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FEBRUARY 2008

Nordic Outlook

US recession and European slowdown
Interest rate cuts on a broad front

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Global: Mild recession in the United States – slowdown in Europe

- The financial market crisis is changing shape as adjustment processes are under way; liquidity problems have eased but credit problems have intensified. The result will be a credit crunch that hampers consumption and investment. No country will escape, but the ability of fast-growing economies to resist this trend will sustain global growth.
- Inflation will culminate in the second half of 2008. The contribution from energy and food prices will diminish, while underlying inflation pressure eases with the cyclical slowdown. There is little risk that rising inflation expectations and demands for wage compensation will cause lasting inflationary effects.
- The US economy is entering a mild recession in 2008. Rising unemployment and falling home prices together with credit problems related to the economic slowdown will worsen problems in the financial sector. GDP growth will reach only 0.9 per cent in 2008. Powerful fiscal stimulus will help recovery begin late in the year. The Federal Reserve will keep cutting its key interest rate, reaching 2 per cent by mid-year.
- The slowdown in Western Europe will become more apparent. GDP growth in both the euro zone and the UK will end up below 1½ per cent this year. The Bank of England will keep trimming its key rate to 3.50 per cent early in 2009. The European Central Bank will begin easing monetary policy in May, then cut its key rate to 3.0 per cent next year.
- The euro will carry a heavy burden in the near future, as the US dollar and British pound remain under pressure. The dollar will weaken to 1.54 per euro this spring, then recover as the focus shifts increasingly to the European slowdown. Bond yields will continue downward a bit in the wake of central bank interest rate cuts.

Sweden

- Economic growth will slow on a broad front. Exports will continue to lose momentum, and the secondary effects on domestic demand will gradually become more apparent. GDP growth will be less than 2 per cent both in 2008 and 2009.
- Job growth will gradually cool. Unemployment will begin climbing this autumn. Public sector surpluses and a less strained resource situation will allow further fiscal stimulus measures as the 2010 parliamentary election approaches. Combined with the great cyclical sensitivity of the budget, this will weaken public saving to ½ per cent of GDP in 2009.
- Inflation will culminate by summer, then fall as energy prices decline and labour cost pressure fades. By mid-2008 both lower growth and a more favourable inflation outlook will pave the way for lower interest rates and the Riksbank will then cut its repo rate, which will reach 3 per cent some months into 2009.

Other Nordic countries and the Baltics

- **Denmark:** Economic deceleration will continue. Due to falling home prices, resource shortages and weakened competitiveness, GDP will grow by a mere 1 per cent annually. Pay increases are faster than in other countries, and inflationary pressure is rising.
- **Norway:** Growth will decelerate from a high level. Resource shortages will hamper expansion as negative growth impulses from abroad gradually have more impact. Rising inflation risks and a strained labour market will keep Norges Bank from cutting interest rates short term. During 2009 it will cut the sight deposit rate to 4.50 per cent.
- **Finland:** The growth peak has passed. Export growth is being slowed by weaker global expansion and a stronger euro, but domestic demand is resisting nicely. GDP growth will end up at 2.8 per cent this year and 2.6 per cent in 2009.
- **The Baltics:** Hot domestic demand is beginning to cool, and credit growth is slowing to some extent. All three economies are decelerating and will grow below potential level next year. Inflation remains high and the risk of a hard landing persists.

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The liquidity crisis that started with the collapse of the American sub-prime mortgage loan market is now gradually changing shape. Losses in the global financial service system will become even more noticeable. The result will be a credit crunch that affects both investment opportunities and consumer spending.

The US economy is now entering a mild recession. American GDP growth will show negative figures during the first three quarters. Measured as an annual average, growth will end up at around +1 per cent in 2008. Western Europe and Japan will also experience significant slowdowns. In the euro zone and the United Kingdom, growth will end up averaging less than 1½ per cent – a halving of the 2007 level. The Nordic countries will show slightly better resistance.

The ability of fast-growing emerging economies to resist the prevailing trend will now be tested in earnest. Our main conclusion is that the domestic dynamism of these economies has developed sufficiently for their growth to remain relatively high, even during a slowdown in the OECD countries.

Global inflation will fall in the course of 2008. The contribution from energy and food prices will diminish during the year, while weak economic conditions lead to increased downward cyclical pressure on inflation. Central banks will thus avoid becoming stuck in a stagflation dilemma. They will have room to support their economies and ease the problems of the financial sector by cutting their key interest rates. The US Federal Reserve has acted vigorously, slashing its federal funds rate by 225 basis points since September. We expect central banks in Western Europe to follow the Fed's example on a broad front. The Bank of England (BoE) has already begun its rate cuts, and the European Central Bank (ECB) is soon likely to follow suit.

The ability of emerging economies to resist the global trend, combined with interest rate cuts, will help limit the depth of the approaching slowdown. In addition, fiscal policy will become increasingly expansive, especially in the United States.

The main risk scenarios we foresee as alternatives to our forecast are fundamentally of the same kind as we have discussed in earlier issues of ***Nordic Outlook***.

A financial crisis with minor secondary effects: So far, we note a clear sense of confidence among many companies outside the financial sector, indicating a risk that forecasts may put too much emphasis on the problems of the financial sector. We thus cannot rule out that the financial crisis may be resolved without hurting households and companies to such a great extent. However, recent developments confirm our earlier assessment that this is not very likely.

A deeper financial crisis: In a deeper downturn scenario, the financial crisis morphs into a widespread global banking crisis, with repercussions on credit supply and thus on consumption and investments. GDP will then fall on a broad front in industrialised countries, with major repercussions in the rest of the world. Government rescue actions will probably become necessary.

The shift in the credit environment from a previously very expansive direction may end up triggering more prolonged effects than we have assumed in our main scenario. In addition, the adjustment process related to home prices may be more dramatic and have a greater impact on the real economy than expected.

Broad slowdown in OECD growth

Our main scenario thus assumes a significant economic cooling in the OECD countries, In the US, this will mean increasing unemployment, falling home prices and tighter credit conditions – a negative dynamic that will tip the economy into recession during 2008. Due to strong balance sheets, cautious capital spending behaviour in the upturn phase and a powerful economic stimulus policy, however, the recession will be mild viewed in a historical perspective.

Last year was characterised by a clear decoupling between different parts of the world economy. Growth held up in Europe and Asia, despite the American slowdown. But the secondary effects of the US deceleration in other parts of the world have gradually become more evident.

GDP growth

Year-on-year percentage change

	2006	2007	2008	2009
United States	2.9	2.2	0.9	1.8
Japan	2.4	1.9	1.2	1.5
China	11.1	11.4	9.5	8.5
Euro zone	2.9	2.6	1.3	1.5
United Kingdom	2.9	3.0	1.4	1.8
Nordic countries	3.7	3.0	2.1	1.8
OECD	3.1	2.6	1.5	1.9
The world	4.9	4.6	3.7	3.8

Sources: OECD, SEB

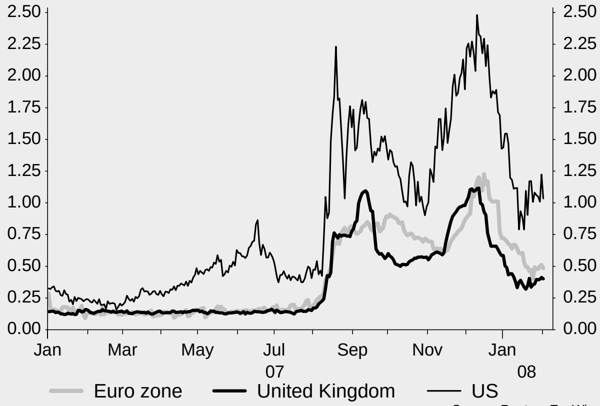
The Japanese economy has suffered a number of reversals in recent months. This is due to both weaker

The dynamic of the financial crisis

The outbreak of the US mortgage crisis last summer quickly triggered an international crisis of confidence among banks and other financial institutions. The ensuing liquidity crisis lasted for an unusually long time, despite generous central bank guarantees of essentially unlimited injections of liquidity. The most acute liquidity crisis has now eased, reflecting a degree of normalisation in the interbank market.

Spread between interbank rate and T-bills

3 months

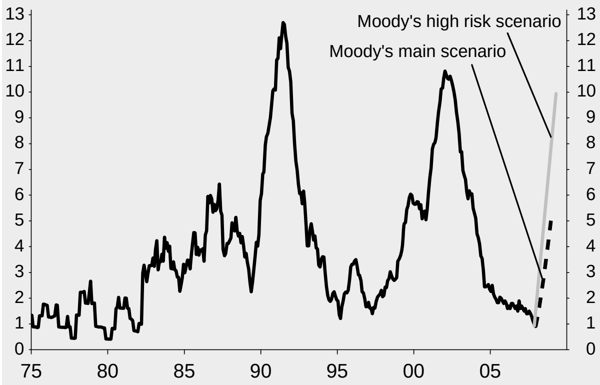


Source: Reuters EcoWin

On the other hand, we have now entered a more conventional credit crisis. The Bank of England goes so far as to describe the situation as a global banking crisis. Although *realised* credit losses are still low, the pricing of various types of credit products hints at large *unrealised* losses. This is partly a reflection of gradually growing cyclical worries.

Default rates

High-yield companies, per cent

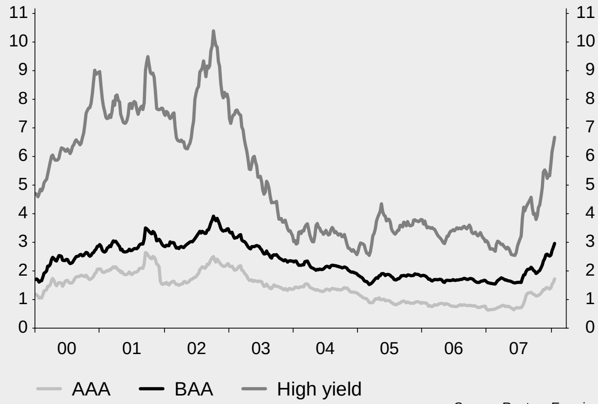


Source: Moody's

At present, the number of corporate bankruptcies is at a record low (see chart), reflecting strong balance sheets in the corporate sector at the outset. But economic activity is now falling, and together with more expensive borrowing costs, this is likely to increase the number of bankruptcies. A more reasonable number of bankruptcies will mean that credit rating institutions will continue to lower the credit ratings of companies. Moody's forecast implies that the number of bankruptices among "high yield" companies will increase to 4.8 per cent (main scenario), but in a worse economic scenario one out of ten companies monitored by Moody's in this field may go bust. According to our macroeconomic forecast, default rates among high yield companies will probably rise more than in Moody's main scenario.

US: Credit spreads

Corporate bonds minus treasury bonds



Source: Reuters Ecowin

Credit risks are now spreading. This is illustrated by the big widening in risk spreads even for manufacturing companies with higher creditworthiness. This implies additional strains on an already weakened financial service sector. The banking system's ability and determination to supply credits are adversely affected by their shrinking equity and the higher costs of the banks' own borrowing.

Even when companies borrow directly in the capital market, they encounter difficulties in the form of higher borrowing costs and smaller capital supply. The negative interaction between the financial and the real economy is thus threatening to deepen the downturn. This will impact economic growth, which in turn will affect the level of traditional cyclically related credit risks.

The negative spiral can be partly cured by interest rate cuts and an expansive fiscal policy. These indirect instruments will stimulate growth and thereby strengthen the earning power of companies. But such an effect does not occur immediately. In the current situation, it cannot be ruled out that credit problems may threaten to cause serious and lasting damage to the financial system. Looking ahead, more specific government intervention may seem necessary to solve these problems.

international demand and to domestic problems that have proved more difficult to resolve than expected.

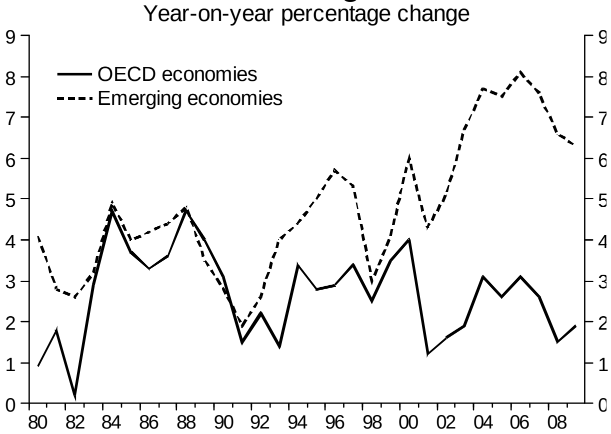
Europe is affected by weaker American imports. In addition, the financial market crisis is causing credit losses and credit tightening here as well. In many countries, a cool-down in the housing market is also under way, for example in Spain, the Netherlands and Ireland. Meanwhile growth is being squeezed by the strong euro. We have thus revised our GDP forecast for the **euro zone** downward by another ½ percentage point and now anticipate that growth will fade from 2.6 per cent in 2007 to 1.3 per cent in 2008. Next year there will be a marginal upturn to 1½ per cent.

The growth rate in the **British economy** will also be halved between 2007 and 2008. A weaker pound will soften the slowdown. On the other hand, there is much more room for declines in the housing market than in the euro zone. Depressed saving and the major importance of the financial services sector will also hamper growth in the next couple of years.

The **Nordic economies** are characterised by somewhat stronger growth than Western Europe in general. Supply-side constraints and weaker consumption have slowed growth in **Denmark** for some time. In Sweden, traditional sensitivity to global fluctuations will mean that the economy will grow at below trend in 2008 and 2009. **Norway's** economy is still showing impressive strength. Supply-side factors and global contagious effects will slow growth ahead, however. In **Finland**, growth will decelerate due to strains in key economic sectors.

Global GDP growth

Year-on-year percentage change



Sources: IMF, SEB

The dual nature of the world economy will persist. Emerging economies, spearheaded by China, will continue to grow rapidly while the OECD countries are now entering an economic slowdown.

In the last issue of ***Nordic Outlook***, we discussed the difficulties of weighing together the various parts of the world economy into a global measure of growth.

The most common way of calculating global GDP growth is on the basis of purchasing power parities (PPPs). The resulting figures reflect changes in world living conditions in a relevant way. However, this measurement method gives an exaggerated picture of stability in the world when it comes to the driving forces behind financial markets, for example. If each country's weight is instead determined by its actual GDP in a common currency (for example USD), we get a better picture of what drives financial developments and the export climate in different countries.

New figures from the International Monetary Fund (IMF) have helped bridge the gap between these methods. Revised calculations now give the emerging economies a weight of about 40 per cent of the global economy, compared to 50 per cent earlier. As a result, global growth is generally ½ percentage point lower per year. In terms of growth, however, the emerging economies are still a dominant force in the world economy.

Contributions to GDP growth, 2008

	PPP old	PPP new	Nominal
United States	0.18	0.19	0.23
Japan	0.07	0.08	0.10
Euro zone	0.19	0.21	0.29
United Kingdom	0.04	0.05	0.07
Rest of OECD	0.31	0.35	0.40
OECD	0.79	0.88	1.09
China	1.50	1.05	0.58
Rest of non-OECD	1.78	1.73	1.00
World	4.1	3.7	2.7

Sources: IMF, SEB

Inflation turning downward

During the past six months or so, inflation has risen sharply. This upturn has been driven by several forces.

Commodity prices trended upward for a long period and on a broad front. In 2007, crude oil prices skyrocketed while electricity prices rose in many countries. Their contribution to CPI inflation will remain high for the next six months.

Food prices have trended upward since the summer of 2006. This is due to such factors as higher biofuel production; greater purchasing power in Asia also pushed up global demand unexpectedly fast. Meanwhile supply was kept down by unfavourable weather conditions.

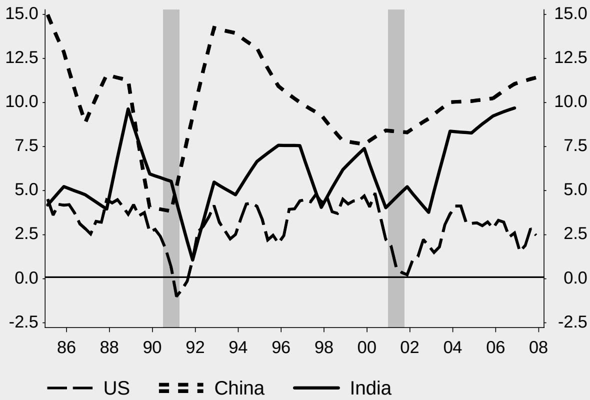
The global price squeeze on consumer goods seems to have eased somewhat. This is due to rising cost levels in emerging economies, strong international demand and early signs that tighter environmental standards are beginning to affect prices, among other things via tax policies.

Testing resistance to the OECD slowdown

Strong growth in many emerging economies has been a stabilising factor in the world economy in recent years. But only now that the slowdown in the OECD countries is intensifying will their power of resistance to such trends be tested in earnest.

GDP in US, China and India

Year-on-year percentage change



Sources: National statistical offices, NBER

So far, the macroeconomic data is encouraging. GDP figures, industrial production and leading indicators are still at high levels in the emerging economies. One explanation for their resilience is that many countries, for example in Asia, now have a stronger, rather autonomous domestic economy. Intra-regional trade has assumed greater importance. This was already partly evident during the last global slowdown, when economic deceleration in such countries as China and India was very modest.

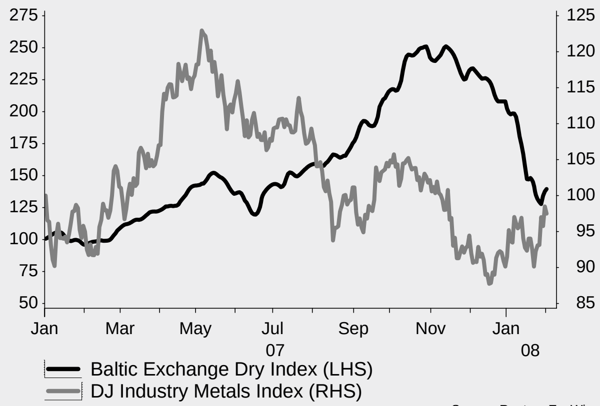
In most countries, a relatively small percentage of exports go directly to the US. Such neighbouring countries as Mexico has the highest exposure, with exports to the US equivalent to 20 per cent of GDP. In China the corresponding figure is around 8 per cent, while in such fast-growing countries as Brazil, Russia and India, exports to the US account for less than 3 per cent of GDP. In Central Europe, the figure is even lower.

Solid external balances, with large surpluses in China and Russia and balanced foreign trade in India and Brazil, contribute to greater resistance against financial market disruptions in other countries. Public sector finances are also in better shape in most countries. This makes it easier for them to respond to the threat of an economic slump with government economic stimulus measures.

There are reasons for concern, however. Since the beginning of 2008, stock market indices in emerging economies have fallen considerably more than broad measures in the OECD countries. For the time being, however, we can interpret these stock market fluctuations as an expression of higher volatility in these markets, not as a genuine lack of confidence in their positive economic performance. The need of investors to cover their losses in other markets may also have amplified the recent downturn.

Commodities

Index, normalised, USD



Source: Reuters EcoWin

Another reason for concern is the impact of the OECD slowdown on demand for the goods exported by the emerging economies. A decline in metal prices during the past six months has reduced export revenue in many countries, although real GDP growth has not initially been affected. Shipping costs for such commodities as coal and iron ore have gone down by 45 per cent since peaking last autumn, according to the Baltic Exchange Dry Index. This can also be interpreted as an early indicator that demand is already about to slow on a broad front.

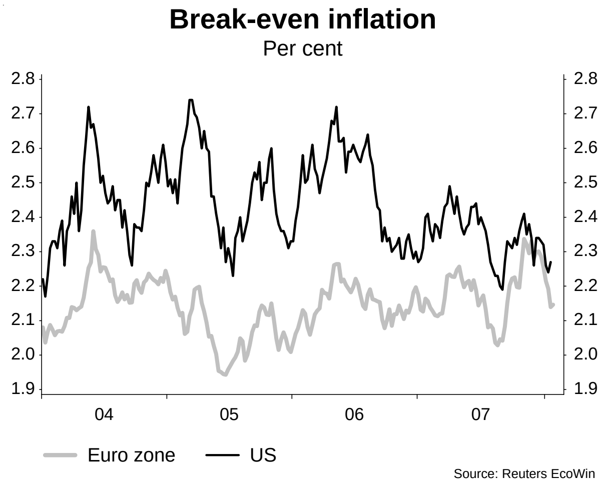
To summarise, our conclusion is that the emerging economies now face a mild slowdown but that there is good potential for them to continue playing a stabilising role for global demand.

Unit labour costs have risen. Rising resource utilisation in recent years has meant higher wage pressure. Meanwhile productivity growth has slowed in many places, amplifying upward cost pressure in the short term.

It is likely that a number of inflation-slowing forces are now weakening. For example, we expect food prices to remain at high levels. Tighter environmental standards will also contribute in various ways to upward price pressure in global markets.

In spite of this, it is difficult to see strong reasons why any far-reaching change in price and wage behaviour among economic players is about to occur. So far, inflation expectations have not deviated from the historically normal pattern of reactions to upturns in spot inflation. In order for inflation to remain high, it will also be necessary for the underlying forces that have contributed to the low-inflation environment of recent decades to weaken.

In Western Europe, it is conceivable that a genuine confidence gap between central banks, leading politicians and the two sides in the labour market might lead to a loss of consensus on the economic policy framework. In Germany and Sweden, for example, we can see tendencies towards growing tensions in this area. Another threat might be that protectionist measures, in the wake of global imbalances, could weaken the global competitive situation, eventually leading to a higher inflation rate.



At present, such a turn of events seems far-fetched. To date, the trend of wages and salaries in the OECD countries has not deviated from what can be expected under the prevailing economic conditions. It is thus likely that global inflation will turn downward, once the effects of rising energy and food prices culminate. Towards the end of 2008, cyclical inflation-slowing forces will begin to make themselves felt.

Key interest rate cuts on a broad front

For a long time slower growth — combined with rising inflation — seemed to pose a difficult dilemma for the interest rate policy of central banks. As recently as early August, even the Federal Reserve expressed a bias towards viewing the threat of inflation as overshadowing growth-related risks.

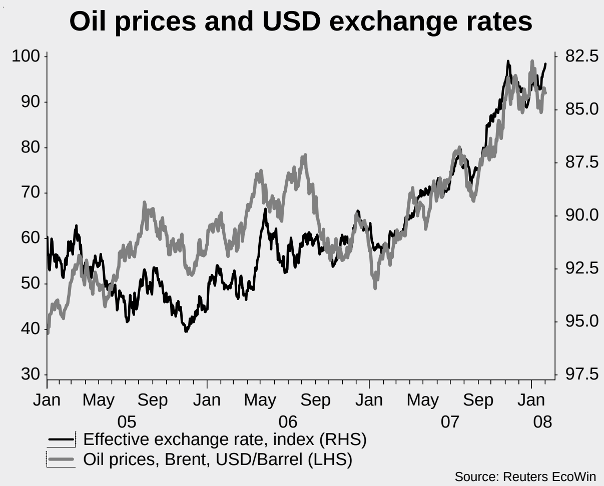
The Fed then underwent a rapid conversion and has surprised the market with its increasingly aggressive interest rate cuts. Obviously the US central bank sees a major risk that weaker economic performance and increased strains in the financial service system could amplify each other and create a negative, depressive spiral. To date, the federal funds rate has been lowered by 225 basis points in the space of just over four months. **As the economy continues to weaken, the Fed is likely to follow up with additional rate cuts.** At present, we believe that a further 100 basis points to 2.0 per cent is a reasonable trade-off, in order to offset the risks of a deeper downturn and the build-up of new imbalances in the long term.

Lower oil price ahead

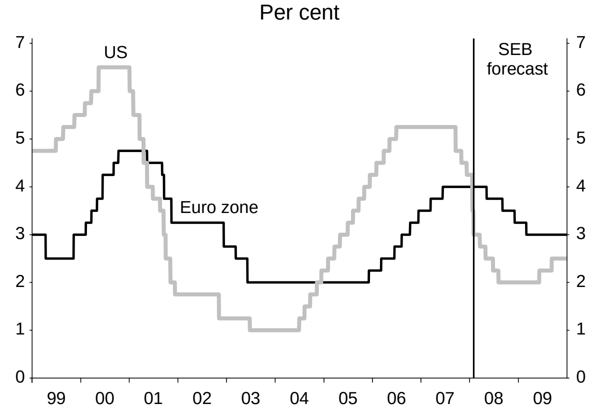
Last year's doubling of oil prices reflected continued strong demand in the emerging economies. Meanwhile supply from both the Organisation of Petroleum Exporting Countries and other oil producers declined. Speculative elements also helped drive up prices in a situation of market volatility. The weaker dollar also seems to have contributed to the upturn. Since its lower exchange rate squeezed revenue in OPEC's domestic currencies, acceptance of higher oil prices seems to have increased among the cartel's members. In fact, the co-variation between oil prices and dollar exchange rates has been strikingly high.

The question now is whether the falling oil price trend seen in recent weeks will continue. The growth in global demand is expected to accelerate from 1 per cent in 2007 to 2.5 per cent in 2008, according to the International Energy Agency (IEA). The upturn will be attributable to continued strong demand in emerging economies and a return to normal weather after last year's unusually mild winter, pushing up demand in the OECD countries.

On the supply side, oil output is expected to continue declining in the OECD countries, while OPEC countries are expected to increase their production. Given our forecast of a US recession and a clear slowdown in global growth, there are reasons to anticipate a larger downturn in oil prices than the futures market indicates. Overall, we have assumed an average oil price of USD 80 per barrel in 2008 and USD 75 in 2009, and the risk in this forecast is on the downside.



We expect the central banks in Europe to follow suit by lowering their key rates. The **Bank of England began its cuts in December**. The British housing market is now rapidly weakening and the BoE has clearly warned that it regards financial risks as very serious. Although inflation remains rather high, we believe the **BoE will cut its repo rate at a rather quick pace and that by year-end it will stand at 4.00 per cent**. The BoE is thus sticking to its tradition of quickly following in the footsteps of the Fed when an international threat scenario begins to take shape.



The **European Central Bank** has not yet signalled its readiness to support the euro zone economies with interest rate cuts. It is no surprise that the ECB is less inclined than the Fed and the BoE to cut interest rates in the prevailing inflationary environment. However, we believe that relatively soon, the economic slowdown will reach such intensity that the ECB will become more forward-looking in its inflation analysis and will begin interest rate cuts. Historical experience indicates that after a certain period of demonstrating their independence, Western central banks do not usually stay out of phase for any long period. **We foresee that during the second quarter, the ECB will begin cutting its refi rate, which will stand at 3.25 per cent at year-end and 3.00 per cent early in 2009.**

The Nordic central banks are likely to wait longer before cutting their key interest rates. Sweden's **Riksbank** is probably more growth-oriented than the ECB. However, due to a stronger Swedish economy and a more stable financial situation, among other things in the housing market, we expect that no rate cut will materialise until this summer. Early in 2009, the repo rate will stand at 3.00 per cent. In Norway, **Norges Bank** will need to take overheating risks into account for significantly longer than its European colleagues. We anticipate that a further hike in the sight deposit rate may well be likely, and we do not expect rate cuts to begin until early in 2009.

Due to weaknesses in the Japanese economy, the **Bank of Japan's** ambition to normalise its key interest rate will be postponed. Given renewed deflation risks, an increasingly deep stock market downturn and a strong yen in the wake of decreased global risk appetite, interest rate hikes seem very distant. The situation in **China** is diametrically different. Overheating risks will require continued tightening of economic policy, including interest rate hikes.

Key rates

Per cent

	Currently	Mar 2009	Neutral
United States	3.00	2.00	4.25
Euro zone	4.00	3.00	4.00
United Kingdom	5.50	3.50	4.50
Sweden	4.00	3.00	4.25
Norway	5.25	5.00	5.00

Source: SEB

A larger role for fiscal policy?

For a long time, monetary policy has been the main stabilisation policy medicine during an economic slump. Although interest rate policy will account for most economic policy stimulus this time too, fiscal policy may assume a larger role than for many years.

For certain reasons that the IMF and others have recently identified, **important parts of economies will be less responsive to interest rate cuts than usual**. Another argument for letting fiscal policy carry a large burden is that excessively low interest rates threaten to trigger renewed imbalances.

In the United States, there is great faith in fiscal policy. Stimulus packages began to be designed as soon as the severity of the economic situation began to be evident. The Fed has also underscored the importance of rapid fiscal policy stimulus. In Europe, the attitude is different. A lack of discipline related to official budget targets, especially within the framework of the EU's Stability Pact, has been a focus of fiscal policy debate. Fundamentally, of course, this is about problems related to the low structural level of public saving. This seemed to have spilled over into a general scepticism about the potential for applying fiscal stimulus measures at the right time.

Overall, however, we expect an active role for fiscal policy in most countries. Due to the total impact of fiscally expansive programmes and the effects of the economic cycle, we foresee rather rapid deterioration in public finances in the next couple of years.

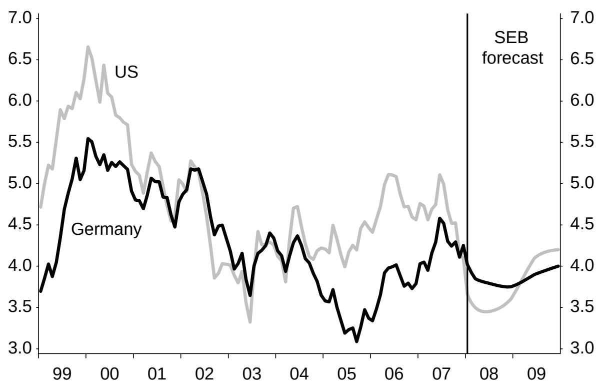
Potential for falling long-term yields

Bond yields have fallen sharply during the past six months. The fixed income market adapted more quickly than the stock market to a significant economic slowdown. Our forecast of far-reaching central bank rate cuts implies a certain additional potential for falling long-term yields.

Meanwhile there are also reasons to argue that this potential is no longer so large. Despite our relatively optimistic view of inflation, a higher inflation rate is likely to create a somewhat higher floor for long-term yields compared to the situation in 2003 and 2004, when the threat of deflation seemed imminent. The weakening of public sector financial saving will also lead to a rather large increase in the supply of government securities, which will push up interest rates somewhat on the margin.

Overall, we expect US Treasury bond yields to bottom out at 3.45 per cent in mid-year. In Germany, long-term yields will remain under pressure in the autumn due to the ECB's interest rate cuts, reaching 3.75 per cent by year-end. In Sweden, the Riksbank's interest rate cuts will largely coincide in time with those of the ECB. This will contribute to small movements in the long-term yield spread. However, we expect a return to normal conditions, with a certain positive yield spread between Sweden and Germany. Due to the strong Norwegian economy, the yield spread between Norway and Germany will again increase somewhat in the near future and stand at around 50 basis points.

10-year government yields
Per cent



Sources: Reuters EcoWin, SEB

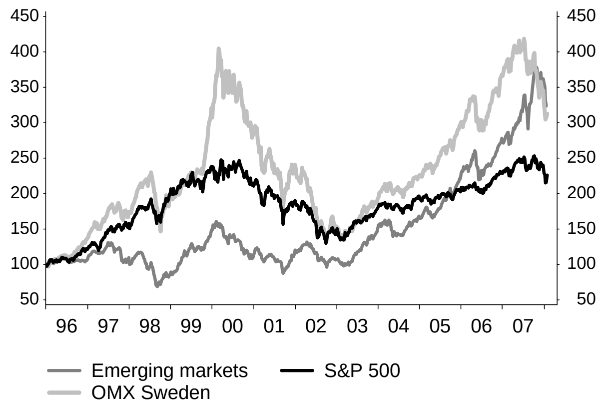
Low valuations, but continued risks

In recent months, the deteriorating economic outlook has triggered sharp downturns in the world's stock markets. The downturn in the broad American stock market indices has been comparatively modest, among other things due to support from the weak dollar, whereas the downturn on the Nordic stock markets has been significantly larger.

Our macro scenario implies that further growth disappointments are to be expected in the immediate future. This probably also means there is some potential for disappointments about corporate profits, putting additional pressure on stock markets. We thus anticipate that the stock market climate will remain unsettled in the months ahead.

Stock market valuations have fallen to historically low levels, however. This means that there should be rather limited room for further declines, unless the economic slowdown is deeper than we predict. Given historical experiences of the interaction between interest rate cuts, economic cycles and stock market movements, it is thus likely that the stock market outlook will brighten as the summer approaches.

Stock market trends
Index, per cent



Source: Reuters EcoWin

Euro close to peaking

In recent years, European currencies have had to carry a heavy burden when it comes to the adjustments needed to correct global imbalances. Due to the weakness of the Japanese economy, the yen has shown a weakening trend, which has probably only been temporarily interrupted by the current credit crisis. The appreciation of the Chinese yuan against the US dollar has admittedly intensified recently but still occurs so slowly that the concurrent weakening of the dollar has blocked the adjustment process when it comes to currency rate relations between China and Western Europe.

The decline of the British pound in the past six months has further increased the burden on the euro. In effective terms, the appreciation of the euro has been sharply accentuated during the past year.

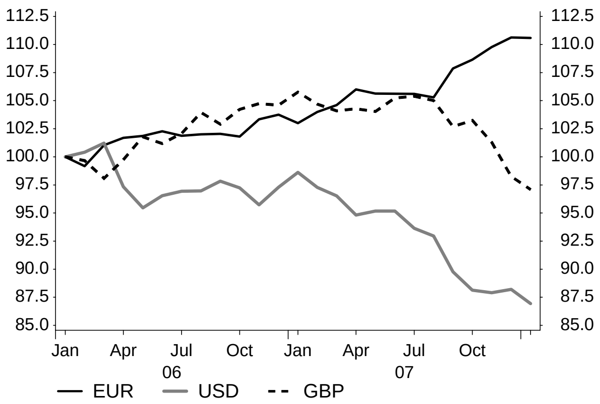
We expect a further strengthening of the euro in the immediate future. The Fed's aggressive interest rate cuts and the deepening slump in the American economy will dominate exchange rate movements for another while. Our forecast is that the EUR/USD exchange rate will exceed 1.54 during the spring. Meanwhile the euro will continue to strengthen against the pound as the Bank of England carries out large interest rate cuts.

The focus will gradually shift to weaknesses in the euro zone and the ECB's interest rate cuts, at the same time as the end of the Fed's rate-cutting cycle begins to loom on the horizon. This means that we see room for a gradual recovery in the dollar to 1.40 per euro.

Continued weak risk appetite will also affect other exchange rate forecasts for the near future. This means that the Japanese yen will stand at comparatively strong levels of around 105 per USD in the coming months. After that it will gradually weaken to 118 towards the end of 2009.

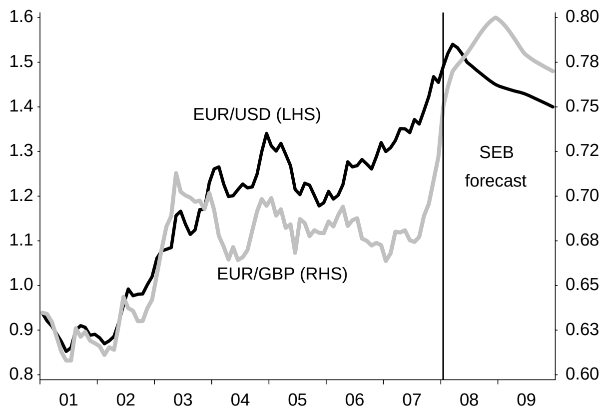
Effective exchange rate

Index January 2006 = 100



Source: Bank of England

Exchange rates EUR/USD and EUR/GBP



Sources: Reuters EcoWin, SEB

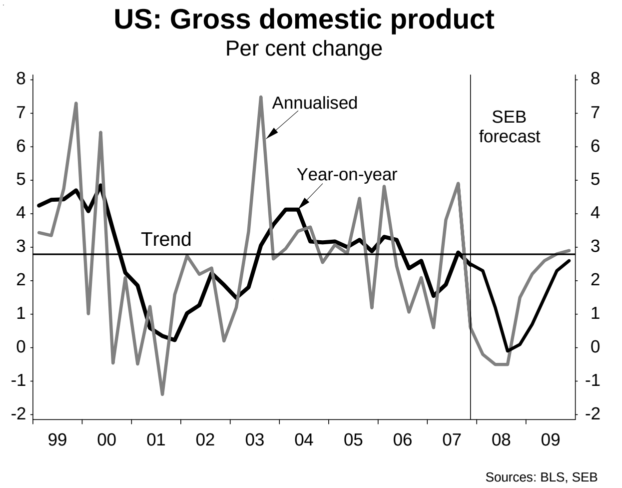
The Swedish krona will also have difficulty strengthening against the euro in the prevailing environment. We expect the EUR/SEK exchange rate to remain around 9.45 during the spring. The subsequent strengthening of the Swedish krona will be very modest. We expect the EUR/SEK exchange rate to be around 9.30 at year-end. The Norwegian krone, however, will enjoy continued support as a strong economy prevents Norges Bank from cutting interest rates for another substantial period.

Recession during 2008

- **Housing market will continue to fall**
- **Unemployment will climb to 6.5 per cent**
- **Core inflation will fall**
- **Key interest rate will be cut to 2.00 per cent**

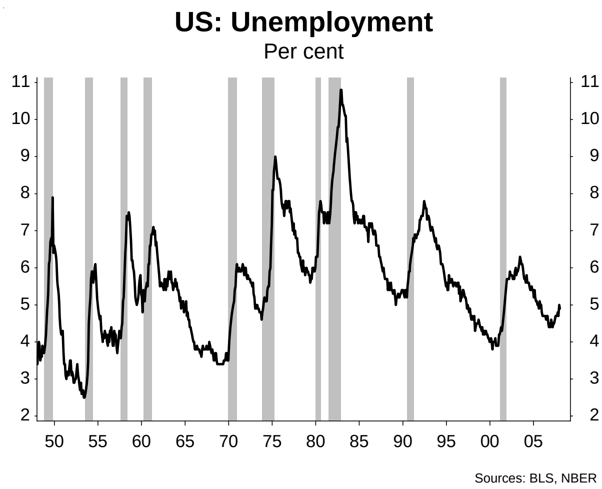
The American economy is now moving into a recession. A combination of ever-tightening credit conditions, falling home prices and a weaker labour market is creating a negative dynamic that will lead to a deeper slowdown than we had previously thought. After strong third-quarter growth figures, the economy decelerated sharply during the fourth quarter. GDP growth was a mere 0.6 per cent. Our assessment is that the slowdown will accelerate and GDP growth will be negative during the first three quarters of 2008. **We expect average GDP growth of only 0.9 per cent this year and 1.8 per cent in 2009**.

The Federal Reserve will continue to prop up the economy, and we anticipate that the **federal funds rate will be cut to 2.00 per cent during 2008**. This means that we are adjusting our dovish interest rate forecast by 150 basis points compared to the November ***Nordic Outlook***. Vigorous Fed action, fiscal stimulus, the weak dollar and relatively decent demand in other countries will help soften the slowdown.



Many indicators have passed the limit that is reconcilable with the type of mid-cycle correction that was previously our main scenario. Manufacturing performance has weakened despite a strong export upturn. The ISM purchasing managers' index in manufacturing has fallen over the last six months and the Fed's index of industrial production fell during the fourth quarter. The effect on the household sector is also becoming apparent. Consumer confidence has fallen, and retail sales were down in December.

Clear recessionary signals are also coming from the labour market. In December, unemployment totalled 5.0 per cent and remained around that level in January, compared to 4.4 per cent ten months earlier. In the past 60 years, such a large upturn has, without exception, led the economy into a recession. Other labour market indicators are also pointing south. According to the Bureau of Labor Statistics' Household Survey, job growth is now slower than in the initial phase of the last two recessions. Many companies are already poised to trim their workforce, as reflected in the BLS' "diffusion index", which has fallen well below the 50 mark.



Although not all indicators agree yet, there are many signs that negative tendencies will strengthen further. Large credit losses are paralysing the financial services systems in some respects. The credit crunch, combined with falling home prices and a weaker labour market, will create a negative spiral that will dominate economic trends during 2008. Macroeconomic analysis is thus **confirming the recessionary fears that first dominated the fixed income market and then spread to the stock market**.

Negative spiral in housing market

We previously predicted that residential construction and home prices will continue to fall throughout 2008. The ongoing credit market crisis will deepen this downturn. Even households with good creditworthiness are encountering tighter credit conditions, which will help amplify the downturn in both home prices and market volume.

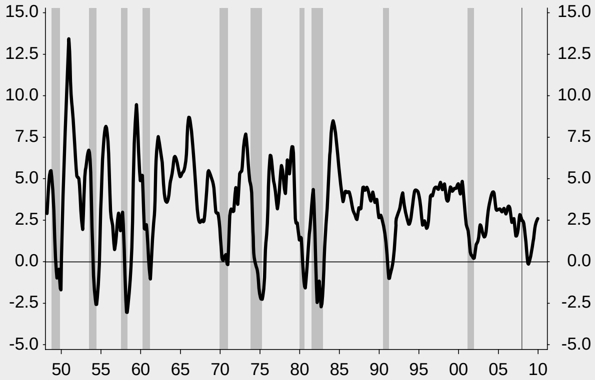
Although the number of housing starts has more than halved since the peak in January 2006, the oversupply of homes has not decreased significantly. Vacancies are still at the highest levels that have been measured. Not until well into next year is the housing supply expected to be at the level of demand. **By then, we expect home prices to have fallen by 15-20 per**

American recessions

According to the National Bureau of Economic Research (NBER), which is responsible for the dating of US economic cycles, what characterises recessions is that the activity level of certain key variables (real GDP growth, real income, employment, industrial production, retail and wholesale trade) has peaked and is declining. The most common definition — two consecutive quarters of negative GDP growth — is thus not the official one. GDP growth usually falls for a few quarters during recessions, however, so the definitions often coincide.

US: GDP and recession

Year-on-year percentage change



Sources: US Department of Commerce, NBER, SEB

Since the Second World War, the NBER has identified ten recessions. Earlier American recessions indicate that the **stock market peaks about six months before the recession begins** and falls by around 25 per cent from its peak. **The Fed cuts interest rates by a total of 400 basis points** and the key interest rate falls below zero in real terms. Year-on-year GDP growth **bottoms out at -1 per cent. Unemployment rises by 3 percentage points and the recession lasts ten months** before an economic upturn begins again.

Another observation is that recessions dominated by a slowdown in consumption seem to last longer than those that are investment-led. In 2001 companies cut back on their capital spending, while today we are mainly looking ahead at a consumption-dominated slowdown.

Comparing recessions

Trough in year-on-year growth, percentage points

	2008*	2001	1990	1981
GDP	-0.1	0.2	-1.0	-2.7
Private consumption	0.2	1.9	-0.4	0.0
Private investments	-5.0	-11.7	-5.2	-9.6
Unemployment**	2.0	2.4	2.8	3.6
Fed funds	-3.25	-4.75	-5.25	-11.0

*SEB forecast

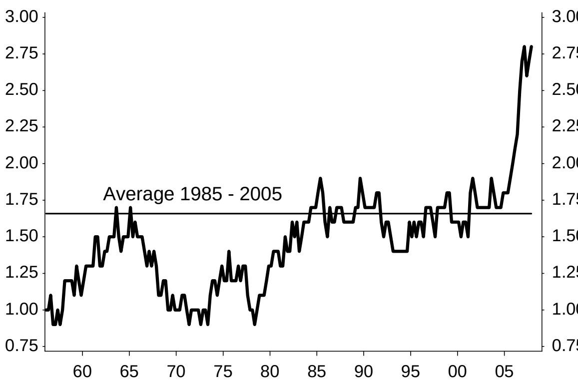
**Total increase in unemployment

cent from their peak in 2006. Home investments as a percentage of GDP will reach historical lows.

The downturn in residential construction will also affect other industries. Such sectors as building material sales, infrastructure expansion, estate agent services, interior decorating, banking and finance expanded rapidly as a result of the preceding construction boom. It is reasonable to assume that we are also facing adjustments in these fields as the housing market downturn continues.

US: Vacancy rates

Per cent



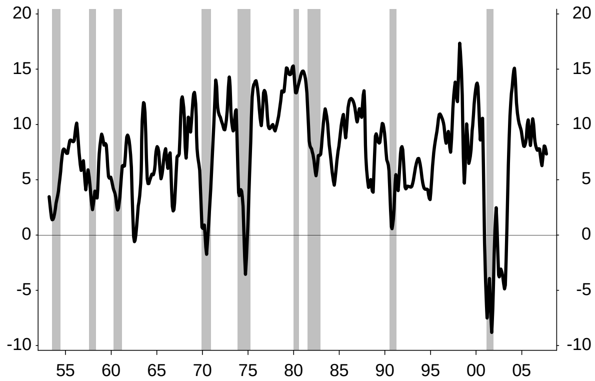
Source: Bureau of the Census

Sharply slower consumption growth

Household consumption growth will slow sharply during 2008. Consumption is being squeezed from several directions. Rising unemployment, lower job growth and high inflation are pushing down income. We expect the growth rate in real disposable income to cool from more than 3 per cent in 2007 to 1.7 per cent in 2008.

US: Net worth

Year-on-year percentage change



Sources: Federal Reserve Board, NBER

Consumption will also slow via the wealth effect. According to empirical estimates, about 5 per cent of a change in household wealth is expressed as a change in consumption. Our estimates indicate that the consumption-dampening effect in 2008 and 2009 will be equivalent to nearly one percentage point. The stock market slide of recent months will worsen the situation. Total growth in net worth will probably fall during 2008.

We expect a decline in household consumption in both the second and third quarter of this year. Annual average consumption growth will slow from 2.9 per cent in 2007 to 0.8 per cent in 2008, then rise somewhat in 2009. This forecast implies that household saving will climb above 2 per cent of disposable income towards the end of our forecast period.

Cautious capital spending behaviour

To date, capital spending outside the housing sector has shown varying trends. Robust growth in many service sectors has led to a rapid increase in the construction of commercial space. Lower demand for construction resources in the housing sector has certainly played a role for the upturn in other construction.

However, we expect that capital spending outside the housing sector will now also decelerate. This is partly due to tighter credit conditions, especially related to construction of commercial space. Weaker demand and a poorer profit outlook are other important reasons why we are now revising our capital spending forecast downward. We anticipate further adjustments in profit forecasts during the next six months or so. A strong profit trend outside the US can hardly offset the downturn, since only around 20 per cent of American corporate profits are generated abroad.

Overall, we expect corporate capital spending measured as annual averages to stagnate in 2008, then decrease by about 1.4 per cent in 2009. **This capital spending downturn is relatively mild in historical terms.** Since the level of capital spending is relatively low at the outset, the need to lower it is less today than during previous downturns.

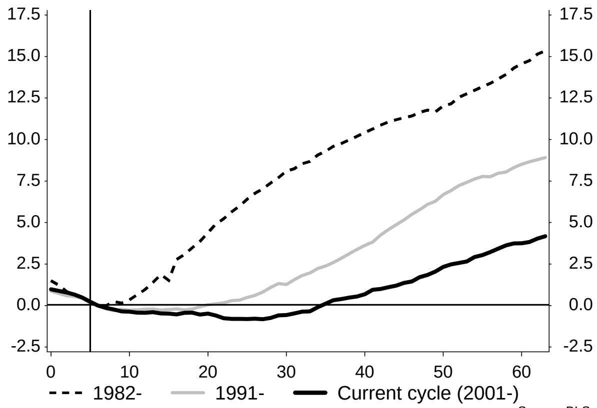
Rising unemployment

Although the rate of economic growth has been below trend for some time, the labour market situation has remained relatively tight. We now anticipate that companies will have to respond relatively soon to further slowdowns in production by cutting their workforce. This year's outcome will be that employment will shrink by an average of 100,000 per month.

Before the cyclical upturn has been confirmed, as during the two previous economic cycles, companies will be restrictive with new hires. We thus expect unemployment to keep climbing well into 2009, peaking at about 6.5 per cent in the spring. This implies an upturn of only about 2 percentage points, compared to the historical average of 3 percentage points during the 10 most recent US recessions. One reason is that companies were more cautious in their hiring decisions during the most recent economic cycle. In addition, today there is a clearer connection between profit and labour costs at many companies. This indicates that companies will not need to trim their workforce quite as much as demand and profits weaken. In addition, underlying trend growth in the labour supply has become lower in recent years. A given slowdown in employment thus does not have as big an impact on the jobless rate as previously.

US: Employment over previous cycles

Percentage change from trough



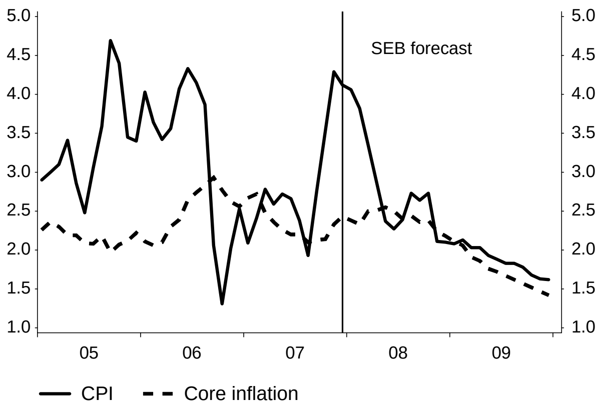
Source: BLS

Core inflation will fall

The Consumer Price Index climbed at a rapid pace last autumn. Early in 2008, CPI inflation peaked at more than 4 per cent, driven by energy and food prices. Although inflation will now fall relatively fast, our forecast means that in 2008 CPI inflation will average nearly 3 per cent, for the fourth consecutive year.

US: Inflation

Year-on-year percentage change



Sources: BLS, SEB

Core inflation, which fell during most of 2007, rose late in the year. One important reason for the upturn in core inflation is rising rent costs. The housing market situation has increased the demand for rental flats, pushing up rent levels. Looking ahead, there are many indications that core inflation will slow. The shelter component usually reacts to interest rate cuts, with a certain lag. Core inflation should also react to the slowdown in the economy. The historical association seems to indicate that **core inflation reacts to changing unemployment with a lag of about one year**. This means a cyclical slowdown in core inflation during the second half of 2008.

According to our overall forecast, core inflation will thus remain somewhat above 2 per cent on average during 2008, then fall in 2009. Core inflation according to the Personal Consumption Inflator (PCE) deflator is trending a little lower than core CPI, so it is likely that this measure will end up averaging around 1½ per cent in 2008 – in the middle of the Fed's 1-2 per cent preferred target interval.

Stimulus policy will soften slowdown

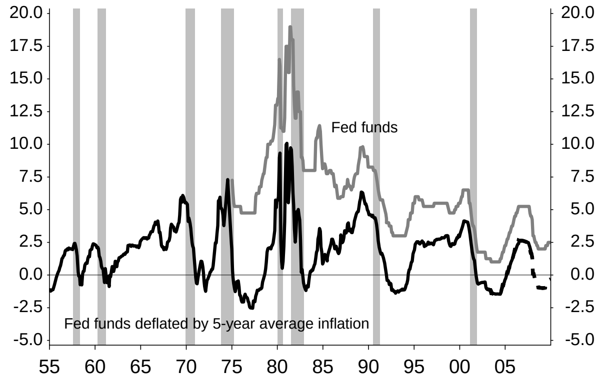
Our overall assessment is that the economy will slowly turn upward around the end of 2008, but that 2009 will be another year of GDP growth below trend. The slowdown in domestic demand will be deeper than according to the consensus scenario. However, the recession will be relatively mild in historical terms. Except for 2001, as a rule GDP growth has fallen year-on-year during recessions. We now predict that **year-on-year GDP growth will bottom out around zero late in 2008**.

The nature of this scenario is based on historical parallels, assumptions about economic policy and the special character traits of the current slowdown dynamic. The most recent recession in 2001 was mainly investment-led. Companies sharply cut back their capital spending activities, while the Fed's large interest rate cuts combined with lower taxes helped keep household consumption up. In many respects, the recession we now see ahead of us is more reminiscent of the early-1990s downturn, which was driven by a noticeable slowdown in consumption initiated by the savings and loan crisis and partly connected to a housing market deceleration.

The housing market now has such large adjustment needs that adjustments are likely to continue for longer than a historically normal recession period. This is also in line with the historical pattern, with consumption-led slowdowns tending to be more prolonged than investment-led slowdowns.

US: Real and nominal federal funds rate

Per cent



Sources: Fed, NBER

On the other hand, there are factors that indicate that the trough will not be too deep and prolonged. One important reason for this is the positive impact of foreign trade. To a greater degree than previously, American exporting companies will be helped by a weak dollar and by resilient growth in demand from other countries. This, in turn, is paradoxically a consequence of the shrinking global dominance of the American economy. The dependence of other countries on trade with the US has trended downward during the 21st century.

The US savings bank crisis

Caution is advisable when comparing the current mortgage crisis to the US savings and loan crisis of the late 1980s and early 1990s. The savings and loan crisis occurred after various deregulation measures gave rise to excessive risk-taking on loans, among others to a property market that was in an upward phase. The savings and loan crisis is generally regarded as the biggest US financial crisis since the Great Depression of the 1930s.

About a thousand savings and loans associations went bust or were restructured. The cost of rescuing the savings bank industry was about USD 160 billion – equivalent to more than 2.5 per cent of GDP – of which about USD 125 billion was borne by American taxpayers. The conventional view is that it was not the savings and loan crisis that triggered the US recession of the early 1990s, but it was probably a contributing factor. Credit conditions were tightened, adversely affecting growth.

At present, the US central bank's assessment is that credit losses directly related to "sub-prime" mortgages will total a few hundred billion dollars. We believe this is the amount the Fed regards as corresponding to realised credit losses. In addition, there are unrealised losses for various credit products that have arisen due to sharply higher risk pricing in the credit market. If the final bill for the sub-prime crisis ends up at USD 350 million, it will be as big as the savings and loan crisis, adjusted for today's prices.

Change of power on the way

Historically speaking, the economic situation has been a very important factor in presidential elections. The weak economy thus points towards a change of power and a Democratic victory in this autumn's presidential election, as public opinion surveys also indicate. It is rare for a presidential election to take place in as weak an economy as we predict this year. Since the Second World War, only one presidential election been held during an ongoing recession: in 1980, when Ronald Reagan won by a landslide over the incumbent president, Jimmy Carter. In 1992 a weak economy also probably helped bring down the incumbent when Bill Clinton defeated the first George Bush.

The election outcome is not likely to greatly affect the economic cycle. A new president, whether it is Hillary Clinton or Barack Obama, will probably continue to strengthen federal fiscal stimulus policy. Looking further ahead, it is difficult to predict events. Protectionist forces are traditionally stronger in the Democratic camp, and what has been said so far during the election campaigns does not seem to change this. Meanwhile there are many examples of how changes of power between Democratic and Republican presidents have brought an injection of new ideas for shaping US economic policy.

Economic policy naturally also plays a key role. Having already slashed its key interest rate by 225 basis points, the Fed has been unusually proactive. We expect the Fed to lower the funds rate further to 2 per cent. Combined with our inflation forecast, this means that in real terms, the key rate will drop below zero, giving US monetary policy a clearly expansive bias.

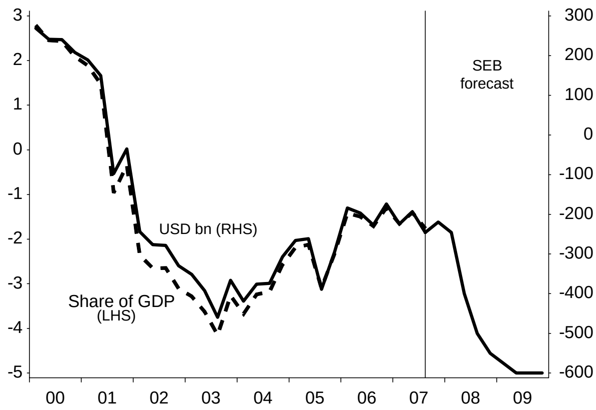
Consumers, companies and financial institutions will feel the effects of looser monetary policy by late 2008. Combined with fiscal policy measures, this implies that the economy will recover in the course of 2009, although adjustments in the housing market will continue to weigh the economy down. Wise from earlier experience, when excessively long period of loose monetary policy have helped pump up asset price bubbles, the Fed will probably again start normalising its monetary policy late in 2009, i.e. relatively soon after the economic recovery has begun.

More vigorous fiscal policy on the way

The fiscal stimulus package that the Bush administration has so far announced is equivalent to about USD 150 billion or 1 per cent of GDP. The plan includes tax cuts for both households and companies. Our forecast assumes that further fiscal policy measures equivalent to ½-1 per cent of GDP will be implemented as the economy weakens and the November 2008 presidential election approaches.

US public finances have improved in recent years, but the deficit will now increase sharply as a consequence of fiscal stimulus combined with cyclical effects. According to the Congressional Budget Office, during previous recessions the budget has automatically weakened by between 1 and 3 per cent of GDP as a consequence of declining revenue and rising expenditures. The mirror image of this is stimulation of demand by means of "automatic stabilisers".

US: Federal budget balance



Source: Reuters EcoWin

Looking further ahead, demographic pressures will contribute to greater uncertainty about the sustainability of US public finances. This will reduce the stimulative effect of fiscal measures, since households will assume that the related gains will only be temporary. The household savings ratio is also significantly lower today, which may indicate that tax rebate cheques, once in the hands of households, will have less impact than in 2001.

To summarise, economic policy will help ease the slowdown, but the effects of both monetary and fiscal policy will be delayed for so long that a recession will not be avoided. However, these measures will help sustain the recovery during late 2008 and in 2009. Viewed in a historical perspective, the dose of stimulation seems rather normal in scope for a recession. This medicine may possibly have been introduced a little earlier than normal, which may improve its effectiveness.

Less resilient

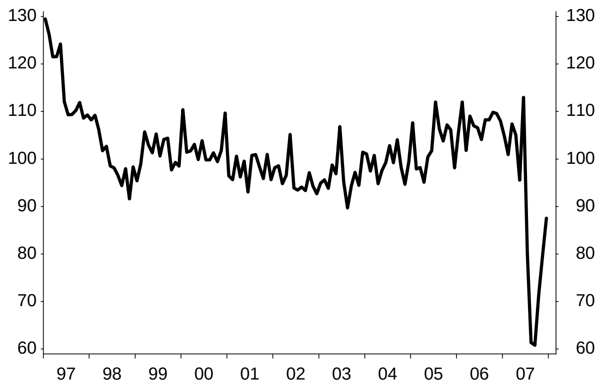
- **Dual economy**
- **Greater domestic downside risks**
- **Bank of Japan keeping rates unchanged**

The recovery that followed the "lost decade" has decelerated during the past year. In particular, domestic demand has been a disappointment — with only a tentative consumption upturn and a cooling investment climate. Given the lingering weaknesses in the domestic economy and a deceleration in the global economy, Japanese growth will slow further. **We expect GDP growth to fall to 1.2 per cent in 2008 and then recover somewhat to 1.5 per cent in 2009**.

To date, Japanese exports have held up relatively well despite the American economic slowdown. Exports to other Asian countries, especially China, have increased strongly. Japanese export-oriented companies have benefited from the earlier weakening of the yen and low pay increases have reinforced their competitiveness. Exporters also remain in a decent mood, according to the important Tankan survey. Small and medium-sized companies that focus mainly on the domestic market are substantially more pessimistic. This reflects a still sluggish domestic economy but to some extent it may also be connected to tighter credit conditions. This is due more to new domestic regulations than to the contagious effects of global credit market turmoil. Owing to the cautious financial investment strategies of Japanese banks, sub-prime-related losses have been small or negligible.

Japan: Housing starts

Thousand units



Source: Ministry of Land, Infrastructure and Transport

A number of forces are now contributing to a cool-down in Japanese domestic demand. More stringent construction standards, aimed among other things at improving earthquake safety, have caused a dramatic downturn in activity. Some recovery has admittedly occurred, but it is still possible that construction will remain weak for an extended period. A shrinking population points in the same direction, for example. One bright spot, however, is that property prices are recovering, especially in major metropolitan regions.

The opposition Democratic Party's victory in the upper house election has increased political uncertainty. An election to the lower house of the Diet (Parliament) will probably be announced during 2008, and there is a risk that the governing Liberal Democratic Party (LDP) will be further weakened. Because of this political deadlock, fiscal policy consolidation has been put on hold and household pessimism has grown. Household confidence indicators have fallen to their lowest level in four years. Also contributing to this trend is that the downturn in the stock market has been larger in Japan than in most countries.

On the other hand, a stronger labour market points towards a certain recovery in private consumption. Unemployment has continued to fall and is now lower than for nearly a decade. The strong wealth position of Japanese households also indicates there may be a slight upturn in consumption. Overall, we foresee private consumption rising by an average of 1½ per cent annually during 2008 and 2009.

In recent months, the Bank of Japan has become rather more cautious in its assessments. The BoJ has left its key interest rate unchanged at 0.5 per cent since February 2007. Due to the weaker economic outlook, an interest rate hike is hardly likely in the coming year, despite the BoJ's obvious ambition to "normalise" monetary policy. Inflation has admittedly climbed relatively fast in recent months, but this is almost exclusively a result of rising energy prices and, to a lesser degree, food prices. However, the stronger labour market and accelerating pay increases have had hardly any impact on the inflation trend. Since growth will barely reach the trend level and there is continued structural wage pressure, underlying inflation pressure will remain very weak.

Due to Japan's low interest rates, there is still reason to borrow in yen and invest in more high-yielding assets. Due to poorer risk appetite in the wake of the credit market crisis, however, this carry trade has become less attractive. Given our assessment that risk appetite will remain weak during much of 2008, we also expect this to support the yen. Meanwhile there are now signals that the BoJ may begin to intervene to slow the strenghtening of the yen. At the end of 2008, the exchange rate will be JPY 112 to the US dollar.

Slight cooling

- **Global slowdown has an effect**
- **Tightening measures intensify**
- **Continued overheating risks**

China's economy continued rushing at an unhealthy pace last year, with GDP growth topping 11 per cent. We anticipate that a combination of **global slowdown** and **economic policy tightening** will **curb growth** to 9.5 per cent this year and 8.5 per cent in 2009 – **still a bit above the long-term official target** of 7-8 per cent.

As earlier, investments and exports were the main growth engines in 2007. Foreign direct investments rose by 14 per cent to USD 83 billion. Most of these continued to focus on the overheated property and automotive sectors, as well as other export-oriented manufacturing. **Export growth** – in current USD – **remained** at 27 per cent, **despite** a **substantial slowdown in exports to the US**. This is a departure from the historical pattern; during the global recession after the turn of the millennium, the two curves stayed close together. The main reason is higher intra-Asian trade, but also rising exports to the EU, leading to a record currency influx. The foreign currency reserve now stands at a staggering USD 1,500 billion.

In the short term, it is difficult to discern any economic deceleration. Corporate sentiment surveys are clearly expansive; for example the manufacturing purchasing managers' index remains at around 53-54, but we believe that some deceleration will occur.

The global economic slowdown will intensify significantly, especially through a further deceleration in import demand from the US. The effects on the Chinese economy are admittedly difficult to assess. One World Bank **rule of thumb** says that a 1 per cent **reduction in American private consumption** only **slows Chinese GDP** by 0.2 per cent. In that case, the deceleration we predict in the US between 2007 and 2008 would only cool growth by 0.4 percentage points in China during 2008. Yet such rules of thumb often risk underestimating total effects. For example, it is likely that secondary effects via lower exports to other Asian countries will be far bigger. A large proportion of intra-regional trade consists of input goods that are ultimately also dependent on end customers in the US market. The spread of the slowdown to Europe will also contribute to an export slowdown in China.

The government is also **intensifying its economic policy tightening**. Last year it raised interest rates six times and bank reserve requirements ten times. Late in 2007, it accelerated the annual pace of yuan revaluation against the US dollar to about 7 per cent, and we expect further upward adjustments in 2008. New policy elements are also on the way. In November, banks were ordered to freeze lending for the rest of the year. Meanwhile the government announced stricter lending controls, with quarterly ceilings. The target of the authorities is to keep credit growth from exceeding 14-14.5 per cent in 2008. This represents a significant reduction from earlier levels.

The inflation rate rose almost continuously last year, from 2 to nearly 7 per cent – largely due to rising food prices, especially for pork. But other prices have also begun moving upward recently. For the first time in many years, the authorities responded with price controls, while imposing taxes on grain exports. The effects of these actions are uncertain, but we expect the **inflation rate to slow slowly** in the coming year.

With China aiming at more sustainable growth levels, the global economic slowdown may help ease the imbalances over the next couple of years. But it remains an open question to what extent central planning-style austerity policies will actually succeed in slowing the increasingly market-oriented Chinese economy. The risks of a hard landing thus persist.

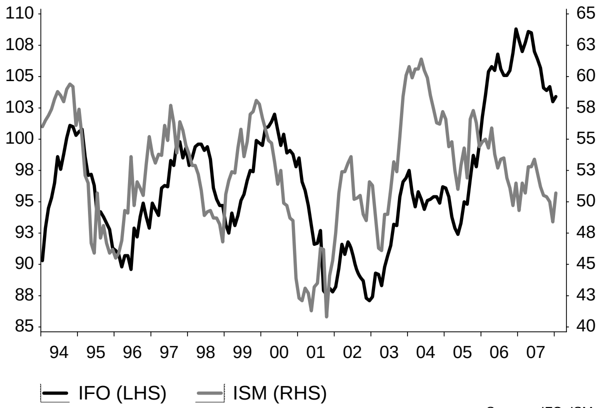
Below trend for two years

- **Exports now losing momentum**
- **No consumer upturn in sight**
- **Deceleration squeezing core inflation**
- **ECB will cut refi rate to 3.25 per cent this year**

The euro zone is about to lose its economic momentum. The effects of the American slowdown and the financial market tightening are gradually becoming more apparent. The strong euro is also squeezing exports, and purchasing power is being eroded by rising energy and food prices. We expect GDP growth to cool to 1.3 per cent in 2008, then climb somewhat faster in 2009. Worries about the inflation trend will gradually dissipate, helping persuade the European Central Bank to lower its refi rate to 3.25 per cent during 2008.

IFO (Germany) and ISM (US)

Index

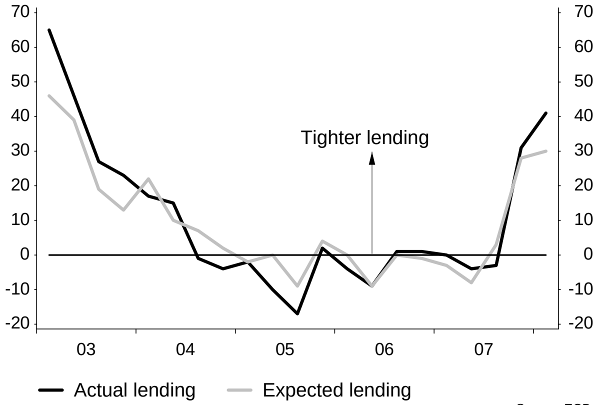


Sources: IFO, ISM

The euro zone economy remained vigorous during much of 2007, mainly due to a continued strong export trend. Third-quarter GDP growth reached 2.7 per cent year-on-year. In recent months, however, it has begun to be increasingly clear that a slowdown is on the way. Germany's important IFO index has fallen since its high point in April last year indicating that the manufacturing sector has peaked this time around. The ZEW index, which measures the level of economic optimism in the German financial market, has fallen sharply. In January the index hit its lowest level since 1993, when the German recession bottomed out after a brief reunification boom in the early 1990s.

Euro zone: Corporate credit standards

Net percentage, tighter minus looser

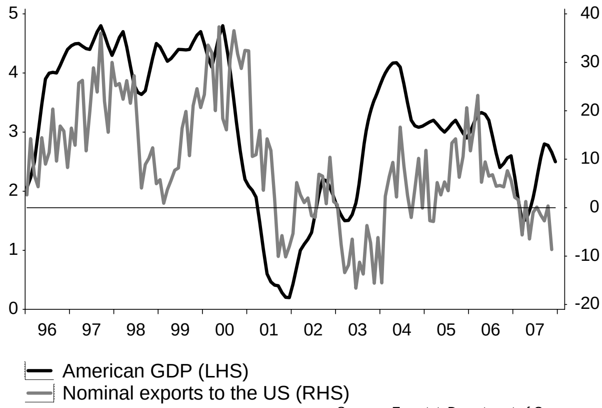


Source: ECB

Contagious effects from the US slowdown are arriving via exports, as well as via financial market channels. The ECB's bank lending survey shows that corporate credit conditions have tightened significantly since the second quarter of 2007.

US GDP and euro zone exports

Year-on-year percentage change



Sources: Eurostat, Department of Commerce

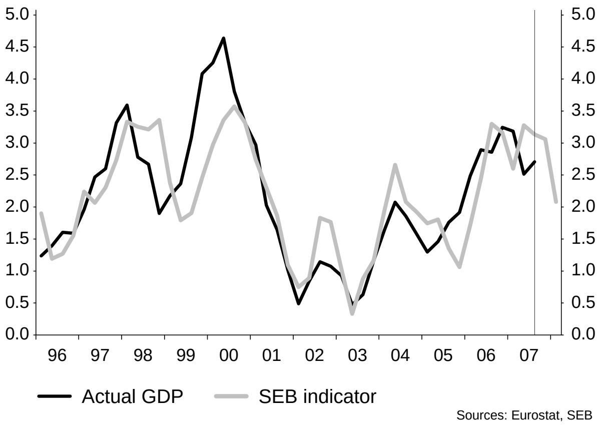
Euro zone exports to the United States have gradually slowed from around a 20 per cent rate of increase in the spring of 2006 to a weak downturn late in 2007, measured in nominal terms. Most indications are that exports to the US will cool further as the economic slowdown deepens. US demand for imports will weaken on a broader front.

Euro zone: Retail sales and confidence

Sources: DE ECFIN, Eurostat

Changes in the **euro zone's export structure will soften the slowdown, however**. The US share of exports has decreased from 18 per cent at the turn of the 21st century to 13 per cent today, while the share of euro zone exports destined for fast-growing economies in Asia and Eastern Europe has increased. Most apparent is the expansion in trade with Russia and Central Europe (Poland, Slovakia, the Czech Republic and Hungary), whose share of euro zone exports has risen from below 10 per cent in 2000 to more than 15 per cent today.

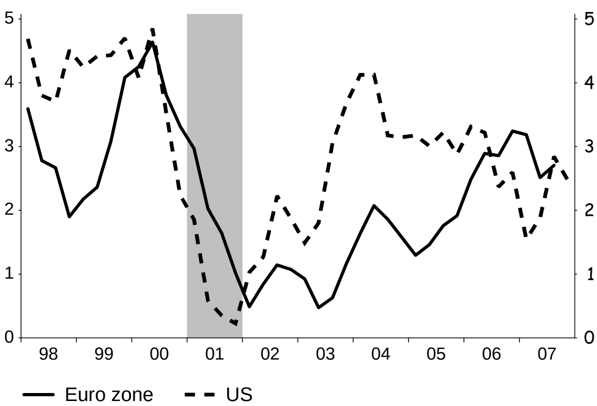
Euro zone: GDP growth and growth indicator
Year-on-year percentage change



Sources: Eurostat, SEB

A continued strong labour market, rising pay increases and a strong balance sheet in the household sector will also help improve the resilience of the euro zone economies. The weak retail figures of recent months, combined with increasingly tight credit conditions, nevertheless make it difficult to believe that households could fully replace the export industry as the engine of the economy. Our forecast implies that **consumption growth will only reach a modest 1.5 per cent or so this year and in 2009.**

GDP in the euro zone and the US
Year-on-year percentage change



Sources: Eurostat, US Department of Commerce

We now anticipate that **GDP growth will end up at 1.3 per cent this year and somewhat higher in 2009**, which is below our November forecast. Our short-term growth indicator – based on an estimated correlation between euro zone growth and a selection of leading indicators – is pointing towards GDP growth of around 2 per cent year-on-year during the first quarter of 2008 and a further cooling during the second quarter. In both Germany and France, GDP will grow by just below 1.5 per cent this year, while Italian GDP growth will reach only about 1 per cent. The slowdown in the euro zone will thus not be as sharp as in 2001-2003 after the IT bubble had burst.

Shaky housing market

Today the housing market is about to weaken in the euro zone as well. Although the structure of the housing market is different, residential price movements in the US and Western Europe have been strikingly synchronised in recent decades. Studies from the IMF show that some 25 per cent of the home price upturn in the euro zone lacks any basis in underlying economic performance. This indicates that there is also room for a home price decline in Europe. Ireland, the Netherlands and Spain are especially vulnerable countries, considering the long preceding period of sharp price increases. In various countries, construction volume has also been pushed up to historically very high levels. Our assessment is that even though a number of countries in Europe – especially Ireland and Spain – have already been pulled into a housing market downturn, the **financial market and real economic strains will be less than in the US**. German home prices have been very restrained in recent years, which will have a stabilising effect in this context since the risk of dramatic slides will thus be lower.

Labour market will level off

So far the economic slowdown has not affected the euro zone labour market. Unemployment continues to fall in most countries. Germany noted a new six-year low in December, and clear declines were also reported in Italy, France and Spain. No rapid swing in the labour market is discernible; for the time being, new jobs are being created at a healthy pace and recruitment plans remain at a high level.

With growth now dropping below its trend level, there are nevertheless indications that job creation will gradually slow and unemployment will eventually level off and then increase. We believe that **unemployment in the euro zone as a whole will end up at 7.1 per cent this year, then rise to 7.4 per cent in 2009**.

Rising wages late in the economic cycle

Several German wage agreements were concluded at a higher level in 2007 than for many years. The collective contracts between the IG Metall union and metalworking employers, for example, represent pay hikes of about 4 per cent this year. In recent months there have been further signs that wages and salaries are on their way up. After several years of stagnation, there are calls for **record-high pay increases in the service sector**. The Verdi union (second in size to IG

Metall) has demanded an **8 per cent pay hike for its members in the public sector**. In other sectors, pay demands are between 4 and 8 per cent. These demands are motivated by large corporate profits and by weaker purchasing power due to rising inflation.

Germany's Chancellor Angela Merkel and Labour Minister Olaf Scholz have expressed some support for higher wage demands. Moreover, the Social Democratic Party wants to **extend minimum wages to other sectors** than the postal sector, but Merkel refuses. Most economists, including those at the ECB, have warned about the risk of a wage-price spiral in the euro zone's largest economy. However, we consider this risk to be small, since the agreements only encompass about 10 per cent of the labour force and **actual contracts usually end up well below demands**. Furthermore, in recent years unit labour costs have increased significantly more slowly in the euro zone than in most other comparable countries, which means cost pressure remains low.

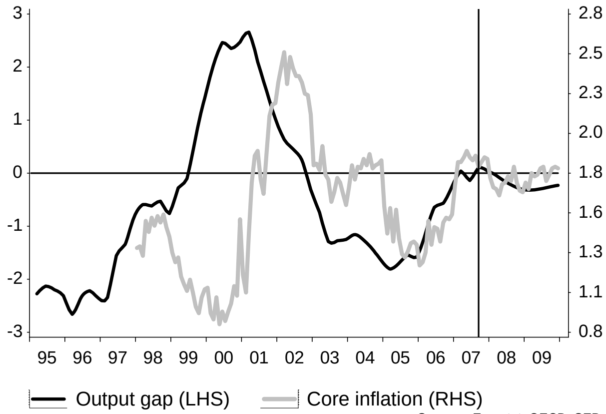
Gradual slowing in resource utilisation

The jobless rate is now in the vicinity of the **traditional measure of equilibrium unemployment — the non-accelerating inflation rate of unemployment (NAIRU)**. In the short term, there is consequently some risk of accelerating pay hikes, which various labour shortage yardsticks also indicate. Historical associations between lower unemployment and future hourly wages also point towards rising pay increases. We thus anticipate that **hourly wage increases will accelerate from today's low 2.5 per cent to about 3.5 per cent next year**.

Until recent the output gap – the difference between actual and potential output – has signalled that **cost pressure is on the way up**. However, our GDP forecast implies that the **output gap will shrink somewhat during 2008 and 2009**. This lowers the risk that high energy and food prices will spread, triggering a general upturn in inflation.

Euro zone: Core inflation and output gap

Per cent



Sources: Eurostat, OECD, SEB

Inflation above target

The inflation rate has increased rapidly in recent months: from 1.7 per cent in August to 3.1 per cent in December. Rising petrol prices are contributing 0.8 percentage points to inflation. There are many indications that the Harmonised Index of Consumer Prices (HICP inflation) will stay above 3 per cent throughout the first quarter. Food prices will probably continue to rise further – the pace of the increase will peak at about 5 per cent around mid-year.

After that, the inflation rate will gradually slow as economic growth weakens and as energy and food prices contribute less to inflation. **HICP inflation will end up averaging 2.7 per cent this year, then fall**

Weaker budget balances

As expected, Germany's public sector budget was in the black last year, for the first time in nearly 20 years. The surplus was mainly a result of strong economic performance and improvement in the social security system in recent years, but fiscal policy measures such as a hike in value-added taxes (VAT) also played a part.

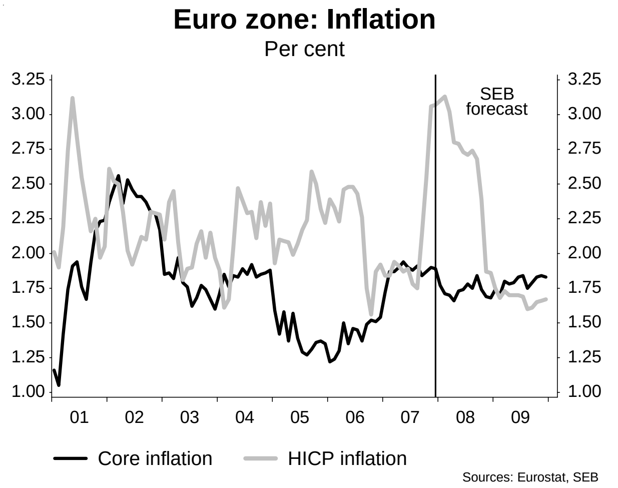
The budget improvement was most apparent at the local and state level, but the federal budget also strengthened. The budget balances of German states vary greatly. About half remain in the red, with the most troublesome deficit in Brandenburg, which surrounds Berlin.

As the German economy loses momentum, though, the budget situation will deteriorate; one common rule of thumb is that a 1 percentage point decline in GDP growth lowers the budget balance by about 0.5 percentage point of GDP. This year, corporate tax cuts and lower unemployment contributions will also help shrink federal revenue, while rising public sector pay will push up expenditures.

The French government does not expect to achieve a balanced budget until 2012. President Nicolas Sarkozy has had major problems with his plan to jump-start the French economy by any means necessary. His plans to change the pension rules that grant special privileges to employees of publicly owned companies were met by strikes. He has also been forced to back off from his election promise to replace only one out of two civil servants who retire.

Looking ahead, we expect the budget balance in the euro zone as a whole to weaken. We estimate the deficit at between -0.5 and -0.8 per cent of GDP this year and next.

to an average of 1.7 per cent in 2009. Core inflation will stay below 2 per cent throughout our forecast period.



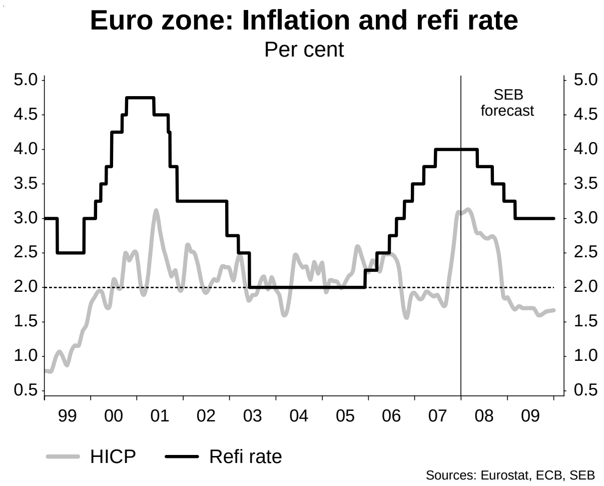
A continued tight labour market for some time to come – combined with certain, albeit anecdotal, indications of higher pay increases in Germany – imply an upside risk in our inflation forecast. This should, however, be offset by the risk that the credit and financial market crisis will become more prolonged and deeper, resulting in larger negative effects on the real economy and lower inflation pressure. Our assessment is that the **inflation risk is symmetric**.

ECB will cut refi to 3.25 per cent in 2008

We anticipate that this spring, the ECB will gradually tone down its currently hawkish rhetoric. Arguments against interest rate cuts — such as rising money supply, a tight labour market and the risk that high energy and food prices will fuel inflationary expectations and pay demands – are likely to weaken gradually. Instead, the focus will shift towards the risks on the growth side. An economic slowdown, a strong euro and a deepening of financial market risks indicate that the **ECB will cut its refi rate to 3.25 per cent during 2008**. We expect these rate cuts to begin in May.

By all indications, the US economic slowdown will be more dramatic than the ECB previously anticipated. The Federal Reserve has already slashed its key interest rate by 225 basis points and has announced that continued vigorous measures to stimulate the economy are on the way. **Historical experience shows that monetary policy in the US and Western Europe almost never end up completely out of phase.** It is difficult to find support for the viewpoint that today's situation is so historically unique that this pattern will be interrupted.

At the beginning of a period of US key interest rate cuts, it is also common for European central banks to want to dampen expectations of rate cuts on their side of the Atlantic. For this purpose, they usually tone down the connections between the US and Western Europe and the mechanisms that spread economic changes between them – a position which is then gradually undermined by the actual course of events. The ECB cut its interest rates during the period 2001-2004, **even though inflation was then mostly above 2 per cent, which also shows a more pragmatic approach to interest rate policy** than the bank's rhetoric sometimes implies.



In recent years, the actions of the ECB have strengthened its stature and credibility. At an early stage, the bank showed its confidence in the economic recovery. Backed by a strong cyclical expansion, it guided the market firmly through its rate hiking cycle. Now that the economy is weakening and problems such as those related to the housing market vary sharply between countries, strains and tensions may once again emerge among the countries working together in the ECB. The same applies to the EU's Stability Pact, whose public budget deficit target may limit room for fiscal stimulation measures in some countries. In case of genuinely large strains, it may turn out that rigidities and conflicts among euro zone countries become so large that the **economic slowdown will even end up being deeper than in the US, due to a lack of appropriate policy responses**.

A halving of GDP growth

- **Domestic demand weakening**
- **Pound will continue to slide**
- **Sharp key interest rate cuts ahead**

The British economy will decelerate noticeably in 2008, after more than two years of stable above-trend growth. In line with our earlier forecasts, relatively sharp monetary policy tightening by the Bank of England (BoE) in 2006-2007 will have an impact on speculatively inflated home prices and highly indebted households. The downturn is now also being reinforced by tighter credit conditions and a less favourable global outlook. A powerful shift in monetary policy, with key interest rate cuts totalling 225 basis points including the December 2007 cut — combined with a falling currency — will save the economy from recession. We expect **growth to fall from** about **3 per cent** last year **to 1.4 per cent this year and 1.8 per cent in 2009**. We have adjusted our 2008 forecast downward by about half a percentage point since the November issue of ***Nordic Outlook***.

Exactly as in the US, **households play the largest role** in British economic performance. Retail sales fell in December, and there are many indications that this is the beginning of a decelerating trend in consumption growth. A late-autumn downturn both in various service sector confidence surveys and in household optimism also point in this direction. The labour market remains strong, and in the course of 2008 it will weaken only modestly. But households will be **squeezed by accentuated tendencies towards weakness in the property market**, combined by **continued credit tightening** in the wake of financial market turmoil. Household saving will thus climb from today's very low levels, and consumption growth will slow from 3 per cent in 2007 to 1½ per cent this year.

The long home price upturn that started in the mid-1990s is ending. The residential market previously showed cooling tendencies in both 2000 and 2005. But the signs of weakness are now significantly more serious. The Halifax House Price Index has shown monthly downturns since September, except for a probably temporary rebound in December. The price expectations of estate agents, as measured by the RICS survey – a good leading indicator – have never been lower since the survey started a decade ago. We expect home prices to fall by about 10 per cent in 2008, with a continued price decline in 2009.

Exports are performing relatively well despite weak exports to the US over the past year. The US weighs heavily in British foreign trade, accounting for about 15 per cent of total exports. In 2008-2009, however, we expect modest 3-5 per cent export increases. Exports will be sustained by the **competitive advantage** the UK will now gain due to a **sharp weakening in the pound**.

United Kingdom: Effective exchange rate

Index 100=Jan 2005

Source: Reuters EcoWin

Inflation turned upward again last autumn after a weakening trend in the spring and is back at slightly above the 2 per cent official target. Underlying inflation has continued downward, but due to high energy prices and sharply rising price hikes planned by wholesalers and retailers, we expect some further short-term acceleration in inflation. Our forecast is thus that **inflation**, measured as the **2008** annual average, will **remain above 2 per cent**. However, we are sticking to our forecast that it will drop below target in 2009. The slide in the pound is not a major inflationary risk. Over the past 25 years, the historic association between currency rate and price changes has been weak.

For the BoE, the growing downside risks in the economy weigh far heavier than lingering inflationary risks. In recent months, the bank has also expressed increasingly serious fears concerning the financial threat scenario. We thus expect more **aggressive rate cuts** than the market has now priced in. The repo rate will be trimmed by 50 basis points both in February and May. From its current 5.50 per cent, we expect the key rate to stand at 4.00 per cent by year-end. The BoE will thus follow its tradition of quickly following in the wake of the Fed when global growth falters.

Since its peak in July, the pound has weakened by more than 9 per cent, measured in effective terms. The currency is still overvalued. It stands at 4 per cent above the average for the past 25 years, and the British current account deficit is record-sized. In addition, interest rate spreads against both the US and the euro zone will shrink from today's levels. Overall, we thus expect the **pound to weaken further**.

Resilience is eroding

- **Domestic demand resists global weakening**
- **Euro zone slowdown affecting exports**
- **Deceleration in Baltic countries, but continued imbalances**

Economic growth in Central and Eastern Europe is holding up well, despite a weakening world economy. The reason is continued **favourable consumption and investment conditions**. **But persistent high inflationary pressure** is partly **undermining** household **purchasing power**, and export growth is cooling somewhat due to the euro zone slowdown. Current account deficits remain relatively high; and in the Baltics, high.

GDP growth in the nine countries of the region covered here, including the Baltics, will cool **from 7 per cent** last year **to 6 per cent this year and 5.5 in 2009**. In most countries, we have **lowered forecasts** by 0.5-1.0 percentage points compared to November's ***Nordic Outlook***. Ukraine and Slovakia will show the fastest growth, about 7 per cent annually. Hungary will grow the slowest during the next couple of years.

We expect **Russia and Ukraine** to grow by 6-7 per cent a year in 2008-2009. Commodity prices will cool, yet still remain high enough to stimulate their economies, which will also continue to be driven by an upturn in private consumption, partly fuelled by credit expansion. Investments will show strength. Both countries have expansive fiscal policies, despite their inflation problems. We do not expect Russia's economic policy to change after the March presidential election.

Three factors indicate that generally speaking, the countries of **Central and Eastern Europe** will emerge relatively unscathed from the global economic slump:

- Domestic demand has been the key driving force for the past few years. Private consumption is being stimulated by high wage and salary growth and in many countries also by expansive fiscal policy. Investments are fuelled by EU structural funds and low real interest rates, although investment activity is now cooling somewhat, due to global uncertainty and somewhat tighter credit.
- In the past five years, economic fundamentals have improved in such countries as Russia, Poland, the Czech Republic and Slovakia, making these economies more stable and less vulnerable to global financial turmoil.
- Central and Eastern European countries have very little direct American exposure in their foreign trade. Less than 5 per cent of their exports go to the US.

The **Central European countries** will be **affected to a greater extent**, however, as secondary effects of the American slowdown now pour into Western Europe. As seen in the table below, Poland's euro zone exports are relatively low, since it is a more closed economy, while the share of exports to the euro zone is clearly higher and of similar in size in the other countries.

Central European exports

Per cent

	US	Euro zone
Slovakia	2	40
Czech Republic	2	40
Hungary	2	38
Poland	1	17

Source: SEB

Sluggish downturn in inflation

Inflation has climbed steeply in the past six months. In Central Europe (except Hungary) this represents an upturn from low levels, while the Baltics, Russia and Ukraine have larger inflation problems. This is partly due to rising energy and food prices, but is also a long period of high resource utilisation. **Price pressure** is **slowly easing**. Inflation in Latvia, Russia and Ukraine will remain above 10 per cent this year.

Poland and the **Czech Republic** will continue to **tighten** their **monetary policy**. We expect the Czech key interest rate to be raised from 3.5 to 4.0 per cent during the spring, with a risk of further hikes later. Poland's central bank will continue to hike its key rate after a late January hike to 5.25 per cent, and we expect it to reach 6.0 per cent by autumn.

Hungary's central bank will keep easing monetary policy, but interest rate cuts will be delayed by a weak currency and new inflationary impulses. Slovakia will adjust its monetary policy before this spring's evaluation of its application to join the euro zone in 2009. Harmonisation of interest rates down to ECB level must occur at a slow pace to prevent inflation problems. We believe that Slovakia will meet the Maastricht criteria and convert to the euro on January 1, 2009.

The Polish and Czech **currencies** will continue to **appreciate** this year, although we expect a slight weakening in the short term. Slovakia's koruna will also strengthen somewhat before euro zone accession. The Hungarian forint will remain weak but will not fall further.

Baltics: Broad-based deceleration

The Baltic economies will **decelerate significantly** during 2008. Next year all three will grow at **below potential**, after five or six years of high growth that was ultimately unsustainable. In the past year, **tighter credit conditions** and higher interest rates have dampened extremely rapid credit growth, and we expect further tightening this year. In recent months, one effect of somewhat slower credit expansion has been a slump in domestic demand. Additional factors behind the current deceleration in Baltic growth rates are **weaker global demand**, and in **Latvia some tightening of fiscal policy**.

However, the three economies will continue to be plagued by **significant imbalances** over the **next couple of years**. Their large **current account deficits** will persist, since not only imports but also exports will decelerate. Extremely high pay increases in the Baltics – most accentuated in Latvia – probably culminated in late 2007 and will be more subdued in the future. In Latvia and Lithuania, **inflation** will remain **disturbingly high** this year, while a downturn is on the way in Estonia. Rising energy and food prices during the past six months, which weigh more heavily in the consumer price index in the Baltics and other Eastern European countries than in the West, have worsened the inflation picture.

The accelerating pay increases of recent years have **undermined competitiveness**. Compounding these problems has been the strengthening of the currencies, which has occurred in the wake of euro appreciation. So far, however, it is difficult to discern any serious effects from this on exports. Latvia maintained its high level of export growth last year, while Lithuanian and Estonian exports weakened. There are some specific main reasons for these troubles, though: in Lithuania, disruptions at the country's oil refinery; and in Estonia, disruptions in trade with Russia and cutbacks in the electronics sector.

Our main scenario is that the Baltic currencies' **euro pegs will survive**. The basic problem in Latvia and Lithuania is that their partly credit-driven domestic demand remains too strong. The risk scenario in Estonia has instead shifted to an economy that is slowing down too fast. Our conclusion is that the **risk of** a **hard landing** in the Baltic countries **remains**, especially in Latvia.

Estonia has been in the midst of a broad economic slowdown for the past year. Growth is now cooling further. The combined sentiment indicator for companies and households has slid to its lowest level since the Russian crisis of 1998-1999. GDP growth will fall from about 7 per cent last year to 3.0 and 4.0 per cent, respectively, in 2008-2009. Due to rising unemployment and clearly lower pay increases, inflation will drop from an annual rate of almost 10 per cent in December to an average of 7 per cent in 2008.

Latvia's GDP rose by an estimated 10.5 per cent in 2007. Economic confidence surveys have shown declines since last spring (but not more than in the euro zone, for example), indicating that a slowdown is now on the way. We anticipate GDP growth of 7.2 per cent this year and 5.5 per cent in 2009. The government is expected to unveil a fiscal stabilisation package shortly, including somewhat higher public financial surplus targets. The inflation rate doubled in 2007 and was running at 14 per cent in December, but the underlying inflation rate – HICP adjusted for energy and food – is showing signs of having peaked at just below 10 per cent last autumn. We are raising this year's inflation forecast radically, to an average of 12.8 per cent, primarily due to higher energy and food prices and regulated prices. Next year, Latvian inflation will fall.

Lithuania's economy grew by 8.7 per cent last year. We predict that GDP growth will gradually drop to 6.5 per cent this year and 6.0 per cent in 2009. Inflation will decline from 6.5 to 5.0 per cent.

Broader-based weakening

- **Exports continuing to lose momentum**
- **Asset prices will squeeze consumption**
- **Inflation will fall below 2 per cent**
- **Key interest rate cuts by summer**
- **Sharply lower government budget surplus**

After an export-led deceleration in 2007, the Swedish economy is now weakening on a broader front. The financial market crisis has deepened and become more prolonged, which will affect both exports and domestic demand. Leading indicators are still at a relatively high level but are rapidly weakening. The effects of weaker global growth, tighter credit conditions and eroded asset values will gradually become more apparent to households and companies. **GDP growth will thus slow from 2.8 per cent in 2007** (adjusted for the number of work days) **to 1.8 and 1.7 per cent in 2008 and 2009, respectively**.

Two years of clearly below-trend growth will leave their mark on the labour market. Job growth has slowed since last summer and will stagnate during the course of 2008. An upturn in unemployment is probably not too far away. The jobless rate will then climb from 4.4 per cent this year to 5.0 per cent in 2009, measured as annual averages.

Strong public finances at the outset may soften the economic slowdown. Fiscal stimulus measures can now be put in place without risk of overheating. Given the great cyclical sensitivity of Sweden's central government budget, however, the budget surplus will rapidly shrink. We anticipate that public saving will drop to ½ per cent of GDP in 2009, i.e. below the official target of a 1 per cent surplus over an economic cycle.

Inflation has climbed steeply. The main reason has been rapid increases in food and energy prices, but underlying inflation pressure has also risen, among other things due to increasing unit labour costs. Given a gradually less strained labour market situation ahead and diminishing contributions from energy and food, price pressure will gradually ease. We expect inflation to culminate as summer approaches. Next year it will be somewhat below 2 per cent.

By the middle of 2008, both the growth and inflation outlook will thus begin pointing towards lower interest rates. **We expect the Riksbank to begin cutting interest rates by mid-year**. It will lower its repo rate to 3 per cent some months into 2009, when the cyclical slowdown bottoms out.

Exports losing ground

Swedish exports weakened last year. Demand decelerated significantly, while Swedish companies lost market share. In the past 1-1½ years Swedish exports have lost ground, compared to such important competitors as the United States and Germany. The loss vis-à-vis the US can largely be explained by the weaker dollar, which has buoyed up American exports. Sweden's relative weakening against Germany may instead be linked to Sweden's greater dependence on the US. The share of exports going to high-growth emerging markets is significantly larger in Germany than in Sweden, however. Additional reasons for Sweden's relative setback may be capacity obstacles in some sectors, as well as problems in certain leading Swedish industries such as pharmaceuticals and telecoms.

Market growth will now weaken further as the international economy continues to decelerate. In 2008-2009, average export growth will reach only 3½ per cent, well below trend but still better than in the early years of the 21st century. At that time, the downturn was deepened by the slide in the telecom sector, and the economy was squeezed to a greater extent by a global investment crisis that was particularly unkind to Sweden's export structure.

Sweden

Sharp reversal in capital spending

The capital spending upturn of the past four years has meant that the investment ratio climbed from 16 per cent to nearly 19 per cent, its highest level since 1992. Last year, capital spending in the manufacturing sector rose by 10 per cent, but signals of more cautious investment behaviour showed up as early as last autumn's capital spending survey.

Due to the deterioration in the international economy, the need to expand production capacity is now diminishing. Poorer profitability and tighter credit conditions are contributing to the postponement of capital spending. Looking ahead, housing construction will also cool as the price upturn in the real estate market decelerates. Continued expansion of infrastructure and certain domestically oriented industries will serve as a counterweight, but overall growth in **capital spending will cool from nearly 9 per cent in 2007 to slightly below 3 per cent this year**.

Slower consumption growth

Strong balance sheets, high savings, good income increases and a strong labour market provide a solid basis for continued expansion in household consumption, **but most of these driving forces now risk weakening**. Household wealth will be eroded by the stock market decline and by a gradual housing market deceleration. Income will be eroded by high price increases, especially during 2008. A weaker labour market will curb both income and optimism, but continued support will come from the government's fiscal policy.

Economic situation of households

Year-on-year percentage change/level

	2006	2007	2008	2009
Private consumption	2.5	3.1	2.6	2.1
Disposable income	2.8	4.6	2.7	2.5
Savings ratio, %	7.7	9.2	9.3	9.7

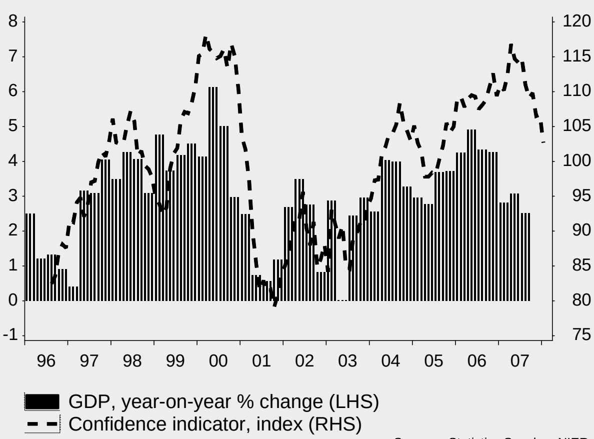
Sources: Statistics Sweden, SEB

There are thus many indications that **consumption growth is about to decelerate**. This is also apparent from the relatively sharp decline in household confidence in recent months. Meanwhile retail sales have decelerated. The decline in equity prices, a cooler house market and slower household lending also point to more cautious households going forward. Our overall assessment is that consumption will largely follow the trend of income during 2008 and 2009, i.e. households will stick to relatively high saving. It should also be noted that a large share of savings is locked up in collective private and public pension plans, implying that households have access to far less funds in practice than the official saving ratio implies. Given a significantly weaker wealth trend ahead, **the risks in our consumption forecast are mainly on the downside**.

Unusually abrupt economic slowdown

Last year, economic slowdown tendencies emerged with unexpected speed. The GDP growth rate faded to 2½ per cent as early as the third quarter, and Sweden's GDP figures for the first half have subsequently been revised downward to modest levels. This early slowdown was in contrast to the very positive mood that prevailed among companies and households. Forecasters thus did not receive the customary guidance indicating that the economy was about to slow.

Sweden: Confidence indicator and GDP

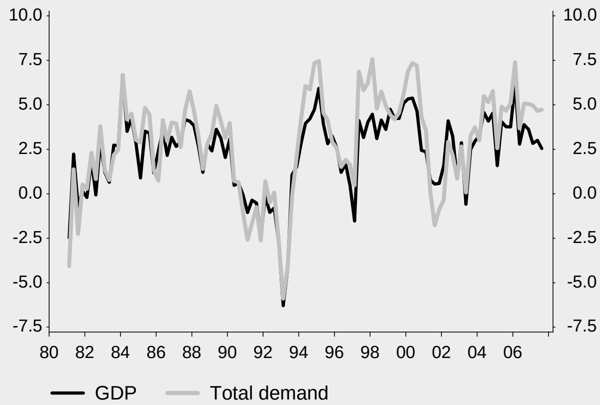


Sources: Statistics Sweden, NIER

The GDP slowdown also provides an additional reason for reflection. Total demand — the sum of exports, consumption and investments — continued to grow by about 5 per cent. The GDP slowdown was thus attributable to an ever-larger share of demand

Sweden: GDP and total demand

Year-on-year percentage change



Source: Statistics Sweden

being satisfied via imports. Such a shift from domestic production to imports is often due to capacity shortages in the economy. This was possibly also a partial explanation for the slowdown in the initial phase, but weaker demand has gradually become an increasingly important driving force.

Unemployment close to bottoming out

Last year was characterised by rapid improvement in the labour market. Employment numbers increased by nearly 2½ per cent, and regular jobs rose by nearly 3 per cent. The number of hours worked increased even more, among other things because of reduced absences due to illness. The employment level increased especially fast among people born outside Sweden, which is important since this group will account for a large share of Sweden's future increase in working-age population.

Sweden: Lending to household sector

Year-on-year percentage change

Source: Statistics Sweden

Weaker stock market dampens growth

The Swedish stock market has now fallen by nearly 30 per cent since July — its fifth largest downturn since 1980. One important question is to what extent the performance of the stock market affects the real economy.

Historical stock market declines

Jul 07	Jan 08	-28%
Mar 00	Oct 02	-69%
Jul 98	Oct 98	-39%
Jul 90	Oct 92	-51%
Oct 87	Nov 87	-38%
Feb 84	Jul 85	-26%

Source: Affärsvärlden General Index

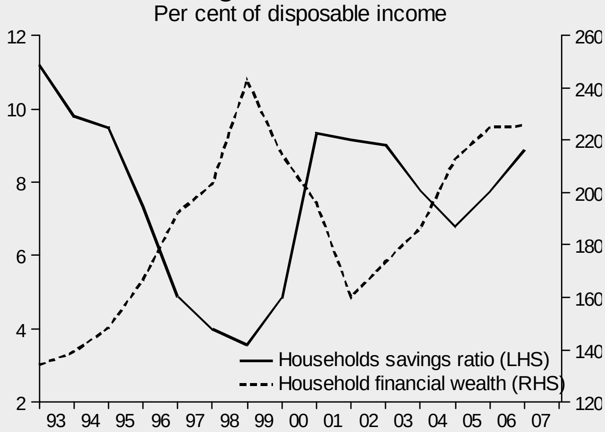
The role of asset prices in the real economy is, above all, a consequence of household wealth effects. Given a certain medium-term goal for their wealth position, households must save a larger proportion of their income to offset the effect of falling share values. This means that consumption will increase less than it otherwise would have done. Investments are also affected, among other things via poorer financing opportunities.

There is strong empirical support for the contention that asset price changes affect consumption and, although to a lesser extent, also investments. The size of the effect varies between different studies and countries. In the US, one rule of thumb is that a 10 per cent downturn in wealth leads to a GDP decline of about 0.4 per cent, The effect in Sweden is somewhat less, roughly 0.25 per cent.

The historical connection between wealth and the savings ratio can be illustrated by the chart below. The stock market upturn of the 1990s led to a downturn in saving, whereas the savings ratio climbed after the stock market downturn of the early 2000s. Since then the connection has been less clear. Despite a sharp upturn in financial wealth, household saving has remained high. Increased uncertainty about future pensions and demographic effects — large cohorts of people born in the 1940s having reached an age when a high savings level is normal — may be among the explanations for the caution recently shown by households.

Sweden: Savings ratio and financial wealth

Per cent of disposable income



Source: SCB

The effect on the economy depends on how long-lasting the downturn is. The 1987 stock market slide was admittedly one of the largest in history, but it turned out to be very short-lived, which probably contributed to the small size of its impact on the real economy.

During the 2000-2002 stock market slide, rising home prices helped soften the downturn in total wealth. This time around, the real estate market may again serve as a stabilising factor. In a slightly longer perspective, Swedish home prices — in line with the trend in many other countries — will be pushed downward.

Labour market and productivity
Year-on-year percentage change/level

	2006	2007	2008	2009
GDP	4.4	2.8	1.8	1.7
Productivity	2.4	-0.3	0.8	2.1
Employment	1.8	2.4	1.1	-0.2
Hours worked	2.0	3.1	0.8	-0.4
Labour supply	1.3	1.6	0.9	0.4
Unemployment, %	5.4	4.6	4.4	5.0
Unemployment, % (EU definition)	7.0	6.1	6.0	6.6

Sources: Statistics Sweden, SEB

Sweden: Labour shortage
Share of firms in per cent

Sources: NIER, SEB

Now, however, the slowdown in production is beginning to have an impact on the labour market. The number of job vacancies has stopped increasing, while job growth has cooled substantially since last summer. The decline in unemployment has also lost momentum, but the jobless rate has not yet bottomed out. Towards summer, however, **we expect unemployment to slowly begin climbing**.

Sweden: New vacancies and employment
Year-on-year % change, 3 m moving average

Sources: Statistics Sweden, Swedish National Labour Market Board

The labour market slowdown implies that resource utilisation will decelerate. The labour shortage may already have culminated, judging from the responses to the National Institute of Economic Research’s Business Tendency Survey, for example. During the previous economic downturn, employment was kept high for a long time – initially through downward adjustments in the number of hours worked per employee. It is likely that we will see such an effect this time as well.

Now that companies are adjusting their workforce in response to falling production, productivity will recover. However, we expect continued weak productivity growth this year. Then productivity will take off again. Historical experience indicates that productivity often peaks before economic expansion takes off in earnest.

Lower pay increases than expected

According to official statistics, **pay increases have continued to provide downside surprises**. With a large proportion of the new collective agreements now included in these statistics, it turns out that 2007 wage and salary hikes were previously overestimated. This is partly because forecasters exaggerated the direct pay-hiking effects in their earlier interpretations. Wage drift has also been lower, indicating that the labour market is not as tight as expected.

Pay increase
Percentage change

	2006	2007	2008	2009
Manufacturing	3.2	3.6	4.0	3,9
Construction	3.4	3.8	4.5	4,0
Business sector	3.1	3.7	4.3	4.0
Public sector	3.0	3.4	4.8	4.3
Total	**3.1**	**3.6**	**4.4**	**4.1**

Sources: Statistics Sweden, SEB

The unexpectedly low average pay increases may also be due to special structural effects. For example, we are seeing a larger number of retirements, where older and well-paid people are often replaced by younger people earning lower wages. Higher employment among people born outside Sweden and other groups with less working experience is also helping keep down the average rate of pay increases.

These structural effects are thus partly a consequence of the government’s efforts to end labour market discrimination. We have previously singled out this effect as one important reason for slower productivity growth. It now turns out that its impact on wages and salaries is a little larger than expected.

Overall, we have lowered our pay increase forecast by 3-4 tenths of a percentage point annually, partly because the labour market has weakened since our previous forecast. This means wage and salary hikes during 2007-2009 will average around 4 per cent, compared to a 3.6 per cent average in 1998-2006.

The acceleration in pay increases during the current collective agreement period thus appears likely to be rather modest compared to 1998-2006, the years after the 1997 Agreement on Industrial Development and Wage Formation. This is usually described as a very favourable period in the history of Swedish labour market agreements. In spite of this, there are now clear signals that the prevailing negotiating model is undergoing a reassessment. The role of the manufacturing sector as a wage leader is now being questioned from various quarters, both among employer and employee organisations. A tug-of-war is under way within the Swedish Trade Union Confederation (LO), and the formation of the new employee organisation Unionen (a merger of white collar employees in industry and distributive trades) means that the service sector will gain additional clout in its calls for greater influence on wage formation.

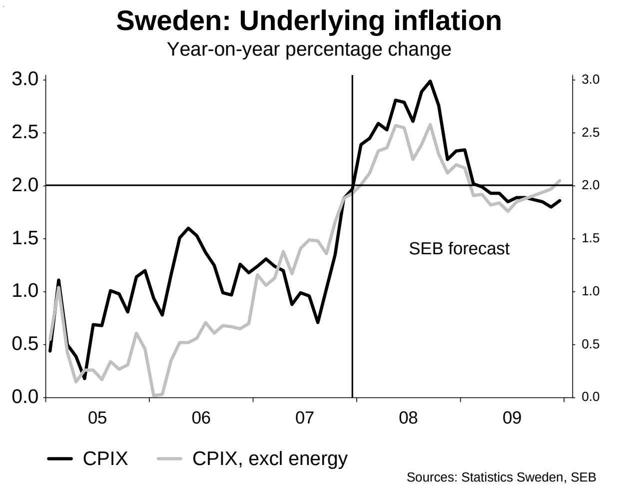
Complicating the situation are signals regarding possible renegotiation of existing agreements. From the trade union side, this is primarily due to dissatisfaction with high inflation, which is undermining real wages and salaries. This autumn, the union and employer sides will decide whether they will renegotiate the third year of their agreements, but a weaker economy and a poorer labour market situation make it less likely that the unions will terminate these agreements. The tensions surrounding the wage formation process are thus primarily a matter for the 2010 wage round.

Inflation up, then down

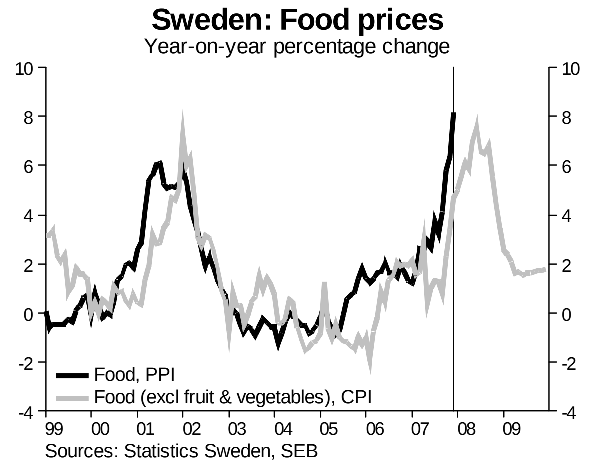
The upturn in inflation that began last autumn has been dramatic. Price increases are now well above the official inflation target for the first time since 2003. We expect this surge in inflation to continue for another while. The upturn has been rather broad, although most of it is due to rising energy and food prices. The prices of food and electricity are likely to continue upward this year, while petrol prices will level off as world market prices for oil decline.

Due to higher pay and weak productivity growth, underlying inflation pressure will continue during much of 2008. This trend is becoming stronger as the international price squeeze on consumer goods fades. Productivity growth will gradually recover, while wage inflation will fall slightly as the labour market situation weakens. This will cause inflation pressure to ease and CPIX to fall during the course of 2009. CPIX, a measure of underlying inflation previously called UND1X, is the Consumer Price Index (CPI) minus household mortgage interest expenditure and direct effects of changes in indirect taxes and subsidies. Overall, **we expect CPIX inflation to reach 2.6 per cent this year and 1.9 per cent in 2009**.

Inflation measured as CPI rose in December to 3.5 per cent – the highest level since 1993. We expect CPI to average 3½ per cent in 2008 as well. Aside from the factors that have driven up CPIX, the Riksbank's earlier interest rate hikes will play a significant role for the CPI upturn in the short term. Changes in indirect taxes will result in a slight positive contribution to CPI both this year and in 2009; this includes higher taxes on tobacco products and energy. Given our forecast of repo rate cuts, the contribution from home mortgage interest expenses will fade, and in 2009 CPI inflation will average only 2 per cent.



Overall, the sharp upturn in inflation has largely been driven by temporary factors. In our assessment, these will gradually disappear. The risks in our inflation forecast are primarily on the downside. The slowdown in global growth may have a larger effect on price trends than we have anticipated, especially via lower commodity prices. We have also been cautious about the impact of somewhat lower oil prices on consumer prices.



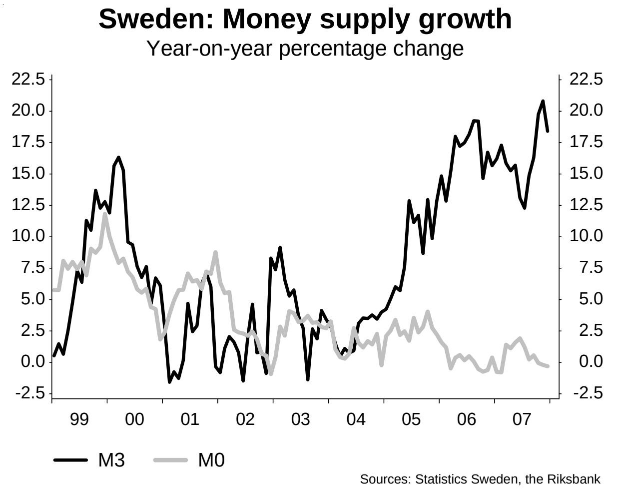
The trend of food prices may constitute an upside risk, however. Such structural factors as increased biofuel production and rising consumer demand in Asia may lead to a larger price effect than we have anticipated.

Money supply no inflationary threat

According to the latest Prospera Research survey for the Riksbank, inflation expectations have continued to rise among employer and employee organisations as well as corporate purchasing managers. Combining five categories of market players, inflation expectations two years ahead are now at their highest level – 2.8 per cent – since these measurements began in 1995. But so far, the upturn has been relatively modest among money market players (see chart). Their expectations are well within the 1.5-2.5 per cent interval the Riksbank stated as the strategic target for monetary policy in its 2008 operational plan.

The rapid growth in the money supply is another factor that has been singled out as an upside inflation risk, especially by the ECB but sometimes also the Riksbank. It is mainly the broadest measure of the money supply (M3) that has climbed rapidly. For a long time, this rapid increase was driven by greater demand for the interest-bearing securities with maturities of up to 2 years specifically included in this aggregate. A few years ago, an ever-flatter yield curve was important in generating demand for interest-bearing securities with short maturities.

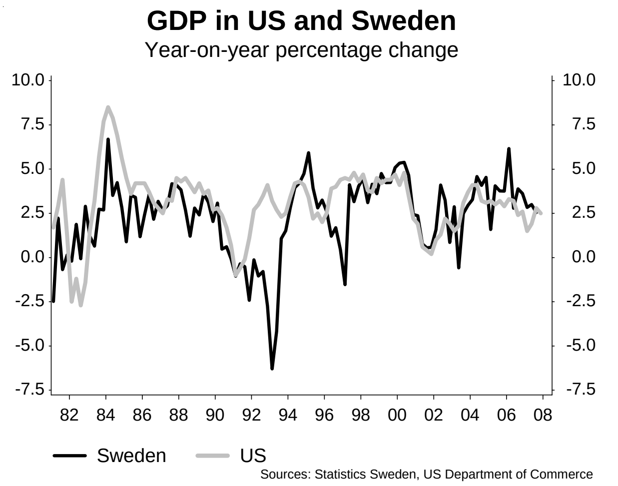
The acceleration in M3 since the summer of 2007 reflects the general downturn in risk-taking in the wake of the credit market crisis. Our interpretation is thus that a reallocation of financial assets is the most important factor behind the M3 upturn in recent years. The value of money supply as an indicator of the inflation trend is thus very small.



Key rate will be cut to 3 per cent

The Riksbank still faces a dilemma. Swedish economic growth is still relatively strong and inflation is expected to remain at a higher level for a longer period than in many other countries. The inflation expectations of households and companies may also be viewed as uncomfortably high, posing a risk of demands for compensation. This calls for cautious behaviour by the Riksbank in the coming months.

The Riksbank's principle of not guiding the market between monetary policy meetings is now creating obvious uncertainty about how seriously the bank views the impact of the global financial market crisis on the real economy. In the current situation, with large fluctuations in financial markets, this silence is extra apparent. The members of the Riksbank's Executive Board – like many economists – are probably divided in their opinions on how these financial market risks should be weighed against the lingering inflationary tendencies and what conclusions should be drawn for interest rate policy.

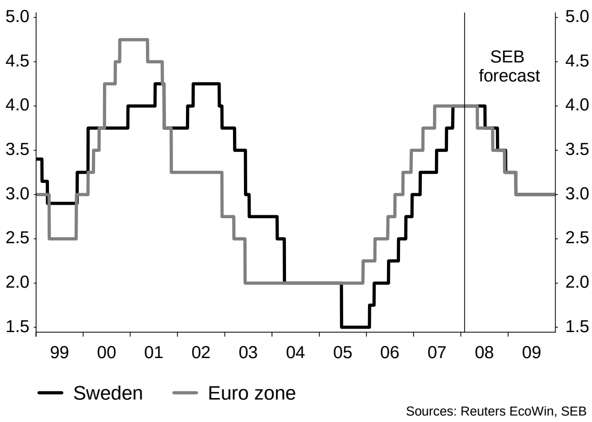


Riksbank Governor Stefan Ingves and Deputy Governor Lars Nyberg probably attach relatively great importance to impact on the real economy via assets and credit supply. Among other Deputy Governors, Svante Öberg has focused so far on resource utilisation and wage formation in a slightly more historical perspective.

Experience shows that the Riksbank's forecasts are relatively conservative and thus more reactive rather than proactive in taking into account international economic changes. This indicates that it will take a little time before the scales tip in the direction of an interest rate cut.

But international forecasters, such as the IMF, are now beginning to signal downward revisions in growth for most countries. In our assessment, the global financial market crisis will have increasing consequences for both international and Swedish economic performance. Lower Swedish growth, combined with a risk scenario which is skewed in a negative direction, will gradually open the way for the Riksbank to begin easing monetary policy.

Key rates
Per cent

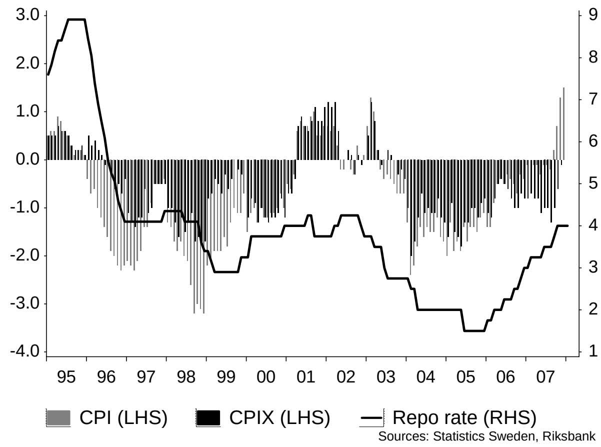


We expect a first interest rate cut in July. The Riksbank will lower its repo rate by a total of 100 basis points to 3.0 per cent by early 2009. This is close to the average key rate for the past decade. The Riksbank might consider a temporarily lower key rate during an economic slowdown, but the bank's future deliberations must also take into account that Swedish fiscal policy will be more expansive, both for cyclical and pre-election tactical reasons. Our forecast implies that the Riksbank will continue to follow in the footsteps of the ECB and that in principle, the spread in short-term interest rates will remain zero.

Once the weakening of the real economy becomes more evident, we believe that the Riksbank's worries about lingering late-cycle inflationary tendencies will diminish. The bank's inflation forecasts in a somewhat longer perspective have shown relatively great sensitivity to changes in the economic and labour market situation and in resource utilisation. This approach has also been confirmed in various sensitivity simulations that the Riksbank has reported.

The debate on the symmetry problem started by the autumn 2006 report "An Evaluation of Swedish Monetary Policy between 1995 and 2005" (Francesco Giavazzi and Frederic S. Mishkin) will play a part in the Riksbank's actions. Inflation has remained below the bank's 2 per cent target for an overwhelming proportion of the period such a target has existed. This will help persuade the bank not to be overly worried that actual inflation is above target for a while. But all the calls for compensation for temporarily higher inflation pressure would of course sharply reduce the Riksbank's room for cutting interest rates.

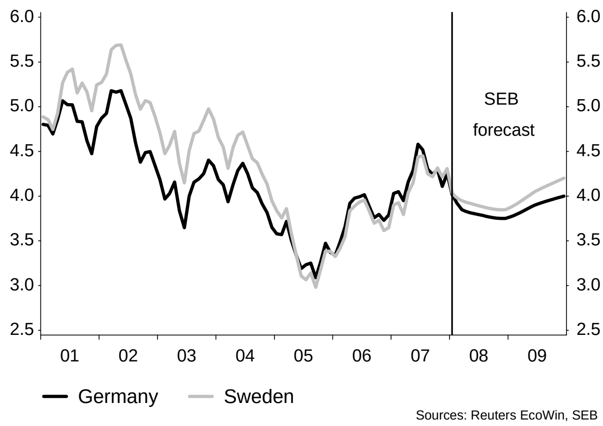
Inflation deviations and repo rate



Falling long-term yields, wider spread

Bond yields have fallen rapidly in the wake of the recent global financial and credit market turmoil. As the global economy continues to slow, there is still some room for bond yields to fall further.

Sweden: 10-year government bond yields
Per cent



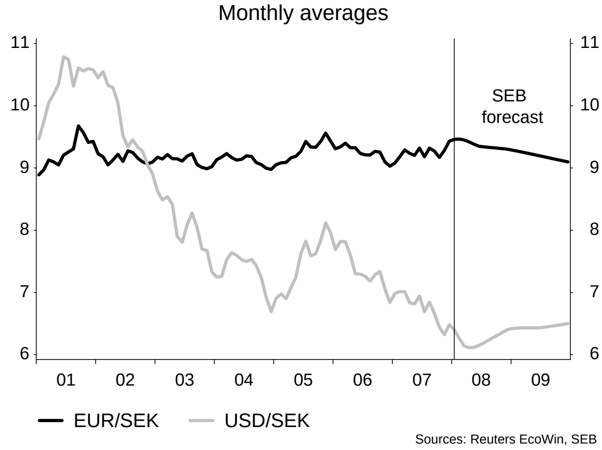
Practically all central banks are now shifting their monetary policy in a more expansive direction. Both the ECB and the Riksbank will cut their key interest rates by a total of 100 basis points, from 4.0 to 3.0 per cent. We expect the ECB to move first, trimming its refi rate in May, a couple of months before the Riksbank. In the short term, this may contribute to a somewhat slower decline in Swedish bond rates than in German ones.

In the long term, Swedish bond yields should normally also be a bit higher than German ones, since Sweden is a small, open – and more volatile – economy and market. Lower Swedish inflation and stronger central government finances previously helped narrow the spread against Germany. Now that inflation has converged and uncertainty concerning the privatization process and Swedish government financing is about to increase, these arguments diminish in importance. We also believe that structural demand for government securitites from such investors as pension companies may diminish somewhat in the future. We thus expect the bond yield spread against Germany, which is nearly zero at present, will climb to 10 basis points in the next quarter.

When it is clear that the worst global economic worries are past and the American economy is beginning to recover, bond yields are likely to rise on a broad front. At that time, we believe that the spread between Sweden and Germany will gradually increase to 20 points at the end of 2009. Structured demand on government bonds from pension funds may fall back going forward.

Sweden: Exchange rates

Monthly averages



Sources: Reuters EcoWin, SEB

The Swedish krona will remain weak against the euro in the prevailing uncertain international environment, but **we expect the krona to gradually regain some of its strength** as global worries fade and strong fundamentals, such as a continued large current account surplus, make themselves felt. The EUR/SEK exchange rate will move down to 9.35 in June and somewhat lower in December this year. The krona will appreciate even more against the US dollar – we expect the USD/SEK exchange rate to bottom out at 6.15 in March, then rise gradually. It will stand at 6.40 in December this year and 6.50 in December 2009.

Weaker government budget on the way

The Swedish central government budget showed a **surplus of SEK 103 billion in 2007**. The year's budget improvement was due to privatisation revenue and restraint in government expenditures. Good economic conditions also contributed strongly to this trend. The public savings surplus surpassed 3 per cent of GDP, and central government debt fell to 38 per cent of GDP at year-end.

In December, however, the National Debt Office reported an unexpectedly weak borrowing requirement figure. This can be interpreted as a first signal that the period of continuously positive surprises regarding the strength of central government finances may be over. It is not unusual for a cyclical swing to entail an abrupt shift in this respect.

In fact, several coinciding factors indicate that we may see rather sharp downward revisions of budget forecasts from the public authorities responsible. Our growth forecast implies, for example, that GDP growth in 2008-2009 will be more than 2 percentage points lower than the NIER forecast. One rule of thumb is that a one per cent decrease in GDP weakens public finances by 0.75 per cent of GDP. In international terms, this is an unusually high level of sensitivity, but experience shows that the impact of rapid cyclical swings may be larger than this.

Public finances

Percentage of GDP

	2006	2007	2008	2009
Revenue	53.8	53.2	52.4	52.0
Expenditures	51.6	50.0	50.2	51.5
Financial savings	2.2	3.2	2.2	0.5
Public debt (Maastricht)	47.0	39.5	36.0	33.8
Central government debt	43.8	38.0	34.0	31.8
Central govt borrowing req, SEK bn	-18	-103	-72	-37

Sources: National Debt Office, Statistics Sweden, SEB

Weaker economic growth is an indication that we will gradually see an increasingly expansive fiscal policy as the September 2010 parliamentary election approaches. Our forecast assumes unfinanced government programmes totalling SEK 20 billion (equivalent to 0.6 per cent of GDP) in this autumn's budget for 2009. There is an obvious risk that the government's dose of fiscal policy medicine may end up being larger than this.

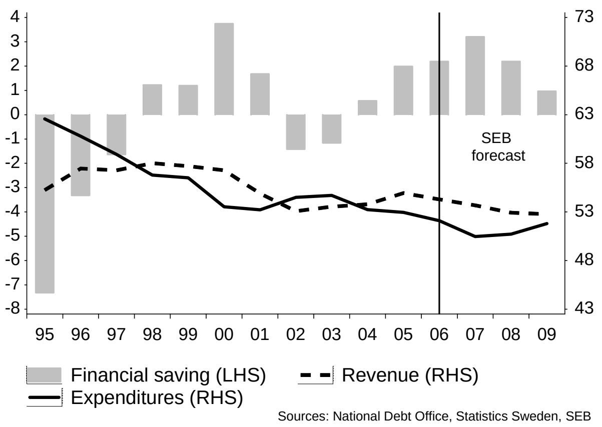
Our forecast implies that public sector financial saving will fall from 3.2 per cent of GDP last year to 2.2 per cent this year and 0.5 per cent in 2009. The surplus will thus end up SEK 38 billion above the target of 1 per cent of GDP this year but will fall SEK 16 billion short in 2009.

The central government's difficulties in carrying out SEK 150 billion worth of planned privatisations of its shares in various companies during 2007-2009 will also affect its future borrowing requirement. Last year the government only sold SEK 18 billion worth of shares (telecom operator TeliaSonera). In the prevailing environment of financial market turmoil, it seems very unlikely that the government will sell off another SEK 132 billion in shares during 2008 and 2009. The prevailing situation makes it especially difficult for the government to sell off shares in the financial service companies Nordea and SBAB and in the property company Vasakronan. However, its divestment of shares in the stock exchange operator OMX and the alcoholic beverages company Vin & Sprit can probably be completed as planned. We expect privatisations equivalent to SEK 40 billion per year to take place in 2008 and 2009.

Overall, our forecast indicates a central government budget surplus equivalent to SEK 72 billion this year and SEK 37 billion next year (i.e. a negative borrowing requirement). This means that **central government debt will fall from 38 per cent of GDP last year to 32 per cent in 2009**. Consolidated public debt (Maastricht definition) will fall from 40 per cent to 34 per cent.

Sweden: Public sector finances

Percentage of GDP



Sources: National Debt Office, Statistics Sweden, SEB

It cannot be ruled out that the swing in central government finances will be even sharper. During the economic crisis at the turn of the millennium, for instance, a surplus of 3.7 per cent of GDP in 2000 turned into a deficit of 1.4 per cent in 2002 – a swing of SEK 119 billion in only two years. The borrowing requirement deteriorated from SEK -102 billion in 2000 to SEK 47 billion in 2003. This illustrates how quickly central government finances can worsen when the economy becomes weaker.

New dilemma for the finance minister

Finance Minister Anders Borg has said that he has **"dry powder if it should be needed"**. He is thus announcing that the government is prepared to respond to an economic deceleration with more powerful fiscal stimulus measures. The latest autumn budget was characterised by significant restraint. Fear of adding fuel to the economy had a clear disciplinary effect on the government. Due to a poorer growth outlook, the goal conflict that prevailed earlier between high resource utilisation (an argument for tighter fiscal policy) and excess saving in the treasury (an argument for looser fiscal policy) is in the process of vanishing.

The finance minister is thus avoiding a dilemma, but instead he faces other choices that are perhaps at least as difficult from a political perspective. The question is what programmes the government should now enact, if the cyclical situation opens the way for a more aggressive economic policy. If the government emphasises tax cuts and more aggressive support for entrepreneurs, this will reduce criticism from representatives of business organisations and the more traditional wing of the coalition-leading Moderate Party. At present, however, most indications are that the government's economic policy will focus on improvements in infrastructure and in such core public sector activities as health care, schools and social services. In that case, its policy would be aimed at battling for the political middle ground, including those voters who have been identified by public opinion surveys as having deserted the non-socialist governing coalition in droves and returned to the Social Democratic fold.

The size of the government's fiscal stimulus programmes may also become a political hot potato. If the economic slowdown deepens, there is reason to greatly increase the dose of fiscal medicine, which would lead to new deficits in public sector financial saving. This is in fact natural during an economic slump. Yet it may be politically troublesome for a non-socialist finance minister to face an election with a central government financial deficit, bearing in mind that previous non-socialist governments during the 1970s and 1990s left behind record-sized deficits. In particular, such a situation may throw new light on the debate now emerging on whether the public sector budget surplus target should be made less ambitious. If lowering the surplus target is to be politically viable, it will certainly have to be undertaken from a position of strength. Lowering the surplus target as one element of an expansive fiscal policy during an economic slowdown is certainly too risky a venture.

Even weaker

- **Consumption will slow further**
- **Exports being squeezed from several directions**
- **Expansive fiscal policy despite inflation upturn**

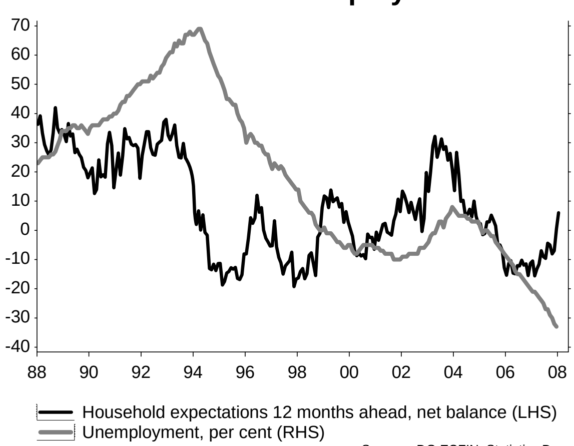
Resource shortages, continued home price declines and weaker international economic conditions will mean weak growth in Denmark. We expect **GDP** to rise by about **1 per cent annually** in 2008-2009, after last year's 1.7 per cent increase. The means that growth will end up well below the 2 per cent trend level, not far from levels during the 2001-2003 slump.

The **deceleration in growth** since early 2007 has been **consumer-led**. But **exports** have **also** gradually **lost momentum**. Measured in current prices, exports increased by only 2½ per cent last year, compared to 9 per cent in 2006. We expect continued weak exports. Demand is now dwindling in Germany and in other important markets in Western Europe. Meanwhile Denmark's competitiveness is being eroded by **pay increases** that again climbed **above the pace** in the **euro zone** in 2007, for example. Exports outside the euro zone are also hampered by continued currency appreciation; the krone strengthened by 3 per cent last year and will appreciate further in the short term.

Home price drop slowing demand

Corporate capital spending is continuing to increase, though at a modest pace. However, housing investments are shifting to negative growth figures due to the earlier construction boom and subsequent property market cool-down. During the fourth quarter, prices of flats continued to fall by 8 per cent year-on-year — as earlier with even faster declines in the Copenhagen region — while the single-family home market showed weak price increases. Sales were sharply down for both categories. We predict that **home prices** will fall by **5-10 per cent** this year.

Denmark: Unemployment



Sources: DG ECFIN, Statistics Denmark

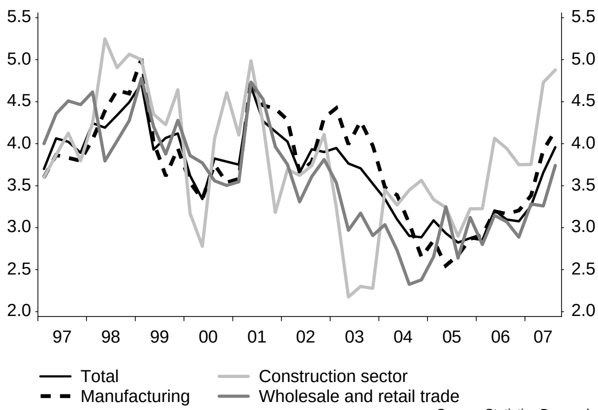
Consumption grew by a moderate 2 per cent last year and will **slow further**, to about a 1.5 per cent rate in both 2008 and 2009. Higher real pay and income tax cuts will provide decent increases in disposable income, but spending will be held back by lower asset values for homes and shares as well as by rapidly mounting worries about higher unemployment.

Actual unemployment has nevertheless continued to fall, reaching a low 2.7 per cent in December. Our assessment is still that **unemployment** will **now level off** during the first half of 2008, then turn upward. This year's average level will end up around 3 per cent.

Wages and salaries have accelerated due to an ever-tighter labour market. The upturn has been clear in most sectors. The total rate of pay increases was about 4 per cent last year and will reach 5 per cent in 2008.

Denmark: Wages

Year-on-year percentage change



Source: Statistics Denmark

Rising energy and food prices have been the main reason why the inflation rate has climbed from 1 to 2.5 per cent in the past six months. Looking ahead, **higher pay** and **weak productivity** growth will contribute to **increased underlying price pressure**. This means that the broad measure of inflation will remain at 2.5 per cent in 2009 as well, when base effects from energy and food have disappeared from the statistics.

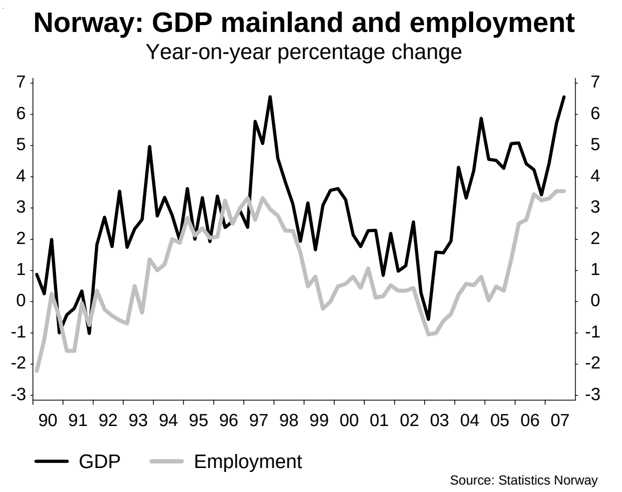
Fiscal policy will remain **expansive**. It cannot be ruled out that the government will implement further tax cuts or expenditure increases, beyond those already approved for 2008-2009. There is room. Public sector finances are strong.

A referendum on Danish euro zone accession may be called during our forecast period. Public opinion surveys currently show only a narrow gap between the Yes and No sides.

Deceleration from a high level

- **Weaker global demand slowing export growth**
- **Household buying spree fading**
- **Continued tight labour market**
- **Key interest rate has peaked – cuts in 2009**

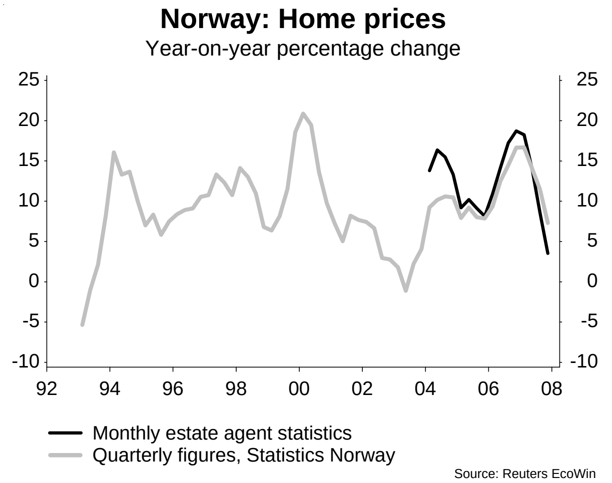
Norway's boom gained further strength in 2007. The mainland economy (excluding offshore oil and gas) grew by more than 5½ per cent, while job growth set a record. In the past four years, GDP has risen by an average of 4.7 per cent. The power and duration of this upturn have been possible because of a flexible labour supply, among other things due to a sizeable influx of labour from abroad, plus unexpectedly strong productivity growth. Globalisation has also pushed up the prices of Norwegian export products, while imported consumer goods have become cheaper. This has held down inflation and bolstered purchasing power, enabling Norges Bank to normalise its key interest rate at a slow pace and providing an extra stimulus to consumption and capital spending.



Sentiment indicators point towards continued strong growth in the short term. After that, we see a number of reasons why growth will decelerate. Unemployment can hardly be squeezed any lower, meaning that job growth must come from rising labour supply. Productivity growth will also slow in this mature phase of the economic cycle. Growth impulses from abroad will dwindle due to weaker global growth and falling commodity prices. Finally, interest rate hikes are now finally beginning to have an impact, among other things via a weaker housing market. Overall, **we expect mainland GDP growth to fall to 2.9 per cent in 2008 and 2.1 per cent in 2009**.

Record-strong consumption will slow

Household income growth in recent years has been driven by high pay hikes, strong employment and low inflation. Extremely low inflation, among other things due to falling electricity prices, enabled household disposable income to climb by more than 5 per cent last year. Consumption rose by nearly 7 per cent, which signified a further decline in the household savings ratio.



Meanwhile there are clear signs that the housing market is about to decelerate. Prices have fallen six months in a row, according to estate agent statistics. There has been a deceleration in year-on-year price increases from nearly 20 per cent at the beginning of 2007 to below 4 per cent in December. A weaker household wealth position might thus lead to higher saving ahead. Income growth will also cool as job growth moves into a calmer phase and as real wage increases are eroded by higher inflation. We thus expect a gradual slowdown in consumption growth to 3 per cent this year and 2½ per cent in 2009.

Looking ahead, capital spending will also cool. It is true that corporate capital spending plans are relatively expansive, stimulated by high capacity utilisation. But demand from abroad will slow rather sharply this year, affecting both export volume and prices. In recent months, export companies have become clearly more pessimistic. We anticipate that the growth of traditional merchandise exports will decelerate from 7 per cent last year to 2 per cent this year. In addition, future profitability will be squeezed by more subdued productivity growth, the krone's previous appreciation and continued high pay increases. To summarise, we expect the growth rate of mainland capital spending to halve between 2007 and 2008, then slow even more in 2009. Also contributing to the slowdown is the trend of residential construction, which we expect to level off this year.

Unemployment close to bottoming out

Employment continued to increase rapidly during the autumn. Due to a rising labour supply, however, unemployment has largely remained unchanged at around 2½ per cent, according to the Labour Force Survey. The demand for labour remains very strong, but it is difficult to foresee unemployment falling much more from today's extremely low levels. The underlying rate of growth in the labour force will be less than one per cent during the next two years. In addition, the participation rate can be expected to increase further as a consequence of the strong labour market situation. Overall, we estimate that both employment and labour supply can be expected to increase by nearly 2 per cent this year, though largely attributable to the strong trend during 2007.

Norway: Labour supply and employment

Year-on-year percentage change

Source: Statistics Norway

During the course of 2008, the effects of the international slowdown will become increasingly evident in the Norwegian economy, gradually reducing demand for labour. Towards year-end, unemployment will slowly begin to move upward, but will nevertheless remain at a historically low level in 2009 as well.

Mounting domestic inflation pressure

Underlying inflation (CPI-ATE) has trended upward since the summer of 2006. In December it amounted to 1.8 per cent, still well below Norges Bank's 2½ per cent inflation target. Domestic inflation pressure is rapidly accelerating, however. Price increases on Norwegian-produced consumer goods, for example, have risen sharply in the past year and were running at 4½ per cent in December. High pay increases will thus have a gradually larger impact on inflation.

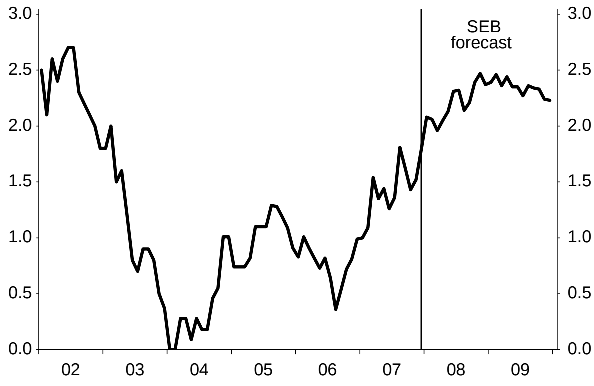
The upturn in inflation is being kept down to some extent by the fall in import prices, which has again accelerated, among other things due to the strengthening of the krone. Because of rising unit labour costs, we anticipate that inflation will continue upward during 2008. Norway's inflation path will thus remain above the path that Norges Bank described in its latest monetary policy report. **CPI-ATE will average 2.2 per cent in 2008 and 2.3 per cent in 2009**.

For years, Norges Bank has struggled with below-target inflation, on the one hand, and ever-clearer signs of overheating, on the other. Now that inflation is finally beginning to move close to the central bank's target, this dilemma should ease. But the deepening of the international credit market crisis, a weaker global growth outlook and key interest rate cuts in other countries have complicated the picture. The bank's own interest rate path implies that it will keep its sight deposit rate unchanged during the first quarter, followed by a 50 per cent probability of a final rate hike during the second quarter. Given our pessimistic view of global growth and our forecast of relatively aggressive interest rate cuts by a number of central banks in other countries, our assessment is that the probability of a further hike is well below 50 per cent.

Although inflation may very well continue to provide upside surprises, while growth will remain strong in the short term, the international threat scenario is likely to dominate the bank's deliberations. In particular, the risk of a sharp krone appreciation is one motive for not deviating much from other countries. At the same time, it is reasonable to assume that Norges Bank will wait longer than other central banks to cut its key rate. After the end of 2008, we expect that growth will have slowed so much that **Norges Bank will begin a rate-cutting cycle**. **By the end of 2009, the sight deposit rate will be 4.50 per cent.** While some of the cuts we have factored in for 2009 – a total of 75 basis points – might be brought forward, any shift in the policy rate cycle will be slow in coming as long as domestic growth remains healthy and upside risks to inflation persists.

Norway: CPI-ATE

Year-on-year percentage change



Sources: Statistics Norway, SEB

Given the rising interest rate spread against other countries, we expect the krone to strengthen further to NOK 7.85 per euro and to NOK 5.10.per dollar in the next few months. Meanwhile, there will be a certain downward pressure on the krone from falling oil prices. When expectations of further rate hikes in Norway fade away the support for the krone will diminish and the currency will weaken somewhat.

Calmer phase on the way

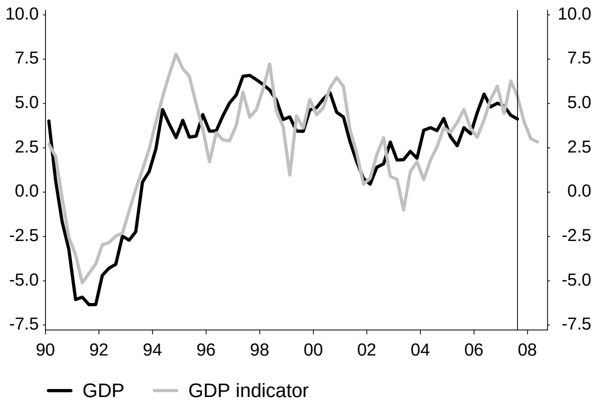
- **Exports and capital spending decelerate**
- **Falling jobless rate, accelerating pay hikes**
- **Temporarily high inflation this year**

As expected, the Finnish economy grew by **just above 4 per cent in 2007**. Due to weaker export and capital spending expansion, **growth will now slow to 2.8 per cent this year and 2.6 per cent in 2009**, or somewhat below trend.

In 2007, growth was driven by both strong domestic demand and a competitive export sector. Late in the year, however, a deceleration became apparent as confidence survey indices for the construction, manufacturing and service sectors showed rapid declines. Capital spending for machinery then fell sharply, and according to the historical pattern this is usually also followed by a slowdown in construction investments. Weaker international demand and uncertainty in the wake of the ongoing credit market crisis are causing many companies to postpone their capital spending and re-assess their production structure. We expect cutbacks in such key sectors as telecoms and the forest product industry.

Finland: GDP and indicator

Year-on-year percentage change



Source: SEB

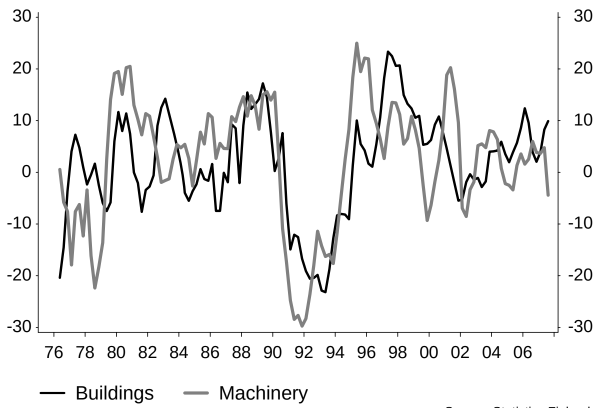
To some extent, private consumption is sustaining economic growth as exports and capital spending slow. Last year, consumption was driven by reduced saving, while large real wage increases are contributing to rapid income growth this year. A vehicle tax cut is also benefiting the car business.

The economic slowdown has not yet had any impact on the labour market. **Unemployment reached a 2007 low of 6.7 per cent in December** and will continue downward for another while. It will level off at mid-year, then slowly begin moving upward in the late summer and autumn. Measured as an annual average, unemployment will fall from 6.9 per cent last year to 6.6 per cent this year, then climb to 6.7 per cent in 2009. Private consumption, which will thus enjoy support from the labour market for another while, will increase by 2.7 per cent this year and 2.3 per cent in 2009.

Falling unemployment will result in rising pay increases. We anticipate that **hourly pay hikes will accelerate from 3.2 per cent last year to nearly 5 per cent this year**, but good corporate productivity increases will soften their impact on inflation. Gradually weaker economic growth will contribute to a deceleration in wage and salary hikes to 4.5 per cent in 2009.

Finland: Investments

Year-on-year percentage change



Source: Statistics Finland

As in other Western countries, rising energy prices contributed to higher HICP inflation last autumn. Measured as an annual average, inflation still only amounted to 1.6 per cent. It will now rise to an average of 2.5 per cent this year, then fall to 2.0 per cent in 2009. Underlying inflation unexpectedly moved downward during the autumn – from 1.8 per cent in August to 1.1 per cent in December. We expect core inflation to turn upward this year.

Last year's strong growth helped make the government budget surplus larger than expected, but looking ahead it will shrink somewhat – despite the cancellation of income tax cuts – as the economy slows. We anticipate a **surplus of just below 4 per cent of GDP in 2009**.

Nordic key economic data

Nordic Outlook - February 2008

DENMARK

Yearly change in per cent

	2006 level, DKK bn	2006	2007	2008	2009
Gross domestic product	1,642	3.3	1.7	1.1	1.0
Private consumption	794	3.4	2.0	1.4	1.5
Public consumption	420	1.6	1.7	1.9	1.7
Gross fixed investment	371	13.0	6.1	2.0	2.2
Stockbuilding (change as % of GDP)		0.4	0.0	0.0	0.0
Exports	853	10.1	2.0	2.2	3.5
Imports	804	14.5	4.2	3.3	4.7
Unemployment (%)		4.5	3.4	3.0	3.8
Consumer prices, harmonised		1.9	1.7	2.6	2.5
Hourly wage increases		3.1	3.8	4.5	4.4
Current account, % of GDP		2.7	1.5	1.0	1.3
Public sector financial balance, % of GDP		4.6	4.1	3.0	2.5
Public sector debt, % of GDP		30.3	25.0	21.0	18.0

FINANCIAL FORECASTS	Jan 31	Mar 08	Jun 08	Dec 08	Jun 09	Dec 09
Lending rate	4.25	4.25	4.00	3.50	3.25	3.25
10-year bond yield	4.09	4.00	3.90	3.85	4.00	4.10
10-year spread to Germany, bp	16	15	10	10	10	10
USD/DKK	5.01	4.84	4.97	5.14	5.21	5.32
EUR/DKK	7.45	7.45	7.45	7.45	7.45	7.45

NORWAY

Yearly change in per cent

	2006 level, NOK bn	2006	2007	2008	2009
Gross domestic product	2,156	2.2	3.3	2.7	1.9
Gross domestic product (Mainland Norway)	1,569	4.3	5.7	2.9	2.1
Private consumption	879	4.2	6.9	3.0	2.5
Public consumption	415	3.0	3.0	2.8	2.8
Gross fixed investment	406	6.5	7.5	4.9	1.3
Stockbuilding (change as % of GDP)		0.5	-0.2	0.3	0.1
Exports	1,005	0.5	2.6	1.7	1.4
Imports	612	8.2	7.4	4.0	2.5
Unemployment (%)		3.5	2.5	2.5	2.9
Consumer prices		2.3	0.8	3.6	2.5
CPI-ATE		0.8	1.4	2.2	2.3
Wage cost		4.1	5.5	5.8	4.8
Current account, % of GDP		16.4	15.0	16.5	14.5
Public sector financial balance, % of GDP		19.3	19.5	19.0	18.0

FINANCIAL FORECASTS	Jan 31	Mar 08	Jun 08	Dec 08	Jun 09	Dec 09
Sight deposit rate	5.25	5.25	5.25	5.25	4.75	4.50
10-year bond yield	4.35	4.40	4.35	4.25	4.30	4.40
10-year spread to Germany, bp	41	55	55	50	40	40
USD/NOK	5.41	5.10	5.27	5.52	5.66	5.79
EUR/NOK	8.03	7.85	7.90	8.00	8.10	8.10

Nordic key economic data

SWEDEN

Yearly change in per cent

	2006 level, SEK bn	2006	2007	2008	2009
Gross domestic product	2,900	4.1	2.7	2.1	1.6
Gross domestic product, working day adjusted		4.4	2.8	1.8	1.7
Private consumption	1,374	2.5	3.1	2.6	2.1
Public consumption	762	1.5	0.4	1.2	1.4
Gross fixed investment	525	7.7	8.7	2.9	-1.2
Stockbuilding (change as % of GDP)	1	0.2	0.6	-0.2	0.0
Exports	1,491	8.9	4.8	3.5	3.6
Imports	1,253	8.2	8.1	3.5	3.1
Unemployment (%)		5.4	4.6	4.4	5.0
Unemployment (%) (EU definition)		7.0	6.1	6.0	6.6
Employment		1.8	2.4	1.1	-0.2
Industrial production		5.1	2.0	1.5	1.8
Consumer prices		1.4	2.2	3.4	2.0
CPIX		1.2	1.2	2.6	1.9
Hourly wage increases		3.1	3.6	4.4	4.1
Household savings ratio (%)		7.7	9.2	9.3	9.7
Real disposable income		2.8	4.6	2.7	2.5
Trade balance, % of GDP		5.8	4.8	4.3	4.4
Current account, % of GDP		7.1	6.5	6.2	6.3
Central government borrowing, SEK bn		-18	-103	-72	-37
Public sector financial balance, % of GDP		2.2	3.2	2.2	0.5
Public sector debt, % of GDP		47	40	36	34

FINANCIAL FORECASTS	Jan 31	Mar 08	Jun 08	Dec 08	Jun 09	Dec 09
Repo rate	4.00	4.00	4.00	3.25	3.00	3.00
3-month interest rate, STIBOR	4.46	4.36	4.26	3.56	3.31	3.31
10-year bond yield	3.95	3.95	3.90	3.85	4.05	4.20
10-year spread to Germany, bp	1	10	10	10	15	20
USD/SEK	6.36	6.14	6.23	6.41	6.43	6.50
EUR/SEK	9.46	9.45	9.35	9.30	9.20	9.10
TCW	125.9	124.8	123.5	123.0	122.0	121.3

FINLAND

Yearly change in per cent

	2006 level, EUR bn	2006	2007	2008	2009
Gross domestic product	167	5.0	4.1	2.8	2.6
Private consumption	86	4.3	3.3	2.7	2.3
Public consumption	36	1.0	1.4	1.4	1.5
Gross fixed investment	32	4.1	4.4	3.1	3.3
Stockbuilding (change as % of GDP)		0.2	0.1	0.0	0.0
Exports	74	10.4	5.8	4.3	5.1
Imports	66	8.3	4.0	3.9	5.0
Unemployment (%)		7.7	6.9	6.6	6.7
Consumer prices, harmonised		1.3	1.6	2.5	2.0
Wage cost		3.0	3.2	4.9	4.5
Current account, % of GDP		5.2	6.0	5.5	5.1
Public sector financial balance, % of GDP		3.8	4.5	4.1	3.9
Public sector debt, % of GDP		39.2	36.7	35.3	34.8

International key economic data

Nordic Outlook - February 2008

EURO ZONE

Yearly change in per cent

	2006 level, EUR bn	2006	2007	2008	2009
Gross domestic product	8,438	2.9	2.6	1.3	1.5
Private consumption	4,800	1.9	1.5	1.4	1.6
Public consumption	1,720	1.9	2.0	1.8	1.7
Gross fixed investment	1,790	5.2	4.9	2.7	3.3
Stockbuilding (change as % of GDP)		-0.2	-0.1	0.0	0.0
Exports	3,390	7.9	6.1	4.0	4.2
Imports	3,290	7.6	5.5	5.1	5.4
Unemployment (%)		8.2	7.4	7.1	7.4
Consumer prices, harmonised		2.2	2.1	2.7	1.7
Household savings ratio (%)		10.0	9.9	9.7	9.4

US

Yearly change in per cent

	2007 level, USD bn	2006	2007	2008	2009
Gross domestic product	14,080	2.9	2.2	0.9	1.8
Private consumption	9,930	3.1	2.9	0.7	1.5
Public consumption	2,770	1.8	2.1	3.8	3.5
Gross fixed investment	2,110	2.9	-1.8	-5.3	-3.3
Stockbuilding (change as % of GDP)		0.1	-0.3	-0.2	0.0
Exports	1,730	8.4	7.9	5.5	5.0
Imports	2,460	5.9	2.0	-0.4	0.6
Unemployment (%)		4.6	4.6	5.6	6.4
Consumer prices		3.2	2.9	2.8	1.9
Household savings ratio (%)		0.4	0.5	1.4	2.4

LARGE INDUSTRIAL COUNTRIES

Yearly change in percent

	2006	2007	2008	2009
GDP				
United Kingdom	2.9	3.0	1.4	1.8
Japan	2.4	1.9	1.2	1.5
Germany	2.9	2.5	1.4	1.6
France	2.2	1.8	1.3	1.6
Italy	1.9	1.7	1.1	1.3
Inflation				
United Kingdom	2.3	2.3	2.2	1.9
Japan	0.2	0.1	0.6	0.4
Germany	1.8	2.3	2.3	2.0
France	1.9	1.6	2.2	1.9
Italy	2.2	2.0	2.2	1.9
Unemployment (%)				
United Kingdom	5.4	5.5	5.6	5.8
Japan	4.1	3.9	3.8	3.7
Germany	9.8	8.4	8.0	8.1
France	9.2	8.3	8.0	8.1
Italy	6.8	6.0	5.8	6.0

International key economic data

CENTRAL AND EASTERN EUROPE

	2006	2007	2008	2009
GDP, yearly change in percent				
Czech Republic	6.4	6.3	4.5	4.8
Estonia	11.2	7.0	3.0	4.0
Hungary	3.9	1.5	2.0	3.0
Latvia	11.9	10.5	7.2	5.5
Lithuania	7.7	8.7	6.5	6.0
Poland	6.1	6.5	5.0	5.0
Russia	6.7	7.6	6.8	6.0
Slovakia	8.5	9.0	7.0	6.5
Ukraine	7.1	7.3	7.0	7.0
Inflation, yearly change in per cent				
Czech Republic	2.1	2.9	5.0	3.5
Estonia	4.4	6.7	7.0	3.0
Hungary	4.0	7.9	5.5	4.0
Latvia	6.6	10.1	12.8	7.7
Lithuania	3.8	5.8	6.5	5.0
Poland	1.3	2.6	3.5	3.0
Russia	9.7	9.0	10.7	8.9
Slovakia	4.3	2.0	2.8	3.0
Ukraine	9.1	12.8	12.0	10.0

FINANCIAL FORECASTS

		Jan 31	Mar 08	Jun 08	Dec 08	Jun 09	Dec 09
Official interest rates							
US	Fed funds	3.00	2.75	2.25	2.00	2.25	2.50
Japan	Call money rate	0.50	0.50	0.50	0.50	0.75	0.75
Euro zone	Refi rate	4.00	4.00	3.75	3.25	3.00	3.00
United Kingdom	Repo rate	5.50	5.00	4.50	4.00	3.50	3.75
Bond yields							
US	10 years	3.60	3.50	3.45	3.60	4.10	4.20
Japan	10 years	1.44	1.40	1.45	1.50	1.55	1.65
Germany	10 years	3.93	3.85	3.80	3.75	3.90	4.00
United Kingdom	10 years	4.52	4.30	4.10	4.00	4.10	4.30
Exchange rates							
USD/JPY		106	105	110	112	118	118
EUR/USD		1.49	1.54	1.50	1.45	1.43	1.40
EUR/JPY		158	162	165	162	169	165
GBP/USD		1.99	2.00	1.92	1.81	1.83	1.82
EUR/GBP		0.75	0.77	0.78	0.80	0.78	0.77

GLOBAL KEY INDICATORS

Yearly percentage change

	2006	2007	2008	2009
GDP OECD	3.1	2.6	1.5	1.9
GDP world	4.9	4.6	3.7	3.8
CPI OECD	2.4	2.3	2.5	1.9
Export market OECD	8.9	6.5	4.4	5.5
Oil price, Brent (USD/barrel)	64.8	73.0	80.0	75.0

Economic Research available on Internet

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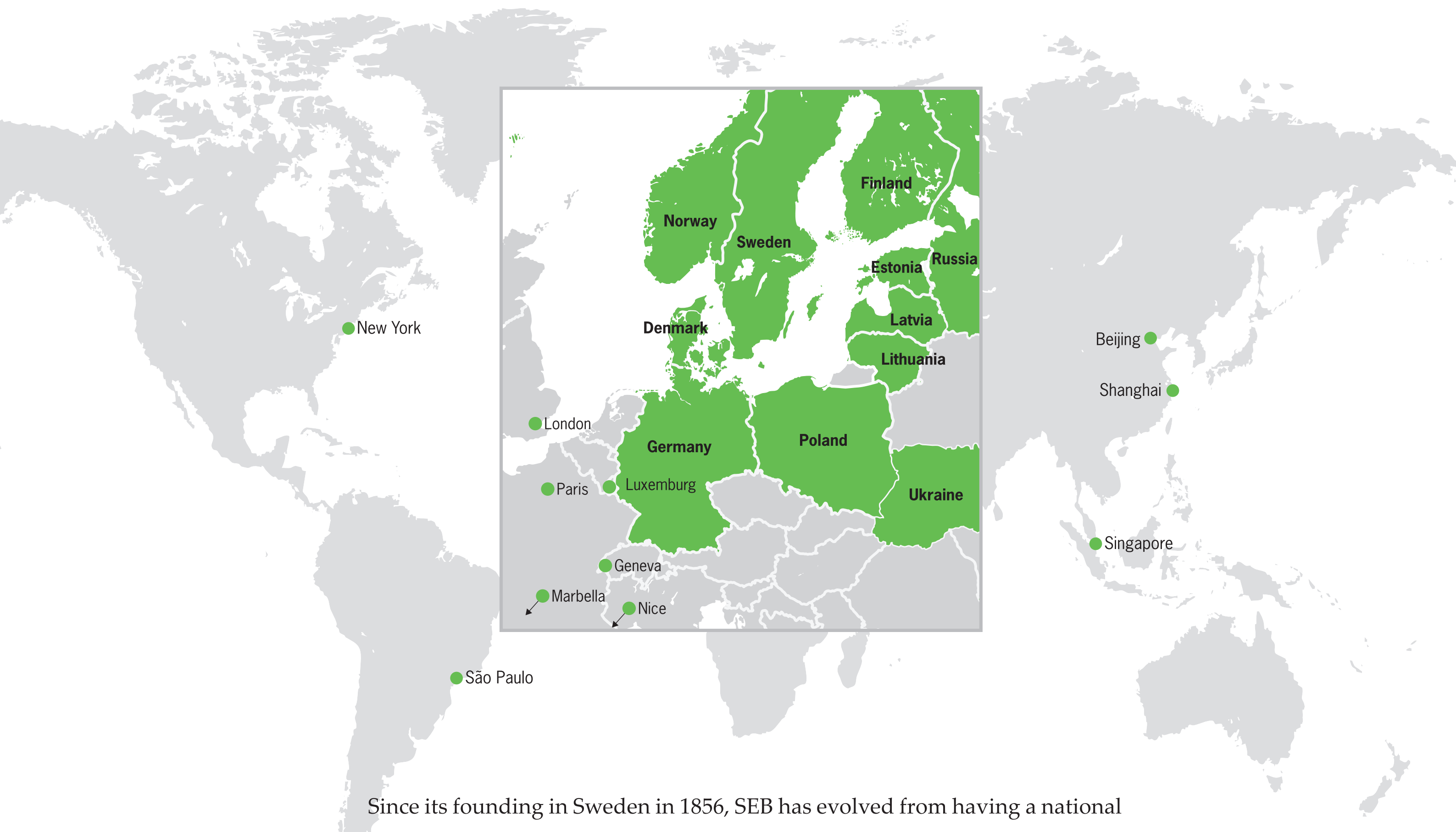

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One of the key publications from the Economic Research unit is the quarterly Nordic Outlook, which presents analyses covering the economic situation in the world as well as Europe and Sweden. Another publication is Eastern European Outlook, which deals with Central and Eastern Europe including Russia and appears twice a year.