

Press release

Stockholm, November 24, 2015

Nordic Outlook: Hesitant growth amid heightened uncertainty

Our main scenario is that despite various reversals and new challenges, global growth will strengthen in 2016-2017. The economies of the 34 mainly affluent countries in the Organisation for Economic Cooperation and Development (OECD) will be driven by relatively strong domestic demand that will be lifted by the extreme stimulus policies of central banks. Among other things, this will benefit the labour-intensive service sector – despite warning signals from the manufacturing sector, which will continue to show signs of weakness worldwide. China’s growth deceleration will still be under way and will adversely impact global risk appetite, but there are good prospects for improvements in growth. Yet downward price pressures on commodities and energy will persist. One outcome will be uncertain, strongly exchange rate-oriented central banks. Meanwhile various emerging market (EM) and oil-producing countries will have to adjust to lower revenue flows and re-assess their growth models and economic policies.

Third time’s the charm for the Fed in December, but the ECB will do the opposite

In the United States, economic growth will be a solid 2.9 per cent in 2016, then it will slow to 2.6 per cent in 2017: well above trend. The manufacturing sector will be squeezed by the strength of the US dollar and by weak foreign demand, as well as by low oil prices that hamper capital spending in energy extraction. On the other hand, both households and construction activity will show strength. Unemployment will fall to 4.2 per cent by the end of 2017. US wage and salary growth will thus accelerate to 3-3.5 per cent yearly, from about 2 per cent since 2011.

After seven years of “zero interest rates”, **the US Federal Reserve (Fed)** will raise its key rate in December 2015, after having tried to initiate an interest rate normalisation process both in June and September. But the rate hiking cycle will be gentle, taking into account the fact that US inflation is under control, the US economy’s sensitivity to interest rates, the impact of Fed rate hikes on other countries and the risk of an undesirably strong dollar. The next Fed rate hike will occur in June 2016. At the end of 2017 the key rate will stand at 2.0 per cent. Fed policies, including the monetary effect of its large securities portfolio of USD 4.5 trillion, will be clearly expansionary during our forecast period.

In recent years, US monetary policies have increasingly become a matter of global concern for several reasons: their impact on exchange rates has played a more important role in the inflation outlook and policies of various countries; EM economies have growing dollar-denominated debts; and countries with currencies pegged more or less closely to the dollar are forced to “import” US monetary policy even if their position in the economic cycle may diverge from that of the US. But the Fed’s rate hike has been carefully prepared and are well rooted in the global analyses of most other central banks. Thus we do not believe that the **European Central Bank (ECB)**, which is only half-way through its latest quantitative easing (QE) programme totalling EUR 1.1 trillion, will abstain from delivering further monetary easing. Because of worries about strong disinflationary forces and the need for a weak euro, the ECB will lower its deposit rate for banks by 10 basis points to -0.30 per cent and add EUR 10-20 billion in monthly asset purchases to its current EUR 60 billion. Monetary policy divergence will drive the EUR/USD exchange rate to parity, but the long-term valuation of the dollar and a global reduction in dollar-denominated US assets as well as the Fed’s focus on the dollar will slow the currency’s appreciation. In December 2017 the EUR/USD rate will be 1.05, in other words close to today’s level.

More expensive dollar-denominated funding will be a challenge to various EM economies which, at the same time, must adjust the size of their public sectors to significantly lower revenue inflows. **A Chinese hard landing** is probably the biggest risk to the EM economies, but a soft landing in China remains the most likely scenario – with the help of a rapidly

growing service sector, annual real wage increases of about 8 per cent and additional government economic stimulus. We expect China's GDP to grow by 6.5 per cent in 2016, a deceleration from 6.9 per cent this year. During **2017**, the economy will grow by 6.3 per cent. **India's economy** is growing faster than China's: by 7.5 per cent this year, 7.8 per cent in 2016 and 8.0 per cent in 2017. Inflation pressure will remain historically low in many EM countries, giving households more purchasing power. Meanwhile monetary policy can assume a more expansionary direction. We expect the People's Bank of China to cut its key interest rate by nearly half a percentage point, while allowing the yuan to fall towards 6.70 to the dollar in the short term.

Refugee crisis, terrorist threats will have a political impact on EU cooperation

Despite large storm clouds, **the euro zone economy** will grow at a decent pace: 2.0 per cent in 2016 and 2.1 per cent in 2017, stimulated by a weak euro and low interest rates. Aside from Germany and Spain, such large euro zone countries as France and Italy are also showing economic growth, though it is weak. The ongoing refugee crisis and risks of escalating tensions after the terrorist attacks in Paris represent new political challenges for cooperation within the European Union (EU) and the euro zone. We are probably facing added border controls and less mobility. Yet so far, the crisis is primarily of a humanitarian and political nature, not economic, although more countries are now being offered the opportunity to interpret the EU's budget rules more flexibly. All this is occurring in a situation where long-term, fundamental questions remain unanswered – for example, about economic integration and political union and about what adjustments the EU must make to keep the United Kingdom as a member. **Increased uncertainty may generally hamper economic growth.**

The Norwegian economy is being squeezed by falling oil investments, and there are clear contagious effects on other portions of the economy. GDP growth is being sustained by expansionary monetary policy and by the earlier weakening of the krone. We expect Norwegian GDP to increase by 1.5 per cent next year and by 1.6 per cent in 2017, compared to 1.9 per cent this year. Norges Bank will cut its key interest rate to 0.50 per cent in December, and the first rate hike is not expected until two years from now. This means that the krone will remain undervalued. In Denmark, growth will continue to improve despite higher external risks. The ECB's expansionary policies will be transmitted via the DKK/EUR currency peg into **the Danish economy**: GDP growth will be 2.2 per cent in 2016 and 2.5 per cent in 2017 (up from 1.8 per cent this year). The weakest economic performance in the Nordic region will occur in Finland. Although some indicators offer hope for the future – unemployment will fall and monetary conditions will become more expansionary due to ECB policies and a stronger Swedish krona – economic activity in Finland will be squeezed by continued structural and sectoral weaknesses as well as by the problems in the Russian economy. **Finnish GDP** will grow by 0.7 per cent next year and 1.3 per cent in 2017, after largely going nowhere in 2015.

Stronger Swedish growth, but rapidly increasing risks of various kinds

The ongoing refugee crisis, with its historic dimensions, will have a sizeable impact on **the Swedish economy and political scene**. Refugee resettlement in Sweden will require major spending, which will largely be unfunded in the government budget process. Three "holy cows" in the Swedish fiscal framework will quickly be slaughtered: the budget surplus target, the "krona-by-krona" principle and the expenditure ceiling. The prevailing situation justifies greater fiscal flexibility. In the short term this will lead to a fiscal stimulus, which is one reason why we are raising our forecast of GDP growth in 2016 and 2017 by 0.8 and 0.5 percentage points to 3.6 and 2.8 per cent, respectively. Because of a growing labour supply, unemployment will begin to climb again during 2016, and by the end of 2017 it will stand at about 7 per cent. Yet in the short term, stronger GDP growth will mean that public sector debt as a percentage of GDP will be stable at close to 44 per cent despite growing budget deficits.

The risks to the Swedish economy as a whole are now increasing, due to growing imbalances in the housing market and greater strains on public finances. Housing construction will climb rapidly (contributing 1 percentage point to GDP growth in both 2016 and 2017) and the construction sector will move towards overheating. Yet because of rapid population growth, the housing shortage will become even more acute: home prices will continue to rise in 2016 despite an expected decision to impose repayment requirements on home mortgage loans and to reduce interest deductions on such loans. Not until 2017 will home prices level out when the Riksbank has begun its rate hiking cycle.

It is difficult to understand all the long-term economic and political ramifications of the refugee crisis. Even if we assume the implementation of political decisions that will sharply decrease the refugee flow, the Swedish model will be challenged in the coming years. There will be a focus on sensitive political questions – related to such issues as whether to introduce low-wage jobs and change labour laws – and fresh approaches will be needed in order to realise the potential of the population increase, which among other things will ease demographic imbalances. Unless Sweden improves its ability to integrate the new arrivals into society, the country risks entering a downward spiral, with increased social segregation, a need for higher taxes and a deterioration in the quality of education that threaten its international competitiveness. These major challenges will increase the likelihood – among other things due to growing pressure from voters – of some form of government reshuffle and/or deeper cooperation across the lines that separate the leftist and Alliance political blocs. Sweden's way of managing the economic, financial and political crisis is already being questioned by international financial markets, in the form of wider bond yield spreads against countries like Germany in recent weeks, despite the Riksbank's expansion of its bond purchases as recently as late October.

The Riksbank will change course in 2016 after a final rate cut in December

There is an increasingly striking contrast between sharply expansionary monetary policy, on the one hand, and above-trend GDP growth, rising resource utilisation and accelerating household debts, on the other hand. This suggests that a change of monetary policy direction will occur in 2016. **In the short term, because of further stimulus from the ECB the Riksbank will lower its key rate to -0.45 per cent but it will abstain from both expanding its securities purchases and from risky, ineffective currency interventions.** We expect the first Riksbank rate hike late in 2016, that is, six months earlier than the Riksbank is forecasting today. With inflation beginning to rise towards the Riksbank's target, household debts will also gain renewed importance to future monetary policy. In December 2017 the repo rate will stand at 0.75 per cent. The krona will appreciate somewhat against the euro but will weaken against the US dollar until mid-2016. At the end of 2017, the EUR/SEK exchange rate will stand at 8.60 and the USD/SEK rate at 8.20.

Due to strong job growth as well as matching problems between job seekers and openings, resource restrictions and bottlenecks are increasingly evident in the Swedish economy. We expect the refugee crisis to speed up the rate of pay increases by 0.2-0.3 percentage points, despite rising unemployment during 2017. Although the Swedish Trade Union Confederation has failed to achieve the desired coordination on the employee side in the 2016 national wage round, and although the industrial unions' opening bid calls for one-year collective agreements, we still believe that the final agreements will run for longer periods. We expect wage and salary growth to end up at 3.2 per cent in 2016 and 3.4 per cent in 2017, somewhat higher than we had anticipated in August and closer to the level that the Riksbank regards as compatible with its 2 per cent inflation target. The potential for achieving this inflation target is thus better today than previously – supporting our forecast increase – but it is worrying that negative interest rates and large-scale government bond purchases have so far had such a limited impact on inflation and wage expectations.

Key figures: International & Swedish economy (figures in brackets are forecasts from the August 2015 issue of *Nordic Outlook*)

International economy, GDP, year-on-year changes, %	2014	2015	2016	2017
United States	2.4	2.5 (2.4)	2.9 (3.1)	2.6 (2.6)
Eurozone	0.9	1.5 (1.6)	2.0 (2.1)	2.1 (2.0)
Japan	-0.1	0.6 (0.8)	1.1 (1.3)	0.8 (1.0)
OECD	1.9	2.1 (2.2)	2.4 (2.6)	2.4 (2.4)
China	7.3	6.9 (6.8)	6.5 (6.5)	6.3 (6.3)
Nordic countries	1.6	2.1 (1.8)	2.3 (2.1)	2.2 (2.1)
Baltic countries	2.8	2.0 (2.2)	2.7 (2.7)	3.3 (3.4)
The world (purchasing power parities, PPP)	3.4	3.1 (3.2)	3.6 (3.8)	4.0 (3.9)
Swedish economy. Year-on-year changes, %				
GDP, actual	2.3	3.2 (3.0)	3.6 (2.8)	2.8 (2.5)
GDP, working day corrected	2.4	3.0 (2.8)	3.4 (2.6)	3.0 (2.7)
Unemployment, % (EU definition)	7.9	7.4 (7.5)	6.8 (7.3)	6.8 (6.9)
Consumer Price Index (CPI) inflation	-0.2	0.0 (0.1)	1.0 (1.1)	1.9 (2.0)
Government net lending (% of GDP)	-1.7	-1.2 (-1.4)	-1.6 (-0.8)	-1.8 (-0.2)
Repo rate (December)	0.00	-0.45 (-0.45)	-0.25 (-0.25)	0.75 (0.75)
Exchange rate, EUR/SEK (December)	9.39	9.20 (9.20)	8.70 (8.80)	8.60 (8.60)

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