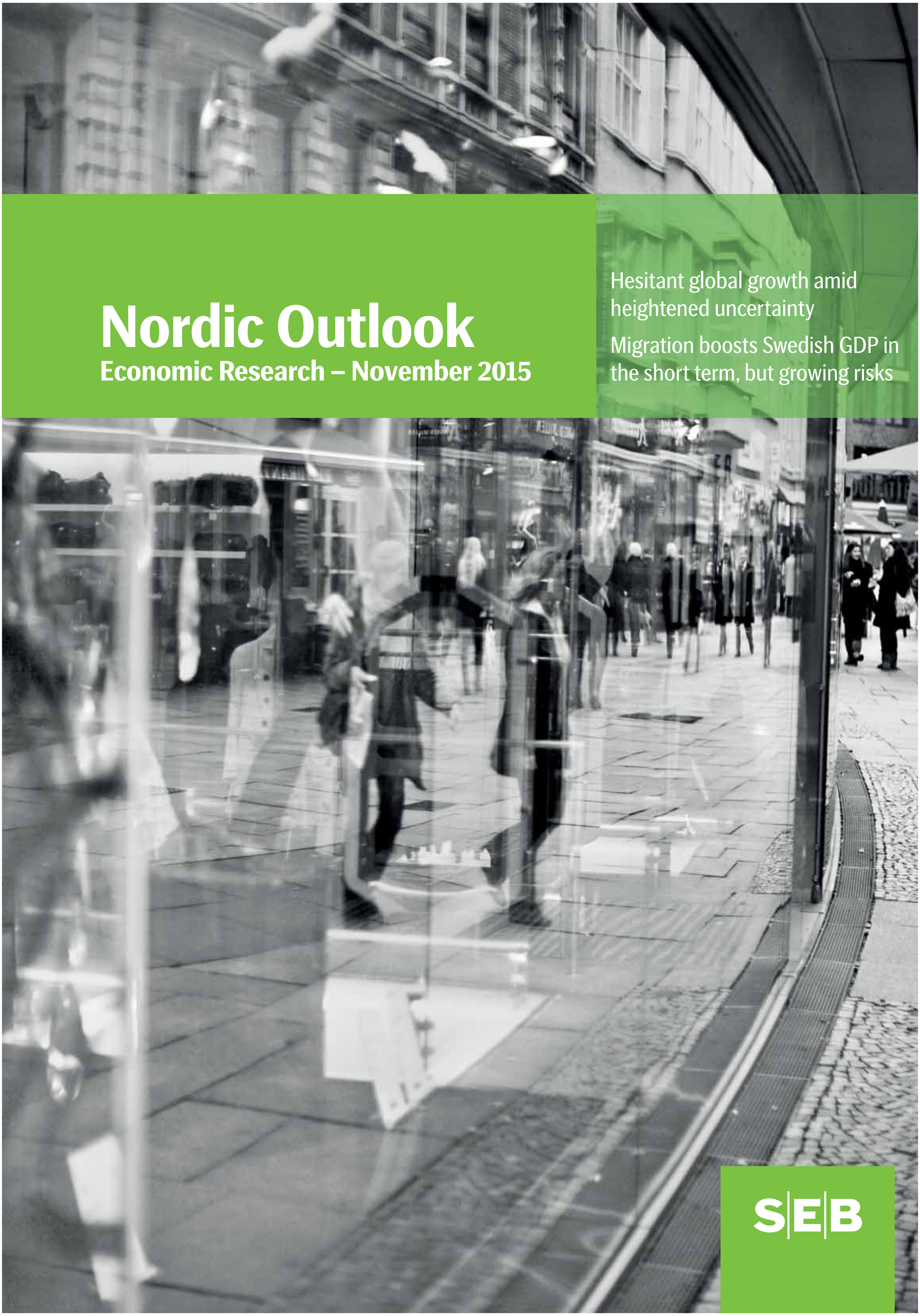
Nordic Outlook

Economic Research – November 2015

Hesitant global growth amid heightened uncertainty

Migration boosts Swedish GDP in the short term, but growing risks



Contents

Boxes

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Hesitant growth with monetary divergence

- **Manufacturing slump will be temporary**
- **Strong domestic demand in Western world**
- **Downside risks from China and divided EU**
- **Sweden: Fast growth but rising imbalances**
- **Fed will hike key rate, rely on Phillips curve**
- **EUR/USD rate will continue towards parity**

The global economy remains hesitant. Industrial activity has been squeezed by factors like Chinese deceleration and the hobbling effects of falling commodity prices. The summer's acute financial market unrest has faded, but **China's slowdown has not really hit bottom**. Meanwhile domestic demand is strong in many countries, expressed by a **robust service sector upturn** and a trend towards two-speed economies. European refugee crisis management and the consequences of the Paris terrorist attacks will impact future EU cooperation, but the short- and medium-term economic effects of greater political uncertainty will probably be minor.

We have adjusted our global GDP growth forecast for both 2015 and 2016 slightly downward, but our scenario of slowly strengthening global growth during 2016-2017 remains in place. Despite China's slowdown, faster Indian growth combined with a certain stabilisation in crisis-hit countries like Russia and Brazil will enable GDP growth among emerging market (EM) countries to accelerate, while advanced countries will benefit from low oil prices and loose monetary policies. Overall, we expect global grow to **climb from 3.1 per cent this year to 3.6 per cent in 2016 and 4.0 per cent in 2017**.

Disinflationary forces in the world economy are still strong; **for example, we believe that both the consensus view and central bank forecasts will need to be adjusted a bit lower**. Yet inflation is on its way upward, partly because oil price effects will disappear from year-on-year figures, but also due to higher resource utilisation. A combination of rather low inflation, yet decreasing disinflationary risks, is giving central banks considerable manoeuvring room. The actions of central banks, especially the US Federal Reserve, will depend on how they view the association between the labour market and inflation, as well as how they judge the sensitivity of the economy to interest rates and the risks of secular stagnation.

This autumn we have seen how central banks have hesitated; they have interpreted tendencies towards appreciation of their own currency as threats to the desired upturn in growth and inflation. The constant interplay between exchange rate movements and central bank actions will increase the uncertainty of forecasts a bit further ahead. Tendencies towards currency wars will open the way to scenarios where central banks keep an eye on each other and where the Fed will perhaps not start its rate hikes at all or is forced to halt them.

We still believe that the financial and real economic environment is stable enough for **the Fed to begin rate hikes in December**, followed by slow increases to a 2.0 per cent level by the end of 2017 – even though the European Central Bank (ECB) will probably expand its asset purchases and lower its deposit rate for banks. Our main scenario thus implies that monetary policy will slowly be normalised. With varying periods of delay, most central banks will follow the Fed upward, although central banks in the Nordic countries and elsewhere will deliver further stimulus measures in the immediate future.

Given this central bank scenario, we expect long-term bond yields to move slowly. For example, US 10-year Treasuries will yield 2.90 at the end of 2016. Wider monetary policy differences will open the way for rather large long-term yield spreads between Germany and the US. This also implies that the dollar will strengthen towards parity with the euro in the next six months, but then we believe excessive USD valuations will justify a rebound in the EUR/USD rate.

Global GDP growth

Year-on-year percentage change

	2014	**2015**	**2016**	**2017**
United States	2.4	2.5	2.9	2.6
Japan	-0.1	0.6	1.1	0.8
Germany	1.6	1.5	2.0	2.1
China	7.3	6.9	6.5	6.3
United Kingdom	2.9	2.4	2.5	2.6
Euro zone	0.9	1.5	2.0	2.1
Nordic countries	1.6	2.1	2.3	2.2
Baltic countries	2.8	2.0	2.7	3.3
OECD	1.9	2.1	2.4	2.4
Emerging markets	4.7	4.0	4.5	5.0
World, PPP*	**3.4**	**3.1**	**3.6**	**4.0**

Source: OECD, SEB

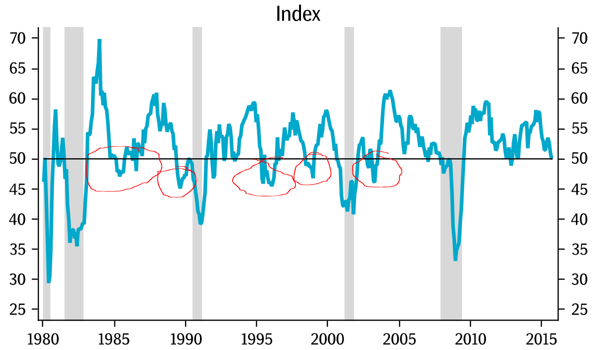
*Purchasing power parities

Industrial slump is not spreading

In the past six months, manufacturing has shown signs of weakness all over the world. There are several reasons. The growth slowdown in China is of especially great international importance, with that country's economy rebalancing from import-heavy investments to more domestically driven consumption. The contagious effects of lower capital spending in the oil sector have probably also grown larger than expected, while the decline in commodity prices is hampering investments in extraction. We have also seen a slowdown in the information technology (IT) sector.

ISM below 50 not equal to US recessions

Index



Source: ISM, NBER, SEB

Weaker industrial activity is a warning signal. Although the manufacturing sector has diminished as a share of GDP, it is still important to the cyclical dynamic of the world economy. **Still, at present we do not believe this is the start of a broader downturn**. Service sector expansion is continuing at a robust rate. Given the idle resources in the economy, monetary policy will remain very supportive. In such a situation, it is very unusual for a general recovery to be interrupted. In the US, for example, it has not been unusual for the purchasing managers' index (PMI) in manufacturing to fall to the neutral 50 level or below without a broad recession having occurred; 43 is usually described as the critical level. At present, the danger of recession is mainly associated with risks that the Chinese economy will continue downhill in a way that falls outside our main forecast.

The European project faces new choices

The refugee crisis and the terrorist attacks in Paris will change the prerequisites for European cooperation. It is too early to draw any far-reaching conclusions, but the European Union and the euro zone face major political challenges and choices. Differences in opinion about how the refugee crisis should be managed seem too large to be resolved within the framework of today's system. Some form of change will thus probably occur. An intensified battle against terror and extremism will also affect the cooperative and social climate. Most indications are that we are moving towards tighter border controls, for example by changing or ending the Schengen system or by reinforcing the external borders of the EU. If the acts of terror escalates, the economy may be hampered. But generally speaking, **the short- or medium-term economic impact need not be so big**. At the European level, the refugee flows we have seen so far are not large enough to affect economic performance especially much; the crisis is more political and humanitarian than economic. Nor will the possible collapse of the Schengen system necessarily to have such major consequences, although it is vital that free movement of labour is not undermined.

But the European project is also at a crossroads when it comes to fundamental long-term issues – accentuated by the fact that **EU institutions in Brussels** have ambitions to continue pursuing their 10-year plan for **creating a political union**, while the UK is calling for **renegotiation of EU treaties**. In order to lay the groundwork for a Yes vote in the referendum on continued EU membership (to be held at latest 2017), the Tory government has unveiled a far-reaching list of demands. It includes expanded independence – for the UK but also for other countries – in relation to the EU. This applies, for example, to an option to block proposed EU legislation and to be able to "protect" a country's own social welfare system against intra-EU migration.

These diametrically opposed strategies in Brussels and London show that unlike previously, it is **not a matter of European convergence at two different speeds, but of two totally different directions** on issues concerning the **basic foundations of the EU**. The British agenda comes at a time when it is clear that crisis resolution in the EU, for example in the case of Greece, is hampered by too many opportunities for national vetoes. If the euro is to survive, cooperation must be strengthened and supranational authority must increase. Adding to this dilemma the consequences of Europe's dysfunctional actions related to refugee resettlement, what emerges is a picture of increased political disunity and uncertainty, which has the potential to **hamper the economic recovery that Europe so greatly needs**.

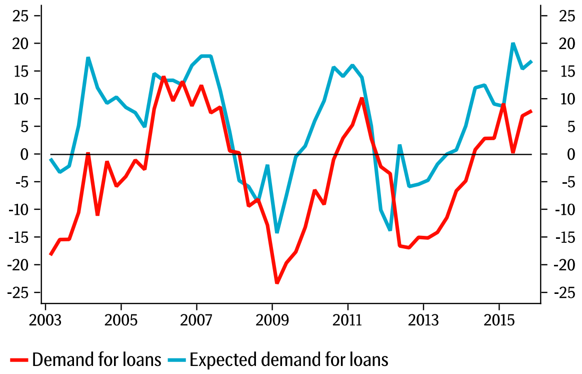
Above-trend growth in advanced countries

The potential for continued domestically driven growth is rather good in most of the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD). In the **US**, households enjoy support from rising employment, low energy prices and robust wealth increases, though this is not fully reflected in confidence indices. Given the dynamic housing market, construction is providing a sizeable contribution to growth. In spite of this, **the level of**

the most cyclically sensitive portions of the economy (construction, machinery investments and durable goods consumption) remains historically low as a share of GDP, which indicates potential for continued recovery. But cutbacks in the oil sector and the strong US dollar have hampered industrial production to a greater degree than we had expected. This is one reason why we have revised our GDP growth forecast for 2016 somewhat lower. In the **UK**, too, robust domestic demand will lead to annual growth of around 2.5 per cent. With unemployment now close to or even below equilibrium in the US and UK, supply side factors will become more important to their growth potential. We foresee prospects of a certain rebound in productivity growth. Meanwhile the labour supply can increase in a situation of strong demand for labour.

Euro zone: Growing demand for loans

Index



Source: ECB Bank Lending Survey

Despite continued worries, **the euro zone economy is also growing at a decent pace**, stimulated among other things by low oil prices and a weak euro. The European Central Bank (ECB)'s actions have also helped ease the credit market, and demand for loans is now rising. The **Spanish** recovery has intensified, while **France and Italy** are now also showing positive, albeit weak growth. German manufacturers have been hampered by weak international demand, and the Volkswagen crisis has fuelled more uncertainty, but we do not believe this will have any significant lasting consequences for German industry. **Overall, we expect euro zone GDP growth of 2.0 per cent in 2016 and 2.1 per cent in 2017**. This is above trend but not enough to resolve the imbalances in the labour market and weak public finances. Low resource utilisation is creating continued disinflationary pressure. Damage associated with uncomfortably low inflation and the resulting high real interest rates is especially sizeable, given today's high public debt.

EM economies squeezed on several fronts

There is persistent uncertainty about developments in the emerging market (EM) economies. Although the summer's financial market turbulence has faded substantially, China's growth deceleration has still not bottomed out. This implies that many EM countries are facing the task of simultaneously managing their national structural problems and weaker Chinese import demand (see the theme article: *China's deceleration and the world economy*). In addition, oil producers face the challenge of adapting to lower income flows.

BRIC countries, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
China	7.3	6.9	6.5	6.3
India	7.1	7.5	7.8	8.0
Brazil	0.2	-3.1	-1.2	1.5
Russia	0.6	-3.6	-0.8	1.5
EM economies	4.7	4.0	4.5	5.0

Source: OECD, SEB

Downside risks predominate

At present, we mainly foresee downside risks in three areas. The most important is that **Chinese authorities may not be capable of ensuring a soft landing** in their economy. A sharper Chinese downturn may have rather large global contagious effects. Another risk is that we are overestimating the **resilience of many vulnerable emerging economies to Fed rate hikes**. The third risk area concerns the possible **economic impact of the various problems and setbacks that threaten European cooperation**.

The main potential for stronger growth is that **low oil prices will, after a certain lag, have a larger stimulus effect** than we expect in our main scenario. It is also possible that we are underestimating the probability of a **rebound in productivity growth** after the large decline that has occurred in most advanced countries. If this is the case, we are underestimating supply side growth potential. Our overall assessment is that the downside risks predominate, but the probability that these risks will trigger markedly worse economic performance than in our main scenario is not as high as before. We thus believe that there is a 20 per cent probability for our low-growth scenario and 15 per cent for higher growth, Both the problems related to European cooperation and the potential for faster productivity growth are factors that primarily affect the outlook in a slightly longer perspective.

Alternative scenarios

GDP, year-on-year percentage change

	2016	2017
Low-growth scenario (20%)		
United States	2.5	1.5
Euro zone	1.2	0.5
OECD	1.7	1.2
EM economies	3.5	4.5
High-growth scenario (15%)		
United States	3.2	3.4
Euro zone	2.5	3.0
OECD	2.8	3.2
EM economies	5.0	5.5

Source: SEB

We have adjusted our GDP growth forecast for the EM countries a bit downward and expect substantially lower GDP increases than before the financial crisis. **Yet we still view a soft landing in China as the most likely scenario**, although the risk of a hard landing has increased somewhat. Domestic service output is growing rapidly. This is logical in light of the government's ambitions to transition to somewhat more consumer-driven growth. There is also substantial room for further easing of economic policy if this becomes necessary.

India's growth remains at a higher level than China's. Although there are political obstacles to the government's structural reform agenda, the economy is being stimulated by low oil prices while falling inflation is opening the way to further monetary policy stimulus. **Brazil is plagued by political problems and economic policy dilemmas**. High inflation due to sharp currency depreciation is preventing a loosening of monetary policy, while a rising budget deficit is forcing the government to tighten fiscal policy. GDP is expected to fall by more than 3 per cent in 2015, and the downturn will continue in 2016, though somewhat more gently. **In Russia, too, GDP is expected to fall markedly this year**. Economic activity is still hampered by high inflation, tight monetary policy and Western sanctions, but rouble depreciation is providing some support in the form of export stimulus. We are already seeing an industrial rebound. Rouble depreciation is also helping strengthen government finances, since oil revenue in national currency terms is holding up despite the price decline in the world market.

Oil market under pressure

This autumn the oil market is dominated by **overproduction** and **stockpiling** due to China's growth slowdown and more tenacious American producers. In the run-up to the December 4 meeting of the Organisation of the Petroleum Exporting Countries (OPEC), there are few signs of willingness to reduce production quotas. For example, Saudi Arabia has cut its prices for oil exported to Europe and the US and is sticking to its strategy: **maximising production in order to squeeze out non-OPEC countries (read: the US) with higher production costs**. This strategy has succeeded insofar as **oil investments in the US have slowed** but has failed because US companies have meanwhile **managed to lower their production costs**.

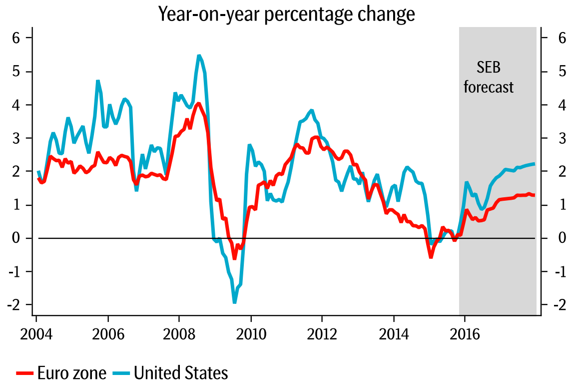
Our price forecast (for Brent crude oil) is an average of **USD 55/barrel in 2016** and **USD 60/barrel in 2017**, compared to **USD 53/barrel** this year. The downside risks in our forecast weigh heavier; due to several factors, **oil prices will remain under pressure**. During the first half of 2016, overproduction will persist since Iran is also expected to enlarge its exports. The Fed's expected rate hike and a stronger dollar are other negative factors for oil prices. Both the International Energy Agency (IEA) and OPEC are also exuding pessimism in the longer term, even if demand rises. One clear source of concern about global stability is that various oil-exporting countries cannot finance their public obligations at today's oil prices; cutbacks will increase the risk of social and political unrest.

Inflation will slowly rebound

Inflation remains squeezed. The oil price decline is still keeping headline inflation down, but its effects will begin to disappear from 12-month figures in the coming months. The impact on petrol prices will nevertheless be partly delayed, allowing an extra downward push on the Consumer Price Index (CPI), which will linger for a while, but core inflation has delivered some upside surprises both in the US and the euro zone.

Consumer Price Index (CPI) inflation

Year-on-year percentage change



Source: Eurostat, BLS, SEB

Our assessment is still that the consensus forecast has not fully taken into account the disinflationary forces in the world economy. **Yet we believe that inflation is on its way up**. CPI inflation will soon climb steeply as the effects of the oil price decline disappear from 12-month figures. Although fluctuations in oil and petrol prices will trigger a downward correction in mid-2016, the trend is upward. Looking further ahead, developments will largely be determined by the extent to which a tighter labour market situation will affect wages and salaries (see theme article). So far, they have responded feebly, but now we are beginning to see faster pay hikes in countries such as the US, Germany and the UK. Tough global competition will have a restraining effect, but it is reasonable to expect pay to increase by about 3 per cent annually in the next couple of years. To some extent, productivity growth will normalise after a long period of stagnation, holding back the impact of inflation. **Overall, we expect average CPI inflation in the US of 1.4 per cent in 2016 and 2.1 per cent in 2017**. The corresponding euro zone figures are 0.8 and 1.3 per cent, respectively, which the ECB finds uncomfortably low.

December hike: third time's the charm

Recent central bank actions have given an impression of uncertainty. Deflation risks have subsided, but quantitative easing (QE) policies have not had any major impact in terms of higher inflation expectations. **Real interest rates have thus not fallen in the way that would have been desirable**. Low supply side-driven inflation need not be a problem, but a new economic downturn when there is already low inflation would create renewed deflation pressure and make the global **build-up of debt from recent years even tougher to manage**. This gives central banks especially strong incentives for ensuring that inflation actually rises, and it may thus explain why the trend towards currency wars is so hard to eliminate.

But there are still many indications that the Fed will soon end its seven-year "zero interest rate policy" and **raise its federal funds target interval by 0.25 percentage points in December**. It will decide on this rate hike based on a traditional view that a **tighter resource situation will finally lead to rising inflation**. It is thus indirectly playing down the risks of secular stagnation and defying the recommendations of both the IMF and the World Bank that it should take a global view and hold off for another while, since low inflation offers such an opportunity. The Fed probably intended to hike its key rate both in June and September, but it chose not to deliver a rate cut amid turbulent financial market environments.

For several reasons, **the Fed's policies have increasingly become a matter of global concern**. The foreign debts of emerging economies have doubled to USD 3 trillion since the collapse of Lehman Brothers in 2008. A number of countries, including China, have pegged their currencies more or less closely to the US dollar. A less expansionary US monetary policy is thus transmitted to countries that are in a different cyclical phase than the US. Since these countries are also forced into fiscal austerity due to falling commodity prices, **this subjects them to economic, financial, political and social pressures**.

Even if the Fed hikes its key rate in December, a global view will help ensure that it proceeds cautiously. But there are also various domestic reasons for a gentle, predictable **normalisation process**. Inflation is under control and there is a constant risk that the dollar will become undesirably strong. We expect **the Fed's next interest rate hike to occur in June, and the key rate will reach 2.00 per cent by the end of 2017**. This implies a significantly gentler hiking cycle than the historical norm. But our rate path forecast is more aggressive than implied by today's market pricing. Once the Fed has begun its hiking cycle based on the above premises, clear macroeconomic setbacks will be needed before the Fed will completely interrupt its rate hikes. We believe that the risks of such setbacks are rather small, especially considering the stimulus effect of the Fed's securities portfolio (see below).

Central bank key interest rates

Per cent

	Dec 2015	Dec 2016	Dec 2017
Federal Reserve	0.50	1.25	2.00
ECB (euro zone)	0.05	0.05	0.05
Bank of England	0.50	1.00	1.50
Bank of Japan	0.10	0.10	0.10
Riksbank (Sweden)	-0.45	-0.25	0.75
Norges Bank	0.50	0.50	0.75

Source: Central banks and SEB

The US rate hike has been carefully prepared and has probably been the main scenario in global analyses by other central banks. We thus do not believe that recent dollar appreciation will cause the ECB to abstain from delivering further stimulus consistent with the signals provided at its November policy meeting. We expect the ECB to enlarge its monthly asset purchases to EUR 70-80 billion and to lower its deposit rate by 0.10 points to -0.30 per cent. We also expect the Bank of Japan to expand its QE programme during 2016.

Despite **cautious US and UK rate hiking cycles** – the Bank of England will begin its hikes in August 2016 – **global monetary policy, including QE portfolios, will remain stimulative**. For example, IMF calculations show that the Fed's System Open Market Account (SOMA), totalling USD 4.5 trillion, is equivalent to an interest rate effect of about 2 percentage points in expansionary stimulus. Not until autumn 2016 do we expect the Fed to abstain from reinvesting all or part of its maturing bond holdings, but the tightening effect will be marginal.

Riksbank approaching its target

The Nordic economies are being driven by different forces**. In Sweden, large-scale refugee resettlement will require spending that will be largely unfunded in the budget process.** In the short term this represents a fiscal stimulus, which is one reason we have revised our GDP forecast sharply higher. Meanwhile economic risks will increase due to growing housing market imbalances and pressures on public finances. To avoid major tax hikes further ahead, Sweden must significantly improve its ability to integrate the new arrivals into society.

Falling oil investments are now squeezing the Norwegian economy and we see clear contagious effects on the rest of the economy. Due to such counterforces as expansionary fiscal policy and the export stimulus from a 15 per cent currency depreciation (trade-weighted since 2014), GDP will grow by about 1½ per cent both in 2016 and 2017**. In Denmark, the recovery is gradually gaining further ground,** although external risks have increased a bit. **The Finnish economy faces continued strong headwinds**, but a slight improvement is discernible due to ECB stimulus policies.

Nordics, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
Sweden	2.3	3.2	3.6	2.8
Norway	2.2	1.9	1.5	1.6
Denmark	1.1	1.8	2.2	2.5
Finland	-0.4	0.2	0.7	1.3

Source: OECD, SEB

This autumn, the Riksbank has continued its fight to push inflation and inflation expectations higher. We predict that further ECB stimulus measures will provoke the bank into a small key rate cut to -0.45 per cent in December but that it will abstain from fulfilling its threat of currency interventions. Looking **ahead, several factors suggest that a monetary policy shift will occur.** The contrast between economic growth far above trend, rising resource utilisation and growing household debts, on the one hand, and extremely expansionary monetary policy, on the other, is becoming more and more striking. In the second half of 2016, after the national wage round is completed, we expect the Riksbank to reverse its negative key rate in small steps. By the end of 2017, the repo rate will stand at 0.75 per cent.

Today the Norwegian central bank is strongly growth-focused. **Its monetary policy has aimed at offsetting the negative contagious effects of low oil prices and at keeping the krone weak.** Core inflation, which is now above target, thus plays a subordinate role. We expect Norges Bank, as it has already strongly indicated, **to cut its key interest rate to 0.50 per cent in December. The first rate hike will not occur until late 2017.**

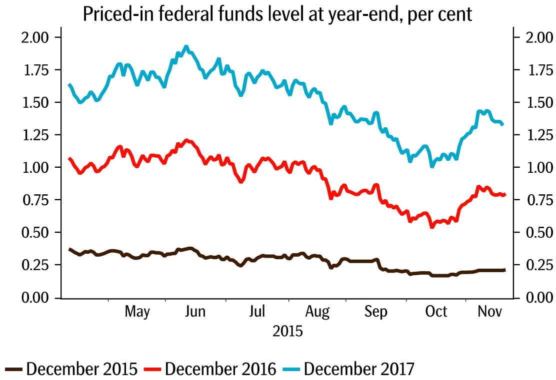
Rising low-term yields after Fed rate hike

Rising expectations that the Fed will hike its key interest rate at its December policy meeting have exerted renewed upward pressure on long-term bond yields. Because the fixed income market has not yet fully discounted the Fed rate hike, **long-term yields are likely to rise further once the US central bank has delivered its hike**. The Fed will proceed cautiously compared to earlier hiking cycles. This meanwhile implies that the upturn in long-term yields during our entire forecast period will be moderate in a historical perspective.

Higher US bond yields will spill over into long-term yields in Europe as well but will be partly offset by continued highly expansionary central bank policies, especially since the ECB is now expected to expand its dose of stimulus. Right at the outset, however, the spread between 10-year government bond yields in the US and Germany are historically high, both in absolute terms and in relation to the gap between policy rates. The market has thus already anticipated divergent future monetary policies in the US and the euro zone. **This makes it difficult for German yields to completely resist the effects of higher long-term yields in the US.** Our forecast is that 10-year government bond yields in the US will stand at 2.45 per cent at the end of this year, then gradually rise to 2.90 per cent at the end of 2016 and 3.10 per cent at the end of 2017. The corresponding German bonds will trade at 0.60 per cent by the end of 2015, 1.20 per cent at the end of 2016 and 1.50 per cent at the end of 2017. This implies small changes in the yield spread from today's 175 basis points or so down to 160 points at the end of our forecast period.

Rising expectations of Fed key rate hikes

Priced-in federal funds level at year-end, per cent



Source: Bloomberg, SEB

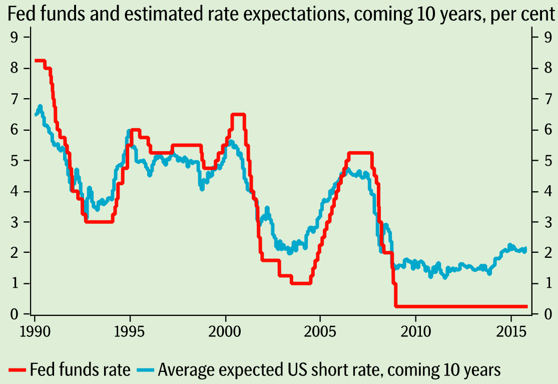
Decomposition of long-term yields

One way of analysing the long-term yield outlook is to divide the yield into its two main components: the **term premium**, that is, the risk premium for investing in longer maturities instead of a series of short-term fixed income securities, and **expected short-term interest rates**. Such a model has been developed by the New York Fed. It shows that historically, the risk premium has tended to increase ahead of and immediately after the first key interest rate hike. We believe that the same pattern will repeat itself this time around. This is especially true since the risk premium for 10-year US Treasury notes is close to record lows. **Once the Fed has started with its rate hikes, long-term yields are usually determined more by changing views about short-term interest rates**.

According to the model, right now short-term interest rates are expected to be somewhat above 2 per cent on average during the coming 10-year period. Unlike the risk premium, this is not especially low in a historical perspective, but is consistent with the levels ahead of the previous rate hiking cycle in 2004. One interpretation of this is that today's low market pricing does not provide a completely fair picture of investors' short-term rate expectations in a slightly longer perspective, for example due to uncertainty about the starting point for rate hikes. This interpretation implies that **the market has already made allowances for higher short-term interest rates**. Combined with the cautious and gradual Fed rate hikes that we foresee, this suggests that the upturn in 10-year bond yields will be moderate.

Short rate expectations in line with 2004 hiking cycle

Fed funds and estimated rate expectations, coming 10 years, per cent



Source: Macrobond, NY Fed, SEB

Historically, the risk premium has fallen once the hiking cycle has become established. Whether it will do so this time around is doubtful. The term premium for 10-year government bonds has trended downward since the early 1980s. **According to the Fed's model, today the term premium is close to record lows in the US.** It is difficult to say what is actually behind this downturn, but it probably reflects a combination of depressed risk premiums for inflation and greater demand for government bonds due to central bank QE programmes. Because the risk premium is so depressed, long-term yields are sensitive to a future re-evaluation of how to view both inflation and supply/demand factors. One example is the vigorous upturn in long-term German yields last spring, after the earlier search for returns ahead of the ECB's current QE programme.

The spread between Swedish and German 10-year yields narrowed after the Riksbank expanded its QE programme late in October. In recent weeks, the long-term yield spread has widened again in response to rising uncertainty about Swedish government finances due to the refugee crisis and growing imbalances. We also foresee a risk that poor liquidity in the wake of the Riksbank's future bond purchases may cause investors to demand a premium in order to invest in Swedish government bonds. Higher economic growth and inflation in Sweden than in the euro zone will have an impact on the long-term yield spread in 2016, once the Riksbank moves closer to renewed interest rate hikes late in the year. **Swedish 10-year bond yields will climb from 0.95 per cent at the end of 2015 to 1.80 at the end of 2016 and 2.30 at the end of 2017**, or 60 and 80 points above the corresponding German yields, respectively.

The spread between Norwegian and German 10-year government bonds is now historically wide, partly reflecting krone depreciation against the euro. Stabilisation and later appreciation of the krone should boost market interest in Norwegian government securities, thereby squeezing the wide spreads. In the near term, the fixed income market will also be helped by further monetary easing. Especially the middle segment of the curve will benefit from a yield curve that signals low interest rates for a long time to come, while yields further out on the curve will be influenced more by supply factors. **We forecast a 10-year spread against Germany of 75 points at the end of 2016, equivalent to a 1.95 per cent yield.** At the end of 2017, when Norges Bank has again started hiking its key rate, the spread will be 80 points and 10-year yield will be 2.30 per cent.

Stronger dollar as central banks diverge

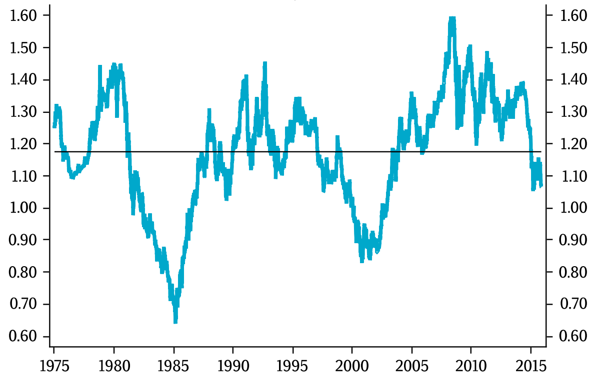
Currencies remain sensitive to central bank signals. Meanwhile exchange rates are important to the reaction function of central banks. This interplay creates a complex situation for both central banks and other foreign exchange market players. Our forecast that the Fed will hike rates starting in December, while the ECB delivers additional stimulus measures, implies further **divergence between the two dominant central banks ahead**. Since 2014, the dollar has appreciated by nearly 25 per cent, and the question is how much potential is left.

Experience of previous hiking cycles (starting in 1994, 1999 and 2004) shows that the dollar normally appreciates before the first rate hike but then weakens during a period after it is delivered. This appreciation is probably due to the Fed's frequent success in steering market expectations, but it is not equally obvious why the dollar should weaken after the first rate hike. The Fed's action may possibly fuel expectations that other central banks will follow suit. This time around, however, the cyclical differences between the US and the euro zone are so great that a Fed rate hike will probably not lead to speculation about a policy shift by the ECB. The euro will be used to a greater extent as a financing currency, since low interest rates help push the currency downward. **We expect the dollar to remain strong, with a EUR/USD exchange rate of 1.00 at the end of the second quarter of 2016 and 1.03 at the end of 2016**. We do not expect the dollar to appreciate further, since we regard its valuation to be strained at these high levels. In addition, oil-producing countries with large USD reserves will have a growing need to sell dollars to finance their burgeoning budget deficits, due to low oil prices.

The British pound will rise on expectations that the Bank of England will soon follow the Fed's example. Inflation remains well below the BoE's target, but the labour market gap is rapidly closing and there are signs that wages and salaries will grow faster. We expect a rate hike in August 2016, which will push up the pound against currencies like the euro. Looking ahead, uncertainty about continued EU membership will pull down the pound. The UK is dependent on foreign portfolio inflows to finance its sizeable current account deficit, and withdrawal from the EU would thus adversely affect the pound. **We expect the EUR/GBP exchange rate to fall to 0.73 during 2016 and to 0.75 in the following year**.

Dollar valuations not yet extreme

EUR/USD



Source: Macrobond

A stronger dollar and low commodity prices will continue to hurt commodity-related currencies. For example, the downward pressure on the Norwegian krone will persist as long as there is continued uncertainty about how the Norwegian economy will be affected by low oil prices. We expect a further interest rate cut to 0.50 per cent in December, which will help weaken the Norwegian krone further against various other currencies, including the Swedish krona. **By the end of next year, the EUR/NOK rate will stand at 8.80**.

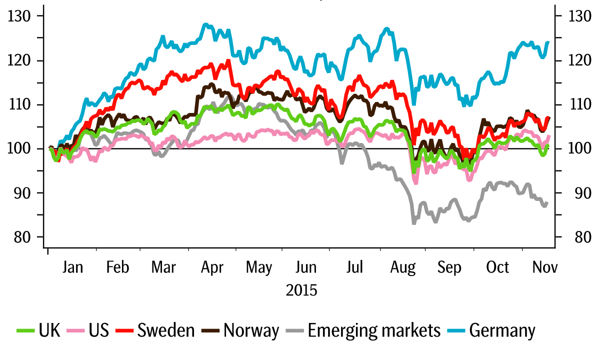
Sweden's good economic fundamentals suggest a stronger krona ahead. The krona is undervalued, while the flow situation is favourable in a number of ways, for example because of cutbacks in speculative positions that previously weakened the krona. The currency has become an increasingly important piece of the puzzle in the Riksbank's efforts to boost the inflation rate. Our main scenario is that the bank will cut its key interest rate one more time in order to counter krona appreciation. But after that, we expect higher inflation to bring an end to the rate cutting cycle. The Riksbank will be forced to accept a stronger krona. Nor is a slight increase in uncertainty about Swedish central government finances enough to prevent currency appreciation. **We expect the EUR/SEK exchange rate to fall a bit below 9.00 during 2016**.

Profit revisions dampen stock market mood

Stock markets have gained back some of their China-related downturn in August and September, supported by an interest rate cut in China and dovish signals from the ECB. Except for emerging markets, broad indices are back at the levels prevailing at the start of 2015 or higher. Meanwhile profit forecasts have continued to be revised lower, especially in the US. This largely reflects problems in the energy sector, but also downward adjustments in the outlook for manufacturing and other sectors. It means that in many places, share valuations have become even more stretched. **Our forecast of relatively good, rising global growth during the next two years should basically be favourable for equities,** and become reflected in leading indicators and profit forecasts. But as long as there are lingering question marks about manufacturing performance, stock markets will probably lack a clear direction.

Stock market recovery after worries about China receded

Index: Jan 2015 = 100, local currencies



Source: Macrobond

The beginning of Fed rate hikes is a risk factor, but the normal pattern is that this will only have temporary negative effects on the stock market. The foremost exceptions were the Fed's unsuccessful rate hikes in the 1930s, early 1940s and 1970s. As long as the Fed does not make erroneous assumptions about the economic situation, **higher key interest rates have historically not posed an obstacle to rising share prices**. Meanwhile stock markets will also enjoy support from expanded stimulus measures by the ECB.

Continued economic recovery – which is supported by leading indicators – combined with increased ECB stimulus should especially benefit European equities, whose valuations are also more moderate than US equities. **The downturn in EM stock markets implies that valuations must now be regarded as low.** As earlier, the outlook seems to be best in Asia and worst in Latin America.

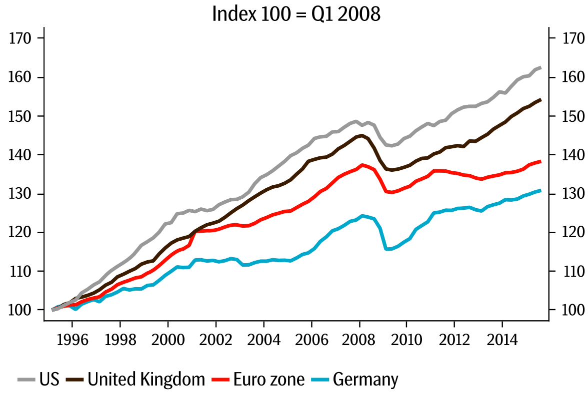
At present, Swedish share valuations are consistent with what we regard as a long-term equilibrium level, given a continued subdued outlook for long-term yields. **We believe that the OMX30 index in Stockholm can rise** approximately in line with expected earnings, or **by more than 10 per cent during the coming year**. The Nordic stock market index also looks set to increase by nearly 10 per cent during the same period. The trend of oil prices will remain the most important factor for the Oslo exchange, while Finnish equities may derive support from a weaker euro and more stable developments in Russia. The potential for a rapprochement between Russia and the West in the wake of the November terrorist attacks in France is one factor that may be expected to benefit Finland in particular.

- **Achieving targets enjoys global approval**
- **Arguments for both higher and lower inflation targets are not convincing**
- **Riksbank can adopt a more relaxed attitude towards its target without formal changes**

Central banks are continuing their highly expansionary stimulus policies. Although seven years have passed since the Lehman Brothers crisis, this autumn has been dominated by signals of loose monetary policy. Growth is still not really taking off, increasing frustration and rekindling the debate about the key role of inflation targeting in economic policy. For example, the Bank for International Settlements (BIS), has again stressed that **zero interest rate policies risk creating financial bubbles, leading to less efficient allocation of financial resources**. In Sweden this issue is especially hot, since the Riksbank has pursued far-reaching unconventional policies despite good economic growth, a well-functioning credit market and overheating tendencies in the housing market. The question now is whether the Riksbank will find outside help when it comes to fresh thinking. Central banks such as the Bank of Canada are now evaluating and studying potential improvements. To assess whether any change or shift of policy emphasis can actually occur in the next couple of years, it may be worthwhile discussing what issues and problems are really in focus when it comes to the challenges of inflation targeting.

Wide gap compared to earlier growth trend

Index 100 = Q1 2008



Source: Eurostat, BEA

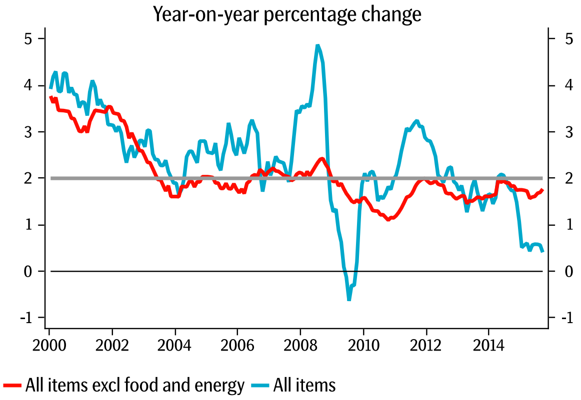
Is monetary policy too ineffective? One rather common opinion is that monetary policy is no longer an efficient way to stimulate production and growth. The discussion of secular stagnation that has been under way in recent years has gained new energy as the economic upturn has failed to gain real traction. The main thrust of this debate, especially as it was first formulated by US economist Larry Summers, is that the problem is demand-related and that at present not even zero interest rates are enough to create a balance between saving and capital spending. In such a situation, it is logical to continue pursuing unconventional monetary policies such as negative key interest rates and quantitative easing (QE). Maintaining that fiscal policy has an important complementary role to play when monetary policy is under such pressure does not really imply a rejection of inflation targeting. But there are also more system-critical **supply side-related arguments in the spirit of the BIS, which focus on inefficient allocation resulting from zero interest rates**. A mechanism that exerts weak pressure for change enables inefficient businesses to survive, hampering new investments and thus also productivity growth. This weakens growth in the long term.

Is it too hard to push the inflation rate higher? The price-lowering power of globalisation and digitisation has been an important theme for a number of years. An increasing labour supply together with technological innovation and pricing transparency, for example by means of e-commerce, is sometimes described as a set of insurmountable forces facing central banks. The recent downturn in commodity prices has further reinforced disinflationary tendencies in the world economy. Total CPI inflation in advanced countries is now being squeezed to lows only exceeded during the 2009 crisis. But energy prices play a large role. If we look at core inflation instead, the stability of the inflation rate is striking. Deviations from the 2 per cent level have been small during the past decade, which can actually be regarded as a good mark for policymakers. Although current disinflationary forces are strong, **at present it is thus difficult to claim that inflation targets are impossible to achieve**.

Has the association between resource utilisation and inflation weakened? One important question about the inflation process is whether we can rely on old associations between resource utilisation – especially in the labour market – and inflation. Although the stability of the Phillips curve (the association between unemployment and inflation) has long been questioned, it still enjoys a strong position in central bank forecasts and communication. Unless a tight labour market situation will sooner or later lead to pay increases, central banks are in treacherous economic terrain. Likewise, they assume that businesses can raise their prices when demand becomes sufficiently intense. In many countries, resource utilisation is not high enough to test this assumption. But we already have a situation where the three largest OECD economies – the US, Japan and Germany – are close to non-accelerating inflation rate unemployment (NAIRU), or equilibrium, without any major upturn in wages and salaries. This is also rather consistent with experience over the past decade. **Wage and inflation impulses arrive rather late in the cycle, which is tricky from a central bank perspective**. The Fed is now facing this dilemma as it prepares key interest rate hikes. Its strategy seems to be maintaining faith in the view that inflation will eventually react to the labour market situation, without necessarily having to receive confirmation of this before initiating rate hikes. We have also seen examples of this type of pragmatism earlier. Before we know the outcome of the US inflation process, it is too early to determine whether the link between inflation and unemployment has changed.

Core inflation approaching 2 per cent in OECD

Year-on-year percentage change



Source: OECD

Does the current monetary policy framework risk creating new financial bubbles? After the 2008-09 financial crisis, policymakers began intensive efforts to improve the mechanisms for preventing financial bubbles and imbalances. The introduction of macroprudential supervision as a complement to monetary policy was one important element of this. Interest rate policy can focus more whole-heartedly on meeting the inflation target, which implies both risks and opportunities. So far we do not know how efficient macroprudential supervision is, at a time when monetary policy is assuming ever more extreme forms. Today there is already enough reason to discuss whether pricing in certain markets has reached unhealthy levels. **But generally speaking, equity and housing market valuations in major economies are not that alarming**. It is thus unlikely that risks of financial imbalances and bubbles will lead to any shift in the monetary policy framework during the next couple of years.

Would an adjustment in inflation target levels be helpful? In public discourse there are arguments for both raising and lowering inflation targets. The purpose of the latter would be to make it easier to achieve, thus reducing the need for extreme monetary stimulus, but it is difficult to argue theoretically that a given inflation level is easier to achieve than another. Central banks can hardly accept the existence of such a magic level. They also seem to perceive it as a loss of credibility to adjust their target based on the actual outcomes in recent years. The idea of raising the target to 4 per cent has been proposed by such observers as the IMF secretariat. The idea is to create greater monetary policy manoeuvring room during crises by making the zero lower bound on interest rates more distant. Higher inflation would also facilitate relative changes in prices and especially wages, thereby improving the functioning of the economy. The question of raising inflation targets will undoubtedly crop up again, but it is not such a hot topic in today's strongly disinflationary environment.

How will a possible change in frameworks formally occur? The question of inflation targeting and monetary stability is rather closely connected to the question of central bank independence. Being able to separate and distinguish one important element of economic policy from other targets creates an opportunity to draw a line between central banks and the political system. In some cases, it may appear as if central banks are being subjected to political pressures, but on the whole the independence of central banks enjoys wide acceptance. A change in the economic policy framework would thus have rather large political consequences, and it is not easy to see how such a change would be initiated during normal times. **It will probably be necessary for inflation targeting to generate another major international crisis before a change will be seriously considered**. This has also been true of earlier major changes at the global level.

The Riksbank can still take some steps

Our conclusion is thus that inflation targeting policy will continue to be questioned as long as inflation fails to take off and interest rates remain extremely low. **But at present there are hardly strong enough arguments to justify a major reassessment.** There is a shortage of clear ideas about how to design an alternative. In Sweden's case, this means that the Riksbank or Parliament should hardly expect any help with ideas from other countries when it comes to easing economic policy tensions. Within the framework of the current system, this will not prevent the Riksbank from taking the opportunity to change its approach and adopt a more relaxed attitude towards the inflation target in order not to be forced into increasingly dramatic actions whose effectiveness is also unclear. This may involve **reintroducing a tolerance interval** or announcing that the bank accepts the fact that **achieving the target will take more time**. It can also admit that there is an element of **goal conflict between its inflation target and the financial stability target**, at least in a situation where other policymakers are unable to act forcefully.

The Riksbank's main argument for not adopting this approach is that it actually sees significant dangers, since failure to achieve the target will lead to lower inflation expectations. But the question is whether this is actually so serious, since inflation is rising and long-term inflation expectations are not so far from 2 per cent. The Riksbank made such an interpretation earlier too, but then went on the defensive after being severely criticised in 2014 – mainly by unions and employer organisations, but also by financial market players and influential academics both in Sweden and abroad. **With a little perspective on this issue, their criticism seems rather lacking in nuance**, especially compared to the way the passivity of fiscal policymakers and macroprudential supervisors is viewed in public discourse. We can also compare this with the Fed's actions as it prepares to hike its key interest rate in a roughly similar inflation environment, but one with substantially smaller financial imbalances. It is possible that Mervyn King and Marvin Goodfriend's evaluation of the Riksbank, which will be published in January, will propose changes in this direction on at least some points, which may be the starting signal of a reform process.

Households show their economic clout

- **Strong domestic demand is offsetting weakness in manufacturing**
- **Unemployment will fall below equilibrium...**
- **...and speed up pay growth in 2016**
- **Low inflation will not stop the Fed from making cautious key interest rate hikes**

US manufacturers are being restrained by the rising dollar, combined with weak foreign demand. Low oil prices have also greatly impacted oil-related capital spending, and a shift in the inventory cycle hampered third quarter GDP growth. But we believe that the risk of a broad slowdown is small, since housing construction and private consumption are driving powerful domestic demand. Overall, we predict that **GDP will grow by 2.5 per cent this year, 2.9 per cent in 2016 and 2.6 per cent in 2017**. Despite a small downward revision for 2016 compared to the last *Nordic Outlook*, our main scenario is unchanged: **the economy will grow above trend** (just over 2 per cent) **and better than the consensus view for the next couple of years**. Several factors explain our basically optimistic forecast. Households are benefiting from the higher purchasing power provided by sagging oil prices, while demographic changes are contributing to a continued housing sector upswing. Fiscal policy will also contribute positively to growth, as Washington avoids a repeat of earlier debt ceiling standoffs. This year's growth headwinds will also gradually fade: this is true of both US dollar appreciation and the impact of oil price declines on capital spending. In addition, demand from emerging markets will strengthen somewhat in 2016 compared to 2015.

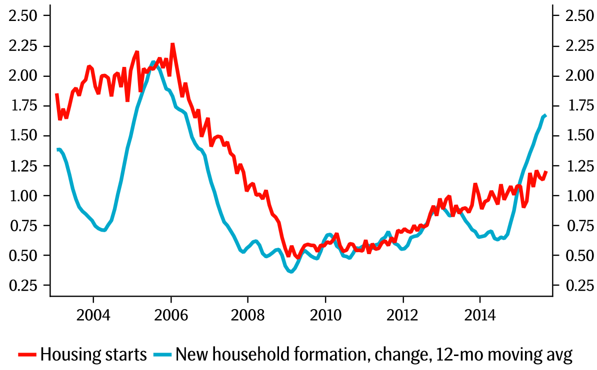
Unemployment is continuing to fall and we predict that **by the end of 2017 it will reach 4.2 per cent**. The tight labour market situation will help push up the rate of pay increases in 2016 and 2017 from a low level. A cautious normalisation of monetary policy can be launched; **the first key interest rate hike will already occur in December according to our forecasts**. By the end of 2017 the key rate will stand at 2.00 per cent, well above market pricing but still somewhat below our estimate of a neutral level.

Households have the power

Despite sputtering wage and salary growth, household consumption has climbed by more than 3 per cent (annualised) in five of the past six quarters. We have to go back to the 2005 credit boom and, before that, to the robust expansion of the 1990s to find equivalent strength. Petrol (gasoline) prices are falling towards a six-year low, boosting purchasing power and **setting the stage for a record-setting Christmas shopping season**. Lower petrol prices are also reflected in consumption patterns; the number of miles driven is increasing at its fastest rate since the 1980s, as car sales reach historic highs. Not since 2002 have there been two consecutive months of car sales as strong as in September and October. Leading consumer confidence indices provide somewhat conflicting signals but the big picture is that consumer confidence is back at pre-crisis levels. Consumption is mainly being driven by discretionary goods, a sign of confidence. **Overall, households will remain the most important driver of US economic growth**; consumption will grow by 3.1 per cent this year, by 2.7 per cent in 2016 and by 2.5 per cent in 2017, with an upside risk.

Fast growth in new households

Million



Source: Census Bureau, Macrobond, SEB

Hot construction market

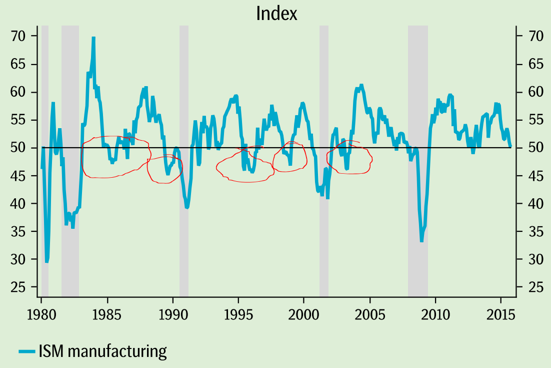
The housing market is the strongest-performing sector at the moment. Home sales are continuing to climb, along with mortgage loan applications and housing starts. Earlier this autumn, construction industry confidence reached its highest level since 2005. Historically, the housing market is the most cyclical part of the economy and the sector that rebounds first in the economic cycle. It is performing strongly even though the economic upturn has been under way for six years, which is an indication that the recovery is far from running out of steam. Underlying demand – expressed as the number of newly formed households – also points to a bright outlook; **a full 1.5 million is a reasonable forecast for 2015**, making it the highest figure since 2005. Housing starts are thus expected to climb sharply from today's levels. Residential investments, which have risen by an estimated 8.5 per cent this year, are expected to accelerate a bit further in 2016. **Next year, residential investments will increase by 9 per cent and in 2017 by 5.5 per cent, according to our forecasts**. Meanwhile the home price upturn has slowed to moderate figures, and **overheating risks are not imminent**. According to the Case-Shiller index, home prices are increasing at about 5 per cent year-on-year, and nominal home prices are still 14 per cent below their 2006 peak.

Manufacturing slump will not kill recovery

Manufacturing has slowed markedly, and confidence indicators in the sector are now showing neither expansion nor contraction. The oil price slide has severely impacted energy-related investments, but sub-contractors are also affected. The slowdown in major EM economies such as China and Brazil is limiting export sales, while a strong dollar is eroding international profits and competitiveness. After excessively rapid stock-building earlier this year, the inventory cycle has also contributed to slower growth.

ISM below 50 not equal to US recessions

Index



Source: ISM, NBER, SEB

The Institute for Supply Management (ISM) purchasing managers' index for the manufacturing sector is a dominant US economic indicator. This is partly due to its long history, but is mainly because manufacturing is often a leading indicator of domestic demand. At present, however, we see several reasons why the manufacturing slump will not pull down the US economy. First, **the role of manufacturing in the economy has been steadily shrinking**. In the 1950s, it accounted for 30 per cent of output, compared to 12 per cent today. This explains why manufacturing has been in recession on various occasions in recent decades while the economy has continued to grow (see the chart, where grey areas denote recessions). Historical associations indicate that the critical level when the ISM manufacturing index signals a recession for the whole economy is at 43. Our conclusion is that the risk of recession is low when domestic demand and especially household consumption are growing as rapidly as they are today.

Temporary dip for companies

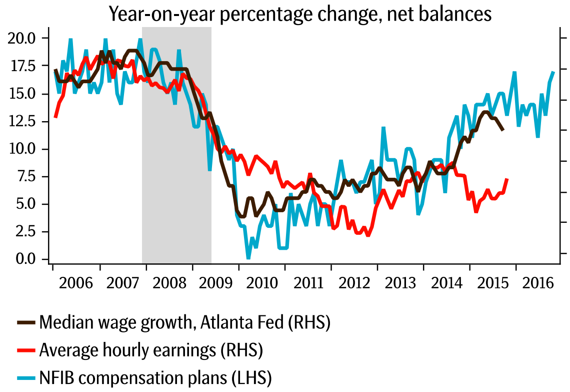
The weakness in manufacturing is offset by the strength of the service sector, and the gap between the ISM's manufacturing index and its service sector index is the second-widest on record. Our composite indicator for manufacturing and services points to yearly GDP growth of nearly 4 per cent. The dip affecting large manufacturing companies is also expected to be temporary. Next year, we foresee slightly stronger demand from developing economies again, while the dollar effect is expected to fade gradually. Although **some further strengthening of the USD is predicted in 2016, the pace of appreciation will be mild compared to 2015**. After large-scale stock reductions during the third quarter, inventories are also not expected to hold back growth; faster production for stock-building will be needed to meet demand. After several strong years, corporate earnings as a percentage of GDP are also close to historic highs for domestically oriented sectors, which suggests stronger capital spending growing ahead. Our overall assessment is that **business investments will grow by 3.7 per cent this year, accelerating to an average of 7.2 per cent in 2016-2017**. Short-term indicators such as order bookings point to weakness, however, and the risk in our capital spending forecast is on the downside.

Speedier wage and salary growth in 2016

After a couple of weak months, job growth rebounded in October. Growth as strong as last year, when monthly payroll growth averaged 260,000, can nevertheless not be expected in a situation where the labour market is close to equilibrium (non-accelerating inflation rate of unemployment, or NAIRU) and businesses find it harder to recruit. Employment will increase by an average of 200,000 per month this year and by 180,000 in 2016 and 2017. Such job growth figures will continue to push unemployment lower; **by the end of 2017 the jobless rate will be 4.2 per cent, according to our forecasts**. That level is also low in a historical perspective; in the two preceding economic cycles, unemployment bottomed out at 3.8 and 4.4 per cent, respectively.

Wage growth about to accelerate?

Year-on-year percentage change, net balances



Source: BLS, NFIB, Atlanta Fed, SEB

The tightness of the labour market is apparent from weekly statistics showing that the number of new job-seekers hit a 42-year low earlier this autumn. **The competitive situation is increasingly shifting to the advantage of employees**. This suggests that earnings growth will accelerate during the next couple of years, even though the tight labour market has so far had very little effect on wage formation. Average hourly earnings have shown yearly increases of around 2 per cent since 2011, but they grew at a clearly faster pace in October. They are expected to increase by 3.0 per cent in 2016 and 3.5 per cent in 2017. Indicators such as the compensation plans of small businesses also point to stronger earnings growth in the coming year. Meanwhile broader wage growth indicators like the Atlanta Fed's are already showing 3 per cent pay increases.

Stable core inflation

Inflation, which fell steeply last winter, remains just above zero, but in the next few months it will rebound as the oil price collapse vanishes from 12-month figures. Lower food prices and lagging USD effects will slow the inflation upturn **in 2016, when prices will rise by a modest 1.4 per cent according to our forecast**. We expect inflation of 2.1 per cent in 2017.

Meanwhile underlying inflation is showing a slightly upward trend. Core inflation excluding food and energy prices is now just below 2 per cent. Factors keeping core inflation higher include the trend towards renting homes; rents are rising at 3 per cent. Services are also **helping keep deflation risks small**; excluding energy, service prices are rising at a year-on-year rate of 2.7 per cent, the fastest since December 2008. **Core inflation will be 1.8 per cent both this year and next, and 2.1 per cent in 2017, our forecasts show**. For the Fed, core inflation is more important than headline inflation. Since inflation curve are pointing towards the Fed's 2 per cent target, it can normalise interest rate policy at a slow pace. Inflation expectations, which reached their lowest break-even levels since 2009 earlier this autumn, have also recently moved higher and are now consistent with the Fed's inflation target.

Less fiscal policy discord than usual

The recurring political tensions of recent years reflect the fundamentally chilly climate of cooperation in Congress. But this year, Democrats and Republicans have managed to avoid shooting themselves in the foot. **The debt ceiling issue**, which caused havoc in prior years, **was resolved painlessly this time around** and is not expected back on the agenda until the spring of 2017. Congress also approved a two-year budget that raises expenditure caps and will help **make fiscal policy slightly expansionary in 2016 and 2017**. The federal deficit will increase from 2.4 per cent of GDP in 2015 to 2.7 per cent in 2016, but the effects are expected to be so small – 0.2 per cent of GDP annually – that fiscal policy will have no direct impact on monetary policy. For President Barack Obama, who got nearly the entire budget increase he had requested, and for the new Speaker of the House, Paul Ryan, the budget decision was welcome. Ryan's popularity may possibly also open the door for a broader tax deal in 2016, but there is still a lingering risk that federal operations may be forced to shut down when the fiscal "continuing resolution" expires on December 11.

In the 2016 presidential race, betting organisations now view the conservative Senator Marco Rubio as the favourite among Republicans, followed by upstart candidate Donald Trump. Hillary Clinton will probably be the Democratic candidate; she is far ahead of challenger Bernie Sanders in the polls. This means that American voters are likely to face an ideological choice. While recent acts of terror may favour the Republican candidate, **by virtue of her experience, Clinton is the most likely winner**. But it is very unusual for the same party to hold on to the White House for three consecutive terms. The only time that has happened in recent decades is during the Reagan-Bush era in 1981-1993.

Fed will begin cautious normalisation

A combination of economic instability abroad – especially uncertainty concerning the seriousness of China's growth deceleration – and a tightening of financial conditions caused by this past summer's turbulence in financial markets gave the Fed reasons not to rock the boat at its September policy meeting. Instead the central bank has signalled that the first key interest rate hike will occur at its December meeting, which the market has also priced in after the extremely strong October employment report. Financial markets have also stabilised and worries about growth have receded, also suggesting a December rate hike. Another key factor is that fiscal policy will not trip up the recovery, since domestic economic forces seem robust. **Our forecast is that the Fed will raise its key rate in December to 0.25-0.50 per cent**. As for 2016 and 2017, our forecasts of the year-end key rate are 1.00 and 2.00 per cent, respectively. In historical terms, this is a cautious rate hiking pace, yet more aggressive than the market is now pricing in; at present, forward contracts are indicating 0.71 per cent at the end of 2016 and 1.16 per cent at the end of 2017. **But because of the dollar's sensitivity to interest rates, the risk in our key rate forecast is on the downside**.

Meanwhile some market players are sceptical that the Fed can begin interest rate normalisation at all – in a situation where other leading central banks are continuing to stimulate their economies – since wider key interest rate gaps risk driving up the dollar excessively. It is also now clear that the Fed is paying closer attention to financial conditions, including currency fluctuations. **But there are no formal obstacles to a combination of Fed key rate hikes and monetary easing abroad**. If, for example, the ECB increases its stimulus measures this will lead to stronger growth in both the euro zone and the US, according to the IMF's big macroeconomic model. The US is a relatively closed economy, resulting in small expected adverse exchange rate effects in this type of models. As far as the Fed is concerned, it is also advantageous that other central banks will continue the global deflation war while the global economy benefits from lower international interest rates and rising asset values. So provided that the dollar does not appreciate uncontrollably, and more than our exchange rate forecasts indicate, **our assessment is that further monetary policy easing abroad will not stop the Fed**.

The Fed's balance sheet, which levelled out at USD 4.5 trillion this year and is thus already falling in relation to the size of the economy, will continue its downward trend in 2016 and 2017. According to the central bank's normalisation principles, rollovers of maturing securities in the government bond portfolio will cease once rate hikes have begun. In 2016 and 2017, this applies to maturities of USD 215 and 194 billion, respectively. **By the end of our forecast period, the Fed's balance sheet will total 21.5 per cent of GDP** according to our estimates, compared to 25 per cent today.

Export-led growth strategy is battling headwinds

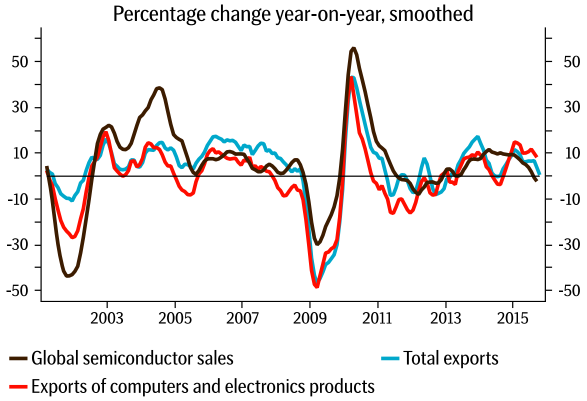
- **Growth slump paves way for new stimulus**
- **Exports struggling, no investment surge**
- **Resilient domestic economy**

The Japanese economy has again lost momentum. GDP declined further in the third quarter, compared to Q2. The government is expected to launch yet another fiscal stimulus programme, though modest in size (just over JPY 3 trillion or 0.6 per cent of GDP) compared to earlier packages. Due to disappointingly low inflation, the Bank of Japan (BoJ) remains under pressure to expand its stimulus. We have revised our GDP growth forecast 0.2 points lower for each year from 2015 to 2017: to **0.6 per cent, then 1.1 and 0.8 per cent** – but still above the long-term trend of some 0.5 per cent. Economic policies have relied on hopes of a positive spiral: a competitive yen helping exports and boosting corporate earnings, in turn spilling over into rising capital spending, higher pay and more consumption. That strategy is battling various headwinds.

China's deceleration and change of growth model have led to new setbacks for Japan's foreign trade, both directly and via effects on trade with other parts of Asia. China alone buys 18 per cent of exports, equivalent to 2.7 per cent of GDP. Weak manufacturing and lower capital spending in emerging Asia are especially harmful to exports of investment goods, in which Japan has a strong position. Generally weak global demand for IT-related products has contributed to poor exports from Japan and other Asian countries this year, but our scenario of a soft landing in China and strong US growth should allow an export recovery ahead.

Soft IT demand contributes to weak exports

Percentage change year-on-year, smoothed



Source: Ministry of Finance, local and global industry associations

Hopes that high and rising profits would help kick-start capital spending have not materialised either, even though corporate profitability is now back at pre-crisis levels and companies have remained fairly confident, according to the BoJ's quarterly Tankan survey. Business investments are also increasingly being made outside Japan. While total business investments have stagnated since the crisis, capital spending abroad has risen to about one fourth of overall volume. Exports thus also encounter structural obstacles. Due to relocation of factories to low-cost Asian countries, a growing share of sales to other countries occur from units abroad. A more competitive yen and a less uncertain electricity supply – once nuclear power production resumes – may slow the relocation trend. Yet the challenges of shrinking population and weak underlying domestic growth will remain. Structural reforms may potentially boost productivity but are moving sluggishly. Successfully increasing labour force participation by women and older people will not suffice to solve the labour shortage. Female participation, for example, is already at the US level.

Yet there are also economic bright spots. Good momentum in domestic services and construction – helped by the 2020 Olympics – maintained the demand for labour during the latest slump. We expect unemployment to level out around 3.3 per cent. **The tight labour market has not yet pushed up wages and salaries, but real incomes are increasing due to low energy prices**. Private consumption shrank during Q2 but now seems to have resumed a cautiously rising trend. While total inflation has fallen due to renewed energy price declines, core inflation is trending upward. Excluding energy and food prices, it is just below 1.0 per cent. Aside from temporary effects because of tax hikes, this is the highest core inflation since the mid-1990s. **Total inflation will creep up from 0.8 per cent this year to 0.9 per cent in 2017** and remain below the BoJ's 2 per cent target throughout the period. Combined with falling inflation expectations, this will **persuade the BoJ to stimulate the economy more** by expanding its existing asset purchase programme from JPY 80 trillion a year to JPY 90-100 trillion, most likely in April 2016, ahead of the upper house election in July. This will further weaken the yen to 127 per USD in December 2016.

Crucial to Japan's growth profile in the next couple of years is whether the government implements its plans to raise the consumption tax one more time to 10 per cent in April 2017. We have assumed that this hike will again be postponed, in light of the large negative impact of the 2014 tax hike. In the long term, however, steps to slow the unsustainable build-up of public sector debt will still be necessary.

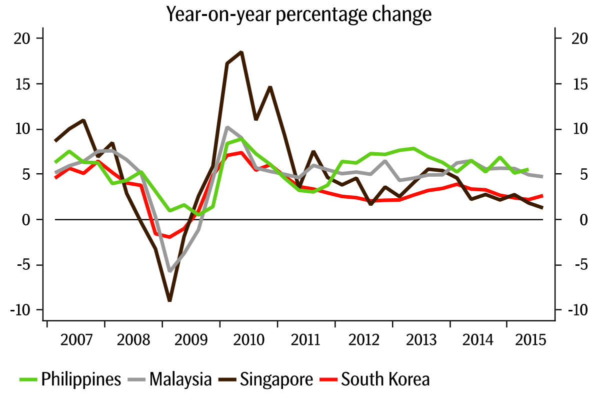
Decent growth, but China's deceleration will continue

- **Economic growth is stabilising**
- **China: Increased mistrust of GDP figures**
- **India: Slow going for growth-boosting reforms**

Asian emerging market (EM) economies are under continued pressure. Growth remains considerably lower than before the financial crisis. Export performance is still weak. These problems are greatest for commodity-exporting economies like Indonesia and Malaysia, but weak external demand is being offset by good domestic demand and loose monetary policies. Non-commodity-exporting countries are benefiting from renewed price declines, especially for energy. **We expect GDP growth to stabilise or to accelerate cautiously during the next couple of years** in most of the region's economies, though with China as an important exception.

GDP growth has stabilised

Year-on-year percentage change



Source: National statistical offices

Inflation pressure remains historically low and inflation in some economies is now close to or below zero. Inflation will rebound in most countries during 2016 as last year's sharp drop in oil prices fades from the statistics. Monetary policies will remain loose in 2016-2017. Aside from China and India, we expect the central banks in South Korea, Thailand and elsewhere to continue cutting their key interest rates in 2016.

After this past summer's financial market turmoil – mainly driven by increased uncertainty about the Chinese economy – equities and currencies have recovered but are generally lower than at the start of 2015. **The US Federal Reserve's coming interest rate hikes may lead to turbulence**, but not to the same extent as in the summer of 2013. Individual economies with current account deficits (Indonesia) or large-scale USD borrowing (Malaysia) may suffer noticeable effects.

China: More uncertainty but no hard landing

In the third quarter, Chinese GDP rose by 6.9 per cent year-on-year. This was higher than expected but still the slowest growth since the first quarter of 2009. Scepticism about official GDP statistics has increased even further in recent quarters. Many other indicators – such as purchasing managers' indices, industrial production, exports, imports and capital spending – suggest that the economy has decelerated more than the 2015 GDP figures indicate, and this has contributed greatly to financial market instability. Meanwhile the latest figures show that economic activity is stabilising rather than collapsing, among other things aided by more accommodative economic policies that have been implemented or are being planned.

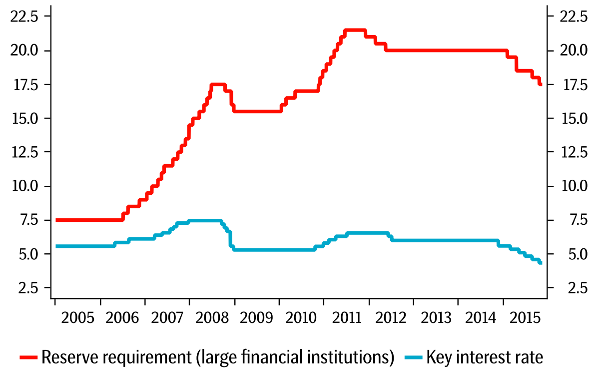
Actual GDP growth is likely to be well below what China's official figure shows. It is naturally difficult to determine how high growth is. Various observers have ventured estimates far below the official level, but our own assessment is not so dramatic. Growth is generally weighed down by weak manufacturing performance, while services and retail sales are doing substantially better. One risk is that service sector performance will be underestimated due to measuring difficulties, for example due to the sharp increase in online sales. An important aspect is that growth deceleration is a key element in official ambitions to shift to a model with lower but more balanced growth. GDP statistics show that the service sector grew significantly faster than the manufacturing sector in the third quarter, which is in line with more consumer-driven growth. Overall, we expect gradual deceleration to continue and believe that China can avoid a hard landing. **In 2015, we expect GDP to increase by 6.9 per cent.** Growth will slow to **6.5 per cent in 2016** and to **6.3 per cent in 2017**.

Inflation pressure remains low: in October, CPI inflation was 1.3 per cent. Because food represents a large share of the CPI basket, food prices have a major impact and contribute to large month-to-month fluctuations. Most indications are that underlying price pressure will gradually increase and that **China will avoid deflation**; inflation is expected to accelerate in the new few months as last year's sharp drop in oil prices disappears from the statistics. Measured as a full-year average, **inflation will be 1.5 per cent in 2015. Next year inflation will accelerate to 2.0 per cent, and in 2017 to 2.5 per cent.**

Late in October, the People's Bank of China lowered its key interest rate by 25 basis points to 4.35 per cent: the fifth rate cut this year. The bank reserve requirement was also lowered. The central bank's ambition is to implement a gradual but clear easing of monetary policy. If it maintains the same frequency as in recent months, there is room for one further cut in the key rate and the reserve requirement before year-end. This easing will continue next year, and **we believe the key rate will stand at 3.85 per cent by the end of 2016**.

Plenty of room for easing

Per cent



Source: People's Bank of China

Late in October, the Central Committee of the Communist Party discussed **the five-year plan for 2016-2020**. It will be approved and announced at the National People's Congress in March 2016. Most indications are that economic reforms will continue and that this summer's clumsy official interventions in the stock market and currency policy change should not be interpreted as a deliberate shift in reform policies. One important element of China's five-year plans is the economic growth target. During 2010-2015 this target was 7.0 per cent. The Central Committee has stated that the target should be "medium-high to high" growth during the coming five-year period. One interpretation of this statement is that the target will be lowered to 6.5 per cent in 2016-2020. The October meeting also decided that the one-child policy will be completely abandoned, and the ceiling on bank deposit rates will be removed. Both reforms are steps in the right direction, but their near-term economic effects will be small.

After the August devaluation, the yuan has recovered a bit. The short-term focus of currency policy is on stability in the run-up to the IMF's decision on whether to start including the yuan in its Special Drawing Rights (SDR), a basket of reserve currencies. Looking a bit further ahead, growth deceleration and looser monetary policy will lead to a depreciation of the yuan. We expect a **CNY/USD exchange rate of 6.70 at the end of 2016 and 6.40 at the end of 2017**.

India: Reforms facing continued obstacles

Second quarter GDP growth in India decelerated to 7.0 per cent year-on-year from 7.5 per cent in Q1. Purchasing managers' indices are well below historical averages, and consumer confidence has deteriorated. Exports and imports have weakened further. Car sales indicate that household demand remains subdued. Capital spending has stagnated and is being held back by heavy corporate debt.

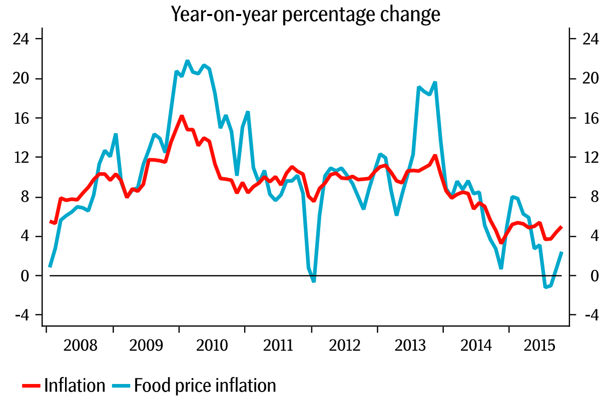
Yet at the same time, various factors are making India a bright spot among emerging markets. Inflation has fallen steeply and India's budget and current account deficits have declined sharply. These improvements are reflected in the performance of both the rupee and the stock market, which have easily outperformed most other EM economies. Smaller deficits, combined with substantially lower inflation, have allowed more expansionary monetary and fiscal policies that will help accelerate future growth. **We expect India's GDP to increase by 7.5 per cent in 2015**. Growth will accelerate cautiously to **7.8 per cent in 2016** and to **8.0 per cent in 2017**. The **risks are on the downside**.

But looking ahead, it is doubtful that India can achieve even faster growth. It is **becoming less and less likely that the Narendra Modi government will succeed in implementing the reforms that could lift growth above 8 per cent**. Three steps are crucial in order to boost GDP growth: implementing a national sales tax, loosening restrictive labour market legislation and reforming land purchase laws. In all three cases, the outlook for clear breakthroughs is small. Modi's BJP party lacks a majority in the upper house, and the Congress Party together with other opposition parties has stopped these reforms by defeating the necessary changes in legislation.

Both inflation and inflation expectations have fallen greatly in the past two years. In October, the CPI inflation rate was 5.0 per cent. We expect full-year **average inflation of 5.0 per cent in 2015, 5.3 per cent in 2016 and 5.5 per cent in 2017**. Low inflation pressure has allowed room for continued monetary policy easing, and in late September the Reserve Bank of India lowered its key interest rate by 50 points to 6.75 per cent. This was its fourth rate cut during 2015. We believe that the **RBI will continue to lower its key rate. At the end of 2016, the key rate will be 6.25 per cent.**

Inflation has slowed greatly

Year-on-year percentage change



Source: Indian Ministry of Statistics and Programme Implementation

The **rupee** demonstrated good resilience during the China-driven market turmoil this past August, and it has performed substantially better than most EM currencies during 2015. It has weakened by a few per cent against the USD this year. We expect the rupee to weaken as a consequence of the Fed's initial rate hikes but it will stabilise later in the hiking cycle and then appreciate, sustained by good economic fundamentals. **We expect an INR/USD exchange rate of 68.0 at the end of 2016 and 66.0 at the end of 2017**.

- **Commodity exporters suffer biggest adverse effect**
- **The world economy can manage a gradual deceleration in Chinese growth...**
- **...but China's importance continues to grow over time and risks will increase**

One key factor behind last summer's financial market turbulence was concern about events in China. The country's management of its stock market slide and sudden change in currency policy were important factors, but the biggest source of worries is China's growth deceleration. This uncertainty has been reinforced by increasing scepticism about official GDP statistics, with actual GDP growth probably significantly lower. SEB's assessment is that **China can avoid a hard landing** but that growth will continue to decelerate during the next couple of years and will end up at just above 6 per cent in 2017.

The financial market turbulence in August showed that there is a connection between the market's sentiment and assessment of Chinese economic performance. One question, however, is whether the adverse effects of the country's growth deceleration on the rest of the world economy are sufficiently large to justify the market's occasionally forceful reactions. For example, China's transition from a growth model based on government investments and exports to a model featuring slower consumption-driven growth will – in various ways – create both direct and indirect winners in other countries.

China accounts for some **17 per cent of global GDP** in terms of purchasing power parities (PPP). With expected growth of around 7 per cent, China thus contributes just over one percentage point to global growth. As recently as 2010, the Chinese economy was growing by more than 10 per cent annually. It is thus possible to argue that the biggest deceleration is past, as long as our assumption that China will avoid a hard landing proves correct. On the other hand, despite its continued deceleration China is still expected to be one of the world's fastest-growing economies. In the future it **will thus become increasingly important to global growth**. There are numerous links between China's performance and world economic growth. The following is a review of the most important such links.

Lower Chinese imports

One result of China's growth deceleration is lower imports. Countries that send a sizeable share of their direct exports to China thus risk being adversely affected. The volume of trade between two countries or regions is largely determined by geographic distances. Exports to China consequently account for a small share of both European and US trade, while a large proportion of Japan's exports end up in China. When exports are compared to the size of the exporting countries – expressed as a percentage of GDP – this reinforces the impression that **neither Europe nor the US is especially dependent on China**. Yet because of its large-scale commodity imports, export-driven and commodity-exporting economies in its vicinity – such as Australia and Malaysia – are clearly dependent on China's imports. In Europe, Germany stands out because a relatively large proportion of its GDP depends on large-scale exports of machinery and vehicle parts.

Exports to China

	Percentage of total exports	Percentage of GDP
Australia	33.7	5.6
France	3.7	0.7
Germany	5.8	2.1
Japan	18.3	2.7
Sweden	3.3	0.9
United Kingdom	3.5	0.5
United States	7.6	0.7
Brazil	18.0	1.7
India	4.2	0.6
Malaysia	12.0	8.6

Source: IMF, SEB

Downward pressure on commodity prices

Most of China's growth deceleration is attributable to weak performance in heavy industry and the construction sector. Both sectors are commodity-intensive. Since China is the world's largest importer of numerous commodities, this deceleration is one important reason behind the commodity price declines. Falling commodity prices have a net positive effect on long-term global growth. Lower commodity prices help sustain demand by boosting the purchasing power of lower-income households, which consume a larger proportion of their disposable income. But at present this positive effect is expected to be relatively limited.

In commodity producer countries, the impact of these price declines may be highly negative. For example, current oil prices are far below the levels needed to enable most oil-exporting countries to balance their government budgets. An oil price of more than USD 100 per barrel is needed by Saudi Arabia to balance its budget. Although **lower commodity prices** have a **net positive effect on global growth**, they meanwhile have a **sharply negative impact on individual countries**. This may affect the stability of the world economy.

Downward pressure on global inflation

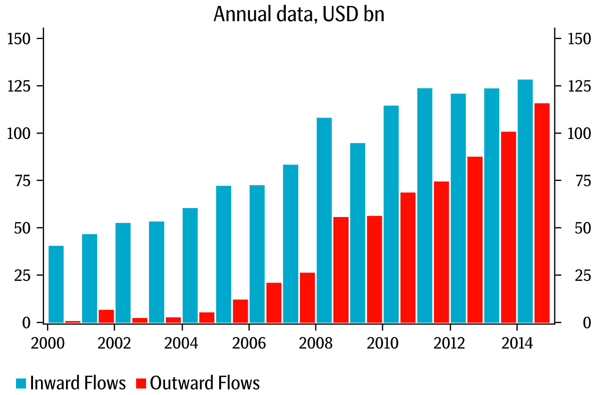
China's influence on commodity prices may also have an impact on global inflation. Sharper deceleration would risk squeezing already historically low inflation by pushing down commodity prices further. Another channel through which China can influence international inflation is devaluation of the yuan, which would result in lower import prices for China's trade partners. In both cases, the effects would probably be relatively small. China's influence on the commodities that are most important to consumer prices – oil and food prices – is considerably less than on industrial metals. For most of the world's advanced economies, the share of imports from China is limited and it would thus require a powerful devaluation of the yuan to achieve a sizeable effect on global inflation.

Direct investments and financial links

China is an important country for both outflows and inflows of direct investments. Rapid deceleration would thus have a dampening effect on global growth, but inflows of foreign direct investments to China would probably be more affected than investments of Chinese companies abroad.

Inflows and outflows of FDI are increasing quickly

Annual data, USD bn



Source: UNCTAD

Because of its relatively closed capital account balance and state-owned banks, China's **financial links with other countries are still limited**. Its financial system is shielded from the rest of the world. In general, the banking sectors of major economies are not especially exposed to China; both lending and portfolio investments are small. One exception is the United Kingdom, but most of its exposure is to Hong Kong rather than to mainland China. China's currency reserve includes a large proportion of US government securities. In spite of this, the connection between Chinese demand and American bond yields is weak. The surplus in China's current account balance has already decreased greatly without resulting in any clear upward pressure on yields.

Geopolitical tensions

The steadily increasing economic importance of China is also having geopolitical effects in the form of **rising tensions with neighbouring countries**. This is most obvious in **the South China Sea**. Because of large-scale gas and oil reserves, combined with one of the world's most significant maritime transport routes, the South China Sea is very important to the global economy. In recent years, China has become much more aggressive and has ramped up its rhetoric against the US, which so far has been the guarantor of security policy stability in the region. Despite relatively weak real links between the Chinese and American economies, there is thus a clear and increasingly significant political interaction. A serious conflict between China and the US is unlikely. Meanwhile the increasing number of incidents in the South China Sea region represents an **escalating risk of limited conflict between China and one or more of the countries in the region**.

Another example of how China's growing influence will have a geopolitical impact is in its relations with Russia. The two countries are working together in the New Development Bank, as well as through agreements on Russian gas deliveries and currency swaps. At the same time, China and Russia are competing for geopolitical influence in Central Asia. There is a significant risk that relations will be dominated by competition rather than cooperation.

China's future choices about how to manage its relations with other countries will have a clear impact on economic developments both in its immediate vicinity and globally. Although China has assumed a more assertive tone in recent years, **its general strategy still focuses on economic development and cooperation** with other countries rather than on military ambitions. But this might change if an economic hard landing leads to social unrest and if the government responds to this with increased nationalism. More aggressive behaviour would increase instability in China's vicinity and have an adverse impact on growth due to deteriorating sentiment and reduced investments in the region.

Both losers and winners

Countries that are clearly being negatively affected by China's growth deceleration are commodity exporters, especially economies in China's vicinity such as Malaysia and Australia. Because of its geographic proximity, Japan is also dependent on developments in China. We believe **that Europe and the US will be resilient to Chinese deceleration**. Some economies are also benefiting from it. For example, both India and Central European countries such as Poland are net importers of commodities, while their direct links with China through trade and investments are small. Rapidly rising Chinese wages are creating opportunities for low-wage countries like Vietnam to take over labour-intensive production, while countries like South Korea will be exposed to stiffer competition as Chinese companies move upward on the value chain.

Overall, we believe that a scenario of **gradual deceleration in China will have negative but manageable effects on the world economy**. Meanwhile, despite its deceleration, China will continue to increase in importance to the global economy. Because of increased financial integration, imbalances in China's financial sector may also have an impact on other countries in the future.

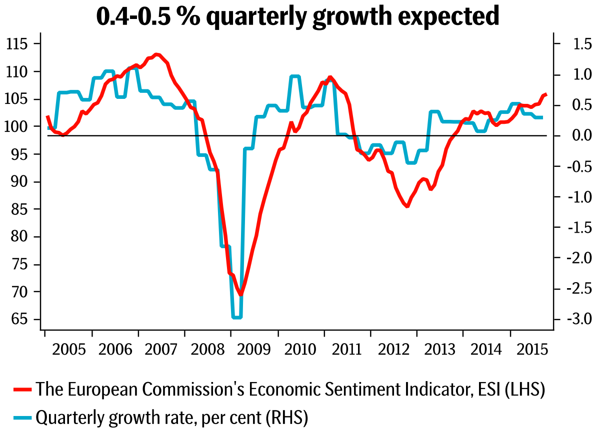
A hard landing might have consequences that are difficult to foresee. Commodity prices would end up under heavy pressure, which could lead to greater instability. A rapid deceleration could also impact the Chinese labour market and cause social unrest. Such a scenario would create a risk that China, like Russia, would try to counter popular discontent with increased nationalism and an aggressive foreign policy.

Recovery without a real growth surge

- **Economic growth will accelerate somewhat**
- **Continued good consumption growth**
- **The ECB will expand its asset purchases and lower the deposit rate**
- **The refugee crisis is more political and humanitarian than economic and financial**

The euro zone economy continues to move in the right direction but considering the large downturns during the crisis years and the level of economic slack, it is happening slowly. Indicators signal **quarterly growth of 0.4-0.5 per cent for the region as a whole**, with exports and consumption as the most important drivers. Germany is showing continued stable growth, while Spain's recovery has intensified. France and Italy are also seeing positive development. Decent global economic conditions, continued low inflation and **expansionary European Central Bank (ECB) policies will stimulate the economy**. We also expect the ECB to expand its monthly asset purchases by EUR 10-20 billion to EUR 70-80 billion in December and lower its deposit rate by 10 basis points to -0.30 per cent. **Euro zone GDP will grow 1.5 per cent in 2015, 2.0 per cent in 2016 and 2.1 per cent in 2017, but not without risks**. Cyclical portions of the economy, especially capital spending, continue to lag behind. Meanwhile political developments in the region are a constant source of concern.

0.4-0.5 % quarterly growth expected



Source: Eurostat, European Commission

Although the economic situation has stabilised and some of the crisis-hit countries are showing decent recovery, **the region continues to grapple with cooperation problems and long-term challenges**. Follow-ups of crisis programmes for bailed-out countries and the current refugee disaster clearly show that the euro zone consists of 19 countries with different policies and priorities. Even when solutions are achieved, this occurs after gruelling negotiations, contributing to political uncertainty. The refugee crisis shows how the approaches of various countries are challenging fundamental elements of the European Union, such as open borders. The border issue has been put further in focus after the recent terrorist attacks in Paris. There is thus greater doubt than for a long time about what direction EU cooperation is taking: towards more integration or less. This is especially true of the United Kingdom's role in Europe and the risks that the country will leave the EU.

Euro zone public sector debt is high but poses no acute problems now, due to low interest rates. ECB measures have helped even an indebted country like Italy achieve near-zero sovereign bond yields on maturities up to two years. Yet there is little room for stimulus; **fiscal policies will be largely neutral in 2016-2017**. For the region as a whole, the impact of the refugee crisis on public finances is relatively small, raising deficits by 0.1-0.2 per cent of GDP. In countries like Germany, the impact will be a bit larger but still manageable. In the short term, increased costs for refugee services will provide a positive GDP effect of about 0.1-0.2 per cent connected to near-term increases in public spending. After that, the effect will depend on how rapidly the new arrivals join the labour market. **The challenges of the refugee crisis to the euro zone as a whole are thus more political than economic**.

GDP forecasts

Year-on-year percentage change

	2014	2015	2016	2017
Germany	1.6	1.5	2.1	2.1
France	0.2	1.2	1.7	1.7
Italy	-0.4	0.7	1.2	1.3
Spain	1.8	3.2	3.2	3.0
Greece	0.7	-1.5	-1.5	3.0
Portugal	0.7	1.7	2.0	2.2
Ireland	5.2	6.0	4.5	3.5
GIPS countries	2.0	2.8	2.7	3.0
Euro zone	**0.9**	**1.5**	**2.0**	**2.1**

Source: Eurostat, SEB

Stable indicators and rising exports

For the region as a whole, indicators have been relatively stable since last spring. Purchasing managers' indices have been around 54, and during the same period the European Commission's **ESI** index has risen slightly and **in October**

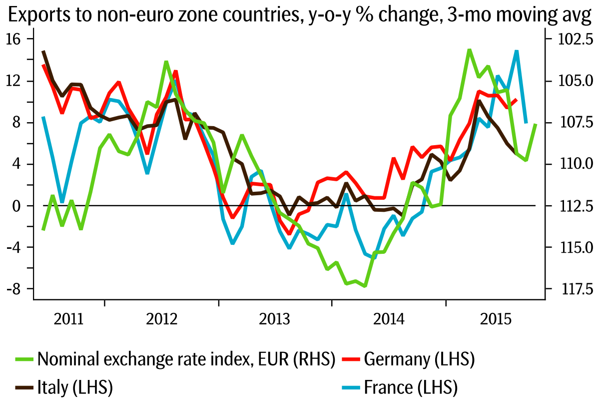
reached its highest level since mid-2011. The outlook nevertheless varies within the region and between economic sectors. Of the four largest euro zone countries, Germany and Italy are close to the region's overall figure while France is lagging. Spain, which has shown good growth this year, has lost some ground recently. Services and retailing are the main sectors that are pulling composite sentiment indices higher, while the outlook in manufacturing and especially in construction is worse. Yet industrial production improved in the latest quarter. This inspires some hope after a couple of years of falling or weakly rising output. We thus expect **some further acceleration in industrial production** late in 2015.

Volkswagen's emission test manipulation is creating question marks. Since several brands in the VW family are affected and they are produced in many countries, the issue is not limited to Germany. It is too early to draw any definitive conclusions, but by all indications the impact on economic growth and the damage to Germany's industrial brand will be minor. Although trust issues may lower VW sales and lead to less capital spending, customers can switch to other German or European brands. The need for repairs to millions of cars will also generate extra demand for components to fix these problems.

Exports have also taken off and their growth rate has gradually improved this past year. Improved world economic conditions and a weaker euro will continue to provide support, a fact that is being confirmed by order bookings. **But one source of uncertainty is the international manufacturing trend**, plus slower growth in China and other EM economies. Exports of consumer goods and services are expected to grow faster than those of more traditional industrial goods. In recent years, consumer products have become a more vital element of exports, partly at the expense of capital goods. International demand will enable consumer goods to gain ground, although capital goods exports have also recently rebounded.

Weaker euro is bolstering exports

Exports to non-euro zone countries, y-o-y % change, 3-mo moving avg

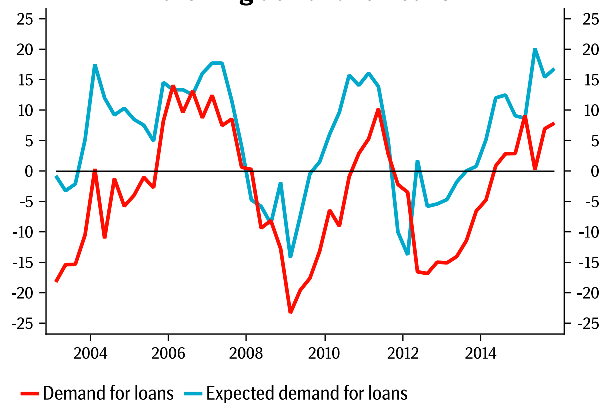


Source: ECB, Eurostat

Capital spending will rise from a low level

Low demand and a shortage of optimism have contributed to weak capital spending. This is one important reason why the recovery has not really taken off. Pre-crisis overinvestments in such areas as housing partly explain this sluggishness. Total capital spending is 15 per cent lower than in 2008. As a share of GDP, it has fallen by 5 percentage points since 2007-2008. Although we expect no sharp upturn in the near term, **capital spending will now increase on a somewhat broader basis**. A gradually brighter outlook, combined with a long period of low fixed investments and relatively high capacity utilisation, suggest that **the upturn in capital spending may gain somewhat more momentum in the next couple of years**.

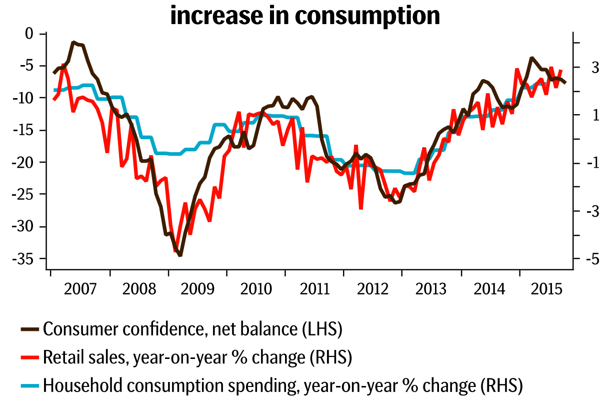
Growing demand for loans



Source: ECB Bank Lending Survey

Bank lending is also increasing, though weakly. Demand for loans is rising, according to the ECB's survey. The improved outlook is reflected especially in the high level of expected demand for loans. Although the demand side is strengthening, **the banking sector is still struggling with bad loans**, especially in southern Europe. This is why it is hesitant about letting balance sheets grow. Statsitics show a continued fragmented trend on the lending side. Even in Spain, which is showing a good general economic recovery, overall lending portfolios are shrinking. Financial conditions have eased recently as the euro has weakened and will continue to do so.

High consumer confidence and continued good increase in consumption



Source: Eurostat, European Commission

Consumption an important growth engine

Consumption is becoming an increasingly important growth engine. Various forces are now driving the economy in a positive direction. Retail sales suggest continued decent growth and car registrations are rising by about 10 per cent yearly, a sign of strong optimism. Continued job growth, low interest rates and low inflation will help expand the room for consumption despite low nominal pay increases. The savings ratio is expected to remain stable at the level established in recent years. We thus expect increased earnings to be used to restore previous cuts in consumption. **Consumption will increase by almost 2 per cent a year in 2016 and 2017**.

The labour market is improving, but slowly

In September, euro zone unemployment fell to 10.8 per cent – down 1.3 points since it peaked in spring 2013. The downturn is broad-based, but jobless levels and the pace of the downturn vary greatly. Spain and Portugal stand out with relatively sharp downturns. Germany continues to have a strong labour market, but unemployment is now expected to level out at a historically low 4.5 per cent or so. Above-trend growth suggests continued job creation. Partly as a result, **euro zone unemployment will fall from 11.0 per cent in 2015, 10.6 per cent in 2016 and 10.2 per cent in 2017**. We estimate equilibrium unemployment to around 9 per cent – at the end of 2017 there will still be idle capacity. The refugee flow to Europe represents a major uncertainty factor, however. This includes uncertainty about how many people will be able to stay, and how quickly they can enter the labour force and become employable.

Inflation is climbing, but well below target

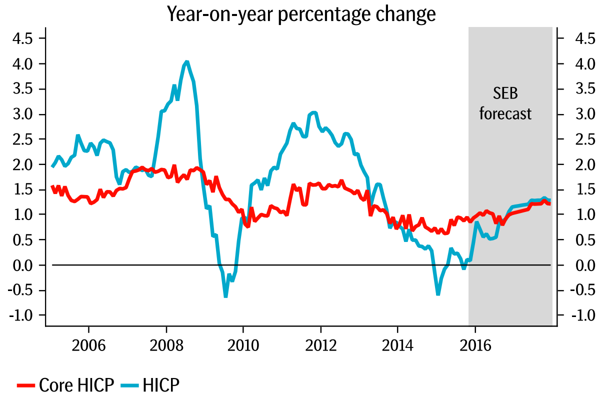
Inflation remains low. For example in Spain, which is showing a good recovery in the real economy, prices are still falling. **Inflation will continue to be squeezed** – among other things due to persistently low pay increases. The rate of pay hikes in the euro zone as a whole is now around 1.5 per cent a year, and in the GIIPS countries just above zero. The inflation rate will rise somewhat as the effect of falling oil prices disappears from comparative figures. The weak euro, about 10 per cent below its 2014 level in trade-weighted terms, will also impact inflation. The ECB's rule of thumb implies that this trend will boost inflation by about 0.5 percentage points, but we believe the effect will be smaller as weak demand and tough global competition make it hard for companies to raise prices. Overall, we expect the Harmonised Index of Consumer Prices (HICP) to climb to **0.8 per cent in 2016 and 1.3 per cent in 2017**. Inflation will thus remain at an uncomfortably low level for the ECB. The pressure on the ECB to continue defnding the credibility of its inflation target (just below 2 per cent) is illustrated by long-term market-based inflation expectations, which have fallen to 1 per cent (in a 5-year perspective).

Further ECB stimulus measures

The ECB and its president, Mario Draghi, gave unexpectedly clear signals at their last policy meeting. **Further loosening is thus very likely**. The ECB is worried about EM weakness, low inflation expectations and risks of an undesirably strong euro. It is rather surprising that the ECB foresees greater downside risks to growth, in view of relatively strong domestic demand, but growth is rebounding from a low level and unemployment remains very high. We also see several strong reasons for further stimulus. The dollar has appreciated, but the ECB wants to ensure a continued weak euro in order to boost exports and inflation. This will be especially important if the Fed should again soften its policy and abstain from a rate hike in December, for example. The financial risks of monetary expansion are small. The ECB wants to ensure that euro zone interest rates and yields remain low and that any USD upturn when the Fed begins rate hikes will not spread to the euro zone. Inflation is rising, but wage pressure is low and we believe that underlying inflation pressure is weak. HICP and core HICP will rise no further than 1.2-1.3 per cent by late 2017. Our inflation forecast is above consensus and ECB forecasts. We expect to see downward revisions by other forecasters.

Low inflation pressure – unchanged prices in 2015

Year-on-year percentage change



Source: Eurostat, SEB

There are several ways to achieve more stimulus:

1. Cut interest rates. The main purpose of rate cutting is to weaken the euro, but cutting the deposit rate may increase costs to banks participating in targeted long-term financing operations (TLTRO). A lower deposit rate expands the bond supply available to the ECB, since purchases are made only at yields above the deposit rate. Yet a deposit rate cut would also push down market rates, partly offsetting this effect.

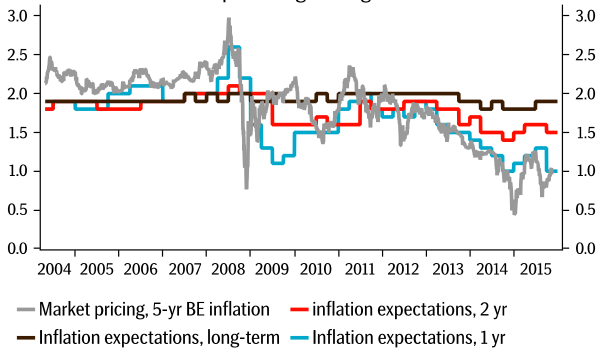
2. Expand monthly purchases. This is the easiest alternative, probably combined with statements that total purchase volume will expand compared to the existing programme.

3. Extend the programme. The ECB has said that asset purchases will continue until the end of September 2016 or as long as necessary but can be more explicit that no end-date exist.

We regard a combination of 1 and 2 as the most likely: **cutting the deposit rate by 10 points to -0.30 per cent and expanding monthly purchases to EUR 70-80 billion**.

Low inflation expectations a problem for the ECB

Market and forecasters' inflation expectations, year-on-year percentage change



Source: Bloomberg, ECB

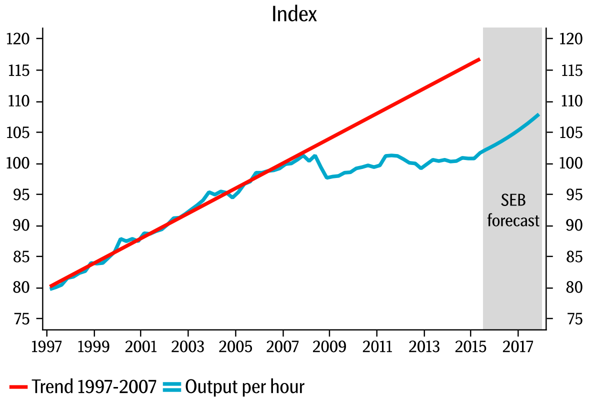
Low unemployment will drive wages and salaries higher

- **Productivity an increasingly important growth factor**
- **Low inflation, but no danger of deflation**
- **Bank of England will hold off for longer**

The summer's financial market turbulence and global growth jitters are not expected to have a lasting impact on the British economy. **GDP will climb by a stable 2.4 per cent in 2015, 2.5 per cent in 2016 and 2.6 per cent in 2017** despite fiscal headwinds. Compared to the consensus, our divergence is greatest in 2017 – when an optimistic view of rebounding productivity pushes up our growth forecast. The UK will barely avoid falling prices in 2015. **Inflation will average 0.1 per cent this year, 0.6 per cent in 2016 and 1.4 per cent in 2017**, well below consensus. An ever-tighter labour market, with unemployment that has fallen below equilibrium, is instead providing the Bank of England (BoE) with arguments for gradual interest rate normalisation. **The first key rate hike will occur in August 2016** according to our forecasts. Forward contract pricing suggests that the first hike will be delayed until a couple of quarters later. By the end of our forecast period, the most important key interest rate will stand at 1.50 per cent.

Time for a recovery in productivity growth

Index



Source: Office for National Statistics, SEB

The steep fall in unemployment during the past few years is slowing. **By the end of 2017, the jobless rate will be at 4.7 per cent**: half a point below today's level and matching the bottom level in the last economic cycle. Low unemployment will limit supply-side growth, and job growth will decelerate from a 25-year high in 2014. After several years of treading water, a productivity rebound is now in sight. This trend will persist, and **productivity growth will gradually take over as the main engine of the recovery**. Due to high resource utilisation, there will be continued robust pay growth; earnings are currently rising at a 3 per cent annual rate, both in real and nominal terms. Productivity will ease the inflationary pressure from pay hikes, but inflation will still gradually climb during the coming year as base effects from earlier petrol and oil price declines vanish from 12-month figures and downward pressure from the appreciation of the pound eases. The risk of lasting deflation is low, judging from household inflation expectations.

There is potential for continued robust household consumption. Low inflation and rising wage and salary curves will boost purchasing power, while credit conditions will gradually ease and household balance sheets will improve. Although consumer confidence is elevated, retail sales have recently sagged; instead, services and durable goods are benefiting from the upturn in purchasing power. **Household consumption will rise by an annual average of 2.7 per cent in 2015-2017**. These figures will keep pace with real income growth, implying that the savings ratio will remain at a stable low level. **Tight fiscal policy will contribute negatively to growth** – in the range of 1 per cent of GDP in 2016 and 2017 – and will prevent an even stronger consumption surge.

As for capital spending, the construction sector will account for a gradually larger share of overall growth. Major infrastructure investments are in the pipeline; the government's target is to build a million new homes by 2020. Housing starts are thus likely to climb sharply from today's levels. While low oil prices will create profitability problems for new North Sea wells, the energy sector has other opportunities in the form of large shale gas deposits. But it remains to be seen how much can actually be extracted in the end. **The competitiveness of British businesses seems intact, despite GBP appreciation** of nearly 13 per cent in effective terms since 2013; confidence among manufacturers rose steeply in October and the current account deficit has shrunk sharply this year to a manageable 3.6 per cent of GDP.

No later than 2017, the UK will hold a referendum on whether to stay in the EU. Prime Minister David Cameron recently unveiled a number of reform demands, including less supranational power and amended rules for labour migration from other EU countries. According to public opinion surveys, most Brits still want to stay in the EU; if Cameron receives a positive EU response to his reform demands, this majority will be overwhelmingly large. The referendum, combined with an already highly valued pound, suggests that the pound will not appreciate further against the euro despite the expected monetary policy differences. **The EUR/GBP rate will be 0.75 and the GBP/USD rate 1.40 at the end of 2017.**

Stronger growth, but growing structural challenges

- **Refugee resettlement funds will boost GDP**
- **Labour market shortage situations will push up pay and inflation somewhat**
- **Riksbank will lower its key interest rate in December but begin rate hikes late in 2016**
- **Weaker public finances when migration-related costs are financed by borrowing**

The economic upturn, which has gradually accelerated over the past year, **looks set to gain further strength during the coming year**. It is being driven by somewhat stronger international growth, but especially by rising demand due to the large flow of migrants to Sweden. We believe that a sizeable share of the increasing costs will be financed by larger public sector deficits, leading to **fiscal stimulus of more than one per cent of GDP**. Although certain crowding-out effects in both public and private consumption are likely, we believe **GDP will climb by no less than 3.6 per cent during 2016, then decelerate somewhat to nearly 3 per cent in 2017**. Compared to the August issue of *Nordic Outlook*, we have adjusted our growth forecast nearly one percentage point higher in 2016 and a quarter of a point in 2017. Our forecast is based on the latest assumptions from the Swedish Migration Agency (October 2015), which foresees a shrinking migrant influx.

Due to strong job growth, combined with matching problems between job seekers and openings, **resource restrictions and bottlenecks are increasingly evident**. Although we expect job growth to accelerate, unemployment will remain relatively high. Because of low inflation expectations and more expansive European Central Bank (ECB) policies, Sweden's Riksbank will cut its repo rate by another 10 basis points in December to -0.45 per cent but implement no further stimulus measures despite its dovish signals. After that, rising resource utilisation and inflation suggest that the bank has reached the end of this rate-cutting cycle. **During 2016 the monetary policy focus will shift**. As inflation approaches its 2 per cent target, the **Riksbank will hike the repo rate late in 2016**: about six months earlier than it now expects. By end 2017, the repo rate will stand at 0.75 per cent.

According to our estimates, **direct refugee resettlement costs** to public finances will be **SEK 40-50 billion in 2016**, financed partly by cutbacks in foreign development assistance. The impact on public finances will also be partly offset by higher tax revenue due to stronger growth. There is a risk that pressure on local governments will be so heavy that further government funds must be provided, beyond the approximately SEK 10 billion announced recently. Aside from initial fiscal stimulus due to the wave of refugees, Sweden faces **sizeable political challenges** to benefit from the potential of its expanded population. This includes housing construction and education, which will require major resources for many years to come. Housing market imbalances, combined with the challenges of the large refugee influx, have increased economic vulnerability and risks. Unless the integration process improves, **further increases in public outlays may put upward pressures on bond yields**, partly due to weakened international confidence. Combined with an increased need for tax hikes, this may trigger a significant downturn in home prices.

Shaky recovery in manufacturing

Manufacturing activity is still lethargic. A slight upturn is discernible in merchandise exports and production, but forward-looking sentiment indicators both in Sweden and elsewhere remain at moderate levels. Stable growth in Europe suggests that merchandise exports will gradually accelerate in any event, after being largely flat for the past two years. This will especially benefit consumer products and investment goods, with sectors like vehicles and pharmaceuticals showing more optimism than for years. In mining and metals as well as the machinery sector, the outlook is far gloomier, since these are the industries most affected by the growth deceleration in China. The global information technology (IT) slowdown is reflected in a lack of optimism in the electronics industry. Partly due to continued good growth in service exports, overall **export growth will accelerate to 4.9 per cent next year and then slow to 4.6 per cent in 2017**. Compared to historical economic upturns, exports growth will be relatively weak.

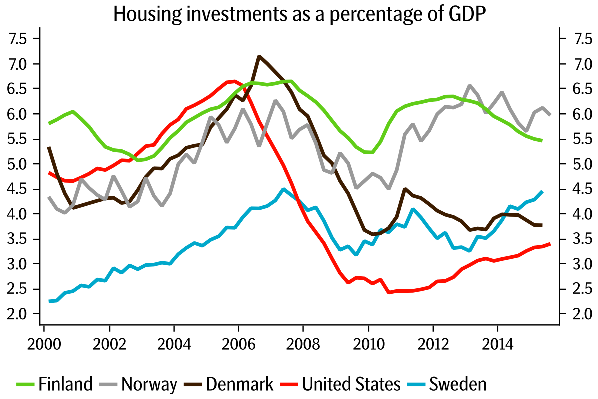
Housing investments may grow even more

Capital spending rose by an average of nearly eight per cent during the first half of 2015, driven especially by rising investments in housing. Because population growth will accelerate further, the demand for housing will remain very high. This will **continue to push home prices upward**. Providing enough housing will be a very difficult structural policy challenge. Because of regional imbalances, the demand for housing is greatest in Sweden's already overheated major metropolitan areas. Although we can see signals of consensus across the dividing line between the leftist and Alliance political blocs when it comes to simplifying the rules that govern the housing market, this is likely to have rather marginal effects. The rate of increase in home-building slowed during the first half of 2015, but the larger number of housing starts now indicates a renewed upturn. We believe that **home-building will**

contribute nearly one percentage point to GDP growth in both 2016 and 2017. According to our forecast, housing investments will grow to more than 6.5 per cent of GDP. **The construction industry is already showing certain signs of overheating, and the situation will worsen**. Rising construction labour shortage may lead to faster pay increases in 2016-2017 than our main forecast indicates.

Rising investments in housing

Housing investments as a percentage of GDP



Source: Macrobond

Home prices have accelerated steadily since late 2011, and the annual rate of increase is now close to 16 per cent. SEB's housing price indicator suggests that late this year, the upturn will cool somewhat. Assuming that a home loan repayment requirement is enacted next May as planned, we believe that the price upturn will slow to less than 10 per cent. **Further measures to dampen prices will probably be enacted in 2017**; for example, we believe that a change in existing mortgage interest deductions will take effect. Continued low interest rates and a rising shortage of housing suggest that home prices may rise somewhat further in 2017, but there are major risks that they will fall when the economic cycle turns.

Higher private and public consumption

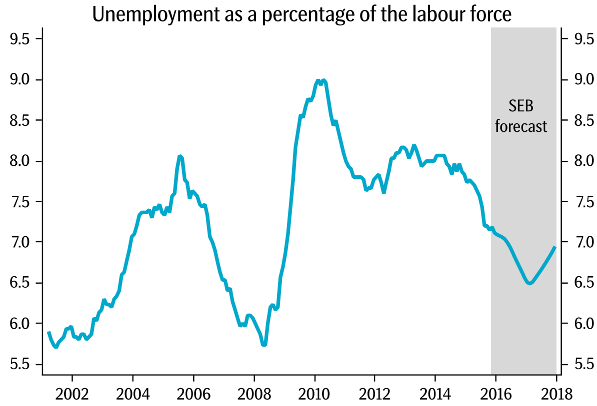
Aside from construction investments, consumption will be the strongest driving force behind economic growth in 2016-2017. A rapid population increase and rising incomes and employment will stimulate consumption to an even greater extent than we previously anticipated. Altogether, we believe that **private consumption will rise by 3.3 per cent in 2016 and 2.8 per cent in 2017**. The stimulus effect related to refugee resettlement in Sweden will be partly offset by other households that reduce their consumption to compensate for expected future tax hikes ("Ricardian equivalence"). **The impact of the refugee crisis on public sector consumption will be even larger**. In addition to refugee housing, there is a signifycantly greater need for education, training and health care. During the first half of 2015, public consumption grew by 2 per cent. We believe that growth may reach a full 3.5 per cent next year. During 2017, public consumption will grow by 2.5 per cent.

Rapid job growth, lower unemployment

For a long time, employment has grown rapidly, driven by large-scale immigration. Annual job growth today is about 1½ per cent, but short-term indicators suggest the rate of increase may accelerate this autumn. For example, the number of new job openings has climbed to record levels. With **growth now driven largely by labour-intensive components**, especially in the public sector, we have **adjusted our employment forecast for 2016-2017 upward**. The unemployment outlook is uncertain, but partly because of the increased labour supply, it will fall slowly. Only a small percentage of refugees now arriving are expected to be available for the labour market in the next 1-2 years; we have thus revised our labour supply forecast only slightly compared to August. Towards the end of our forecast period, however, unemployment will rise again as the labour supply grows more rapidly. **A large share of this increasing unemployment also risks being structural in nature**.

Lower unemployment now, higher later

Unemployment as a percentage of the labour force

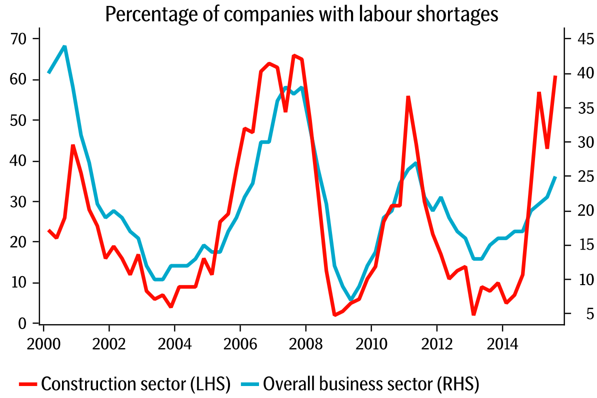


Source: Statistics Sweden, SEB

Despite high unemployment, resource utilisation indicators – such as the share of companies stating that it is difficult to recruit suitable employees – **have climbed since late 2013 and are now close to their historical average**. We have not yet reached the level that has historically been associated with accelerating wages and salaries, but there are many indications that labour shortages will continue to increase during the next couple of years. Some sectors with strong demand, such as construction, already have shortages close to historical peaks. In the public sector, too, there will be noticeable shortages in many occupational categories.

Increasing shortages, especially in construction

Percentage of companies with labour shortages



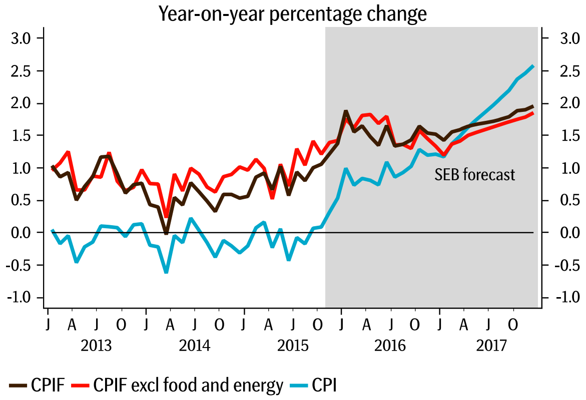
Source: NIER

A little more upward pressure on pay

The ongoing **national wage round will enter a crucial stage early next year** (see the theme article in *Nordic Outlook*, August 2015, "Wage round will not solve Riksbank's dilemma"). The Swedish Trade Union Confederation (LO) has given up its ambition to achieve coordination on the employee side, changing the playing field somewhat. Industrial unions recently unveiled an opening bid for one-year collective agreements including pay hikes of 2.8 per cent, the same as their starting bid in the 2013 wage round. Due to relatively weak industrial activity, agreements in that sector will probably also end up at about the same level as in 2013-2015: 2.3 per cent a year. Agreed hikes in domestic sectors will probably be somewhat higher, as indicated by their stronger labour market position and ambitions to narrow pay gaps between men and women. Because LO's coordination effort has collapsed, it is more likely that collective agreements in many fields will run for only one year, in line with the industrial union bid. Yet our main scenario is that most agreements will ultimately run for three years; in the past, employer organisations have often gone along with slightly higher pay increases in exchange for union acceptance of longer agreements. We have adjusted our forecast of total pay increases including wage drift a bit upward due to higher resource utilisation. **We now expect wages and salaries to rise by 3.2 per cent during 2016 and 3.4 per cent in 2017**.

Inflation is finally accelerating

Year-on-year percentage change



Source: Statistics Sweden, SEB

Higher inflation, but partly temporary

Inflation has recently been flat, with CPI around zero and CPIF (CPI excluding interest rate effects) about one percentage point higher. **But we now see clear signs that inflation is about to climb**. CPIF rose to 1.8 per cent in September. When the energy price declines of late 2014 disappear from year-on-year figures, total CPIF will increase significantly. Early in 2016, this upturn will gain further strength due to higher taxes on petrol and home repairs (lower tax deductions). This appears likely to bring CPIF close to the Riksbank's target by the beginning of next year. However, **the forces driving this inflation upturn are largely temporary in nature**. The krona depreciation of recent years is driving up prices, especially for goods, but according to our models this effect will fade next year. In addition, the contribution from indirect taxes will probably be much smaller in 2017 than in 2016. In recent months, inflation has also been pushed higher by abnormally large price increases on vegetables, travel and other items that are very likely to prove temporary. Our conclusion is that inflation will begin to fall during the second half of 2016 and reach a level of less than 1½ per cent early in 2017. During 2017, however, a cyclical upturn in inflation will begin, driven by a tighter resource situation that will lead to rising wages and salaries, followed after a certain lag by higher inflation as well. **By the end of 2017, CPIF will largely be back at 2 per cent**.

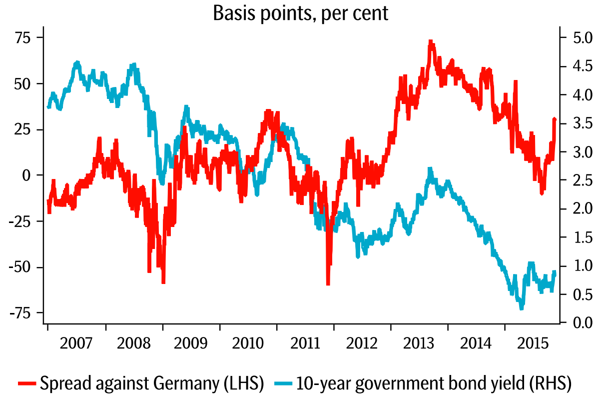
Riksbank will change course during 2016

In the near future, the Riksbank will remain under pressure due to uncomfortably low inflation expectations and the ECB's expansionary policies. We thus expect the bank to **cut its repo rate another 10 points to -0.45 per cent in December**. The Riksbank has also clearly signalled that it is prepared to take further unconventional policy steps, for example by expanding bond purchases to other assets besides government securities. **It has already shown a much more aggressive tone about currency interventions**, yet we do not believe it will take such action. Nor do we expect any new quantitative easing (QE) measures after the bank ends its current programme next June.

Looking ahead, several factors indicate that a policy shift will occur. There is an increasingly striking contrast between economic growth far above trend and rising resource utilisation, on the one hand, and extremely loose monetary policy, on the other. As inflation starts rising, it is also likely that inflation expectations will gradually begin to climb. In a theme article (page 13) we also discuss the prospects of the Riksbank moving in the direction of making monetary policy more flexible, which would provide further arguments for abstaining from stimulus measures in a situation of soaring home prices. We believe that the **Riksbank will begin rate hikes late in 2016**, or earlier than its rate path indicates, and that the **repo rate will be 0.75 per cent at the end of 2017**.

Widening yield spread against Germany

Basis points, per cent



Source: Macrobond

The spread between Swedish and German 10-year government bond yields narrowed after the Riksbank expanded its QE programme by SEK 65 billion in late October to a total of SEK 200 billion, but the long-term yield spread recently widened again in response to greater uncertainty about Swedish government finances. With the Riksbank poised to buy nearly 35 per cent of outstanding nominal government bonds, the trend towards a wider spread will ease. Poor market liquidity will create problems that, in the short term, will mainly be expressed by higher volatility but a bit further ahead imply that **Swedish bonds will begin to be traded with a premium**. Higher growth and inflation will also gradually make themselves felt. Overall, we believe that the 10-year bond yield spread between Sweden and Germany will widen to 50 basis points by mid-2016, then to 80 points at the end of 2017.

Riksbank will reluctantly let the krona rise

As a result of the Riksbank's aggressive policy during the past year, **the krona has been relatively stable against the euro despite stronger economic growth in Sweden**. We believe that monetary policy will remain the decisive factor for the krona in the next six months. Given our forecast that the ECB will significantly expand its monetary stimulus in December, the krona is likely to appreciate in the next few months. To keep inflation from falling, the Riksbank is likely to ease its monetary policy again if the krona rises too fast. When economic growth accelerates in 2016 and the Riksbank takes a further step back, **krona appreciation will become even clearer**. Uncertainty connected to the impact of the refugee crisis on the central government budget is probably less important to the krona than to the yield spread, since implicit fiscal stimulus in itself suggests an upward trend for the krona.

More risks, but still sound public finances

Public finances are now being squeezed by rising expenditures due to the migrant crisis, but given a strong starting position these effects are not especially dramatic. Our main scenario is that the government will need to revise migration-related spending upward by SEK 40-50 billion in 2016 and another SEK 5-10 billion in 2017 – on top of SEK 10 billion in extra grants to local governments announced in 2015. There is also a risk that expenditures will be higher in various other fields, for example labour market policy. Spending increases will mainly be financed through borrowing, but some cost-cutting will occur. The budget bill for 2016 proposed that about SEK 8 billion out of SEK 43 billion in foreign development assistance should be used for refugee resettlement. We assume that another SEK 5-10 billion can be taken out, although it will squeeze foreign development assistance. We also expect that a further SEK 10-15 billion in cost-cutting will take place through transfers of unused appropriations under way within the Finance Ministry.

Yet there are forces that will pull the public financial balance in the opposite direction. Higher employment, consumption and housing construction will help push up tax revenue faster, perhaps creating an upside surprise. Public finances will thus not worsen as much as previously estimated. **The deficit will be around 1.5 per cent of GDP in 2015-2017.** Central government debt will 44 per cent of GDP in 2016-2017. We also believe that the National Debt Office's latest forecast underestimates the borrowing requirement. Swedish government finances thus remain robust, but the relatively strong interest rate and yield reaction when Finance Minister Magdalena Andersson unveiled her supplementary budget on November 12 shows that the situation has changed. Above all, it is important to market confidence that the migration crisis should not lead to constant revisions in a negative direction.

Migration expenditures & financing

SEK billion

	2015	2016	2017
Refugee resettlement*		50	55
Grants to local authorities	10	15	20
Internat. development assistance		-5	-5
Other cost-cutting measures		-10	-15
Total (financed by borrowing)	**10**	**50**	**55**

*Swedish Migration Agency, start-up assistance etc. Source: SEB.

As for Sweden's fiscal policy framework, its official target of a budget surplus totalling 1 per cent of GDP over an economic cycle is distant, but this target had been played down by the government even earlier. If the government should exceed its expenditure ceiling, this would be a bigger change. The ceiling has previously been adjusted only in connection with changes of government but will most likely need to be raised in 2016. **Looking ahead, there will be no room on the expenditure side for other reforms in the 2017 and 2018 budgets**.

Public finances

Per cent of GDP

	2014	2015	2016	2017
Net lending	-1.7	-1.2	-1.6	-1.8
Borrowing req., SEK bn	72	45	50	70
Gen. gov't gross debt	43.8	44.1	43.9	43.9

Source: Statistics Sweden, SEB

Minority government under pressure

Despite relatively budget stability, **the political situation is fragile after the recent collapse of the December Agreement (DA)**, under which the four opposition Alliance parties agreed not to block the minority leftist coalition's budgets. Aside from problems created by its weak parliamentary support, the government is now also plagued by the migration issue and its budgetary consequences. There is a rather high probability that the Green Party will leave the Social Democratic-led government as migration policy is further tightened. But since there are clear internal differences on migration issues inside both the leftist and Alliance blocs, one possible solution is for the ruling Social Democrats and the Moderates – who dominate the Alliance – to reach a consensus, then allow other parties choose whether and to what extent they can join or passively accept it. The Alliance parties do not yet have any common strategy after the collapse of the DA. The Liberal Party has been clearest in signalling its willingness to work together in earnest with the government, while the Moderates and Centre Party are acting to some extent according to the intentions of the now-defunct DA. The Christian Democrats have shown the greatest inclination to try to trigger a change of government when the opportunity arises. During the current acute emergency, it is unlikely that the Alliance is willing to provoke a government crisis. In a slightly calmer situation, where the political battle mainly concerns migrant integration issues – on which the Alliance parties have greater level of consensus – this may change. Shifts in prevailing public opinion will be especially important in such a situation.

- **Unfunded expenditures will provide fiscal stimulus**
- **Sweden's robust economic immune system will reduce credibility problems**
- **Integration-related challenges will increase pressure for political consensus**

In most EU countries, macroeconomic forecasts are not being affected especially much by migration flows due to the refugee crisis. But the situation is different in Sweden, which receives **by far the largest number of migrants among EU countries in proportion to its population**. The latest Swedish Migration Agency forecast states that the number of asylum seekers will total 160,000 (140,000-190,000) in 2015 and around 110,000 in 2016. This can be compared to an earlier forecast of around 80,000, which in turn was a bit above the average for the past five-year period. We have assumed a notional level of 70,000 people in 2017 but there is great uncertainty about the number of asylum seekers, as well as about their educational status and age structure. **During 2015-2017, this is equivalent to about 3½ per cent of Sweden's population**. But even these high estimated figures assume that steps will be taken to slow down the influx from their dramatic current levels.

In the next couple of years the demand-side effects of extra spending will dominate the picture, while in the long term it will be crucial how well the new arrivals are integrated into society and how many join the labour force. Our Sweden chapter describes how this will affect various parts of our economic forecast. Below we discuss some matters of principle in more detail. The government has signalled that it will not fund most extra spending via cost-cutting or tax hikes, but instead via increased borrowing (see the public finance section). **This must be interpreted as meaning that it is making exceptions from Sweden's normal fiscal policy rules**. The government expenditure ceiling will probably be raised, while the surplus target for public finances will be further postponed.

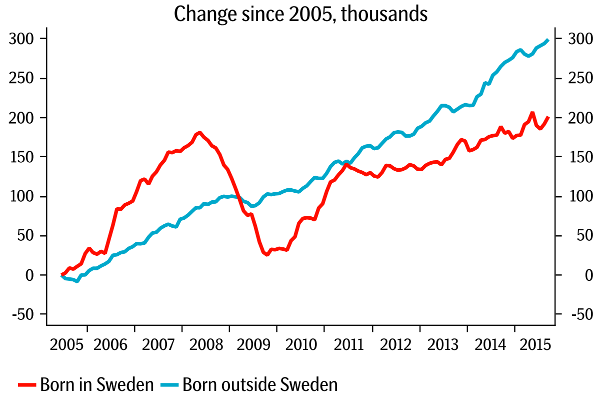
The table on page XX presents estimates on Swedish public finances. Given the Migration Agency's forecasts, the risks are probably on the upside. In particular, the costs of local government education and training programmes or the Public Employment Service's programmes to enable new arrivals to join the labour market may prove to be higher. On the other hand, the migration forecast for 2016 and 2017 might be adjusted downward, considering the increasingly clear political ambition to limit the flow of refugees.

The management of the crisis will thus provide extra fiscal stimulus, which will mainly occur via public and private consumption. Some of the cost-cutting that will be implemented will affect the international development assistance budget, further amplifying the expansionary impact on domestic demand. **In our forecast, we have boosted GDP growth by more than ½ percentage point in 2016 and nearly ½ percentage point in 2017 as a consequence of new assumptions**. Total direct spending for refugee resettlement in Sweden will be even larger, but we are also taking into account certain crowding-out effects. This applies to re-prioritisations by the public sector as well as lower private consumption, since households will probably assume that there will be future tax hikes. The overall weakening of public finances will be partly offset by an increase in tax revenue as an indirect consequence of the short-term GDP stimulus.

Sweden's relatively long period of large-scale immigration has generated significant labour force expansion. **For example, most job growth in recent years has come from foreign-born individuals**. At the same time, their level of employment remains substantially lower than that of other population categories, as reflected both in lower participation and significantly higher unemployment. This is among the factors that have caused equilibrium unemployment to rise in recent years to somewhat below 7 per cent.

Foreign-born are behind job growth

Change since 2005, thousands



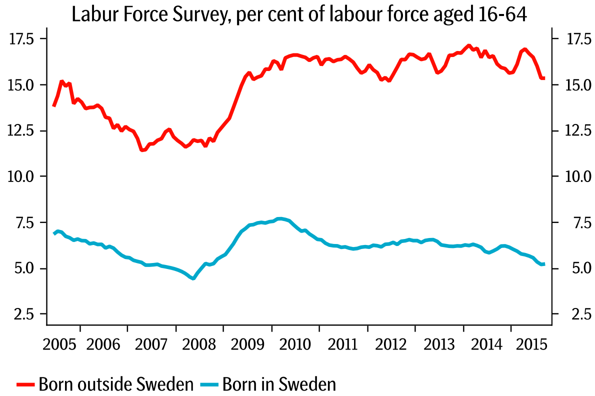
Source: Statistics Sweden

The dominant short-term effect of the changing refugee resettlement situation is an upward adjustment in employment connected to extraordinary spending and the higher level of economic activity. **Unemployment will thus be a little lower during the coming year, too**. During 2017 we expect unemployment to rise somewhat as the new arrivals begin to enter the labour market. Even if programmes are launched to speed up various integration processes, we believe that a rather small percentage of the new arrivals will join the labour market during our forecast period.

Effects on inflation and wage formation will be determined, among other things, by the degree to which shortages arise in the labour market – for example in the educational system or the construction sector. This will lead to upward pressure on wages and salaries in some sectors, **but we believe that the impact on total pay increases in the economy will be only 0.2-0.3 per cent**, in light of such factors as the tight financial situation of local government and downward international wage pressure. So far, the signals from the national wage round do not indicate any major change in the rate of pay hikes. Consequently, **upward pressure on inflation will be small during the next couple of years**; we have raised our inflation forecast by only a few tenths of a percentage point.

Higher unemployment among foreign-born

Labur Force Survey, per cent of labour force aged 16-64



Source: Statistics Sweden

These changes in the macroeconomic picture will also have some impact on financial developments. **Higher growth and inflation will justify somewhat tighter monetary policy**. Combined with an increased supply of government securities, this implies that yields will be pushed higher, although the Riksbank's bond purchases will limit movement. Looking at the currency, there will be effects in different directions: a somewhat less expansionary monetary policy will lead to a stronger krona, while increased uncertainty about government finances will have the opposite effect. But in general, strong underlying fundamentals give the Swedish economy a rather robust immune system. For example, we do not believe there will be any downgrading of Sweden's credit rating. Before credibility problems assume a dominant role, there has to be a far more weakening of public finances than now appears likely.

Tensions in integration policy

The effects we have discussed so far focus on the next couple of years. Looking further ahead, Sweden's ability to integrate the new arrivals into the labour market and into society in general will be crucial to the economic, social and political consequences of migration. **Migration flows have the potential to revitalise the economy in various ways, for example by reducing demographic imbalances**. Large-scale immigration from the Balkan countries in the 1990s is an example of successful integration. But to realise the potential this time around, integration must be improved compared to what Swedish society has managed to achieve in recent years. The challenge will be all the greater, now that the influx of people is increasing sharply. Over a four-year period, the total number of new arrivals is likely to be nearly three times larger than in the 1990s. In this situation, it will take time to achieve orderly resettlement, and a large percentage of refugees will be placed in rural areas with weak labour market situations. In addition, integration of non-European immigrants has so far proved more difficult. Today we believe that the uncertainties are too great to enable us to create scenarios for public finances in a 5-10 year perspective. It will be an important task for organisations like the National Institute of Economic Research and the Swedish National Financial Management Authority to show the sustainability of public finances based on various assumptions within such time frames.

There has been broad public support for a generous and liberal immigration policy in Sweden. Both the political system and society at large have shown great willingness to improve integration. But at the same time, it is clear that **visions and impact assessments** of what open borders and migration entail are quite different **on the right and left sides of the Swedish political spectrum**. This risks creating future tensions and stalemates. Speeding up the processes related to validating foreign professional qualifications is one example of uncontroversial measures. There is also a broad-based ambition to lower the barriers to the labour market, but the methods used vary for ideological reasons. For example, the opposition Alliance bloc is more inclined to advocate changing labour law and opening up a low-wage sector, while the leftist bloc is more interested in providing tax subsidies. The Social Democratic-led government also wants to rely on broad educational programmes to improve the skills of the new arrivals. Traditional demand stimulus, for example public financing for large housing construction projects, is another path advocated by the trade union movement and others.

It is not so easy to predict how the different approaches will ultimately be balanced in Swedish integration policy. We also expect political conflicts within each of the political blocs. The question is **how far the Social Democrats can compromise on labour law and low-wage jobs**; these are issues that can change the balance of power in the labour market, and the union movement is already hard-pressed by growing support for the right-wing populist Sweden Democrats among union members. In the Alliance bloc, too, there are conflicts between a radically economic liberal a more social liberal approach, for example regarding the extent to which the Swedish labour market model should be changed. Many of the recommendations made in recent years have focused on how Sweden can compete for labour in a globalised world with increasingly open borders. The question is how much of this can be applied in the current situation, with borders seemingly on their way towards closing. In the short and medium term, Sweden faces challenges different from other countries.

But the potential for broad political consensus should not be underestimated. A failed integration policy and political disunity risk creating a downward spiral – social tensions, poorer educational quality or higher taxes might make Sweden less attractive in the global competition. With so much at stake, there will be heavy pressure on the political system, perhaps making it easier to slaughter sacred cows and break up bloc-based politics. The Swedish labour market model will probably need to change, but the question is how much it can diverge in the long term from the other Nordic countries.

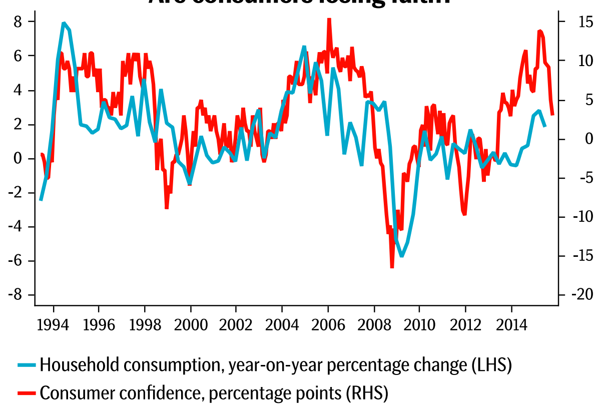
Main domestic drivers of recovery intact

- **Downward revision to growth forecast**
- **Global risk from EMs and refugee crisis**
- **ECB challenge rate hike expectations**

Because of weaker than expected capital spending in the first part of the year and tougher signals on fiscal policy – combined with rising global risks – we have lowered our growth forecast. Although we expect a bounce in the third quarter, on average the near-term trajectory will likely be slightly flatter, spilling into lower full-year forecasts for 2015 and 2016. We now **expect GDP growth of 1.8 and 2.2 per cent this and next year**, respectively (our previous forecast: 2.0 and 2.5). **For 2017, we are sticking to our forecast of 2.5 per cent.**

Recent growth has been slower than expected, but the main drivers of the recovery are still intact. Nonetheless, the recent downtrend in consumer confidence constitutes a risk to household spending, which is the main ingredient in a solid recovery. Strong media focus on the refugee crisis in Europe may have made consumers more uncertain about the future, while the turbulence in financial markets this autumn may also have taken a toll on sentiment. Despite the drop, sentiment indices are still pointing to solid consumption growth, although they did overshoot in the past couple of years. However, in the background **the fundamental drivers of consumption have stayed intact**. The housing recovery is gaining momentum, job growth continues and wage inflation has picked up modestly. We thus believe that consumption is still well supported.

Are consumers losing faith?



Source: Statistics Denmark

Risks to this outlook, apart from the above-mentioned signals of caution by households, **mainly stem from more uncertain global developments**. Slower than expected growth in emerging market (EM) countries has already negatively affected global trade, but it also increases the likelihood of severe problems in some of the weaker countries, and this could more negatively affect global growth. Via the export channel, financial linkages and business sentiment, Denmark could also see an impact. The increased uncertainty surrounding global developments could lead to lower capital spending as a cautionary measure at company level. While this is a downside risk, Danish exports are much more dependent on Europe, and so far the European recovery looks to be well on track. Further European Central Bank (ECB) policy easing should only add to that impression.

The 2016 fiscal budget is being finalised. Negotiations so far confirm our first impression: the new government will be tough on spending (except on health care) and the main beneficiary will be the business sector, which will see some burdens lifted. It remains to be seen whether companies will invest the proceeds in staff and capital or save it. For the sake of the balance in the economy, already running a 7 per cent of GDP current account surplus, the former is preferable. But recent international experience points in the direction of the latter.

The inflation dynamic remains weak, based on both core and headline measures. But the country's latest annual core and headline inflation readings are still some half a percentage point above euro zone levels. We expect such a divergence to persist, mainly because Denmark is facing a tighter labour market than the euro zone.

With the ECB moving towards further easing, it has become **less likely that the Nationalbank will have to hike interest rates** meaningfully. As stated before, we view the market's pricing of Danish rate normalisation after last winter's attack on the DKK/EUR peg as too aggressive. With much higher chances of both ECB deposit rate cuts and extension of the current bond purchase programme, this view has been further strengthened.

However, with Denmark's currency reserve almost back at its level prior to the peg attack, the risk of a unilateral rate hike is not negligible. A rate hike is not our base scenario, though, since structural elements point towards the risk of a renewed currency inflow due to increasing euro zone excess liquidity, which could potentially spill over to the Danish market. Also worth noting is that FX intervention activity is already slowing, with only DKK 12 billion in October. We thus do not believe that the Nationalbank is in a hurry to hike the deposit rate over the short to medium term.

Chilly winds from the North Sea

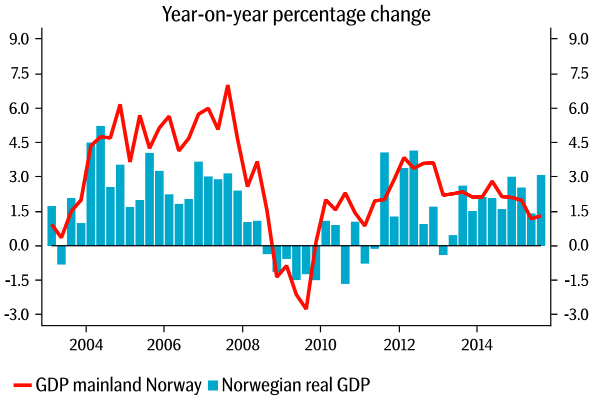
- **Major drag from the petroleum sector**
- **Home prices a risk to consumption**
- **Norges Bank to deliver a final rate cut**

The negative effects from plunging petroleum investments and general cost-cutting in the sector continue to reverberate through the economy. The effect will only be a bit less severe next year, with **declining demand from the petroleum sector** – investment, intermediate consumption and overall wage costs – **corresponding to roughly one percentage point of mainland GDP** (i.e. excluding oil, gas and shipping).

The focus is on the knock-on effects. However, considering the extent of the drop in capital spending within petroleum and oil prices far below the norms of recent years, the downshift in the rest of the economy is not as deep as one might have feared. Moreover, **significant offsets are coming from historically low interest rates and more expansionary fiscal policy** (in 2016 equivalent to some 0.75 percentage point of mainland GDP). Moreover, the roughly **15 per cent depreciation in the trade-weighted exchange rate** since mid-2014 is **boosting exports of non-petroleum goods**, which should be up a solid 5.5 per cent in 2015 and a further 4.3 per cent next year.

Growth slowing less than feared

Year-on-year percentage change



Source: Statistics Norway

Overall GDP jumped fully 1.8 per cent from the second to the third quarter, with the better part of it owing to surging value added within petroleum activities. A correction is likely in the fourth quarter, but **we are lifting our forecast for overall GDP growth in 2015 to 1.9 per cent and to 1.5 per cent for 2016**. Momentum in **mainland GDP** has slowed over the past year: our **forecast is unchanged at 1.4 per cent for 2015 but we are lowering it to 1.8 per cent next year and to 2.3 per cent in 2017** (from 2.0 per cent and 2.4 per cent, respectively, in the August issue of *Nordic Outlook*).

Oil sector outlook not uniformly bleak

Capital spending in the petroleum sector had long been in for a sharp drop as operators adjust their expenditures after years of runaway cost inflation, and due to sharply lower oil prices.

The reported fall in investments during the first half was surprisingly modest. However, the GDP report for the third quarter saw a sharp but as-expected 7.5 per cent drop. With revisions lowering the trajectory, we expect **a 14.5 per cent drop in investment in 2015 and a 12 per cent decline in 2016** (previously -12 per cent and -9 per cent) in part because persistently low oil prices should push down exploration.

The outlook for the next couple of years is dire, but we would warn against a static view of a sector marked by constant technological advances. Meanwhile cost-cutting by operators and efficiency gains are already having an impact. For example, nominal capital spending estimates for Phase 1 of the vast *Johan Sverdrup* field have been reduced and costs at the smaller *Maria* field are 30 per cent below the original Plan for Development and Operations submitted in 2014. Cost-cutting measures like squeezing supplier prices and improving productivity reduce nominal investments, but the volume of sector demand on the rest of the economy is unaffected.

Improving project economics are also making other potential field developments more likely than assumed, say, a year ago. Due to concept changes and other cost-cutting measures, the break-even oil price for the *Johan Castberg* discovery in the Barents Sea (a potential development for the 2020s) is thus being cut from some USD 90/barrel to USD 50-60/barrel.

Home prices a potential risk

The third quarter seemingly saw a sudden shift in private consumption as sequential growth all but came to a halt, though year-on-year change held up at 2.2 per cent. While household spending on services remains strong, the slowing was due to declining goods consumption, which continued its one-quarter-up next-quarter-down pattern. Including downward revisions to the first half, **we are lowering our 2015 forecast for consumption growth to 2.2 per cent, while 2016 should see growth of 2.0 per cent**.

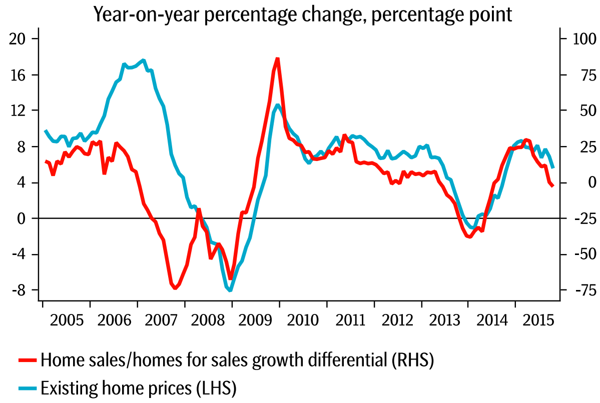
Nonetheless, consumption is holding up much better than indicated by well below-normal consumer confidence which should be consistent with declining spending on a year-on-year basis. As such, the main risk to the outlook is if consumers start to act as they feel. A marked drop in existing home prices and/or declining employment and sharper increase in unemployment might trigger such a downturn.

The existing home market shows signs of cooling. Prices have levelled off in recent months, slowing the year-on-year increase from a recent peak of 8.1 per cent in June to 5.6 per cent in October. The market has been fuelled by historically low mortgage rates, resulting in even higher leverage among households and risking a more abrupt downturn in home prices. This remains a key argument against deep rate cuts.

Any marked downturn in existing home prices risks hurting private consumption, as in 2013. At that time, slightly lower prices led to warnings of an imminent collapse. Sellers rushed into the market and pushed down prices further. The decline in prices proved to be a modest two per cent from May to December 2013 (prices have since gained almost 12 per cent), but consumers nonetheless immediately retrenched.

Tipping balance?

Year-on-year percentage change, percentage point



Source: Macrobond

Demographics and still-low mortgage rates remain supportive, while rising unemployment is geographically confined thus far. Yet existing home price developments in recent months with a deteriorating ratio between sales and inventory, suggest that home price inflation should moderate further.

Labour market continues to weaken

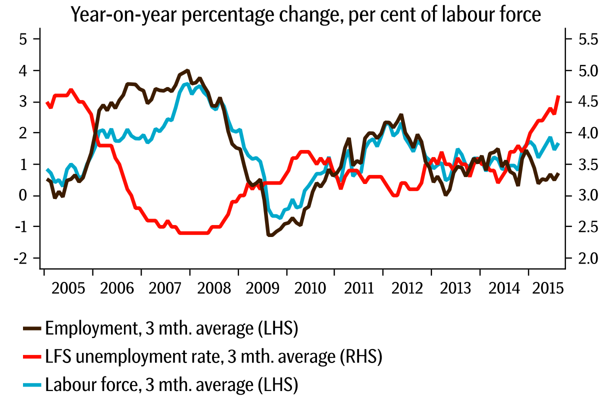
The gradual deterioration in the labour market that we have seen for more than a year seems to be feeding on itself. Over the past few months, registered unemployment has thus started to catch up with the sharp rise seen in the Labour Force Survey (which is much more erratic and less reliable), although the level still differs quite substantially.

It is important to note that a **rapidly expanding labour force – not net job losses – is the most important reason for the sharp increase in the LFS unemployment rate** over the past year from 3.7 per cent to a ten-year high of 4.6 per cent.

Hence, while employment is up 0.7 per cent year-on-year the labour force expanded by a stronger 1.7 per cent, twice as much as in early 2014 and contrasting with population growth in the 15-74 year cohort, which slowed to 1.3 per cent. **The "extra" increase in the labour force lifted the LFS unemployment rate by almost 0.5 percentage point**.

Increasing labour force boosts unemployment

Year-on-year percentage change, per cent of labour force



Source: Statistics Norway

The faster increase in the labour force than in population runs counter to what one might expect when economic growth slows well below trend. The dominant group aged 25-54 is following the script, but the labour force among youngsters is up more than five per cent year-on-year amid stagnant population as students seek part-time jobs. For those 55 years and older, the labour force expanded much faster than population until mid-year, but the gap has since narrowed.

Our forecast fo LFS unemployment has successively crept up since we have been surprised by labour force growth. Meanwhile expectations for employment are little changed. Hence, we expect LFS unemployment **to increase from 4.4 per cent on average in 2015 to 4.8 per cent in 2016** (revised up 0.3 percentage point) with a peak at or close to 5 per cent next spring/summer, but dropping **to 4.6 per cent in 2017**.

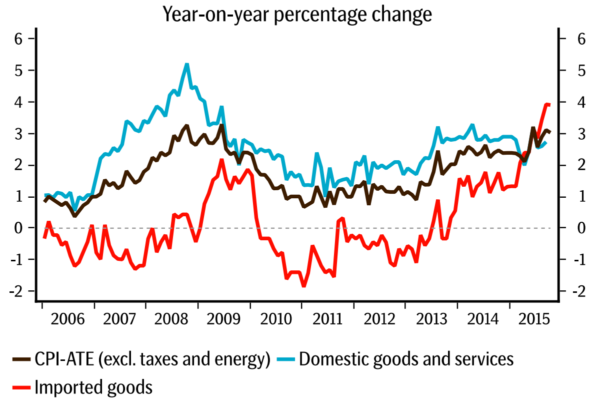
Easing inflation still in the forecast

Norway is unusual among its European and US peers by having visible inflation at a rate above the official target (which is higher than elsewhere). Core consumer price inflation has been a bit choppy since spring, but following a sharp jump in June, the year-on-year CPI-ATE rate (which excludes taxes and energy) has **stabilised at around 3 per cent, well above the 2.5 per cent medium-term target**. Overall CPI had been held back by lower electricity prices, but these rebounded in October and lifted headline inflation to 2.5 per cent.

Despite markedly slower momentum in the broader economy and lower wage growth, core inflation has thus trended higher in the past couple of years. The lift was initially led by domestic goods and services, but stronger imported inflation due to a sharply weaker NOK has been the main driver more recently. Average imported core inflation was thus negative in 2013 but lifted to 1.4 per cent in 2014 and to 3.9 per cent in September and October. Core domestic inflation has moderated in the past year but is still slightly above the overall target.

Core inflation stays well above target

Year-on-year percentage change



Source: Statistics Norway, SEB

Our forecast calls for elevated core inflation in the near term, followed by gradual moderation through 2016. While the NOK exchange rate has weakened recently, the trajectory suggests that imported inflation measured on a year-ago basis will crest before long. In addition, moderating wage growth should slow domestic service inflation. In all, while nudging the forecast higher, we expect core inflation **to slow from 2.7 per cent in 2015 to 2.5 per cent next year and 2.0 per cent in 2017**.

Growth concerns dominate at Norges Bank

Norges Bank remains dovish on the growth outlook and is fixated on mitigating downside risks. The two rate cuts so far in 2015 – lowering the deposit rate to a historic low of 0.75 per cent – and the continuing downward revisions to the bank's rate path have thus aimed at stimulating demand and keeping the NOK on the weak side, Growth concerns are consequently trumping elevated core inflation, which – based on the bank's forecast – will not return to target until early 2017.

The rate path in the September Monetary Report saw a 64 per cent probability of a (final) 25 basis point rate cut. Events since then give little reason to assume that Norges Bank is moving away from its conclusion in September that "the key policy rate may be reduced further in the coming year".

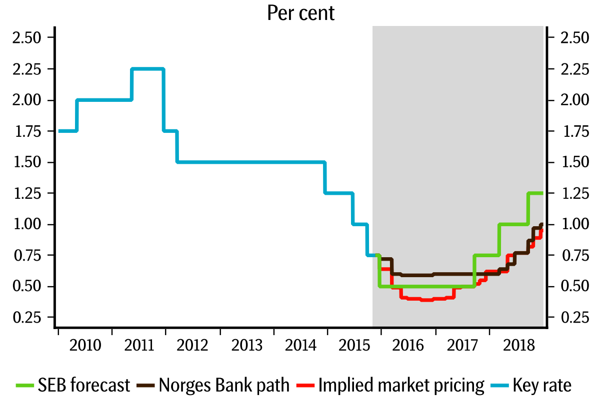
With the labour market becoming weaker, oil prices remaining depressed and growth risks still skewed to the downside, we expect the bank to cut its key rate further. We think the oil investment survey (published November 24) and in particular the report from Norges Bank's regional network (due December 4) will **tip the odds in favour of a rate cut to 0.50 per cent at the December 17 policy meeting**. The rate path should be lowered further to keep the door open for even lower rates. However, since we believe that Norges Bank will be positively surprised by growth data in 2016, the December cut should be the final one in this cycle, though risks are tilted to the downside. **Norges Bank is not expected to start lifting its key rate until late 2017**.

We do not believe unconventional measures will become a reality in Norway. First, the economic outlook does not justify such aggressive actions. Second, there is ample leeway in fiscal policy. While growth is well below trend and slack is building, the government is holding back and fiscal policy is set to become only slightly more expansionary next year – paling in comparison to the measures introduced in early 2009.

Norges Bank Governor Øystein Olsen said in a speech in early October that there is little likelihood of a negative key interest rate in Norway, since "we still have room for manoeuvre in economic policy". Only from a NOK perspective could negative interest rates or a QE program be discussed, but the current krone level is far from suggesting it would become a reality.

Norges Bank delivers one more rate cut

Per cent



Source: Norges Bank, Bloomberg, SEB

The outlook for the krone is heavily dependent on monetary policy and oil prices. The NOK is particularly sensitive to surprises from Norges Bank, which have resulted in increased volatility in EUR/NOK in connection to rate announcements.

The NOK is trading at unsustainably weak levels and its valuation is attractive, but continued dovish monetary policy in the next 3-6 months coupled with downside pressure on oil prices suggest that there is more EUR/NOK upside in the short term. However, NOK should gradually strengthen once growth momentum stabilises and Norges Bank takes a more neutral approach. We expect a **EUR/NOK exchange rate of around 8.80 by year-end 2016 followed by 8.50 by the end of 2017.**

Norwegian government bonds (NGBs) should be supported by continued dovish monetary policy. Especially the mid-part of the curve should benefit from a rate path signalling low rates for longer. The long end of the curve is more driven by the supply outlook. The government's 2016 budget bill revealed a borrowing requirement of NOK 55 billion, which is relatively unchanged from the current year. Long-end NGBs trade at historically wide levels vs. Germany, partly reflecting the unfavourable krone trend vs. the euro. The positive medium-term currency outlook suggests FX-related demand will gradually pick up as investors capitalise on wide spreads. We foresee a **10-year spread vs. Germany of 75 basis points and 80 bps by the end of 2016 and 2017, respectively**.

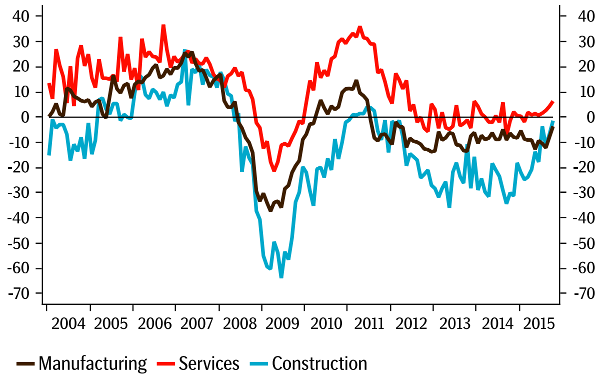
Growth slightly above zero

- **Indicators provide some hope for the future**
- **Jobless rate falling, but equilibrium distant**
- **Public sector deficit will decrease, but debt will continue to rise in 2016-2017**

Finnish economic performance remains weak and the quarterly growth rate will stay just over zero for 2015 as a whole. Further austerity programmes will hold back growth in 2016-2017, while the economy continues to struggle with cyclical and structural problems as well as falling demand from Russia. Due to years of listless performance, GDP is still 6-7 per cent below its level at the beginning of 2008. Yet some improvement is discernible. The European Central Bank's stimulus policies are helping keeping the euro weak, while Finnish exports will also benefit from good growth in important customer countries. Low inflation is propping up otherwise weak real income growth, and capital spending will also slowly take off. **Overall, GDP will climb by 0.2 per cent in 2015, 0.7 per cent in 2016 and 1.3 per cent in 2017**.

Indicators are not pointing to any quick recovery

Net balance



Source: European Commission

Indicators confirm that the economy has bottomed out and that a slight improvement can be expected. Confidence is rebounding on a relatively broad front. After suffering through five recessions since 2008, Finland will thus probably escape another one. The margins are narrow, however; for example, the Statistics Finland GDP indicator has fallen in the last two months. **Manufacturing output continues to fall slightly** but is expected to begin rising late this year. Exports have increased so far during 2015 after contributing negatively to growth in 2014. Service exports are leading the upturn, but merchandise exports are also improving. Good growth in important customer countries such as Germany and Sweden and a weak euro are outweighing the negative effects of falling exports to Russia. **Exports are stagnant this year as a whole but will increase by 1.8 per cent in 2016 and 3.5 per cent in 2017**. Capital spending will fall in 2015 for the fourth straight year, but a slight recovery can be expected. Interest rates are low and production has bottomed out, while the future outlook is somewhat brighter and home prices have again risen. One downside risk in the near term is that lending to non-financial companies has plunged in 2015 to a year-on-year rate of zero: the lowest rate of increase in over 10 years.

The labour market has been disappointing, with a sharp upturn in unemployment during the first half of 2015. The jobless rate is now falling again but remains high despite a decent number of job openings. September unemployment stood at 9.3 per cent, while the equilibrium level is estimated at just below 8 per cent. We expect a slow downturn to slightly below 9 per cent at the end of 2016. **High unemployment is squeezing households**, whose income is also being pushed down by public austerity programmes and low nominal pay increases. Employer and employee organisations are aiming at restoring Finland's competitiveness. This will lead to low wage and salary hikes during the next couple of years. Growth in compensation per employee has decelerated from 3.5 per cent in 2004-2012 to its current rate of around 1 per cent. Meanwhile the household savings ratio has fallen in recent years, and there is little room for further reductions. Household incomes and consumption have been saved by low interest rates and slightly falling prices in 2015. **Consumption will increase moderately in 2015-2017, by about 0.5 per cent yearly**. Consumer confidence has decreased, creating some downside risk, but meanwhile home prices are rising again.

Weak economic performance has severely hurt public finances, because of higher public expenditures and lower tax revenue. Finland has been one of the countries that have pushed hardest for tight fiscal policy in the euro zone. It has thus been disappointing that despite earlier austerity programmes, the country has now **exceeded both the 3 per cent of GDP budget deficit ceiling and the 60 per cent ceiling on public debt**. The Centre Party-led coalition that took power in May has unveiled major austerity programmes, and together with unions and employers the government is trying to improve Finland's competitiveness. Meanwhile its cost-cutting has encountered criticism, and the coalition has been under pressure both from the opposition and from internal disputes. We expect the deficit to be squeezed below 3 per cent of GDP as early as 2016 and to reach 2.5 per cent in 2017. Barring new political or economic setbacks, public debt will increase in the next couple of years and peak at 65 per cent of GDP in 2017.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2014	2015	2016	2017
GDP OECD	1.9	2.1	2.4	2.4
GDP world (PPP)	3.4	3.1	3.6	4.0
CPI OECD	1.7	0.4	1.1	1.6
Export market OECD	3.3	4.5	5.1	4.8
Oil price, Brent (USD/barrel)	99.6	53.0	55.0	60.0

USA

Yearly change in per cent

	2014 level, USD bn	2014	2015	2016	2017
Gross domestic product	17,616	2.4	2.5	2.9	2.6
Private consumption	12,061	2.7	3.1	2.7	2.5
Public consumption	3,163	-0.6	0.7	0.4	0.0
Gross fixed investment	2,937	5.3	4.4	7.6	6.6
Stock building (change as % of GDP)		0.0	0.1	-0.2	0.0
Exports	2,350	3.4	1.8	5.5	6.1
Imports	2,895	3.8	5.3	5.1	6.8
Unemployment (%)		6.2	5.3	4.5	4.2
Consumer prices		1.6	0.1	1.4	2.1
Household savings ratio (%)		4.8	4.9	5.6	6.2

EURO ZONE

Yearly change in per cent

	2014 level, EUR bn	2014	2015	2016	2017
Gross domestic product	10,091	0.9	1.5	2.0	2.1
Private consumption	5,620	0.9	1.6	1.8	1.9
Public consumption	2,124	0.6	0.5	1.0	1.0
Gross fixed investment		1.2	1.8	2.7	2.5
Stock building (change as % of GDP)		-0.1	0.0	0.0	0.0
Exports	4,482	3.8	4.3	4.6	4.6
Imports	4,094	4.1	4.3	4.4	4.4
Unemployment (%)		11.6	11.0	10.6	10.2
Consumer prices		0.4	0.0	1.0	1.2
Household savings ratio (%)		6.5	6.5	6.7	6.8

LARGE INDUSTRIAL COUNTRIES

Yearly change in per cent

	2014	2015	2016	2017
GDP				
United Kingdom	2.9	2.4	2.5	2.6
Japan	-0.1	0.6	1.1	0.8
Germany	1.6	1.5	2.1	2.1
France	0.2	1.2	1.7	1.7
Italy	-0.4	0.7	1.2	1.3
China	7.3	6.9	6.5	6.3
India	7.1	7.5	7.8	8.0
Inflation				
United Kingdom	1.5	0.0	0.7	1.4
Japan	2.7	0.8	0.6	0.9
Germany	0.1	0.2	1.2	1.6
France	0.1	0.0	0.7	1.0
Italy	0.2	0.0	0.7	1.0
China	2.0	1.5	2.0	2.5
India	7.3	5.0	5.3	5.5
Unemployment, (%)				
United Kingdom	6.2	5.6	5.1	4.8
Japan	3.6	3.4	3.3	3.3
Germany	5.0	4.6	4.7	4.9
France	10.3	10.4	10.4	10.2
Italy	12.7	12.4	12.2	12.0

EASTERN EUROPE

	2014	2015	2016	2017
GDP, yearly change in per cent				
Estonia	2.9	1.9	2.7	3.4
Latvia	2.4	2.4	2.7	3.5
Lithuania	3.0	1.8	2.8	3.2
Poland	3.4	3.4	3.6	3.8
Russia	0.6	-3.6	-0.8	1.5
Ukraine	-6.5	-12.0	1.0	2.0
Inflation, yearly change in per cent				
Estonia	0.5	0.5	2.3	2.7
Latvia	0.7	0.4	1.7	2.3
Lithuania	0.2	-0.7	0.3	1.2
Poland	0.1	-0.8	1.2	2.0
Russia	7.8	15.7	9.5	6.0
Ukraine	12.1	48.0	18.0	10.0

FINANCIAL FORECASTS

		18-Nov	Dec-15	Jun-16	Dec-16	Jun-17	Dec-17
Official interest rates							
US	Fed funds	0.25	0.50	0.75	1.25	1.50	2.00
Japan	Call money rate	0.10	0.10	0.10	0.10	0.10	0.10
Euro zone	Refi rate	0.05	0.05	0.05	0.05	0.05	0.05
United Kingdom	Repo rate	0.50	0.50	0.50	1.00	1.25	1.50
Bond yields							
US	10 years	2.28	2.45	2.55	2.90	3.00	3.10
Japan	10 years	0.30	0.40	0.40	0.45	0.45	0.50
Germany	10 years	0.51	0.60	0.80	1.20	1.35	1.50
United Kingdom	10 years	1.93	2.05	2.35	2.85	2.95	3.05
Exchange rate							
USD/JPY		124	125	127	127	125	123
EUR/USD		1.06	1.05	1.00	1.03	1.04	1.05
EUR/JPY		132	131	127	131	130	129
GBP/USD		1.52	1.48	1.41	1.41	1.41	1.40
EUR/GBP		0.70	0.71	0.71	0.73	0.74	0.75

SWEDEN

Yearly change in per cent

	2014 level, SEK bn	2014	2015	2016	2017
Gross domestic product	3,915	2.3	3.2	3.6	2.8
Gross domestic product, working day adjustment		2.3	3.0	3.4	3.0
Private consumption	1,818	2.4	2.7	3.3	2.8
Public consumption	1,029	1.9	2.0	3.5	2.5
Gross fixed investment	912	7.4	7.0	7.0	6.0
Stock building (change as % of GDP)	8	0.2	0.2	0.1	0.0
Exports	1,744	3.3	4.1	4.9	4.6
Imports	1,596	6.6	5.4	6.8	6.4
Unemployment (%)		7.9	7.4	6.8	6.8
Employment		1.4	1.4	1.7	1.5
Industrial production		-2.0	2.5	3.0	4.0
CPI		-0.2	0.0	1.0	1.9
CPIF		0.5	0.9	1.5	1.7
Hourly wage increases		2.7	2.6	3.2	3.4
Household savings ratio (%)		15.8	16.9	16.3	16.7
Real disposable income		2.6	4.0	2.5	3.4
Trade balance, % of GDP		0.8	1.0	0.8	0.7
Current account, % of GDP		6.2	6.7	6.0	5.5
Central government borrowing SEK bn		-72	-45	-50	-70
Public sector financial balance, % of GDP		-1.7	-1.2	-1.6	-1.8
Public sector debt, % of GDP		43.8	44.1	43.9	43.9

FINANCIAL FORECASTS	18-Nov	Dec-15	Jun-16	Dec-16	Jun-17	Dec-17
Repo rate	-0.35	-0.45	-0.45	-0.25	0.25	0.75
3-month interest rate, STIBOR	-0.39	-0.55	-0.40	-0.10	0.40	0.95
10-year bond yield	0.83	0.95	1.30	1.80	2.00	2.30
10-year spread to Germany, bp	32	35	50	60	65	80
USD/SEK	8.73	8.76	8.80	8.45	8.32	8.19
EUR/SEK	9.30	9.20	8.80	8.70	8.65	8.60
TCW	131.4	130.1	125.5	123.4	122.5	121.6
KIX	112.4	111.2	107.3	105.5	104.7	103.9

NORWAY

Yearly change in per cent

	2014 level, NOK bn	2014	2015	2016	2017
Gross domestic product	3,139	2.2	1.9	1.5	1.6
Gross domestic product (Mainland)	2,474	2.3	1.4	1.8	2.3
Private consumption	1,254	1.7	2.2	2.0	2.5
Public consumption	671	2.9	2.4	2.5	2.1
Gross fixed investment	717	0.0	-3.1	-0.8	1.7
Stock building (change as % of GDP)		0.4	0.2	0.0	0.0
Exports	1,231	2.2	3.5	2.1	1.7
Imports	889	1.5	1.0	2.0	3.4
Unemployment (%)		3.5	4.4	4.8	4.6
CPI		2.0	2.1	2.5	2.0
CPI-ATE		2.4	2.7	2.5	2.0
Annual wage increases		3.1	2.7	2.7	2.8

FINANCIAL FORECASTS	**18-Nov**	**Dec-15**	**Jun-16**	**Dec-16**	**Jun-17**	**Dec-17**
Deposit rate	0.75	0.50	0.50	0.50	0.50	0.75
10-year bond yield	1.56	1.50	1.60	1.95	2.10	2.30
10-year spread to Germany, bp	105	90	80	75	75	80
USD/NOK	8.69	8.86	9.25	8.54	8.32	8.10
EUR/NOK	9.26	9.30	9.25	8.80	8.65	8.50

DENMARK

Yearly change in per cent

	2014 level, DKK bn	2014	2015	2016	2017
Gross domestic product	1,943	1.1	1,8	2.2	2.5
Private consumption	931	0.9	2.5	3.0	3.0
Public consumption	512	0.2	1.5	0.0	0.5
Gross fixed investment	387	4.0	0.9	4.3	5.9
Stock building (change as % of GDP)		0.3	-0.4	0.1	0.0
Exports	1,037	2.6	1.9	3.4	4.2
Imports	919	3.8	0.6	4.2	5.4
Unemployment (%)		5.0	4.5	4.2	4.0
Unemployment, OECD harmonised (%)		6.1	5.8	5.2	4.6
CPI, harmonised		0.6	0.5	1.1	1.6
Hourly wage increases		1.3	1.7	2.2	2.6
Current account, % of GDP		6.2	7.0	6.5	6.0
Public sector financial balance, % of GDP		0.0	-1.5	-0.5	0.5
Public sector debt, % av GDP		43.5	43.0	41.5	40.0

FINANCIAL FORECASTS	**18-Nov**	**Dec-15**	**Jun-16**	**Dec-16**	**Jun-17**	**Dec-17**
Lending rate	0.05	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.76	0.85	1.00	1.40	1.55	1.70
10-year spread to Germany, bp	25	25	20	20	20	20
USD/DKK	7.01	7.10	7.46	7.24	7.17	7.10
EUR/DKK	7.46	7.46	7.46	7.46	7.46	7.46

FINLAND

Yearly change in per cent

	2014 level, EUR bn	2014	2015	2016	2017
Gross domestic product	206	-0.4	0.2	0.7	1.3
Private consumption	114	0.5	0.5	0.5	0.7
Public consumption	51	-0.2	0.0	-0.1	0.2
Gross fixed investment	42	-3.3	-0.8	1.8	2.2
Stock building (change as % of GDP)		0.4	-0.2	0.0	0.0
Exports	78	-0.7	0.0	1.8	3.5
Imports	79	0.0	-0.6	1.5	2.5
Unemployment (%)		8.7	9.3	9.0	8.7
CPI, harmonised		1.2	-0.1	0.5	1.3
Hourly wage increases		1.5	1.5	1.5	1.8
Current account, % of GDP		-0.9	-2.0	-1.8	-1.6
Public sector financial balance, % of GDP		-3.3	-3.1	-2.8	-2.5
Public sector debt, % of GDP		59.3	62.5	64.5	65.0

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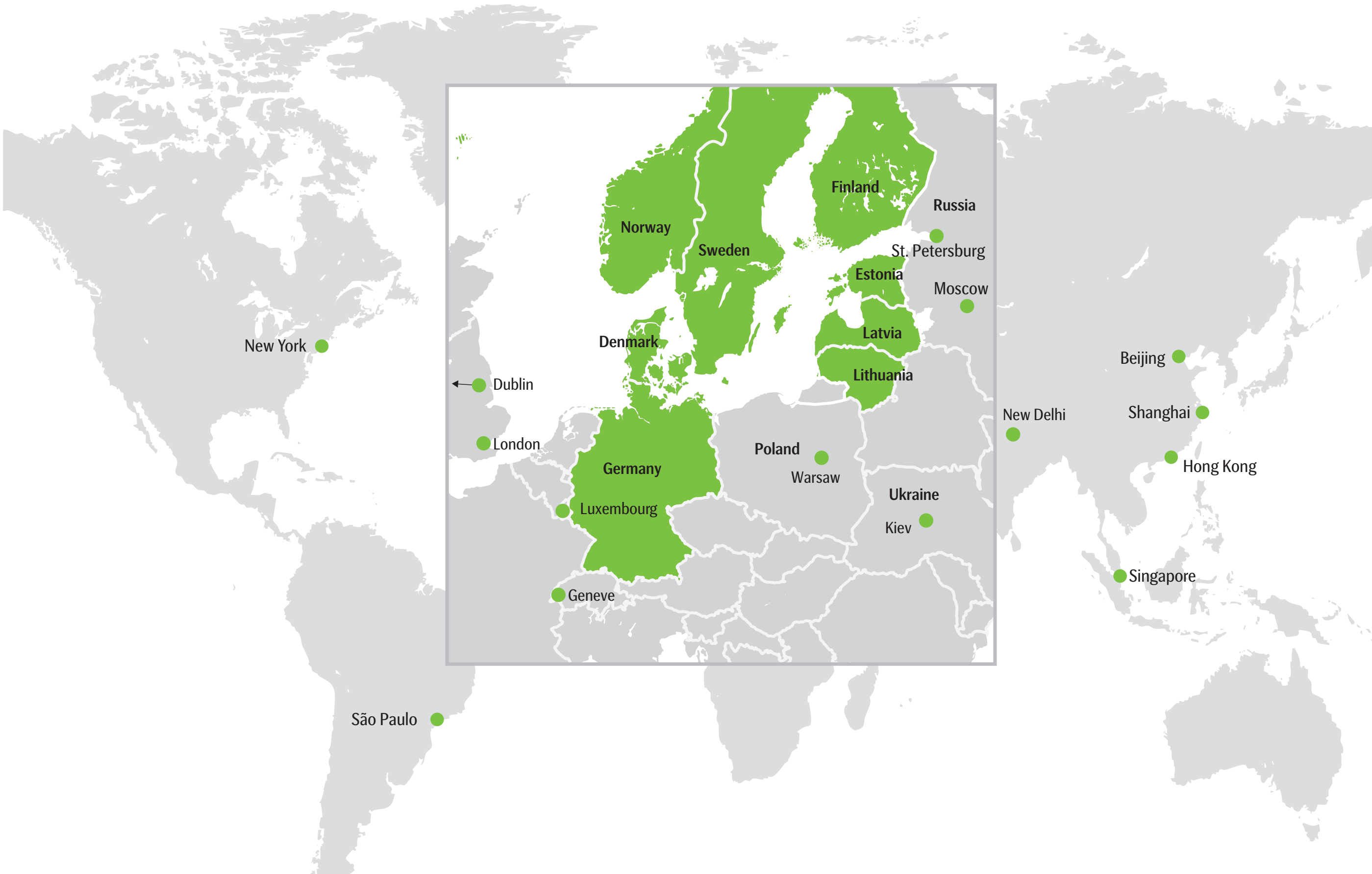

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