

Press release

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Nordic Outlook: The world economic situation is improving Growing risks of imbalances in overstimulated Swedish economy

Late-cycle growth forces are lifting the global economy, which will expand faster than the historical average throughout our 2017-2019 forecast period. But forecasts point to a complex balancing act between dramatic political events and classic cyclical issues such as the sustainability of growth, the resource situation and inflationary forces, according to SEB economists writing in the September 2017 issue of the quarterly *Nordic Outlook* report. So far this year, statistics have provided renewed support for a high Swedish GDP forecast. There are mounting risks of overheating, and Sweden's Riksbank will hike its key interest rate twice in 2018 and three times in 2019 to 0.75 per cent.

Despite dark political clouds, activity has surprised on the upside in many economies – for example in China, Japan and the euro zone as well as in the Nordic and Baltic countries – driven by ever-stronger labour markets, rising resource utilisation, increased trade and higher asset prices. Aside from greater geopolitical risks, there are also major social challenges such as economic inequality, ageing populations and sectoral job losses due to digitisation and automation. **GDP growth in the 35 mostly affluent countries of the Organisation for Economic Cooperation and Development (OECD) will reach 2.1 per cent this year and in 2018, then slow to 1.9 per cent in 2019.**

Central banks are encountering **diminished deflation and recession risks**. There are reasons to keep pursuing expansionary monetary policy, but it is becoming increasingly hard to justify its more extreme forms. Since 2008, central banks have created a **money surplus of about 15 trillion US dollars**, equal to 20 per cent of global stock market capitalisation. This will increase to about USD 16 trillion by the end of 2018. Monetary policy will thus maintain its expansionary direction during our forecast period, but with steps towards **continued normalisation** (US Federal Reserve), **reduction/phase-out** of stimulative bond purchases (European Central Bank, Riksbank) and **gradual key interest rate hikes** (ECB, Riksbank, Norges Bank, Bank of England). It is debatable whether the **Phillips curve** – which posits an inverse relationship between the unemployment level and the inflation rate – can serve as a policy anchor and communications tool for central banks, but studies by the International Monetary Fund (IMF) and the Bank for International Settlements (BIS), as well as our own estimates, conclude that this relationship persists – though weakened. **Inflation will thus move slightly upward in 2017-2019** amid continued challenges to achieving inflation targets. A combination of improved growth prospects and expansionary monetary policies will provide **continued support to stock markets**.

Labour market offsetting Trump's foreign policy rhetoric and changeability

In the United States – as expected – the political turbulence surrounding President Donald Trump's administration is not affecting the economy significantly, and tax cuts will not be enacted in 2017. **GDP growth will reach 2.2 per cent in 2017 and 2.4 per cent in 2018, then fall to 2.0 per cent in 2019** due to rising interest rates and worsening bottleneck symptoms. The federal debt ceiling will be raised this autumn, but the White House will continue to have difficulty in pushing through its political programme. The labour market is strong, with job growth more than twice as fast as needed to keep up with population growth. **Unemployment will fall below 4 per cent and pay increases will slowly move up towards 3.5 per cent yearly by the end of our forecast period.**

The Federal Reserve will hike its key rate one more time this year, three times during 2018 and once in 2019 to **2.50 per cent**, a level that is below what the Fed now regards as normal (about 3 per cent). The Fed will gradually

reduce its monetary policy portfolio during a four-year period, which represents a cautious monetary tightening. This will provide support for a stronger dollar, but as other central banks begin to follow the Fed's example, the dollar will lose ground against currencies such as the euro; **at the end of 2019, the EUR/USD exchange rate will be 1.25.** A weak dollar is beneficial to many debt-burdened emerging market (EM) economies.

Growing hopes of revived EU and euro zone integration

Euro zone growth has been the clearest exclamation point so far during 2017, and the upturn is becoming increasingly broad-based in sectoral and geographic terms. **GDP will increase by a bit above 2 per cent in 2017 and 2018, slowing marginally in 2019. Unemployment will fall** by about 1 percentage point to slightly above 8 per cent in 2019, which is close to its equilibrium level. A probable victory by Chancellor Angela Merkel and her CDU/CSU in September's German parliamentary election will confirm our scenario of a significantly more stable political situation in the euro zone than widely feared early in this super-election year, although the Italian election in the spring of 2018 still adds some uncertainty. Looking ahead, however, the focus of attention will shift from national elections to **an intensive agenda of proposed European Union (EU) and euro zone reforms. A renewed German-French leadership duo** will aim at the European Parliament election in 2019, with the ambition of launching multi-speed EU cooperation starting in 2025. A flare-up of tensions connected to overly zealous federalist ambitions – for example between Denmark/Sweden and core EU countries, combined with disappointing French structural reforms – is a potential risk.

An improved budget situation thanks to earlier austerity programmes, economic growth and low interest rates will enable national governments to pursue weakly expansionary fiscal policies. If the euro zone also increases its integration and takes steps towards a fiscal policy union with Germany as “guarantor”, this will **decrease pressure on the ECB** to maintain negative interest rates and make stimulative bond purchases. This autumn, the ECB will formally decide to reduce its monthly purchases from 60 to 40 billion euros in the first half of 2018. After that it will end the bond-buying programme and raise its deposit rate for banks from -0.40 to -0.25 per cent. **During 2019 the ECB will hike its refi rate from 0.00 to 0.50 per cent.**

The Brexit process (United Kingdom withdrawal from the EU) remains surrounded by big questions. British households are being squeezed by loss of purchasing power due to inflation, which has climbed as the pound has lost value. Uncertainty will halve economic growth in 2018 to 1 per cent, compared to 2017, due to weaker capital spending. This autumn London and Brussels must agree on future reciprocal rights for UK and EU citizens and how much the British must pay to leave the EU. The domestic political situation makes another UK snap election possible.

EM economies accelerating after a period of slower growth

Growth curves are pointing upward in the emerging market sphere (accounting for about 60 per cent of the world economy in terms of purchasing power parities, PPP), with overall GDP in the sphere accelerating from an 4.3 per cent increase in 2016 to around 5.0 per cent in 2017-2019. Beijing is now orchestrating a partly credit-related deceleration, aimed at achieving a stable economy that will make its political succession process easier. **China's GDP growth will be 6.8 per cent this year**, well above the official target of about 6.5 per cent, but will fall to **6.4 per cent in 2018 and 6.1 per cent in 2019.** Inflation is expected to be lower than the informal 3 per cent target. **The yuan will appreciate** during our forecast period from 6.70 to 6.40 per dollar at the end of 2019. In **India**, yearly growth will accelerate to nearly 8 per cent as certain reforms are implemented. **Russia** and **Brazil** are emerging from recessions, but GDP will increase by only 2 per cent annually in 2017-2019; in Russia the lack of reforms will hold back growth, while the Brazilian economy will be slowed by political instability. Our forecast for EM economies assumes **oil prices (Brent crude) of USD 55-60 per barrel, with clear downside risks.**

Positive growth signals in the Nordic and Baltic economies

The upswing in the world economy, especially in Europe, will contribute to new growth improvements in the Nordic and Baltic countries. The **Finnish economy** will expand by 2-2.5 per cent annually in 2017-2019 and will also be helped by the more stable outlook in Russia. Household consumption will be an increasingly important growth

engine in **Denmark**, as previously tight credit market conditions are eased; GDP will expand by 2-2.5 per cent yearly in 2017-2019. The situation in **Norway** will also be more positive; capital spending in the oil sector will recover, and sentiment indicators are upbeat. GDP will increase by 1.5-2.0 per cent a year. In **Estonia**, exports will lift the growth rate to a high 3.6 per cent this year, followed by a slight deceleration as inflation dampens private consumption. **Latvia's** high GDP growth will eventually run into bottleneck problems and rising wage pressure; growth will retreat from 4.1 per cent this year to 3.1 per cent in 2019. Aside from exports, capital spending is an important economic driver in **Lithuania**; the labour force is shrinking. Growth will decelerate from 3.7 per cent this year to about 3 per cent in 2019.

Sweden is booming, but a lack of policy coordination poses major risks

Broad-based Swedish growth is being fuelled by pro-cyclical fiscal policy, extreme monetary policy and a weak krona. We predict that **GDP will increase by 3.2 per cent this year, 2.8 per cent in 2018 and 2.4 per cent in 2019**. Residential investments remain the most important driver, while private consumption is increasing more sedately and new measurement methods indicate stagnating public sector consumption volume despite record-high public job growth. Increasingly serious recruitment problems, especially in construction and the public sector, will hamper economic growth during the latter part of our forecast period. Despite a rapidly expanding labour supply, we anticipate that **unemployment will fall below 6 per cent in 2018. The annual rate of pay increases will climb to 3.5 per cent in 2019**. An unexpectedly strong labour supply will allow a longer period of above-trend economic growth and generate room in the central government budget for new spending, but there are clear signs of imbalances in the trend of home prices and household debt.

Sweden's centre-left minority government is pushing hard to win the September 2018 election amid a confused domestic political landscape. We expect the government's autumn budget for 2018 to include **SEK 30 billion in reforms and stimulus measures**. Due to a lack of tax hikes, this represents a more expansionary and pro-cyclical fiscal policy. Yet government debt will fall to just above 35 per cent of GDP during 2019, in line with the "debt anchor" in Sweden's new official fiscal policy framework. A budget surplus of about 1 per cent of GDP per year in 2017-2019 along with the Riksbank's loan repayments to the National Debt Office will push down government debt. A shrinking supply of government bonds will squeeze Swedish long-term yields.

Although inflation will climb somewhat, it will not reach the 2 per cent Riksbank target on a sustained basis despite the economic boom, but given a tightening resource situation and policy normalisation in other countries the Riksbank will hike its key interest rate in April 2018 and then carry out another **four rate hikes during 2018-2019 to 0.75 per cent**. Because monetary policy is extremely loose amid strong expansion, there are **increased risks of major economic reversals** ahead, due to pumped-up household debts and home prices.

Today the krona is 5 per cent undervalued against the euro and US dollar. As the Riksbank's rate hikes approach, the Swedish currency will appreciate. **The EUR/SEK exchange rate will be 9.35 at the end of 2017 and 9.00 at the end of 2018. As the euro strengthens on the global stage, the EUR/SEK rate will rebound to 9.20 during 2019.** After an upturn this autumn, **we expect the USD/SEK exchange rate to reach 8.20 at the end of 2017 but then fall to 7.50 at the end of 2018 and 7.35 at the end of 2019.** The adverse effect on Swedish export companies will be softened by stronger global economic conditions.

Key figures: International & Swedish economy (figures in brackets are forecasts from the May 2017 issue of *Nordic Outlook*)

International economy, GDP, year-on-year changes, %	2016	2017	2018	2019
United States	1.5	2.2 (2.3)	2.4 (2.5)	2.0
Eurozone	1.8	2.1 (2.0)	2.2 (2.0)	2.0
Japan	1.0	1.3 (0.8)	0.8 (0.5)	0.7
OECD	1.8	2.1 (2.1)	2.1 (2.2)	1.9
China	6.7	6.8 (6.7)	6.4 (6.3)	6.1
Nordic countries	2.1	2.5 (2.2)	2.3 (2.1)	2.2
Baltic countries	2.0	3.5 (3.1)	3.3 (3.2)	3.1
The world (purchasing power parities, PPP)	3.1	3.8 (3.7)	3.8 (3.8)	3.7
Swedish economy. Year-on-year changes. %				
GDP, actual	3.2	3.2 (3.1)	2.8 (2.6)	2.4
GDP, working day corrected	2.9	3.5 (3.4)	2.9 (2.7)	2.5
Unemployment, % (EU definition)	6.9	6.5 (6.4)	6.0 (6.1)	6.1
Consumer Price Index (CPI) inflation	1.0	1.8 (1.6)	1.8 (1.6)	2.0
CPIF (CPI minus interest rate changes)	1.4	1.9 (1.7)	1.7 (1.6)	1.8
Government net lending (% of GDP)	0.9	1.0 (0.6)	0.9 (0.6)	0.8
Repo rate (December)	-0.50	-0.50 (-0.50)	0.00 (0.00)	0.75
Exchange rate, EUR/SEK (December)	9.19	9.35 (9.30)	9.00 (8.95)	9.20

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