 level, DKK bn	2016	2017	2018	2019
Gross domestic product	2,065	1.7	2.3	2.4	2.4
Private consumption	987	2.1	2.3	2.7	3.2
Public consumption	525	0.4	1.1	0.8	0.4
Gross fixed investment	414	5.6	1.3	3.8	3.6
Stock building (change as % of GDP)		-0.2	-0.2	-0.1	0.0
Exports	1,102	2.5	4.8	3.8	3.6
Imports	963	3.5	3.6	4.1	4.1
Unemployment, OECD harmonised (%)		6.5	6.0	5.6	5.2
CPI, harmonised		0.0	0.9	1.1	1.4
Hourly wage increases		1.7	1.5	1.8	2.1
Current account, % of GDP		8.1	6.0	6.0	6.0
Public sector financial balance, % of GDP		-0.6	-1.6	-1.1	-1.1
Public sector debt, % of GDP		40.4	40.8	40.5	40.5

FINANCIAL FORECASTS	**23-Aug**	**Dec-17**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Lending rate	0.05	0.05	0.05	0.05	0.30	0.55
10-year bond yield	0.52	0.70	0.80	1.00	1.20	1.40
10-year spread to Germany, bp	11	10	10	10	10	10
USD/DKK	6.30	6.53	6.47	6.20	6.07	5.95
EUR/DKK	7.44	7.44	7.44	7.44	7.44	7.44

LITHUANIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	39	2.3	3.7	3.2	3.0
Private consumption	25	5.6	4.2	3.9	3.5
Public consumption	7	1.6	1.5	1.3	1.3
Gross fixed investment	7	-0.5	8.0	7.0	4.0
Exports	29	3.5	6.4	4.9	3.7
Imports	28	3.9	7.6	5.8	4.3
Unemployment (%)		7.9	7.3	7.0	6.8
Consumer prices		0.7	3.3	2.8	2.5
Public sector financial balance, % of GDP		0.3	0.0	0.3	0.2
Public sector debt, % of GDP		40.2	41.5	36.5	37.5

LATVIA

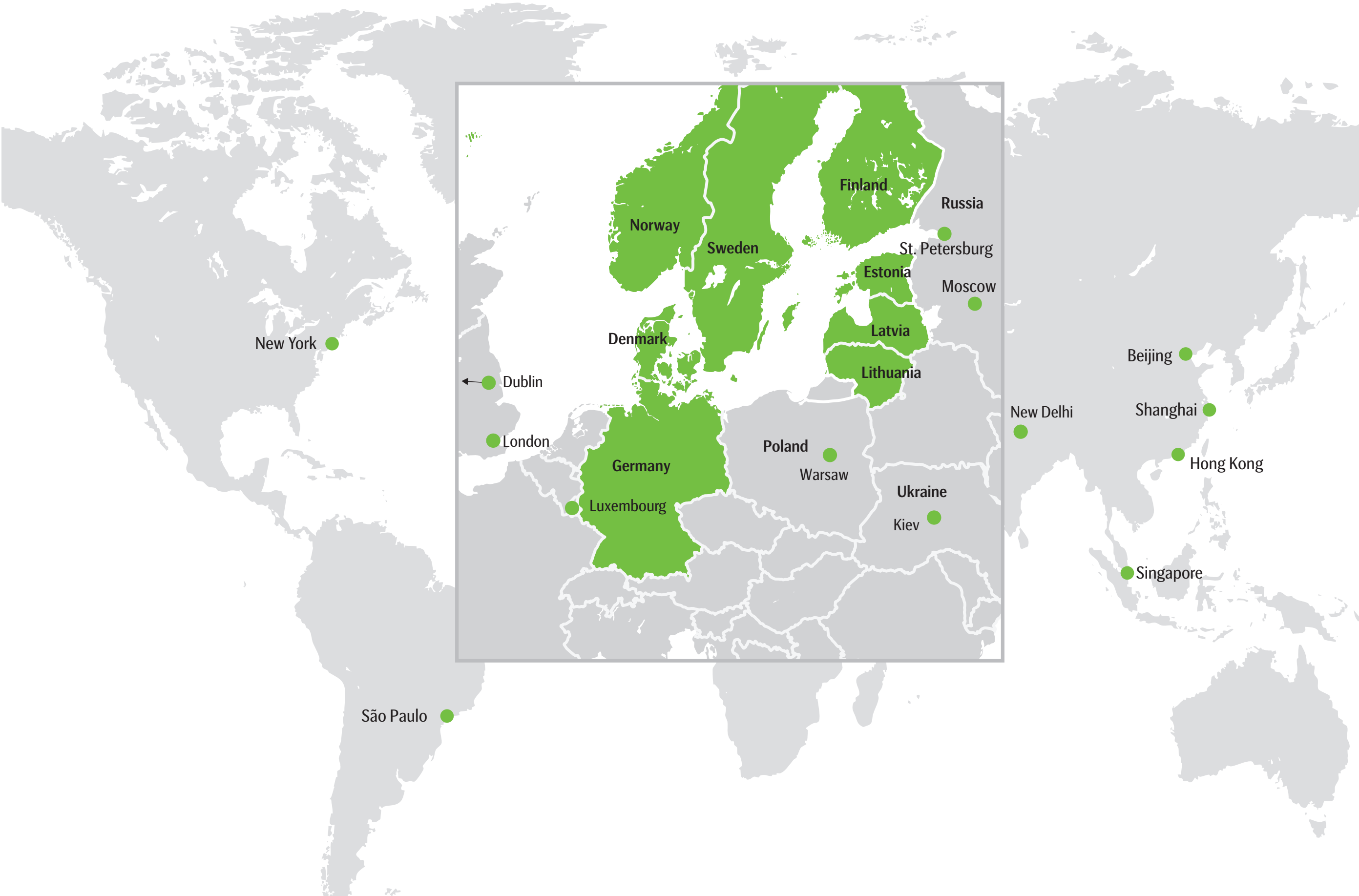
Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	25	2.0	4.1	3.7	3.2
Private consumption	15	3.5	5.2	5.7	4.1
Public consumption	4	2.7	3.4	2.0	1.8
Gross fixed investment	5	-11.7	8.5	9.0	7.5
Exports	15	2.8	8.4	6.6	5.5
Imports	14	4.6	8.0	8.0	6.0
Unemployment (%)		9.6	8.9	8.1	7.2
Consumer prices		0.1	3.0	2.7	2.3
Public sector financial balance, % of GDP		0.0	-0.6	-1.4	-1.3
Public sector debt, % of GDP		40.1	38.6	37.3	36.5

ESTONIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	21	1.6	3.6	3.2	3.0
Private consumption	11	4.3	2.5	4.5	2.8
Public consumption	4	1.0	2.5	2.0	2.4
Gross fixed investment	5	-2.8	10.6	1.8	4.2
Exports	17	4.0	5.8	3.8	4.0
Imports	16	5.3	6.2	4.0	3.7
Unemployment (%)		6.8	6.8	7.5	8.0
Consumer prices		0.8	3.2	2.8	2.5
Public sector financial balance, % of GDP		0.3	-0.3	-0.8	-0.8
Public sector debt, % of GDP		9.5	10.2	10.6	10.8



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