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Downside risks from bottlenecks and markets, but dovish central banks help prolong upturn

Swedish growth slump, despite dovish Riksbank and fiscal stimulus measures

Nordic Outlook

SEB

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International overview

Risks from bottlenecks and market fears, but no recession

Late-cyclical bottlenecks, changing risk appetite and continued trade-related and other political uncertainties complicate the economic outlook, but financial market worries are not strong enough to trigger a recession. Robust household balance sheets and capital spending needs, due to high capacity utilisation, provide underlying strength. Moderate inflation will also allow central banks to ease their pace of normalisation. Our global growth forecasts have again been lowered a bit but remain above trend.

The end of 2018 was **dominated by weak economic data and sharply lower risk appetite due to increased recession worries**. Signs of weakness were clearest in Western Europe and Asia, while the American economy showed continued strength. The US Institute for Supply Management (ISM) purchasing managers' index showed a slowdown in December, however, especially for the key question about order bookings. Various political factors helped to intensify financial market worries. The budget conflict between the Trump administration and Congress could not be resolved; instead it led to a partial federal government shutdown. President Donald Trump has also continued to deliver capricious statements, especially in the trade policy field. Because the British Parliament has now resoundingly rejected the agreement on the terms of United Kingdom withdrawal from the European Union which the government had negotiated, the threat of a hard Brexit persists.

We are now seeing a typical late-cyclical pattern, where **negative economic and political news can suddenly trigger powerful and seemingly disproportionate financial market reactions**. In recent weeks, market sentiment rebounded a bit as the US Federal Reserve (Fed) signalled increased sensitivity to market worries and a greater inclination to adapt its monetary policy to incoming economic statistics. Moderate inflation figures give the Fed room for such an attitude. Market relief that the risk of policy mistakes has decreased is also rational. Meanwhile strong US labour market data show that sooner or later, bottleneck problems will emerge. Of course a more dovish monetary policy is not the right medicine for this.

In the November issue of *Nordic Outlook*, we lowered our global growth forecast by about a quarter of a percentage point. This time around we are taking a smaller step in the same direction, with **downward revisions of about a tenth of a point in both 2019 and 2020**, mainly attributable to weaker performance in the 36 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD). In the United States, this is mainly due to increasingly evident supply side restrictions. In Western Europe, it is due to generally weaker demand, yet we believe that temporary factors – especially adjustment problems related to new auto industry regulations – amplified the downturn late in 2018. We have also revised our Swedish GDP growth forecast sharply lower, among other things because of weakness at the end of 2018. Due to looser economic policy in China – related to both credit and monetary policy, as well as fiscal policy – and a continued strong economic upturn in India, emerging market (EM) economies will continue to demonstrate growth of nearly 5 per cent in 2019 and 2020. This means that overall **global GDP will grow by 3.5 per cent (in terms of purchasing power parities, or PPP) both in 2019 and 2020**.

Global GDP growth
Year-on-year percentage change

	2017	2018	2019	2020
United States	2.2	3.0	2.4	1.7
Japan	1.7	1.1	1.0	0.8
Germany	2.2	1.5	1.2	1.4
China	6.9	6.6	6.3	6.1
United Kingdom	1.8	1.4	1.3	1.6
Euro zone	2.4	1.9	1.6	1.7
Nordic countries	2.2	1.6	2.0	2.0
Baltic countries	4.4	3.7	3.2	2.7
OECD	2.5	2.4	1.9	1.8
Emerging markets	5.0	4.9	4.7	4.8
World, PPP*	**3.7**	**3.7**	**3.5**	**3.5**

Source: OECD, IMF, SEB. * Purchasing power parities

A number of leading central banks face the same general dilemma as the Fed, though to varying degrees. Unemployment in advanced economies (the OECD countries) is now at its lowest since 1980. Most forecasts indicate that it will continue to fall during the next couple of years even though growth is slowing. But although the rate of pay increases has accelerated by about one percentage point in our composite metric for the four largest economies (the US, the euro zone, Japan and the UK), pay hikes are still historically low. This is contributing to persistently low underlying inflation pressure, **enabling the central banks to further slow the pace of an already leisurely normalisation process**. We believe they will also use this manoeuvring room, and we have thus lowered our key interest rate forecasts. We now believe that the Fed will content itself with one rate hike in June 2019 and then **stop at a federal funds level of 2.75 per cent**. We have also adjusted our forecasts for central banks in Western Europe downward by 25-50 basis points.

More dovish central banks will also affect our other financial forecasts. Above all, the existing low interest rate environment will continue. For example, **we do not believe 10-year US Treasury yields will climb above 3 per cent again** in 2019-2020, after losing about 60 basis points since peaking close to 3.25 per cent last autumn. Ten-year German yields have also fallen extremely low, to around 0.2 per cent. **Given the extreme caution of the European Central Bank (ECB), we do not believe they will climb above 0.70 per cent during our forecast period**.

Last year saw a gradual lowering of corporate earnings expectations, but the dramatic stock market slide late in 2018 was instead driven by unsatisfactory macro data and increased recession worries. Valuations have now fallen, and price-earnings (P/E) ratios for our global equity index are around 13. The US pulls up the average, while Europe stands at about 12 and the EM sphere as low as 10. The ongoing Q4 2018 report season will be important, setting the tone for much of 2019. **Earnings estimates will probably be adjusted downward towards a rate of increase around 5 per cent in 2019**. Stock markets will remain very sensitive to recession signals and thus show continued high volatility, but if our forecast that the world will avoid recession proves correct, we see prospects of slightly rising share prices in 2019-2020.

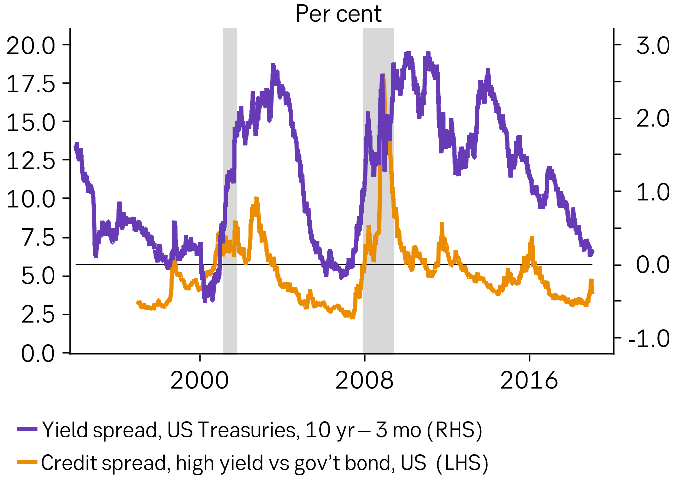
Interaction between markets and the real economy

The interaction between financial markets and the real economy is now dominated by a typical late-cyclical pattern. Investors are especially sensitive to negative news that increases the risk of recession and thus radically changes the conditions governing the corporate earnings outlook. Economic analysts, for their part, must take into account the extent to which prevailing financial market worries will impact the real economy: either because they already foresee falling profits and consequent lower investments or because a downturn in asset prices will weaken the balance sheets of households and businesses, hampering consumption and capital spending via the wealth channel. As we discussed in the November issue of *Nordic Outlook* (see box, page 11), we have seen US equities fall by at least 10 per cent 18 times since the mid-1980s, a period when we have only had three global recessions. During the thin trading around the Christmas 2018 holidays, however, they were down by some 20 per cent, which has only happened 4-5 times during this period without being followed by a recession.

The corporate bond market also provides important signals about the state of the economy, especially when it comes to high-risk companies. **Yield spreads against government bonds have widened somewhat during the prevailing turbulent period, and there has been a substantial decrease in the volume of new issues**, especially in the European market. Generally, however, spreads remain narrow in a historical perspective and also shrank somewhat as risk appetite recovered in recent weeks.

An inverted yield curve (with short-term yields higher than long-term yields) is a historically reliable recession indicator (see *"Theme: Recessions, stock market dips – what can history teach us?"*, page 18). However, there are episodes, such as in 1994 and 1998, when the slope of the yield curve was almost entirely flat without triggering a recession. On these occasions, however, resource utilisation was relatively moderate, **giving the Fed room to soften its policy actions in order to lower recession risks**. In 1994 this occurred with a certain lag, while in 1998 the Fed rather immediately lowered its key rate.

Slopes and spreads provide important signals



Source: Macrobond, SEB

The situation preceding the Fed's first rate cut ahead of the recession right after the millennium shift also has a bearing on today's situation. At that time, the stock market downturn had been of about the same magnitude as we saw late in 2018 (around 15 per cent for broad US indices) and growth had begun to decelerate somewhat. Like today, however, the labour market was very tight and unemployment was at a 30-year low of less than 4 per cent. In this environment, the Fed's rate cut came very unexpectedly and led to a relief rally of no less than 14 per cent in one day on the Nasdaq stock exchange. Yet this turned out to be only a brief interruption in the downward stock market trend that would last for another two years. Although there are major differences compared to the current situation – especially that today's share valuations are much more cautious than at that time – this is a good example of the fact that **in some situations it is impossible to prolong an economic expansion by loosening monetary policy**.

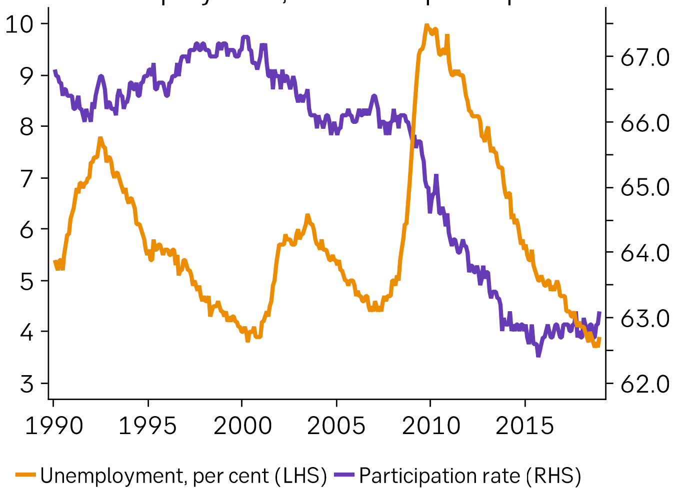
In the current situation, our conclusion and that of most other economists is that the impact of financial market turmoil on the real economy is not strong enough to trigger a recession. The more dovish attitude of central banks instead has the potential to strengthen risk appetite to some extent. Underlying strengths such as robust household balance sheets and capital spending requirements, due to high resource utilisation, may again make themselves felt. **This would mean that we can hope that future developments will follow the pattern from 1994 and 1998 and not that of 2001**.

The further along in the economic cycle we move, the more the downside risks increase, however. Arguments in favour of strong demand are usually present well into a mature economic expansion, and they are usually not exhausted once the downturn arrives. Once the recession is actually triggered, it is often because financial markets believe that the bias in the economic forecast is leaning excessively in a negative direction. The upside is not closed, but for supply side reasons it is so small that it is not defensible to position oneself for a continued economic expansion. This triggers a financial market reaction that finally forces such sharp downward revisions in the GDP outlook that the recession spiral can no longer be stopped. However, **we believe that at present the risk of a recession is around 20-25 per cent**.

US: Labour market is crucial

The US economy slowed down gradually in 2018, following its 4.2 per cent growth peak in the second quarter, but the economy also grew above trend during the latter part of the year. Recently, however, uncertainty on the demand side has increased, partly due to the downturn in the ISM purchasing manager's index for December. Trade disruptions have also drawn greater attention, although so far the concrete effects of increased trade tensions have been minor. The partial shutdown of the federal government due to a budget conflict between President Trump and Congress will also hamper growth somewhat in early 2019. This may only be a matter of temporary effects, but recession worries might still increase if Q1 were to show very weak figures. Overall, we still believe that demand will hold up, mainly due to good potential for continued consumption growth. **Expressed as full-year averages, we expect GDP growth to gradually slow from 3.0 per cent in 2018 to 2.4 per cent in 2019 and 1.7 per cent in 2020**.

Low unemployment, moderate participation rate



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

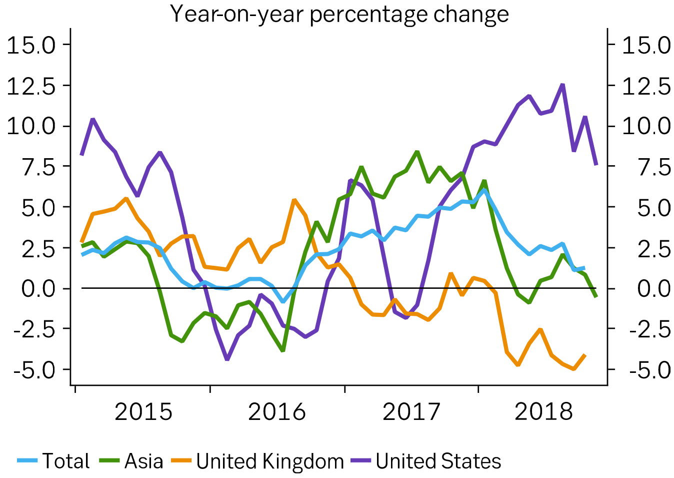
Supply side restrictions will play an increasing role in the slowdown as our forecast period progresses. The latest monthly labour market figures were interesting in many ways. December's exceptionally high job growth of 312,000 boosted the average monthly upturn in 2018 to an impressive 220,000. Yet unemployment rose to 3.9 per cent from a record-low 3.7 per cent (three months in a row). This combination was possible because labour force participation rose by two tenths of a per cent to 63.1 per cent. Since September, participation has thus gained 0.4 points. Overall participation is still well below the levels achieved in 1990-2005 (see chart), partly due to demographic effects. As for the 15-64 age group, participation has risen by 2 points since bottoming out in 2015. If the ageing of the population is factored in, our calculations suggest **room for an upturn of about another 2 percentage points**. There is now little potential for further downturns in unemployment. We expect it to bottom out at a bit below 3.5 per cent at the end of 2019. In such a situation, the participation rate trend is crucial in determining how long the recession can be postponed.

Euro zone: Slight rebound from depressed level

Developments in Western Europe differ in many ways from those in the US. Signs of weakness predominated throughout 2018, and sagging demand was a major threat. Indicators fell, with purchasing managers' indices (PMIs) at their lowest since 2013. Quarter-on-quarter GDP growth slowed from 0.7-0.8 per cent in 2017 to 0.2 per cent in Q3 2018. We can single out a number of temporary reasons, such as weather effects and especially adjustment problems in the auto industry due to the introduction of new rules. The downturn was seemingly driven mainly by international factors such as China's slowdown, worries about the Brexit process and trade policy tensions.

Euro zone exports have decelerated

Year-on-year percentage change



Source: Eurostat Database, Macrobond, SEB

A many-faceted political situation will continue to cast its shadow over euro zone performance. In some ways the situation may become clearer, but overall uncertainty will remain heightened. The threat of escalating global trade wars will hurt this export-dependent region. Brexit will also hamper trade with a vital export market and make companies hesitant to spend for the future. In France, the "yellow vest" strikes have lowered activity in domestic sectors like services and retailing. There is continuing uncertainty about Italy's government and fiscal policy. Although Rome and Brussels appear to have called a temporary truce, Italy's weak growth, high public debt and the bad loans in the banking sector remain problematic.

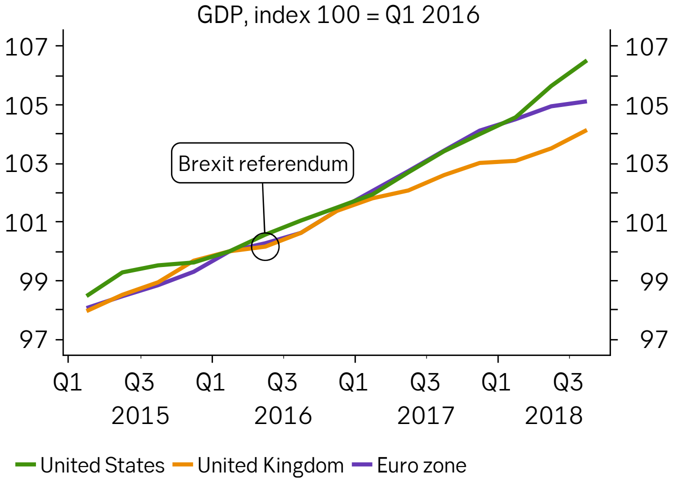
Yet the underlying conditions for domestic expansion in the euro zone are still good, with major capital spending needs in the wake of high capacity utilisation and with favourable potential for household consumption, partly due to increasingly loose fiscal policies. We thus foresee a slight rebound in sentiment indicators and quarter-on-quarter GDP figures. **We expect annual GDP growth to end up at 1.6 per cent in 2019 and 1.7 per cent in 2020**: a downward revision by 0.3 and 0.1 points, respectively, but somewhat above trend and enough to make a slight further downturn in unemployment possible.

Parliamentary defeat increases Brexit uncertainty

The EU withdrawal agreement negotiated by Prime Minister Theresa May was defeated by the widest margin in the history of the British Parliament. It is unlikely that this proposal can now be saved by minor tweaking. Instead the government will now be forced to choose another path. At present it is difficult to discern what might work. This makes a decision to withdraw on by the scheduled date of March 29 increasingly improbable. Withdrawal is likely to be postponed by at least three months. The negative consequences of the Brexit decision for economic growth and capital spending have been apparent since early 2017, even though various actors seem to have assumed that it would be possible to find a workable transitional solution. If no alternative solution is presented soon, it is thus reasonable to believe that the risk of a no-deal Brexit will now have an increasingly large adverse impact on the UK economy.

UK losing ground against US and euro zone

GDP, index 100 = Q1 2016



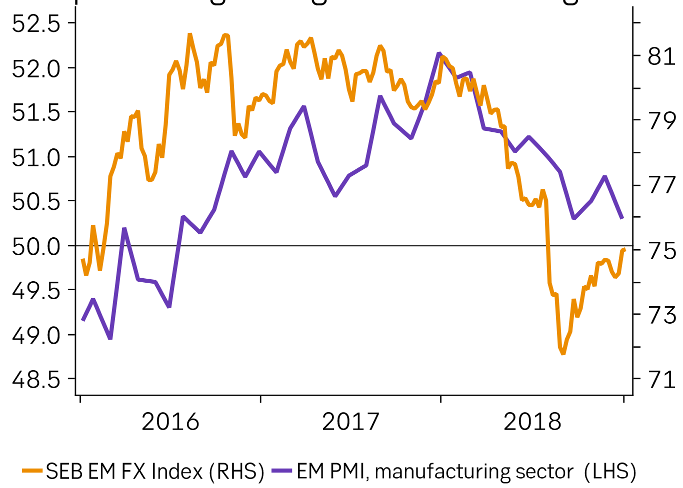
Source: BEA, ONS, Eurostat

Although our forecast assumes that a no-deal Brexit will be avoided, uncertainty about future UK-EU relations persists. **Partly because of weak capital spending, GDP growth will be stuck at around 1½ per cent despite the weak pound**. This means the UK is losing ground against most other economies. Despite below-trend growth, the labour market is tight and we are seeing clear signs of accelerating pay growth. This is making the UK central bank worried about future cost pressure and will contribute to further key rate hikes during our forecast period.

Moderate slowdown for EM economies

GDP growth in emerging market (EM) economies slowed in 2018. The downturn was the most evident in manufacturing, where the purchasing managers' index (PMI) late in the year was at its second lowest since August 2016. The slowdown is largely driven by more subdued industrial production in the US, EU and China, which has hampered international trade. Expectations of weaker global demand have also driven down commodity prices, hurting the external balance of many commodity-exporting EM countries and increasing their worries about how to fund foreign-currency loans. Yet our aggregate figure for EM economies shows only a marginal downturn in GDP growth: a preliminary 4.9 per cent, compared to 5.0 per cent in 2017. **In 2019 there will be a further decline to 4.7 per cent and in 2020 a slight upturn to 4.8 per cent**.

EM purchasing managers' index heading lower



Source: IHS Markit, Macrobond, SEB

Financial markets have focused on the slowdown that has been under way for about a year, leading to plunging stock markets and currencies in countries with large foreign funding needs such as Turkey and Argentina, as well as South Africa, India and Indonesia. Viewed from a historical perspective, though, the growth rate in the world economy and in the EM countries is still good. Despite the slowdown, international trade keeps growing at a decent 3-5 per cent year-on-year. The manufacturing outlook remains uncertain, but **consumption and labour markets still look strong in most of the countries in our EM sphere**. Above all, looser economic policy in China – both credit and monetary policy (see *"Theme: Chinese and US monetary policies increasingly interconnected"*, page 27) – combined with continued robust growth in India will help the EM economies remain an important engine of the world economy.

GDP growth, BRIC countries and EM sphere

Year-on-year percentage change

	2017	2018	2019	2020
China	6.9	6.6	6.3	6.1
India	6.3	7.6	7.8	7.3
Brazil	1.0	1.2	2.5	2.6
Russia	1.5	1.6	1.6	2.0
Emerging markets, total	**5.0**	**4.9**	**4.7**	**4.8**

Source: OECD. SEB

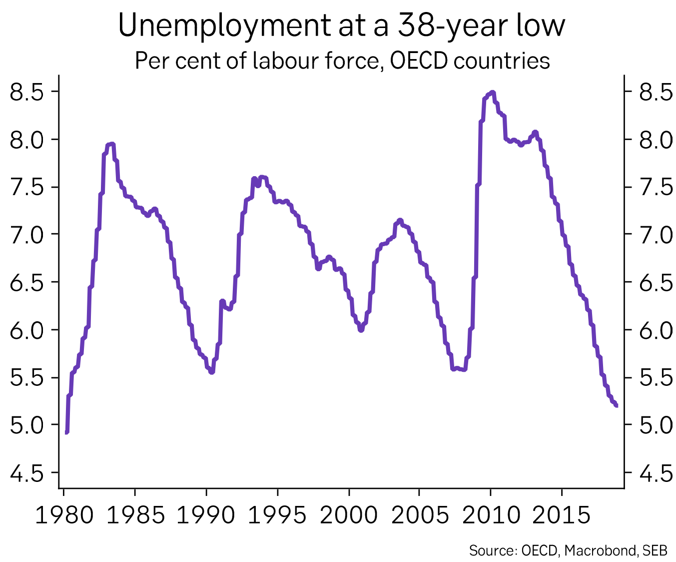
One reason to look ahead at 2019 with a degree of confidence is that **inflation is still subdued in the EM sphere**, with some exceptions. Lower oil and other energy prices have helped hold back price increases, but core inflation has also been subdued. Some interest rate hikes can be expected, especially early in 2019, to compensate for the inflation surge resulting from a general weakening of EM currencies in 2018. Thanks to continued moderate inflation and a more dovish attitude, especially by the US Federal Reserve, there is room in countries such as China, Mexico and Russia as well as Turkey for interest rate cuts, which will support growth further ahead. **The risk of an interest rate shock that might choke off capital flows to**

EM countries and cause payment difficulties has decreased, but it has not disappeared.

Although the slowdown in our main scenario is not powerful enough to lead to a broader crisis, volatility and uncertainty are likely to remain predominant in 2019, as they were in 2018. Worries about a deeper deceleration in China and the impact of the trade war will probably cause periods of risk aversion and market fluctuations. The EM economies will also be especially sensitive to concerns about an American hard landing. Eastern Europe is also highly vulnerable if a hard Brexit has negative consequences for European trade.

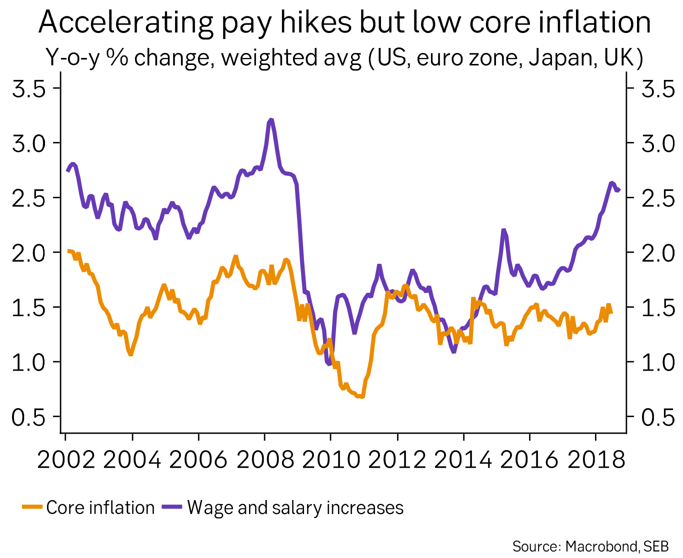
OPEC+ production cuts will stabilise oil prices

Early in 2019, oil prices (Brent crude) were around USD 55-60/barrel after a sharp decline from USD 86 at the beginning of October 2018. One important reason for the decline was that "OPEC+" (the Organisation of the Petroleum Exporting Countries plus Russia and nine other countries) sharply increased oil production starting in May 2018 and until the OPEC meeting in December. Weaker macroeconomic indicators combined with strong growth in US oil output as well as speculative repositioning also contributed. But now OPEC+ is lowering production significantly. These cutbacks began in December 2018 and will intensify during the first half of 2019. We also believe that the price decline since October 2018 will lead to more cautious US shale oil investments and thus to a weaker growth path for American oil production. We believe that this will lead to an average 2019 price level of USD 65/barrel, rising somewhat further during 2020.



Falling CPI inflation

Although oil prices are now stabilising and are expected to climb slightly, consumer price index (CPI) inflation is on a clear downward path as the effects of earlier prices increases disappear from the 12-month figures. Headline inflation will thus be lower than core inflation (which excludes volatile components such as energy and food prices) during most of 2019. Core inflation has recently remained flat. Despite relative high resource utilisation, businesses have found it hard to pass on higher input costs to consumers. Nor is the drought in Europe this past summer likely to have any major impact.



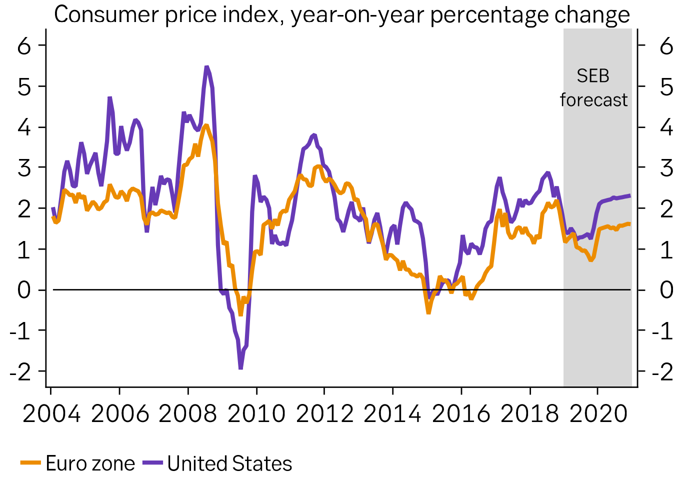
Looking ahead, the crucial question in determining the inflation trend is this: To what extent will record-low unemployment lead to higher wage pressure? **The overall rate of pay increases in the world's four largest advanced economies has accelerated from 1.7 per cent in the spring of 2017 to about 2.5 per cent** (see chart below). This is still a modest rate, considering that unemployment is now generally lower than in 2007. But from an inflation perspective we should also take into account that the underlying productivity growth trend after the Lehman Brothers crisis of 2008 has fallen significantly. If this trend persists, in the future **it will require a lower rate of pay increases than before to achieve 2 per cent inflation**. But because of relatively good growth in both household purchasing power and corporate earnings, there is reason to suspect that national accounts may underestimate the underlying trend of productivity growth (see theme article, page 13). Cost-side inflation pressure in the form of unit labour cost (ULC) may thus be exaggerated. In light of this, as well as more subdued economic performance, we foresee fewer upside risks than in our previous forecast.

Central banks easing the pace of normalisation

In 2018 the retreat from ultra-loose monetary policies broadened as the Bank of England, Norges Bank and finally the Riksbank joined the Fed in hiking key interest rates, while the European Central Bank phased out its bond purchases. This policy was justified by ever-tighter labour markets and signs of accelerating pay increases in several major countries. Because of the more uncertain economic picture, worries about long-term inflation risks are now fading. Falling stock markets and tendencies towards wider credit spreads are contributing to somewhat tighter financial conditions. Market-based inflation expectations have also fallen again, due to new oil price declines, while underlying inflation metrics have remained modest, with few signs of speeding up. The US fixed income market has even occasionally started to discount Fed interest rate cuts further ahead.

Falling CPI inflation

Consumer price index, year-on-year percentage change



Source: Eurostat, BLS, SEB

This changed risk picture is reflected in the latest easing of central bank signals. In December, Fed policymakers revised their average individual forecasts for 2019 from three to two rate hikes and slightly lowered their estimate of a neutral interest rate. Early in 2019 the Fed softened its rhetoric further, including signals of a pause in rate hikes. At its December policy meeting, the ECB chose not to disagree with the market's lower interest rate expectations and indicated greater uncertainty about economic trends. As Norges Bank had previously done, the Riksbank moderated its initial rate hike by simultaneously decreasing the number of planned future hikes. How monetary policy unfolds in the future will depend on how quickly and to what extent the economy slows down. Our scenario – with a deceleration in GDP growth to levels somewhat above trend and with inflation remaining moderate – allows room for a cautious response ahead which tries to extend the economic expansion.

We now believe that the Fed will be content to carry out only one rate hike during 2019 (June), leaving its key rate at 2.75 per cent. This is roughly in line with the Fed's new estimate of a neutral interest rate. The reduction in the Fed's balance sheet will continue as planned, however, though Chairman Jerome Powell has indicated a more flexible approach to this part of Fed policy as well. The ECB has stuck to its statement that an initial rate hike will occur no earlier than after this summer, and we do not expect any policy changes in the near term. Our forecast is now that that ECB's first rate hike will occur in December 2019 and that the ECB will be content to raise its rate for banks by 15 basis points to -0.25 per cent. **Not until late 2020 will the ECB hike both its deposit rate and refi rate to 0.00 and 0.25 per cent, respectively**. Our December 2020 forecasts for both the Fed and ECB are thus 50 bps lower than in November's *Nordic Outlook*. As earlier, we expect the ECB to ensure continued access to cheap liquidity by approving new targeted longer-term financing operation (TLTRO) floating rate loans this spring, while reinvesting its maturing bonds. In Japan, the inflation target will remain out of reach and **the Bank of Japan will continue its ultra-loose monetary policy, with a slightly negative key interest rate** and a continued long-term government bond yield benchmark of around zero. China will keep its key rate stable in order to avoid capital outflows but will **stimulate the credit supply by other means, including further cuts in bank reserve requirements**. British withdrawal from the EU will be postponed, and as long as uncertainty continues the Bank of England will leave its key rate unchanged. Otherwise the tight UK labour market would justify rate hikes, and **we expect one hike this year to 1.00 per cent, followed by one hike to 1.25 per cent in 2020**: 50 bps below our earlier forecast.

Domestic strengths will also provide support for continued normalisation by Norges Bank. **We are maintaining our earlier forecast of two rate hikes during 2019**. This will be followed by two more hikes in 2020. The Riksbank also appears to have broadened its perspective to a greater extent than before, with its monetary policy being determined more than before by the domestic resource situation. The Swedish central bank has relaxed its earlier strong connection to ECB policy and toned down its concerns about krona appreciation, while its picture of inflation risks has become more balanced. However, since the Swedish economy is also on its way towards a deceleration, while inflation remains low, the Riksbank will most likely have to ease its rate path somewhat further. Our forecast is that the next rate hike will occur in October 2019 and that **the Riksbank will be content with one hike during 2020 to a repo rate of 0.25 per cent**, or 50 bps below our November forecast.

Central bank key interest rates
Per cent

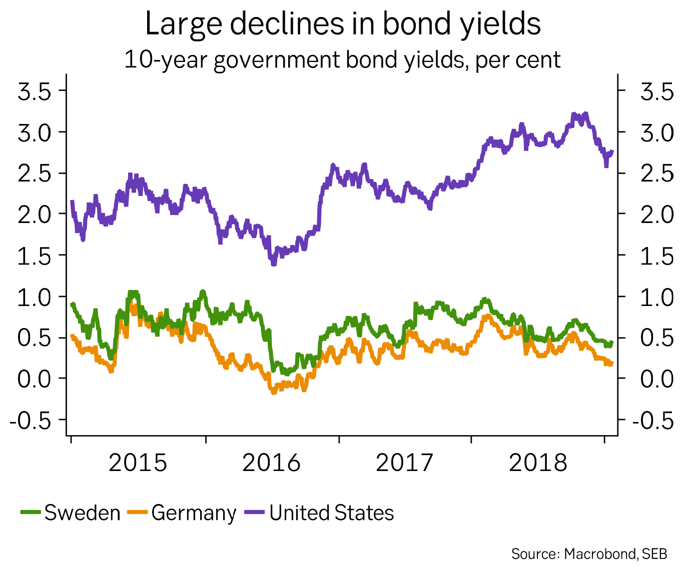
	Jan 16	Jun 2019	Dec 2019	Jun 2020	Dec 2020
Federal Reserve (Fed)	2.50	2.75	2.75	2.75	2.75
ECB (refi rate)	0.00	0.00	0.00	0.00	0.25
Bank of England (BoE)	0.75	0.75	1.00	1.00	1.25
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10	-0.10
Riksbank (Sweden)	-0.25	-0.25	0.00	0.00	0.25
Norges Bank (Norway)	0.75	1.00	1.25	1.50	1.75

Source: Central banks, SEB

US Treasury yields have peaked

Recent months have witnessed large fluctuations in the bond market, and 10-year US Treasuries have fallen by around 50 basis points since peaking at nearly 3.25 per cent last autumn. This downturn in yields has been closely connected to lower expectations of Fed key interest rate hikes. After remaining largely flat during 2018, the market's inflation expectations have also fallen in recent months. The downturn has been largest for short-term expectations, but long-term inflation expectations have also fallen.

The risk appetite trend will probably determine which way long-term yields move during the next few months. We believe that improved risk appetite, a somewhat higher inflation outlook due to rising US wages and salaries as well as **a final Fed rate hike will boost 10-year Treasury yields to 3.0 per cent in mid-2019**. However, the market is already pricing in a relatively high probability of a Fed rate cut during 2020, and most indications are that we will not return to last autumn's yields. Long-term US yields are thus past their peak. **Our forecast for 10-year Treasury yields is 2.75 per cent at the end of 2019 and a continued downturn to 2.40 per cent at the end of 2020**. This represents a sizeable downward adjustment compared to our previous forecast. Because of budget deficits, the US will essentially need to double its Treasury security issues over the next 10 years, while the Fed continues to reduce its balance sheet as planned. Assuming that the Fed sticks to this plan, by the end of 2019 its balance sheet will be approaching the upper limit of the range that the Fed has previously indicated as an appropriate long-term level. Changes in Fed communication may have a certain signalling value, but we believe that the supply side will not be a driving factor for US yields during 2019.



A 10-year German government bond is trading nearly 30 bps lower than at the beginning of 2018 and is again approaching zero, with a yield of around 0.20 per cent. In addition to the latest downturn in US yields, European yields are being pushed down by weak data and lower expectations about ECB key rate hikes. The market is now pricing in an initial hike of 15 bps no earlier than summer 2020. Considering today's extremely depressed yields and our forecast of cautious ECB rate hikes late in 2019, we believe German yields will gradually **climb to 0.50 per cent by the end of 2019 and 0.70 per cent by the end of 2020**: a downward adjustment of 30 bps compared to *Nordic Outlook* in November. The ECB ended its net bond purchases at the close of 2018. This has not yet affected government bond yields, but it is reflected in wider yield spreads in the credit market. The ECB's plan to reinvest all holdings in its EUR 2.6 trillion QE portfolio is expected to remain a restraining factor, especially for German yields, but during 2019 these reinvestments will only amount to about half of the ECB's purchases during 2018.

10-year government bond yields

	Jan 16	Jun 2019	Dec 2019	Dec 2020
United States	2.73	3.00	2.75	2.40
Germany	0.21	0.30	0.50	0.70
Sweden	0.50	0.65	0.90	1.15
Norway	1.75	1.90	2.00	2.05

Source: Central banks, SEB

The yield spread between US and German bonds has narrowed somewhat in recent months, due to a larger decline for American yields. In the short term, it is reasonable for the spread to widen somewhat again as the Fed raises its key rate one more time. As the ECB starts moving in a slightly less expansionary direction while the Fed's hiking cycle is over, we expect the spread to **narrow gradually to 170 bps by the end of 2020**.

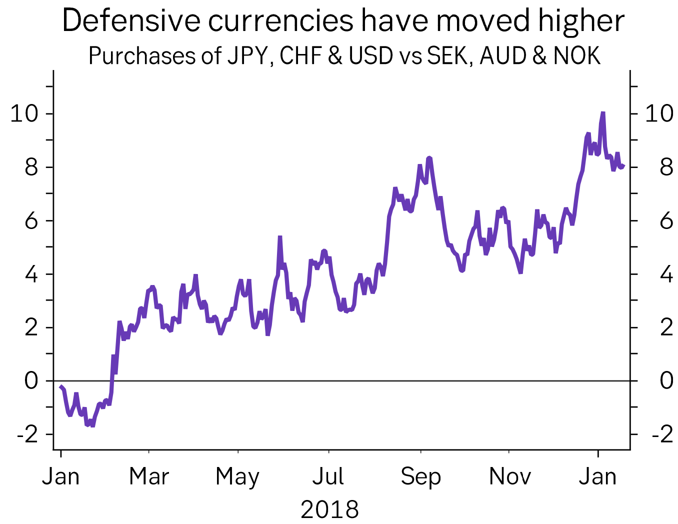
Swedish short-term interest rates have climbed a bit since the Riksbank's December rate hike, but the Riksbank lowered its rate path and thereby softened the reaction. The yield spread against Germany has largely remained unchanged at around 30 bps. We expect the spread to widen to 40 bps by the end of 2019, when the Riksbank hikes its key rate one more time before the ECB acts. We believe that starting in autumn 2019, the Riksbank will reinvest one third of its bond holdings that mature in December 2020 (about SEK 70 billion in nominal and inflation-indexed bonds). **In this way, the Riksbank's share of the outstanding nominal bond supply will remain unchanged at around 50 per cent until the end of 2020**.

Norwegian bonds have traded with a wide yield spread against their German equivalents for years. This can be explained by differences in monetary policy and the unfavourable EUR/NOK exchange rate trend. We expect that a positive outlook for the NOK exchange rate and low yields elsewhere may boost demand for Norwegian government securities. A more cautious ECB policy normalisation than previously assumed, combined with continued key rate hikes in Norway, will still cause the 10-year yield spread to remain at historically high levels. We forecast a **yield spread of 150 bps at the end of 2019**.

Foreign exchange market at a crossroads

The foreign exchange (FX) market continues to lack strong trends, despite a few sharp movements for currencies including the yen. Currency movements seem to be generated mainly by short periods of heightened financial market stress and worries connected to some specific event. Otherwise currencies have not moved significantly. As we pointed out last autumn, the FX market is mainly affected by worries about a global slowdown. The chart below shows that **a basket of the most defensive currencies vs more aggressive currencies from a risk standpoint has trended upward since February 2018**.

Interpretation of the US dollar's performance largely depends on what currency relationships we focus on. We have previously pointed out that the dollar's defensive qualities have again become more prominent as it has appreciated against smaller currencies. Traditional driving forces such as stronger US growth, continued Fed tightening and higher interest rates have strengthened the dollar against other major currencies, but their impact has been significantly weaker than normal. Based on an equilibrium perspective, the dollar appears to be reasonably valued against the euro, for example, while it seems overvalued against smaller currencies such as the SEK and NOK as well as against emerging market currencies. Mainstream analysts now seem to expect a dollar depreciation ahead, but our assessment is that a number of dollar-positive factors are still of some importance and will help slow a USD depreciation ahead. We believe that the EUR/USD exchange rate will remain at around 1.15 during the first half of 2019, but after that we expect a weaker dollar as other central banks begin tightening. Meanwhile our relatively optimistic growth scenario suggests a continued fairly healthy risk appetite. **Our EUR/USD forecast is 1.18 at the end of 2019 and 1.26 at the end of 2020**.



Source: Bloomberg, SEB

The yen's defensive qualities are offset by its negative yield outlook. The Japanese yen has continued to appreciate as soon as worries about the global economy intensify. This was especially clear during the stock market turmoil that occurred at the end of 2018, when the USD/JPY exchange rate fell from 114 in mid-December to 105 in early January. The slide in the USD/JPY rate was also reinforced by the downturn in US yields due to expectations of more dovish Fed monetary policy. An environment of decent growth and rising long-term yields outside Japan is negative for the yen, but now that forecasts are being revised in a direction that weakens these forces, an undervalued yen has room to appreciate. We are sticking to our forecast that **the USD/JPY rate should gradually move down towards 100 by the end of 2020**.

Exchange rates

	Jan 16	Jun 2019	Dec 2019	Dec 2020
EUR/USD	1.14	1.15	1.18	1.26
USD/JPY	109	108	104	100
EUR/GBP	0.89	0.85	0.83	0.86
EUR/SEK	10.26	10.15	9.95	9.70
EUR/NOK	9.73	9.40	9.00	8.90

Source: Central banks, SEB

The progress of Brexit negotiations will continue to be the dominant driver of the British pound. The pound has remained undervalued since the depreciation following the 2016 Brexit referendum. After Parliament's rejection of the proposed agreement between the EU and the British government, uncertainty will continue to keep the pound weak. A controlled withdrawal from the EU based on an agreement would lead to some pound appreciation during 2019, but there is lingering uncertainty about how the economy will react in the long term when the UK more clearly cuts its ties with the EU in 2021 or 2022. This should result in a certain persistent negative effect on the pound during the next couple of years. Our forecast is that **the EUR/GBP exchange rate will remain around today's level of about 0.90. After that the pound will temporarily appreciate to 0.83 during 2019, before we see a weakening to 0.86 by the end of 2020**. If the UK should crash out of the EU next year, it will not help that the pound is already undervalued. Instead we must expect a substantial pound depreciation.

The actions of the Riksbank will continue to be the most important driver of the krona. Although the central bank has now begun its rate hiking cycle, its slow pace will mean that Sweden's key interest rate will be lower than that of other countries during our forecast period. As a result, positive effects on the krona will be limited. To some extent, the krona still appears to be negatively affected by flare-ups of geopolitical uncertainty and periods of falling risk appetite. If the krona is to appreciate during 2019, it will be necessary for our more optimistic growth scenario to help stimulate a decent risk appetite. During 2019 the krona will continue to appreciate slowly, and **the EUR/SEK rate will reach 9.95 at the end of 2019 and 9.70 at the end of 2020**. Given a weak krona at the outset, we expect a substantial appreciation against the dollar during our forecast period, with **the USD/SEK exchange rate falling from about 9.00 to 7.70 by the end of 2020**.

All signs point to a stronger NOK. Customary seasonal patterns combined with falling oil prices lowered the Norwegian krone significantly before the end of 2018, but fundamentals unanimously suggest a stronger NOK. These include robust domestic demand, rising oil sector investments and oil prices, further key rate hikes and a housing market rebound. It is hard to imagine a more solid basis for a forecast that the NOK will approach levels more justified by such fundamentals. **Our EUR/NOK forecast is 9.20 at the end of 2019, continuing down to 8.90 by the end of 2020**.

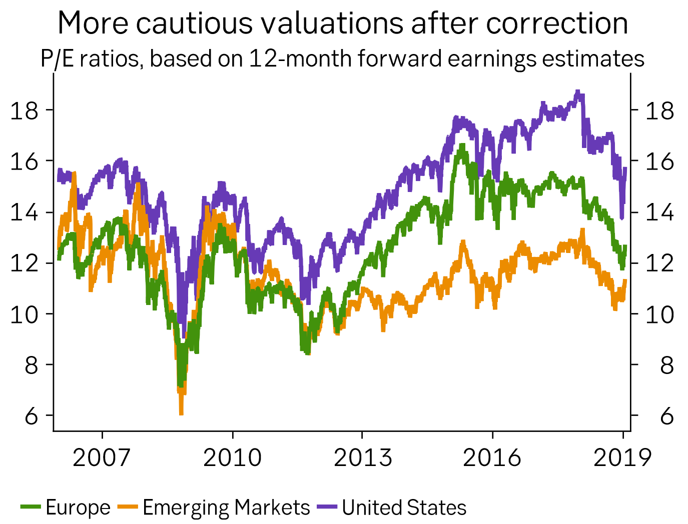
Cautious share valuations provide resilience

In the last *Nordic Outlook*, our view was that a more unclear trend and greater volatility would characterise stock markets ahead. Their performance has mainly followed this pattern, with the sharp downturn late in 2018 now being succeeded by a significant rebound around year-end and afterward. But our forecast that earnings and valuations would provide support to markets has so far proved incorrect. **Instead, risk appetite has faded due to unexpectedly weak economic statistics**.

At the beginning of last autumn's downturn, trading volumes were relatively limited and investors were cautious. Late in Q4, as uncertainty increased, so did sell-off pressure. Share prices fell substantially. This is also reflected in the fact that many large asset managers and strategists made clear downward adjustments in their forecasts for aggregate global earnings in 2019. During December, corporate analysts followed suit. Comparing the euphoric mood at the beginning of the year to its gloomy ending, **the proportion of downward revisions to upward revisions in the course of 2018 was the gloomiest since 1988**. As for revisions of earnings forecasts in absolute numbers, however, there is still a way to go to the previous low-water marks in the 2001 and 2008 recessions.

In our assessment, today asset managers and strategists are expecting earnings to increase by about or just below 5 per cent (lower in Europe). Meanwhile corporate analysts, whose published revisions have gone from 10 to 8 per cent, are at around the 7 per cent level right now. Since asset managers quickly adapt to changing conditions, it is **reasonable to expect continued downward revisions by corporate analysts** as a consequence of the weaker growth picture.

Downward revisions are rarely good news for stock markets, as proved by the sell-off pressure and share price declines late last year. Because of the sharp price declines, and the fact that earnings still rose, valuations have now fallen significantly. P/E ratios in major stock markets fell greatly in 2018, from around 16 to around 13 for the world equity index including the EM sphere. The US remains at the top, with valuations averaging just below 15, while European shares are trading at P/E ratios around 12 and EM shares at just above 10. Since their peak about a year ago, P/E ratios have fallen by more than 25 per cent. This is in line with earlier periods of growth worries such as 2015, but less than we usually see in a recession scenario. From a historical perspective, it is far from daunting. Even if earnings forecasts end up being adjusted a bit lower, **these valuations provide room for modest upturns if uncertainty decreases**.



Source: Macrobond, SEB

As a result of the relatively large portfolio reallocations we saw last year, which accelerated during the final months, the investor community has also **shifted from a fairly aggressive positioning with a high proportion of equities to substantially more balanced portfolios**. Last year was also characterised by a rotation within equities, from riskier positions such as EM and cyclical companies to more cautious positioning in US equities and pharmaceutical companies. Our view is that investors have thus adapted their portfolios for a period of weaker and more volatile market performance. This provides upside potential in case of positive growth surprises. But investors have hardly made allowances yet for a more recession-like scenario, which means that increasing recession risks would probably rattle stock markets.

We are now in the early weeks of the Q4 2018 report season. At an aggregate level, good earnings will undoubtedly be reported, especially in the US where the 2017 tax reform continues to contribute to higher profits. Overall, 2018 looks set to be the strongest year for earnings increases since the beginning of the recovery around 2010. But we see some worrisome signs, partly in relation to reported earnings but especially regarding companies' own forecasts. In the reports for Q3 2018, especially from Sweden and other Nordic countries, companies mentioned signs of weaker order bookings and rising costs. Among the weaker macroeconomic figures we have seen in recent weeks are falling purchasing managers' indices. In these PMIs, the order component has taken the biggest beating, which is concerning in this perspective. With a few exceptions, Nordic companies are signalling that this will not have a major impact on Q4 figures. On the other hand, these companies seem increasingly unwilling to make statements about their future outlook, which suggests increased uncertainty and a risk of weaker forecasts.

Stock market performance in the coming months will probably be determined by how the ongoing deceleration will unfold, and how investors assess the risk of recession. We believe that last year's market downturn means that a deceleration is priced into most share prices today. Given our cautiously positive growth scenario, signs of stabilisation might lead to renewed optimism, although greater uncertainty suggests continued major fluctuations along the way. **We expect a slightly positive return on shares in 2019, with the biggest potential probably in the depressed EM sphere**.

Theme: Productivity

Low productivity: Inflation risk or measurement problem?

The post-crisis recovery has been hampered by weak productivity growth, despite advances such as AI and robotisation. Earlier rules of thumb on the wage/inflation relationship may need to be reassessed. But there are also more benign interpretations. Since low interest rate policies and weak balance sheets seem to have played a key role, low productivity growth may be temporary. Other factors point to measurement problems. In that case, the risk of cost-driven inflation shock is also being exaggerated.

Unemployment in the world's advanced economies is now at its lowest since 1980. Although there are prospects of further declines in the jobless rate, within the not-too-distant future bottleneck problems will limit the potential for further economic expansion and above-trend GDP growth. **If we instead look at GDP performance during the economic upturn of this past decade, it provides a different perspective**. In the OECD countries, GDP rose by only 23 per cent during the period 2010-2018, which is below average for post-war recoveries. In the US, GDP growth averaged 2.1 per cent, low in the post-WWII period and even more so compared to the post-1980 period.

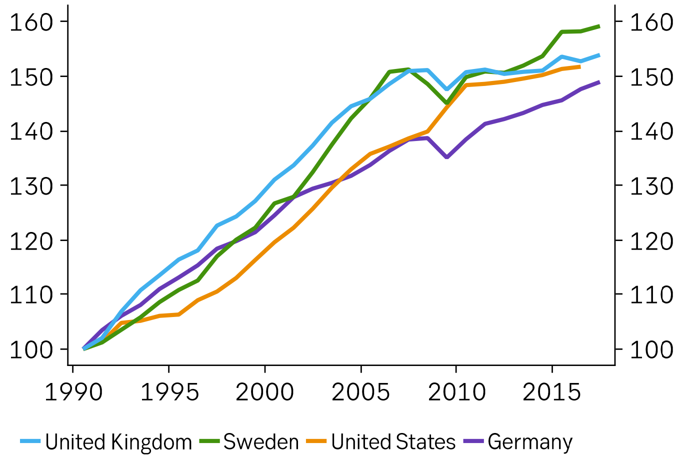
This performance reflects the very weak productivity growth that has been measured since the financial crisis. It is normal for productivity to fall at the beginning of a crisis, since it takes time to adapt the production system to lower demand, but productivity usually rebounds when demand recovers and companies have plenty of spare capacity. Productivity growth is very important to the inflation rate and to the interpretation of recent wage and salary trends. For example, the International Monetary Fund (IMF) maintains that the Phillips curve is working as previously if we adjust for lower productivity growth.

Low productivity growth may seem a bit paradoxical, in light of increasingly intensive public discourse about technological advances and robotisation. The now-classical aphorism that "you can see the computer age everywhere but in the productivity statistics" may indicate that measurement problems are part of the explanation (see more below). US economist Robert Gordon's thesis that the productivity surge of the late 1990s and early 2000s – especially in the IT and telecom sector – was the exception and not the rule appears to have gained general acceptance. **This would indicate that the problem is partly structural**, but it does not fully explain exceptionally weak post-crisis productivity growth.

Perhaps the innovations of recent years connected to new communication services have been more important to consumers than to business sector production. Meanwhile the technologies of the future, such as artificial intelligence (AI) and robots, have not yet made their breakthrough. Purely structural effects related to the labour force (a higher proportion of low-productive labour due to factors like migration), but also sectoral aspects (a lower weighting for capital-intensive industry) are a more general explanation they but do not explain weak productivity growth within each sector, especially manufacturing. According to the IMF, ageing populations may have contributed to slower productivity growth, since the ability to develop new skills can be expected to decline above a certain age. Declining world trade growth and reversals in the earlier trend towards rising educational levels are other examples of structural factors that have slowed productivity growth.

Can productivity growth regain momentum?

Index 100 = 1990



Source: OECD

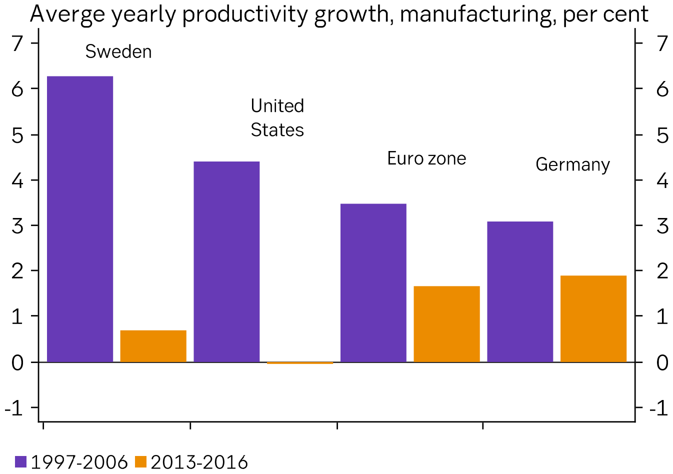
Another interesting observation is that productivity tends to grow especially weakly after deep financial crises. This may be due to **misallocation of capital during an earlier boom**, but it may also occur because the low interest rate environment after the crisis lowers pressure for change and enables zombie companies to survive. The need for balance sheet adjustments may limit companies' capacity and incentives for productivity-raising investments in new technology, in favour of more short-term spending. IMF studies show that post-crisis productivity has been **weaker in financially stretched companies than in well-capitalised competitors** with similar pre-crisis productivity trends. We can find similar gaps when we compare countries with more stretched credit markets, for example in many parts of Europe, and those with better-functioning credit markets. In light if this, steps aimed at cleaning up and strengthening the financial service sector might lead to a resumption of higher productivity growth.

Are weak productivity problems being exaggerated?

There are different ways of approaching the question of whether national accounts actually measure productivity in a relevant way. This is especially important in the paradoxical situation we now find ourselves in. On the one hand, we have an intensive public discourse about how technological progress is happening faster than ever and that within a few decades, 40-50 per cent of employees will be replaced by robots. On the other hand, we are seeking explanations for weak productivity growth and are worried that pressure for change in the economy is being hampered by the low interest rate environment.

Falling productivity growth in manufacturing

Averge yearly productivity growth, manufacturing, per cent

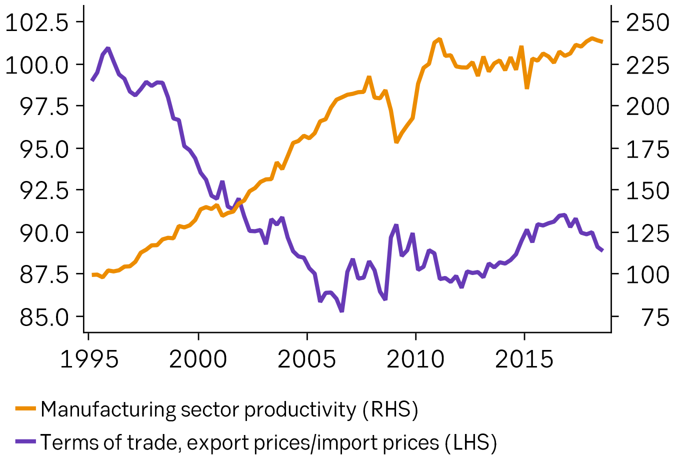


Source: Macrobond, SEB

A review of productivity in different countries and sectors shows that **it is in manufacturing that productivity growth has stagnated in recent years**. Service sector productivity improvements have been far less restrained. Comparing the golden period 1997-2006 with the years since 2013, productivity growth in US manufacturing has fallen from 4½ to 0 per cent yearly, and in Swedish manufacturing from 6.3 to 0.7 per cent. More than half the downturn is explained by the telecom and computer sector, where average yearly productivity growth fell from from +25 per cent to -5 per cent.

Slower growth, more stable export prices

Index 100 = 1995



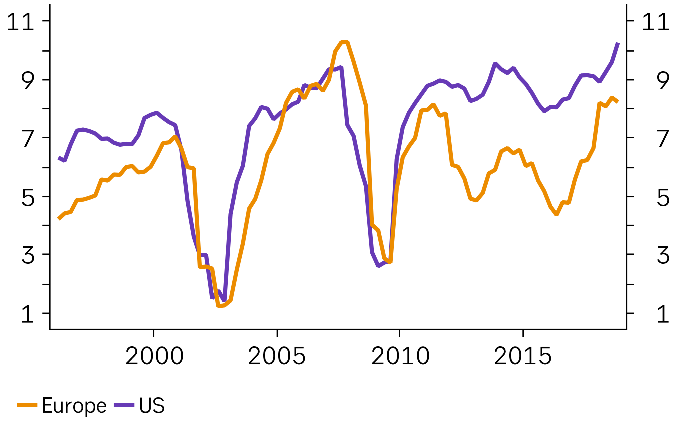
Source: Statistics Sweden

Developments in the telecom sector are a good illustration of how hard it can be to interpret productivity. Extremely strong productivity growth was matched by rapidly falling prices, which lowered telecom sector revenues and thus Swedish exports in current prices. **The declining prices of electronic products were a major reason why terms of trade steadily deteriorated between 1996 and 2006**. Over the past 10 years, a sizeable proportion of electronics production has moved abroad. This – and not stagnating technological development – is probably behind plunging productivity. The trend in this sector has thus contributed to stagnating productivity growth in Swedish manufacturing. But since the decline in terms of trade has also stagnated, the consequences for manufacturing revenues in current prices have been greatly reduced.

Looking at the demand side of the economy, interpretation problems also arise when it comes to low productivity. Despite relatively low nominal pay increases, the absence of productivity improvements causes unit labour cost (ULC) to climb relatively fast. Low consumer price index (CPI) increases indicate that businesses find it hard to pass on cost increases in the form of higher prices, which should result in falling profit margins. Although many retailers currently have problems and are struggling to deal with competition from e-commerce, profit margins **in the business sector in general has been at high levels both in in the US and Europe, despite below-target inflation**. We can perhaps explain this by noting that other demand-side prices are rising faster than consumer prices. In pure accounting terms, this is expressed by the GDP deflator, which weighs together all components and has risen faster than CPI in the past five years.

Profit margins are at high levels

% of sales



Source:Bloomberg

But it is hard to avoid the impression that overall, real household purchasing power and corporate profitability have grown in such a favourable way that they are not fully reconcilable with the low productivity growth trend that the national accounts show. Put differently, this indicates that **in recent years GDP growth may be underestimated, for example because not all new economic activities are included**. This would also be positive in the sense that the risks of an inflation shock caused by accumulated cost pressure are less. Looking at the entire economy, in Sweden there is also a tendency to underestimate public sector productivity growth (see the Sweden section), which we believe has lowered annual GDP growth by 0.3 per cent in recent years.

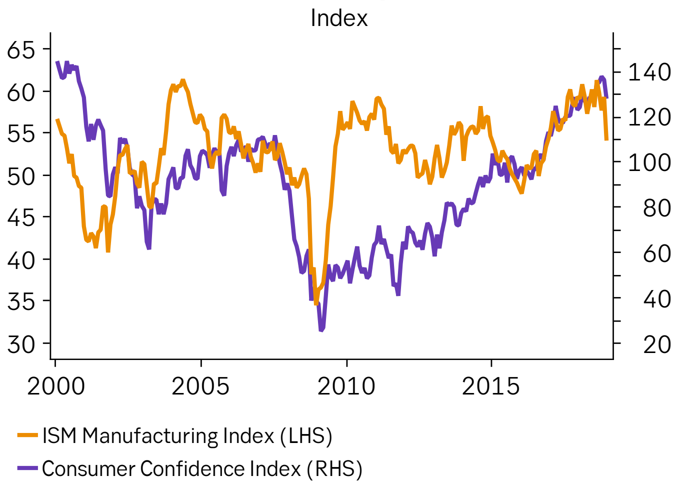
The United States

The economy is decelerating, but from a high growth rate

Economic activity is expected to slow gradually in 2019-2020, but it remained well above potential growth in Q3 2018. We believe the labour market will strengthen for another while, but signs of bottleneck problems are increasingly apparent. Inflation pressure is moderate, and lower energy prices will push CPI inflation well below 2 per cent in 2019. The Fed raised its key rate again in December and is expected to hike it once more in 2019, but amid great uncertainty about the number of hikes and their timing.

GDP growth decelerated in the third quarter of 2018 to an annualised 3.4 per cent, down from 4.2 per cent in Q2. This is still well above potential growth. Indicators generally remained at relatively high levels. Consumer confidence is still solid, and the Institute for Supply Management (ISM) purchasing managers' indices are high despite a clear downturn for the manufacturing index in December. Among generally strong hard data, private consumption was especially impressive, but we are increasingly convinced that GDP growth will continue to decelerate. Capital spending was unexpectedly weak in Q3 and there are reasons to assume that it will continue to be hampered by slightly higher interest rates, lower oil prices and worries about increasing trade tensions. Nor do we expect net exports to contribute much to growth, due to dollar appreciation and – to some extent – trade disruptions. The housing market is also undergoing a clear slowdown, though this sector's importance to the economy is less than in the period before the financial crisis. Overall, this means that growth will be more heavily dependent on household consumption behaviour. Our forecast is that **GDP growth will gradually slow from 3.0 per cent in 2018 to 2.4 per cent this year and 1.7 per cent in 2020**: a downward adjustment of two tenths in both 2019 and 2020.

Sentiment indicators at high levels despite dip



Source: Conference Board, Institute for Supply Management (ISM), Macrobond, SEB

As expected, in December the **Federal Reserve (Fed)** raised its key interest rate to 2.50 per cent, and we believe that the central bank will **carry out one more hike in 2019**. During 2020 we expect the key rate to remain at 2.75 per cent.

Trade policy, debt ceiling cause concerns in 2019

Trade tensions between the US and China have eased, at least in the near term. Their agreement at December's G20 meeting led to a **"truce" until March 1**. The US has thus abstained from the tariff hikes on imports from China it had planned for January 1, opening the way for continued negotiations. But no clear signs of a more permanent détente are evident, and there is a great risk that the negotiations will break down. The arrest of Huawei's chief financial officer on behalf of the US is a clearly complicating factor that will probably make China less inclined to grant concessions. Even if a tariff accord can be reached, the broader US-Chinese conflict will continue. **Tensions extend far beyond tariff issues** and include forced technology transfers from foreign to Chinese companies and cybersecurity issues, but also control of the South China Sea and, more generally, China's increasingly prominent global role in the political, military and economic fields. A more hard-line attitude towards China is also one of the few issues that unite Republicans and Democrats.

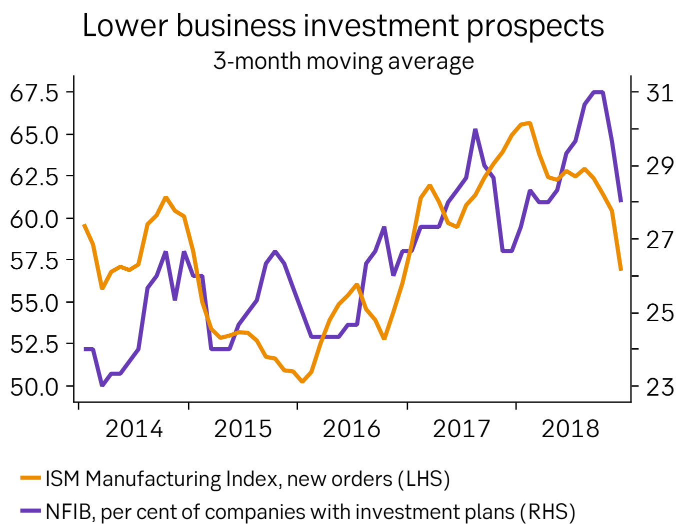
The trade conflict between the US and Europe continues, but it has not worsened. There is fundamental potential for reaching agreements, since the US and Europe share major concerns about China's behaviour. Sharply higher American tariffs on imported European cars still pose a risk, however. Overall, **we expect trade disruptions to have relatively little impact on US growth and inflation**, though they will lower business investments and exports somewhat.

Just before Christmas, congressional Republicans and Democrats managed to reach a budget agreement, but President Donald Trump refused to sign it. This led to the closure of various US federal agencies on December 22 due to a lack of funds. A temporary closure of certain federal operations has little impact on the real economy, but there is now a risk that the budget conflict may escalate and turn into a new argument about the **debt ceiling**. Raising the federal debt ceiling is actually a formality that is necessary to enable the US to cover its budget deficit through continued borrowing, but the debt ceiling issue has become a recurrent topic of political bickering in recent years (most recently in 2017). In a worst-case scenario the US may be forced to default on its debts, but this is something that no one wants to be held responsible for, suggesting that the debt ceiling will be raised as in earlier episodes. Yet quarrelling about the debt ceiling poses a risk of financial market turmoil. The debt ceiling needs to be formally raised in March, but the US Treasury Department can resort to various measures to avoid hitting the ceiling for another few months.

Capital spending and exports are decelerating

Capital spending was unexpectedly low in the third quarter, when its contribution to GDP growth consisted almost exclusively of stock building. Construction investments remained weak as the housing market decelerated, hampering growth for the third consecutive quarter. It is also becoming increasingly clear that the resources generated by corporate tax cuts have primarily been used for higher dividends and share buy-back programmes, instead of expanding production.

Several factors point to subdued capital spending ahead as well. The sharp downturn in oil prices is hampering investments in the mining and oil industries. Worries about trade conflicts and tariffs may eventually have a dampening effect, but so far there are few signs that companies have actually changed their capital spending plans. Somewhat higher interest rates will also contribute to lower investment appetite. On the plus side, capacity utilisation keeps getting closer to the 80 per cent level, where capital spending normally takes off. Growing difficulty in recruiting staff may also drive companies to make investments that can speed up automation processes. Overall, we believe that **capital spending growth was 5.3 per cent in 2018, but that growth will slow down to 2.9 per cent in 2019 and 2.3 per cent in 2020**.

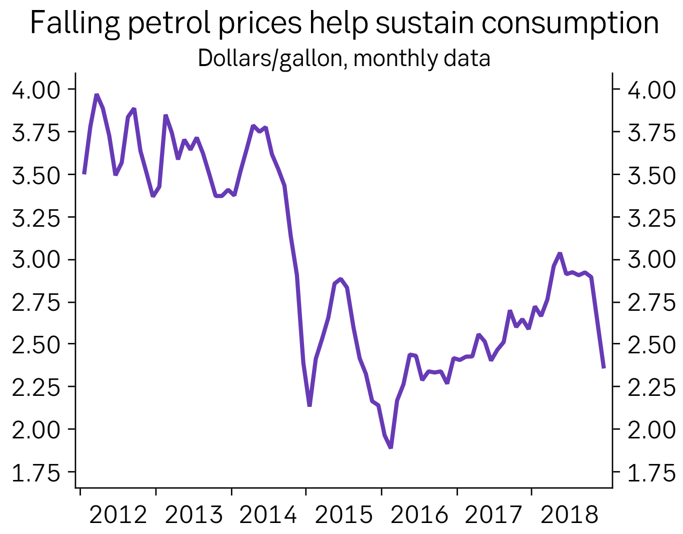


Source: National Federation of Independent Business (NFIB), Macrobond, SEB

As expected, the contribution of net exports to GDP growth shifted in a strongly negative direction in Q3. The reason was a downturn after US exporters had made major efforts to beat import tariffs by temporarily boosting their exports to China sharply during Q2. Together with trade tensions, dollar appreciation in 2018 is having a generally slowing effect on exports. Combined with strong import demand, **this will make the contribution of net exports to growth neutral in 2019-2020**.

Growth is more dependent on private consumption

Private consumption has remained impressive, contributing nearly 2.4 percentage points or 70 per cent of GDP growth in Q3. Consumption was again strong in Q4 and appears to have accelerated somewhat compared to the preceding quarter. Consumer confidence has not been affected significantly by stock market turmoil, but instead is still close to record-high levels. Because of lower petrol (gasoline) prices, household purchasing power is rising. Meanwhile job growth and cautiously accelerating pay increases continue to provide support, but **the rapid increase in consumption during the past few quarters cannot continue**. The impact of last year's tax cuts is fading, while households are facing higher interest rates for both mortgage loans and consumption-related borrowing. Despite the expected deceleration, private consumption will be the main driver of US growth. Our forecast is that **the consumption increase will end up at 2.7 per cent in 2018 and 2.5 per cent in 2019**. In **2020** it will slow further to **1.9 per cent**.



Source: Energy Information Administration (EIA), Macrobond, SEB

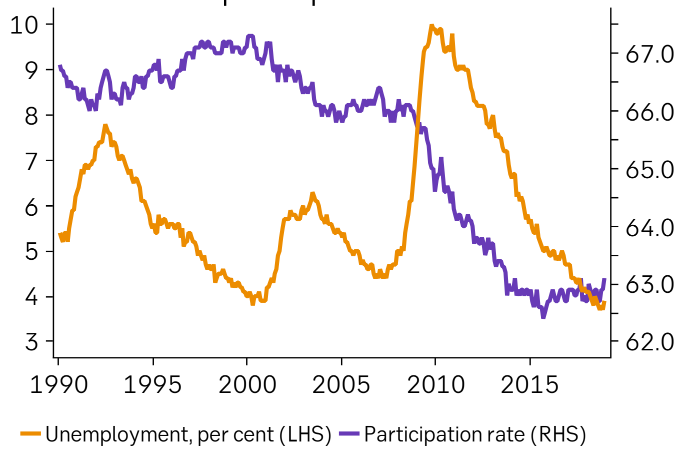
An increasingly tight labour market

We are sticking to our forecast that the labour market, despite its already tight situation, **is capable of strengthening further for another while**. The latest monthly figure for non-farm payroll growth showed no fewer than 312,000 new jobs, bringing the average monthly increase during 2018 to an impressive 220,000. Looking ahead, job growth will probably slow as GDP growth falls. We expect an average monthly increase of 160,000 jobs in 2019, which is well above the increase in the working age population.

During the period September-November 2018, unemployment was 3.7 per cent – the lowest since the late 1960s – but in December it climbed to 3.9 per cent despite rapid job growth. This reflects an increasing labour force participation rate. Our forecast is that unemployment will turn downward again in the near future, bottoming out somewhat below 3.5 per cent at the end of 2019.

The rate of pay increases has continued to accelerate cautiously. In December it totalled 3.2 per cent year-on-year: **still moderate** given the overheated labour market situation. Although job growth will now slow, an ever-tighter labour market –with increasing signs of bottleneck problems – will mean a further acceleration in pay hikes. The Fed's *Beige Book* economic report indicates that many American companies are facing recruitment difficulties. Aside from higher pay, companies are being forced to offer expanded fringe benefits as well. According to the NFIB indicator, corporate compensation plans reached new record levels at the end of 2018. Meanwhile there are still **indicators** that are **pointing to a certain degree of slack** in the labour market. The broadest unemployment metric, U-6, is still above the low levels achieved in 2000. Labour force participation in recent years has fluctuated around 63 per cent, which is well below the peak of 67 per cent, achieved – as with U-6 – in the year 2000. Since August 2018, the participation rate has increased from 62.7 per cent to a December figure of 63.1 per cent. Our job growth and unemployment forecast is that this upward trend will continue for another while.

Extremely low unemployment, but moderate participation rate



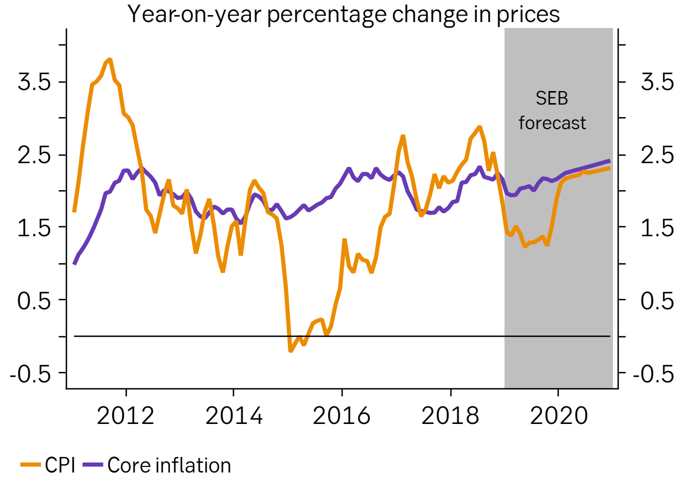
Source: U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

Moderate inflation pressure

Inflation pressure is subdued. In December, CPI inflation fell to 1.9 per cent – driven by the downturn in energy prices. Given current oil and petrol price levels, **CPI inflation will be well below 2 per cent in 2019**. Dollar appreciation will also contribute to more subdued inflation next year due to lower important prices. The effect of higher tariffs will be minor. Imports from China are not extensive enough and tariff levels are not high enough to have any major impact on inflation. In addition, US companies have largely allowed tariffs to shrink their margins rather than raise consumer prices. Inflation expectations have also fallen noticeably since last autumn, mainly reflecting the downturn in energy prices. Annual average **CPI inflation was 2.5 per cent in 2018**. In **2019** we expect inflation to end up at **1.4 per cent** and in **2020** at **2.2 per cent**. Core CPI will also fall in 2019.

CPI inflation will slow in 2019

Year-on-year percentage change in prices



Source: Macrobond, SEB

Inflation using the personal consumption expenditures (PCE) deflator was 1.8 per cent in November. The **Fed's favourite metric, core PCE**, was 1.9 per cent. The updated forecasts that the Fed unveiled after its December policy meeting show that the central bank expects inflation to be at its 2 per cent target at the end of both 2019 and 2020. Our forecast is **core PCE will increase by 1.8 per cent in 2019 and by 2.0 per cent in 2020**.

Fed approaching neutral rate and will stop at 2.75

The Fed hiked its key interest rate at the December meeting to 2.5 per cent, despite speculation that stock market turmoil and Trump's criticisms of the Fed might block the latest hike. There is nevertheless increased uncertainty about monetary policy during 2019, both regarding the number of rate hikes and their timing. The Fed's hikes have brought the key rate close to its estimated neutral level. After the December hike, **the key rate is somewhat below the Fed's median forecast of the neutral level**, which has been revised downward to 2.8 per cent. Individual Federal Open Market Committee (FOMC) members report estimates implying that the current interest rate is already in line with, or even above, the neutral level. At the December meeting, FOMC members' individual rate path forecasts ("dot plots") shifted towards indicating two instead of three rate hikes in 2019. Two hikes would bring the federal funds rate to 3.0 per cent at the end of 2019, somewhat above the neutral level, but market pricing points to an unchanged key rate in 2019. This reflects market doubts that the Fed will be able to keep hiking its key rate in a situation of stock market worries and decelerating economic growth rates.

The Fed's communication suggests that it is **trying to increase its flexibility**, leaving behind its 2018 pattern of one rate hike per quarter. At its December meeting, the Fed loosened the formulation in earlier press releases on **"further gradual increases"** by adding "some". The Fed has also announced that it will become more **data-dependent**, which implies that it will increasingly focus on how economic variables actually perform when preparing its monetary policy decisions. The Fed's earlier decision to hold press conferences after all policy meetings starting in January 2019 is another way of increasing the flexibility of its monetary policy.

The Fed's ambition to increase its flexibility makes it harder to forecast US monetary policy. Compared to the November issue of *Nordic Outlook*, we have **revised our forecast** and now believe that the Fed will **only hike its key rate once during 2019 (June)**. We have also **removed the hike we previously predicted during 2020**. The Fed's rate hikes will thus stop at 2.75 per cent.

We believe that the Fed's balance sheet reductions will continue as planned. Although Chairman Jerome Powell changed the Fed's communication in January and declared that the reduction schedule may change as needed, we believe it is more likely that the Fed will choose to cancel further interest rate hikes instead of modifying its **balance sheet** reductions. The reductions are based on predictability, and the size of the balance sheet is still well above the upper end of the range that the Fed has indicated as an estimate of the balance sheet's appropriate long-term size.

During 2019 the Fed will **review its monetary policy framework**. Last year it published a number of speeches in which FOMC members discussed such matters as alternatives to the inflation target and the "floor system" that causes the fed funds rate to be close to target. Changes in the framework might have clear monetary policy consequences, especially for the size of the Fed's balance sheet.

Theme: Recession worries

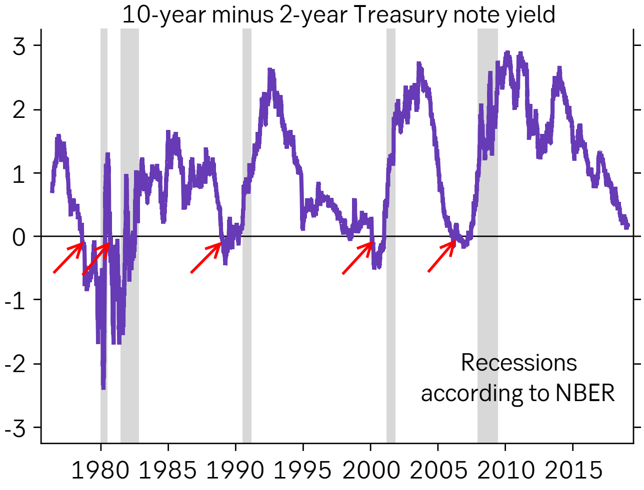
Recessions, stock market dips – what can history teach us?

Worries that a new US recession is lurking around the corner intensified during the autumn. The fixed income market, which has historically been best at predicting imminent recessions, is now very close to tripping the alarm. This theme article discusses what the yield curve can tell us about coming developments and its historical significance to stock markets. There are many reasons for concern, but also positive things to hope for if historical associations should continue to prove correct.

Historically, one of the most reliable indicators for predicting an imminent US recession is the slope of the yield curve, which is simply the differential between long- and short-term bond yields. More specifically, this usually refers to the spread between 10-year and 2-year Treasury note yields. Since it normally costs more to borrow money for 10 years than for 2, this spread (10 minus 2 years) is usually positive, but sometimes the curves shift in such a way that 2-year yields become higher than 10-year yields, making the slope inverted (negative). An inverted yield curve has correctly predicted all nine US recessions since 1955. Only once during the past 40 years (in 1998) has it provided a false signal, but on the other hand the yield curve at that time was only minimally inverted – by a maximum of 7 basis points – for a very short period.

The US yield curve as a recession indicator

10-year minus 2-year Treasury note yield



Source: NBER (National Bureau of Economic Research), Macrobond, SEB

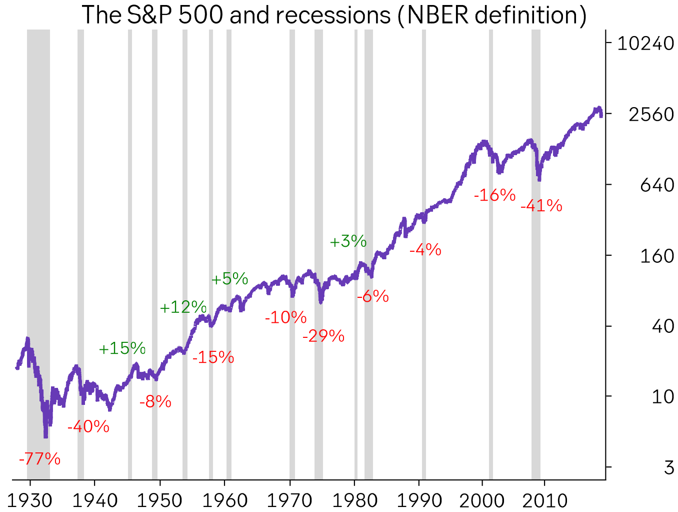
Recessions are uncommon…

Luckily, recessions are relatively uncommon. Nearly 10 years have passed since the United States experienced its most recent recession. Instead, the normal state of the economy is growth. The US has had 18 recessions during the past 100 years, and the economy has been in recession for a total of less than 20 per cent of that period. In recent decades, recessions have also become less frequent. Over the past half century the US has seen only seven recessions, lasting a total of 14 per cent of this period. Since the long-time historical pattern has been that the US economy is first in the economic cycle, the risk of American recessions is not only of great interest in the US but also for financial markets worldwide.

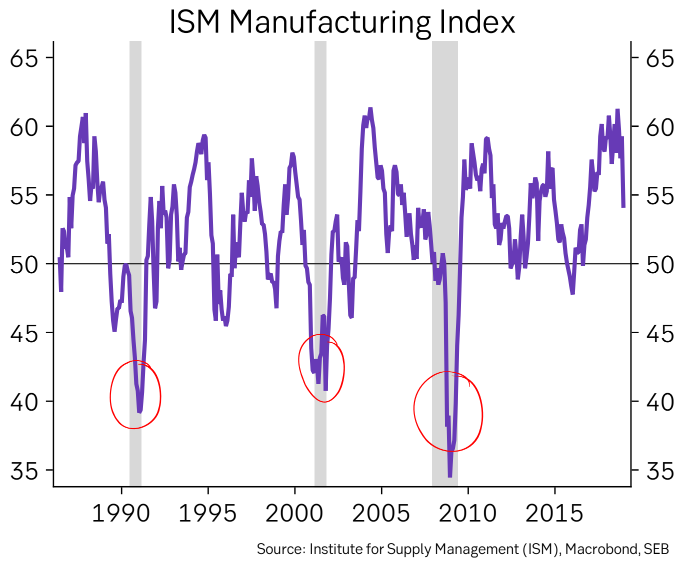
… but are almost always tough on stock markets

Just as with the economy as a whole, the normal state of the stock market is rising share prices. Since 1928 the yearly growth of the S&P 500 equity index (excluding dividend yields) has averaged slightly below 6 per cent. The clearest exception to this normal situation is periods of economic recession. Looking at recessions from the 1930s Great Depression until today, the S&P 500 has fallen during no fewer than 10 out of 14 such periods. While stock markets may continue to perform relatively well even during periods of weaker growth, recessions – with their negative growth – are thus usually associated with poor stock market performance, as shown in the chart below.

The S&P 500 and recessions (NBER definition)



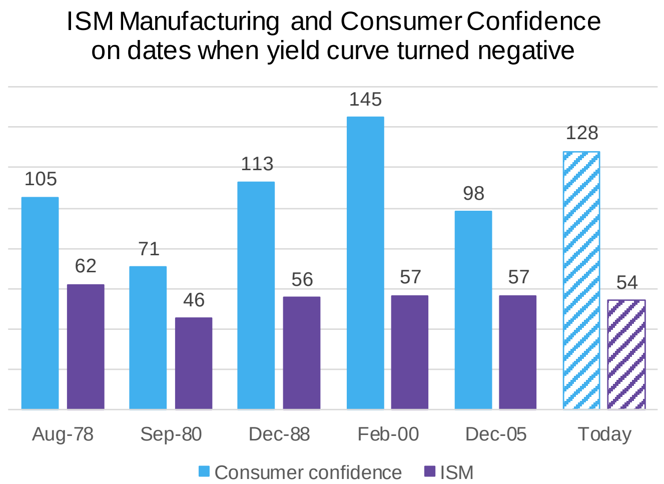
One thing that may seem strange is that most economic indicators today are showing rather strong US economic performance. Although the Institute for Supply Management (ISM) purchasing managers' index – historically an excellent predictor of GDP growth in the next few quarters – has begun to fall, it is still far above the low levels (just over 40) normally associated with a recession in the US economy.



The US labour market is strong, with nearly record-low unemployment and high job growth. The expansion keeps chugging along; GDP grew by an annualised 3.5 per cent during the most recently reported quarter. A highly relevant question is thus: What is the fixed income market worried about that is invisible in other indicators? One way of answering that question is by going back in history and looking at how some of these economic indicators looked during earlier periods when the yield curve turned negative and meanwhile correctly predicted a coming recession. This would provide an answer as to whether today's situation is unique, or whether things instead usually look something like this when the yield curve turns negative.

The labour market: Historically, the economy has often shown decent job growth and relatively low unemployment when the curve inverted. In itself this is not so strange, since the labour market is a lagging indicator that is usually strong late in the economic cycle. On earlier dates when the yield curve inverted, job growth has actually been about as high as it is today. A strong labour market instead supports the thesis that recession is approaching, as supply side restrictions become more apparent and companies find it ever harder to find workers.

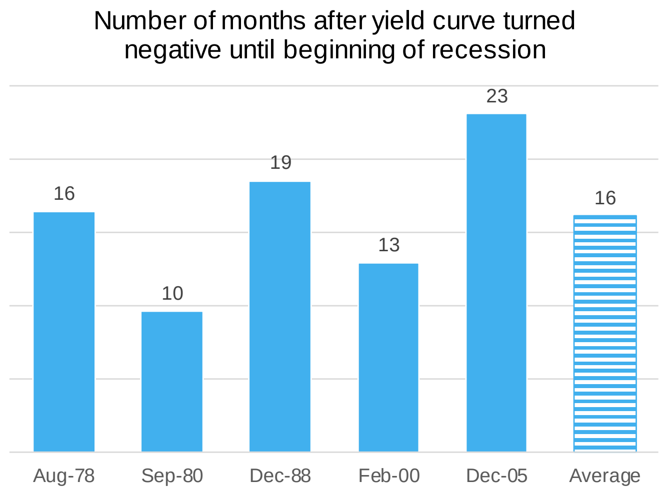
Leading indicators: The picture is also clear when looking at the ISM Manufacturing Index and the Conference Board's Consumer Confidence Index. Ahead of all five of the last recessions except the one in 1981, on the date that the yield curve inverted, the ISM index was actually at stronger levels than today. Consumer confidence was usually relatively high on these dates as well.



On the whole, it is difficult to find convincing support today for the argument that economic indicators will be so divergent from the historical pattern that we can say *"this time is different"*. It will thus also be difficult to ignore an upcoming signal from the fixed income market that a recession is around the corner.

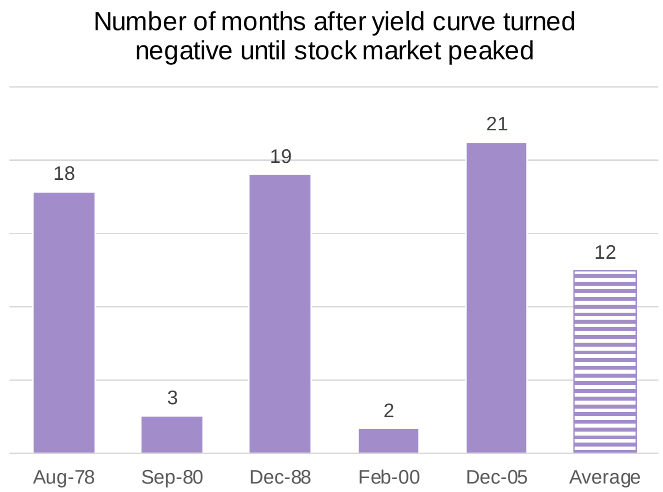
When will the next recession begin?

The next highly interesting question is naturally what "around the corner" may actually mean in terms of timing. The historical pattern from the last five recessions shows that it has taken anything from 10 to 23 months from the day the yield curve inverted until the recession has begun. If we choose to look at the average – 16 months – it would thus take until the summer of 2020 before the economy entered a recession. This scenario naturally also assumes that the yield curve continues to flatten and actually turns clearly negative early in 2019.



When will the stock market peak?

How long does it usually take from the date the yield curve turns negative until the stock market peaks? As the chart below indicates, this varies greatly. The S&P 500 index has peaked anything from nearly two months to 21 months after the curve inverted. On average during the last five recessions, it has taken 12 months. Especially interesting is also that so far, at least during the past five recessions, the stock market has never peaked before the yield curve turned negative. If this pattern persists in the future, the stock market will hit a new peak before entering really tough times.



The euro zone

GDP growth will stabilise at lower level but stay above trend

Last year was full of disappointments. Several factors were behind the slowdown, including temporary ones like a downturn in auto sales. Looking ahead, there is potential for a rebound in sentiment indicators and an export recovery. Business investment needs and a stable outlook for household finances mean underlying positive domestic drivers remain. But due to political uncertainty – and to some extent mounting supply side restrictions – growth will be only 1.6-1.7 per cent in 2019-2020.

The euro zone economic outlook has gradually worsened since it peaked at the end of 2017. **Incoming data have mainly brought downside surprises, and storm clouds have gathered on several fronts**. Indicators have fallen and purchasing managers' indices (PMIs) are now at their lowest since 2013. Quarter-on-quarter GDP growth has slowed from 0.7-0.8 per cent in 2017 to 0.2 per cent in Q3 2018. In coming forecasts, it is important that we estimate to what degree **the slowdown has been caused by temporary factors** and to what extent **its drivers have been domestic or external**. Several factors are temporary, such as weather effects that hampered construction early in the year and agriculture in the summer. Last autumn the auto industry was hurt by new regulations (see box). External factors such as China's slowdown and worries related to the Brexit process and trade policy tensions have also played a part.

GDP forecasts

Year-on-year percentage change

	2017	2018	2019	2020
Germany	2.2	1.5	1.2	1.4
France	2.2	1.5	1.3	1.5
Italy	1.6	0.9	0.7	1.2
Spain	3.0	2.5	2.2	2.0
Euro zone	**2.4**	**1.9**	**1.6**	**1.7**

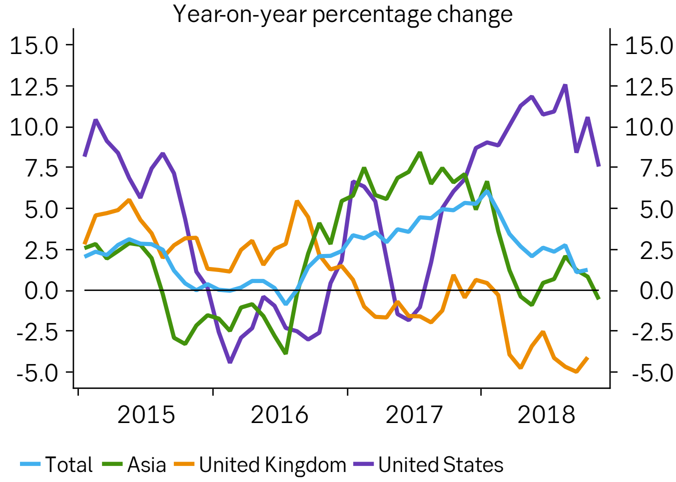
Source: Eurostat, SEB

Given the **relatively large weight we assign to temporary and external factors, there is good potential for a slight rebound** in both sentiment indicators and quarterly GDP growth. Global demand is expected to remain relatively strong, which should allow some recovery in exports. The underlying conditions for domestic expansion are still good, with significant capital spending needs in the wake of high capacity utilisation and favourable potential for household consumption, partly due to increasingly expansionary fiscal policies. Meanwhile it is not realistic to believe that we can revert to 2017 growth figures. Uncertainty will remain high in various respects, hampering demand. Meanwhile supply side restrictions in the labour market are now becoming discernible, especially in Germany. Our overall forecast is that **average annual GDP growth will end up at 1.6 per cent this year and 1.7 per cent in 2020**, which is a bit above trend and enough to allow another slight downturn in unemployment.

A many-faceted political situation will continue to cast its shadow over euro zone performance. In some ways the situation will become clearer, but overall uncertainty will remain heightened. The threat of escalating global trade wars will hurt the export-dependent region. Brexit will also hamper trade with a vital export market and make companies hesitant to spend for the future. In France, the "yellow vest" strikes have lowered activity in such domestic sectors as services and retailing. There is continued uncertainty about Italy's government and fiscal policy. Although Rome and Brussels appear to have called a temporary truce, Italy's weak growth, high public debt and the bad loans in the banking sector remain problematic. The threat of further successes for EU-sceptical forces in the upcoming European Parliament elections has contributed to greater passivity in Brussels about pursuing further European integration. The EU election is also rather unlikely to result in a new European Parliament that is more dynamic than today's.

Decelerating euro zone exports

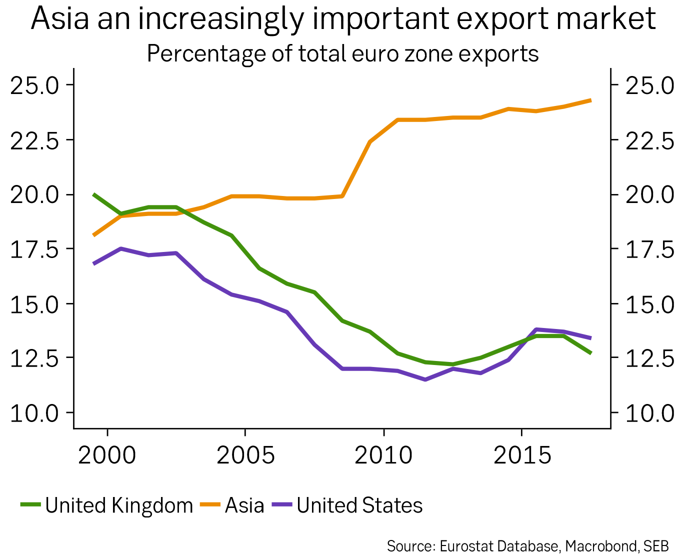
Year-on-year percentage change



Source: Eurostat Database, Macrobond, SEB

Deceleration mainly driven by external factors

The 2018 slowdown was largely attributable to a **deceleration in exports**. Flagging demand in such key export markets as Asia and the UK and a more positive trend for trade with the US could not offset this completely. Problems in the auto industry also amplified the downturn late in 2018. A likely normalisation of the auto industry's situation and continued decent international economic performance and global trade suggest that **euro zone exports will also rebound**. The country-by-country structure of euro zone exports has changed in recent decades, which may prove to bea source of strength ahead. Fifteen years ago the US, UK and Asia each accounted for nearly 20 per cent of euro zone exports. Today about 25 per cent of exports go to Asia, while the UK and US share of exports has shrunk, together now accounting for as much as Asia. This makes the euro zone less vulnerable to Brexit-related disruptions and the US slowdown we now foresee. But despite stronger exports, **net exports, an important growth driver in 2017-2018, will be a more neutral contributor to growth in 2019-2020**. The euro zone's overall current account surplus is expected to fall somewhat, reaching about 3 per cent of GDP towards the end of our forecast period.



More countries are opening for fiscal stimulus

The economic upturn and the austerity programmes of recent years have greatly improved public budget balances. The situation has only been better a few times since the euro project began and its "fiscal framework" was introduced. Euro zone public finances are generally in far better shape than those of other major advanced economies such as the US, Japan and the UK. Germany has now had five consecutive years of surpluses (and a record high surplus in 2018 of 1.7 per cent of GDP), and public debt has fallen from 80 to 60 per cent of GDP, but France, Italy and Spain still run deficits of 2-3 per cent of GDP, with public debt ratios of 100 per cent of GDP or higher. Their room for stimulus measures thus varies, but more and more countries are now **shifting from fiscal austerity to stimulus**. Germany is likely to remain cautious about utilising its potential, while the governments of Italy and France are being pressured into stimulus measures due to election promises and anti-austerity protests, respectively. Brussels will probably react cautiously to deviations from the rules, in order to avoid further fuelling EU-critical parties in this spring's European Parliament elections. Due to looser fiscal policies, **the euro zone budget deficit will be some 1 per cent of GDP throughout our forecast period**. Public debt will thus fall at a slow pace.

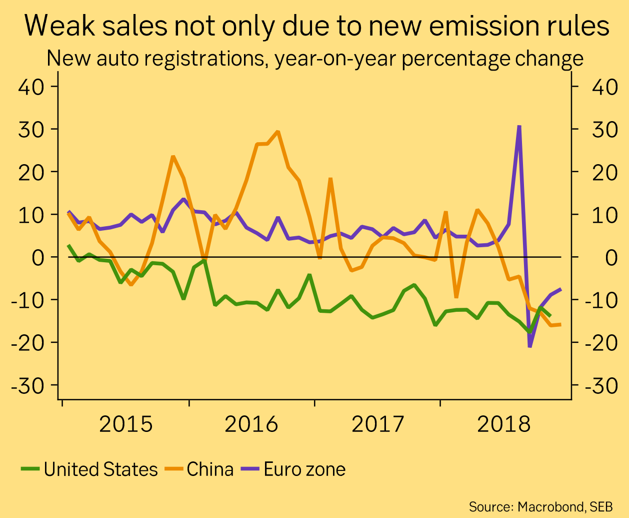
Households remain cheerful but cautious

Households are still relatively optimistic; despite a decline this past year, **consumer confidence is at about the level of earlier cyclical peaks**. After a weak summer, retail sales accelerated late in 2018 and **the outlook for a continued consumption upturn is good**. Employment is rising while pay increases are speeding up, fiscal policymakers are moving in an expansionary direction and lower inflation is providing larger real income

Upturn and downturn for auto sales

The automotive industry is important to a number of European countries. The EU accounts for about 20 per cent of overall global vehicle production, and vehicle export value is about 3 times larger than import value. Although employment in this sector is only one per cent of the total, according to the European Automobile Manufacturers' Assocation this rises to as much as 5-6 per cent if we include sub-contractors and others dependent on automotive production.

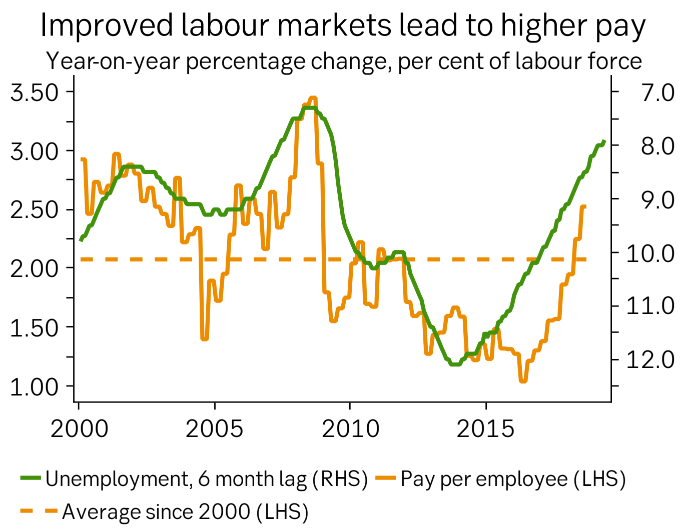
Major fluctuations in auto sales during the autumn of 2018 contributed to the general economic slowdown. The most important factor was a set of **revised emission rules imposed by the EU on September 1, 2018**. The new rules are more far-reaching than earlier ones, and several manufacturers have experienced problems with implementtation, leading to production disruptions. Historically, retailers have made large purchases in the months before rules are tightened so that they could sell and register cars according to existing more favourable regulations. Once new rules have taken effect, we have seen a period of lower registrations and sales, since the market was saturated. This time around, the pattern has been especially clear, but the rebound that usually occurs in a third phase of normalisation was weaker than expected. New regulations do not explain everything, though; **sales to the most important export markets, China and the US, also decelerated**. In addition, the fastest-growing US automotive market has recently been pickup trucks, of which Western Europe is not a major supplier. Auto sales are also probably being affected by the **transition to fuels other than traditional ones**. Producers are still finding it hard to develop cheaper alternatives for the broad market, contributing to consumer hesitation. Overall, we believe that European auto sales will revert to more normal levels, but due to a global growth deceleration a strong rebound cannot be expected.



increases. Continued low interest rates and strong household wealth positions are also helping. But the household sector is not immune to the prevailing uncertainty, and some hesitation is apparent in consumption decisions. **We thus expect consumption growth to slow to 1.5 per cent yearly in 2019-2020**. The trend this past year towards higher savings ratios from a historically low level is thus expected to persist.

Job growth will continue, but at a slower pace

Labour markets continue to improve. Unemployment fell in November to 7.9 per cent, its lowest in 10 years. Of the four largest euro zone countries, Spain has showed the biggest drop in joblessness this past year (nearly 2 percentage points), though the level remains high at 14.8 per cent. Germany is down to a record-low 3.3 per cent, and the level is expected to fall further, but in France and Italy the decline has been very modest. In numbers, unemployment has fallen by nearly 6 million in the past five years while job growth has been twice this high. **Unemployment will keep falling to 7.7 per cent in 2019 and 7.5 per cent in 2020**. It is will thus be at its equilibrium, an estimated 7.5 per cent, by the end of 2020.



Source: ECB (European Central Bank), Eurostat, Macrobond, SEB

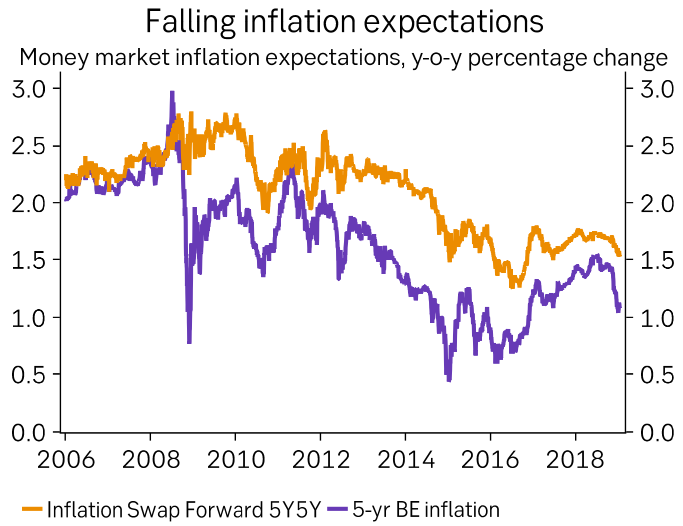
Strong labour markets, with growing shortages of well-educated staff in particular and positive hiring plans, **are having an ever clearer impact on wage formation**. The rate of yearly pay hikes (pay per employee) has now reached about 2.5 per cent. This is 1 point higher than a year ago and almost 0.5 points above the average since 2000. For years, modest increases were driven by higher wage drift, but in the past six months most of the acceleration has been in collective pay agreements, which have a more lasting effect. **Pay increases will rise a bit further, to 2.6 per cent in 2019 and 2.8 per cent in 2020**.

After staying close to target, inflation is now falling

Having been at or above the European Central Bank's target of close to 2 per cent for much of the second half, inflation **fell to 1.6 per cent in December 2018**. As we predicted earlier, we expect falling energy prices and base effects to push inflation below target. Last summer's drought may contribute a bit to inflation, but so far this effect has been minor. In this situation, rising wages are a major factor for the ECB, but the upward surge in pay will not be strong enough to achieve its inflation target. Since 2013, underlying inflation has been stable at about 1 per cent. We expect it to rise slowly to about 1.5 per cent in 2019-2020. Historically, inflation has had difficulty exceeding the target without help from more volatile components such as energy and food prices. **Average annual inflation will fall to 1.1 per cent this year, then climb to 1.5 per cent in 2020**.

Decreasing likelihood of ECB rate hike in 2019

The ECB has now taken its first step away from unconventional monetary policy by **ending its bond purchases starting in January 2019** (but it is reinvesting coupons and maturing bonds). At its latest policy meeting in December, the ECB made it clear that its objective is to keep its portfolio of bonds purchased in various euro zone countries at largely the same level as at the end of 2018 and that the transition to its new capital quotas (which will reduce Italy's share, for example) will occur gradually to avoid disrupting the functioning of the market. Current ECB communication suggests small if any policy changes in the near term and a key interest rate hike no earlier than after summer 2019. Although the ECB still foresees balanced risks in the euro zone economy, headwinds will increase as GDP growth decelerates, while inflation and inflation expectations fall. **In recent months the market has become more dovish and is not pricing in any ECB key rate change at all this year**.



Source: Bloomberg, Macrobond, SEB

In this environment, we now expect a somewhat more gentle path forward than earlier. We believe the ECB will meet the market halfway by hiking key rates only in December 2019 and that it will only raise its deposit rate for banks by 15 basis points. In 2020 it will continue a gentle hiking cycle by raising the entire interest rate corridor by 25 bps once. **The risk is clearly on the downside, and there is a growing likelihood that the first hike will be postponed further**. To provide continued access to cheap liquidity for banks, this spring **we expect an announcement about new targeted longer-term financing operation (TLTRO) floating rate loans**. As for who will succeed Mario Draghi, whose term as ECB President expires in October, discussion and speculation will be intensive. Jens Weidmann, head of Germany's Bundesbank, has been singled out as a major candidate, but we believe that Germany is more interested in landing leading positions in Brussels than Frankfurt. Finland's Erkki Liikanen has been mentioned as a compromise candidate if it proves impossible to achieve consensus on a candidate from one of the larger euro zone countries.

Japan

Impact of tax hike will determine growth and interest rates

The government of Shinzo Abe is using time-limited tax cuts in an attempt to ease the adverse impact of the controversial consumption tax hike on household spending in 2019 and 2020. The economy faces both domestically and internationally determined downside risks. The Bank of Japan (BoJ) inflation target remains out of reach. The BoJ will thus continue its ultra-loose monetary policy, in spite of its diminishing usefulness and growing pressure on the banking sector's earnings due to the flat yield curve.

Japan's GDP growth shows continued high volatility. After a strong second quarter of 2018, GDP fell by 0.3 per cent in Q3, mainly due to a **negative contribution from exports** because of production disruptions related to extreme summer weather and flagging global demand. **GDP growth in 2018** is expected to end up at **1.1 per cent**. In **2019** and **2020**, it will be **1.0** and **0.8** per cent, respectively. The economy thus continues to grow faster than its 0.5 per cent trend rate, but downside risks predominate.

The planned **consumption tax hike from 8 to 10 per cent** on October 1, 2019 is a risk factor. It will lower GDP growth by about **0.5 percentage points** in 2020. Meanwhile the effects of earlier fiscal stimulus are gradually fading and investments related to the 2020 Tokyo Olympics are close to completion. To **ease the impact of the tax hike** on private consumption, which accounts for 60 per cent of GDP, the Abe government is providing **certain time-limited tax cuts** for household interest costs, car purchases and other items. The government wants fiscal policy to have a **neutral growth effect in 2020** and has postponed its target for balanced public finances from 2020 to 2025. Yearly budget deficits will be 2-3 per cent of GDP in 2019-2020, while public debt will remain just below 240 per cent of GDP.

Japanese businesses remain optimistic, according to the BoJ's Tankan survey. High earnings will allow room for capital spending in 2019-20. The economy is also largely unaffected by the US-Chinese trade war. Last July's Japanese-EU trade pact takes effect on February 1 and will favourably impact companies. Meanwhile Japanese-US trade talks are resuming.

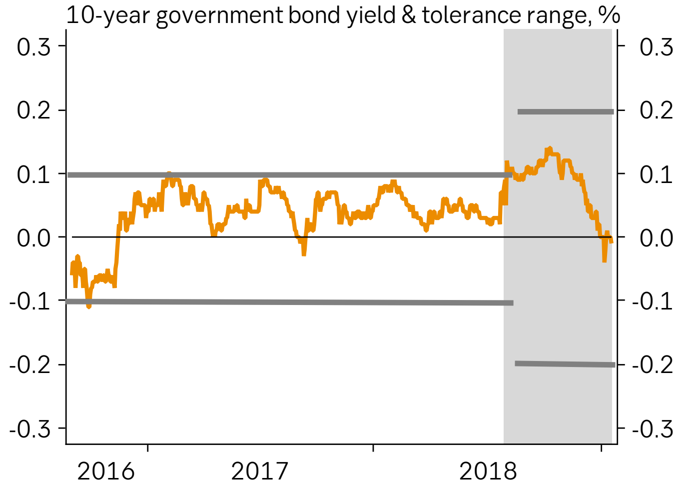
With **unemployment now around 2.5 per cent**, the economy is stretched. The BoJ estimates the output gap at +2 per cent of GDP. Unemployment will fall to an expected **2.2 per cent at the end of 2019 and 2.0 per cent at end- 2020**. From a supply side standpoint, **demographic headwinds** will create continued strains, but efforts to expand the labour force are bearing fruit; participation by women and older people has risen, while the number of foreign-born workers is increasing. Starting on April 1, the government will allow 340,000 foreign workers to immigrate over five years. The government is concerned that the 2018 birth rate is expected to be the lowest in 120 years.

An accelerating decline in Japan's working-age population is driving up labour shortages, especially in the service sector, along with **wage and salary growth**. The 2 per cent pay rise in 2018 was related to labour shortages but was also due to larger summer bonus payments. **During 2019 and 2020, annual wage growth is expected to end up at between 1.5 and 2 per cent**.

Despite pay growth, inflation risks remain on the downside. The BoJ faces continued challenges in sustainably achieving its 2 per cent target. Low oil prices are favourable to growth in the oil-dependent Japanese economy but make it harder to meet the inflation target. The tax hike will temporarily boost inflation, but **we believe the BoJ will still fall short of its target: CPI inflation excluding food was 1.0 per cent in 2018. We expect inflation of 1.0 per cent this year and 1.3 per cent in 2020**.

Lower yields are decreasing bond purchases

10-year government bond yield & tolerance range, %



Source: Macrobond, SEB

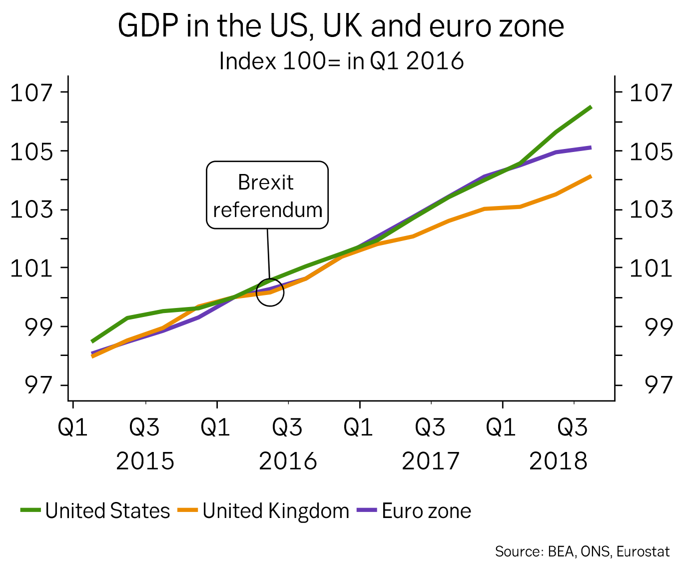
We are sticking to our forecast that the **BoJ will try to keep 10-year government bond yields at close to 0 per cent during 2019, even though its tolerance band has been widened** (see chart). The monetary base will thus keep growing by 5-10 per cent yearly. Long-term (5-10 year) inflation expectations by households, businesses and economists have been troublingly stable at around 1.2 per cent in recent years. BoJ monetary policy will lead to continued **strains in the financial system due to pressure on earnings**, while ultra-loose policy encourages **increased risk-taking**. We believe that the **USD/JPY exchange rate will be 104 at year-end and 100 at the close of 2020**. Yen appreciation due to increased global risk aversion will make it even harder to meet the inflation target.

The United Kingdom

No-deal Brexit will be avoided, but uncertainty will persist

British withdrawal from the EU has already hampered growth due to weaker capital spending and will continue to determine UK economic performance during our forecast period. We still expect the country to avoid a no-deal Brexit, but uncertainty about future UK-EU relations will persist. Despite below-trend growth, the labour market is tight and we see clear signs of accelerating pay increases. This is making the central bank worried about future cost pressure and will contribute to further key rate hikes during 2019-2020.

After a weak start to 2018, British growth accelerated to 0.6 per cent quarter-on-quarter in Q3. This was, in part, a rebound after the weak first half and thus exaggerates the underlying strength in the economy. The unclear situation concerning withdrawal from the EU has probably also had a temporary expansionary effect, since British companies are stock building and speeding up sales in order to bridge over a possible no-deal Brexit in March. Monthly data from Q4 suggest a slight cooling, but still a decent end to the year. Meanwhile it is clear that **the United Kingdom's withdrawal from the EU is hampering underlying economic activity**: given the weak currency and international developments, growth should have been stronger over the past two years.

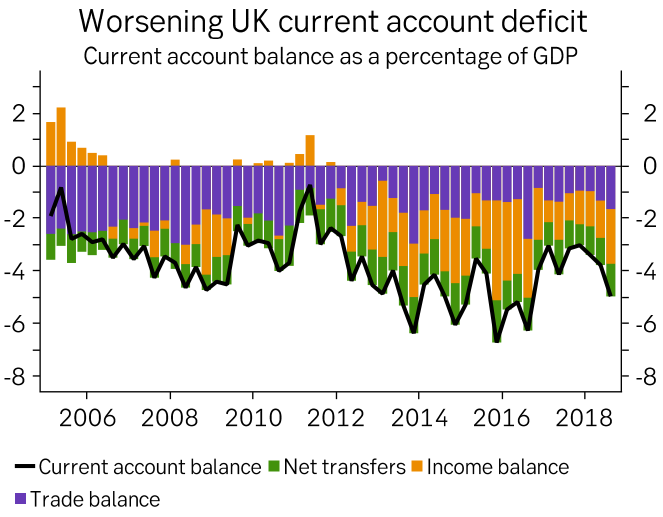


The unclear situation about EU withdrawal late in March makes forecasting especially uncertain. Assuming a controlled withdrawal including a transitional solution – which is still our main scenario – **the negative economic consequences of withdrawal should be rather limited**. Meanwhile there is persistent uncertainty about how the future trade relationship between the EU and the UK will look. But Brexit is not the only risk. **The household savings ratio remains at historically low levels** and real wage growth is still slow. The need for consolidation and increased saving should reasonably dampen household demand during our forecast period, posing a risk to growth since consumption accounts for 60 per cent of GDP.

Uncertainty about EU withdrawal has contributed to a decline in capital spending during the past three quarters. A survey of corporate investment plans also indicates lower optimism about future capital spending. However, if a withdrawal agreement is put in place, **capital spending should recover in late 2019 and during 2020**. Our main scenario thus assumes small changes in growth during our forecast period. **We expect GDP growth to reach 1.4 per cent in 2018 and 1.3 per cent this year, and then we foresee a slight acceleration to 1.6 per cent in 2020**. However, if the UK leaves the EU without a transitional solution, the negative consequences will be significant. **Estimates indicate that the long-term impact may lower economic growth by 0.4-1.0 per cent yearly over the next 15 years**. These effects should reasonably be largest in the beginning, which suggests a recession in the United Kingdom.

The British labour market remains tight, although job growth decelerated during the autumn. In the past year, employment has risen by an average of 86,000 people per month. Unemployment bottomed out at 4.0 per cent during the summer but now stands at 4.1 per cent: still a historically low level. Such a tight labour market would normally push pay increases higher, and **in recent months nominal wage and salary growth has indeed accelerated. In October, year-on-year pay increases were above 3.5 per cent**, which is their fastest upturn in nearly 10 years. The labour supply is now also being adversely affected by an increase in citizens of other EU countries who are leaving the UK. Net immigration from other EU countries to the UK has fallen to its lowest since 2012, which may eventually worsen already tight conditions in the British labour market.

A weak pound has benefited the British export sector. In spite of this, the latest statistics show that **the trade deficit is again widening, and the current account deficit grew to 5 per cent of GDP during Q3**. This is generating some fears ahead of EU withdrawal. All indications are that a future free trade agreement between the UK and the EU (if it materialises) will mainly cover merchandise trade, while trade in services will be affected by various limitations. Withdrawal will thus probably have a negative impact on the British current account balance, although it is difficult to estimate how big this impact will be. We also expect the pound to appreciate if the British Parliament finally accepts a withdrawal agreement, and this should also lower exports somewhat.



Source: U.K. Office for National Statistics (ONS)

Uncertainty about Brexit is also spilling over into the UK monetary policy outlook. In August 2018, the Bank of England raised its key interest rate to 0.75 per cent as growth rebounded. Meanwhile the BoE believes that CPI inflation will remain above its target during our forecast period. Yet it appears as if **the central bank is primarily focusing on the tight labour market and accelerating pay increases**, which it fears may drive up domestic cost pressure. Although we foresee CPI inflation following the trend of underlying inflation and falling somewhat below target during 2019, we believe the BoE will continue hiking its key rate, assuming an orderly withdrawal from the EU. This year we expect **two more rate hikes in our main scenario, for a key rate of 1.25 per cent by the end of 2019**. This would allow room for slower tightening after that, with the key rate reaching 1.5 per cent during 2020.

The value of the pound will be almost completely determined by the ongoing EU withdrawal negotiations and the domestic political situation. The problem of winning parliamentary support for the government's current negotiated agreement has weakened the pound, since the risk of a no-deal withdrawal has greatly increased. Because of continued uncertainty about Brexit, a risk premium on the pound is still justified. We anticipate that the pound will remain rather weak against the euro as long as this uncertainty persists. If Parliament should accept an agreement that allows an orderly withdrawal, we expect the pound to appreciate as the risk premium falls. In addition, **tighter monetary policy should give the pound additional strength during the year, with the EUR/GBP exchange rate reaching 0.83 at the end of 2019 and 0.86 at the end of 2020**.

Brexit process – from disruptive to surrealistic

The proposed EU withdrawal agreement was rejected 432-202 by the UK House of Commons: the largest-ever defeat in a British parliamentary vote. After this clear outcome, the EU withdrawal plan that Theresa May's government had negotiated with Brussels over the past two years appears dead. Minor tweaking or concessions by the EU will not be enough to reverse such massive opposition in Parliament. The government must now choose another path if it wishes to bring about an orderly UK withdrawal.

Although a no-deal Brexit on March 29 remains the default outcome, it can probably be ruled out since it lacks a House of Commons majority. So what are the other alternatives? A complete renegotiation with the EU is one alternative but is hardly a viable forward path, since it would force both sides to abandon their red lines. For example, the EU wants to protect its four freedoms and not allow the UK to cherry-pick from its current membership benefits. If the British want to stay in the EU single market and enjoy its advantages, they must accept various restrictions and obligations incumbent on members. The agreement was precisely such a compromise, which took into account the red lines of both sides, yet it was rejected by the UK Parliament. So the only remaining alternative is a no-deal Brexit, meaning that all UK-EU ties are completely severed at midnight on March 29, with no transitional solution – no free trade and no agreement on future relations in any of the areas where EU membership today involves natural cooperation.

There has also been talk of other alternative solutions, such as membership of the European Free Trade Association (EFTA), supplemented with a limited customs union to ensure an open border between Ireland and Northern Ireland. A second proposal is to simply terminate the whole withdrawal process – which is fully possible in legal terms – and then formulate what type of post-Brexit relationship the UK wants with the EU, then initiate a new Article 50 withdrawal process. A third alternative is to let the British people decide in a second referendum whether the UK should leave the EU based on the government's negotiated agreement or remain in the EU. The question though is why the outcome of a new referendum should make it easier for Parliament to approve the same agreement it has just rejected. Regardless of what happens with British EU membership, one thing is becoming increasingly clear: EU withdrawal on March 29, 2019 is more and more unlikely. Regardless of which alternative one supports, time is too short. We thus expect the withdrawal period to be extended by at least three months, unless the UK revokes its withdrawal application first. Every alternative has its advantages and disadvantages, but no matter which solution is ultimately chosen, it is a highly disruptive process to break up an international relationship that has evolved on all levels for nearly half a century.

The consequences of the Brexit decision for economic growth and capital spending have been apparent since early 2017, even though various actors seem to have assumed it would be possible to find a workable transitional solution without far-reaching restrictions. If no alternative solution is presented soon, it is reasonable to believe that the risk of a no-deal Brexit will now have an increasingly large adverse impact on the UK economy.

China

Further deceleration in 2019 as downside risks persist

Chinese economic activity will continue to lose momentum. Manufacturers will be squeezed by the ongoing trade war and by decreased domestic demand because of structural reforms. Growth will fall to 6.3 per cent this year and 6.1 per cent in 2020. The trade war is casting long shadows over economic sentiment. A weaker US dollar and a gentler Fed will reduce downward pressure on the yuan, enabling the currency to appreciate slightly against the dollar later this year and in 2020.

The manufacturing purchasing managers' index (**PMI**) from the National Bureau of Statistics has fallen gradually since May 2018 to below 50, putting Chinese **industry in the "contraction zone"** and confirming the challenges facing economic policy makers in 2019 and 2020. Industrial output is falling due to persistent weakness in textile and auto production and despite looser environmental requirements that are helping maintain activity in the nonferrous metal and steel industries. Auto sales have decelerated sharply in the past six months, and overall retail sales have been surprisingly weak.

These challenges are expected to increase further in 2019, after good overall growth of **6.6 per cent in 2018** (in line with the official target of "about 6.5 per cent"). The first half was strong, while the second was weaker than expected. The economy is still looking for a bottom, as structural reforms and the trade war hold back economic activity. **GDP growth will be 6.3 per cent in 2019 and 6.1 per cent in 2020**.

Some data include **bright spots**, too, for example a stabilisation in investment growth: state-controlled companies showed a slight uptick in capital spending late in 2018. The service sector, which accounts for more than half of GDP, is showing continued expansion, according to the PMI, but we believe that a **broader recovery will become evident only in the second half of 2019**.

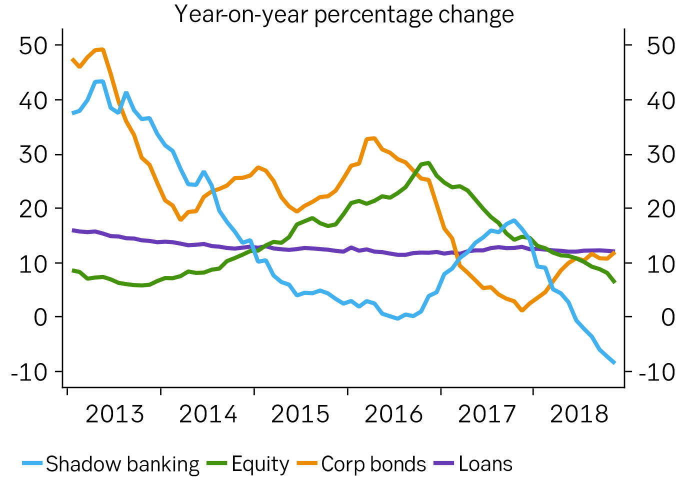
The trade war with the US has hurt economic sentiment. For example, China's stock markets fell by more than 25 per cent in 2018. Negotiations with the US are under way ahead of the March 1 deadline, and early 2019 signals are favourable. If no agreement is reached, the US will raise tariffs on many Chinese goods from 10 to 25 per cent. Despite recent optimism following mid-level negotiations, the US continues to demand more structural reforms. Already, China has softened its rhetoric with regard its "Made in China 2025" policy. However it will be far more difficult to reach a lasting accord. In the near term, progress in the trade talks may favourably affect growth.

Structural reforms are in the spotlight. Most of China's growth deceleration is due to the effects of measures aimed at decreasing risks to financial stability and the environment. **Chinese officials have cracked down on shadow banking activities**, making it harder for small and medium-sized companies to borrow money. Overall financial conditions have tightened despite broadly steady growth in bank lending. Although the People's Bank of China (PBoC) continues to lower reserve requirements for major banks, there is anecdotal information about companies that have seen disruptions in production due to credit shortages.

From an interest rate perspective, **Chinese monetary policy** will remain officially neutral in 2019 and 2020 (for more on China's policy dilemma, see the theme article on page 27), but the PBoC is also taking various steps that will expand access to credit for small and medium-sized companies. We expect the central bank to lower the reserve requirement three more times during 2019 to 12.0 per cent; in 2020 it will remain unchanged. So far, though, lower reserve requirements have had only a modest effect on the credit supply, forcing the PBoC to try out measures that will improve monetary policy transmission. In light of the challenging macroeconomic situation, many banks prefer to own government risk instead of corporate and credit risk.

Shadow banking under pressure

Year-on-year percentage change



Source: CEIC, SEB

The yuan is expected to continue recovering. It will trade at **6.75 to the US dollar at the end of 2019 and 6.55 at the end of 2020**. A somewhat weaker dollar, hopes of progress in trade talks and the inclusion of Chinese bonds in the Bloomberg Barclays indices starting in April 2019 have helped ease pressure on the yuan. A gentler Fed will also provide some support to the yuan, but a breakdown in trade negotiations with the US would pose a major depreciation risk for the Chinese currency.

Theme: Policy headaches

Chinese and US monetary policies increasingly interconnected

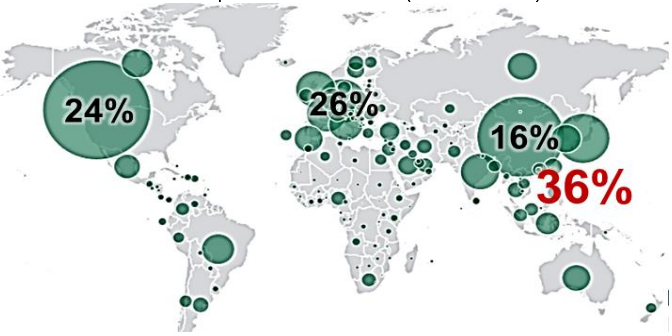
Growing signs of Chinese economic weakness have become an ever more important piece of the puzzle in the Federal Reserve's monetary policy decisions. China's financial balance faces intensifying challenges as the US hikes its key interest rate and the Chinese leave theirs unchanged. Destabilising currency outflows from China pose a risk of adding to global financial market turmoil and forcing sell-offs of US government securities in a situation of disturbingly large American federal budget deficits.

China's 6.6 per cent GDP growth in 2018 remains impressive, but **2019-20 prospects look far more challenging** after last autumn's growing signs of economic weakness. Structural and cyclical slowdown will complicate Beijing's choice of an optimal economic policy mix (for more on China's economy, see page 26).

Economic and political developments in China have assumed an ever more important role in shaping US monetary policy. The **Federal Reserve** (Fed) does not usually name individual countries in its analyses of international conditions, but the minutes of a very recent policy meeting **mentioned China nine times** – only once in connection with the current trade conflict.

Asia comprises 36 per cent of the world economy

2019 GDP at current prices. USD billion (Source: IMF)



Total exports account for only about 10 per cent of American GDP (8 per cent of it destined for China). With Asian economies making up 36 per cent of global GDP and with Asian goods and services integrated into global supply chains, China's economic growth and financial balance are both also relevant to the US. This **affects the Fed's degree of monetary policy freedom**.

Short-term spread eliminated...squeezing the yuan

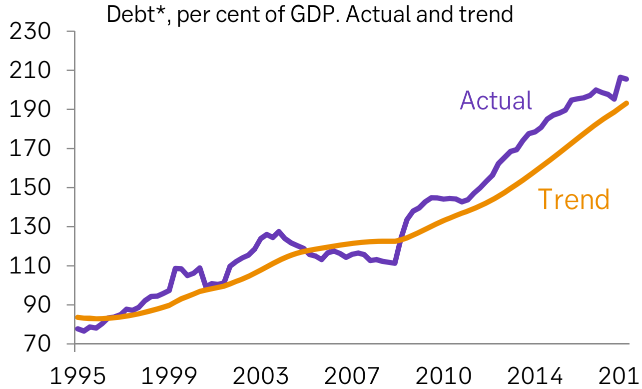
Since late 2015 the Fed has hiked its key interest rate from 0.25 to 2.50 per cent, while the People's Bank of China (PboC) has raised its 7-day repo rate from 2.25 to 2.50 per cent. This has **essentially wiped out the Chinese-US short-term rate spread**, depriving the Chinese yuan of the past decade's interest rate support and helping fuel speculation that **the yuan will fall past 7.00 to the dollar**. Five years ago, the rate spread was about 4 percentage points, and the USD/CNY exchange rate was 6.10.

The yuan – and the Fed – will face **a major flow risk** if the Chinese-US rate spread turns negative and if the world starts believing that the yuan will depreciate against the dollar, risking capital outflows (see more on page 28). We believe that China wants to avoid letting the yuan fall to more than 7 per USD for as long as possible. Our forecast is a **USD/CNY exchange rate of 6.75 at the end of 2019 and 6.55 at the end of 2020**. Letting the yuan rise by about 5 per cent against the dollar would also ease the risk of new trade conflicts with the US.

Our forecast is that the Fed will hike its key rate further. This would turn the short-term spread negative and challenge our yuan forecast. In light of China's debt build-up, Beijing would follow the Fed and hike its own key rate, but due to China's downside risks to growth, rate hikes may cause problems.

High Chinese debt will level out

Debt*, per cent of GDP. Actual and trend



* Total lending to private non-financial sector. Source: BIS

Since the 2008 Lehman Brothers collapse and subsequent US unconventional monetary policy, Chinese companies – state-owned and private – and foreign companies in China have benefited greatly from low interest rates and faith in a stronger yuan. Rapidly increasing Chinese dollar debt – today around **USD 3 trillion** – has been part of China's total debt build-up.

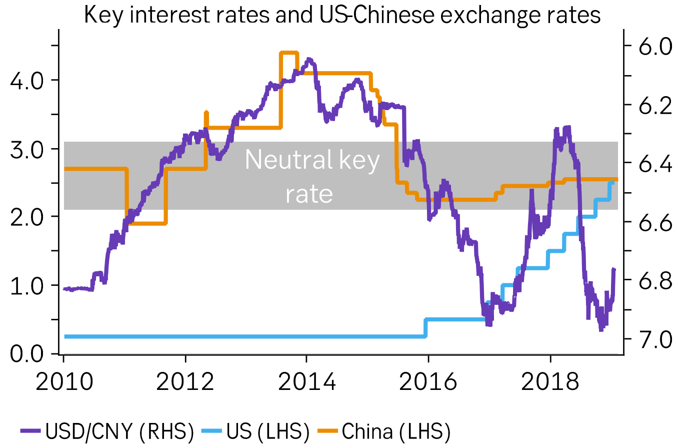
Credit policy reassessment – unchanged key rate

In 2017 Beijing thus **prioritised a "deleveraging"** that was aimed at reducing financial stability risks as well as making economic growth less credit-dependent. In hindsight, this credit policy seems to have had a **larger negative growth impact** than planned, partly because it coincided with the US-Chinese trade war and a cyclical deceleration. Without changing its long-term plan, in 2018 Beijing thus chose to **ease credit restrictions** and try to avoid building in any financial instability.

China's **2019-20 economic policy** is best summarised as **discretionary gradualism**. It thus stimulates growth through targeted support to specific groups. In 2018 the PBoC lowered the **reserve requirement** for major banks four times by a total of 2.5 percentage points to 14.5 per cent, and in January 2019 by another point to 13.5 per cent. It will cut the requirement three more times this year to 12.0 per cent and leave it unchanged in 2020. The aim of this increased credit expansion is to ease lending to small and medium-sized companies that have been affected by trade tariffs, the elimination of shadow banks and other adversities. **Key interest rates** will remain unchanged during our forecast period, however, despite increased risks to economic growth; such rate cuts would risk accelerating the movement towards negative Chinese-US key rate spreads.

Positive Chinese-US rate spread eliminated

Key interest rates and US-Chinese exchange rates



Source: Macrobond, SEB

Fiscal policy is also expansionary. This year China is cutting **taxes and fees** amounting to more than 1 per cent of GDP, mainly targeting these cuts to households and companies. With public debt totalling 72 per cent of GDP (IMF's metric, which is higher and broader than China's), there is room for further measures. Local governments are also being encouraged to **speed up infrastructure projects**, again boosting local and regional public debt, but this is the most effective tool for quickly accelerating China's growth rate.

China: Strong muscles for managing capital outflows

International investment position, 2017, USD billion

	Assets	Liabilities
Direct investments	1,522	2,951
Equity portfolios	308	726
Bond holdings	211	403
Bank borrowing	419	463
Loans	684	415
Trade credits	621	289
Miscellaneous	57	44
Currency reserve	3,206	--
Total	**7,028**	**5,291**

Source: SEB, People's Bank of China

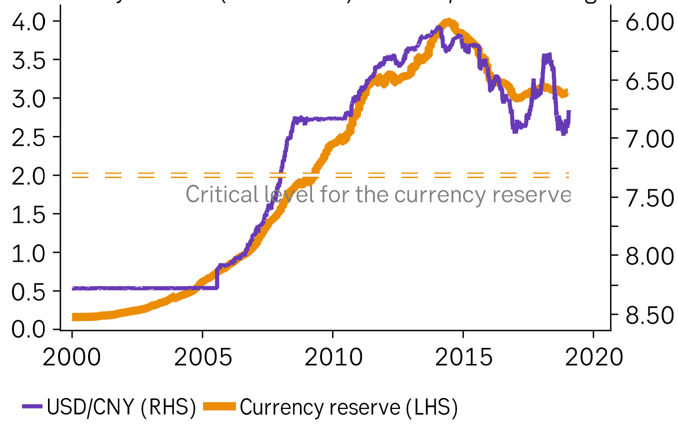
The short-term interest rate *spread* between China and the US in 2019 and 2020 – either due to Chinese rate cuts and/or US hikes – thus risks destabilising outflows. Growth is slowing simultaneously in China and the US, making it easier for the Fed and the PBoC to pursue synchronised interest rate policies that are not domestically, and thus also internationally, destabilising. **The neutral rate in both the US and China** – a level that neither stimulates nor slows economic growth – **is estimated[1] at 2.6 per cent**. Both the Fed and the PBoC are already there today.

Growing risk of destabilising currency outflows

In the past 20 years, **China's currency reserve** has swelled from USD 160 billion to **USD 3,062 billion**. Clear contributing factors have been its current account surpluses against other countries (totalling USD 3.2 trillion until 2017) and extensive direct investments in China by foreign companies.

China's currency reserve: a solid buffer

Currency reserve (USD trillion) and USD/CNY exchange rate



Source: SAFE, Macrobond, SEB

Our conclusion is that the yuan can probably withstand destabilising capital outflows, **even if the US hikes its key rate a bit further**, but this also requires Beijing to show clearly that it **does not intend to let the yuan depreciate**.

Destabilising currency outflows have two main sources:

■ **China's dollar loans being paid down**. As mentioned above, these loans total about USD 3 trillion. A fairly large proportion of them should have been used to finance China's purchases of equities and companies abroad. But if they have been used in China, there are now good reasons to replace them with loans in yuan. This means selling CNY in exchange for USD, generating a capital outflow. To stabilise the yuan, the PBoC may be forced to intervene, for example by selling US government securities.

■ **Foreign direct investments in China**. As the table on the international investment position indicates, the largest foreign claim on China consists of direct investments in Chinese businesses (USD 2,951 billion). We believe that many of these investments are unhedged against exchange rate movements, among other things due to confidence in an appreciating yuan. If the yuan instead falls, there will be reason to currency-hedge direct investments, for example through new yuan-denominated loans – again forcing the PBoC to sell US government securities.

The currency reserve is big enough to enable China to manage large capital outflows. But a reduction in the reserve may lead to sell-offs of government securities, in a situation of disturbingly large US federal budget deficits and while the Fed is decreasing its own such holdings. It is thus in the Fed's best interest to carefully monitor developments in the Chinese economy and in the short-term key interest rate spread.

[1] Neutral key interest rate estimates were made by SEB for the US and by the International Monetary Fund (IMF) for China.

India

The upcoming election is largely shaping economic policy

Growth has peaked but will be fuelled by the Modi government's increasingly expansionary economic policy ahead of the April-May parliamentary election. This is true of both fiscal and monetary policies. Tensions between the government and the Reserve Bank of India led to a change in RBI leadership, which is expected to result in more dovish monetary policy. The rupee recovered as oil prices fell, but the leadership change and worries about the RBI's independence have caused renewed depreciation.

India's third quarter GDP growth decelerated to 7.1 per cent year-on-year, compared to 8.2 per cent in Q2. Despite this slowdown, the pace of economic expansion is relatively strong in a historical perspective. Purchasing managers' indices for both manufacturing and services are well above the growth threshold of 50. Industrial production continued its strong performance, growing by more than 8 per cent year-on-year in October, but auto sales – a good indicator of household demand – have stagnated. The April-May election is approaching, and more expansionary government economic policy will provide extra fuel to growth, at least in the near term. We believe that **GDP** increased by **7.6 per cent in 2018** and expect it to grow by **7.8 per cent in 2019 and 7.3 per cent in 2020**.

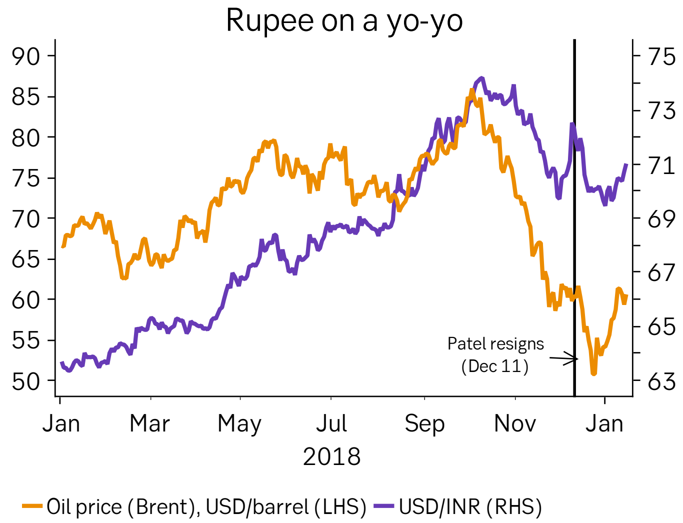
Oil price fluctuations have a major impact, due to India's large-scale energy imports. **Lower oil prices** are now creating a number of **positive effects**. The current account deficit widened in Q3, but the sharp oil price drop will help keep future deficits in check. Rupee depreciation is also helping exports to some extent, thereby reducing the trade deficit. Lower oil prices are also decreasing government fuel subsidy expenditures.

Economic policy is increasing being shaped by the upcoming **April-May parliamentary election**. Narendra Modi's Bharatiya Janata Party (BJP) government has already taken steps towards loosening fiscal policy, for example by waiving loans to farmers. Unexpectedly weak BJP outcomes in December state elections can be interpreted as opposition to government reform programmes. Although the BJP still has a good chance of winning the spring election, these reversals have created concern in the government. The risk that it will pursue an even more expansionary economic policy has increased.

CPI inflation fell to 2.2 per cent in December, the fifth straight month of inflation below the RBI's 4 per cent target, but this slowdown was largely driven by lower food price inflation. CPI is expected to accelerate again. Core inflation cooled somewhat but is expected to remain high as capacity utilisation is driven upward by continued good growth. Household inflation expectations declined a bit in the fourth quarter. Average annual **inflation was 4.0 per cent in 2018**. Our forecast is that inflation will end up at **3.7 per cent in 2019 and 4.3 per cent in 2020**.

Tensions between the government and the central bank took an unexpected turn in December when **RBI Governor Urjit Patel resigned**. The government has tried to influence RBI policy in various fields, for example by advocating gentler management of banking regulations and a more dovish interest rate policy, but also by raising the dividend paid to the national treasury. Patel's predecessor, Raghuram Rajan, was not granted a second term by the government, probably due to his outspokenness. Patel's resignation **again raises questions about the central bank's independence**. The government quickly appointed Shaktikanta **Das** as the **new RBI governor**. Das has a Finance Ministry background and is believed to be more inclined to adapt the RBI's monetary policy to government wishes. The result will probably be **more growth-promoting policy in the short term**, which will damage confidence in the RBI's independence.

During 2018 the RBI hiked its key interest rate twice to the current 6.50 per cent. We believe that the RBI, led by Das, will pursue a more dovish monetary policy. Our **forecast** is that the **central bank** is now **finished with its rate hikes**.



Source: Macrobond Financial AB, Intercontinental Exchange (ICE), Macrobond, SEB

After bottoming out at a record-low level against the US dollar in October, the **rupee** recovered in response to lower oil prices, but tensions between the government and the RBI triggered a new plunge in the currency. Since the beginning of 2018, the rupee has lost more than ten per cent against the dollar. Our forecast is that the **USD/INR** exchange rate will be **69.9 at the end of 2019 and 69.0 at the end of 2020**.

Russia

Slow growth and higher inflation, due to tax hikes

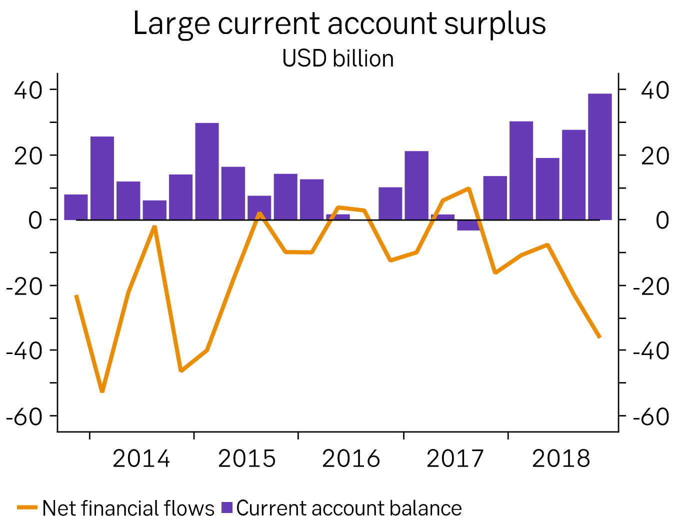
GDP growth will stabilise at a low level this year because of tax increases and tight fiscal and monetary policies. Sanctions are not crucial but are contributing to slower growth. President Vladimir Putin has promised economic and social improvements, but far-reaching reforms to boost productivity growth will not be implemented. The rouble weakened in 2018 but will probably stabilise now, thanks to higher oil prices and a gradually lower risk of new sanctions against Russia's government and central bank.

Russian GDP rose by nearly 1.6 per cent year-on-year in the first three quarters of 2018. Available Q4 statistics indicate a slight acceleration in economic activity. We expect full-year GDP growth to end up at 1.6 per cent. Industrial and agricultural production are growing, but the import substitution policy initiated after the US and the EU imposed sanctions in 2014-2015 has not provided the boost that authorities had hoped for. Private consumption, along with exports, contributed the most to 2018 growth, but the value-added tax (VAT) hike that took effect on January 1, 2019 will limit growth in household purchasing power this year. Overall, **we expect GDP growth of 1.6 per cent in 2019**. Partly due to low capital spending, an ageing population and weak productivity improvements, **growth will only reach its potential of around 2 per cent in 2020**.

Far-reaching new sanctions against Russia's government or central bank are not in our main scenario but are a sizeable risk factor. We believe the Kremlin will avoid escalating the Ukraine crisis and trying to influence Western elections on a large scale, thus limiting the reasons for new sanctions against the Russian government. We expect further sanctions against individuals and companies, but their macroeconomic effect will be limited.

Inflation rose gradually in 2018 from about 2.2 per cent year-on-year in January to 4.2 per cent in December: a bit above the central bank's 4.0 per cent target. Base effects are part of the explanation, but the increase was mainly driven by a weak rouble and higher food and fuel prices. Nominal pay hikes of about 10 per cent year-on-year also contributed to the acceleration. **Inflation looks set to climb at just above 5.0 per cent this year** due to the VAT hike from 18 to 20 per cent, **before dropping back to around 4.0 per cent in 2020**. The central bank has pursued a tight, proactive monetary policy aimed at slowing price increases before they drive up inflation expectations. This policy direction has boosted the bank's reputation among international investors, but more work remains in order to persuade Russian consumers and businesses. We expect the bank to leave its key rate at 7.75 per cent in February but hike it to 8.00 per cent in March, since inflation looks set to fall too slowly to lower price expectations.

Despite Russia's tight monetary policy, the rouble fell by more than 15 per cent against the dollar in 2018, driven by lower oil prices and worse international relations – especially with the US – following the imposition of new sanctions due to Russian attempts to influence elections and cyberattacks against US and international organisations. Private capital flight accelerated to USD 67.6 billion in 2018 from USD 25.2 billion in 2017 but was completely covered by the current account surplus. Yet the Finance Ministry's foreign currency purchases when oil prices exceeded USD 40 per barrel prevented the rouble from rising sharply. We forecast that **the rouble will stabilise and be worth 67.50 per dollar at the end of 2019**. In 2020 we expect it to weaken a bit, reaching about RUB 71 per dollar. This will partly offset the effects of high inflation on Russia's competitiveness. Our forecast is dominated by risks that may weaken the rouble further.



Source: Central Bank of the Russian Federation (CBRF), Macrobond, SEB

Oil price changes have previously had a major impact on GDP growth, but a budget rule that was introduced in 2018 – which mandates setting aside a portion of oil export revenues in a government reserve fund – will decrease GDP volatility. The 2018 federal budget looks set to end up with a surplus of about 1.5 per cent of GDP: the biggest since 2007. Investments to improve demographics, health care, the educational system, housing, infrastructure, scientific research and the digital economy are on their way. However, the Kremlin will not spend the surplus in the next couple of years, since its priority is to rebuild budget reserves, which have been drained since 2014. Funding of investments in the economy will occur outside the budget via state-owned companies. We expect this year's budget surplus to be on a par with last year's, but government debt will increase slightly to about 15 per cent of GDP due to guarantees issued for borrowing by government institutions.

Sweden

Growth is slowing, despite expansionary economic policy

The growth outlook has dimmed in recent months, with worrying signals from both the domestic economy and exporters – thus weakening the forces that can offset the sharp decline in home construction now under way. Yet loose economic policy is providing some support, and GDP growth will rebound in 2020. Low inflation will contribute to more dovish monetary policy than indicated in the Riksbank's December rate path: only one hike per year, bringing the key interest rate to 0.25 per cent by the end of 2020.

The 0.2 per cent quarter-on-quarter GDP decline in Q3 was partly due to temporary factors such as weak consumption caused by a new "bonus-malus" tax aimed at encouraging low-emission autos. Q4 data are not convincing either, but most indications are that GDP will rebound somewhat. However, a broad decline for both business and household sentiment indicators suggests that we are in a period of more underlying slowdown. This is primarily because residential investments, which have been the main growth engine in recent years, will fall sharply in 2019. **GDP will slow from a 2.2 per cent increase in 2018 to 1.6 per cent this year**: a sizeable downward adjustment, by 0.6 percentage points. About half of this forecast revision is due to overhang effects from weakness late in 2018. **In 2020 we expect GDP growth to recover a bit to 1.9 per cent** as the negative contribution from home construction fades.

Expansionary fiscal policy, continued low interest rates and a weak krona suggest that an even more serious economic slowdown can be avoided. Underlying conditions for investment and consumption are also good, yet downside risks predominate in Sweden too. If the international economy enters a recession, **Sweden is especially vulnerable because of its highly inflated home prices** and lack of monetary policy ammunition.

Due to lower oil prices, CPIF inflation (CPI excluding interest rate changes) will drop below 2 per cent early this summer. Slight upward pressure from the weak krona exchange rate and higher food prices, due to the dry summer, suggest that CPIF excluding energy will climb temporarily early this year, but that underlying inflation pressure will remain moderate. Despite headwinds from inflation, **we expect the Riksbank to raise its key rate again in October**. It will carry out only one hike in 2020, bringing the repo rate to 0.25 per cent at the end of our forecast period.

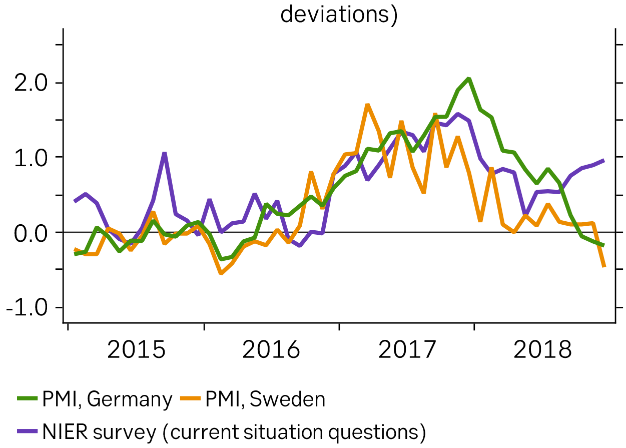
Swedish politics are moving in a sharply centre-right direction because of a new budget cooperation agreement between Social Democrats (S), Green Party (MP), Centre (C) and Liberals (L) that will allow a new S+MP government headed by S leader Stefan Löfven to take power, four months after the September election. The pact is both reassuring and concerning; it will give Sweden a stable government capable of enacting its budgets, but recriminations about broken political promises and internal tensions represent a latent threat to the agreement, which may very well collapse during the 2018-2022 parliamentary term. Fiscal policy will be somewhat more expansionary in 2019 than we had previously expected. Yet Swedish public finances are strong in a European perspective; the budget surplus will end up at around 0.5 per cent of GDP in 2019 and 2020 and the public sector debt ratio will continue to fall.

Greater uncertainty about manufacturing activity

Manufacturing sector indicators remain at decent levels. This is especially true of the Economic Tendency Survey of the National Institute of Economic Research (NIER), which actually shows increased optimism about order bookings and production in the past 3-4 months. Yet there is a risk that the **NIER survey overestimates underlying economic strength**. The clear downturn in the December purchasing managers' index (PMI) was troubling. The decline in manufacturing PMI has mainly coincided with the same development in Germany, although the Swedish downturn has been somewhat milder. This is probably due to the weak krona and a less exposure to the auto industry. Looking ahead, our forecast is that industrial production will grow at a decent pace, mainly driven by an estimated **export increase of 3.4 per cent this year and 3.3 per cent in 2020**. This will depend, however, on whether the European economy actually recovers in accordance with our forecast.

Contradictory signals from manufacturers

Manufacturing sector sentiment (median 0, standard deviations)



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

Sweden's current account surplus has gradually fallen since peaking at 8 per cent of GDP before the financial crisis and is now about 2 per cent, after a downward acceleration this past year. The fact that this could happen despite the weak krona raises the question of whether a higher cost trend in Sweden, especially compared to Germany, has undermined its relative competitiveness. If so, the equilibrium EUR/SEK exchange rate has shifted upward in recent years. We believe this is true to some extent, but considering the high earnings level in foreign currency-exposed sectors, it is very difficult to perceive any general competitiveness problem among Swedish manufacturers. Instead the main reason for lower surpluses is capacity restrictions in the export sector, combined with a rapid increase in imports due to strong domestic demand. Assuming a slowdown in domestic demand, our forecast is that the current account surplus will recover slightly during 2019-2020.

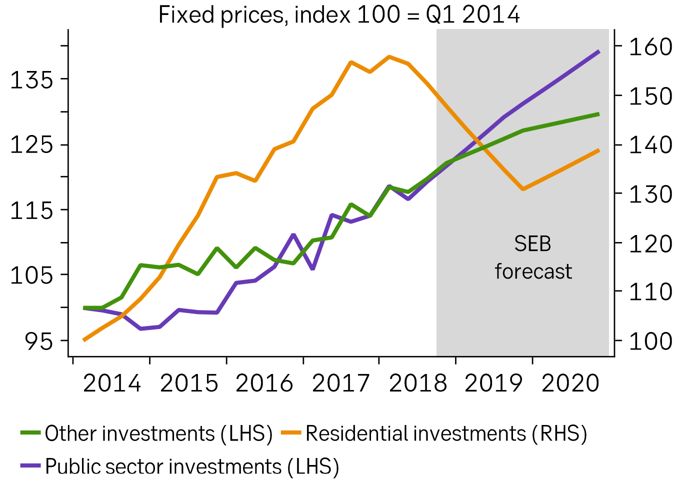
Home construction will fall sharply this year

The strong investment upturn of recent years is now slowing significantly because of the downturn in home construction. The number of housing starts plunged during Q3 2018, and **residential investments are expected to shrink by 12 per cent in 2019**. This marks a shift from positive contributions to GDP growth in recent years to a sharply negative contribution, which is expected to peak at 0.7 percentage points at the end of 2019.

For other capital spending, the picture is more mixed. High capacity utilisation and good profitability in Swedish manufacturing – partly due to the weak krona – suggests rising industrial investments. But Statistics Sweden's survey shows continued great hesitation in many economic sectors, probably reflecting greater uncertainty about the sustainability of the mature global expansion. Our forecast is that industrial investments will increase by 3 per cent this year. In the past 2-3 years, public sector investments have been more expansive than for a long time, and because of rapid population growth the demand for public services is continuing to increase at a pace that will require sizeable new investments both this year and next. Other expansive fields are infrastructure and logistics investments, while the construction of business premises has now slowed sharply due to the problems of the retail sector. Overall, **we expect capital spending to increase by 2.0 per cent this year and 2.8 per cent in 2020**. Excluding homes, the upturn is still robust, with increases of 5.3 and 3.7 per cent in 2019 and 2020 respectively.

Rising public sector investments

Fixed prices, index 100 = Q1 2014



Source: Statistics Sweden, SEB

Cautious households, despite strong finances

Despite the strong labour market and rising incomes, **households remain cautious** and the increase in consumption during Q3 2018 was the slowest since 2012. Falling auto sales due to changes in tax rules on July 1 and new EU emission rules were an important an important factor, but retail sales were also weaker than for a long time. Household optimism has fallen to its lowest level since early 2016, making a rebound unlikely in the near term. Unless there is a significant weakening in the labour and/or housing market, however, a decently strong consumption trend is quite likely. Household incomes continue to increase at a healthy pace, and falling oil prices are now strengthening household purchasing power. An initially record-high savings ratio will also provide support. **We expect private consumption to increase by 1.7 per cent both this year and in 2020**, which implies growth just below the trend for the period 2015-2018, but per capita consumption is considerably more modest and well below the long-term historical trend.

Household incomes and saving

Year-on-year percentage change

	2017	2018	2019	2020
Real disposable income	1.8	2.4	2.7	1.6
Private consumption	2.2	1.6	1.7	1.7
Savings ratio, per cent of income	15.1	16.0	16.3	16.2

Source: Statistics Sweden, SEB

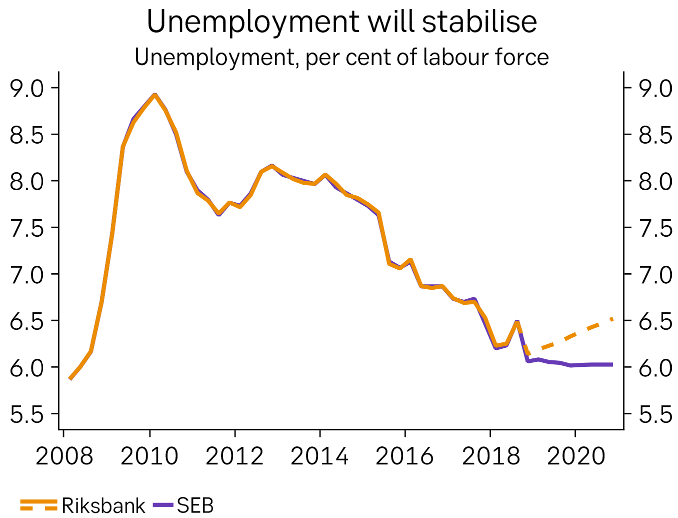
Home prices have been largely flat this past year. Short-term indices such as the SEB Housing Price Indicator have recently weakened, and a large supply of relatively expensive, newly built apartments in major cities suggests some further price declines. We are thus sticking to our forecast that **prices will fall by another 3-4 per cent this year**. Including a decline of about 5 per cent during the second half of 2017, the total home price downturn will be nearly 10 per cent. Expected Riksbank rate hikes also appear likely to contribute to further downward pressure on home prices, but we continue to believe that these rate hikes will not initially have a full impact on mortgage interest rates. Interest expenses as a proportion of household incomes will climb very moderately, reaching 2.9 per cent at the end of 2020 compared to the current 2.5 per cent.

SCB underestimates public consumption

Problems with methods for measuring public consumption are continuing to hold back GDP growth, as we have previously pointed out. Despite rapid growth in public sector employment, public sector consumption is showing extremely modest increases, due to the imprecise methods for measuring consumption volumes being used by Statistics Sweden (SCB). We believe **the effect of this is pulling down GDP growth by 0.3 percentage points**, partly explaining the weak productivity growth of recent years in the economy as a whole. Both SCB and the NIER have pointed this out in the past few months, but merely note laconically that new measuring methods would make the figures hard to interpret. There is thus no reason to believe that Statistics Sweden will change its measuring methods in such a way that they harmonise with those applied in practice by the rest of the EU. Our forecast is thus that public consumption growth will only reach 0.2 per cent this year, but this also reflects a certain underlying slowdown.

Unemployment will level out

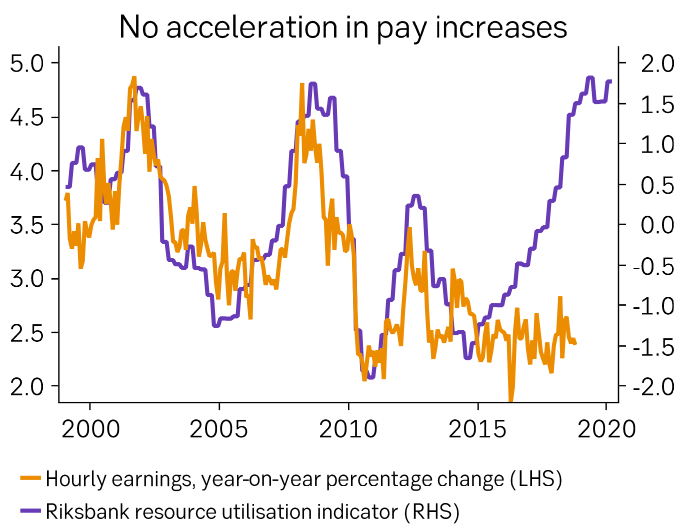
Unemployment was unusually difficult to interpret in 2018, with large downturns early and late in the year but a rising unemployment rate during the summer. Job growth was strong throughout the year, however. We believe that unemployment showed a fundamentally downward trend in 2018 and that the low fourth quarter levels will persist. Meanwhile there are clear signs that **the labour market is approaching a calmer phase**. Business sector hiring plans fell in December to their lowest level since 2014 and we now expect job growth to slow in a way that will cause unemployment to stabilise at around 6 per cent.



Source: The Riksbank, Statistics Sweden, SEB

Late-cyclical upturn in collective pay increases

Despite its recent downturn, Swedish unemployment looks set to remain permanently well above the northern European average. Yet in the last *Nordic Outlook*, we drew the conclusion that **equilibrium unemployment is probably lower than the nearly 7 per cent** that NIER and Riksbank analyses indicate. One major reason why such a large share of companies are experiencing difficulties in recruiting suitable workers may be that job growth is so fast (speed limit effect). It is thus not necessarily strongly connected to the level of unemployment as such. Pay increases are not yet showing any accelerating tendency, which supports this conclusion.



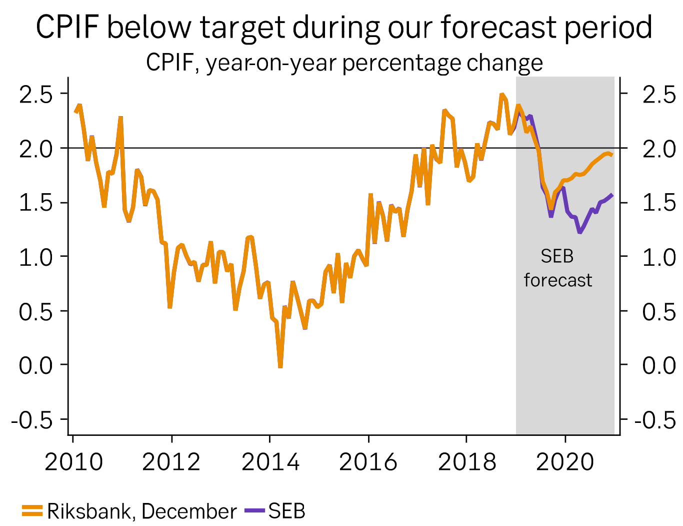
Source: Swedish National Mediation Office, Riksbank, SEB

It is increasingly doubtful that pay hikes will have time to speed up at all before new collective agreements across much of the labour market go into effect early in 2020. Higher inflation expectations and a continued good labour market suggest that **wage and salary agreements will end up exceeding the 2.2 per cent average increases per year that the employer organisations and unions approved in their 2017 contracts**. But there are also restraining factors. For example, our forecast indicates that inflation will be a bit below the Riksbank's 2 per cent target when the wage round is under way. As a result, the two sides will continue to debate whether the inflation target can serve as an "anchor" for pay hikes. In addition, the international outlook for the period 2020-2022 is likely to appear uncertain. Our overall assessment is that contractual pay increases will end up about 0.5 percentage points higher than in the last wage round. Together with slightly rising wage drift, this will push up pay increases to an average of 3.2 per cent in 2020.

CPIF will fall below 2 per cent this spring

CPIF inflation exceeded 2 per cent during most of 2018, largely driven by rising energy prices. Oil prices have now fallen significantly, but because of continued high electricity prices this winter, inflation will fall more slowly in Sweden than in many other countries. CPIF will remain above target until the end of May 2019. Once electricity prices also decline during the second half, **CPIF will bottom out at 1.3 per cent and then climb to somewhat above 1.5 per cent in 2020**.

Our forecast reflects various forces that are pulling in different directions. Short-term indicators, such as producer prices for consumer goods and price-hiking plans by retailers in the NIER survey, indicate some continued upward pressure on inflation during the next few months. Faster rent increases are expected to speed up inflation by a few tenths of a point in 2019 and 2020 compared to the average for the past three years. But offsetting this effect is the fact that the home price component included in our interest expense estimate will gradually approach zero over the next five years, after having provided a positive contribution to inflation of 0-2-0.3 points for the past 20 years. Although this effect is small, stabilising home prices thus imply long-term downward pressure on inflation.



Source: Riksbank, Statistics Sweden, SEB

Core inflation (CPIF excluding energy) surprised analysts on the downside during most of 2018. Driven by a weaker krona and somewhat higher food prices, CPIF excluding energy rebounded slightly after the summer but then fell. CPIF excluding energy is expected to peak a bit below 2 per cent this spring and then decline again during the rest of 2019. **Over the past 30 years, CPIF excluding energy has been a low 1.3 per cent**. Despite a trend towards a weaker krona and higher food prices, CPIF excluding energy has only reached 2 per cent in a single month during the past three years, due to a change of methodology that led to an unusually large seasonal upturn for package tours. It is thus unlikely that this will happen during the next couple of years, despite a faster rate of pay increases.

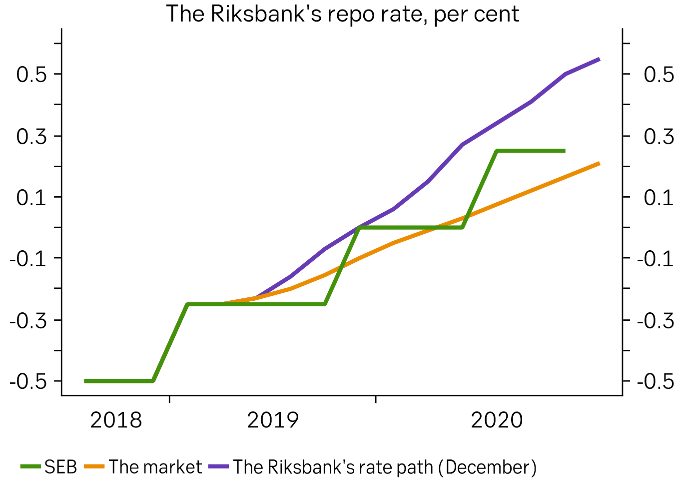
More cautious rate hikes due to inflation headwinds

In December the Riksbank hiked its key interest rate for the first time since 2011 even though inflation surprised on the downside and despite increased worries about the economic expansion both internationally and in Sweden. After clearly signalling that a rate hike was imminent, the Riksbank thus chose to act in order to avoid speculation that there would be no hike at all. In order to offset the rate hike, the Riksbank lowered its rate path and is now signalling only one hike during 2019 (most likely in September) and two further hikes during 2020.

The Riksbank's Executive Board has obviously become more determined to raise the key rate in the future. The bank's earlier mantra that it is far more serious if inflation surprises on the downside than on the upside, and that it is difficult to hike rates long before the European Central Bank does – for example due to the risks of rapid krona appreciation – has disappeared or in any case been greatly toned down. The Riksbank hiked its key rate even though it meanwhile lowered its inflation forecast significantly in December. This also confirms the impression that the bank's focus has shifted from divergences in the inflation outlook to **a broader view of economic conditions, inflation and the degree of monetary policy stimulus**.

Slow key interest rate hikes

The Riksbank's repo rate, per cent



Source: Riksbank, SEB

Given our forecast of a continued decent international economic expansion and cautious rate hikes by other European central banks, it is reasonable to assume that the Riksbank will carry out additional hikes. The question, however, is how much tolerance it actually has towards low inflation. The Riksbank's inflation forecast for the second half of 2019 is well above ours. If ours proves correct, it is likely that long-term inflation expectations will also decline over the next 6-12 months. The shortage figures in the NIER survey and the Riksbank's resource utilisation indicator will probably also fall during the coming year, **weakening arguments that inflation pressure will rise**. In this environment, we believe that the Riksbank will lower its rate path somewhat. Our forecast is that the next rate hike will occur in October 2019 and that the Riksbank will then be content with one hike in 2020, bringing the repo rate to 0.25 per cent at the end of the year.

Riksbank is content to own half of government debt

Swedish short-term interest rates have climbed somewhat since the Riksbank's December rate hike, but compared to earlier hiking cycles, reactions have been very moderate. Swedish long-term yields have fallen in response to international trends. As with German government bond yields, Swedish 10-year yields are about 20 basis points lower than at the beginning of 2018. Despite the Riksbank's rate hike, the yield spread to Germany has been largely unchanged since December at approximately 30bps. The next Riksbank hike is expected to occur before the ECB's, suggesting that the 10-year Swedish-German yield spread will widen to **40 bps at the end of 2019, which implies a level of 1.0 per cent**.

Until mid-2019 the Riksbank has planned to purchase another SEK 20 billion by reinvesting government bonds that mature this spring. By June 30 it will own 50 per cent of the outstanding supply. The next maturity date is in December 2020, when the Riksbank will hold about SEK 60 billion in nominal bonds and about SEK 10 billion in index-linked bonds. No later than its April policy meeting, the Riksbank will signal its strategy. We see a relatively high probability that the Riksbank will announce continued purchases during autumn 2019. To avoid boosting its holdings to nearly 60 per cent of the nominal outstanding supply of government bonds, however, we believe that it will be content to reinvest one third of maturing bonds in advance. **This will leave the Riksbank's share of the nominal supply largely unchanged at around 50 per cent**.

The krona will slowly recover

The actions of the Riksbank remain the most important driver of the Swedish krona. Although the Riksbank has now begun a hiking cycle, its slow pace will keep Swedish key rates below rates elsewhere. This will limit any upward effect on the krona. The negative key rate continues to affect currency flows, among other things via large forward exchange discounts to hedge USD-denominated export revenues. Exporters are also reluctant to exchange all foreign revenues and deposit them in SEK accounts, since this costs money (negative interest). The krona has become less sensitive to geopolitical uncertainty, and periods of falling risk appetite have not weakened the krona especially much. In 2019 the krona will continue to appreciate slowly. **The EUR/SEK exchange rate will reach 9.95 at the end of 2019 and 9.70 at the end of 2020**. Given a weak krona at the outset, we foresee significant appreciation against the dollar during our forecast period. **We expect the USD/SEK rate to fall from about 9.00 to 7.70 by the end of 2020.** If the Fed should cut its key rate during our forecast period, SEK appreciation is likely to be dramatic. We believe that Swedish institutions have a sizeable open currency exposure to the USD, which creates potential for major krona-positive flows.

Theme: A new government

Rightward shift in policies, but a continued red-green regime

A new government finally took office after the Centre (C) and Liberals (L) signed a reform pact with the Social Democrats (S) and Greens (MP). The policies of this S+MP regime represent a sharp turn in a centre-right direction. The arrangement is reassuring but concerning: Sweden has a functioning government in the short term, but quarrels about broken promises and internal tensions might bring it down before its four-year term ends. Falling fiscal surpluses in any future slowdown may also delay reforms.

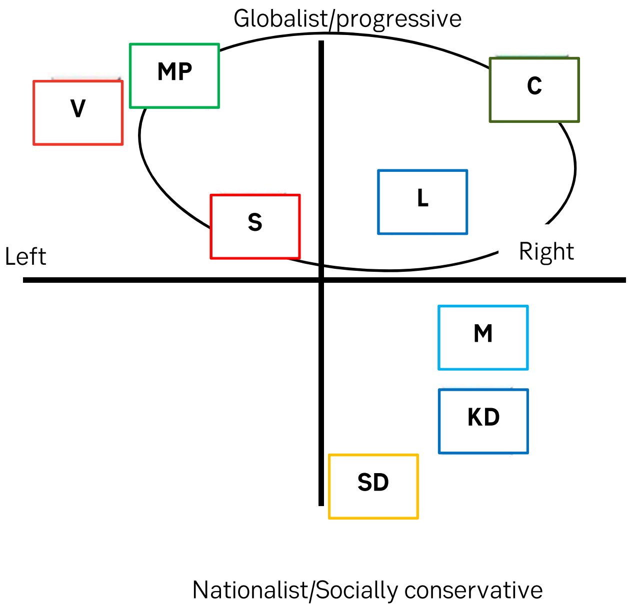
Löfven II takes office after signing a pact with C & L

More than four months after the September 9 election, the Swedish Parliament has approved a new prime minister. The Centre Party (C) and Liberals (L) decided to let the previous minority governing coalition of Social Democrats (S) and the Green Party (MP) headed by S leader Stefan Löfven return to office. To avoid a government that would be dependent on support from the right-wing populist Sweden Democrats (SD), C and L thus took the major step of ending their collaboration with the other two Alliance parties; the Moderates (M) and (Christian Democrats (KD). The C-L-S-MP agreement covers cooperation on budget policies, not day-to-day government decision making. In order for Parliament to tolerate the new Löfven government, the Left Party (V) had to abstain from voting. Initial V reactions had been very negative, partly because government policy would move sharply rightward, but above all because the new cooperation agreement explicitly states that one of its aims is to ensure that V will have no political influence. But after a few days, Löfven managed to calm down the Left Party enough that its MPs chose the yellow button instead of the red one. Another reason for their decision not to oppose Löfven II was that the Left Party does not regard the alternatives – M leader Ulf Kristensson being elected prime minister in a fourth and final vote or, failing this, a snap election in April – as more attractive.

Economic policy shifting towards centre-right

The 73-point C-L-S-MP agreement unveiled on January 11 represents a major policy shift in a centre-right direction compared to the 2014-2018 Parliament, when the S+MP minority government had negotiated its budget bills with V. The new policies also represent a clear reform agenda, compared to the cautious approach that predominated during the four-party Alliance government's second term of office in 2010-2014. For example, the agreement proposes more flexible residential rents and bolder labour market reforms. It remains unclear how many parts of the reform agenda will be funded, but we expect even more expansionary fiscal policy in 2019. The M+KD budget that was approved in December is likely to be supplemented with an extra budget this spring, aimed at rapidly setting the new reform agenda in motion. Another motive for such quick action is to dampen internal C and L worries that the government will try to bury proposed centre-right reforms in government research studies. Overall, we expect fiscal stimulus to total nearly one per cent of GDP, although some reforms will be funded by tax hikes (such as a "green shift", with lower taxes on labour in exchange for higher environmental pollution taxes).

Positioning of Swedish parties in two dimensions



A new political landscape

The government constellation now being formed represents a major change in the political landscape. When Sweden's four main non-socialist parties at the time formed their Alliance in 2004, their aim was to end the decades-long dominance of the Social Democrats. Now the Alliance is splitting up in a rather dramatic way. C and L are trying to play down the significance of their action, describing it as a logical consequence of the red-green parties (S+MP+V) having won more seats than the Alliance in the September election and saying that they must seek some kind of agreement with S in order to block SD from gaining any influence. But reactions from the other two Alliance parties, M and KD, have been strong and condemnatory. In the future, C and L will probably be repeatedly accused of having too easily allowed an S-led government to take power. Above all, the discussion will focus on how much of the C-L-S-MP agreement actually consists of concrete political proposals and how much of it can be delayed and buried in slow-moving government studies. The splitting of the Alliance is a strategic victory for both S and SD, which see potential for new collaborative constellations. SD will gain no influence in the short term but will probably have increased opportunities to move closer to M and KD in the future.

But S and to some extent MP are also taking a major political risk by concluding an agreement with C and L. Parts of the labour movement, including trade unions and the tenants' movement, feel that their interests as being threatened, and the left wing of S views the party leadership's concessions as unacceptable. V will meanwhile be able to burnish its image as the only party that stands for traditional principles of social justice and equality, while attracting dissatisfied former left-wing S voters.

To summarise, an S-led government that adheres to the agreement negotiated this month would pursue a more centre-right economic policy than the previous S-led government. Once Mr Löfven takes office, the agreement means that he will have no problem pushing through his budget. The taxation, housing and labour market reform measures that are proposed in the agreement could serve as the basis for continued reform efforts. But the question is how interested M and other parties will be in joining any broad-based agreements in this new situation. Accusations of broken promises within both the Alliance parties and from the labour movement will also create such great pressures that there is an underlying risk that the agreement will fail before the 2018-2022 Parliament is over.

Fiscal policy will remain expansionary

The Moderate Party and Christian Democratic budget that won parliamentary approval in December includes a fiscal stimulus totalling 0.6-0.7 per cent of GDP in 2019. The new government's supplementary budgets will add another tenth or more. In cyclical terms, this stimulus is well-timed now that the economy is decelerating, but important structural reforms were postponed for natural reasons in the deadlocked political situation that prevailed last autumn. Although major structural reforms will take time, the new budget collaboration pact seems to include openings and proposals in a number of areas highlighted in recent years as especially ripe for reform – such as taxation, housing and integration of immigrants.

Public finances
Per cent of GDP

	2017	2018	2019	2020
Net lending	1.5	0.9	0.6	0.5
Borrowing requirement (SEK bn)	-62	-80	-48	-10
General government gross debt	40.8	37.4	35.1	33.6

Source: Statistics Sweden, SEB

Public finances remain strong. For example, public sector debt is now substantially lower than it was during the cyclical peaks of 2000 and 2007. However, the net lending surplus in 2017 peaked at 1.5 per cent of GDP, which was lower than earlier peaks. In 2000 and 2007, significantly lower unemployment contributed to a surplus somewhat above 3 per cent of GDP. Last year the budget surplus fell to around 1 per cent, according to our forecasts. We believe that fiscal policy will remain expansionary in 2020, though to a somewhat lesser extent than during 2019. The budget surplus will thus decrease somewhat, reaching 0.5 per cent of GDP, but **public sector debt as a share of GDP will continue to fall at a relatively rapid pace**.

The 73-point agreement

The agreement between the Centre, Liberal, Social Democratic and Green parties emphasises that it is limited to budget cooperation and only consists of the points that have been put into writing. The agreement restricts the policies of the two governing parties (S+MP) on these 73 points, but it also allows them freedom of action in fields not covered by the agreement. Very few of the proposed reforms currently have a price tag. The following is a summary of selected reform proposals in different fields:

General economic and fiscal policy: Elimination of the 5 per cent extra tax on high incomes introduced in 1995 as an austerity measure, along with other far-reaching tax reforms. Lower taxation of pensions, larger grants to local governments, various small business-related reforms. No ban on profits for social and other public services that are outsourced to private companies.

Jobs and entrepreneurship: More adult education, expanded tax credits for home renovation and maintenance expenses, a reform of the Swedish Employment Service and opening the way for private alternatives, changes in the unemployment insurance system and "modernised labour law" (such as expanded exceptions from the last-in/first-out hiring and firing rule that was enacted in the 1970s).

Regional investments: Expanded rural broadband service, no new government authorities in Stockholm, more public service offices in small towns, high-speed trains. More renewable energy, improved agricultural competitiveness and strong forest ownership rights.

Climate: No elimination of the recently enacted aviation tax, investments in fossil-free transport technology.

Integration of immigrants: Faster paths into the labour market for immigrants, a language requirement for Swedish citizenship.

Housing: No limits on rents in newly built housing units, elimination of minor taxes on home sales, simplification of construction rules, subsidies for construction of rental housing and solar energy systems etc.

Schools and health care: Investments to increase knowledge, expand staff, improve quality and shorten queues. No additional private religious schools.

Migration: Extension of the temporary law restricting non-EU immigration, but more generous family reunification rules. A parliamentary study on future migration policy.

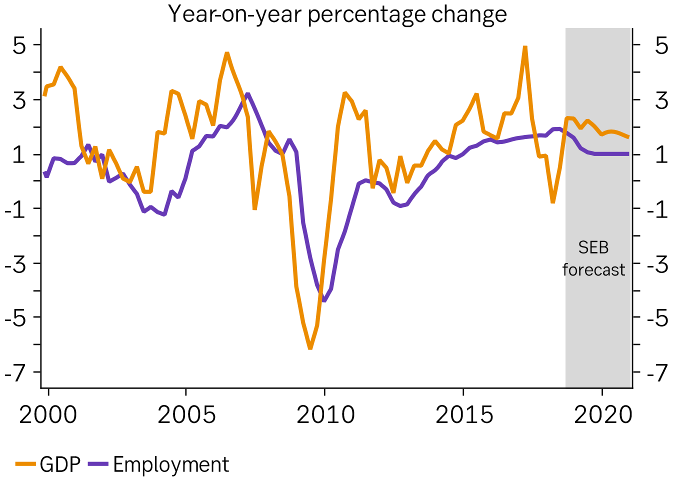
Public safety and security: Continue strengthening of the defence system. More police officers. Strengthening of media independence.

Denmark

Consumers hold back

Denmark's growth slowed sharply in the first three quarters of 2018, but we think this masks a gentler underlying slowdown to the 1.5-2 per cent range. Domestic demand remains robust, but tighter credit conditions, weaker confidence and a slowing home price upturn suggest that the savings ratio will remain high. Exports face a challenge from weaker demand, but competitiveness is still strong. Euro zone demand is the key risk. DNB intervention to support the DKK is unlikely to be the start of a bigger move.

Denmark's GDP growth slowed to just above 1 per cent in 2018, less than the 1.5 per cent we estimated in November. However, this exaggerates economic weakness due to a technical shift in the growth profile. Behind this technical noise, a more gradual underlying slowdown is expected to take growth from close to 2.5 per cent 2017 to **2 per cent in 2019 and 1.7 per cent in 2020**.



Source: Macrobond, SEB

Consumers and exports behind slowdown

There are two main reasons for the expected slowdown. First of all, tightening credit conditions and weaker confidence suggest that the household savings ratio will remain elevated. Second, net exports are likely to weaken as global growth slows. However, in a broader perspective, growth remains well supported by strong job growth and rising real wages. The main risk to the forecast is a sharper slowdown in external demand that could hit both exports and credit conditions.

Private consumption was strong in the first half of 2018 but appears to have slowed in the second half. The latest bank lending survey shows that lending conditions have started tightening again. This probably contributed to the decline in consumer confidence and softening home prices late in the year, along with sharp Q4 declines in financial asset prices.

The result is a further increase in the household savings ratio, thus holding consumption back. Income growth remains well supported as employment continues posting annual growth of almost 2 per cent and real wages are picking up. Rising home prices also continue to add support, even though the increase has slowed to a more manageable rate of below 5 per cent.

The savings ratio is likely to stay high, but as long as both employment and real wages are rising at their current pace, we may still get decent consumption growth. Our forecast is growth of **2 per cent in 2019 and 2.2 per cent in 2020**.

Business investment trends were obscured in 2018 by a temporary H1 boost from large ship imports, but investments appear to be growing. Capacity utilisation has levelled off and demand growth has weakened in key export markets. **Residential investments are likely to continue providing a robust growth contribution, supported by the relatively high price level.**

Low inflation and strong external balances

The labour market continues to improve. Unemployment is below 5 per cent for the first time since 2009, but **wage inflation is still lower than in export markets, and inflation is below the euro zone average** both for headline and core CPI. The current account surplus narrows to a still impressive 6 per cent of GDP, but the trade surplus has stabilised after an H1 slump.

This is an election year, which may have contributed to a slight easing of fiscal policy. Apart from that, we do not expect political events to influence the economy or markets.

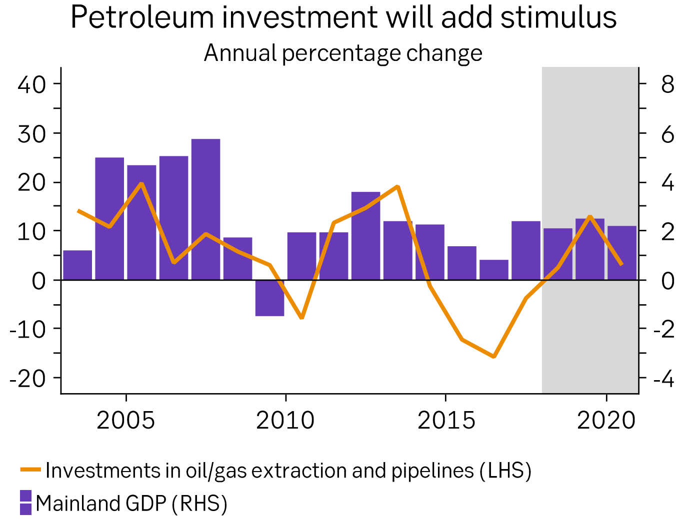
Danmarks Nationalbank (DNB) intervened in December to support the krone after the EUR spot rate moved above DKK 7.465, but this does not look like a sustained outflow. Political uncertainty in the euro zone also suggests that this would be unlikely. We don't think the DNB will be forced to hike rates, but a small move is likely if DKK intervention continues in January.

Norway

Solid domestic economic expansion justifies rate hikes

The economic outlook remains firm despite the recent oil price decline. Capital spending in the petroleum sector will increase markedly, adding to demand in the mainland economy and making Norway more resilient to the slowdown abroad. Residential investment is stabilising, and capital spending should be an important growth driver combined with solid private consumption. A positive output gap, rising wage pressures and inflation at target suggest that Norges Bank is bound to continue hiking its key rate.

The Norwegian economy has recovered from the oil-related downturn in 2014-2016. The output gap has closed and the economy is in a cyclical upturn. Mainland GDP growth (excluding oil, gas and shipping) seems to have slowed in Q3, but adjusting for temporary weakness in the agricultural sector following the summer drought, it held up at a trend-like pace (the national accounts for the fourth quarter will be published on February 8). Growth is expected to remain above trend in the next couple of years, driven by reviving petroleum sector activity, solid household fundamentals supporting private consumption and a turnaround in residential investment. Tighter monetary policy and a stronger krone will moderate the upturn. **We forecast growth in mainland GDP of 2.5 per cent in 2019 and 2.2 per cent in 2020**. Positive contributions from petroleum investment will lift overall GDP to 2.8 per cent in 2019 and 2.5 per cent in 2019. We expect no contribution to growth from fiscal policy.



Source: Statistics Norway, Macrobond, SEB

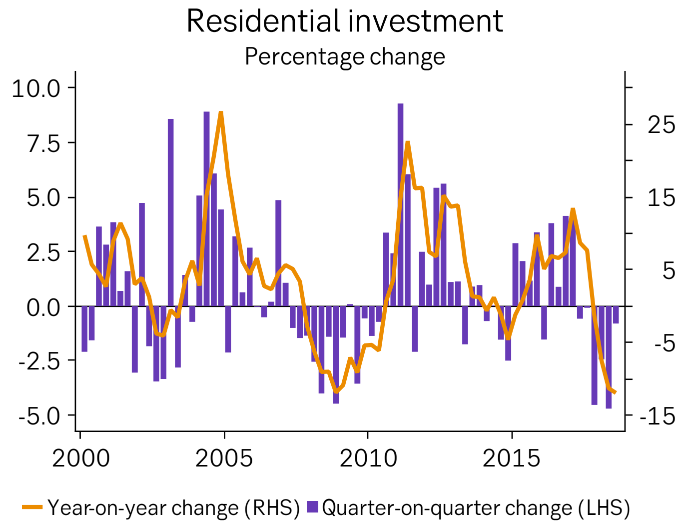
Petroleum investment outlook remains solid

Although oil prices have fallen quite substantially since early October, lower costs will make many petroleum investments profitable in the years ahead. A downward revision of oil price assumptions may result in somewhat slower growth in capital expenditures (capex) on exploration and fields already in operation. However, roughly 45 per cent of planned capex for 2019 is on new field developments and the largest projects, such as Johan Sverdrup Phase 2 and Johan Castberg, will proceed as planned. We expect **petroleum investment to increase by 13 per cent in 2019 and by 3 per cent in 2020**.

Sharply higher investments in the oil sector will add stimulus to the broader economy, making Norway more resilient to the growth slowdown abroad. This is already visible in various sentiment surveys which show that manufacturers remain optimistic on order bookings and production. We expect capital spending in the manufacturing sector to remain strong, but due to a sharp upward revision to investment in previous years in the latest national accounts, we have lowered our forecast slightly.

Residential investment is levelling out

The correction in the housing market resulted in a steep fall in construction activity. Housing investment has fallen a cumulative 13 per cent since early 2017 and lowered GDP growth by an estimate half per cent in 2018. The outlook is nonetheless positive, since national account data for the third quarter of 2018 showed that residential investment is levelling out and housing starts have rebounded. We expect residential investment to resume growth later this year, though its contribution to GDP growth in the years ahead will be moderate.



Source: Statistics Norway, Macrobond, SEB

The correction and subsequent rebound in home prices over the past two years have turned out to be moderate. The rise in home completions in the second half of 2018 caused supply of existing homes to reach an eight-year high. While the supply was absorbed by solid housing demand, momentum in the price upturn faded. Growth in existing home price slowed to 0.7 per cent in 2018 from 5.9 per cent a year earlier. Reviving growth in household real incomes should underpin home prices in the next couple of years, but higher interest rates and slower population growth suggest that the upturn will be modest. **We expect yearly price gains of nearly 2 per cent in 2019 and 2020**.

Solid consumption on the back of rising real incomes

Momentum in private consumption softened in the third quarter, but this reflects the surge in electricity prices following the summer drought, which weighed on growth in household real disposable income. Consumer goods were particularly hard hit, and there are signs that weakness continued into Q4. Households' real disposable income is expected to accelerate due to a solid increase in real wages and higher employment. We expect private consumption growth of nearly 2.5 per cent in both 2019 and 2020. Higher interest rates will remain a drag, and the risk of an increase in precautionary savings remains.

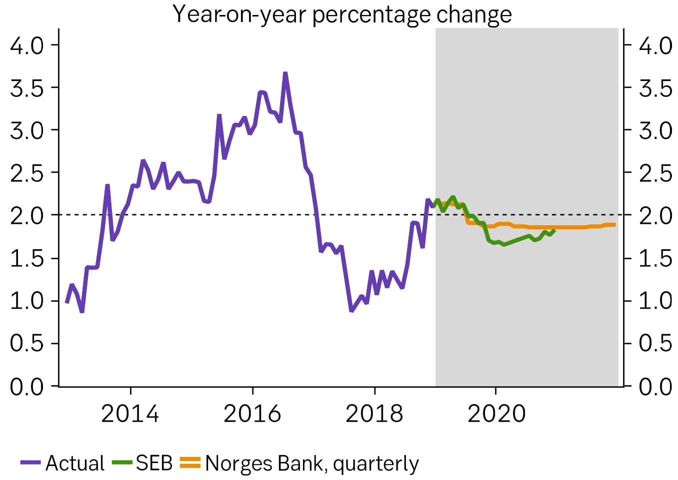
The labour market has improved noticeably over the past 2 years, driven by solid job growth. As the real economy gained ground in 2018, growth in the labour force accelerated and the downward momentum in unemployment slowed. As measured by the Labour Force Survey (LFS), the jobless rate hovered around 4 per cent in 2018. Employment indicators suggest that the labour market will continue to improve, but owing to a further increase in labour participation, unemployment will only fall moderately going forward. We expect the LFS jobless rate to average 3.8 per cent in 2019 and 3.7 per cent in 2020.

Inflation at target in 2019

CPI-ATE inflation (excluding taxes and energy) rose during the second half of 2018 to end the year just above Norges Bank's 2 per cent target. The upturn was driven by a combination of higher goods prices – reflecting the weaker krone exchange rate – and a normalisation of previously unusually low food prices.

CPI-ATE close to target in 2019

Year-on-year percentage change



Source: Bank of Norway (Norges Bank), Statistics Norway, Macrobond, SEB

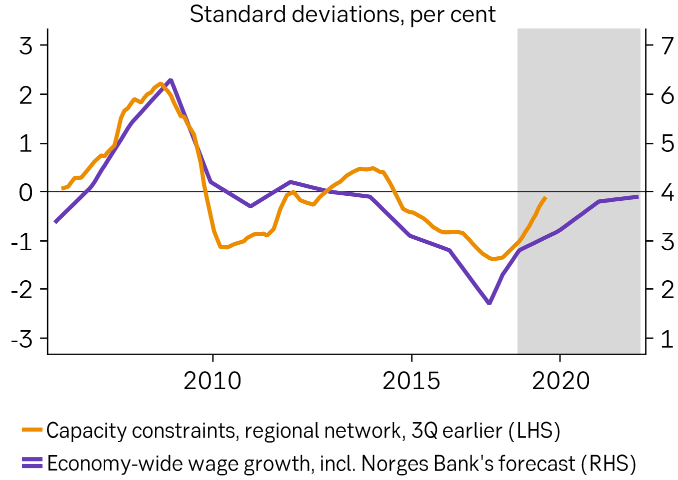
Upward pressure from the exchange rate is expected to increase further in the short term, but this effect will fade later in the year. As a result, **CPI-ATE will remain above 2 percent in the first half of 2019, after which it will fall by half a percentage point**. Core inflation will gradually increase towards target in 2020, driven by higher resource utilisation and rising wage growth. CPI inflation has remained very high, despite falling oil prices, due to rising electricity prices. Forward contracts indicate that electricity prices will rise further early in 2019 and then fall. The decline has been delayed, but we still believe that CPI inflation will fall below 1.5 per cent.

Norges Bank on a steady course

Norges Bank initiated a rate hiking cycle in September 2018 by lifting its key rate to 0.75 per cent. The central bank has signalled a gradual hiking trajectory, with **the next move expected in March**. Although global growth prospects have weakened somewhat and market expectations of policy normalisation abroad have been scaled back, Norges Bank has reiterated its plan to hike the key rate by 50 basis points to 1.25 per cent in 2019. The solid outlook for domestic growth and inflation implies that tighter monetary policy is necessary to avoid overheating. We expect a positive output gap, with mainland GDP growth remaining above trend in 2020. **We are maintaining our forecast of two more hikes to 1.75 per cent in 2020** but expect the pace of rate hikes to slow after that.

Rising wage pressure

Standard deviations, per cent



Source: Bank of Norway (Norges Bank), Macrobond, SEB

Fundamentals should underpin the NOK

The NOK was surprisingly weak in 2018, given the strength of its usual drivers. The best explanation is that poor risk sentiment has hurt small and relatively illiquid currencies such as the NOK. The fundamental outlook should underpin the krone in 2019. The expected rebound in oil prices, combined with the turnaround in the Norwegian petroleum investment cycle, will generate positive NOK flows. Market rate hike expectations are too cautious. We expect the **EUR/NOK exchange rate to fall from 9.20 at the end of 2019 to 8.90 in 2020**.

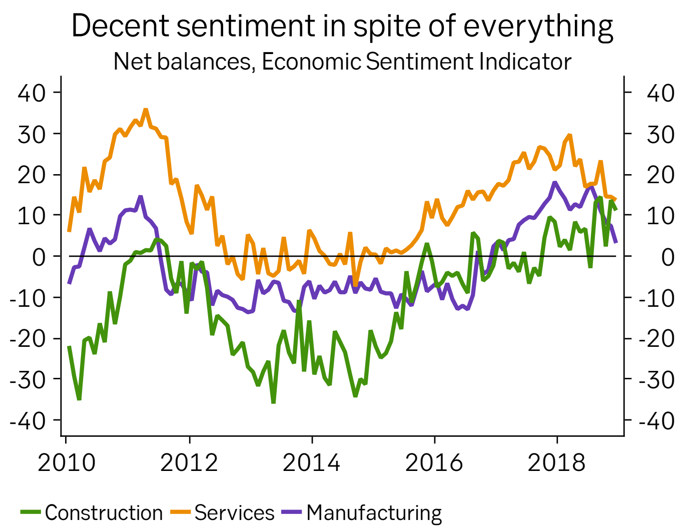
Norwegian government bonds (NGBs) have traded with a large spread against their German equivalents for several years now. This can be explained by the ECB's aggressively loose monetary policy and unfavourable developments in the EUR/NOK exchange rate. We expect the positive NOK outlook and low yields abroad to enhance demand for NGBs. However, more cautious policy normalisation by the ECB than previously assumed, combined with ongoing Norwegian rate hikes, will keep the 10-year yield spread against Germany at a historically wide level. We forecast **a spread of 150 basis points by the end of 2019.**

Finland

Strong labour market, despite downshift in economic growth

After accelerating in recent years, economic activity is slowing but remains above trend and the euro zone average. Falling global growth and trouble spots around the world are hurting Finland, with businesses and households hesitating despite many positive factors and capacity utilisation at levels where business investments usually accelerate. Household consumption will increase only slightly despite rapid job growth. We are lowering our forecast of yearly GDP increases to 2 per cent in 2019 and 2020.

As overall euro zone growth decelerated, the Finnish economy showed resilience during most of 2018. However, **in several areas its outlook has now deteriorated**. Although sentiment has worsened, the downturn is not as sharp as in the euro zone as a whole. In the construction sector, sentiment has actually improved year-on-year. This suggests a moderate slowdown, with GDP growth of about 2 per cent yearly in 2019 and 2020.



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

Facing headwinds, exports provided a negative contribution to GDP growth late in 2018. The yearly increase in manufacturing output has slowed to around 2.5 per cent, but this falling trend is reversing and we expect increases of 2.5-3 per cent annually in 2019-2020. The investment side looks more positive. **Capital spending will continue to increase, driven primarily by residential construction and the public sector**. Building permit statistics suggest that residential investments will decelerate ahead, but business investments are expected to speed up. Although machinery investments fell sharply in the third quarter of 2018, in light of decent business optimism and high capacity utilisation we believe that this downturn was temporary. Lending to non-financial companies has accelerated rapidly in the past year and is now increasing by more than 6 per cent year-on-year, which also indicates a strong willingness to invest. **Overall capital spending will grow by 3-3.5 per cent yearly in 2019-2020**.

The labour market has been surprisingly strong, and **the number of jobs has increased by 2.5-3 per cent year-on-year in recent quarters**. This is in line with the fastest upturns of the past 30-40 years; the last time Finland saw such rapid job growth was around the end of 2007. Construction is the most expansionary sector, but job growth is broad-based in sectoral terms. Unemployment has fallen by more than one percentage point this past year. The number of job vacancies is record-high, suggesting a continued downturn in unemployment, though at a slower pace as economic growth decelerates and companies have greater difficulty finding staff. Average annual **unemployment will be 7 per cent in 2019 and 6.6 per cent in 2020**. The 2016 Competitiveness Pact between government, employers and unions has held back wage and salary increases in recent years, but pay hikes are now accelerating cautiously and will reach 2 per cent annually both in 2019 and 2020.

Inflation has remained at around 1.5 per cent in the past six months, and falling oil prices will continue to have a dampening effect. Assuming only slightly rising wages and salaries, average annual inflation will remain at today's level in 2019, then climb somewhat during 2020. At present, **real wages are largely unchanged**. This is contributing to weak household consumption. Real household income increases are currently being driven primarily by job growth. Although employment is increasingly rapidly, consumer confidence has fallen but remains at a decent level. **Retail sales and consumption have been surprisingly weak**, but household hesitation can be explained in part by global uncertainty, shaky stock markets and a savings ratio that was pushed down to a historically low level during Finland's crisis years. Household consumption will be driven to above 1.5 per cent yearly in 2019-2020 as employment continues to expand and incomes accelerate a bit.

Cost-cutting programmes and the economic upturn of recent years have improved public finances. The 2018 budget deficit looks set to remain at 0.5 per cent of GDP, while government debt will fall towards 60 per cent of GDP. Because of this and the April election, **fiscal policy will become slightly expansionary over the next couple of years**. The deficit will consequently shrink only slightly, but government debt will be lower than the EU's 60 per cent ceiling by the end of our forecast period.

Estonia

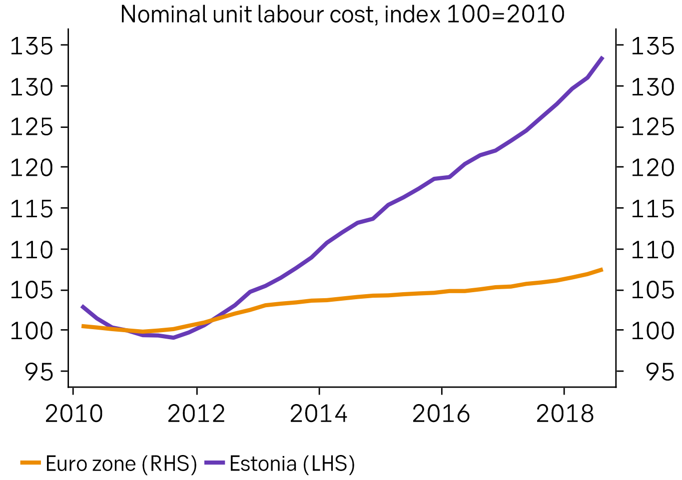
Tight labour market and slowing construction lowers growth

After a strong 2018, many indicators now point to slower growth ahead. GDP rose by 3.8 per cent during the first three quarters of 2018 but was not broad-based, since almost half of total value-added came from the construction and real estate sectors. Now that the number of building permits has started to fall, the economy is running at full employment but export growth has almost halted. We expect a gradual slowdown, with GDP expanding by 2.8 per cent in 2019 and 2.5 per cent in 2020.

Although Estonia has been one of the euro zone's **fastest growing economies** during the past couple of years, many factors that have been driving the expansion are now losing momentum. Much of it relates to the labour market. The Great Recession left Estonia with an abundant supply of qualified labour, which helped companies to quickly expand. From 2010 to 2017 the employment rate rose from 54 per cent to 68 per cent, one of the highest in the EU. This was also the most significant contributor to the growth of private consumption. Yet now the economy has been running at **full employment** for some time, putting **pressure on wages**, while gains in productivity have been unimpressive. **Average salary has risen by 23 per cent** over the past three years. Although average labour cost is still around half the levels seen in Nordic countries, this has been a difficult challenge for companies, which have not been able to pass on increased costs to their pricing.

Labour costs have surged

Nominal unit labour cost, index 100=2010



Source: Eurostat

Exports still account for around 75 per cent of GDP, but Estonia's **cost-based competitiveness** has suffered. Many of the largest exporters are subsidiaries of large Nordic corporations that previously moved their manufacturing units to Estonia to benefit from lower labour costs. As this advantage is now fading, it is increasingly likely that at least some of them may restructure their operations and thus leave a large dent in the Estonian economy. In addition to structural problems, cyclical effects are being felt. The growth of exports in 2018 was largely driven by sales of energy products, while trade in other important goods stagnated. In Q3 **merchandise exports stagnated** in real terms. Cooling international demand has slowed the economies of Estonia's main trading partners, Finland and Sweden. Since these problems will persist in 2019, we have revised our forecasts and now expect exports to grow by only 2.2 per cent in 2019.

Domestic demand has been in much better shape, favoured by solid private consumption and investments. A large **increase in the tax-exempt minimum** of personal income benefited household spending in 2018, but part of this effect will move to 2019 due to tax refunds. Households have also been optimistic towards buying new homes, but the trend seems to have peaked and negative demographics will increasingly start to shape the real estate market over the next few years. According to our forecast, private consumption will expand by 4.0 per cent in 2019 and by 3.4 per cent in 2020. After two years of **high inflation**, the surge in living costs is finally expected to ease. HICP inflation will decline from 3.4 per in 2018 to 2.6 per cent next year.

Although capital spending improved in the third quarter of 2018, this did little to turn around the longstanding trend of **declining investment rates in the business sector**. In light of the uncertain economic environment and the structural shift from manufacturing to services, there are few reasons to expect this trend to reverse during our forecast period. However public sector investments as a share of GDP remain the highest in the EU and will again contribute significantly to gross fixed capital formation in 2019 and 2020. The outlook becomes more uncertain after 2020, when EU financial support for public sector projects will be cut. All in all, we expect capital spending to increase by 3.6 per cent in 2019 and 2.0 per cent in 2020.

Parliament elections will be held in early March, and both tax and fiscal policy will be major topics of discussion. While more **expansionary measures are likely**, tax reforms have also caused confusion and uncertainty that needs to be addressed. Yet the future governing coalition is likely to include both left- and right-leaning parties, helping to keep the future policies of the government close to the centre of the political spectrum.

Latvia

Low business investment and productivity moderate growth

Latvian GDP growth peaked at 4.5 per cent in 2018. In response to global trends, it will slow to 3.5 per cent 2019. Yet, wage pressures will ease only slightly, as the labour market has heated up further. The top challenge is to speed up productivity growth and the low investment rate and continue structural reforms. Inflation pressures will remain moderate. Difficulties forming a new government and approving a new 2019 budget generate uncertainty, but pose little risk to Latvia's economic performance.

Latvia's economic expansion remained impressive in 2018, with GDP growth of 4.5 per cent, driven primarily by construction. **GDP growth will slow to 3.5 per cent this year and to 3.2 per cent in 2020.** Private consumption will be the main driver, with a growth rate of 3½-4 per cent sustained by a strong labour market and a solid real wage upturn. Capital expenditure will be stimulated by EU funds, although business risk appetite for investment will be somewhat lower due to external uncertainty and surging construction costs. Weakening international demand will lead to sluggish export expansion.

In 2019-2020 the focus will be on the construction sector, where more signs of overheating are appearing. During the first three quarters of 2018, construction rose by 22 per cent. Cost increases are starting to have side effects. The sector is attracting workers from other industries and immigrants, while rapidly rising costs are putting many projects on hold. Over the next two years, EU funds will keep up construction activity, but both capacity and efficiency constraints will limit expansion. Among other sectors, information and communication services have provided upside surprises – growing by 12 per cent in the first nine months of 2018. We believe this increase has the potential to continue in 2019. We expect a 3.5 per cent upturn in retail. **The manufacturing outlook is souring**, but supported by domestic demand it **will expand at a 3-3.5 per cent pace**.

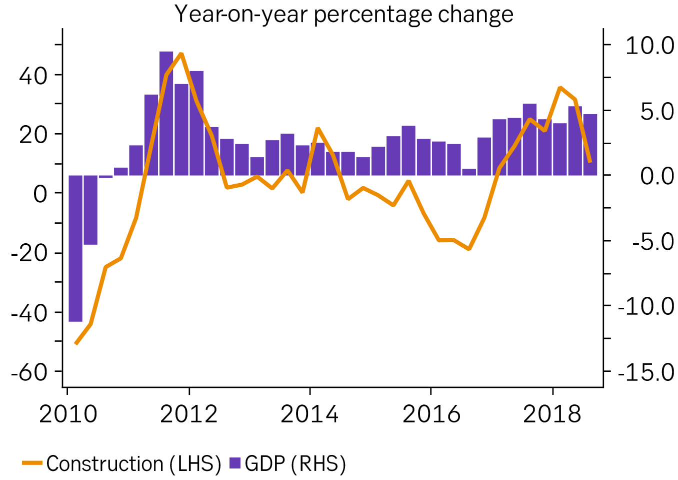
In November 2018, year-on-year inflation stood at 3 per cent, with prices of both goods and services rising at this rate. The inflation outlook for the next two years is mixed. On the one hand, external inflation pressure is still subdued. On the other hand, we foresee mounting cost pressure that should show up in higher prices for services. We also foresee higher prices for food, electricity and heating. **Our inflation forecast is 2.9 per cent in 2019, slowing a bit to 2.5 per cent in 2020**.

Unemployment has dropped to 7 per cent, close to pre-crisis lows. Meanwhile the participation rate is an unprecedented 65.3 per cent. Demand for labour will remain high, but the potential for further decline in unemployment is limited. **Unemployment is expected to fall to 6 per cent by the end of 2019.** The number of job vacancies will grow further. Thus labour mobility and housing construction plans will be high on the government's agenda. It will also be necessary to address the issue of immigration. At present, flows are in balance, with emigration of Latvians being offset by immigration from lower-wage countries. It will take several more years of relatively rapid wage growth to slow the emigration of domestic labour.

The average pay increase was 8 per cent in 2018, which we expect to slow to 7 per cent in 2019, with the average monthly gross wage reaching 1,100 euros. Not only the private sector, but also the public sector will be under considerable wage pressure. The government will have to keep up the pace of structural reforms and cost-cutting to minimise pressure on its budget. Competition for labour is generally fierce in Central and Eastern European, with 8-13 per cent yearly pay hikes. Even if economic growth slows down, high capacity utilisation and demographic trends will not allow employers to expect much relief from these problems. In an environment where rising wages are squeezing profits, to ease their labour shortages, businesses will be forced to increase their pace of investment.

GDP and construction

Year-on-year percentage change



Source: Latvian Central Statistical Bureau

Latvia is experiencing **the lengthiest government formation period since the restoration of independence in 1990**. KPV LV, the New Conservative Party, Development/For!, the National Alliance and New Unity (the latter with 66 seats in Parliament) have the potential to form a new five-party coalition led by New Unity. In the absence of a new government, 2019 is starting with a temporary budget that does not change existing policies, thus creating uncertainty regarding planned expenditure hikes. **So far we do not believe this poses any threat to the economy**. A new government should be in place during the first quarter of 2019.

Lithuania

Global slowdown will weigh on growth

As expected, the economy expanded at a slower pace in 2018, but the overall picture remained positive. The largest concern for short-term growth relates to economic developments of major trading partners. The labour market will remain tight and favourable to employees. In 2019, we expect unchanged inflation. The increase in residential property prices has moderated recently and we do not foresee a faster increase this year. Government fiscal policy remains slightly expansionary.

2018 was another successful year for Lithuania's economy. GDP growth was close to 3.4 per cent, supported by strong private consumption and capital spending. Meanwhile, export growth decelerated due to both demand and supply side factors. The worsening situation in external markets is leading to a more cautious growth outlook in the next couple of years. **We have revised our 2019 GDP growth forecast downward from 3.0 to 2.9 per cent and our 2020 forecast from 2.6 to 2.4 per cent.**

Economic sentiment indicators dropped only marginally in the final months of 2018, indicating a still-positive mood among consumers and businesses. **There are no clear signs so far that the businesses will be delaying their investments in 2019**. However, if the situation deteriorates abroad, their plans might change. The emergence of trading difficulties in case of a hard Brexit and the consequent temporary turmoil would be painful to Lithuanian exporters. It is also worth pointing out that this year **investments financed by EU structural funds will peak, providing support to the construction sector too**.

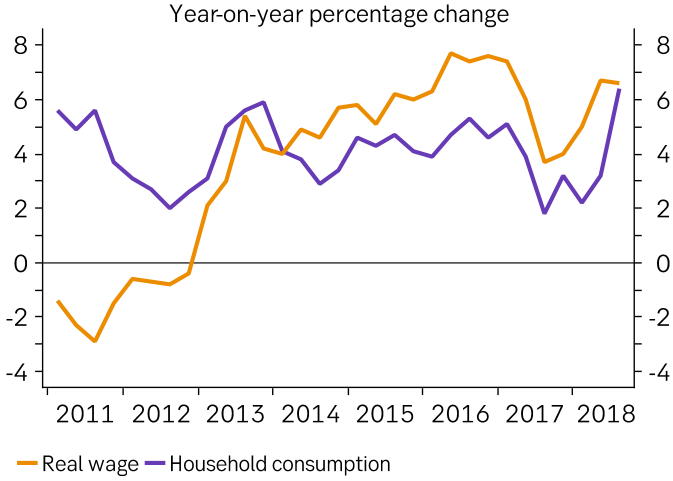
The labour market continues to heat up. Average unemployment fell from 7.1 to 6.3 per cent in 2018. **However, we forecast that unemployment will stabilise at close to 6 per cent in the next two years.** The unemployment level in remote regions will remain rather high due to low mobility and other structural reasons, while unemployment in the Vilnius district is already record-low. Businesses will keep importing and training labour from Ukraine and Belarus, due to persistent shortages of domestic employees in the construction and transport sectors.

Rapid wage growth continued in 2018. In the third quarter, gross wages and salaries were up by 10 per cent year-on-year. Contrary to the situation in previous years, wages increased more for public sector employees. Discontent about low public sector pay increased sharply last year, and a teachers' strike in December was instrumental in this process. The teachers' demands were rational, because employees in the education and health care sectors used to be underpaid. **One reason for their relatively low salaries is still the country's ineffective network of education and health care institutions.** Another reason is that the Lithuanian national budget is relatively small (33.6 per cent of GDP in 2017) and the government's capacity to raise wages is low. The government has no choice but to keep on working to repair this situation over the next few years.

In 2018 average annual inflation decreased from 3.7 to 2.5 per cent, a relatively low level considering the sharp growth in labour costs. Lower inflation and high real wage growth had a positive impact on household consumption last year. At the beginning of 2019, annual inflation will reflect increases in government-regulated prices. Electricity and natural gas for households have thus become 15 and 12 per cent more expensive. Even taking these changes into account, we feel comfortable in maintaining our previous forecasts that **inflation will average 2.5 per cent in 2019 and 2020.**

Household consumption is booming

Year-on-year percentage change



Source: Statistics Lithuania

Residential property prices were up by 6.6 per cent annually in the third quarter, the slowest increase since mid-2016. Prices rose faster in smaller cities, while in the capital Vilnius home prices were up slightly more than 3 per cent. A sufficient supply of new homes and higher uncertainty regarding household incomes will limit home price increases ahead.

The government's **fiscal policy remains slightly expansionary** despite the expected minor nominal budget surplus. We are sticking to our forecast that budget surpluses will be 0.2 and 0.0 percent of GDP in 2019 and 2020, respectively. Lower labour taxation will have a slightly positive effect on private consumption this year. However, the above-mentioned problem of a relatively small budget remains unresolved, as no significant new sources of government revenue were introduced.

Global key indicators

Yearly change in per cent

	2017	2018	2019	2020
GDP OECD	2.5	2.4	1.9	1.8
GDP world (PPP)	3.7	3.7	3.5	3.5
CPI OECD	2.3	2.7	1.5	2.1
Oil price, Brent (USD/barrel)	55	72	65	75

US

Yearly change in per cent

	2017 level, USD bn	2017	2018	2019	2020
Gross domestic product	19,754	2.2	3.0	2.4	1.7
Private consumption	13,654	2.5	2.7	2.5	1.9
Public consumption	3,407	-0.1	1.6	1.5	1.1
Gross fixed investment	3,295	4.9	5.3	2.9	2.3
Stock building (change as % of GDP)		0.0	0.2	0.0	0.0
Exports	2,420	3.0	4.2	3.1	2.8
Imports	3,022	4.6	4.6	3.2	2.7
Unemployment (%)		4.4	3.9	3.5	3.7
Consumer prices		2.1	2.5	1.4	2.2
Household savings ratio (%)		6.7	6.9	7.0	7.1
Public sector financial balance, % of GDP		-3.8	-4.6	-4.9	-4.8
Public sector debt, % of GDP		105.8	106.4	108.7	109.3

Euro zone

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	10,534	2.4	1.9	1.6	1.7
Private consumption	5,743	1.6	1.3	1.5	1.6
Public consumption	2,173	1.2	1.0	1.2	1.2
Gross fixed investment	2,111	2.6	3.2	3.0	3.0
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	4,867	5.2	3.5	3.5	3.5
Imports	4,392	3.9	3.0	4.0	4.0
Unemployment (%)		9.1	8.2	7.7	7.5
Consumer prices		1.5	1.7	1.1	1.5
Household savings ratio (%)		6.3	6.2	6.0	6.0
Public sector financial balance, % of GDP		-1.0	-1.0	-0.8	-0.8
Public sector debt, % of GDP		86.8	85.9	83.7	82.7

Other large countries

Yearly change in per cent

	2017	2018	2019	2020
GDP				
United Kingdom	1.8	1.4	1.3	1.6
Japan	1.7	1.1	1.0	0.8
Germany	2.2	1.5	1.2	1.4
France	2.2	1.5	1.3	1.5
Italy	1.6	0.9	0.7	1.2
China	6.9	6.6	6.3	6.1
India	6.3	7.6	7.8	7.3
Brazil	1.0	1.2	2.5	2.6
Russia	1.5	1.6	1.6	2.0
Poland	4.8	5.1	3.5	3.2
Inflation				
United Kingdom	2.7	2.5	1.9	1.8
Japan	0.5	1.0	1.0	1.3
Germany	1.6	1.7	1.7	1.7
France	1.2	1.9	1.6	1.6
Italy	1.3	1.3	1.2	1.4
China	1.6	2.1	2.3	2.3
India	3.3	4.0	3.7	4.3
Brazil	3.5	3.7	4.2	4.4
Russia	3.7	2.9	5.0	4.1
Poland	2.0	1.7	3.0	2.5
Unemployment (%)				
United Kingdom	4.4	4.1	4.2	4.3
Japan	2.8	2.5	2.2	2.0
Germany	3.8	3.4	3.4	3.6
France	9.1	8.8	8.6	8.4
Italy	11.3	10.5	10.2	9.9

Financial forecasts

Official interest rates		16-Jan	Jun-19	Dec-19	Jun-20	Dec-20
US	Fed funds	2.50	2.75	2.75	2.75	2.75
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.25
United Kingdom	Repo rate	0.75	0.75	1.00	1.00	1.25
Bond yields						
US	10 years	2.73	3.00	2.75	2.50	2.40
Japan	10 years	-0.01	0.00	0.05	0.05	0.10
Germany	10 years	0.21	0.30	0.50	0.60	0.70
United Kingdom	10 years	1.31	1.50	1.70	1.80	1.90
Exchange rate						
USD/JPY		109	108	104	102	100
EUR/USD		1.14	1.15	1.18	1.23	1.26
EUR/JPY		124	124	123	125	126
EUR/GBP		0.89	0.85	0.83	0.85	0.86
GBP/USD		1.29	1.35	1.42	1.45	1.47

Sweden

Yearly change in per cent

	2017 level, SEK bn	2017	2018	2019	2020
Gross domestic product	4,579	2.1	2.2	1.6	1.9
Gross domestic product, working day adjustment		2.4	2.3	1.6	1.7
Private consumption	2,041	2.2	1.6	1.7	1.7
Public consumption	1,196	0.0	0.6	0.2	0.1
Gross fixed investment	1,143	6.0	4.5	2.0	2.8
Stock building (change as % of GDP)		0.1	0.2	0.0	0.0
Exports	2,076	3.2	3.0	3.4	3.3
Imports	1,908	4.8	3.2	3.2	2.6
Unemployment, (%)		6.7	6.2	6.0	6.0
Employment		2.3	1.8	1.4	0.8
Industrial production		4.5	4.1	3.5	3.2
CPI		1.8	2.0	2.0	1.7
CPIF		2.0	2.1	1.9	1.4
Hourly wage increases		2.3	2.5	2.7	3.2
Household savings ratio (%)		15.1	16.0	16.3	16.2
Real disposable income		1.8	2.4	2.7	1.6
Current account, % of GDP		3.2	2.0	2.5	3.0
Central government borrowing, SEK bn		-62	-80	-48	-10
Public sector financial balance, % of GDP		1.5	0.9	0.6	0.5
Public sector debt, % of GDP		40.8	37.4	35.1	33.6

Financial forecasts	16-Jan	Jun-19	Dec-19	Jun-20	Dec-20
Repo rate	-0.25	-0.25	0.00	0.00	0.25
3-month interest rate, STIBOR	-0.08	-0.15	0.00	0.10	0.25
10-year bond yield	0.50	0.65	0.90	1.05	1.15
10-year spread to Germany, bp	29	35	40	45	45
USD/SEK	9.00	8.83	8.43	7.97	7.70
EUR/SEK	10.26	10.15	9.95	9.80	9.70
KIX	117.7	117.1	115.0	112.4	110.8

Finland

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	220	2.8	2.3	1.9	2.0
Private consumption	119	1.3	1.1	1.6	1.7
Public consumption	52	-0.5	1.5	1.0	1.0
Gross fixed investment	47	4.0	2.2	3.4	3.0
Stock building (change as % of GDP)		-0.2	1.6	-0.6	0.0
Exports	78	7.5	2.0	3.5	3.5
Imports	80	3.5	3.8	2.0	3.0
Unemployment, %		8.6	7.5	7.0	6.6
CPI, harmonised		0.8	1.2	1.3	1.5
Hourly wage increases		-1.2	1.0	1.5	2.0
Current account, % of GDP		-0.7	-0.3	0.0	0.0
Public sector financial balance, % of GDP		-0.7	-0.5	-0.4	-0.4
Public sector debt, % of GDP		61.3	60.0	58.0	56.0

Norway

Yearly change in per cent

	2017 level, NOK bn	2017	2018	2019	2020
Gross domestic product	3,181	2.0	0.9	2.8	2.5
Gross domestic product (Mainland)	2,768	2.0	2.1	2.5	2.2
Private consumption	1,443	2.2	1.9	2.6	2.5
Public consumption	778	2.5	1.9	1.8	1.6
Gross fixed investment	819	3.6	0.6	4.7	2.2
Stock building (change as % of GDP)		0.1	0.0	0.0	0.0
Exports	1,096	-0.2	0.5	2.6	3.3
Imports	1,064	1.6	2.3	2.8	2.3
Unemployment (%)		4.2	3.9	3.8	3.7
CPI		1.9	2.8	2.3	1.5
CPI-ATE		1.4	1.5	2.0	1.8
Annual wage increases		2.3	2.7	3.2	3.7

Financial forecasts	**16-Jan**	**Jun-19**	**Dec-19**	**Jun-20**	**Dec-20**
Deposit rate	0.75	1.00	1.25	1.50	1.75
10-year bond yield	1.75	1.90	2.00	2.05	2.05
10-year spread to Germany, bp	154	160	150	145	135
USD/NOK	8.54	8.17	7.80	7.28	7.06
EUR/NOK	9.73	9.40	9.20	8.95	8.90

Denmark

Yearly change in per cent

	2017 level, DKK bn	2017	2018	2019	2020
Gross domestic product	2,178	2.3	1.1	2.0	1.7
Private consumption	995	2.1	2.5	2.0	2.2
Public consumption	536	0.7	0.3	0.6	0.9
Gross fixed investment	462	4.7	6.2	1.9	4.4
Stock building (change as % of GDP)		-0.1	0.1	-0.2	0.0
Exports	1,188	3.7	0.3	2.9	3.3
Imports	1,033	3.6	3.5	1.5	4.0
Unemployment, OECD harmonised (%)		5.4	4.8	4.5	4.2
CPI, harmonised		1.1	0.7	1.2	2.0
Hourly wage increases		1.7	2.2	2.4	2.9
Current account, % of GDP		9.0	8.0	7.0	6.0
Public sector financial balance, % of GDP		0.0	0.5	1.0	1.0
Public sector debt, % of GDP		37.0	36.0	35.0	34.0

Financial forecasts	**16-Jan**	**Jun-19**	**Dec-19**	**Jun-20**	**Dec-20**
Lending rate	0.05	0.05	0.05	0.05	0.30
10-year bond yield	0.22	0.35	0.55	0.65	0.75
10-year spread to Germany, bp	1	5	5	5	5
USD/DKK	6.55	6.49	6.32	6.07	5.92
EUR/DKK	7.47	7.46	7.46	7.46	7.46

Lithuania

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	42	4.1	3.4	2.9	2.4
Private consumption	26	3.4	4.1	3.5	3.1
Public consumption	7	-0.4	0.4	1.0	1.0
Gross fixed investment	8	6.8	7.9	6.0	5.0
Exports	34	13.6	4.1	3.2	2.7
Imports	33	12.0	3.7	4.7	4.2
Unemployment (%)		7.1	6.3	6.1	6.0
Consumer prices		3.7	2.5	2.5	2.5
Public sector financial balance, % of GDP		0.5	0.5	0.2	0.0
Public sector debt, % of GDP		39.4	34.8	38.0	37.0

Latvia

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	25	4.5	4.5	3.5	3.2
Private consumption	15	5.1	4.6	3.7	3.2
Public consumption	4	4.1	4.0	2.7	2.5
Gross fixed investment	5	16.0	13.7	7.5	6.5
Exports	15	4.8	3.0	2.7	2.8
Imports	14	9.5	6.0	5.8	5.5
Unemployment (%)		8.9	7.4	6.4	6.0
Consumer prices		2.9	2.5	2.9	2.5
Public sector financial balance, % of GDP		-0.6	-0.5	-1.0	-1.0
Public sector debt, % of GDP		40.0	39.6	38.3	37.6

Estonia

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	23	4.9	3.6	2.8	2.5
Private consumption	12	2.6	4.4	4.0	3.4
Public consumption	5	0.6	-0.3	1.8	1.8
Gross fixed investment	5	12.5	0.1	3.6	2.0
Exports	18	3.5	2.4	2.2	2.8
Imports	17	3.6	5.9	4.2	3.4
Unemployment (%)		5.8	5.7	6.0	6.3
Consumer prices		3.7	3.4	2.6	2.4
Public sector financial balance, % of GDP		-0.2	0.2	0.0	-0.1
Public sector debt, % of GDP		8.7	8.3	7.8	7.5

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