Swedbank Economic Outlook August 2015

Emerging markets - the main threat to the global economic recovery

- Growth expected to return to mature economies, but the first step toward US monetary policy normalisation could cause large market gyrations, with impact on the real economies
- Weaknesses in emerging market economies could get out of control, with wider global implications
- Swedish growth upswing sustained, but inflation impulses are muted and monetary policy exceptionally loose

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Executive Summary

Developed economies are strengthening

We expect global growth to regain speed in 2016 and 20176 after a temporary setback in 2015. The US slowdown early in the year, together with the Greek crisis in the euro area, took some steam out of the world economy this year, but conditions in developed economies are improving. Short-term activity and sentiment indicators point to a pickup in activity, and economic policy conditions, with loose monetary policy and the fiscal consolidation largely over, remain favourable. Falling energy and commodity prices also boost household purchasing power. The outlook in emerging markets is less rosy. The Chinese economy is struggling with changing the growth model while unwinding large imbalances, and in India confidence in the government's ability to reform is eroding. Brazil and Russia have been hit by the return of falling oil prices when the political situations in the two countries are already strained. Globally, we forecast growth to reach 3.8% and 3.9% in 2016 and 2017, respectively, up from 3.2% in 2015.

Swedish growth relies on domestic demand

Growth in Sweden is expected to remain strong throughout the forecast period but will also become increasingly dependent on household spending power. This will boost domestic demand, both through private consumption and the housing market. The Riksbank will remain in an expansionary mood, and, although the uptick in the July inflation numbers delays further cuts, we remain convinced that another cut of the repo rate to -0.45% will be effected in the fall, and that an expansion of quantitative easing is in the cards. Fiscal policy will tighten next year through higher taxes, despite the likely future relaxation of the surplus target. Swedish export performance is expected to remain lacklustre, despite the depreciation of the krona. Lower commodity prices affect the Swedish economy directly through the mining industry and indirectly through exports to Norway.

Macroeconomic indicators, 2014 - 2017

	2014	2015f	2016f	2017f
Real GDP, annual change in %				
Sweden (calender adjusted)	2.4	2.8	2.7	3.2
Estonia	2.1	1.9	2.8	2.8
Latvia	2.4	2.1	3.3	3.0
Lithuania	3.0	1.8	3.3	3.0
Unemployment rate, % of labour force				
Sweden	7.9	7.7	7.6	7.2
Estonia	7.4	6.6	6.7	6.8
Latvia	10.8	9.9	9.2	8.3
Lithuania	10.7	9.3	8.3	7.8
Consumer price index, annual change in %				
Sweden	-0.2	0.0	1.4	2.0
Estonia	-0.1	-0.2	1.9	2.5
Latvia	0.6	0.5	2.0	2.3
Lithuania	0.1	-0.8	2.5	3.0
Current account balance, % of GDP				
Sweden	6.2	6.3	6.1	5.9
Estonia	1.3	2.0	1.6	-0.2
Latvia	-3.1	-2.2	-3.8	-5.2
Lithuania	0.1	-3.4	-4.2	-4.7

Sources: National statistics authorities and Swedbank.

Growth to pick up in the Baltics in 2016-2017

The Baltic economies have so far weathered the Russian crisis relatively well, with exporters shifting to other growing markets. Although we do not expect a quick improvement in the economic and political situation in Russia, a pickup in growth in the euro area will support Baltic exports, while gradual EU structural fund inflows will promote investment in the coming years. A robust increase in private consumption will support growth throughout the forecast period, owing to rising incomes and moderate inflation. We thus forecast growth in the Baltics to pick up to around 3% per annum in 2016-2017 from about 2% this year.

Negative risks have increased

The risks to the forecast are large, however, and mainly tilted towards the negative side. This is due to the still-fragile state of many economies. From a global perspective, weaknesses in the emerging economies weigh the heaviest, where Chinese imbalances are largely unknown. The recent move towards liberalising the Chinese exchange rate has had repercussions, not least in other emerging economies, and illustrates the importance of the Chinese economy to world growth. Furthermore, the Fed's expected US funds rate hike could again not only expose emerging markets but also strain growth in the US. In Sweden, lower commodity prices and its effects on Norway, the most important trading partner, could push down exports; meanwhile, the housing market has continued to boom. For the Baltic economies, the largest uncertainty remains developments in Russia, especially political risks.

Global Outlook

Against the background of a largely positive outlook on global growth, there are also a number of growing risks. The looming Fed rate hike is expected to further support the US dollar, which, coupled with the recent depreciation of the Chinese renminbi, could pressure already vulnerable public finances and corporate balance sheets in emerging markets. The recent decline in commodity prices will lower global inflation, but we believe that underlying inflationary pressures in the developed economies will allow for a start in the normalisation of monetary policy. This will raise uncertainty in the world interest and exchange rate markets.

Global growth to pick up after slowdown in early 2015

Following the significant downward revision of global growth in 2015 (mainly on account of the US setback early in the year) we expect the recovery to regain speed in 2016 and 2017. The positive momentum is mainly coming from mature economies, while the weak links are focussed in the emerging economies. The prerequisites for a US growth rebound are in place: a strengthening labour market, and better consumer and business sentiments. Also, the fundamentals of the euro area are in place, with much of the fiscal tightening done and monetary policy set to expand. Among the Nordic economies, growth in Sweden and Denmark will pick up, while the drop in the oil price will act as a drag on Norway and Russia on Finland. We are less certain about the outlook for emerging economies. Brazil and Russia will struggle, and risks in China and India are large.

Swedbank's global GDP forecast [1/] (annual percentage change)

	2014	2015f		2016f		2017f
USA	2.4	2.5	(2.9)	3.1	(2.8)	2.6
EMU countries	0.9	1.3	(1.4)	1.9	(1.9)	1.8
Germany	1.6	1.7	(2.0)	1.9	(2.2)	1.6
France	0.2	1.1	(0.9)	1.9	(1.8)	1.7
Italy	-0.4	0.6	(0.1)	1.4	(1.2)	1.4
Spain	1.4	3.2	(2.5)	2.9	(2.5)	2.4
Finland	-0.4	-0.3	(0.1)	0.5	(0.9)	1.0
UK	3.0	2.6	(2.4)	2.5	(2.4)	2.1
Denmark	1.1	2.0	(2.0)	2.3	(2.3)	2.0
Norway	2.3	1.3	(1.2)	1.4	(1.4)	2.3
Japan	-0.1	0.7	(0.8)	1.1	(1.1)	0.8
China	7.5	6.9	(6.8)	6.6	(6.6)	6.3
India	7.0	7.3	(7.3)	7.4	(7.7)	7.3
Brazil	0.2	-1.8	(-1.2)	-0.6	(-0.8)	0.3
Russia	0.6	-4.8	(-5.5)	-2.0	(-2.0)	1.5
Global GDP in PPP [2/]	3.4	3.2	(3.6)	3.8	(3.7)	3.9

1/ April 2015 forecasts in parenthesis.
2/ World Bank weights (revised 2014). Sources: IMF and Swedbank.

The Greece debacle casts doubt on the EMU project

This summer's macro developments have been surprisingly eventful and characterised by significant turbulence. The Greek government reneged on its commitments to the troika and in the process defaulted on a debt repayment to the IMF--the first developed economy to do so it the organisation's history. This development led to the questioning of the EMU project in its entirety. Although a long-term agreement between Greece and its financiers now seems close to being finalised, mostly on the terms of the lenders, this does not change the fact that the process has put into doubt the integrity and cohesiveness of the whole EMU project. Tensions among the larger members are growing, and populist movements could gain strength in more peripheral countries. The scheduled UK referendum on EU membership, due mid-2016, could deliver another blow to the European integration project.

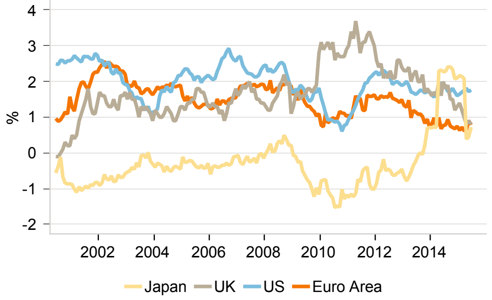
Chinese devaluation not a start of a currency war...

The recent decision by the Peoples Bank of China (PBOC) to take a small step towards liberalising the exchange rate also created significant concerns in the markets and among economic analysts around the world. It was feared that this would be the start of a devaluation of the renminbi to support the struggling Chinese export industries, thereby initiating a series of competitive devaluations. The PBOC, however, denied this and intervened in the currency market to limit the decline. More likely, this was a first step towards making the Chinese currency more tradable, and, thus, qualify for inclusion in the IMF's basket of major global currencies.

...but adds to deflation pressures caused by commodity price falls

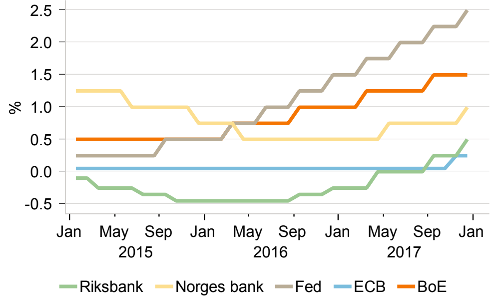
Nonetheless, the depreciation of the renminbi adds to the global disinflationary pressures caused by the resumption in commodity price declines. As we show in the report, we do not expect a quick rebound in energy prices; instead we look towards a reversal of the super cycle experienced over the last decade (Box 2). However, the downward pressures on headline inflation are being countered by a pickup in underlying inflation, albeit protracted, in both the US and the euro area. Thus, over the 2015-2017 forecast period, we expect the end of zero and negative policy rates, starting with the US this year and the EMU in 2017.

Global: Core inflation (y/y)



Sources: Swedbank Research & Macrobond

Global: Central bank policy rate forecasts

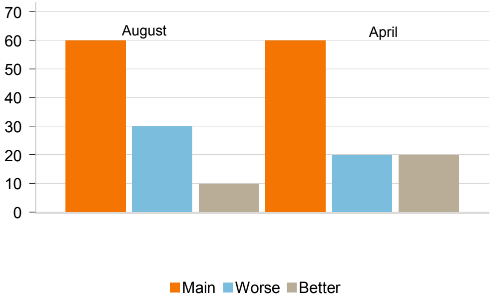


Sources: Swedbank Research & Macrobond

Risks are tilted to the downside

Risks to our forecast are mainly tilted downwards. Partly this is a reflection of our more positive outlook, partly it reflects, in our view, a more uncertain global economy. These uncertainties are mainly found in emerging markets, and there, most importantly, in China and India. Imbalances in China and political gridlocks in India could lower growth outcomes substantially. Political risks are dominating in countries like Turkey and Brazil. There are also downside risks in mature economies, although not as dominant. In the euro area the Greek deal could unravel and weaken commitment in other crisis-struck economies, while in the US there is a risk that the economy cannot cope with a hike in the Fed fund rate.

Global: Forecast probabilities (in %)



Sources: Swedbank Research & Macrobond

Global Markets: Widening spreads and a stronger dollar

Rising long-term interest rates and widening spreads

In late April and early May, there was a sharp rise in long-term market rates, driven by developments in Europe. However, the central banks maintained their soft rhetoric, which contributed to a limited rise in securities with shorter maturities. In consequence, we saw a clear steepening of yield curves across the world. The interest rate spread between the US and Europe has widened in recent months against the backdrop of higher US growth, expectations of a tighter US monetary policy, and the ECB's underscoring of the need for monetary stimulus measures to continue.

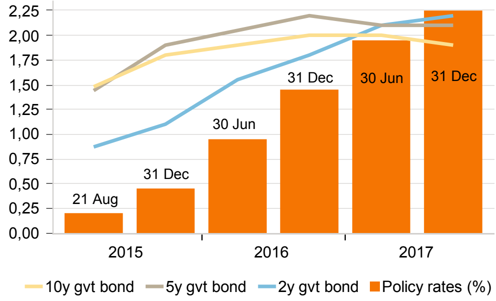
Crisis in Greece brought sharper fluctuations

In Europe, the focus has been on the turmoil in Greece, which has contributed to the periodically high volatility. However, consistent action from the ECB, with the message that the present QE programme will continue until at least September 2016, has helped to stabilise the market. At the same time, it is the ECB's assessment and assertion that growth is strengthening and inflation showing signs of bottoming out. Macroeconomic data in the United States have been mixed, which has also contributed to the financial markets' increased uncertainty about US monetary policy. However, the time of a rate hike is clearly approaching, and the message from the Fed has gradually moved from an emphasis on the timing of the monetary policy tightening to an emphasis on the pace at which it will occur.

Tighter Fed, but ECB still expansive

We maintain our view that the Fed will deliver its first US policy rate hike in September, increasing the rate by 0.25 percentage points. However, we predict that the Fed will proceed relatively cautiously, continuously adjusting the monetary policy based on incoming data. In our main scenario, we expect the Fed to raise interest rates by 25 basis points per quarter. We also predict that the ECB will pursue its government QE programme until September 2016, and leave its refinancing rate unchanged at 0.05% until the end of 2017, when the policy rate will be raised to 0.25%.

Global: Interest rate spreads US vs. EMU (p.p.)



Sources: Swedbank Research & Macrobond

Interest and exchange rate assumptions, %

	Outcome 2015 21-Aug	Forecast 2015 31 Dec	2016 30 Jun	2016 31 Dec	2017 30 Jun	2017 31 Dec
Policy rates						
Federal Reserve, USA	0.25	0.50	1.00	1.50	2.00	2.50
European Central Bank	0.05	0.05	0.05	0.05	0.05	0.25
Bank of England	0.50	0.50	0.75	1.00	1.25	1.50
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10
Government bond rates						
Germany 2y	-0.3	-0.2	-0.1	0.2	0.4	0.7
Germany 10y	0.6	0.6	0.9	1.3	1.5	1.8
US 2y	0.6	0.9	1.5	2.0	2.5	2.9
US 10y	2.0	2.4	2.8	3.3	3.5	3.7
Exchange rates						
EUR/USD	1.14	1.04	1.10	1.13	1.15	1.15
USD/CNY	6.4	6.5	6.6	6.5	6.5	6.5
NOK/SEK	1.02	1.02	1.06	1.07	1.07	1.07
USD/JPY	122	126	127	125	122	121
EUR/GBP	0.73	0.69	0.68	0.68	0.70	0.71
USD/RUB	69	67	75	80	75	70

Sources: Reuters Ecowin and Swedbank.

Diverging interest rates in the US and EMU

The divergence in monetary policy is making its mark on bond yields. With the Fed tightening, long-term interest rates are also rising, albeit at a slower pace. Rising US interest rates will put upward pressure on interest rates globally. However, European long-term interest rates are expected to rise to a much lesser extent as long as the ECB continues its government bond buying. The differing monetary policy on the two sides of the Atlantic means that the respective yield curves look different. When the Fed raises the key interest rate, interest rates on bonds with shorter maturities rise and the yield curve becomes flatter. In Europe, we expect to see the opposite trend. With an unchanged policy rate, we see a slower rise in European short-term bonds, while the ECB's bond buying is holding back the rise in long-term bond yields. The consequence is a steeper yield curve.

Slow monetary policy normalisation, but not without risks

In our main scenario, we expect to see a balanced development in the financial markets, although the divergent monetary policies are increasing the risk of substantial exchange rate volatility, at least periodically. Rising US interest rates may result in an upward pressure globally, which, in turn, will further jeopardise the recovery in emerging economies and the euro area. It is mainly the emerging economies with a clear US dollar link that are most at risk of being affected. For the euro area, this may result in the expansion and/or lengthening of the ECB's QE programme. Another risk is that a rapid appreciation of the US dollar will jeopardise growth in the US. This risk will be accentuated if a further depreciation for the Chinese renminbi is allowed, with an accompanying weakening of most Asian currencies. This scenario would be likely to be met by a pause in the Fed's interest rate hikes. A more widespread "currency war" cannot be ruled out, although it is our assessment that this risk is minimal. In addition, a stronger dollar places greater downward pressure on commodity prices. As this, in turn, means downward pressure on global inflation, it will therefore have an indirect effect on monetary policy in a number of countries, including Sweden.

Central banks' focus on currencies

Currencies have continued to be the major focus of the central banks in light of the globally low inflation and the monetary policy limitations brought to the fore when interest rates are already zero and long-term interest rates are depressed by quantitative easing. From an investor perspective, the downward pressure on interest rates and low risk premiums have meant an increased focus on short-term interest rates and the small remaining interest rate differentials. It is against this backdrop that the currency market's focus on the Fed's anticipated first interest rate change in seven years should be viewed. The same applies to the Bank of England's signalling of possible interest rate hikes early next year, which has contributed to the strength of the pound sterling.

The dollar will not reach full parity with the euro

It remains our forecast that the US dollar will be further strengthened somewhat when the Fed raises its key interest rate by 25 basis points in September. However, the Fed's interest rate hikes will be gradual and relatively cautious, due to factors such as low initial inflationary pressure and the risk of pushing the dollar too strongly. Another reason is the prediction that the long-term neutral interest rate in the US will be lower as a result of a global savings surplus and lower trend growth in the US. Our forecast is for the dollar to reach a bottom position just above US dollar-euro parity. While the euro has the support of a current account surplus and a stock market with a relatively low valuation, the ECB's monthly government bond purchases of EUR 60 billion at zero interest rates are contributing to a latent need for domestic investors to seek a positive return outside the euro area. Towards the second half of next year, the euro-US dollar rate is expected to slowly creep back to 1.10 and then to 1.15 in 2017, as euro inflation rises more persistently and the ECB scales down its bond buying.

The pound sterling is already strong

Looking at the pound sterling, it is reasonable to assume some additional strengthening against the euro in six months' time. The Bank of England appears to be open to raising its benchmark interest rate a little in order to contain the risk of wage-driven inflation in the medium term. However, we have reservations about whether the Bank of England can manage particularly extensive hikes, as there is a risk of strengthening the pound from an already relatively strong level and subduing imported inflation. The record-high current account deficit is also an indication that the pound is at least not undervalued. At present, this deficit is partly financed by capital inflows to a hot real estate market in London, with measures now being taken to mitigate these capital inflows. The euro-pound sterling forecast indicates a gradual strengthening of the pound by 2-3% in the coming year.

Exchange and short term interest rates

	Forecasts				
	3m	**6m**	**12m**	**24m**	**36m**
USD/SEK	8.9	8.8	8.2	7.8	7.7
EUR/SEK	9.3	9.2	9.1	9.0	8.9
NOK/SEK	1.01	1.02	1.06	1.07	1.07
GBP/SEK	13.3	13.3	13.3	12.9	12.4
JPY/SEK	7.0	7.0	6.5	6.4	6.4
CHF/SEK	8.7	8.5	8.1	7.8	7.4
KIX index	112.4	110.9	108.0	107.4	106.3
EUR/USD	1.05	1.04	1.10	1.15	1.15
EURNOK	9.2	9.0	8.5	8.4	8.3
USD/JPY	126	126	127	122	120
USD/CNY	6.4	6.5	6.5	6.6	6.6
USD/RUB	68.0	70.0	77.0	75.0	…

Sources: Reuters EcoWin and Swedbank

NOK under pressure from oil prices

The Norwegian krone is in a weakening phase, driven by falling oil prices and a lowered key policy rate from Norges Bank. In the short term, the Norwegian economy appears to be managing relatively well, and the previous currency weakening is keeping inflation close to the target. With increasing indications that the price of oil will remain at a low level for a relatively long period (see Box 2), the market is likely to push Norges Bank to lower rates further. However, our forecast is that the current EURNOK rate, which is about 9.10, is already largely discounting Norway's weakened growth prospects and falling key policy rate. Norges Bank still has a long way to go to measure up to the ECB's aggressive policy of bond buying and zero interest rates. In addition, Norway has opportunities to use fiscal policy to partly promote a shift in the economy towards other sectors. That said, there is a clear risk of the krone weakening further against both the euro and the Swedish krona in the period ahead. Other commodity currencies, such as the Australian dollar, have depreciated substantially when their terms of trade have deteriorated sharply.

Weak outlook for emerging market currencies

The movements in the currencies in emerging markets have been negative in 2015. Behind the decline are global factors, such as slower growth in China, falling commodity prices, and a stronger US dollar. In addition, several countries are plagued by structural difficulties, such as low savings, worsening government finances, and low investments, the latter of which gives rise to bottlenecks and, hence, high inflation. The currency trends for Brazil and Turkey have been the worst. The political uncertainty is high in these countries. In Turkey, there will be early elections in the fall, for the fourth time in two years. In Brazil, the President could face impeachment. Both countries lack a powerful government alternative, and they may see their credit ratings deteriorate to junk level. Several emerging market currencies have fallen to historically low levels. Despite the low valuation in terms of real effective exchange rates, we expect the negative currency trends to continue due to the political turmoil and continued decline in demand from China.

We have a negative outlook for the Russian rouble as economic growth will stay low and economic sanctions will remain in place. The export sector is slumping and would benefit from a weaker currency. There is a political distaste for a stronger rouble as shown by the foreign currency buying that the central bank started in spring. Foreign capital markets are more or less closed, meaning that Russian banks and corporates are going to face difficulties renewing external debt, even if this is not a problem in the short term. Future refinancing of foreign currency loans will require a high risk premium in the form of a low rouble as long as the global financial markets are closed to Russia. We have a forecast for USDRUB of 75 in 12 months' time but see a risk for an even weaker rouble

Euro area: Growth is set to broaden

Upswing in consumption demand – when will investments pick up?

Growth has come back to the euro area after a temporary slowdown last year. Growth momentum has moved from Germany to the periphery, with Spain growing rapidly, France moderately, and Italy in the starting blocks. We have been optimistic regarding the euro area for some time. The underperformance relative to the US economy since 2011-2012 can be explained by factors such as differences in monetary policy (i.e., higher interest rates and no quantitative easing), more contractive fiscal policy, stronger exchange rate (the euro), and the slow process of cleaning up banks. Over the past year, all of these factors have changed. Perhaps most important are the facts that European banks are better capitalised, and credit markets in Europe are in far better shape. As a consequence, credit to households and businesses is growing again in most countries, and at low interest rates.

European consumers are more upbeat now than in a long time. Consumer confidence has risen in most countries to a high level, and growth in retail sales and private consumption was at its highest in 10 years at the start of the year, helped by lower energy prices, which have boosted household real incomes substantially. Now, unemployment is falling in all but a few countries, and higher wage growth is funding consumption.

In many countries, including Spain and Italy, the downturn in investments since the financial crisis has been severe. Companies continue to seem reluctant to expand. Nevertheless, investments have bottomed out; they have been increasing for more than two years in Spain, and the next move should be upwards in other countries as well. The euro remains weak by historical standards and provides considerable stimulus to many European companies. Exports from the euro area are growing, and the headwinds from weakening Russian and Chinese markets are compensated for by opportunities elsewhere. The improved domestic growth outlook should also lift the willingness to invest. Credit and equity markets are supportive. The scarcity of labour in Germany should provide further incentives.

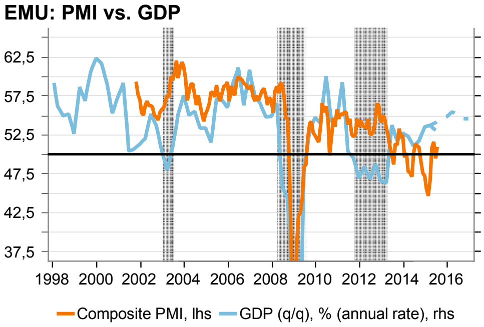
Monetary policy will remain expansionary for long

The European Central Bank (ECB) is implementing a large-scale quantitative easing programme, by which it purchases bonds and lends to banks. The programme has brought down interest rates and weakened the euro, thereby providing a substantial economic stimulus. In large part, this programme was justified on the grounds of low and falling inflation, raising the question of whether it would be ended prematurely if inflation picks up. Over the past months, inflation has stabilised in the euro area as the effects of lower energy prices have faded somewhat. Judging by monthly developments, core consumer prices are rising at a rate of about 1%. This remains, however, well below the inflation target, meaning that the ECB still has considerable leeway. And with the level of unemployment still high, it is legitimate for the bank to pursue an exceptionally expansionary monetary policy for quite some time yet. For a closer look on the inflation outlook, see Box 1

A tragedy, but only for Greeks

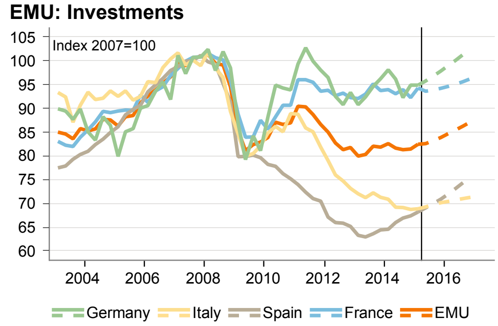
Faced with the risk of total collapse of the banking sector and exit from the Euro area, the Greek government eventually gave in and struck an agreement with its creditors implying substantive reform and continued austerity. The Greek economy has suffered severely from the conflict, erasing earlier signs of improvement. The only positive conclusion to be drawn is that the remaining EMU economy seems little affected.

EMU: PMI vs. GDP



Sources: Swedbank Research & Macrobond

EMU: Investments



Sources: Swedbank Research, OECD & Macrobond

In-depth 1: EMU inflation has bottomed out; moderate acceleration ahead

We expect consumer price inflation in the euro area to accelerate moderately in coming quarters on account of stabilised energy prices and higher economic growth. Unemployment is falling and wage inflation has started to rise, paving the way for gradually higher inflation also in the medium term.

The key determinant of inflation over time is average unit cost. Over the past 15 years, hourly labour cost has increased by 2.5% per year, while productivity has increased by 0.8 – 1% per year, implying a 1.5% - 1.7% rise in labour cost per unit produced. Consistent with this rise in costs, average consumer price inflation has been 1.9%. The consumer price index (CPI)--excluding volatile prices on energy and food and without policy-decided prices on alcohol and tobacco, as well as the impacts of taxes and subsidies--has been 1.4% on average since 2001.

We expect that a gradual tightening of the labour market will continue to push up wage inflation somewhat. Indeed, labour cost inflation has climbed to 3% in the private sector in Germany as unemployment has fallen to a 30-year low. The average labour cost inflation in the euro area was above 2% in the first quarter of 2015, up from below 1% last year. Wage inflation remains below 2% in France, Italy, and Spain, but growth rates are up from troughs at 0 – ½% in Spain and Italy.

Productivity growth in the euro area is slow, as in other developed economies, and we expect it to remain sluggish. Thus, the labour cost per unit produced is now slowly accelerating and will continue upwards.

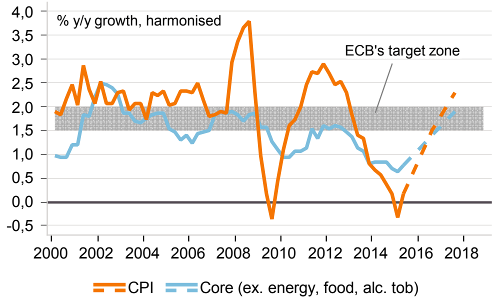
Business margins (prices less costs) in the euro area vary substantially over the cycle but are stable in the long run, and therefore do not affect average inflation in the long run. Profit margins fell sharply after the financial crises and have not recovered much since. A likely margin expansion the coming years will lift the inflation rate to somewhat above the increase in the unit cost level.

We expect EMU core inflation to pick up from the current ¾ - 1% to 1½ - 1 ¾% by 2016, thereby approaching the European Central Bank's target rate of below, but close to,2%. Headline inflation is likely to rise to similar or slightly higher levels as oil prices slowly recover. A 15% annual increase in the oil price from current levels in the coming years will yield an approximate 0.3 percentage point contribution to headline annual CPI relative to core inflation. A moderate appreciation of the euro will contribute on the downside.

Euro area

	2014	2015f	2016f	2017f
GDP	0.9	1.3	1.9	1.8
Productivity	0.7	0.8	1,0	1,0
Employment	0.2	0.6	0.9	0.8
...Labour force	0,0	0,0	0.1	0.1
... Unemployment	11.6	11.0	10.2	9.5
Comp per hour	1.2	2,0	2.5	2.7
Unit labour cost	1.1	1.2	1.5	1.7
HICP, tot	0.4	0.4	1.5	2.3
HICP ex energy food, taxes	0.6	1.0	1.4	1.9
Non core HICP contr.	-0.2	-0.6	0.1	0.4
Margin change vs HICP	-0.5	-0.2	-0.1	0.2
Margin change vs HICP core	-1.3	-0.2	-0.1	0.2

In-depth 1: Consumer prices



Sources: Swedbank Research & Macrobond

US: Fed hike, but don't expect a rapid tightening

Growth pickup after temporary setback

The first half of 2015 was characterised by temporary setbacks due to the harsh winter weather, disinvestments in the energy sector following the plunge of prices, and West Coast port strikes. Nevertheless, initial growth estimates have been revised up, and with the pickup in activity, we are now looking at real growth of around 2.6% annually in the first semester. Activity was supported by growing domestic demand, fuelled by a strengthening labour market, falling energy prices, and a low-interest-rate environment. Subsequently, household consumption is recovering and housing investment increasing. However, due to the sluggish first quarter, we revise down our overall growth forecast for 2015 to 2.5% (from 2.9% in our April forecast).

Continued catch-up before limits are hit

Growth momentum will continue over the next 18 months, supported by strengthening fundamentals and existing slacks. However, the vulnerability to shocks, external and internal, remains large. Employment still has room to grow despite the joblessness rate's falling towards 5%. The participation rate remains low and part-time workers plentiful. This will support income growth, adding further to the windfall provided by the falling energy prices, and, as sentiments strengthen, household consumption will boost demand. We also expect investments, both in the residential sector and business, to pick up, although with a lag. Exports, however, will be hampered by the strong dollar and the still-weak and uncertain external demand. For 2016, growth is expected at 3.1%, after which it falls back to 2.5% in 2017.

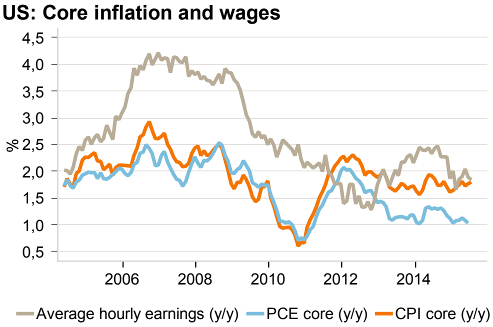
Fed hike a close call

We believe the Federal Reserve (Fed) is set to raise the monetary policy rate at the next meeting in September, provided no negative surprises, in particular regarding the August nonfarm payroll numbers. But it is a close call. The main arguments in favour of a hike are the continued strengthening of the labour market, but also growing concerns of financial market risk taking and imbalances. Fed communications are also increasingly suggesting that it is getting ready to start normalising monetary policy, although the emphasis on data dependency remains strong. The slow increase in wages and prices, and the strong dollar, provide the main reasons for a continued wait-and-see approach. The recent change in the Chinese exchange rate regime (i.e., a managed float with a bias towards depreciation) could put pressure on the Fed, but US monetary policymakers normally put less weight on external developments unless there is a clear impact on the US economy.

Expect modest market volatility

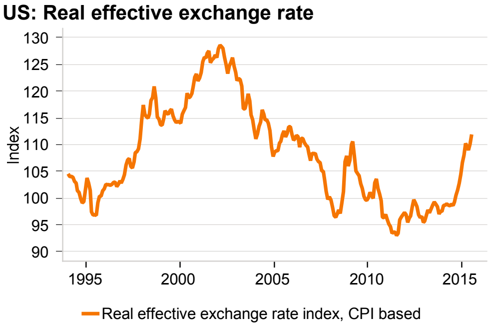
Although volatility is expected to increase following a Fed hike, regardless of whether it comes in September or later in the year, the long-signalled intentions by the Fed should go a long way towards having prepared the markets. We do expect bond rates to increase, raising the spreads vis-à-vis the rest of the world, and the US dollar to strengthen. However, a significant part is likely already priced in (cf. the stronger dollar), and we foresee a modest appreciation over the next 12-18 months, reaching $1.03 per euro towards the end of 2016. We also believe that the interest differentials between US and the euro area can be sustained on the back of the significant difference in economic growth momentum; however, this will limit the ability of the Fed to raise policy rates in a normal, rapid manner. Thus, expect a modest hiking pace over the forecast period, with two hikes per semester after the first one in 2015; at end-2017, the Fed funds rate will be at 2.50%.

US: Core inflation and wages



Sources: Swedbank Research & Macrobond

US: Real effective exchange rate



Sources: BIS, Swedbank Research & Macrobond

Iran deal and the return of the debt ceiling

The US political scene is slowly hearting up in anticipation of the presidential election in November next year. This, in itself, is unlikely to have a material impact on the economy, but it could raise the conflict level in other areas, worsening the political gridlock. The nuclear deal with Iran is at risk to which prominent Democratic leaders in Congress have already voiced opposition. An unravelling of the deal could reverse the decline in the oil price and raise uncertainty in the Middle East. Furthermore, the federal debt is expected to hit the self-imposed ceiling again towards the end of this year, providing ample room for bickering.

Japan: Growth surrounded by downside risks

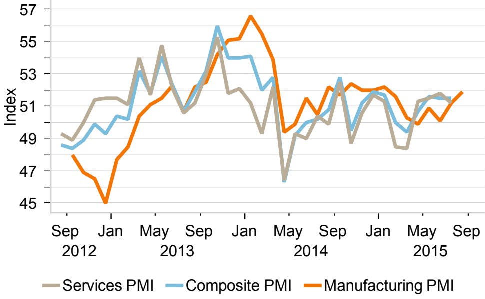
Bumpy recovery in Japan

Economic growth is expected to accelerate in 2015-2016. The negative impact from the consumption tax rate hike, which has been a drag on consumption since April 2014, is gradually waning. Exports are expected to get stronger, benefitting from stronger demand in the US and Europe but also from a weaker yen. Rising corporate profits, improving business sentiment, and steady gains in employment and wages have strengthened domestic demand. Business investment is expected to grow modestly as demand picks up. The recent fall in oil prices will dampen imports and increase enterprises' profits and households' real incomes. In 2017, GDP growth will be somewhat lower due to the second round of a consumption tax hike.

Inflation target out of reach

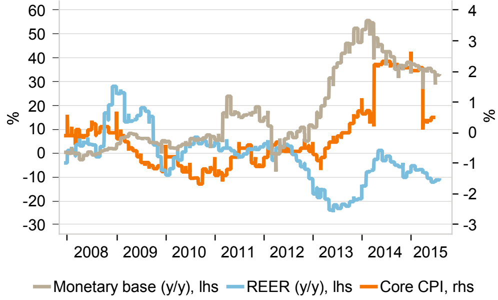
Inflation and inflation expectations are still far below the Bank of Japan's target. Inflation is likely to remain close to 0% in the near term, mainly due to lower energy prices. We expect additional monetary stimulus before the end of the year and quantitative and qualitative easing to continue in 2017, as the Bank's 2% inflation target will not be met until then (if we exclude the impact from the value-added tax (VAT) increase in 2017). Negative risks dominate during the forecast period. The growth of exports has weakened recently. Domestic demand remains fragile and can be suppressed again when the VAT is raised. Externally, the slowdown in China, one of Japan's main trade partners, might, among other things, cause disruptions in financial markets and an undesirable appreciation of the yen.

Japan: Economic sentiment



Sources: Swedbank Research & Macrobond

Japan: Price dynamics



Sources: Swedbank Research & Macrobond

UK: EU referendum and a Bank rate hike in focus

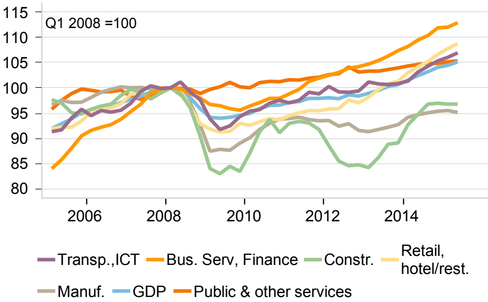
Domestic demand remains driver of growth

Preliminary numbers indicate a 0.7% growth rate from April to June after the slowdown in the first quarter. The services sector has grown significantly, and investment intentions one year ahead are robust. Manufacturing, on the other hand, has continued to lag behind and even if business surveys indicate further expansion, momentum has waned since the start of the year. Household consumption has been strong, supported by rising employment and higher real income. Wage growth has started to pick up and is set to improve further as the labour market tightens. Credit conditions are expected to remain favourable, which, in conjunction with solid demand, may boost investment growth. We expect domestic demand to continue playing an important role and real growth to reach 2.6% this year, and then gradually slow to 2.5% in 2016 and 2.1% in 2017. However, a downside risk is the upcoming EU referendum, scheduled for June 2016. Recent polls indicate support for staying in EU; but this will depend on negotiation outcome.

Protracted tightening in monetary policy after initial hike in 2016

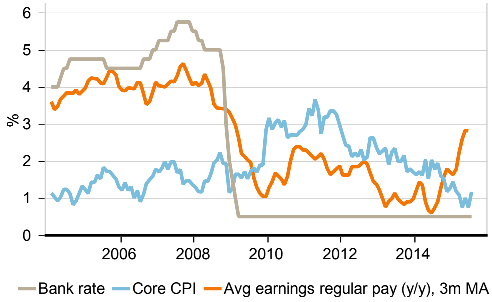
Economic policy has been characterized by the government's commitment to fiscal consolidation and the Bank of England's (BoE's) inflation objective. During the forecast period, inflation pressure is expected to increase, leading the BoE to raise the Bank rate. However, the tightening will be relatively protracted, with one hike per semester starting in 2016, leading to a rate of 1.50% at end-2017. The sterling will be relatively stable, but uncertainties may arise around the EU referendum in mid-2016.

UK: GDP sectors



Sources: Swedbank Research & Macrobond

UK: Inflation, earnings & interest rates

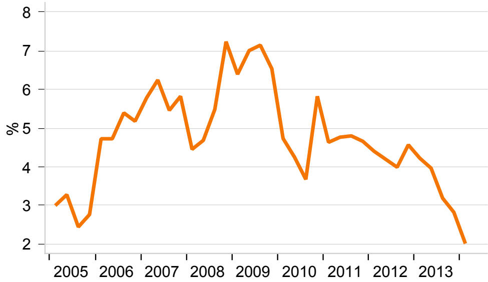


Sources: Swedbank Research & Macrobond

Emerging markets: Weakness all around

The macroeconomic situation in most emerging market countries has deteriorated further this year. China's economy continues to slow, commodity prices are falling, and the market is pushing the renminbi lower. A lower renminbi is negative for countries that compete with China and for those with high exposure to the Chinese market. The biggest effect on the global economy from a weaker renminbi will be more deflationary pressures. Global factors aside, there are a number of structural issues that are now becoming more visible. Debt levels have increased rapidly in many emerging market economies since 2009. This debt buildup has taken place mainly in the private sector. The problem today is that growth is slow, which will create difficulties for many borrowers to service their debt. Bad policy and poor economic management have increased the risk that a number of countries will lose their investment grade rating. High leverage and weak investor confidence create a toxic combination. The situation in Russia is still problematic, with ongoing tensions in Ukraine, economic sanctions that remain in place, and lower oil prices. We expect a turbulent period for the region in 2015-2017.

Emerging markets: Emerging vs. developing market growth difference



Sources: Swedbank Research & Macrobond

Emerging markets: Commodity Indices, S&P GSCI, Total return, USD

Sources: Swedbank Research & Macrobond

<u>**China: Weakness remain but a strong move towards a global currency**</u>

Tight money and slow growth

The Chinese economy continues to weaken as strong deflationary pressure prevails. The leadership has stepped up policy support in order to stabilise growth and to avoid a financial crisis. The results so far are not encouraging. Monetary policy is still tight, as lending rates have been slow to adjust downwards and demand for bank loans has deteriorated. Credit growth has declined to around 14% in annual terms, the lowest in recent history. The bulk of the adjustment has taken place in the shadow banking sector, which is not all bad, seen from the leaders' point of view. Overproduction is pushing producer prices down at an even faster pace. Prices at the factory gate have been deflating since 2012. The recent strengthening of the dollar has pushed the real trade-weighted renminbi up by around 10% during the last 12 months, and by more than 25% since 2011. This has weakened the competitiveness of Chinese corporates and has led to a contraction of export figures.

Liberalisation of exchange rate leads to mild depreciation

On August 11, the central bank in China (PBOC) surprised the market by adopting a new renminbi-fixing mechanism with the aim of moving towards a more market-oriented pricing. This is another step towards liberalising the renminbi and is in line with what the IMF recommended in a report published in August this year. Chinese leaders are preparing their financial system for inclusion in the IMF's Special Drawing Rights basket, a change that would aid China in its ambitions to increase the international use of the renminbi. The IMF staff recently proposed extending the setup of the current basket until September 30, 2016, which would give China more time to implement financial reforms and to develop sufficient depth for its currency in foreign exchange markets. However, this adjustment is not without risks. It will be a challenge to stimulate the economy with further monetary easing and a weaker exchange rate, while avoiding rapid capital outflows. Additionally, Chinese borrowers who have loans in US dollars will be negatively affected by a weaker renminbi. Another challenge is to allow a fall in the renminbi without attracting renewed criticism from US politicians regarding currency manipulation. If, however, the PBOC is successful in its move towards a market-driven exchange rate, it will be hard for US politicians to accuse China of manipulation.

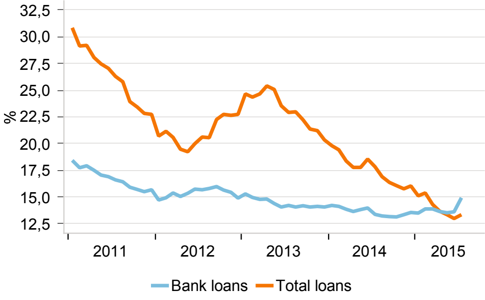
Sharp falls on the Chinese equity market

Meanwhile, the stock market turbulence has been another source of worry this year. However, the risk of a broad-based financial crisis should not be exaggerated. First, the correlation between equity prices and economic growth is very low in China. Second, the wealth effect should be contained, as the majority of households' savings are in bank accounts. Third, most fixed-asset investments have been financed through bank loans. Nevertheless, the Chinese authorities have implemented a number of measures in an effort to stabilise the stock market and restore investor confidence. These measures should be viewed against the background of China's long-term strategy to reduce reliance on debt financing.

A gradual slowdown without a hard landing

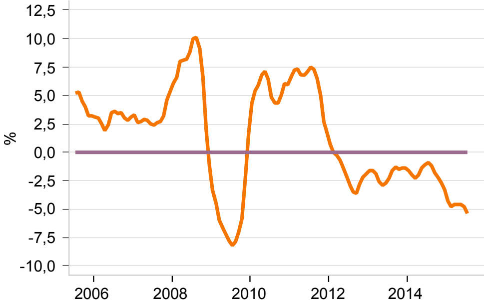
We expect the Chinese leaders to continue to stimulate the economy through various fiscal policy measures. So far, policy stimulus seems to have stabilised the property sector. Since June, house prices for tier 1 cities have been rising, compared with a year ago. Surveys also show that the situation is more balanced in the housing sector. This is very crucial for China's economy as the property market, together with its supplying industries, accounts for almost 30 percent of GDP. China is undergoing a difficult transition towards a more market-based economy, one that poses many risky challenges. A high debt level and slow growth create a risky environment. However, we do not believe China is going to have a hard landing. The risk of this happening has increased, but China still has reserves and policy levers to use if needed, and the banking system is supported by the government. We maintain our forecast of GDP growth of 6.8% in 2015, even though we believe that the true economic growth will probably be closer to 6%. Looking forward, we expect growth to gradually slow and reach 6.6% in 2016 and 6.3% in 2017.

China: Credit Growth (y/y), %



Sources: Swedbank Research & Macrobond

China: Producer Price Index (y/y), %



Sources: Swedbank Research & Macrobond

Brazil: economic downturn made worse by political crisis

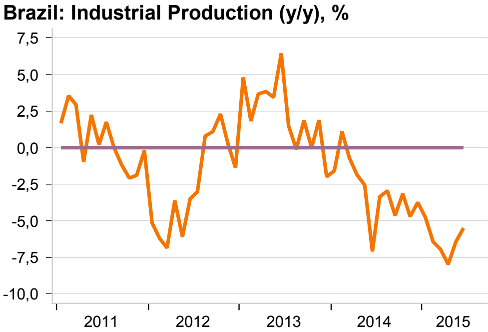
High inflation forces monetary tightening despite weak growth

The economic situation in Brazil is very weak. The real is this year's worst-performing currency among emerging market economies. The economy is struggling with negative growth and rapidly rising unemployment. Low growth in China, Brazil's biggest trading partner, is worsening an already weak situation. GDP fell 1.6% on annual basis in the first quarter, and industrial production has been on a negative trend since the start of 2014. The inflation rate rose to 9.6% in July, the highest level in over 10 years. As a result, the central bank has continued to tighten monetary policy, by a total of 425 basis points since October 2014, to the current level of 14.25%. Economic policy is very tight, as reflected by a 12.5% annualised drop in imports in June and lower retail sales in the first half of 2015. Household demand is held back by a weak job market, high inflation and negative wage growth.

Fiscal policy slippages could risk investment grade

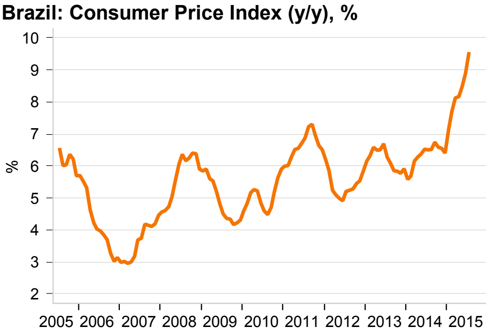
The Petrobras corruption investigation continues to spread, adding to the political uncertainty and restraining investments and growth. This, in turn, leaves less room for fiscal policy. Furthermore, President Rousseff's popularity is at a record low and the threat of impeachment is very high. There is a big risk that the target of a 1.2% primary surplus will not be reached in 2015. Moreover, it is not unlikely that the 2016 surplus target of 2% will be delayed until 2017. This, coupled with a larger current account deficit in 2015, means that the risk of Brazil's losing its investment grade rating is high. Moreover, falling commodity prices have hurt the terms of trade and pushed down the Brazilian real, which in real terms is trading at levels last seen in 2009.

Brazil: Industrial Production (y/y), %



Sources: Swedbank Research & Macrobond

Brazil: Consumer Price Index (y/y), %



Sources: Swedbank Research & Macrobond

India: political gridlock hinders new government's reform agenda

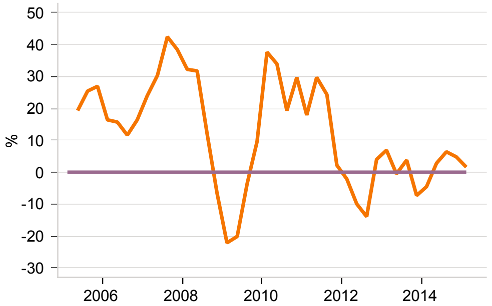
Reforms stall despite Modi's promises

Economic growth has been somewhat of a disappointment in 2015, and the high hopes following the change in government in 2014 have now been tempered. Prime Minister Modi is facing strong opposition in the parliament. In fact, not a single law was passed during the parliamentary session that ended in August. The government never promised rapid changes, but the lack of progress raises questions regarding the prospects of reforms in India. The aim of its reform agenda is to raise growth in the long term. India needs to implement structural reforms that would facilitate doing business and reduce bottlenecks in the economy, such as insufficient infrastructure and a complicated tax system. Investment development has been weak, as has credit growth. The latter is the lowest in about 10 years, even though the central bank has cut its benchmark rate by 75 basis points in 2015, as the banks have not cut lending rates for their borrowers to the same extent.

Falling inflation prompts further policy rate cuts

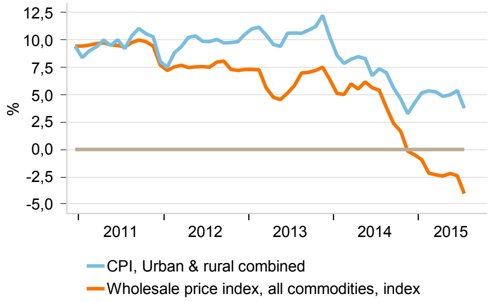
The inflation rate has, on a broad basis, fallen significantly since the second half of 2014. This has been due to better control over food prices, overcapacity in the manufacturing sector, and a more stable currency. The price decline has been even more evident at the wholesale level, where prices have fallen on an annual basis every month since November 2014. In July, they fell 4%, the lowest annual rate in about 40 years. Weak domestic demand suggests that inflation will remain low and stay below the central bank's target of 6% for 2016. The Indian economy should benefit from low energy prices. We therefore expect further rate cuts to stimulate credit growth and speed up investments that are crucial for future economic growth. We expect growth to pick up somewhat during 2015 and 2016. However, the risk to our forecast lies on the downside and will be dependent on political support for the government's reform agenda.

India: Investment in fixed assets (y/y), %



Sources: Swedbank Research & Macrobond

India: CPI & wholesale price index (y/y), %



Sources: Swedbank Research & Macrobond

Russia: recession still to deepen, recovery will be disappointing

Recession still to deepen, timid recovery only towards the spring of 2016

After a surprisingly mild GDP contraction of 2.2% in annual terms (a quarterly drop of 1.3%) in the first quarter of this year, the second quarter flash estimate reports a much sharper contraction of 4.6% (by our estimate, a quarterly drop of 2.5%; official data not yet published), thereby effectively refuting those views that Russia will weather the crisis very lightly. The Ministry of Economics still maintains that Russia has reached the trough and that the trend will turn positive in the third quarter. This is an overly optimistic view, and, although the speed of quarterly contraction is set to lessen, for the baseline scenario we stick to largely the same outlook as in our reports from April and January--very timid positive quarterly growth returning only towards the spring of 2016. It will still get worse before it gets better.

Many of the recessionary forces are just setting in, and it will take time for them to run their course. The fall in the oil price late last year sharply pushed down the rouble and hiked inflation. Real wages have thereby shrunk by nearly 10% annually, as have retail sales. While consumer price inflation has now eased to about 15% (from the peak of 16.9% in March), the most recent fall in the oil price below USD 50 per barrel has again sharply weakened the rouble; this will keep inflation high longer and thereby erode consumer spending more. Poor manufacturing output (down 7.4% in annual terms in the second quarter) shows that policymakers' hopes for a broad and fast import substitution (i.e., import bans and the weak rouble) have been unfounded. The ensuing financial sector squeeze is unlikely to provide sufficient funding for investment to sharply boost output any time soon. Agricultural production and oil output have grown, but they are unable to compensate for shortfalls elsewhere. Fixed-investment activity has shrunk, but the contraction has so far been relatively minor (down about 6.5% annually in the second quarter), and we expect the largest drops to be still ahead. It is the massive double-digit drop in imports that keeps the GDP contraction rates mild.

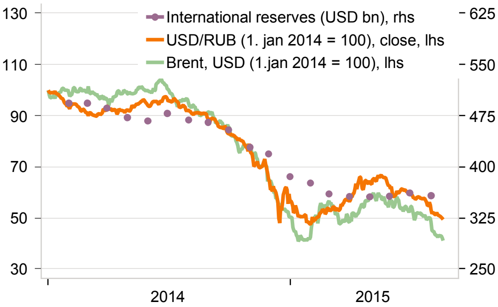
External environment is harsh and Russia's own policy response inadequate

Neither the external environment nor Russia's own policy response is sufficient to turn these forces around any time soon. The oil price is expected to remain low, and any recovery (see the section on commodity prices) will be minor and insufficient for Russia to feel comfortable. The Russia-Ukraine conflict is unlikely to see a quick solution; thus, sanctions will keep weighing on the Russian economy – we expect them to remain broadly as they are throughout 2016, with only a slight chance of gradual easing in 2017. Russia's own monetary and fiscal policy response will reduce the depth of the recession but is not sufficient to provide strong and lasting support to growth. After the initial sharp hike in policy rates, they have since been eased (to 11% from 17%), as has regulatory forbearance; however, the central bank can only reduce the pains of recession, rather than engineer growth. Fiscal policy has helped to ease the crisis (e.g., tapping into the Reserve Fund, and refinancing municipalities and regions via the federal government), but the fiscal rule (which is linked to the now permanently lower oil price) means that fiscal squeeze (e.g., freeze of public sector wages and pension indexation below inflation) will weigh on growth for years to come. Fiscal stimulus is also of a much smaller size than the one following the Lehman crash; hence, the impact will also be smaller. As to the foreign exchange reserves, Russia is comfortable enough to face debt rollovers but is short of funding for investment; this again reduces its GDP growth potential, which we currently see at only 1% per annum. It is very poor by any standard.

Disappointing recovery will mean permanent risk to political stability and policy predictability

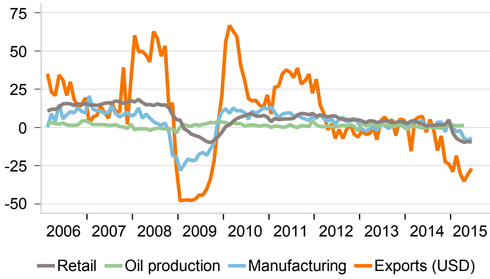
We expect the Russian GDP to shrink by 4.8% this year and by 2% in 2016, followed by a 1.5% recovery in 2017. We expect the rouble to weaken further (see the section on Global markets). The Russian monetary and fiscal policy response has averted a sharp deepening of the crisis but cannot address the lack of growth, which is of a profoundly institutional nature (corruption, poor rule of law, aggressive growth of the share of state-owned companies in the economy, etc.). So far, it seems that such issues are unlikely to find a viable solution under the current political regime. Hence, when the recession ends, Russia is set for a disappointing growth, which means a permanent risk of political instability and policy unpredictability (e.g., asset repossessions, weakening of its fiscal rule). We maintain the view that risks to this baseline scenario are almost fully tilted towards more negative outcomes. A more upbeat story would require (i) a sharp sustained oil price rise, (ii) swift solution to the Ukraine conflict, and (iii) difficult institutional reforms; none of these seem that likely any time soon.

Russia: Exchange rate, oil, central bank reserves



Sources: Swedbank Research & Macrobond

Russia: Annual growth of manufacturing, retail, oil production & exports, %



Sources: Swedbank Research & Macrobond

In-depth 2: A commodity super-cycle, now in reverse

Commodity prices have always been volatile. Changes in demand and supply often create large price swings, as volumes are quite inelastic to price changes. The demand for commodities is usually closely correlated to the overall business cycle Supply usually responds with a lag to demand but eventually creates even larger price swings.

Investments in commodity production are highly cyclical and usually strongly influenced by current market conditions. If prices have soared, often due to strong demand, commodity-producing companies have large cash flows, the outlook is good, and future prices have risen. Banks and financial markets are usually optimistic, too, so external funding is easily available. But, as many companies make the same investment decision, the market often gets oversupplied when the new capacity later enters the market. Demand may have weakened meanwhile, but, even without that, the increase in supply is sufficient to take prices down. At this stage, companies become pessimistic, future prices fall, and financial markets are no longer willing to fund investments in new capacity. As a consequence, investments often remain depressed for many years, eventually reducing capacity. After a while, supply will be too low and prices rise again.

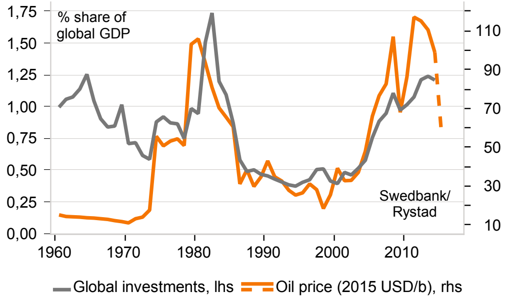
This simple adaptive expectation model provides a straightforward, insightful illustration of the cyclicality in many commodity markets, and it even works for other asset-based markets (including shipping and real estate). Over the longer term, raw material prices have trended downwards in real terms. Technological progress has in general reduced extraction costs, more than compensating for the gradual depletion of remaining resources.

Oil and other raw material prices fell through the 1980s, following the price increases and, thereafter, the supply increases of the preceding years. Investments in commodities were generally low during the 1990s. However, as China entered the world economy around the year 2000, demand for commodities like iron ore, aluminium, copper, and oil soared. Prices rose, which led to a sharp increase in investments in most commodity sectors (see Charts 1 and 2). From 2000 to 2014, China increased its production, equalling 80% of the initial global production level in year 2000. Every second year, China increased its production of steel by more than the entire production level in the US! The financial crises led to a sharp decline in raw material prices in 2008-2009. However, Chinese authorities responded to the downturn in China's exports by launching a huge domestic investment programme. Consequently, commodity demand and prices rose promptly, and investments in commodities worldwide kept up.

Starting in 2011, commodity prices have been declining. New supplies have entered the market, while in China growth has slowed. For many commodities, China is now becoming a net exporter. The market balance has shifted, and most commodity prices have been halved from the peak. Still, real prices remain above their pre-boom average. We therefore expect the decline in commodity prices to continue on average.

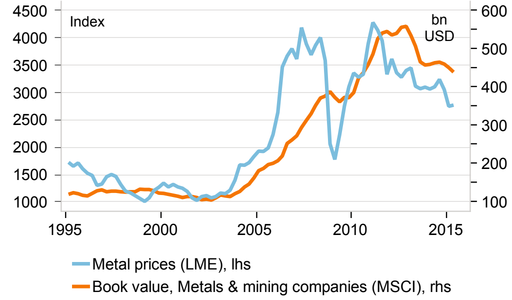
Lower investments in the commodity sectors will be felt in the global economy, but the impact will remain modest. Investments in the oil and gas sector equal only about 1% of global GDP. Lower commodity prices are beneficial for all other sectors in the global economy, and the overall impact on the world economy is likely positive.

In-depth 2: Oil and gas investments



Sources: Swedbank Research & Macrobond

In-depth 2: Global metals and mining



Sources: Swedbank Research & Macrobond

Nordic area: External forces dominating

Norway: Slowdown continues

The economic slowdown continues. GDP grew by only 0.2% in Q2 (0.7% annualised), and according to Norges Bank's regional network, the expected rate of growth has declined to only 0.25% for the months ahead. Oil investments, as well as oil-related manufacturing production, have already fallen close to 15% from the peak, and the decline is set to continue. Manufacturing surveys are at their weakest levels since the financial crisis, and order inflows have slowed significantly. Moreover, we now see the first signs of a broadening of the oil-related slowdown, as corporate services are also reporting a contraction; more than half of all oil-related jobs are in corporate services.

Unemployment is increasing...

Unemployment has increased over the past year – only slightly, according to the unemployment office (NAV), but significantly, according to the Labour Force Survey (AKU). However, both measures agree that the rise in unemployment is concentrated along the "oil coast" (in the southwest), where announcements of downsizing have become commonplace. In other parts of the country, the unemployment rate is still flat or falling. Still, several indicators confirm that the labour market is weakening, including few vacancies, lower wage growth, and very weak labour demand surveys.

... but household demand is keeping up

Household demand is, nevertheless, keeping up fairly well. Retail sales have continued to grow, and new car sales have shown no signs of weakness. Private consumption is now the main driver of total domestic demand. House prices have continued to grow on average, although regional differences are becoming very visible, with Stavanger – the oil capital – reporting falling prices, while prices in Oslo have continued to grow at a decent rate. As the economy slows further and unemployment rises, the downside risk to household demand is high following many years of high growth in incomes, house prices, and debt. Even now, consumer confidence is weakening and has fallen to levels not seen since the financial crisis.

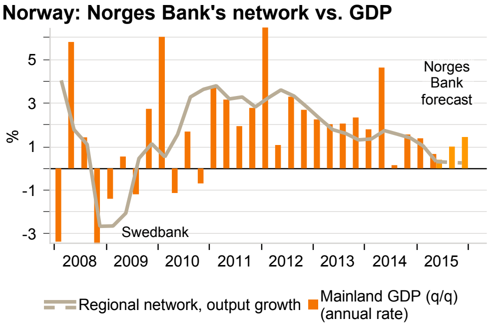
Monetary and fiscal policy stimulus set to increase

Norges Bank has lowered the main policy rate twice in response to the economic slowdown, the last time to 1% in June. The bank's projections indicate a high probability of an additional rate cut this autumn. We believe that the slowdown in oil will be both deep and broad, and that more rate cuts will eventually be necessary. We expect that the rate will be lowered to 0.75% by December and further to 0.5% by next June. More important, we see the potential for many years of very low interest rates in Norway, and we believe that the rate difference between Norway and its trading partners will continue to narrow.

Norges Bank is clearly taking a careful approach to rate cuts. The bank remains concerned about financial imbalances in the household sector and in commercial real estate. It, therefore, does not want to lower interest rates too much or too fast. Two other measures have been put into place that may help contain credit growth. First, it has been decided that the countercyclical capital that buffer banks have to hold will increase by half a percentage point, to 1.5%, next year. Second, the Ministry of Finance has introduced a new regulation on mortgage lending that limits the extent of loans with low down payments and amortisations. However, it is unclear to what extent these measures will curtail current lending practices. Consequently, Norges Bank's careful approach to rate cuts is sensible.

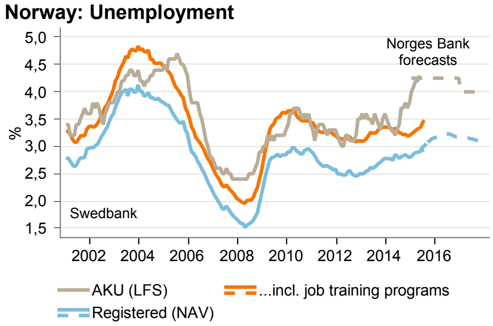
Fiscal policy will also help alleviate the economic slowdown. We expect the national budget for 2016 to increase the structural non-oil budget deficit by up to 0.5% of Mainland GDP. Fiscal stimulus will thus account for a large share of overall economic growth. While this is significant, much more could be done with fiscal policy if needed, given the very large petroleum wealth fund. But rather than increase public spending outright, we expect the conservative/liberal coalition government to prioritise lower taxes. This seems sensible in order to maintain a weak krone (requiring low interest rates) while promoting new investments in an economy that still has relatively little spare capacity.

Norway: Norges Bank's network vs. GDP



Sources: Swedbank Research & Macrobond

Norway: Unemployment



Sources: Swedbank Research & Macrobond

Denmark: a slow recovery is gaining speed –and raising the prospects of overheating

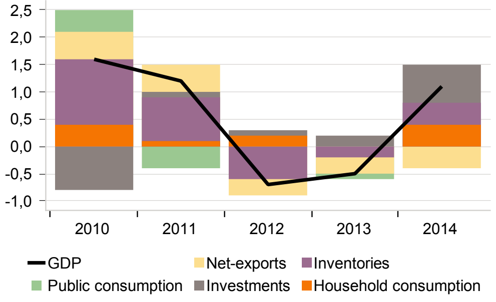
Successful defence of krone bolsters competitiveness

The pickup in growth in the Danish economy in 2014 was sustained in early 2015. The economy expanded at an annual rate of 1.7% in the first quarter, compared with an overall growth of 1.1% in 2014. Growth was driven by domestic demand, primarily by private sector investments, but also household consumption. The appreciation pressure on the Danish krona has weakened somewhat since the beginning of the year, in particular from foreign buyers. However, interest rates remain low, benefitting mortgage holders and investments alike. Thus, housing prices continue to rise, although they are still far below the levels observed prior to the crisis. The elections late this spring resulted in a change in government, but we do not expect this to have a material impact on economic policy.

Risks of labour market and housing bottlenecks

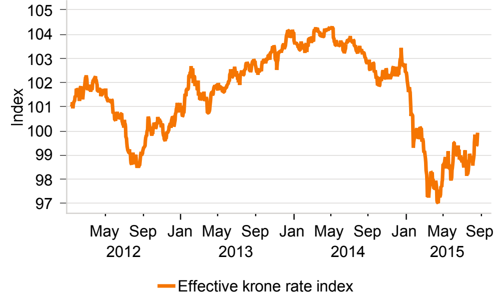
The Danish economy will continue to benefit from low energy costs and a competitive exchange rate. A pickup in external demand from Germany and the UK will support Danish exports. Furthermore, household finances are boosted by a strengthening labour market and sentiments by increasing housing prices and equity markets. We expect annual growth to reach levels of around 2% in the forecast period; this means that resource utilisation risks becoming exhausted. The main risk to the Danish economy is thus be overheating: in the labour market through rising wages and, subsequently, domestic prices, and in the housing market by growing shortages and a return of a house price bubble.

Denmark: Contribution to growth (p.p.)



Sources: Swedbank Research & Macrobond

Denmark: Nominal effective krone rate



Sources: Danmarks Nationalbank, Swedbank Research & Macrobond

Finland: Difficult times ahead despite improved outlook

Export growth will pick-up steam in 2015-2017

Despite the gradually improving economy in many EU countries and the euro depreciation, the export recovery in Finland is very slow. This is primarily due to the contraction in Russia and to the decline in competitiveness of past years. We expect that the aggregated demand of Finland's trading partners will increase in 2016 and 2017 and contribute more to its export growth. Private investment will increase but not compensate for capital depreciation. Thus, capital stock will decrease, having a negative impact on potential growth of GDP.

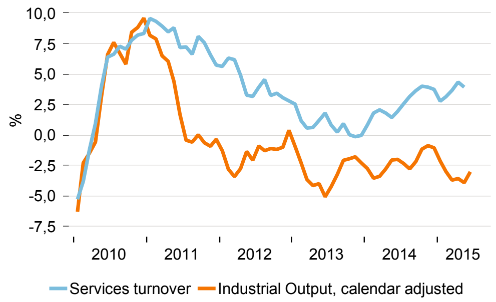
Private consumption relatively strong in 2015-2017

Although nominal wage growth has slowed in Finland, real households' disposable income has increased, and consumer confidence has improved. This has contributed to the growth of private consumption. However, current labour costs exceed output and productivity growth and are too burdensome for the business sector. Wage growth is therefore expected to be modest and together with decreasing employment, private consumption will be supressed. We expect real GDP to contract by 0.3% in this year and growth in 2016 and 2017 will be 0.5% and 1%, respectively.

New government to reverse the worsening trend of public finances

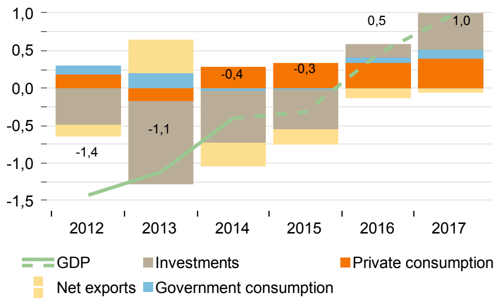
Finland's public finances have worsened resulting in a growing deficit and debt. The new government has committed to comprehensive structural reforms addressing pensions, social welfare, health care and municipalities. The tax policy will be reviewed, but without raising the total tax rate. The corporate tax rate will be maintained "at a competitive level," and labour taxation eased. However, the budget deficit is expected to improve only modestly in an environment of sluggish GDP growth, and it will be even more difficult to halt the debt growth.

Finland: Industrial & services sector growth (y/y)



Sources: Swedbank Research & Macrobond

Finland: Contributions to GDP growth (p.p.)



Sources: Swedbank Research & Macrobond

Sweden: Solid growth and a negative policy rate

Cyclical developments in the Swedish economy are strong, although with a higher risk scenario. The main growth drivers are domestic demand, helped by good household finances, and rapid demographic development – partly through private consumption and partly through housing investments. Export demand remains relatively subdued despite a weak krona. This also brings significant risks, with uncertainty about emerging economies and declining commodity prices that are affecting major Swedish trading partners such as Norway and Finland (via Russia). The sustained low inflation and low wage growth expectations in the lead-up to the wage negotiations will bring a further easing of the Riksbank's monetary policy in autumn, while we expect the fiscal policy to remain tight pending a revised surplus target. The housing market surge continues, and there is still a high risk that if it subsides, there may be serious real economy consequences.

Stronger momentum in 2015, but low inflation means repo rate cut

Low energy bills and falling interest rates in the first quarter led to a decline in private consumption without households' underlying consumption propensity falling. Instead, savings rose, with scope for increased household consumption in the future. Meanwhile, imports fell back as a result of the temporary increase at the end of last year, which pushed up growth. This does not change our overall picture of the Swedish economy. We see a strengthening of growth and have revised our forecast for 2015 up to 2.8 percent. Strong household finances continue to dominate the entire forecast period, and this also applies to the area of housing investments. Exports are being held back by a weak global economy and an external demand composition that is unfavourable to Swedish industry. The investment climate is weak, and declining commodity prices are affecting both Swedish exports and major recipients of Swedish exports. It is our expectation that the Riksbank will see itself obliged to cut the repo rate by 10 points during autumn and announce further asset purchases, while the government imposes a tight budget. A rebalancing of the economic policy is called for and would benefit the Swedish economy.

Key Economic indicators, 2014-2017 1/

	2014	2015f	2016f	2017f
Real GDP (calendar adjusted)	2.4	2.8	2.7	3.2
Industrial production	-1.1	1.3	3.8	4.2
CPI index, average	-0.2	0.0	1.4	2.0
CPI, end of period	-0.3	0.4	2.1	2.1
CPIF, average 2/	0.5	0.9	1.9	1.7
CPIF, end of period	0.5	1.3	2.0	1.6
Labour force (15-74)	1.3	1.1	1.1	0.8
Unemployment rate (15-74), % of labor force	7.9	7.7	7.6	7.2
Employment (15-74)	1.4	1.3	1.3	1.1
Nominal hourly wage whole economy, average	2.9	2.5	3.0	3.1
Savings ratio (households), %	15.8	16.6	16.2	16.7
Real disposable income (households)	2.6	3.6	1.7	2.8
Current account balance, % of GDP	6.2	6.3	6.1	5.9
General government budget balance, % of GDP 2/	-1.9	-1.6	-0.7	-0.3
General government debt, % of GDP	40.6	40.1	39.0	37.5

1/ Annual percentage growth, unless otherwise indicated.
2/ As measured by general government net lending.

Sources: Statistics Sweden and Swedbank

Good growth under a cloud of growing uncertainty

The outlook for the Swedish economy over the next two years remains good, with a growth rate of about 3 percent, but at the same time it has to be said that the risks are increasing, both domestic and external. However, households continue to contribute most to the cost of increased debt and exposure to rising interest rates. The Norwegian economy is being affected by the falling price of oil, and as the country is one of Sweden's largest trading partners and workforce recipients, this also affects the Swedish economy. This highlights the challenges presented by the rapid demographic change in Sweden. Our assessment of inflation growth is affected by energy price trends, but also by increased global competition created by technological development, notably in the form of digitisation. This impedes the Riksbank's target achievement, and we anticipate that the repo rate will remain low throughout the forecast period.

Low interest rates steepening, undervalued krona strengthening

Swedish bond yields are being kept down by the Riksbank's bond buying programme, while international interest rate rises are driving up the long maturities. However, the upturn will be moderate. If the Riksbank also includes mortgage bonds in its bond buying programme, which we believe likely, mortgage rates will remain depressed. It is also our assessment that the Swedish krona is undervalued – again as a result of the Riksbank's policy – and apart from short-term deviations, we expect a strengthening against the euro to about SEK 9 in 2017. After an initial weakening, the krona will also strengthen against the US dollar. The Norwegian krone is expected to lose value in the wake of falling oil prices, and also weaken against the Swedish krona.

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2014	2015f		2016f		2017f
Households' consumption expenditure	2.4	2.5	(3.2)	2.4	(2.5)	2.3
Government consumption expenditure	1.9	2.3	(2.2)	2.4	(2.5)	2.3
Gross fixed capital formation	7.4	3.9	(4.5)	5.7	(6.3)	5.5
private, excl. housing	5.7	2.3	(3.3)	5.2	(6.2)	5.5
public	2.3	1.8	(0.4)	4.9	(4.6)	3.9
housing	20.8	11.9	(13.1)	8.2	(7.9)	6.7
Change in inventories 1/	0.2	-0.1	(-0.1)	0.0	(0.0)	0.0
Exports, goods and services	3.3	4.0	(4.5)	5.0	(5.4)	4.6
Imports, goods and services	6.6	3.2	(5.5)	5.7	(5.7)	5.0
GDP	2.3	3.1	(2.8)	2.9	(3.4)	3.0
GDP, calendar adjusted	2.4	2.8	(2.6)	2.7	(3.2)	3.2
Domestic demand 1/	3.3	2.7	(3.1)	3.0	(3.3)	3.0
Net exports 1/	-1.1	0.5	(-0.2)	-0.1	(0.1)	0.0

1/ Contribution to GDP growth. Sources: Statistics Sweden and Swedbank
April 2015 forecast in parenthesis.

A Norwegian threat to Swedish exports

Exports faltering

Foreign trade made a larger positive contribution to GDP growth than expected in the first six months of the year, but this was primarily driven by weak imports of services (partly due to a realignment of Statistics Sweden's statistics at the end of last year). Exports slowed after last year's recovery. It was mainly exports of goods that declined, while exports of services continued to rise. In terms of destination, there was a marked decline in demand from Finland and France, in particular, while, in terms of goods, it was mainly commodity-related exports that were affected. In terms of annual growth, total export volume rose by 4.1% during the first six months of the year, with exports of services increasing by just over 10% and exports of goods by 2.0%. The emerging exports of services, in particular business services, is of growing importance to total exports and now represents almost one-third of exports.

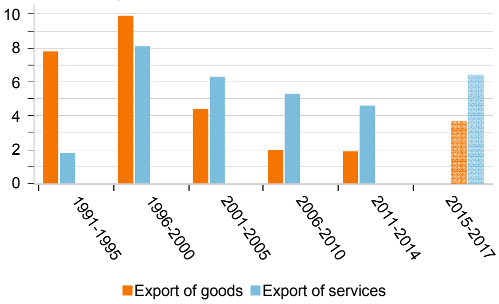
Commodities and Norway negative, Europe gives support

The recovery of Swedish exports is expected to continue during the forecast period, but at a slower rate than we predicted in the spring. First, we expect a slightly weaker world market for the Swedish export industry, primarily because of weaker growth in emerging economies. However, a positive factor is that market growth in the euro area, which accounts for just over 40% of Swedish exports, is expected to continue to increase, although it may slow a little in 2017 when the rate of growth in the European economies loses momentum. The decline in commodity prices and fall in global demand for commodities represent another inhibiting factor for Swedish exports, with exports of commodities accounting for about one-fifth of Swedish exports of goods. It is mainly exports to Norway (10% of Swedish exports) that are in the risk zone in the wake of low oil prices and reduced investments in the Norwegian oil industry. The composition of Swedish exports, with a large proportion of investment goods and a focus on the European market, is expected to support Swedish exports during the forecast period. We expect that the ongoing economic recovery will eventually increase the need for investments when capacity utilisation rises after several years of weak investment growth.

Temporary weakening of the krona strengthens competitiveness

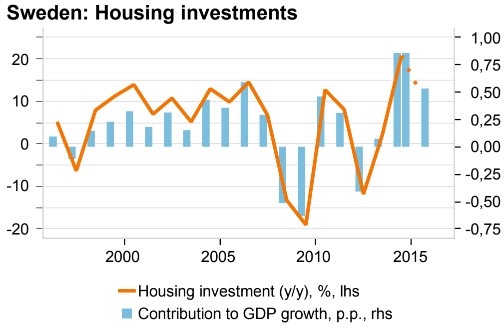
The weak Swedish currency and low unit labour cost increases will improve Swedish competitiveness in the early part of the forecast period. However, competitiveness will gradually become less favourable over the course of the forecast period as the krona strengthens. Strong domestic demand will contribute to more rapid growth in imports in 2016 and 2017 after the temporary slowdown in 2015. This means that the contribution of net exports to GDP growth is expected to be negative next year (-0.1%) and neutral in 2017.

Sweden: Export of Goods & Services



Source: Swedbank Research & Macrobond

Sweden: Housing investments



Sources: Swedbank Research & Macrobond

In-depth 3: Limited global demand inhibiting Swedish manufacturing

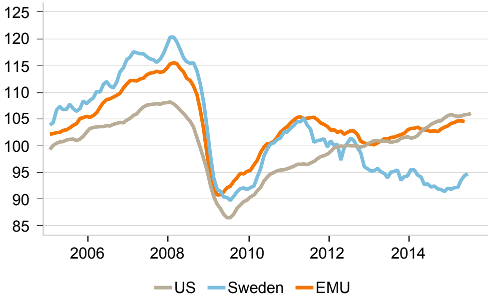
Over the last five years, Swedish industrial production has shown significantly weaker growth than its main competitor countries. Industry's value added in nominal terms was 14.2% of GDP in 2014, compared with 20% in 2000, while this measure has remained largely unchanged in the EU. Meanwhile, the private service sector's importance in the Swedish economy has increased at a rapid pace.

However, industry's loss in relation to GDP is a global trend that has been manifest for a long period. New market economies, increasing specialisation, and the emergence of business-related services are contributing to industry's shrinking share. The increased content of services is also reflected in foreign trade, with steadily growing exports of services, which amounted to 30% of Swedish exports last year, compared with 20% a decade ago.

One explanation why Swedish goods production is showing a larger decline than its main competitor countries is the weak global demand for capital goods and intermediate goods – product groups that are important to Swedish production and exports. Although the global economy has improved, global trade in goods is growing significantly more slowly than in previous economic upturns.

Swedish industry's largest drop in production is in the capital goods industry (44% of total industry). Production here has fallen by over 20% since 2010, according to Statistics Sweden's industrial production index, and, during the same period, is responsible for most of industry's total production decline of just under 9%. Machinery and transport equipment are the sectors with particularly reduced production. The combination of an unfavourable composition of exports and weak demand, notably in the euro area, a recipient of 40% of Swedish goods exports, has had a constraining effect on the Swedish export industry. Low capacity utilisation and weak growth have resulted in a lack of momentum in the European investment cycle. Meanwhile, the previous commodity boom has been succeeded by a reverse commodity cycle, with emerging economies, headed by China, demanding fewer commodities; this is constraining the Swedish mining industry and commodity-related industrial sectors. However, the continuing euro area recovery that we expect during the forecast period 2015-17 may gradually lift capacity utilisation and, ultimately, increase demand for intermediate goods and capital goods, which should benefit Swedish industry. An expected average increase of 3% in industrial production for 2015-2017 is a higher growth rate than the annual average for the last 15 years (2.6%), although the increase is from a low level.

In-depth 3: Industrial production index, 3m MA



Sources: Swedbank Research & Macrobond

In-depth 3: Share of the total industry sector (%)

Sources: Swedbank Research & Macrobond

Investment activity remains dependent on residential construction

Capacity ceiling approaching in the construction sector

Investment growth lost momentum during the first two quarters of the year, with investments in housing and research and development largely responsible for the subdued growth after the sharp rise last year. After the slowdown this year, we expect total investments to rise by 5.7% next year and 5.5% in 2017. Housing investments continue to account for a significant proportion of the investment upswing. The lack of housing, low interest rates, rising disposable incomes, and the government's ambition for a 250,000 increase in residential construction by the year 2020 clearly point to a continuation of the high level of residential construction throughout the forecast period. However, we expect the rate of growth to be held back by a shortage of capacity. Although the labour shortage eased a little in the summer, more than one in two construction companies are still having difficulties finding labour. Lack of access to building development land and stricter repayment requirements could also dampen investment growth.

Public investments picking up

Statistics Sweden's investment survey in the spring revealed optimistic investment plans for both industry and the service companies, where low commodity prices should benefit business investments. However, there are both winners and losers. Weaker Chinese growth and continuing low metal prices mean further investment cutbacks for the mining industry – a trend we have been seeing since 2012. The low energy prices are also likely to dampen investment plans in the energy sector, including the expansion of wind power and other renewable electricity production. The launch of the Stockholm Bypass project is expected to boost public investment in 2016 after a decline in 2014-2015. Local government investment has risen sharply in recent years and will continue to do so during the forecast period. The rapid population growth (see box on demography) in combination with a regeneration of the "million homes programme" and infrastructure investments, place further upward pressure on local government investments

Households saving up

Subdued consumption trend can be discerned

Household consumption has been a major driver of the recovery we have seen in recent years, while a strong household sector has contributed to a sharp rise in housing investments. After 10 consecutive quarters of growth, consumption fell during the third quarter of last year. This marked the start of a period of subdued consumption, and average annual growth over the last four quarters remained at just over 2%.

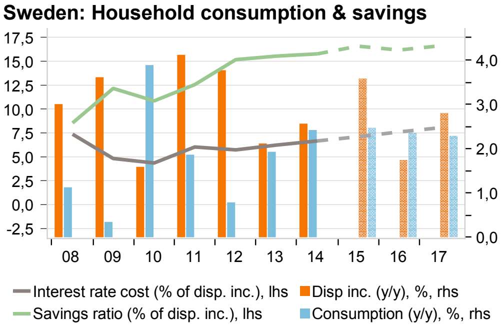
Households coping with fiscal policy

The drivers of household consumption will remain the same during the forecast period. With reasonable employment growth and a continuation of the low inflation rate, we expect real disposable income to rise by almost 4% this year. Next year, the upturn will be down to 1.7% as a result of tax increases and a temporary rise in inflation. For 2017, the year before the next elections, we expect less of a fiscal impact, which means that disposable income will be stronger again, approaching a 3% increase. It is likely that fiscal tightening will be limited in the period ahead, and this could also be a consequence of the investigations of the surplus target.

High saving continuing

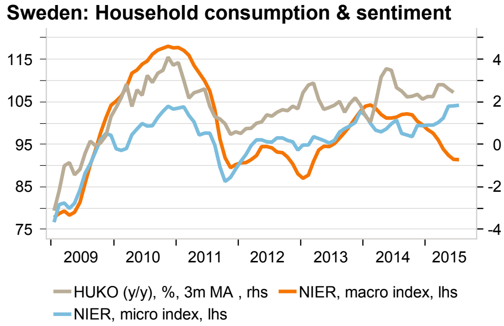
In our baseline scenario, we expect household consumption propensity to hold up relatively well, while we expect the saving rate to continue to rise and remain above 16% throughout the forecast period. One factor behind the higher saving is the increase in repayments as a result of stricter repayment requirements and expectations of tax increases next year. Despite the recent positive developments, household confidence is subdued, largely due to a negative view of the country's economy. This is holding back consumption for reasons of caution. For next year, we expect a shift in fiscal policy in line with the government's previous budget proposal; this is contributing to high saving this year as households endeavour to even out consumption over time.

Sweden: Household consumption & savings



Sources: Swedbank Research & Macrobond

Sweden: Household consumption & sentiment



Sources: Swedbank Research & Macrobond

Underlying consumption weakening

Household consumption will remain a major driving force in the Swedish economy, with growth of about 2.5% both this year and next. Over the course of 2017, we see a slowdown in household consumption. Here, we expect the enduring strong growth in sustainable consumption to start to fall back, due partly to a saturation effect and partly to a slowdown in residential construction and associated consumption of furniture, fixtures, and fittings.

Low interest rates give scope for scaled-down interest deductions

Interest rates will rise only slowly during the forecast period, which means that interest costs will have a moderately suppressing effect on consumption. However, the combination of a moderate rise in interest rates and rising debt will increase households' interest payments as a proportion of disposable income. The rise will be moderate, which allows scope for initiating a gradual decrease in the interest deductions, preferably as part of a major review, which should also include rental regulation and a capital gains tax on house sales. Lasting reform is urgently needed – not only from a stability perspective, but also as rising interest rates place ever-increasing pressure on the state budget.

Unemployment slow to fall despite good underlying growth

Jobs created, more job seekers

The labour market has continued to chug along at a decent pace in the spring and summer. The decline in unemployment is admittedly slow, but demand for labour, particularly in the services sectors, is benefiting from good growth in the domestic economy. The number of job vacancies has increased. On average, about 65,000 more people are expected to be in employment this year compared with last year, representing an increase of almost 1.5%. At the same time, the labour force will increase at almost the same pace, keeping unemployment up at a relatively high level, just over 7.5 percent. Sweden's population is growing at a fast pace, and the number of immigrant job seekers in the labour market is increasing. In addition, there is an increasing trend for older workers (aged 55-74) to remain in the labour market (see the box on rapid demographic change).

Labour shortage despite high unemployment

Over the next few years, the improvement in the labour market is expected to continue, with annual growth in employment of between 1% and 1.5%. The Swedish economy will grow at a good pace, which will also affect the labour market. The services sector is the primary job creator, with jobs increasing in the welfare sector in particular. Employee numbers in the construction sector are also rising, although the increase is being hampered because many companies are experiencing recruitment problems. The labour shortage in the overall business and industry sector had increased slightly last year from its previous low levels, but the shortage levelled off and was unchanged in the second quarter. As in the construction sector, employment in the manufacturing sector fell back, while the shortage figures continued to rise in the private services sector. There are rumblings about certain recruitment problems, particularly in the services and construction sectors, despite high unemployment. The Swedish Public Employment Service also emphasises that, while unemployment is falling among young people and the domestic population, it is rising among the immigrant population. Signs of increased matching problems make it essential to improve training initiatives and the labour market's functioning in the coming years.

Slow decline in unemployment is expected

Forward-looking indicators, such as new job vacancies, recruitment plans, and the purchasing managers' index, point to continuing strong employment growth in the autumn. At the same time, however, the increase in the labour force is expected to taper off. This is accounted for by demographic reasons (an increase in the proportion of older people in the labour force) and the fact that, although the proportion of immigrants is increasing, they still have a somewhat lower participation rate than the domestic population. In addition, the government has implemented or announced a number of reforms that may reduce labour supply and, for that matter, labour demand too. These include raising unemployment insurance, removing the cut-off date in health insurance, abolishing payroll tax rebates for employing young and retired persons, and abolishing/reducing in-work tax credits for high earners. Overall unemployment is only expected to come down slowly over the next few years, reaching 7.2% in 2017, compared with 7.7% this year.

In-depth 4: Demographics – a hot economic issue

Statistics Sweden's latest population statistics, announced in May, involved major revisions to the population projection, accentuating rapid change – both in terms of composition and number. The changed population projection was largely due to an increase in net immigration. We are familiar with the fact that the elderly population is increasing, but the new forecast also points to a constantly rising population of children. The new forecast therefore means significant challenges for the Swedish economy, both for the welfare sector and labour market and for public finances. At the same time, it presents significant opportunities. As a result of higher net immigration, the dependency ratio is expected to increase at a slower rate than in many other countries. However, politicians and the business community must work together to continue to increase the employment rate for the immigrant population and older people. At the same time, the production of education, health and social care must be made more efficient, otherwise there is the danger of a tax shock, while more resources need to be allocated to education – for the ever-increasing future population of children as well as adults who require further education.

The population is expected to reach nearly 11.5 million by 2030. This is about 660,000 more than indicated by Statistics Sweden in its projection last year. If the latest projection is compared with 2000, the difference is even more dramatic (1.9 million). The main explanation why Statistics Sweden has raised its projection so much is the upward revision of net immigration, mainly as a result of the actual growth, but also because of persistent global concerns. The net birth rate will rise over the next few years, largely due to an increased fertility rate, while the upward revision of the projection in the longer term is primarily due to increased net immigration.

Debate is already underway about failing schools and the lack qualified teachers. The latest forecast indicates a rising population of children, which places increased pressure on the school system. This raises the issue that it is high time to discuss the allocation of resources to the education system. Last year, Statistics Sweden estimated that there would be a shortfall of 65,000 qualified teachers in primary schools, after-school centres and secondary schools by the year 2025. Statistics Sweden has subsequently revised its population projection. About five percent more than in the previous projection are now expected in the 7-18 year age group. A simple rough calculation shows that this would increase the teacher shortfall to over 68,000 in 10 years.

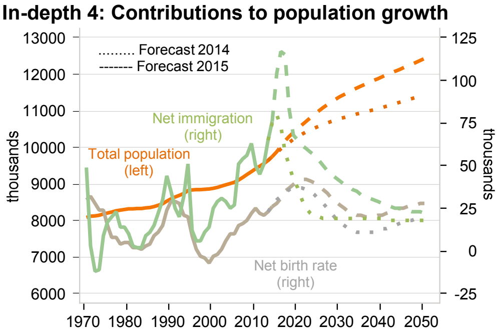
Net immigration means that the working age population proportion will be higher because of the age composition of immigrants. However, the employment rate for the immigrant working age population is not as high as for the rest of the population. The dependency ratio is also affected by how quickly employment is found and how large a proportion find employment. It takes time to find employment for many immigrants. A very simple rough calculation shows that the dependency ratio may be about the same in 2030 if the employment rate for the immigrant working age population rises to the same level as for the native population. It may be considered too optimistic to expect such an improvement. However, the age composition of the immigrant working age group is also favourable, suggesting that a significant improvement is possible.

As the average age increases, so do the effects of increasing numbers of older people who are working longer. The trend in recent years has shown positive growth. In particular, the proportion of the 55-74 age group who are in work has risen rapidly. The outcome for the first six months of 2015 showed that the employment rate for those between 65-74 continued to rise. We predict that the figure will continue to rise for a long time to come. The employment rate for individuals aged 65-74 remains low, unlike the rate for many other age groups. It is therefore in this age group and the immigrant group where there is significant potential to alleviate the dependency ratio in the period ahead.

Efficiency in the production of education, health and social care will be increasingly important. This is difficult to measure, but statistics suggest that productivity growth has been weaker than in other sectors. We therefore consider it of key importance to increase the scope for developing and streamlining these sectors, while improving or maintaining quality. The first step that must be taken is to develop reliable measurement methods that can then be used for working to improve these types of activities.

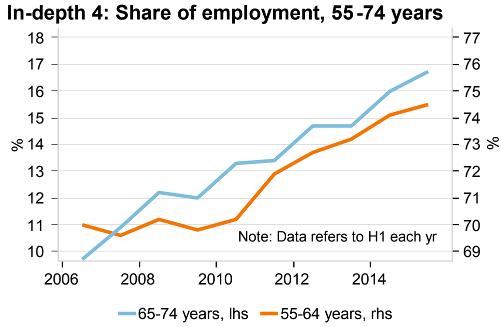
The text is a summary of Macro Focus 08-13-2015: Demographics – a hot economic issue.

In-depth 4: Contributions to population growth



Sources: Statistics Sweden population forecasts, Swedbank Research & Macrobond

In-depth 4: Share of employment, 55-74 years



Sources: Swedbank Research & Macrobond

Modest wage growth keeping inflation down

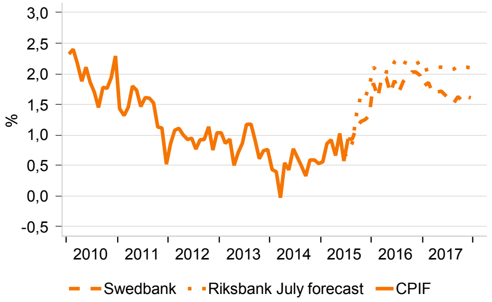
Low wage growth and little wage drift

Most wage agreements expire at the end of March next year. The current agreements run for three years and give average central wage increases of 2.3%. The wage increases in recent years have been historically low. Central wage agreements have generated average wage growth of 2.5% in the period 1997-2014. There has not been any additional growth, referred to as wage drift, over and above the agreements. Wage statistics from the Swedish National Mediation Office have a long lag between preliminary and definitive outcomes. However, the statistics for 2014 and 2015 indicate that the normal upward revision of the final wage statistics has been smaller than normal, which may indicate a relatively subdued wage drift. Plenty of spare capacity in the labour market, high unemployment in Europe with associated low wage growth, and sound real wage growth in the wake of unexpectedly low inflation are factors that are likely to hold back wage increases that exceed the agreements. The next round of wage negotiations begins in the autumn. The situation is tricky, and the opening skirmishes from the labour market parties show that they are worlds apart. The bone of contention is low inflation and the inflation assumption on which the wage negotiations should be based.

Wage negotiations in focus for inflation growth

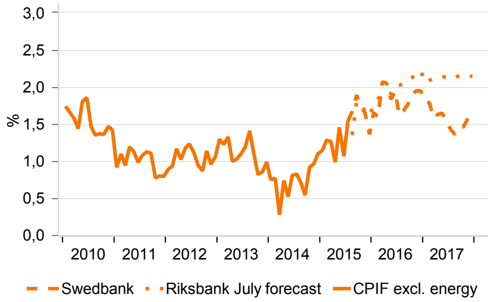
Inflation has been low and well below the Riksbank's inflation target for a long time. This has finally made an impression on long-term inflation and wage growth expectations, which, although they fell during the winter, stabilised a little in the spring. Employees believe that the starting point must continue to be the inflation target, and refer to the Riksbank's determination to bring inflation up to the target. For their part, employers underline the very good real wage increases in recent years and companies' difficulty in passing on increased costs due to intense competition. They point to the persistently low inflation and put forward the opinion that the Riksbank's inflation forecasts are not reliable, at least not in the short term, and that the next agreements must be based on the actual low inflation rate. The risk is that wage negotiations will be lengthy and that agreements will be reached only at a late stage. Disagreement and uncertainty about the inflation trend also imply relatively short agreements. It may therefore be difficult to negotiate three-year wage agreements again. Swedbank expects central wage agreements in line with current levels of 2-2.5%. Overall wage growth is expected to gradually increase to a slightly higher level over the next few years, reaching just over 3% in 2017. Unemployment will continue to fall during the forecast period, and the spare capacity in the labour market will gradually decrease. This suggests that the wage drift will increase slightly over the next few years. Total annual wage growth, which is about 3% is on the low side and would likely hinder the Riksbank's efforts to bring inflation up to the target reasonably quickly.

Sweden: Inflation



Sources: Swedbank Research & Macrobond

Sweden: CPIF excl. energy



Sources: Swedbank Research & Macrobond

In-depth 5: Extensive price effects from digitization – but no reason to revise the Riksbank's inflation target

Digitization is contributing to lower inflationary pressure as transparency increases and global competition grows. New price mechanisms are being created through reduced production and transaction costs. This is particularly true of the goods that are suitable for digital technology, such as streamed music, books, newspapers and movies. Many services can also be streamlined through digitization – in banking and finance, invoice management and many public areas. This increases competition and reduces companies' ability to keep prices up. Development of digital platforms and the sharing economy is moving at a furious pace and this further strengthens the effects of digitization on competition and price formation. *(For a more detailed description of the effects of digitization, see forthcoming Swedbank Macro Focus)*

Digitization means that production, procurement and consumption of certain goods and services is done digitally. Examples include newspapers, movies and music. Once an article has been written or a song has been recorded, the marginal costs of producing an additional unit are significantly lower. This leads to a glut of digital goods and services. It remains to be seen how companies manage to charge more in a digital world where consumers are accustomed to free access.

Digital platforms allow direct meetings between producers and consumers, which increases transparency and competition, even for goods that are not produced or consumed digitally. This strengthens the effects of globalization in that intermediaries have less importance and consumers can easily compare prices. This is likely to result in a lower average price and a smaller price differential between producers or retailers of similar products or services. A growing proportion of the goods in the CPI basket can be traded or compared in price on digital platforms. Swedbank's review shows that these goods and services make up about 46 percent of the CPI basket.

The sharing economy, which is driven by digitization, also means that traditional intermediaries are replaced by digital platforms. Examples of the sharing economy include Uber and AirBnB, which enable private individuals to receive payment for offering transport using their own car or renting out their own home. In June, it was estimated that, for the first time, Uber accounted for a larger share of business trips in the United States than regular taxis, while stays with AirBnB were rated higher by business travelers than hotel stays.

Transaction costs are associated with searching for information, connecting buyers with sellers, negotiating price and delivery and checking that both parties fulfill their part of the agreement. Digitization has meant that these costs have decreased dramatically. A further effect of the sharing economy is more efficient matching of supply and demand, which brings a larger, less expensive and more accessible range of customized goods and services. While competition is improving on the digital platforms, we are seeing monopoly situations arising between platforms. The major players can exploit their monopoly situation to charge their users higher prices for their services.

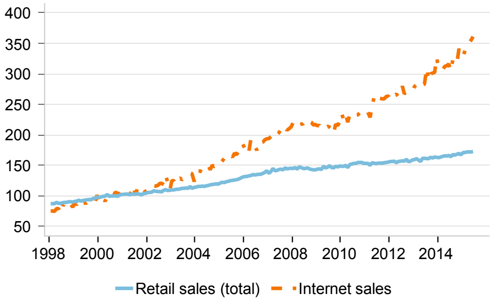
For many products it is difficult to measure how prices have been affected by digitization. Adjusting the quality of a subscription for streamed music or audio books has its obvious challenges. Consequently, it is possible that the official price indices are under- or overestimating inflation. In addition, digitization may lead to polarized price trends. The prices of goods and services that can be digitized fall, while prices of everything that cannot be digitized rise. For example, it is becoming cheaper to consume music at home, but increasingly expensive to watch an artist performing live.

The effects and channels analyzed above have an effect on the price level. The question is how long this price level adjustment will last, and how the Riksbank should deal with it. Debate about a revised inflation target has intensified in connection with the Riksbank's low level of target fulfillment in recent years. If the inflation target is not achieved, there is a risk that the wage negotiation mechanism will set the "wrong" wages in relation to the economic situation.

Sweden is becoming increasingly integrated into the international financial markets and reliant on monetary policy in the external environment, in particular in the euro area. It is therefore difficult to deviate from the ECB's inflation target. Lowering the inflation target in the short term puts Swedish companies' competitiveness at risk through an appreciation of the krona. There is also a danger of creating a downward spiral, with a stronger krona pushing down inflation further. Another factor is that the inflation target needs to be well anchored for wage setting to work. A change to the inflation target opens a door that may lead the market to expect further changes. This increases the volatility of the currency market and creates uncertainty for Swedish companies which can be harmful to growth.

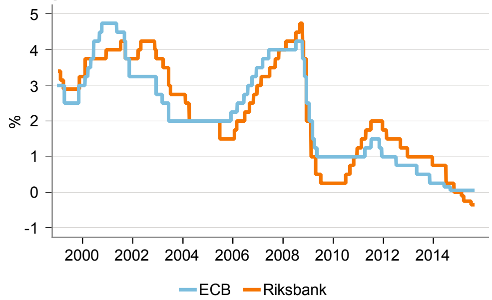
In the current situation, it is our assessment that the Riksbank's freedom of action is limited and that a downward revision of the inflation target is not the best way to go. As long as the ECB pursues an extremely expansionary monetary policy, the Riksbank has few alternatives, but to follow the ECB to minimize uncertainty about the exchange rate and future prospects for Swedish companies. On the other hand, both the ECB and the Riksbank should be able to show greater patience when faced with a deviation from the inflation target. Extending the time horizon for fulfillment of the inflation target would avoid a monetary policy that is too extreme and reduce the risk of undesirable bubbles. In the current situation, no-one knows for how long the rapid digitization will continue to pressure prices. Patience and humility on the part of our central bank representatives is called for.

In-depth 5: Internet sales & retail sales



Sources: Swedbank Research & Macrobond

In-depth 5: Central bank rates



Sources: Swedbank Research & Macrobond

The Riksbank will need to do more despite the negative interest rate

Low inflation forcing further Riksbank measures

The Riksbank cut the repo rate this spring and summer to a record low of -0.35% in the wake of continuing low inflation. At the July meeting, the current government bond-buying programme was extended to the end of the year, which means that the Riksbank will have bought the equivalent of about SEK 135 billion by then. Total government bond holdings would then be equivalent to just over 25% of the outstanding stock (if the SGB 1050 short bond is excluded). This is a relatively high level, which could disrupt the functioning of the market. The longer the Riksbank's bond-buying programme lasts, the closer we are to a point where mortgage bonds and/or municipal bonds might be included. In this case, objections on the lines of a threat to financial stability are likely to recede.

ECB and krona movement crucial for the Riksbank

The purpose of the government's bond buying is to emphasise the Riksbank's soft monetary policy approach and push interest rates down along the entire yield curve. It is also a consequence of the ECB's ongoing bond-buying programme, which runs until the end of September 2016. Inflation is low and has been for a long time, which threatens to undermine confidence in the 2% inflation target. In this situation, the Swedish krona's movement is of key importance to the Riksbank, and this also restricts its manoeuvrability, particularly in relation to the monetary policy that the ECB is pursuing and its effect on the euro. The indications are that the Riksbank will need to continue its bond buying after the end of the year. In general terms, the Riksbank has limited freedom of movement vis-à-vis the ECB. The ECB's target is for inflation to be close to but below 2%, which in substance is similar to the Riksbank's target. As an EU country with obligations to eventually join the euro, it is difficult for Sweden to have a different target without creating great uncertainty for price and wage formation.

Low inflationary pressure and wage negotiations restricting the Riksbank in the near term

The inflation outcome for July was significantly higher than expected and is likely to give the Riksbank breathing space at the September meeting. However, it is our belief that much of the July increase will be reversed as early as August, and that the recent energy and commodity price decline will renew the pressure on the Riksbank. The latest Prospera surveys once again indicate sluggishness in pushing up inflation expectations. We therefore expect further monetary easing later in the autumn. Wage negotiations will begin soon, and the Riksbank's tolerance for continuing consumer price index deviations on the downside is very low, even if these can be attributed to temporary effects of energy and commodity prices. We expect the Riksbank to fight tooth and nail to protect the inflation target's role as a nominal anchor for price and wage formation. Currency interventions appear unlikely in the present situation, but the Riksbank will be very sensitive to a rapid and more pronounced krona appreciation. The likelihood of using bank lending to companies as an instrument also appears to have receded. There remains a further cut in interest rates of about 10 points and more bond purchases. We therefore expect the repo rate to be cut to -0.45% by the end of the year. It is our view that the Riksbank will continue its emphatically soft approach, and further interest rate cuts may be in the cards again soon, particularly if the krona strengthens.

Negative repo rate until 2017

Swedbank expects inflation to gradually increase, but it will take time before the underlying inflation exceeds 1.5% more permanently. This is likely to keep inflation expectations below 2% for some time to come. Consequently, it is our assessment that we will not see the first interest rate hike until autumn 2016. We anticipate that the repo rate will have been raised to -0.25% by the end of 2016 and to 0.5% by the end of 2017.

Interest and exchange rate assumptions

	Outcome	Forecast				
	2015 21-aug	2015 31 Dec	2016 30 Jun	2016 31 Dec	2017 30 Jun	2017 31 Dec
Interest rates (%)						
Policy rate	-0.35	-0.45	-0.45	-0.25	0.00	0.50
10-yr. gvt bond	0.57	0.60	1.00	1.40	1.70	2.00
Exchange rates						
EUR/SEK	9.5	9.2	9.1	9.0	9.0	9.0
USD/SEK	8.4	8.8	8.2	8.0	7.8	7.8
KIX (SEK) 1/	113.0	111.1	108.2	107.6	107.6	107.0

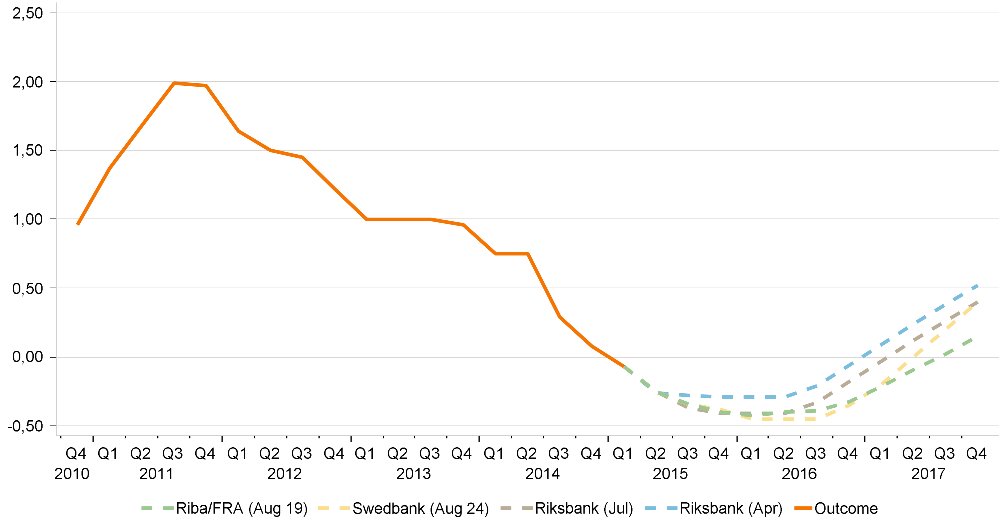
1/ Total competitiveness weights. Trade-weighted exchange rate index for SEK.

Sources: Reuters Ecowin and Swedbank

Downward pressure on Swedish market rates and the krona

The Riksbank's soft monetary policy has had an impact on the Swedish interest rate curve and the krona. The interest rate differential between Sweden and Germany has narrowed considerably, and the krona has weakened. Mortgage spreads will remain relatively wide, and, with our expectation of a more sideways interest rate movement in the near term, mortgage bonds will generate a good extra yield, reinforced by the possibility that the next bond-buying programme will include mortgage bonds. The Riksbank is expected to do its best to maintain an undervalued krona in the short term in order to quickly bring inflation and inflation expectations up towards the target. However, our belief is that the krona will be periodically stronger, down to 9.20 against the euro at times during the autumn, despite a further interest rate cut. Periodical peaks of 9.60/9.70 for the krona-eurorate in the event of low inflation will only be temporary, with investors being quick to perceive the krona as "too" cheap. A negative interest rate differential on deposits of 30 or 50 basis points against the euro does not make a big difference if the krona is perceived as excessively cheap in a long-term perspective, while, also, the market realises that the Riksbank is unable to cut interest rates much more without incurring more negative consequences (negative deposit rates to private customers, etc.). Our expectation is that the krona will gradually fall to 9.00 against the euro in 12 months' time. This means that the krona-US dollar rate will peak at close to 9.00 during the next half year, and end at around 8.00 in the second half of next year.

Sweden: Repo rate path (%)



Sources: Swedbank Research & Macrobond

Fiscal policy without clear goals and direction

Surplus target crucial to fiscal policy and potential for increased spending

The finance minister has promised a tight budget in 2016. Tax increases in the autumn draft budget will be used for reforms. In addition, public consumption will be pushed up by the significant demographic changes. The government's goal is to achieve the lowest unemployment rate in the EU by 2020. To achieve this goal, the government is keen to focus on labour market policies, education and infrastructure. However, the scope for reform is constrained by the surplus target, which means that public finances need a 1 percent surplus over a business cycle. The National Institute of Economic Research (NIER) has recently published a study, which looks into moving to a balanced budget target (i.e., 0 percent surplus over a business cycle). The NIER writes that "average unemployment may be expected to be 0.3 percentage points higher in the period 2016-2018 if fiscal policy is to be adapted to structural saving of 1 percent by 2018". This means an unemployment rate that will be 0.9 percentage points higher over the next three years if the surplus target is not reformed. A balanced budget target would also give the government an additional SEK 25 billion more each year on average for reforms in the period 2020-2040.

There is currently political fighting in parliament about the surplus target. This will have a crucial bearing on the opportunities and direction of fiscal policy in the next few years. It is the government that determines the level of the surplus target, but broad agreement is needed to give credibility to the target. The opposition has asked for a parliamentary committee to discuss the surplus target. A first progress report is scheduled for April 2016 and the final report will be submitted in October 2016.

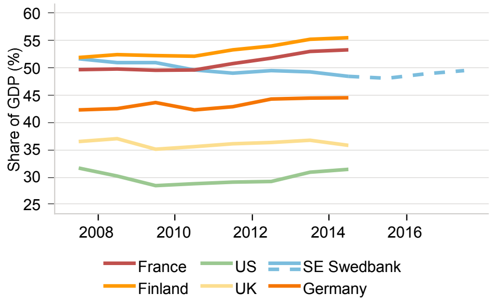
Tight budget promised

The appointment of the parliamentary committee means that the government is not expected to change the surplus target in the autumn budget. Another fully funded budget will be presented instead. It has been announced that large tax increases are on the way, aimed at financing reforms in the areas of jobs, education and infrastructure. Proposals for higher tax, notably on fuel, ROT and nuclear power, and the abolition of the payroll tax rebate for companies employing young people will contribute to marginally higher inflation in 2016 – at least 0.35 percentage points, according to our calculations. This will be a temporary effect which does not permanently raise inflationary pressure. The budget will also contribute to an increase in public consumption and public investment in 2016 and 2017, although tax increases will dampen private consumption at the same time. The effect on Swedish growth will therefore be largely neutral.

Reform of the surplus target provides scope for the period ahead

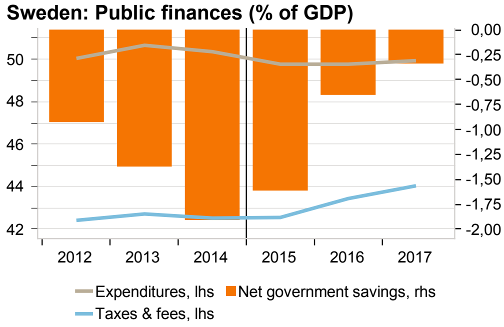
It is our assessment that an adjustment to the surplus target will be made during in 2016. A likely result – in good Swedish tradition – is a compromise of 0.5 percent between the current surplus target and a balanced budget target. On the margin, this will contribute to somewhat increased expenditure at the end of the forecast period, with financial saving continuing to be negative throughout the forecast period. However, the deficit in public finances will be reduced significantly as a result of a stronger economy and increased employment.

Sweden: Total taxes and Swedbank forecast



Sources: Swedbank Research, IMF & Macrobond

Sweden: Public finances (% of GDP)



Sources: Swedbank Research & Macrobond

Estonia: More growth with less people

Economic growth is decelerating in 2015, primarily due to the weak start of the year; however, we expect the second half of the year to be stronger. Although export and output growth has halted, robust growth of private consumption and net exports will contribute to the growth. The outlook for 2016-2017 will be more optimistic as foreign demand is expected to improve.

Key economic indicators, 2014-2017 1/

	2014	2015f		2016f		2017f
Real GDP growth, %	2,1	1,9	(2,1)	2,8	(2,8)	2,8
Consumer price growth, %	-0,1	-0,2	(0,1)	1,9	(2,7)	2,5
Unemployment rate, % 2/	7,4	6,6	(7,0)	6,7	(6,7)	6,8
Real net monthly wage growth, %	4,2	6,7	(7,0)	4,6	(3,0)	3,7
Current and capital account balance, % of GDP	1,3	2,0	(0,8)	1,6	-(0,4)	-0,2
General government budget balance, % of GDP 3/	0,6	-0,5	-(0,5)	-0,2	-(0,5)	-0,1

1/ April 2015 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Estonia, Bank of Estonia, Swedbank.

Estonian exporters have proved their flexibility in searching for new markets

In the second half of last year, production and export of electronic products, primarily from a single producer (Ericsson), got up steam and contributed robustly to economic growth in Estonia. Unfortunately, the risk we pointed out in January, that this cannot be long-lasting, has come true. In the second quarter, the growth of output volume of electronic products halted. Besides electronics, the diminishing production of chemicals, as well as weakening foreign demand for food products, had a remarkably negative impact on exports. While the output of chemicals and food products has suffered primarily from the deterioration in exports to Russia, Latvia, and Lithuania, new orders for and production of electronic products have decreased due to the increased competition on the global market. Whereas, before, the robust growth of exports of electronic products compensated for the fall in exports to Russia, this is not the case anymore. At the same time, it's positive news that enterprises have gradually redirected their exports to new markets in the EU, as well as to the US and China.

Total negative impact of Russia on Estonian economy has been considerable

Russian sanctions have had a relatively modest direct effect on the Estonian economy, affecting primarily the food industry and agriculture. The sanctions and the decline in milk prices have worsened the financial situation of dairy sector and its solvency, but in general, Russia has had a minor impact on the credit quality of the Estonian banking sector. However, together with the deterioration of the Russian economy, the depreciation of the rouble, and the impact of the latter on Estonia's neighbouring trade partners, the indirect negative impact on the economy has been considerable. During the first half of this year, Estonian exports of goods to Russia fell by more than 40% in nominal terms. Still, the largest share, or one-third, of the decrease comes from re-exported construction and industrial equipment; this has not only had a negative impact on the Estonian transport sector, but also affects the Estonian economy in general to a lesser extent. The Estonian transport sector is being harmed more by the Russian policy of redirecting its foreign trade through its own cargo ports. The outlook for the transport sector during the forecast period is far from rosy. Another sector hurt by the weakened demand from Russia is tourism. The number of tourists from Russia has fallen by 40% this year, making a considerable negative impact on hotels, restaurants, and other activities related to tourism. Although the number of local tourists accommodated has increased, this has not been enough to compensate for the falling number of foreign tourists.

Foreign demand for Estonian exports is expected to improve in 2016

Although the EU economy, which accounts for three-fourths of Estonian exports of goods, is gradually improving, the aggregated demand of the main trading partners, especially in neighbouring countries, will be considerably weaker this year than in 2014. Export volume remains on the same level as last year, but the situation is expected to be more optimistic in 2016. The ECB's expansionary monetary policy has a positive effect on the euro area's economic activity, lower commodity prices support household consumption and have some relief to the input costs of the business sector. In addition, the economic recession in Russia and in Finland is expected to bottom out in 2016. This will gradually improve the demand from trading partners.

The weakening foreign demand, together with falling selling prices, has squeezed business sector turnover in Estonia. At the same time, rising labour costs limit the growth of profitability. If we add the deterioration in confidence of the business sector, this explains why investments have decreased. However, the decline has not been broad based and has come primarily from the energy and agricultural sectors. The business sector loan portfolio is increasing, although at a decelerating pace. The government sector is investing less than we expected in the previous *Swedbank Economic Outlook*, as preparations for the use of EU funding in Estonia are far behind schedule. We expect that the government investments using EU funding will be postponed to next year. Ever-increasing competition, as well as the shortage of and a more costly labour force, demands more investments, especially in order to raise business sector efficiency. Business investments are expected to increase, owing to improved foreign demand in 2016 and 2017.

In 2015, GDP growth is supported by net exports and private consumption

GDP growth is supported by net exports and private consumption in 2015. Imports are falling this year as the halt in production and fall in export volume require fewer intermediate goods. At the same time, imports of capital goods have started to increase, boosting investments, albeit with a delay. In 2016-2017, import demand will increase, as production and investments recover. With the support of the fast increase in real net wages, private consumption continues to grow robustly in 2015. The growth will be slower than last year, however, primarily due to the unexpectedly slow growth in the first quarter. The strong growth of private consumption has generated higher receipts of the value-added tax (VAT), while the change in the rules for submitting the VAT declarations since last autumn has had a positive impact as well. Higher VAT revenues, in turn, have contributed both to GDP growth and the increase in total tax revenues in the government budget. The deceleration in the growth of real net wages, together with the decrease in population and employment, will inhibit the growth of private consumption in 2016-2017.

Labour market will remain tight

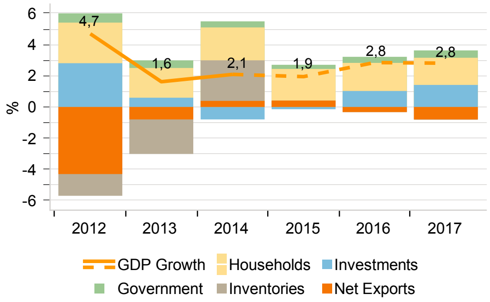
Weaker sales and profits are softening nominal wage growth this year. But wage growth will accelerate again in 2016-2017 in line with the faster growth of the economy. Households' real purchasing power is expected to grow by 7% this year, due to lower labour taxes and deflation. Labour taxes will be reduced further in 2016 and 2017 by a higher non-taxable threshold and by a lower social tax rate in 2017. Although the latter will probably not affect net wages, it will provide welcome relief for enterprises. A rise in pensions, children's allowances, and other social benefits will further support private consumption. The government budget deficit will remain small and will be financed from reserves. Tax policy will shift from income towards consumption, but the overall tax burden is expected to remain more or less the same, around one-third of GDP.

Employment will grow this year due to the labour registration obligation, which will push up official employment statistics in the first half of the year. Also, strong consumption supports employment in the services sector. In 2016-2017, employment is expected to fall because of a lower supply and demand of labour (due to bigger investments in machinery). Employment is expected to decline primarily in sectors that have been struggling with low export demand, i.e., agriculture and industry. The unemployment rate is expected to remain low; however, it might increase marginally in 2016-2017 due to the decreasing working-age population and demand-related problems in certain sectors. Economic growth will accelerate next year, while employment declines. Although labour productivity will increase in real terms, with the fastest pace since 2011, it remains considerably lower than it was before the 2008-2009 crisis.

Prices will decrease in 2015

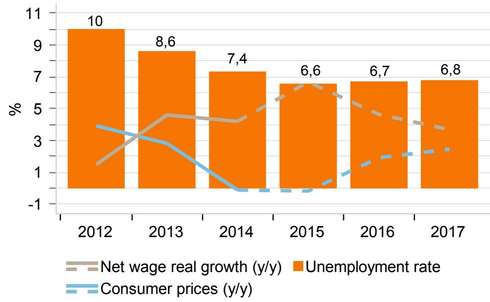
Consumer prices are expected to decrease for the second year in a row in 2015 because of lower commodity prices globally. According to Swedbank estimates, global oil prices would be around one-third cheaper in 2015 in euro terms, compared with 2014; this will lower the prices of fuels and heating in Estonia. Oversupply of food products has also dampened food prices below last year's level. In 2016 and 2017, prices are expected to increase again. Higher excise tax rates on alcohol, tobacco, and motor fuels in 2016-2017 and an increase in the VAT rate for hotels in 2017 are expected to lift Estonia's inflation by 0.6 percentage point (pp) in 2016 and 0.7 pp in 2017. The prices of commodities are expected to recover somewhat in the world markets during 2016-2017, and this will also push prices higher in Estonia. Strong wage growth would also lift the prices of services.

Estonia: Contributions to GDP growth, p.p.



Sources: Swedbank Research & Macrobond

Estonia: Labour market indicators & inflation



Sources: Swedbank Research & Macrobond

Latvia: So far so good, but risks still high

Growth is expected at 2.1% this year, picking up to about 3% in the coming years (i.e., at about potential pace), with export and investment growth accelerating due to the improving global outlook. Household consumption growth is forecast to remain robust – still rather cautious this year, but a tad more brisk in 2016-2017. Risks to growth still sizable, especially political impediments to trade from the Russian side.

Key economic indicators, 2014-2017 [1/]

	2014	2015f		2016f		2017f
Real GDP growth, %	2.4	2.1	(1.9)	3.3	(3.5)	3.0
Consumer price growth, %	0.6	0.5	(0.8)	2.0	(2.7)	2.3
Unemployment rate, % [2/]	10.8	9.9	(10.2)	9.2	(9.2)	8.3
Real net monthly wage growth, %	7.9	5.5	(5.2)	3.6	(2.9)	3.6
Current account balance, % of GDP	-3.1	-2.2	(-2.9)	-3.8	(-4.4)	-5.2
General government budget balance, % of GDP [3/]	-1.4	-1.6	(-1.6)	-1.1	(-1.2)	-1.0

1/ April 2015 forecast in parenthesis.
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: CSBL and Swedbank.

Somewhat better-than-expected growth in the first half of 2015, but setbacks likely in the second half

We are raising our GDP growth forecast for this year to 2.1% from 1.9% in April *Outlook*, given the exceptionally strong second-quarter data. The growth in the first half of the year seems to have been more broad based than expected (no detailed data yet for the second quarter), as exports and investments were stronger, while household consumption somewhat weaker than we had forecast in April. At the same time, setbacks are possible in the second half of the year, especially taking into account the fragility of external demand and likely trade impediments from the Russian side (see below).

About 3% growth seems to be the new normal

While quite volatile quarterly growth is expected in the second half of the year, we forecast a more stable growth going forward, close to a potential pace (currently estimated at around 3% per annum; forget about 4-5% growth without major structural reforms or much stronger external demand). Next year, we anticipate GDP to grow by 3.3%, as investments and exports pick up further with the global and regional outlook improving. Similar growth is forecast for 2017, at 3%. That said, there are still quite a number of risks that could reduce growth, both in this and coming years. The key risks are abroad, mostly concerning developments in Russia (especially political ones), but also in the euro area (e.g., how the ECB withdrawal of monetary policy stimuli works out). Locally, wage pressures in the labour market keep rising, and cost competitiveness might be at risk towards the end of the forecast horizon if productivity gains keep lagging.

Nominal goods and services' exports grew by 2% in annual terms in the first half of the year, while volume growth most likely has been stronger (due to the fall in commodity prices). Goods exports to Russia fell by 20% and to other CIS countries by 11%. At the same time, exports to the euro area grew by 3% (which is one-half of total goods exports) and to the EU countries outside the euro area by 6% (another 25% of exports). Exports to some countries farther away also continued to grow rapidly (e.g., by 41% to the US, 39% to China, and 197% to the UAE), although from low levels (each at 1-1.5% of total). Meanwhile, Russia's share in goods exports fell to 7.6% in the first half of the year from 9.7% a year ago.

Exporters beat expectations, but uncertainty still high

Exporters have beaten expectations so far, successfully shifting away from falling CIS markets, but performance is uneven and volatile across industries. The food sector is under stress, especially milk (as the oversupply in Europe pushes prices downwards), fish, and meat producers. The future of metal production is also uncertain – the steel plant, Liepājas Metalurgs, resumed operations early this year but is struggling, and production volumes seem rather small. Exports of wood products and machinery and equipment keep rising (the latter partly due to re-exports of electronics though). The good grain harvest this year will support exports in the second half of the year.

At the same time, the Russian Railway just announced it would begin maintenance works, which followed shortly after the arrest of the long-standing head of the Latvian Railway (with good personal networks in Russia), being accused of bribery. This will limit freight-carrying capacity through railway to Latvian ports, but it is claimed that existing freight flows will not be influenced (i.e., currently capacity is not used fully). We thus do not reduce services exports in the base scenario because of that (goods exports via these routes to CIS are negligible anyway), but the risk of trade impediments is high. In the worst case scenario, a full stop of railway traffic from Russia may push Latvia in a brief and shallow recession, but such a harsh development is very unlikely as Russia would find it impossible to fully replace the loss of its export route. Risk of smaller impediments is more likely, implying a tad slower growth rather than outright recession with likely impact on other related sectors and employment (e.g., the Latvian Railway employs more than 12,000 persons).

Credit cycle is about to turn

There are signs of investment activity finally starting to pick up, e.g., rising imports of machinery and equipment (for about half a year already). Construction output and the number of issued building permits fell in the first half of the year, mostly due to a falloff in residential and non-residential buildings, while investments in public infrastructure (e.g., roads, the railway, and ports) kept rising. It also seems that the credit cycle is finally about to turn, supporting investments going forward. Resident corporate credit stock is still falling, but might be bottoming out soon. In the first half of the year, new lending to resident nonfinancial companies grew by 10%, supported by fallen interest rates, improving external demand, and high capacity utilisation. EU funds from the new planning period are already supporting investments (and credit) in agriculture and road maintenance, while those funds meant for manufacturing and other business activities are expected to become available only towards the second half of 2016.

Investment and export growth to pick up in 2016-2017

We forecast largely flat gross fixed capital formation this year, and about 9-10% growth in 2016 and 2017. Export volumes are forecast to grow by about 2.3% this year (1.4% before), owing to better-than-anticipated performance in the first half of the year, good prospects for bigger grain exports and continuing growth of electronics' re-exports. Export growth of 4% is anticipated for 2016 and 2017, given better external demand growth and, it is hoped, fewer impediments to trade from Russia. Uncertainty remains, though, and, if railway freight transit continues to be undermined, export growth will suffer.

Household incomes to continue rising steadily

Household incomes continue to grow steadily, mostly through wages, but also owing to timid employment growth. We expect about 6% average net wage growth per annum throughout the forecast horizon. We assume no personal income tax cut (i.e., the existing law scheduling it in 2016 will be withdrawn), as there is no fiscal space for this, and a EUR 20, or 6%, rise in the minimum wage in 2016 (i.e., one-half of what was discussed before and one-half of the increase in 2015). Labour tax cuts might be shifted towards 2017-2018, but so far we do not include them in our base scenario. Minor employment growth is anticipated, held back by weak job creation and the diminishing number of those in working-age. Corporate investments in machinery and digital solutions will continue to be made to reduce labour dependency (especially in producing sectors, but also domestic trade). Lower commodity prices than assumed before, especially of oil, imply lower-than-expected consumer price inflation in Latvia, adding to purchasing power growth. We now forecast price growth of only 0.5% this year, 2% in 2016, and 2.3% in 2017.

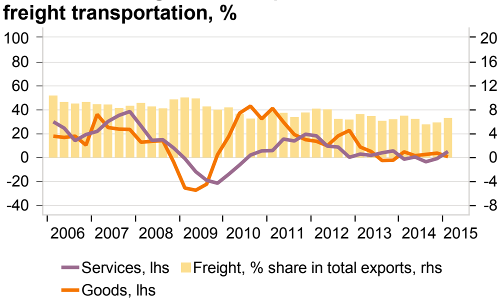
Careful, but robust household spending growth

Household spending growth was rather cautious in the last few years, though. It seems that this continued to lag behind income growth also in the first half of this year. Household deposits were growing by 9% in annual terms in the first half of the year. New lending rose by 23%, but this was still not enough to stop credit stock from falling – so households are still paying back their existing loans more than taking in new loans. We thus lower the household consumption growth forecast to 3% for this year (3.5% before). We expect this growth to pick up to 4% in 2016 (a bit higher than real income growth) and 3.5% in 2017.

The government searching to contain expenditure growth and raise revenues

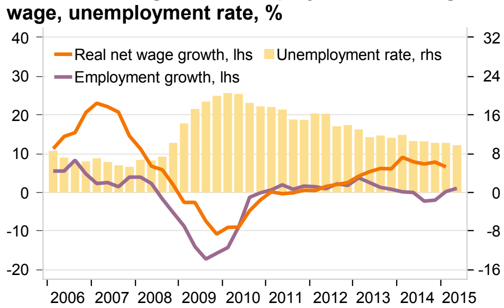
The fiscal situation was still okay in the first half of the year – tax revenues grew by 5%, only 0.7% behind the plan. However, the Ministry of Finance now recognizes that revenues will be lower and the deficit higher than the 2015 budget law assumed – something we warned about already in January. This implies negative fiscal space in 2016. We expect no personal income tax rate cut next year, some smaller tax increases (e.g., excise, perhaps some upward revision in cadastral values for residential properties, etc.), and the continuation of the shadow economy squeeze. Yet, without bolder strategic moves to raise revenues or slash expenditures, the government will keep walking a tight rope of regular shortage of funding for their own prioritized critical areas, such as defence, education, and health care. If business and consumer confidence improves significantly (we see it possible towards the end of the forecast horizon and 2018 along with subsiding geopolitical risks and more solid growth in Europe) so far cautious consumption and investment demand may shoot up sharper than we forecast in the baseline scenario briefly exceeding potential GDP pace. This would not help budget much, though, since budget targets are set in structural terms.

Lativia: Annual growth of exports & share of freight transportation, %



Sources: Swedbank Research & Macrobond

Latvia: Annual growth of employment & average wage, unemployment rate, %



Sources: Swedbank Research & Macrobond

Lithuania: All's well that ends well

Like this Shakespearean play, Lithuania's economic developments this year are neither a tragedy, nor a comedy. As expected, the economy has rebounded from the miseries of the first quarter and growth is likely to accelerate further, mainly on the back of strong domestic demand. Yet the hopes of a revival of the trade relationship with Russia have to be put to bed for now – an easing of bilateral sanctions and growth for the previously important trade partner are unlikely until 2017. Prospects in the EU, on the other hand, seem to be improving and provide ample opportunities for growth.

Key economic indicators, 2014-2017 1/

	2014	2015f		2016f		2017f
Real GDP growth, %	3.0	1.8	(2.3)	3.3	(3.5)	3.0
Consumer price growth, %	0.1	-0.8	(-0.5)	2.5	(2.5)	3.0
Unemployment rate, % 2/	10.7	9.3	(9.7)	8.3	(8.5)	7.8
Real net monthly wage growth, %	5.1	5.6	(5.4)	4.0	(4.0)	2.8
Current account balance, % of GDP	0.1	-3.5	(-1.6)	-4.3	(-3.0)	-4.7
General government budget balance, % of GDP 3/	-0.7	-1.4	(-1.6)	-1.1	(-1.0)	-0.2

1/ April 2015 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

A dismal first quarter, as expected, was temporary; growth will accelerate in the second half of this year and, especially, in 2016.

After a contraction in the first quarter of this year, GDP growth (quarterly, seasonally adjusted) has resumed to 0.6% – in line with last year's average. Annual growth has remained unchanged at 1.3%, but we project it will accelerate back above 2% in the second half of this year. Fears that collapsing trade with Russia will cause deeper disruptions, especially in the food manufacturing and transportation sectors, appear to be unfounded.

Nevertheless, due to the worse-than-expected trade balance during the first half of this year, we revise downwards this year's GDP growth forecast to 1.8%. Growth will rebound sharply to 3.3% in 2016, although this is somewhat less than we previously expected. The GDP growth rate will remain close to its potential in 2017, when we expect it to expand by 3.0%.

Exports to Russia have plunged, but producers have successfully increased their market shares in the EU

The value of exports of goods shrank by 4.0% during the first half of this year compared with the same period a year ago, but some of this is due to falling export prices, especially those of refined petroleum products. Interestingly, exports of services have not suffered and have even increased, by 3.7%. Exports of transport services have shrunk somewhat, but many road transport companies have managed to reroute their trucks away from Russia. During the first half of this year, only 2.2% of total exports of goods produced in Lithuania were sold in Russia, down from 5% a few years ago. Once the re-exports are included, Russia remains an important market – 13.4% of all exported goods are sold there (down from 20.8% last year).

Due to the devaluation of the Russian and Belarussian currencies, the number of tourists from these countries has dropped substantially, but the negative effect has been nicely offset by increasing domestic tourism and visitors from other countries. During the first five months of this year, the number of accommodated tourists (both local and foreign) increased by 4.5%, while the total number of foreign tourists shrank by only 0.5%.

Deeper consumer price deflation, stronger confidence, more consumption

Retail trade growth accelerated in the second quarter of this year, but overall growth during the first half of this year (+4.7%) was below last year's 5.7%. Part of the slower growth was related to the "euro effect" – consumers have been careful in assessing the changes in their purchasing power and have postponed some purchases or have "front-loaded" them before the euro introduction. We forecast that household consumption growth to remain robust in the second half of this year – all important factors for this are in place. Consumer confidence has improved since last year as fears of geopolitical unrest have subsided and Russia's economic woes have had only a limited negative impact on the Lithuanian economy.

Cheaper prices for oil, many foodstuffs, and other commodities provide a great tailwind for Lithuanian consumers, as more than 50% of their total expenditure is on food, transport, gas, water, electricity, and other fuels. As the oil price is unlikely to rebound as quickly and as much as previously expected, we have further cut the CPI forecast – deflation is going to continue until the end of this year, and the average annual consumer price change will probably drop to -0.8%. Inflation will be back next year, mainly due to recovering commodity prices, but also due to increasing labour costs. We forecast inflation to reach 2.5% and 3.0% in 2016 and 2017, respectively.

More important, household consumption will be boosted by positive trends in the labour market, which have persisted despite weaker exports. Somewhat unexpectedly, employment increased by an impressive 1.9% in the first half of this year, compared with the same period a year ago. This brisk pace of job creation is unlikely to continue, but unemployment will drop to 9.3% and 8.3% in 2015 and 2016, respectively. Unemployment will continue declining in 2017, however, we forecast that employment will fall by 0.3%, mainly due to the shrinking working-age population and labour force. This trend will continue and will become a real burden at the beginning of the next decade.

Job creation continues, but shrinking labour force will start biting in 2017 and onwards

Emigration has unexpectedly spiked this year – during the first seven months, the number of emigrants was 33.1% higher than a year ago, while immigration decreased by 2.6%. It is hard to pin the reasons on economic factors – employment and wages have continued increasing, and job vacancies are at the highest level since the beginning of 2008. The reintroduction of military conscription may have nudged some youngsters to seek a “different career” abroad, but this is just a guess.

Tight labour supply will boost wage growth; lagging labour productivity needs to be addressed

On the wage front we have also seen positive developments – in the first quarter, the average gross wage was 4.3% higher than a year ago, but in the private sector, wages have increased by more than 5%. We forecast that wage growth will increase to 5.0% this year, before accelerating to 6.5% in 2016. It is likely that before next year’s parliamentary elections decisions will be made to raise some public sector wages.

Wage growth will moderate to 6.0% in 2017, but the lack of skilled labour will continue to heat up the labour market. On a less pleasant note, real wage growth will continue outpacing labour productivity growth – next year it will mark the fourth year in a row. There is no way or need to stop wage growth, but this means that the companies have to rediscover the taste for productivity-enhancing investments, while governments need to continue implementing structural reforms. The government has completely revamped the labour code, but it still has to go through the parliament – the outcome is very uncertain, given the upcoming elections.

Investment growth will be weak this year, but will accelerate in the upcoming years

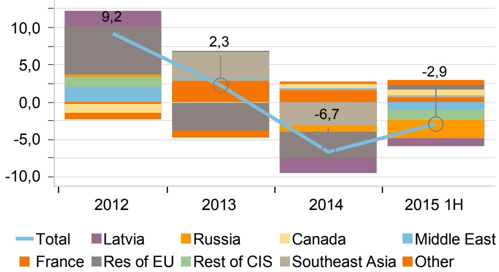
Investment in fixed tangible assets increased by 7.9% in the first quarter of this year compared with the same period a year ago. More important, productive investments (acquisition of equipment and machinery) also rose by 6% after contracting for two quarters. Interestingly, this growth was achieved without loan portfolio growth, which contracted by 3% in the first quarter of this year. The contraction slowed to 1% in the second quarter; however, it seems that companies remain cautious and are reluctant to increase their leverage despite a high capacity utilisation level and low interest rates. Even though the capacity utilisation level decreased from historic highs at the end of 2014, it still remains close to the pre-crisis level. However, industrial confidence remains weak and a more tangible investments growth is likely only next year and in 2017.

Public finances are stable and improving, yet great challenges lie further ahead

The government plans to increase pensions by 6% in the middle of next year and continue increasing them in the future. That seems plausible from the perspective of the current health of public finances – we forecast the budget deficit to ease to 1.1% and 0.2% of GDP in 2016 and 2017, respectively (yet no balanced budget in sight). But we feel compelled to repeat again and again that, in our opinion, politicians are too complacent about the accelerating shrinkage of the size of the labour force. Our projections show that, compared with this year, the number of the working-age population (aged 15 to 65) will shrink by 18% by the end of the next decade and by 25% by 2040.

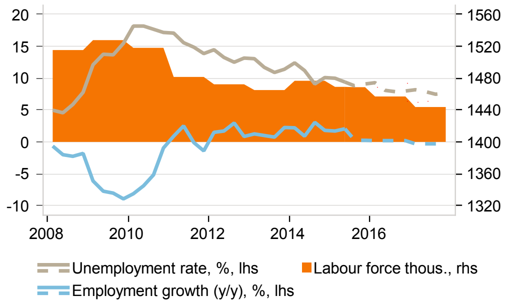
This will put great pressure on the sustainability of public finances, especially the social security system. Public resources will become scarcer and the efficiency of their allocation is becoming crucial. During the past 10 years, the number of school leavers shrank by one-third. Yet the number of higher-education institutions has increased. Seems unsustainable, no? Unpopular and unpleasant reforms in public sector will have to take place, sooner or later. We’d prefer sooner than later.

Lithuania: Contributions to annual growth of LT-origin, exports of goods, p.p.



Sources: Swedbank Research & Macrobond

Lithuania: Labour market indicators



Sources: Statistics Lithuania, Swedbank Research & Macrobond

Appendices

I. The Estonian outlook

ESTONIA: Key economic indicators, 2014-2017 [1/]

	2014	2015f		2016f		2017f
Real GDP growth, %	2.1	1.9	(2.1)	2.8	(2.8)	2.8
Household consumption	4.1	3.9	(4.7)	3.4	(3.6)	3.3
Government consumption	2.3	1.5	(2.0)	2.0	(2.0)	2.5
Gross fixed capital formation	-2.8	-0.5	(2.0)	4.0	(3.5)	5.5
Exports of goods and services	2.9	0.0	(2.1)	3.5	(4.0)	4.0
Imports of goods and services	2.5	-0.5	(3.1)	4.0	(4.6)	5.0
Consumer price growth, %	-0.1	-0.2	(0.1)	1.9	(2.7)	2.5
Unemployment rate, % [2/]	7.4	6.6	(7.0)	6.7	(6.7)	6.8
Real net monthly wage growth, %	4.2	6.7	(7.0)	4.6	(3.0)	3.7
Nominal GDP, billion euro	19.5	20.4	(20.5)	21.5	(21.7)	22.7
Exports of goods and services (nominal), % growth	2.6	-0.8	(1.9)	3.3	(4.5)	4.5
Imports of goods and services (nominal), % growth	1.1	-1.5	(2.1)	3.5	(5.1)	5.5
Balance of goods and services, % of GDP	2.6	3.0	(2.3)	2.9	(1.9)	2.1
Current account balance, % of GDP	0.1	0.4	-(0.3)	0.1	-(1.0)	-0.8
Current and capital account balance, % of GDP	1.3	2.0	(0.8)	1.6	-(0.4)	-0.2
FDI inflow, % of GDP	6.1	3.9	(4.9)	4.7	(4.6)	4.4
Gross external debt, % of GDP	96.8	92.4	(93.0)	87.4	(88.8)	83.4
General government budget balance, % of GDP [3/]	0.6	-0.5	-(0.5)	-0.2	-(0.5)	-0.1
General government debt, % of GDP	10.6	10.2	(10.2)	10.0	(10.0)	9.7

1/ April 2015 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

II. The Latvian outlook

LATVIA: Key economic indicators, 2014-2017 [1/]

	2014	2015f		2016f		2017f
Real GDP growth, %	2.4	2.1	(1.9)	3.3	(3.5)	3.0
Household consumption	2.3	3.0	(3.5)	4.0	(4.0)	3.5
Government consumption	3.4	1.7	(0.6)	1.5	(0.5)	2.3
Gross fixed capital formation	1.3	0.0	(-0.5)	9.0	(10.0)	10.0
Exports of goods and services	2.2	2.3	(1.4)	4.0	(4.0)	4.0
Imports of goods and services	1.6	2.1	(2.3)	6.7	(7.0)	6.8
Consumer price growth, %	0.6	0.5	(0.8)	2.0	(2.7)	2.3
Unemployment rate, % [2/]	10.8	9.9	(10.2)	9.2	(9.2)	8.3
Real net monthly wage growth, %	7.9	5.5	(5.2)	3.6	(2.9)	3.6
Nominal GDP, billion euro	24.1	24.9	(24.8)	26.3	(26.5)	27.8
Exports of goods and services (nominal), % growth	1.8	2.1	(1.2)	5.7	(5.9)	5.0
Imports of goods and services (nominal), % growth	1.2	2.1	(1.5)	8.3	(8.6)	7.9
Balance of goods and services, % of GDP	-2.9	-2.8	(-3.0)	-4.3	(-4.5)	-5.9
Current account balance, % of GDP	-3.1	-2.2	(-2.9)	-3.8	(-4.4)	-5.2
Current and capital account balance, % of GDP	-0.1	0.8	(0.2)	-1.3	(-1.9)	-2.6
FDI inflow, % of GDP	1.5	2.6	(2.4)	3.0	(3.0)	3.1
Gross external debt, % of GDP	138.6	142.2	(135.9)	138.9	(132.0)	137.0
General government budget balance, % of GDP [3/]	-1.4	-1.6	(-1.6)	-1.1	(-1.2)	-1.0
General government debt, % of GDP	40.0	37.0	(39.3)	36.1	(38.3)	35.2

[1/] April 2015 forecast in parenthesis.
[2/] According to Labour force survey.
[3/] According to Maastricht criterion.

III. The Lithuanian outlook

LITHUANIA: Key economic indicators, 2014-2017 [1/]

	2014	2015f		2016f		2017f
Real GDP growth, %	3.0	1.8	(2.3)	3.3	(3.5)	3.0
Household consumption	5.6	4.3	(4.3)	4.5	(4.5)	3.8
Government consumption	1.5	1.5	(2.0)	2.0	(2.5)	1.5
Gross fixed capital formation	8.0	2.0	(2.0)	7.0	(8.0)	6.0
Exports of goods and services	3.4	-1.0	(-2.5)	6.0	(7.0)	5.0
Imports of goods and services	5.7	3.0	(1.0)	7.0	(8.4)	6.5
Consumer price growth, %	0.1	-0.8	(-0.5)	2.5	(2.5)	3.0
Unemployment rate, % [2/]	10.7	9.3	(9.7)	8.3	(8.5)	7.8
Real net monthly wage growth, %	5.1	5.6	(5.4)	4.0	(4.0)	2.8
Nominal GDP, billion euro	36.3	36.9	(37.1)	39.0	(39.3)	41.4
Exports of goods and services (nominal), % growth	1.0	-3.0	(-3.0)	9.0	(9.0)	7.0
Imports of goods and services (nominal), % growth	2.4	-1.5	(-1.5)	10.8	(10.8)	7.0
Balance of goods and services, % of GDP	0.1	-2.7	(-1.1)	-3.5	(-2.5)	-4.0
Current account balance, % of GDP	0.1	-3.5	(-1.6)	-4.3	(-3.0)	-4.7
Current and capital account balance, % of GDP	2.9	-0.7	(1.2)	-1.3	(0.0)	-1.9
FDI inflow, % of GDP	0.8	1.5	(1.0)	2.0	(1.5)	2.0
Gross external debt, % of GDP	69.7	68.2	(70.1)	65.8	(67.5)	66.0
General government budget balance, % of GDP [3/]	-0.7	-1.4	(-1.6)	-1.1	(-1.0)	-0.2
General government debt, % of GDP	40.8	43.0	(42.1)	38.2	(37.5)	40.0

1/ April 2015 forecast in parenthesis

2/ According to Labour force survey.

3/ According to Maastricht criterion.

Contacts

Macro Research

Olof Manner
olof.manner@swedbank.se
Head of Macro
+46 (0)70 567 9312

Anna Felländer
anna.fellander@swedbank.se
Group Chief Economist
+46 (0)8 5859 39 34

Harald-Magnus Andreassen
hma@swedbank.no
Chief Economist NO
+47 23 11 82 60

Tõnu Mertsina
tonu.mertsina@swedbank.ee
Chief Economist EE
+372 888 75 89

Nerijus Mačiulis
nerijus.maciulis@swedbank.lt
Chief Economist LT
+370 5258 22 37

Mārtiņš Kazāks
martins.kazaks@swedbank.lv
Deputy Group Chief Economist, Chief Economist LV
+371 6744 58 59

Magnus Alvesson
magnus.alvesson@swedbank.se
Head of Economic Forecasting
+46 (0)8 700 94 56

Knut Hallberg
knut.hallberg@swedbank.se
Senior Economist
+46 (0)8 700 93 17

Jörgen Kennemar
jorgen.kennemar@swedbank.se
Senior Economist
+46 (0)8 700 98 04

Åke Gustafsson
ake.gustafsson@swedbank.se
Senior Economist
+46 (0)8 700 91 45

Anna Breman
anna.breman@swedbank.se
Senior Economist
+46 (0)8 700 91 42

Cathrine Danin
cathrine.danin@swedbank.se
Economist
+46 (0)8 700 92 97

Martin Bolander
martin.bolander@swedbank.se
Senior Economist
+46 8 700 92 99

Sihem Nekrouf
sihem.nekrouf@swedbank.se
Economist, EA to Anna Felländer
+46 (0)8 5959 39 34

Øystein Børsum
ob@swedbank.no
Senior Economist
+47 99 50 03 92

Helene Stangebye Olsen
hso@swedbank.no
Reserach Assistant
+47 23 23 82 47

Liis Elmik
liis.elmik@swedbank.ee
Senior Economist
+372 888 72 06

Siim Isküll
siim.iskull@swedbank.ee
Economist
+372 888 7925

Andrejs Semjonovs
andrejs.semjonovs@swedbank.lv
Economist
+371 6744 58 44

Lija Strašuna
lija.strasuna@swedbank.lv
Senior Economist
+371 6744 58 75

Vaiva Šečkutė
vaiva.seckute@swedbank.lt
Senior Economist
+370 5258 21 56

Strategy

MadeleinePulk
madeleine.pulk@swedbank.se
Head of Strategy and Allocation
+46 (0)72 53 23 533

Anders Eklöf
anders.eklof@swedbank.se
Chief FX Strategist
+46 (0)8 700 91 38

Hans Gustafson
hans.gustafson@swedbank.se
Chief EM Economist & Strategist
+46 (0)8 700 91 47

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Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
Visiting address: Landsvägen 40, 172 63 Sundbyberg