SEB

Press release

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Nordic Outlook: Central bank U-turn is re-energising tired growth

Sweden: Low inflation is making the Riksbank even more dovish

The rapid shift to more dovish central bank policies provided new support for risk appetite early in 2019. Economic data have been divided, but overall the global economy has been resilient to the recession risks that have been discussed recently. SEB's economists are adjusting their global growth outlook for 2019 somewhat lower – to 3.3 per cent from their earlier 3.5 per cent – but their forecast for 2020 remains at 3.5 per cent, somewhat above the long-term trend. Unemployment in advanced economies is continuing down to its lowest level since the 1970s, while inflation will remain moderate. The Swedish economy is slowing because of subdued international demand and falling residential construction, but thanks to expansionary fiscal policy and a weak krona, growth will still remain close to its trend rate during 2019 and 2020. Low inflation will force the Riksbank to postpone its next rate hike again until July 2020, and after that the repo rate will stay at zero. The krona will depreciate to just below 11 per euro at the end of this year.

No recession as central bank policies and China provide support

Although downside risks predominate in this phase of the economic cycle, our faith in a resilient global economy is supported by several factors. Manufacturing activity is showing signs of stabilising, with increased optimism in emerging market (EM) countries – partly due to expansionary economic policies in China. The EM sphere will thus remain an important global economic growth engine, with stable growth of between 4½ and 5 per cent. In Europe, domestic economies have been generally resilient to weaknesses in manufacturing, and strong labour markets have helped to sustain private consumption. Because exports to Asia have become increasingly important, the recovery in China and other EM economies will also help drive exports in the next couple of years. Euro zone growth will bottom out around mid-year 2019 and improve from an average of 1.1 per cent this year to 1.4 per cent in 2020. The challenges to the US economy look a bit different and are more connected to supply-side restrictions in the labour market and fading fiscal policy support. Together with slightly weaker growth, signs that productivity is improving faster are easing risks of overheating and making the Federal Reserve's balancing act easier. The economy will gradually decelerate from 2.3 per cent this year to 1.7 per cent in 2020, but the United States will avoid a recession.

Despite political uncertainty – for example, connected to US-Chinese trade talks or Brexit – financial market volatility is continuing to trend downward. Instead, worries about interest rates and the economic cycle were factors behind temporary periods of financial market turbulence during 2018. Central bank policies thus appear to be more important than general political events in the current environment. Inflation is again surprising on the downside, and tendencies towards faster wage and salary hikes have faded somewhat, making it easier for monetary policy makers to support growth despite increasingly tight labour markets. SEB's assessment is that the Fed will leave its key interest rate at the current 2.25-2.50 per cent; key rate risks are on the downside, however. As for the European Central Bank, we predict no key rate hikes at all during our forecast period. In light of this, we expect long-term US Treasuries to show a slight falling trend from today's yields, while it is hard to foresee German government bond yields rising especially much from today's yields of around zero.

Moderate stress means a softer market and economic landing

The next global recession will probably have its epicentre in the US. The historical pattern is that recessions, once they arrive, are triggered by acute financial market crises. But the financial stress level in the US does not seem especially high at present. Because of moderate debt, there is low probability of a painful balance sheet recession like the real estate crisis of the 1990s and the Lehman Brothers crisis. It is more natural to make comparisons with the dot-com (IT) crash of 2001, which led to a rather mild recession. Right now financial markets are sending ambiguous signals about growth. Share prices in the US and elsewhere have reached new all-time highs. Meanwhile the fixed income market is pricing in Fed interest rate cuts, and the yield curve has flattened in a way that has historically signalled a risk of recession. SEB's view is that the signalling value of the yield curve has diminished but that downside risks predominate. Stock market valuations have begun to look more stretched and the journey ahead is likely to be volatile, yet the growth picture still suggests that equities can provide positive returns in the coming year.

This issue of *Nordic Outlook* also includes four theme articles that discuss such topics as the challenges facing central banks in a "Japanified" interest rate landscape, the effects of climate change on forecasts and economic policy, the impact of the European Parliament elections on the European Union's decision-making process and the long-term valuation of the Swedish krona.

Norges Bank against the current; Baltics getting less competitive

Norway is in a different position than other Western economies. Growth in the mainland economy (excluding oil, gas and shipping) will accelerate to 2.6 per cent this year, followed by 2.2 per cent in 2020, driven by higher capital spending in the oil and gas sector. Meanwhile residential construction is no longer a negative growth force. Tighter resource utilisation is causing underlying inflation to rise. Norges Bank is going against the prevailing central bank current by hiking its key interest rate three more times to 1.75 per cent by the end of 2020. The other Nordic countries have been affected in varying degrees by the international slowdown. Last year's slump in Denmark exaggerated the underlying trend, however. Danish growth will climb from 1.4 per cent in 2018 to 2.0 per cent this year, followed by 1.5 per cent in 2020. Rising employment and pay hike will drive private consumption, while good competitiveness will help sustain exports. The deceleration in the Finnish economy will be offset by continued decent domestic demand and somewhat better global demand. GDP growth will slow from last year's 2.3 per cent to 1.8 per cent in 2019 and reach 1.9 per cent in 2020.

Last year the Baltic economies showed some of the highest growth figures in the euro zone, thanks to resilient domestic economies, but a deceleration is unavoidable as export growth weakens. Meanwhile substantially higher pay increases than in other countries will harm Baltic competitiveness, with productivity unable to keep up. Economic growth will cool from between 3.5 per cent (Lithuania) and nearly 5 per cent (Latvia) in 2018 to 3-3.5 per cent this year, then to about 2.5 per cent (Estonia and Lithuania) and just over 3 per cent (Latvia) in 2020.

Sweden will grow at more leisurely pace; repo rate will stop at zero

Swedish manufacturing has been resilient to the downturn in Germany early in 2019. Based on strong preliminary first quarter data, we are sticking to our GDP growth forecast of 1.6 per cent for this year, but various signs suggest that we are entering a period of more leisurely growth. We have adjusted our GDP growth forecast for 2020 a couple of tenths of a point lower to 1.7 per cent, which is still stronger than in many other parts of Europe. Looking ahead, manufacturing activity will slow. We have lowered our export forecast. Residential construction will shift from providing positive GDP contributions of more than half a percentage point yearly during 2014-2017 to a negative contribution of almost the same magnitude in 2019. This trend has confirmed expectations of a clear deceleration – but no collapse – in the housing market. In 2020 we expect a slight rebound in construction. Consumption was surprisingly weak during the second half of 2018, despite the strong labour market and rising incomes. In the next couple of years, households will enjoy support from expansionary fiscal policy, including tax cuts, but they will remain cautious. The household savings ratio will remain at close to record levels. Job growth will continue at a healthy pace, although the rate of increase will slow. Rising labour force participation – which is approaching the record levels of the late 1980s – has nevertheless contributed to an unexpected increase in the jobless rate. Our forecast is that the upturn in labour supply will fade and that unemployment will stabilise at close to current levels. Higher inflation expectations and slightly faster pay increases in Germany suggest that the next Swedish national wage round, which will be completed in the spring of 2020, will lead to higher contractual pay hikes than last time around. Total pay increases of more than 3 per cent yearly (including wage drift) will not, however, be enough to ensure stable inflation at around the Riksbank's 2 per cent target, once the effects of earlier krona weakness and energy price increases fade from the 12-month figures. This will make it hard for the Riksbank to hike its key interest rate at all, in an environment where leading central banks are softening their plans. SEB's forecast is that there will be only one rate hike in 2020 and that it will be postponed until July, once the wage round is over. The Riksbank's negative key rate will thus remain a depreciating factor for the krona until the second half of next year. The EUR/SEK exchange rate will be 10.90 at the end of 2019, followed by a gradual krona appreciation to 10.20 per euro by the end of 2020. Because of the dovish Riksbank, a proposal to increase liquidity reserves that will boost demand for safe Swedish assets and a low supply of government bonds, Swedish government bond yields will remain low. Swedish 10-year yields will be at 0.80 per cent by the end of 2020.

Key figures: International & Swedish economy *(figures in brackets are from the January 2019 issue of **Nordic Outlook**)*

International economy, GDP, year-on-year changes, %	**2017**	**2018**	**2019**	**2020**
United States	2.2	2.9 (3.0)	2.3 (2.4)	1.7 (1.7)
Euro zone	2.4	1.9(1.9)	1.1 (1.6)	1.4(1.7)
Japan	1.7	0.8 (1.1)	1.0 (1.0)	0.8 (0.8)
OECD	2.5	2.3 (2.4)	1.7(1.9)	1.7(1.8)
China	6.8	6.6 (6.6)	6.3 (6.3)	6.1 (6.1)
Nordic countries	2.2	1.9(1.6)	2.0 (2.0)	2.0(2.0)
Baltic countries	4.4	3.9 (3.7)	3.1 (3.2)	2.7 (2.7)
The world (purchasing power parities, PPP)	3.8	3.7 (3.7)	3.3 (3.5)	3.5 (3.5)
Nordic and Baltic countries, GDP, year-on-year changes, %				
Norway	2.0	1.4 (0.9)	2.2 (2.8)	2.7 (2.5)
Denmark	2.3	1.4 (1.1)	2.0 (2.0)	1.5 (1.7)
Finland	2.7	2.3 (2.3)	1.8 (1.9)	1.9 (2.0)
Estonia	4.9	3.9 (3.6)	2.8 (2.8)	2.5 (2.5)
Latvia	4.6	4.8 (4.5)	3.5 (3.5)	3.2 (3.2)
Lithuania	4.1	3.5 (3.4)	3.2 (2.9)	2.4 (2.4)
Swedish economy, year-on-year changes, %				
GDP, actual	2.1	2.3 (2.2)	1.6 (1.6)	1.7 (1.9)
GDP, working day corrected	2.4	2.4 (2.3)	1.6 (1.6)	1.5 (1.7)
Unemployment, % (EU definition)	6.7	6.3 (6.2)	6.3 (6.0)	6.3 (6.0)
CPI	1.8	2.0 (2.0)	1.9 (2.0)	1.7 (1.7)
CPIF (CPI minus interest rate changes)	2.0	2.1 (2.1)	1.9 (1.9)	1.5 (1.4)
Government net lending (% of GDP)	1.4	0.9 (0.9)	0.7 (0.6)	0.5 (0.5)
Repo rate (December)	-0.50	-0.25 (-0.25)	-0.25 (0.00)	0.00 (0.25)
Exchange rate, EUR/SEK (December)	10.00	10.17 (10.17)	10.90 (9.95)	10.20 (9.70)

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