Swedbank Economic Outlook January 2016

Slippery road ahead – central banks back in action

- China's handling of the transition crucial in stabilising global growth
- Advanced economies reeling from uncertainty and political pressures
- Strong Swedish growth masks rising imbalances and risks
- The Baltics will benefit from improving external demand, labour market heat up is a concern

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Executive Summary

A strong element of uncertainty in the global outlook

The conditions for global recovery have taken a significant hit in recent months and the risks going forward have turned more negative. However, there is a fundamental basis for higher growth in developed economies, but uncertainty and financial market volatility could derail the journey for a more or less extended period. The slowdown at the end of last year implies that we shift down our growth forecasts. We raise the negative risks. Developed economies should in principle benefit from decreasing energy prices and loose financial conditions. However, US growth surprisingly weakened late last year, which is likely to be exacerbated by financial market turmoil and increased uncertainty early this year. Conditions in the euro area are improving, albeit slowly. Economic policy in both the US and euro area will become more supportive, but external headwinds are gaining strength. The Nordic countries are each facing their own set of problems. In Norway, growth is set to slow more due to the oil price decline, and Denmark's exports dropped unexpectedly in the third quarter. Finland, however, is finally seeing some modest growth. We will closely be watching the developments in China and the policy intentions of the Chinese authorities for clues on how large the risks are.

Strong growth masks rising imbalances in Sweden

On the surface, the Swedish economy is strong. Growth is high, driven by a strong labour market, high private and public consumption, and an upswing in industrial production. The combination of an ultralight monetary and expansionary fiscal policy is mutually reinforcing. This is very supportive for growth but contains inherent risks. The Swedish labour market is becoming increasingly polarised, the housing market is dysfunctional, and integration of refugees into the Swedish labour market needs strengthening. After three years of high growth, the underlying imbalances in the Swedish economy could reach the breaking point. Unless extensive reforms are implemented, growth will slow substantially in 2018.

Macroeconomic indicators, 2014 - 2017

	2014	2015	2016f	2017f
Real GDP, annual change in %				
Sweden (calender adjusted)	2.4	3.5	3.1	3.1
Estonia	2.9	1.2	2.3	2.6
Latvia	2.4	3.0	3.3	3.0
Lithuania	3.0	1.7	3.3	3.0
Unemployment rate, % of labour force				
Sweden	7.9	7.4	6.5	6.4
Estonia	7.4	5.9	6.2	6.4
Latvia	10.8	9.8	9.2	8.3
Lithuania	10.7	9.2	8.1	7.4
Consumer price index, annual change in %				
Sweden	-0.2	0.0	0.9	2.1
Estonia	-0.1	-0.5	0.3	2.2
Latvia	0.6	0.2	0.8	2.3
Lithuania	0.1	-0.9	2.0	3.0
Current account balance, % of GDP				
Sweden	6.0	5.8	5.3	4.8
Estonia	3.1	6.5	3.4	1.5
Latvia	-2.0	-1.4	-2.3	-3.8
Lithuania	3.6	-1.9	-2.3	-3.0

Sources: National statistics authorities and Swedbank.

Growth to pick up in the Baltics in 2016-2017

With the support of the improvement of the European economies, export growth in the Baltic countries is expected to accelerate. This will support business sector investments and, in turn, will strengthen the economic growth. Nominal wage growth will remain decent and, despite slightly higher inflation, household consumption will be the main source of growth. Unfortunately, employment growth will be weak or non-existent, mainly due to aging societies.

Negative risks have increased

Downside risks to the forecast have clearly increased. The outlook for the Chinese economy is characterised by genuine uncertainty. A substantial currency depreciation would send shockwaves through the global economy and make deflation pressures difficult to cope with in advanced economies. Geopolitical tensions in the Middle East are currently running high and could intensify, causing sudden spikes in the oil price. The low oil price could cause political upheavals in Russia. Political tensions are also rising in the developed world. In Europe, the refugee crisis is straining established parties, to the benefit of more populist political movements. In the UK, there are plans for a referendum on the EU membership. The refugee situation in Europe is also threatening the Schengen Agreement, whose demise would generate large losses. In emerging markets, the debt-service cost of the increased debt burden is also a cause for concern. On the positive side, the decline in oil prices together more monetary stimulus could provide a bigger an even bigger boost to growth in developed economies.

Global Outlook

The conditions for global recovery have taken a significant hit in recent months and the risks going forward have turned more negative. However, there is a fundamental basis for higher growth in developed economies, but uncertainty and financial market volatility could derail the journey for a more or less extended period. The slowdown at the end of last year implies that we shift down our forecasts for the next two years, but, more important, we raise the negative risks. We will closely be watching the developments in China and the policy intentions of the Chinese authorities for clues on how big the risk is for the global recovery.

On the brink of recovery or renewed misery?

Global growth momentum appears to have fizzled out as last year drew to an end. Activity in the US economy slowed after two solid quarters, but the strong labour market led the Federal Reserve (Fed) to tighten monetary policy for the first time since 2006. The euro area is a relative bright spot, with a broad-based recovery, not least in crisis economies such as Spain and, to a certain extent, Italy. The pickup, however, starts from modest levels. Emerging markets, on the other hand, met a multitude of headwinds, primary among them concerns about a slowdown in China, but also falling commodity prices and a strong US dollar, which is negatively affecting economies with a large debt burden. All in all, 2015 will in the best case be described as the year when the global recovery took a break, or, in the worst case, as the year when the global financial crisis entered its third phase.

Out of the ashes into the frying pan?

In early 2016, global developments have gone from bad to worse. Concerns that the Chinese economy is slowing much more rapidly are increasing financial market volatility and the flight to safety. Chinese devaluation is amplifying the concerns, and the impact is being felt throughout the global economy. The rapid decline in oil prices should essentially be beneficial for overall global growth, but the negative impact on growth is much more immediate. Energy sector disinvestment is substantial, and many commodity-exporting countries are severely affected. This could have political ramifications, such as in Russia, where the middle class is being squeezed, but also between countries, such as the escalating conflict between Saudi Arabia and Iran. Taken as a whole, and over time, the decline in energy prices is beneficial to global growth, in particular in the euro area and India, but also the US. We have revised down our oil price forecast in 2016 and 2017 to an average of USD 36 per barrel and USD 44 per barrel, respectively (from USD 56 per barrel and USD 63 per barrel in our November forecast).

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

	2014	2015		2016f		2017f	
USA	2.4	2.4	(2.5)	2.7	(3.0)	2.6	(2.8)
EMU countries	0.9	1.5	(1.5)	1.8	(1.9)	1.7	(1.8)
Germany	1.6	1.5	(1.6)	1.8	(1.8)	1.5	(1.6)
France	0.2	1.1	(1.1)	1.5	(1.9)	1.7	(1.7)
Italy	-0.4	0.7	(0.7)	1.4	(1.4)	1.4	(1.4)
Spain	1.4	3.2	(3.2)	2.9	(3.0)	2.4	(2.4)
Finland	-0.4	0.1	(0.1)	0.5	(0.5)	1.0	(1.0)
UK	2.8	2.2	(2.4)	2.1	(2.3)	2.1	(2.1)
Denmark	1.3	1.3	(1.9)	2.0	(2.2)	2.1	(1.9)
Norway	2.3	1.4	(1.1)	1.0	(1.1)	1.4	(2.2)
Japan	-0.1	0.7	(0.6)	1.1	(1.1)	0.7	(0.7)
China	7.4	6.8	(6.8)	6.5	(6.6)	6.3	(6.3)
India	7.1	7.4	(7.6)	7.1	(7.5)	7.2	(7.7)
Brazil	0.1	-3.9	(-3.1)	-3.7	(-2.3)	0.0	(0.4)
Russia	0.5	-3.8	(-4.5)	-2.5	(-2.0)	1.0	(1.5)
Global GDP in PPP [2]	3.4	3.1	(3.1)	3.4	(3.6)	3.7	(3.8)

1/ November 2015 forecasts in parentheses.
2/ IMF weights (revised 2015). Sources: IMF and Swedbank.

More head- than tailwinds

In total, we believe that the headwinds have increased slightly more than the tailwinds. Thus, we have revised down global growth somewhat compared with our November forecast. The main downward revisions are seen in the US, which again will experience a slow start of the year. Over the coming two years, however, we expect growth to increase on the back of stronger household finances, a more expansionary fiscal policy, and a still-loose monetary policy. In India, growth is expected to be slower than we anticipated, although it is still the fastest-growing major economy. The new government is finding it harder than expected to push through its reform agenda. On the upside, the euro area will benefit from continuing monetary stimulus, a recovering banking sector, and a laxer fiscal policy.

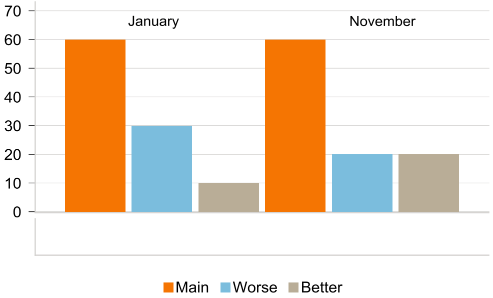
Yuan depreciation, geopolitical tensions, and political challenges

Downside risks to the forecast have clearly increased and are large. The outlook for the Chinese economy is characterised by genuine uncertainty regarding not only the actual state of the economy but perhaps more so concerning the policy intentions of Chinese policymakers. A substantial currency depreciation would send shockwaves through the global economy and make deflation pressures difficult to cope with in advanced economies. Geopolitical tensions in the Middle East are currently running high and could intensify, causing sudden spikes in the oil price. The low oil price could cause political upheavals in Russia, as the middle class is being squeezed. Political tensions are also rising in the developed world. In Europe, the refugee crisis is straining established parties, to the benefit of more populist political movements. In the UK, there will most likely be a referendum on EU membership, and there will be general elections in the US this year and in France and Germany the next. The refugee situation in Europe is also threatening the Schengen agreement, whose demise would generate large losses. In emerging markets, the debt-service cost of the increased debt burden is also a cause for concern. On the positive side, the decline in oil prices together more monetary stimulus could provide a bigger an even bigger boost to growth in developed economies.

Less tension between central banks

Against the background of slower growth outlook and, not least, continuing downward pressure on prices, we now expect the Fed only to hike the policy rate twice this year (presumably in June and December). Although the voters in the FOMC will have a slightly more hawkish bias in 2016, recent developments in the financial and commodity markets will most likely lead to a wait-and-see approach. The Bank of England is expected to follow suit and delay its tightening, while the ECB and Bank of Japan will maintain their very expansionary stances. In the short term, there is, if anything, a bias for further easing. This will alleviate the potential tension among central banks that we have earlier identified as a major concern in the markets. It has to be noted, however, that the room for monetary policy to counter another major downturn is much more limited now, and, should it be necessary, other policy areas need to be involved--in the short term, fiscal policy, and in the medium term, structural reforms.

Global: Forecast probabilities (in %)



Sources: Swedbank Research & Macrobond

Interest and exchange rate markets

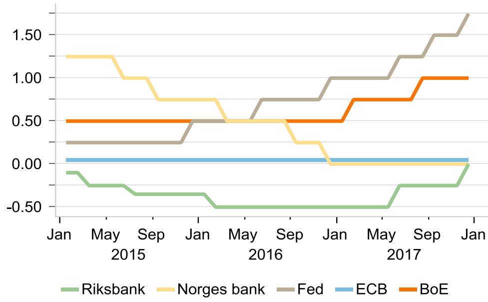
Interest rates are falling

The Fed raised its key interest rate at the end of 2015, which helped to push US short-term bond yields during the fourth quarter. Thus began a period of divergent interest rates in the US and Europe. Meanwhile, the falling oil prices and a modest inflation helped to dampen the impact on longer maturities. In Sweden, the long-term bond yields rose markedly towards the end of last year, when the large refugee immigration increased uncertainty about the Swedish budget development and the borrowing requirement. Thus, the interest differential between Sweden and Germany widened sharply during the fourth quarter of last year. The current year has begun with falling interest rates, both internationally and in Sweden, mainly due to rising concerns about the Chinese economic situation and sharply falling commodity prices. The economic uncertainty has also spread to stock markets, with markedly falling stock prices worldwide as a result.

A slight increase in bond yields

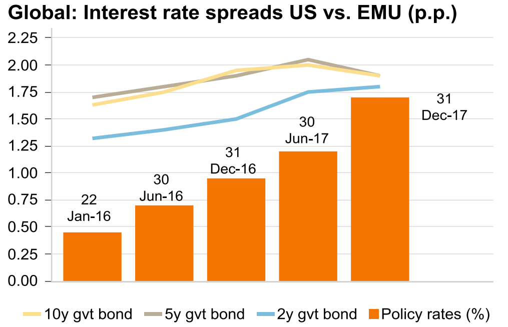
When the dust has settled after the current turmoil, we expect the trend of slightly increasing bond yields to continue, both internationally and in Sweden. As the global and Swedish inflation rates rise, mainly as a result of the so-called base effects, bond yields will also rise albeit at very slow pace. A moderate increase in growth and inflation in Europe may have an impact

Global: Central bank forecasts (in %)



Sources: Swedbank Research & Macrobond

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



Sources: Swedbank Research & Macrobond

here as well and restrict Swedish interest rates. That the United States raised its key interest rate also means that the divergence regarding bond yields is expected to widen by a more apparent rise in the US interest rates compared to European equivalents. However, the divergence is less than we predicted earlier.

Risk sentiment and central banks govern exchange rates

In recent years, a couple of major trends have distinguished the foreign exchange markets: a generally stronger dollar and weaker commodity-related currencies, including the Norwegian krone. These movements are the result of the Fed's raising its key interest rate in December. Commodity-related currencies have been affected for some time by China's faltering demand. In our opinion, the dollar's strength in recent years is nearing its peak. The Fed is likely to raise its benchmark rate twice this year, which is more than the market is currently pricing in. The ECB remains committed to its extended bond buying through March 2017 and have signaled a potential cut of the deposit rate in March. This suggests that the euro-US dollar exchange rate could reach parity at some point later this year. Our forecast is 1.04 in six months.

Volatile markets affect currencies in the short run

In the short term, the slump in the equity and credit markets spills over to exchange rates, which has further weakened commodity-related currencies while strengthening risk-off-related currencies, such as the yen. The euro tends to appreciate because of its role as a financing currency and its current account surplus in times of financial turmoil. There are concerns that China will be forced to yield to depreciation pressure on the renminbi (see the section on China). This could further reduce Chinese export prices and exacerbate price pressures globally. It's worth noting that China accounts for as much as 25% of US imports, so a significantly stronger US dollar-renminbi rate could affect the short-term inflation outlook in the US. At this point, all this is still a risk.

Interest and exchange rate assumptions, %

	Outcome 2015 21-Jan	Forecast 2016 30 Jun	2016 31 Dec	2017 30 Jun	2017 31 Dec
Policy rates					
Federal Reserve, USA	0.50	0.75	1.00	1.25	1.75
European Central Bank	0.05	0.05	0.05	0.05	0.05
Bank of England	0.50	0.50	0.50	0.75	1.00
Norges Bank	0.75	0.50	0.00	0.00	0.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Government bond rates					
Germany 2y	-0.5	-0.3	0.0	0.2	0.6
Germany 10y	0.4	0.7	0.9	1.3	1.8
US 2y	0.9	1.2	1.5	1.9	2.4
US 10y	2.0	2.4	2.9	3.3	3.7
Exchange rates					
EUR/USD	1.09	1.04	1.04	1.08	1.15
USD/CNY	6.6	6.7	6.8	6.9	7.1
EUR/NOK	9.00	9.43	9.14	9.00	8.77
USD/JPY	117	120	120	118	118
EUR/GBP	0.77	0.77	0.72	0.70	0.70
USD/RUB	84	79	80	75	70

Sources: Reuters Ecowin and Swedbank.

The Swedish krona strengthens faster than Riksbank's forecast

Our main scenario is that the Swedish krona strengthens slightly faster than the Riksbank's forecast over the course of the year, provided that the sell-off in equity prices level off. In the short term, the Riksbank will do what it can through currency interventions and a rate cut to slow the krona's appreciation. The rise in the krona in the last month is partly due to weakness in the renminbi, pound sterling, Norwegian krone, which together represent around 20% of the Riksbank KIX (effective exchange rate index). We believe that Riksbank is more focused on what is happening to the krona rate against the euro and the dollar, even if the renmimbi has important indirect effect on the USD. A slight reduction in the benchmark rate has already been priced in by the fixed-income market. The Riksbank has signalled that it will buy bonds until this summer, while the ECB will continue doing so until March 2017. It not yet clear if the Riksbank dare to continue with asset purchases beyond the summer as this would likely need to involve buying mortgage bonds. If you factor in that Swedish growth will probably stay fairly strong, that the krona should be considered undervalued, and that the current account surplus will continue, the euro-krona exchange rate is likely to near 9.00 later this year.

The Norwegian krone close to bottom versus the Swedish

The Norwegian krone has continued to decline as oil prices fall, and there are few signs of a significant reversal in oil prices before the end of the year. Until then, the Norwegian economy will need all the help it can get from a weak currency and further rate cuts to mitigate the risk of a sharper decline in activity. The market has already priced in nearly two rate cuts. Norges

Bank has forecast two cuts itself, but it doesn't seem to be in a rush, since inflation still exceeds the target level and financial stability is reason enough to be cautious. From a longer-term perspective, the current Norwegian krona level is considered weak. Our forecast is that the Norwegian krone will weaken again slightly against the Swedish krona, to 0.96, during the first half year, but that the krone-krona rate is close to bottoming out from a slightly longer-term perspective.

The pound is vulnerable ahead of EU referendum

The UK pound has fallen significantly in recent months. The reason is the pound's previous appreciation due to tight fiscal policy which has kept inflation pressure in check through falling import prices and lower domestic demand. After previously rising, wage growth has dropped off, and the pound's decline has slowed. The market has now priced in an initial rate hike by the Bank of England next year at the earliest. Even more important is the UK referendum on EU membership, which is expected in the second or third quarter of this year. The outcome is far from given (see the section on the UK). As a result, investors have avoided the pound. With a record-high current account deficit, the pound is especially vulnerable. Our basic scenario, however, is that the UK voters will decide to stay in the EU and that the pound will recover some of its losses later this year.

Sweden: Urgent need for reform

On the surface, the Swedish economy is strong. Growth is high, driven by a strong labour market, high private and public consumption, and an upswing in industrial production. The combination of an ultralight monetary policy and expansionary fiscal policy is reinforcing each other. This is dynamite for growth but, like all explosives, has serious side-effects. The Swedish labour market is becoming increasingly polarised, the housing market is dysfunctional, and the education system has been neglected. After three years of high growth, the underlying imbalances in the Swedish economy could reach the breaking point. Growth will slow substantially in 2018 unless extensive reforms are implemented.

Three years of very strong growth

The Swedish economy is expected to grow significantly in 2016 and 2017. This follows strong development in 2015. The economy grew by 3.9% on an annualised basis in the third quarter of 2015. The main drivers in 2016 and 2017 will be high private and public consumption, rising housing investment, and an upswing in exports. The Riksbank's rate cuts and bond buying are contributing to this trend, as low interest rates stimulate household consumption and housing investment, and a weaker krona helps to boost exports. Industrial production has turned higher after struggling for several years. In addition, the huge wave of refugees has contributed to higher private and public consumption (see our analysis of the refugees' impact on the Swedish economy. The number of hours worked is increasing, thanks to higher employment, as well as increased overtime, especially in the public sector.

Key Economic indicators, 2014-2017 1/

	2014	2015	2016f	2017f
Real GDP (calendar adjusted)	2.4	3.5	3.1	3.1
Industrial production	-0.8	3.8	4.3	4.0
CPI index, average	-0.2	0.0	0.9	2.1
CPI, end of period	-0.3	0.1	1.6	2.4
CPIF, average 2/	0.5	0.9	1.4	1.9
CPIF, end of period	0.5	0.9	1.7	1.9
Labour force (15-74)	1.3	0.7	0.9	1.3
Unemployment rate (15-74), % of labor force	7.9	7.4	6.5	6.4
Employment (15-74)	1.4	1.3	1.9	1.4
Nominal hourly w age w hole economy, average	2.8	2.6	3.2	3.4
Savings ratio (households), %	15.3	16.2	17.0	17.1
Real disposable income (households)	2.2	3.6	4.0	2.9
Current account balance, % of GDP	6.0	5.8	5.3	4.8
General government budget balance, % of GDP 2/	-1.7	-0.9	-0.9	-0.9
General government debt, % of GDP	40.6	38.7	37.6	36.8

1/ Annual percentage growth, unless otherwise indicated.

2/ As measured by general government net lending.

Sources: Statistics Sweden and Swedbank

Growing imbalances

While growth is high, the imbalances in the Swedish economy will worsen in coming years: a growing polarisation of the labour market, an increasingly dysfunctional housing market, and a suboptimal mix of monetary and fiscal policy. Mismatches in the labour market will begin to push unemployment higher in late 2017. Unemployment is less than 5% for native-born Swedes and over 15% for foreign-born workers. This is even more polarised if we break down the statistics by education level. During the forecast period, this polarisation will increase, and 75% of unemployed will consist of vulnerable groups that are having difficulty finding work in the Swedish job market. The housing market is characterised by high prices in urban areas, a shortage of rental apartments, and low mobility. With a fast-growing population, this situation will intensify and spread, since residential construction is failing to keep pace with population growth and isn't meeting the demand for more rental apartments.

Poor economic policy mix

The situation is being exacerbated by a poor mix of monetary and fiscal policy. We expect the Riksbank to cut the repo rate to -0.50% in February. It is also likely that currency interventions will be introduced to prevent the krona from appreciating. A repo rate in further negative territory will have little impact on the real economy. Fiscal policy could have a bigger positive impact on real economy than further expansions of monetary policy, if deficits were used for structural reforms and investments that increase potential growth. To improve integration of refugees, Sweden needs to reduce hiring costs and stimulating job growth. Investments in training and education are needed to raise the productivity of the workforce and better match their skills to the market's needs.

Infrastructure investments to enlarge labour market regions

The third element that could contribute to consistently higher growth is investments in infrastructure that create larger labour market regions. This gives more opportunities to commute to work, thus increasing mobility in the labour market. In addition, it would set the stage for more residential construction where land is available at a lower cost. At this point, we are seeing only halfhearted attempts to improve the housing market, and limited investment in infrastructure. Labour market reforms that have raised unemployment compensation and slashed deductions for home repairs and services are having a detrimental effect on integration. After three years of high growth, 2015-2017, we therefore see a risk of a significant slowdown in the Swedish economy from 2018 onwards.

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2014	2015		2016f		2017f	
Households' consumption expenditure	2.2	2.6	(2.5)	3.1	(3.2)	2.7	(2.9)
Government consumption expenditure	1.3	2.2	(2.2)	3.7	(3.9)	2.8	(3.4)
Gross fixed capital formation	7.5	7.3	(4.9)	5.9	(5.5)	5.3	(5.6)
private, excl. housing	6.1	5.8	(3.6)	4.8	(4.4)	4.6	(5.4)
public	2.3	3.7	(2.8)	6.1	(5.7)	5.6	(4.5)
housing	19.8	16.3	(12.4)	9.7	(9.4)	7.3	(7.2)
Change in inventories [1/]	0.1	0.0	(-0.1)	0.0	(0.0)	0.0	(0.0)
Exports, goods and services	3.5	4.9	(3.9)	5.0	(4.8)	4.1	(4.6)
Imports, goods and services	6.3	4.6	(2.6)	6.5	(6.2)	5.4	(5.4)
GDP	2.2	3.8	(3.4)	3.4	(3.5)	2.9	(3.4)
GDP, calendar adjusted	2.4	3.5	(3.2)	3.1	(3.3)	3.1	(3.6)
Domestic demand [1/]	3.1	3.5	(2.9)	3.8	(3.8)	3.3	(3.6)
Net exports [1/]	-0.9	0.3	(0.7)	-0.4	(-0.4)	-0.4	(-0.2)

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

Swedish exports gain market share

Services rise in Swedish exports

Swedish exports gained market share in 2015 in a global economy with the weakest growth since the financial crisis in 2009. In the US and Europe, which account for the majority of Swedish exports, growth has been significantly stronger than in emerging markets. Swedish export volume grew by an estimated 5% in 2015, driven mainly by higher services exports. As the Swedish private sector has become more service oriented and the global market for services has grown, services have steadily risen as a share of Swedish exports, now accounting for 30% of the total, compared with 20% 15 years ago. Goods exports strengthened in the second half of last year, mainly thanks to increases in the transportation equipment and chemical industries; meanwhile, rising export orders signal a continued recovery for Swedish goods exports.

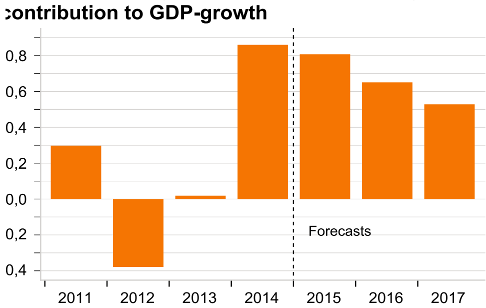
Export to Norway is vulnerable

The global market growth for Swedish exports is expected to strengthen in 2016-2017, though at a slower pace than the historical average. One obstacle is low commodity prices, which have led to less investment by commodity-producing industries and in the long run will affect Swedish exporters. Exports to Norway are especially in danger after the drop in oil prices and falling oil investments. On the other hand, we expect investments in the euro area to accelerate again in the wake of the economic recovery and higher capacity utilisation, which benefits Swedish exporters. Capital goods are the linchpin of goods exports. Investments in the euro

Sweden: Export & import of goods & services (y/y)

Sources: Swedbank Research & Macrobond

Sweden: Housing and public investments growth, contribution to GDP-growth



Sources: Swedbank Research & Macrobond

area have taken a backseat for some time and decreased as a share of GDP. We expect the growing global trade in exports to continue to support overall Swedish exports; these will rise by an estimated 5.3% this year before slowing to 4.3% in 2017 , as Sweden gradually loses some of its competitive advantage due to the expected appreciation of the krona and higher unit labour costs.

Net-export contribution turns negative

Net exports' contribution to GDP is expected to be negative in 2016 and 2017 after a slightly positive contribution last year. Strong private consumption and broader increases in investment are projected to lead to faster growth in imports than exports.

Investment activity strengthens

Housing investment continue to rise

Investments grew broadly in 2015, rising in total by 7.9% on an annualised basis in the first three quarters. Housing investment rose by 16% and was the biggest contributor, but investment in the public and private sectors rose as well.

Housing investment will continue to account for a significant share of investment growth in 2016. A widespread housing shortage, last year's wave of refugees, low interest rates, rising disposable income, and the government's ambition to increase housing construction all point to continued high residential construction. We expect the growth rate to be held in check by capacity shortages, however, which we are now seeing in the form of shortages in manpower and shovel-ready sites. This could become more evident in the latter part of the forecast period. Capacity shortages may have been why the number of housing starts in urban areas was unchanged in the first three quarters of 2015, while they rose in the rest of the country, especially in college towns.

Public investment boosted by population increase

We expect a larger increase in public investment compared with last autumn. The rapid population growth, coupled with the restoration of the so-called Million Program and infrastructure investments, will put further upward pressure on municipal investments. Statistics Sweden's investment survey signalled weak investment activity in the private business sector in 2016. We expect lower investment growth in manufacturing after a big capacity expansion in the transportation equipment industry and further cutbacks in mining. Investment growth is outpacing the long-term trend, however. Low interest rates, low commodity prices, and increased demand domestically and globally suggest continued strength.

Households are conscious of risks to the Swedish economy

Household consumption will remain an important driver in the next two years. Thanks to a combination of continued strong employment growth and consistently low inflation, we estimate that real disposable income will rise by no less than 4.0% this year and nearly 3% in 2017, despite slightly higher tax pressure during the period. We expect interest rates to remain low during the forecast period, and slowly rising rates to have only a modest effect on consumption.

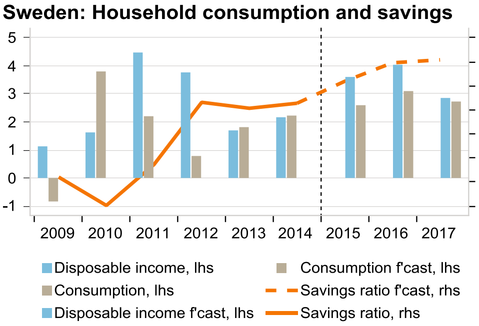
Strong income growth drives consumption...

Thanks to strong income growth, we see household consumption remaining fairly consistent. At the same time, there is considerable uncertainty surrounding fiscal policy and, not least, the housing market, which, in spite of everything, has produced a rising savings rate. One reason for the high savings is increasing loan amortisation as a result of tighter requirements by banks.

...but confidence is weakening

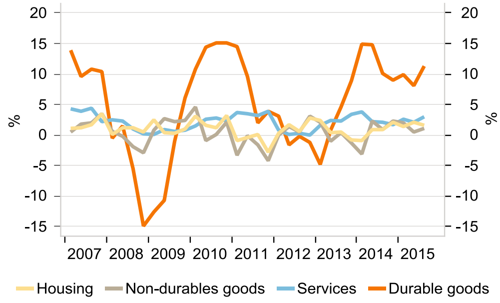
Despite gaining ground in recent years, consumers are feeling less confident, mainly due to pessimism about the national economy. For the year, we still expect continued strong consumption growth, in no small part because of strong spending brought on by the high level of new housing units. The wave of refugees will also contribute positively to household consumption.

Sweden: Household consumption and savings



Sources: Swedbank Research & Macrobond

Sweden: Households' consumption expenditures



Sources: Swedbank Research & Macrobond

Consumption growth will dip slightly to 2.7% next year. We expect the strong trend in durable goods consumption to taper off, partly due to saturation effects and partly because as housing construction and related spending on furnishings and durable goods will slow.

Modest increase in interest expenses

Interest rates will rise at a slow pace during the forecast period, interest expenses will have a marginal effect on consumption. A modest increase in interest rates, coupled with rising debt levels, will raise household interest expenses as a share of disposable income, however. The increase is modest, which will allow for a gradual phase-out of interest deductions – a necessary long-term reform from a stability perspective, but also because rising interest rates create greater pressure on the government's budget.

Full swing in the labour market raises overheating risks

Public sector raises demand for labour

The labour market strengthened significantly in 2015. More people are working and unemployment is falling, a trend we believe will continue in the years ahead. Employment and the number of hours worked are rising, not least in the wake of the wave of refugees. Workers have to be hired by government authorities and municipalities to handle the new arrivals, and more people have to work overtime. The huge influx of asylum seekers has greatly slowed processing times, which means it will take a while, at least until 2017, before these new arrivals reach the job market and can begin to look for work. As a result, job growth will exceed the increase in the workforce in 2016 and 2017 as well, leading to lower unemployment. Because the government has tightened asylum rules and introduced ID controls, we expect the number of asylum seekers to slow more than the Swedish Migration Agency forecast in October. We estimate the number at slightly over 60,000 this year (135,000) and around 50,000 next year (95,000).

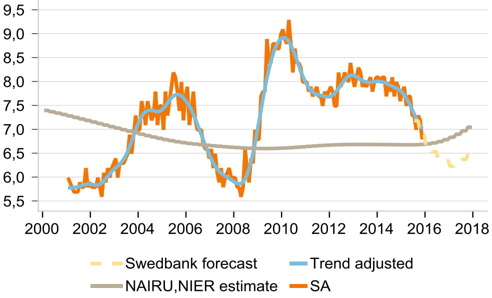
Signs of labour shortages

Expansive short-term hiring plans are confirmed by forward-looking indicators, such as the purchasing managers' index (PMI) and the National Institute of Economic Research's (NIER) Economic Tendency Indicator. The Swedish Public Employment Service's statistics on job openings also offer a positive picture. In 2017, unemployment is expected to fall to a low of 6.2%, below the natural rate of unemployment (in NIER's estimation) of around 7%. We see several signs of an increased labour shortage. It's taking longer to fill open positions, and more employers, especially in the public and construction sectors, are having difficulty finding employees with the right skills. According to the Economic Tendency Indicator, labour shortages have begun to rise. Another sign is that unemployment among native-born Swedes is now declining quickly and has dropped below 5%. Employers probably find them easiest to hire, while unemployment for foreign-born workers remains at just over 15%. It's the latter who now account for the entire increase in the workforce, while the native-born share of the working-age population is seeing less growth.

Wage negotiations could be contentious

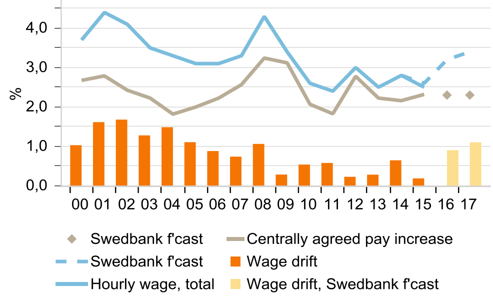
Wage increases were modest in 2015, at around 2.5%. At the end of March, the collective bargaining agreements covering a large portion of the labour market will expire. This winter's negotiations look like they will be anything but easy. Wrangling between the two parties is evidence that they are far apart. The two have different views on inflation expectations and whether the Riksbank's inflation target should be used as a starting point. There is also the issue of infighting in the Swedish Trade Union Confederation (LO). The initial wage demands from the industrial unions, 6F (including the Building Workers' Union), and the Municipal Workers' Union (2.6%, 2.8% and 3.3%) Numbers differ from box numbers] respectively, with significant increases in minimum wages) have been rejected by employers. The union demands are a sign of self-confidence, especially among unions more focused on the domestic market, in the wake of strengthening domestic demand. In coming years, we also expect wage drift to rise (see In-depth 1). Overall, we expect higher wage increases, of nearly 3.5%, next year.

Sweden: Unemployment



Sources:Swedbank Research & Macrobond

Sweden: Agreement, hourly wage & wage drift



Sources: Swedbank Research & Macrobond

Employment will continue to grow at a decent pace throughout the forecast period. In the second half of 2017, unemployment is expected to bottom out and instead turn higher, as the labour force will accelerate when more new arrivals begin to enter the job market. This will present major challenges to the Public Employment Service and for labour market policy (see our analysis of the effect of refugees on Sweden's labour market). A broadening of the labour market is also necessary, in our opinion, to provide new arrivals with varying experience and educations the opportunity to break into the job market. In other words, substantially higher minimum wages in the next collective bargaining agreement would be a disservice.

In-depth 1: Advantage unions ahead of collective bargaining negotiations

Collective bargaining negotiations are close at hand. We expect centrally negotiated wage increases to remain around today's level of about 2.3%. In addition, we see wage drift rising as the labour market strengthens and the labor market gap closes this year. Wage drift of around 1%, or slightly higher, is within reach, in our opinion. This would be significantly lower than in the early 2000s but well in line with what was agreed in 2008, which at this point feels more likely.

We are predicting wage increases of about 3.2% this year and 3.4% next year. This would please the Riksbank, whose wage forecasts have long seemed overly optimistic and symptomatic. The central bank has gradually revised down its forecasts for 2015, e.g. now we see a good chance that the Riksbank's forecasts will be accurate. An outcome in line with our estimates would eventually raise cost pressures in the Swedish economy. This increases the possibility that domestic inflation pressure could take over for imported inflation during the forecast period, just as the Riksbank has mapped out.

Unions in strong negotiating position

The current three-year collective agreement for a large part of the Swedish labor market expires on March 31. Wage drift has been very low in recent years, probably due to high unemployment in Sweden and the rest of Europe. The fact that real wages have increased so much may have also helped to keep wage drift in check. Preliminary wage data indicate that increases were limited to 2.5% last year.

The upcoming negotiations look like they will be anything but easy. If the wrangling we have seen so far is any indication, the two parties are far apart. They cannot agree on inflation expectations, e.g., and whether it is reasonable to use the Riksbank's inflation target as a starting point. For employers, it has been a problem that real wage increases have been unusually high. The initial demands from the Industrial unions, 6F (Building Workers' Union, Electricians' Union, Building Maintenance Workers' Union, Painters' Union, and Union for Service and Communications Employees) and the Municipal Workers' Union (2.6%, 3.2% and 3.3-3.5%, Numbers differ from text] respectively) have gotten a thumbs-down from employers.

Another stumbling block is the demand from unions to significantly raise minimum wages. If this comes to pass, it would probably make it even more difficult for the toughest unemployment cases, including new arrivals, to break into the labour market without significant subsidies. This will be an important aspect to follow in the negotiations, not least from a socioeconomic perspective.

The contractual demands are a sign of self-confidence, especially among the unions more focused on the domestic market, which are benefitting from the breakdown in coordination within the Swedish Trade Union Confederation (LO). Labour demand increased last autumn, leading to lower unemployment. Recruiting problems are growing, especially in the public sector. This is quite a difference compared with the last collective bargaining negotiations, which were held under the shadow of the euro crisis. This time it's advantage unions.

Possible outcomes for wage increases

The chances of again putting together three-year agreements seem remote at this point, considering how far apart the parties are. A one-year agreement at around 2.3% seems more realistic. If, instead, the rate of increase they agree to exceeds 2.3%, it would have to be considered a victory for the unions.

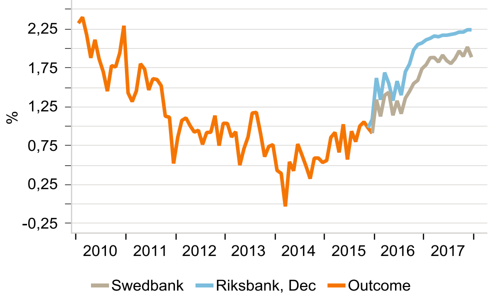
It is possible that the two sides in this year's negotiations will try to wait each other out, and we cannot rule out the threat of job actions before the parties eventually shake hands. This applies especially to the public sector--the Municipal Workers' Union has been facing numerous scandals in the last few weeks, and, therefore, its representatives could feel obligated to deliver on their wage claims. Expect turbulent negotiations.

Slower rise in inflation

Stronger krona dampens prices

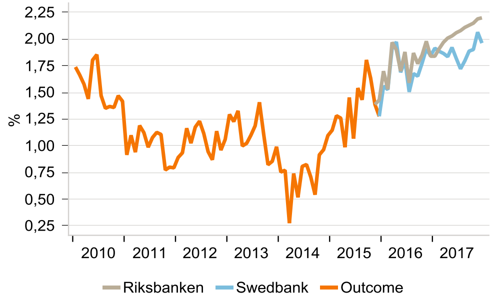
Inflation turned slightly higher in 2015, even though the year finished weaker than expected. We see inflation continuing to rise during the forecast period, but at a slower pace than we forecast last autumn; this means that the annual CPIF (underlying inflation) rate will not reach 2% until the end of next year, a half year later than our previous forecast. Global inflation pressure is expected to be lower in 2016 in the wake of falling commodity prices, and not until next year do we see commodities stabilising, followed by a slight rise from low levels. The appreciation expected in the krona means that imported inflation will be lower and take the edge off the tax hikes introduced in January 2016. A relatively quick rise in unit labour costs is expected to affect inflation, however, especially in the services sectors, at the same time that the labour market continues to tighten. The biggest impact is predicted in 2017. Slightly rising interest rates over the course of the forecast period and an increase in energy prices will lead to higher housing costs, which have been holding back the consumer price index since 2013.

Sweden: CPIF (y/y)



Sources: Swedbank Research & Macrobond

Sweden: CPIF ex energy (y/y)



Sources: Swedbank Research & Macrobond

Additional measures expected from Riksbank

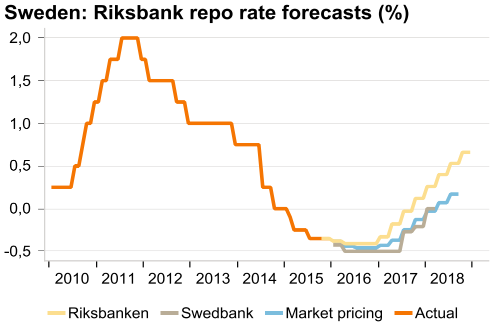
Low inflation forces the hand of the Riksbank

Inflation surprised on the downside in November and December. This is due not only to lower oil prices and a slightly stronger krona, but also to service prices that have turned downward despite strong Swedish growth. The Riksbank decided against any further monetary easing at its policy meeting in December. The decision was in line with our forecast but far from certain. The Riksbank stressed that it remains prepared to act and that the repo rate path still has a strong likelihood (6 basis points) of a rate cut in the near term. A rapid appreciation of the krona in late December caused the Riksbank to sound the alarm and threaten currency intervention. We expect it will have to do so if the krona were again to appreciate quickly and significantly over a number of days. But the Swedish economy has developed more strongly than expected, and forecasts have been revised higher. The labour market has also been revised upward as a result, and, taken together, this raises the forecasts for wage and price increases going forward. Economic data released since the December decision strengthen this picture.

Currency intervention is still a possibility

Swedbank's main scenario is that the Riksbank will introduce currency interventions in the short term if the krona again strengthens to a level of 9.10-9.15 against the euro, and that a rate cut of 15 basis points to -0.50% is likely in February against the backdrop of continued low inflation. Uncertainty is high, however. If it chooses, the recently released monetary policy evaluation could give the Riksbank reason to postpone a repo rate cut and refrain from currency interventions. It is prepared to tolerate a period of inflation exceeding its target level. Any adjustments to monetary policy would be made very slowly in such a scenario. An initial rate hike could be delayed, therefore, until the first half of 2017. By the end of 2017, the repo rate is expected to have been raised to zero %.

Sweden: Riksbank repo rate forecasts (%)



Sources: Swedbank Research & Macrobond

Interest and exchange rate assumptions

	Outcome	Forecast			
	2015 22-jan	2016 30 Jun	2016 31 Dec	2017 30 Jun	2017 31 Dec
Interest rates (%)					
Policy rate	-0.35	-0.50	-0.50	-0.25	0.00
10-yr. gvt bond	0.69	0.95	1.25	1.70	2.25
Exchange rates					
EUR/SEK	9.35	9.15	9.05	9.00	8.95
USD/SEK	8.58	8.75	8.70	8.30	7.74
KIX (SEK) 1/	109.3	108.7	109.0	107.3	105.7

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

Sources: Macrobond and Swedbank

Fiscal policy more important than Riksbank to long-term growth

Fiscal policy will be critical to Swedish growth in the longer term. As we show in our analysis of migration's impact on the Swedish economy, unemployment will rise and the housing shortage will intensify with the current regulations. Extensive reforms are needed to prevent Swedish growth from slowing significantly from 2017.

A more expansionary fiscal policy

We expect a more expansionary fiscal policy in 2016 and even 2017. This will be necessary to fund reforms to improve the integration of new arrivals in the labour market through tax breaks for hiring (e.g., expanded deductions for household repairs and services and lower employer fees) and spending on education. In addition, we expect investments in housing construction and infrastructure. Our forecast is that the number of refugees will decrease and that the direct expenses for migration will therefore be lower than the Migration Agency's latest forecast (November 2015); however, this will be offset by higher costs for labour market reforms. These reforms could produce higher growth in the longer term if they improve the functioning of the labour market

Early elections cannot be ruled out

A key to this forecast is that we expect fiscal policy to be expansionary regardless of whether Sweden experiences a government crisis. Parliament is in a precarious situation. The so-called December agreement has broken down. If the Alliance can coalesce on a budget and get the support of Sweden Democrats, the government's budget will be rejected. There is an election in 2018 and, whether the current government stays in power or a new one is elected, there will be increased pressure to support expansionary policies in order to satisfy coalition partners and demonstrate resolve ahead of the election in 2018.

We expect larger issue volumes from municipalities and county councils and largely unchanged sovereign volumes in 2016-2017. Municipalities and county councils face major investments, which will be partly financed through increased funding in the bond market. Further deficits in the government's finances will mean that financial savings remain negative. The national debt as a share of GDP will decrease, however, since growth is outpacing the increase in debt.

Advanced economies: An uphill struggle

Developed economies should in principle benefit from decreasing energy prices and loose financial conditions. However, US growth surprisingly weakened late last year, which is likely to be exacerbated by financial market turmoil and increased uncertainty early this year. Conditions in the euro area are improving, albeit slowly. Economic policy in both the US and euro area will remain supportive, but external headwinds push down our growth forecasts The growth resurgence in advance economies appears to have taken a step back.

Euro area: Slow but steady

Higher growth in the larger economies

Growth keeps up in the euro area. Purchasing managers' indices continue to show strong growth in Spain and continued expansion in Germany, and confirm an upswing in Italy. Among the largest economies in the euro area, growth remains weakest in France, but that is in part explained by a shallower downturn during the financial crisis. We remain optimistic about the prospects for further improvements in the euro area. Interest rates and the euro remain very low. Credit markets have continued to improve. Fiscal policy seems set to contribute positively to growth this year both in Germany and Italy, following a significant contraction over the past few years.

Employment to expand and unemployment to fall

We project GDP in the euro area to grow by 1.8% this year, slightly more than last year. This is not a high growth rate, but high enough for employment to continue to grow by about 1% and unemployment to fall. At 10.5%, unemployment remains too high, of course, but it is down from 12% in mid-2013 and we expect to see it fall towards 9.7% by early next year, which is in fact the average since 1995. Importantly, unemployment is falling in almost every country in the area. We do not yet describe the situation as normalised, but that is certainly were we are heading.

Consumption set to grow further, inflation remains too low

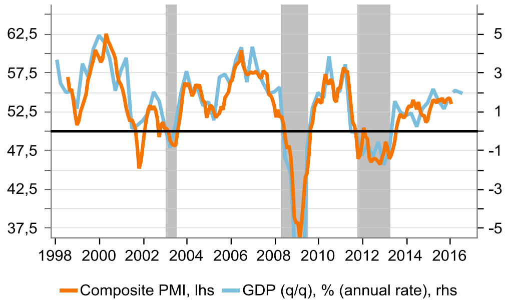
European consumers remain very upbeat. Consumer confidence at high levels in most countries, and growth in retail sales and private consumption has been strong. The continued fall in oil and other energy prices will provide a further boost to households' real incomes and help sustain demand growth. Over time, rising wages will also help to fund consumption growth (in particular in Germany, where unemployment is now record low).

But there is a problem – lower oil prices mean that inflation is likely to remain very low in the euro area this year. Although we see no signs of deflationary behaviour, ECB may be even unhappy with core inflation, which has stabilised at around 1% in most places.

Monetary policy is already doing (almost) all it can do. But Draghi is ready to do even more

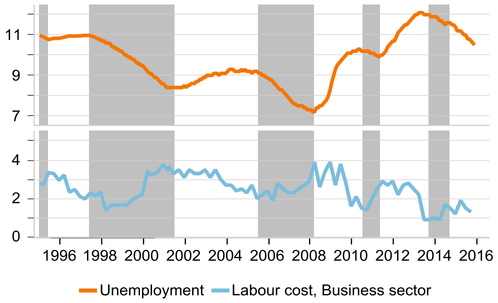
In December, the European Central Bank (ECB) cut the deposit rate another 10 basis points to minus 0.3% and committed to continue the bond purchase programme at least until March 2017. Bond purchases continue to run at EUR 60 billion per month, a very large amount compared with the size of both asset markets and the economy, but financial markets expected even larger purchases and a deeper rate cut in order to stimulate both growth and inflation further. Although the members of the ECB Council do not all agree on the need for further measures, in the January meeting they expressed worries about lower than expected inflation and higher risks. Mario Draghi made it clear that they are ready to do more. If commodity prices do not recover, volatility remains high and there are any signs macroeconomic weaknesses, ECB could act as soon as March. We now expect the first interest rate hike to be postponed at least until 2018.

EMU: PMI vs. GDP



Sources: Swedbank Research & Macrobond

EMU: Unemployment vs. labour cost (%)



Sources: Swedbank Research & Macrobond

Indepth 2: Geopolitical risks, or catch-22

Geopolitics can either support the current economic trends or push the global economy towards more negative outcomes. The risks are clearly tilted to the downside, and it is difficult to see strong tailwinds.

The weak economy has political implications. A graphic example of this is Greece, but this point relates to the EU in general. When economies have been weak for long, populists come to power. They tend to be inward looking and protectionist, which makes the economy weaker and runs a risk of a vicious circle of an ever weaker economy and more political instability. The ECB keeps buying time, but monetary stimulus is a complement to, not a substitute for, solving structural failings like fiscal imprudence, lack of productivity growth, and the habit of breaking rules.

The European economy thrives on the free flow of trade and people, and building impediments to this along national borders would cut growth. The willingness and ability to implement long-overdue reforms are being pushed aside by the refugee crisis. If Europe does not come up with a plausible solution, the division lines within Europe will thicken. German Chancellor Merkel's losing her influence would make averting this problem more difficult. Pan-European politics risk becoming increasingly dominated by national politics. Spain will be busy keeping its unity as the Catalonian independence movement gets stronger. "Brexit" has gone from bluff to a possibility. Le Pen does not seem that likely to win the French presidential elections in the spring of 2017, but her popularity will push mainstream politics in a more populist, more nationally oriented, and perhaps more pro-Russia direction. Poland, earlier very pro-European, has become a potential risk to European unity. Its recent policies also risk alienating the Baltics by driving a wedge between Eastern and Western Europe. Rethinking Europe will be tough. And although Europe often makes the right decision, it is after many wrong ones have been tried.

Economically weak and politically divided, Europe gives more chances to its opponents, like Russia and the ISIS. Revisionist Russia, with its declining economy, may last longer and act as an aggressive spoiler longer. The Russia-Ukraine conflict is far from over. Some major European powers are growing tired of it and may be willing to deal with Russia (e.g., sanctions may not be extended this summer). If this happens, Eastern Europeans' confidence may suffer. If Ukraine is unable to prop up its economy soon, it could cause another political turmoil and be a source of refugees. If oil prices stay at current levels or fall further, Russia's ruling regime may act more aggressively internationally so as to survive amid a deepening recession. The CIS countries would be pulled closer into the Russian sphere of influence.

The global picture harbours many more such risks. For instance, in the run-up to its 2016 presidential elections, the US policy discussions may become more inward looking. Brazil could be wading deeper into trouble, both economically and politically, especially if commodity prices fall further. Slowing growth is pushing China to expand its global presence in order to dump its excess production capacity, which may provoke a confrontation with other regional powers. If China's growth slows sharply (which, however, we do not see likely over the forecast horizon), it may cause social unrest. In any event, the hegemony of the Western world is set to be challenged by the formation of a bipolar world, where the other pole centres on China and not Russia.

Our baseline assumes that the global economy manages to sail through or around most of these risks reasonably well, but this will come with a cost of heightened financial market volatility and weaker global growth.

US: Slower growth and less monetary tightening

Strong growth faded late in 2015

The US economy was characterised by mixed developments during last year. On the one side, real growth in the second and third quarters picked up and employment increased substantially. Average annualised quarterly growth reached almost 3%, while average monthly job creation over the whole year was 220,000 reducing the unemployment rate to 5%. However, the end of last year also saw signs of a weakening of activity. Continuing falling oil prices put pressure on the energy sector and investments, and the manufacturing sector in general suffers from the strong US dollar and the softening of foreign demand, most notably from emerging markets. Thus, we expect activity to have slowed down in the last quarter of 2015, which, due to increased volatility in financial markets, is likely to extend into the early parts of 2016.

Household spending to pick up

Cheaper energy is, nevertheless, expected to provide a net boost to growth in the US, as the benefit to consumers exceeds the cost to producers. While the negative impact has been felt through a sharp reduction in oil-related investments, households have been relatively slow to raise spending. It is estimated that the lower energy prices could add more than 1% of GDP through households' purchasing power, but so far a significant part of the windfall has resulted in increased savings. Furthermore, real disposable personal income is growing above 3% on an annual basis, which will continue to strengthen household finances.

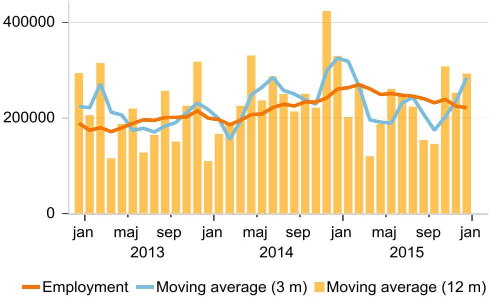
Renewed downward pressure on inflation from energy...

Inflationary pressures, however, remain subdued. Although core inflation exceeded 2% in December, this is mainly due to increased costs of services, and particularly of health. The consumption deflator (PCE), the Fed's preferred measure of inflation, is also much more subdued. In November, the increase was 1.3% compared with the same period the year before. Given that oil and energy prices once again turned down, we expect price pressures to remain low well into 2016.

...and the labour market

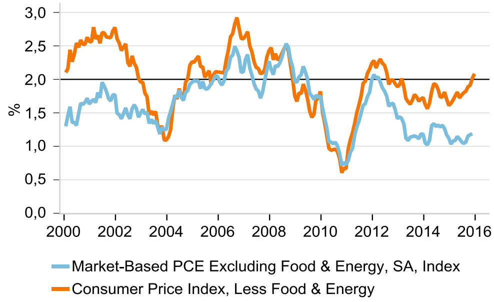
Also the labour market will have a dampening impact on prices through modest wage increases. Despite the unemployment level being at its lowest since January 2008, a low participation rate and a still high degree of part-time workers still leaves a positive employment gap. Structural factors, such as the aging population and increased usage of disability insurance, likely will keep participation rates below previous highs, and we expect these forces will continue to exert a downward pressure on wage developments.

US: Employment (sa)



Sources: Swedbank Research & Macrobond

US: Core inflation measures



Sources: Swedbank Research & Macrobond

Debt ceiling extended beyond the elections

The US is heading into a presidential election campaign, but we do not expect it to have any material impact on the economy. However, in the unlikely event that Donald Trump and Bernie Sanders become the ultimate candidates, uncertainty about the future state of the US economy will increase. Congress reached a budget deal during the fall that included an extension of the debt limit until March 2017, i.e., well past the elections. The agreement also envisages increased spending on defence and discretionary outlays that not will be fully financed. Thus, we expect increased fiscal policy stimulus in 2016 and 2017.

Fed to scale back hiking cycle

However, in light of the persisting dollar strength and renewed financial market volatility, we expect the Federal Reserve again to take a step back in hiking the policy rate. As recently as August of last year, falling equity markets and the prospects of a weakening Chinese currency led the Fed to hesitate, and this scenario is currently replaying, with the added negative impact of lower energy prices on headline inflation and inflation expectations. We also believe that the risks of moving too early (stronger dollar, lower equity prices, and steeper yield curve) exceed the risks of waiting too long (a too-rapid acceleration of wages and prices leading to a faster tightening). Thus, we currently expect two hikes this year, to be followed by three more in 2017.

Japan: The success of Abenomics still questionable

A fragile Japanese economy

Almost three years have passed since the launch of Mr Abe's ambitious macroeconomic programme to revive the economy. But economic growth remains fragile and inflation far from the target, despite further monetary policy easing by the Bank of Japan (BoJ). A technical revision of investment data helped the economy to avoid falling into recession in the third quarter, but Japan is standing on shaky ground and headwinds are expected from nearby Asian markets.

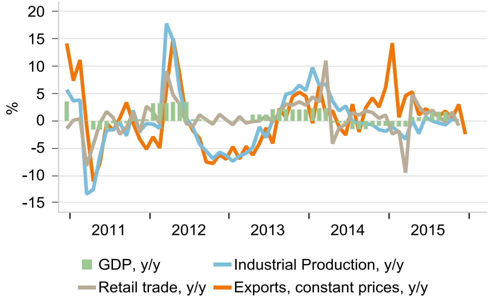
A modest recovery in 2016

Nevertheless, we expect growth to pick up slightly this year. A tightening labour market will gradually lift real wages and push up consumer confidence. The supplementary budget for 2016 will support domestic demand by an estimated 0.6% of GDP. Exports are also expected to increase, benefitting from stronger demand in the US and Europe. The dramatic fall in oil prices will increase enterprises' profits and households' real incomes. Next year, GDP growth will be somewhat lower due to the consumption tax hike, currently planned for April 2017.

Cheaper commodities support the economic recovery but suppress prices

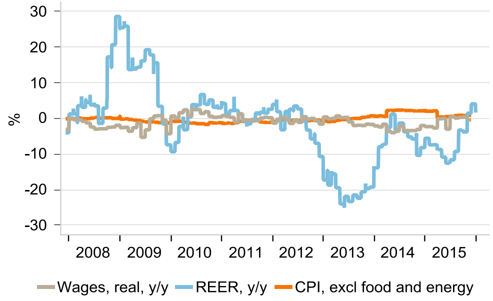
The BOJ will probably fail to meet its inflation target also in 2016. In addition to the rapid fall in commodities prices, there are appreciation pressures on the yen as global money tries to escape volatile emerging markets, lowering import prices in Japan. Other risks include a sharper slowdown of demand in China, and a potentially worse-than-expected impact from the

Japan: Main economic indicators



Sources: Swedbank Research & Macrobond

Japan: Price dynamics



Sources: Swedbank Research & Macrobond

UK: EU referendum creates the rules of the game

Softening data spill over to 2016

Real growth in the UK has disappointed, and data have sent mixed signals. GDP growth in the third quarter was revised down, mainly due to a downward revision of government consumption and housing investments. Data for the fourth quarter also indicate a weak end of the year. We lower our forecasts for 2016 and 2017, but stick to our underlying growth story: a dependency on domestic demand, in particular consumers and services. If the services sector, accounting for 80% of national output, falls behind, this will pose a risk to the outlook.

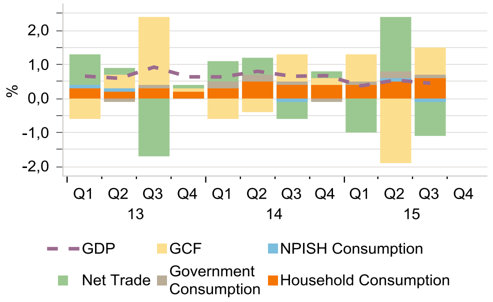
EU referendum will effect growth and monetary policy

The upcoming British referendum on EU membership will dominate the political and economic agenda this year. Our main scenario is that the UK will remain an EU member (a likelihood of 75%), but the outcome of the current negotiations is key, not least on the reforms relating to immigrants right to in-work benefits. Going into 2016, the sterling has depreciated which will support export growth and raise imported inflation. A further depreciation of the sterling is expected as the referendum, which likely will take place in June or September, approaches. A UK exit would have massive economic and political consequences.

Bank rate hike postponed until 2017

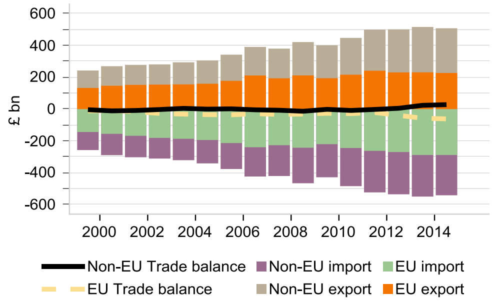
The Bank of England (BoE) is facing many challenges in the near future--volatility surrounding the EU referendum, a softening in economic growth, a renewed downturn in oil prices, and slower wage growth, to mention a few. A more gradual increase of the inflation rate is thus expected, forcing the BoE to postpone the first Bank rate hike, to 0.75%, to the first quarter of 2017. The tightening cycle will likely be protracted, leading to a rate of 1.00% at end-2017.

UK: Contribution to growth (q/q), s.a.



Sources: Swedbank Research & Macrobond

UK: Trade with EU

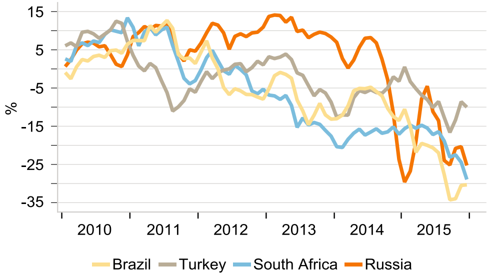


Sources: Swedbank Research & Macrobond

Emerging markets: Scary Monsters

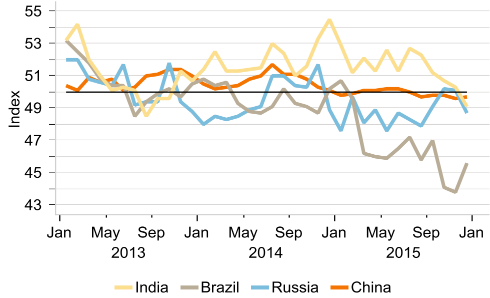
Economic developments continue to worsen among emerging markets economies with currencies selling off to historical low levels. Slower China growth and falling commodity prices are partly to blame. But years of underinvesting, bad policymaking, high debt levels and corruption make things even worse in countries like Brazil and Russia. Moreover, they have run out of policy options as fiscal balances have deteriorated and monetary policy needs to stay tight to fight inflation. China on the other hand is experiencing deflation on a national level. China, in contrast, still can, and will, support growth through economic policy. We do not expect a hard landing but uncertainty is high. In Russia, the recession in 2015 will continue this year, made worse by the most recent decline in oil prices.

EM: Real Effective Exchange Rate Index percent change since 2009-12-31 (BIS)



Sources: Swedbank Research & Macrobond

BRIC: Manufacturing PMI indices



Sources: Swedbank Research & Macrobond

China: Falling prices is a big challenge

Stock market turbulence and currency policy creates considerable uncertainty

The year has begun with the Chinese financial markets in turmoil as plunging equities and a weakening currency have combined with significant capital outflows. Concerns about the state of the Chinese economy have clearly returned. Economic development, on the other hand, has not changed much in recent months. The rebalance of the Chinese economy is on-going with a slowdown in traditional manufacturing and relatively strong development in the service sector. The link between the stock market and the country's economic activity has historically been very weak. The share of households who own equities in China is low (about 8%), and companies finance their businesses mainly through banks and the corporate bond market. Still, the combination of stock market chaos and a falling currency raises important questions about the Chinese leadership's handling of the situation and their currency policy intentions.

More focus on a currency basket but US dollar still most important

After the depreciation in August, the renminbi was held stable ahead of the IMF's decision on November 30 to include it in its basket of currencies (Special Drawing Rights). China then began to gradually depreciate its currency against the dollar and in December announced that its policy would be based not only on the exchange rate against the dollar but also against a new trade-weighted index. While we see this as a natural development in the long term, at this point China is to a large degree a dollar-based economy. China's foreign trade is invoiced primarily in dollar, a large portion of its foreign debt holdings is in dollar and most commodities are priced in dollar. There is considerable uncertainty what politicians want to achieve and how much the renminbi will eventually weaken. The central bank seems to want a lower, or at least a stable, exchange rate, however, probably to slow capital outflows and reduce over-supply in the manufacturing sector, where prices have fallen since 2012.

Deflation and high debt is a toxic combination

Declining prices are not just a problem for the manufacturing industry. Prices are falling broadly in China after years of over-investment and lower demand domestically and internationally (the GDP deflator was negative in 2015). Private debt is high at about 200% of GDP. With an average interest expense of 4-5%, nominal GDP has to grow by 8-10% to keep the debt percentage from rising further. As a reminder, nominal GDP grew by 6.4% in 2015. Interest rate cuts do not have the desired effect when prices are falling this much. Persistent deflation could lead to a downward spiral with lower demand, which would mean less investment and reluctant lenders. Chinese policy will likely focus on mitigating this risk by stimulating the economy through rate cuts, lower bank reserve requirements and expansionary fiscal policy. Against this backdrop it is not unreasonable that politicians would welcome a weaker currency to ease deflation pressure.

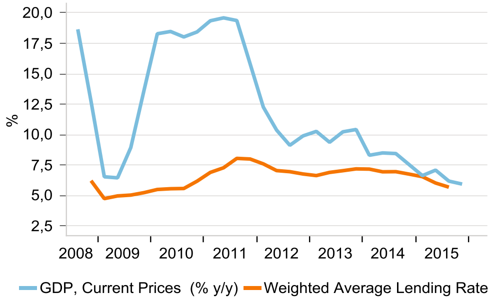
A weaker renminbi but no devaluation

Some are arguing for a big devaluation to slow the capital outflows. There is a pent-up demand among Chinese households to diversify their savings and invest more in foreign assets. These flows are less sensitive to the currency level. To slow this type of outflow, the renminbi would probably have to be significantly undervalued. There is considerable uncertainty where the equilibrium exchange rate is. The risk inherent in devaluations is that it would lead to even more uncertainty and expectations of further devaluations. China has a history of making political changes gradually. A major devaluation would shock the global markets and be seen as threatening, which could come back to haunt the Chinese and thwart their original purpose. Furthermore, a sharp devaluation would tighten consumer purchasing power, a development that China's leaders would like to avoid. However, uncertainty about the currency will persist as long as the central bank does not provide better guidance and information on the direction and objectives of its currency policy. Our expectation is that the renminbi will continue to gradually weaken until deflation pressure eases. The risk to our forecast is if private capital outflows reach unmanageable levels. If this were to happen, we expect China to introduce additional capital restrictions, which means that reform efforts would have to take a step back. A possibility that should not be underestimated.

Downside risk to our growth forecast

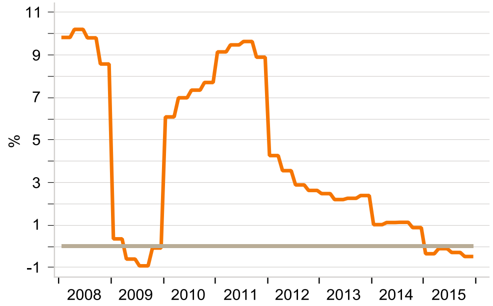
Our GDP forecast is unchanged from August 2015. GDP is largely a political number in China, and we expect leaders to announce a growth target in March of 6.75% for 2016, a downward adjustment from 7%. The "real" growth rate is probably lower. Too much of a deviation on the downside would probably lead to more aggressive stimulus measures. We do not expect a hard landing (this time either), since China has by no means run out of stimulus options. The one-year benchmark rate is currently at 4.35%, the bank reserve requirement is 17% and the national debt is about 60% of GDP. The risk to our growth forecast is on the downside, however. There are strong doubts whether the service sector this year will again manage to compensate for weakness in manufacturing. In 2015 the service sector was largely driven by the financial sector, mainly thanks to unusually high stock market activity.

China: Average Lending Rate and Nominal GDP



Sources: Swedbank Research & Macrobond

China: GDP Deflator YTD



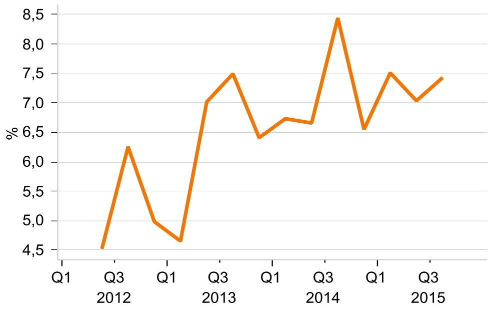
Sources: Swedbank Research & Macrobond

India: High growth but reforms at snail's pace

Export numbers are negative and fixed asset investments are weak

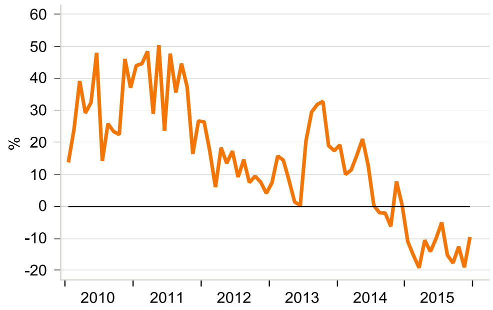
India is one of the fastest growing economies in the world. According to official numbers, GDP expanded by 7.4 percent in the third quarter last year. However, most other economic statistic numbers have disappointed in India. Export growth was negative throughout 2015. We expect India's export numbers to remain weak due to poor global demand and the appreciation in the real trade weighted rupee. Investments are treading water and credit growth is very weak. The central bank has lowered interest rates by a total of 125 basis points to 6.75 percent since December 2014. However, real rates are still too high support growth and banks are troubled by old bad loans and have used lower rates to repair their balance sheets.

India: GDP, Constant Prices (% y/y)



Sources: Swedbank Research & Macrobond

India: Foreign Trade, Export, USD (% y/y)



Sources: Swedbank Research & Macrobond

The reform process is slow

Prime Minister Modi's administration has a strong reform agenda that is promising for future growth. However, the reform process has been slow since the government lacks a majority in the upper house. Modi's Bharatiya Janata Party (BJP) lost the state elections in Delhi and in the third most populous state, Bihar, by wide margins, last year. The setbacks dampen the prospects for BJP to gain more power in the upcoming reshuffle of seats in the upper house of parliament in mid-2016. More influence in the upper house will be very important for BJP to be able to pass important reforms such as the goods and services tax (GST) bill. So far the government has made some progress regarding reforms in key long-term areas, having reduced fiscal subsidies, changed labour laws and liberalised several key sectors for foreign direct investments. India benefits from lower commodity prices and is rather insulated from the re-balancing process in China. The currency reserve amounts to more than USD 350 billion and the current account deficit has been reduced to around 1 percent of GDP. Fundamentally, the situation has improved in India but growth will moderate as the reform process is slow and we do not expect economic stimulus will be there to keep growth expanding at a faster pace.

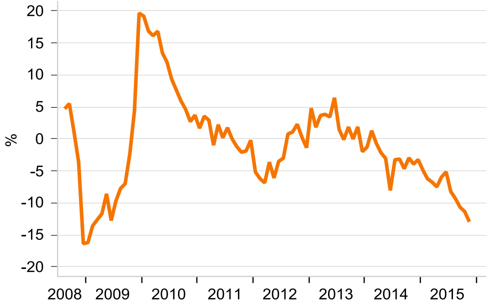
Brazil: The car is still dirty

The recession will get deeper in Brazil

The recession will deepen in Brazil in 2016. The Brazilian economy is suffering from falling commodity prices, corruption scandals (operation car wash) and weak economic policy making. Brazil lost its investment grade status last year as the government was not able to decide and implement fiscal savings to put the public debt on a sustainable path. Due to lack of political support, the government had to scale back their fiscal targets repeatedly last year. At the same time the recession intensified and the fiscal deficit grew bigger. Unfortunately, the outlook for fiscal policy has not improved since the finance minister Joaquim Levy was replaced by former planning minister Nelson Barbosa in December last year. Mr Barbosa is expected to be less committed to austerity measures and will be more sensitive to political considerations.

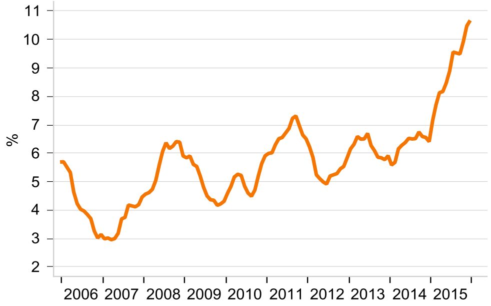
The sharp fall in the Brazilian currency, real, together with hikes in administrative prices have pushed inflation higher. Consumer prices accelerated last year from 6.4 percent to 10.7 percent on a yearly basis and the central bank had to hike policy rates to 14.25 percent. Household spending is squeezed by higher unemployment and falling real wages. Fixed investments will continue to decline. The state-owned oil company Petrobras has announced further cutbacks in their investment plans as their cash flow is negative and from high costs due to charges associated to the ongoing corruption scandal. The room for economic stimulus is limited by high inflation and strained fiscal finances. The budget deficit amounts to 8 percent as a share of GDP. The risk for a political chaos is high as the request for impeachment against president Dilma increases as the recession gets deeper.

Brazil: Industrial Production (% y/y)



Sources: Swedbank Research & Macrobond

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



Sources: Swedbank Research & Macrobond

Russia: Cheaper oil to extend recession

Cheaper oil hits hard: recession unlikely to bottom out before late 2016

The recent fall in oil prices has delivered yet another blow to the Russian economy. Given its massive dependence on oil (about two-thirds of its goods exports and half of federal budget revenues are hydrocarbon related), the rouble has weakened further. This will keep inflation up longer, eating more into consumer spending and investment activity. The policy response to the end of the commodity supercycle and Western sanctions has been clearly insufficient.

To their merit, policymakers have let the rouble float and maintained fiscal discipline. Early estimates suggest that 2015 yielded a budget deficit of 2.6%, i.e. well below the 3% target. The 2016 budget has been drafted with a deficit target of 3%, but its assumptions are unrealistic (GDP growth of 0.7%, average oil price of USD 50 per barrel, a rouble-US dollar rate of 63, and inflation of 6.4%). Only two weeks into the year, Economics Minister Siluanov has asked for a sequestration of about 4% of federal budget expenditures. Fiscal policy is tight, but necessarily so – it treats the oil shock as permanent and provides some policy anchor in an uncertain environment. To raise revenues, Russia has set up a plan to sell off minority stakes in some major state-owned companies, such as Rosneft.

Floating rouble and fiscal discipline alone cannot revive future growth

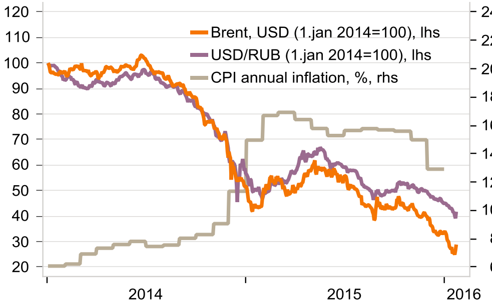
To the policymakers' failing, the key problems are not addressed. The rule of law is poor and corruption is endemic. Instead of improving market institutions, the state is encroaching further into the private sector, making it less efficient. There are some gains from import substitution (e.g., agricultural output is expanding), but the overall impact is negative. The conflict with Turkey adds to investor uncertainty, while Russia's own imposed trade bans raise food price inflation. While the EU, at the most recent round, hesitated before extending its sanctions against Russia, and it is not inconceivable that it does not renew them this summer, it is the US sanctions that are systemically important to allow Russia access global financial markets. Unless the Minsk II agreement is fulfilled (no clear signs of that so far), the US is unlikely to even consider lifting the sanctions in the run-up to its presidential elections, and thus Russia will largely remain cut off from external financing in 2016 and most likely also in 2017. Russia remains a "one-trick pony" and has neither done enough nor seems willing economically and geopolitically to diversify away from oil and build a basis for a new, more dynamic economy.

All in all, the same processes that drove recession in 2015 will continue this year, but will be made worse by the recent oil shock. Following the 3.8% fall in 2015, GDP will shrink by 2.5% this year. Recession is unlikely to bottom out before late 2016. Recovery will be weak, with GDP expanding by just 1% in 2017. Consumer price inflation will average 10% for 2016, then slide to mid-single digits for 2017 as the oil price recovers (to USD 48 per barrel in late 2017), the rouble strengthens (to RUB/USD 70 in late 2017), and weak local demand holds prices down. Inflation will repress purchasing power, pushing consumption down by 9% this year (after a similar drop in 2015), with only a fringe pickup of 1-2% in 2017. Weaker domestic demand and the cheap rouble (and, thus, expensive imports) will keep pushing gross fixed capital formation down, by 15% this year, followed by no growth in 2017. Fiscal drag will add to the weakness of consumer and investment demand. Bank loan overdues will continue to rise, but support from the central bank will keep systemically important banks afloat, thus ensuring systemic stability.

If oil price remains at current levels, foreign reserves could start shrinking again

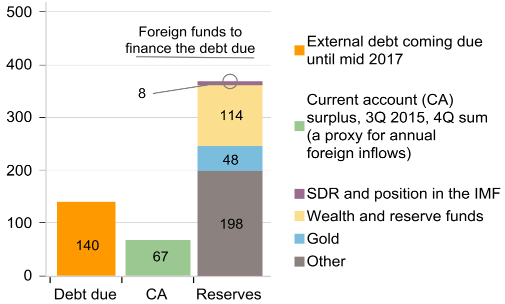
Russia has been able to stabilise its foreign reserves at around USD 360 billion, largely at the expense of a massive cut in imports, but with oil prices down and debt repayments lining up, Russia may again start to bleed its reserves. This is more of a risk for 2017, when it may lead to higher financial market volatility and push Russia into a more negative scenario than the one described above. But, as we have argued before, we see the main risks in Russia being political, not economic. So far public support to Putin's policies remains very high.

Russia: Exchange rate, oil price and inflation



Sources: Swedbank Research & Macrobond

Russia: Foreign reserves and debt due, USD bn



Sources: Swedbank Research & Macrobond

In-depth 3: Supply-driven drop in oil prices

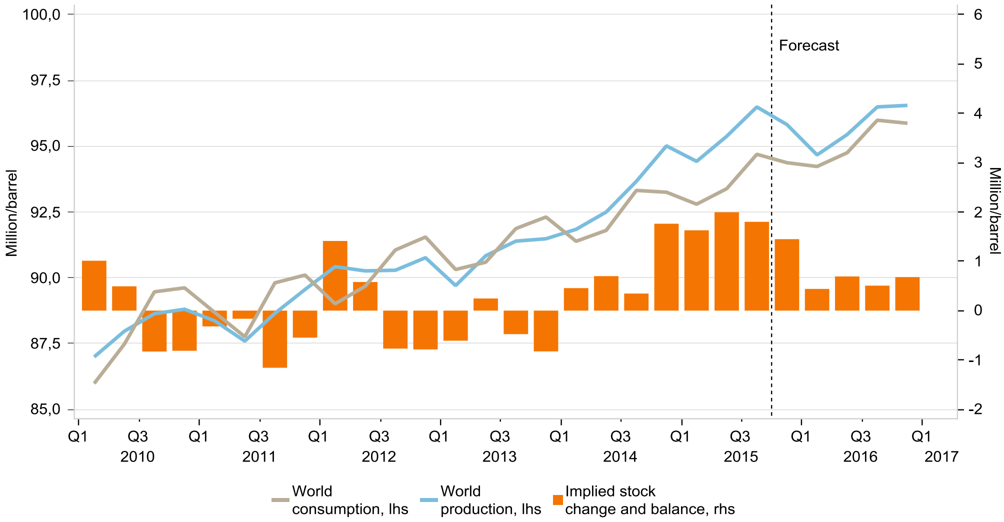
Crude oil prices have fallen by over 75% since the summer of 2014 and have now reached the lowest level since 2003. What is driving the price decline and is it a sign of an impending global recession?

Our view is that the drop in oil prices in the last year and a half has been driven by increased crude supplies and to a lesser extent by lower demand. The current oil price drop clearly differs from the decline in 2008/09, when consumption fell significantly in the wake of the global financial crisis and subsequent global recession. This proved to be the run-up to major production cutbacks by OPEC.

High crude oil prices, technological innovations and lower production costs have led to a big capacity expansion in the oil industry in the last decade. The growth of the US to become the world's second largest producer is a good example of this. Increased competition in the global market has forced OPEC to raise production in order to maintain or gain market share from high-cost producers, but with lower prices as a result. At the same time the split within OPEC has deepened and in December of last year no production quotas could be decided on. The lifting of the Iranian oil embargo in January is likely to lead to a long-term oversupply of oil despite questions about the state of Iran's oil production and its infrastructure for exports. Iran's return to the oil market and its contentious relationship with Saudi Arabia reduce the likelihood of a near-term slowdown in OPEC production. The effect of declining prices on production mainly applies to investments in new capacity, which will decrease significantly in coming years and eventually reduce production growth.

Consumption continues to rise, even though it turned slightly lower at the end of last year mainly due to the mild winter in the northern hemisphere. It should be noted, however, that consumption continues to rise in emerging economies, led by China, where it was significantly higher than a year earlier as well as from a five-year perspective. In the EIA's latest forecast, global consumption is projected to increase by 1.6 million barrels per day, compared with 1.7 million barrels last year. It's in emerging economies that consumption is rising, but from low levels, since per capita consumption is still a fraction of what it is in advanced economies.

In depth: Global production & consumption of crude oil



Sources: Swedbank Research & Macrobond

Nordic area: Unhappy in their own way

The Nordic countries are each facing their own set of problems. In Norway, growth is set to worsen much more due to the oil price decline before a weaker exchange rate will provide support. Denmark's export dropped unexpectedly in the third quarter, but domestic demand is set to continue to drive growth. Finland is finally seeing modest growth ahead as the long recession is coming to an end.

Norway: Into the depths

The economic decline broadens

Growth in the mainland economy remains low. GDP rose by 1% (annualised) in the third quarter, but Norges Bank's Regional Network Survey indicates zero growth in the coming months. Oil-related activities are contracting sharply. The decline is set to continue and may well last longer than previously assumed, as oil prices have fallen further in the past months. As unemployment increases, the slowdown may to spread to the broader economy. On the other hand, the weaker krone has improved competitiveness; however, so far, non-oil-related manufacturing shows no signs of upswing.

Unemployment is increasing steadily...

The labour market continues to deteriorate. According to the Labour Force Survey (AKU), unemployment has already climbed about 1 percentage point (p.p) to 4.6%. Registered unemployment has risen far less overall but is now rising steadily. Thus far, the increase in unemployment remains concentrated in oil-related regions and professions. In other parts of the country, unemployment has remained stable. However, all indicators continue to point to weak labour demand, and employment growth has indeed slowed. We expect unemployment to rise another percentage point this year.

...but household demand should be stable

With rising unemployment, slower employment growth, and no real wage growth, a slowdown in household demand is to be expected. Households have many reasons to be more cautious going forward, and consumer confidence has fallen to its lowest level since the financial crisis, indicating a decline in consumption. It is hard to judge the trend from the volatile retail sales, but growth may have slowed in recent months. Growth in house prices and debt seems to have moderated somewhat. However, household savings are high, and public transfers, such as unemployment benefits, will provide income insurance; this suggests that households may be capable of sustaining their consumption level fairly well. We therefore see the risk of a severe contraction in consumption as very small.

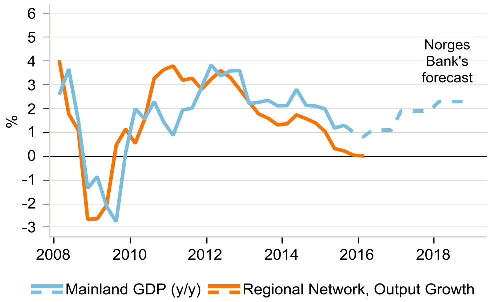
Fiscal policy, rate cuts...

The plentiful petroleum fund allows the government to take an expansionary fiscal stance despite the decline in oil prices. The fiscal stimulus in 2016 is considerable and appropriate, given the state of the economy. Norges Bank has already lowered its main policy rate from 1.5% to 0.75%, and the central bank's projections indicate a further rate cut to 0.5% in the first half of 2016. Financial markets expect yet another cut to 0.25%. Norges Bank is clearly taking a careful approach to rate cuts, as it remains worried about imbalances in house prices and debt. But we do not doubt that it will cut the rate all the way to zero, if needed.

... and a continued weak krone provide stimulus

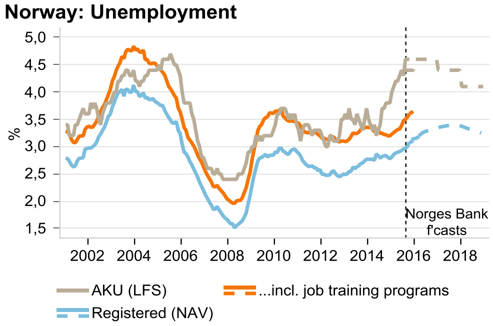
However, the strongest stimulus to the Norwegian economy is the weaker krone, which has significantly improved competitiveness for all firms exposed to international competition. Tourism is flourishing, and, e.g., hotels have seen an upswing in many places. Fish farmers enjoy record prices (measured in krone). Many companies struggled with the high cost level a few years back, but those that survived were presumably the best and most productive, and should be well positioned to expand their activity now. However, the adjustment takes time, in particular if new investments are needed. So far, non-oil-related manufacturing shows no signs of upswing, and non-oil exports are rising very slowly. We remain confident that the weak krone will work, eventually; meanwhile, however, the Norwegian economy remains at risk of worsening.

Norway: Norges Bank's network vs. GDP



Sources: Swedbank Research & Macrobond

Norway: Unemployment



Sources: Swedbank Research & Macrobond

Denmark: Temporary setback, the recovery is on again

Export decline pushes down growth, temporarily

Real growth unexpectedly fell back into negative territory in the third quarter last year after positive growth had been registered for eight consecutive quarters. The decline was explained by decreasing exports, which was surprising given the relatively good performance of main trading partners and the competitive real exchange rate. Both exports of services and goods fell. The domestic economy is, however, continuing its upward trajectory, with household consumption and investment supported by lower oil prices and increased employment.

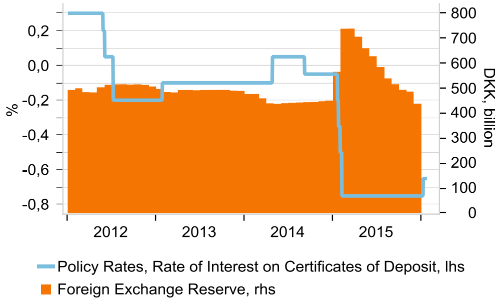
Monetary easing scaled back somewhat

Less pressure on the foreign exchange reserves implied that the Danish central bank could raise the policy rate by a modest 10 basis points to a negative 0.65%. The currency reserves had dropped back to levels last seen prior to the significant inflows registered before the currency interventions to defend the fixed exchange rate. This means that the spread between the Danish certificate of deposits and the ECB's deposit rate has narrowed even further, from 0.55 p.p. --from before the ECB's December decision--to the current 0.30 p.p.

Need for tighter fiscal policy

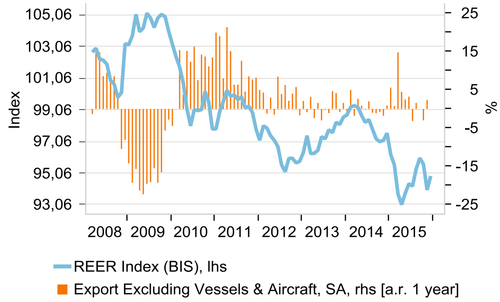
Looking forward, we expect activity to pick up, and we stick to our view that overheating risks are looming, albeit a bit postponed. Output gaps in both the labour market and the overall economy are expected to close next year, and, with persistent low interest rates, housing prices are again a potential risk. Fiscal policy needs to become tighter, in line with the latest budget decision, but reductions in land taxes could, instead, raise risks.

Denmark: Foreign-exchange reserve & policy rate



Sources: Swedbank Research & Macrobond

Denmark: Competitiveness and exports



Sources: Swedbank Research & Macrobond

Finland: Modest growth in a still-vulnerable economy

Recovery will come from investments and exports

Recovery of Finland's economic growth in 2016-2017 will be sluggish and primarily supported by improving investments and exports. The economic situation of the main trade partners is expected to improve, strengthening export demand. Furthermore, several major construction projects in 2016-2017 should contribute to an increase in investments. Private consumption, which made the strongest contribution to economic growth in 2015, will slow this year, as loan repayment holidays expire, and wage and employment growth is modest. Although wage growth has slowed, it is still faster than productivity, worsening export competitiveness.

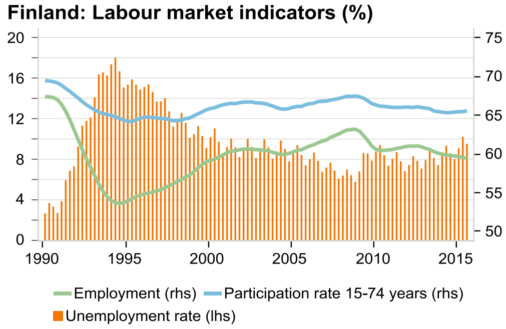
The decrease in industrial production has slowed, while the services sector is growing

More than in many other countries, the share of the industrial sector in economic output has declined, whereas the share of the services sector has gradually increased. The decrease in industrial sector production volume has gradually slowed, whereas turnover in the services sector has been growing since 2014. However, as a considerable share of services' output is used by industry, stronger growth in that sector depends on the recovery in demand by industrial and construction sector enterprises.

The government has ambitious plans to revive the economy and strengthen public finances

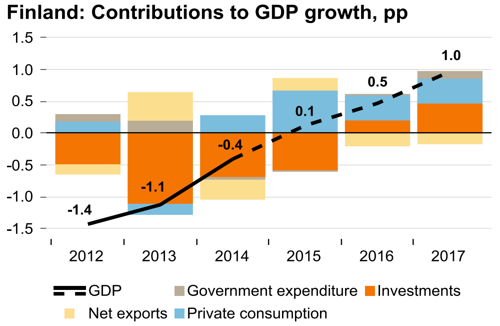
The government has ambitious plans for reforms to revive the economy and strengthen public finances. The high level of unemployment and aging population are increasing government expenditures. At the same time, due to the economic recession and expected sluggish recovery, taxes and other government revenues are insufficient to balance the government budget.

Finland: Labour market indicators (%)



Sources: Swedbank Research & Macrobond

Finland: Contributions to GDP growth, pp



Sources: Swedbank Research & Macrobond

Estonia: Less growth potential ahead

Primarily due to weakened foreign demand and its negative impact on business sector confidence and investments, GDP growth decelerated to 1.2% in 2015. We expect that demand on the European markets should strengthen in 2016 and 2017, offering more possibilities for Estonian exporters. The improved demand outlook, in turn, is expected to have a positive impact on investments. GDP growth is expected to accelerate to 2.3% in 2016 and to 2.6% in 2017.

Key economic indicators, 2014-2017 1/

	2014	2015f		2016f		2017f	
Real GDP growth, %	2.9	1.2	(1.6)	2.3	(2.6)	2.6	(2.8)
Consumer price growth, %	-0.1	-0.5	-(0.4)	0.3	(1.6)	2.2	(2.5)
Unemployment rate, % 2/	7.4	5.9	(6.6)	6.3	(6.9)	6.6	(6.8)
Real net monthly wage growth, %	5.7	8.1	(7.4)	4.9	(4.3)	3.1	(3.7)
Current and capital account balance, % of GDP	3.1	6.5	(5.6)	3.4	(2.8)	1.8	(0.9)
General government budget balance, % of GDP 3/	0.7	0.7	(0.3)	-0.2	-(0.2)	0.0	(0.0)

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

The major negative impact on exports comes from the Russian market

Last year, foreign demand for Estonian goods and services decreased and had a strongly negative effect on the total economy. The major share of the drop in exports came from the Russian market. Although the decrease of exports to Russia was broad based, it affected the Estonian chemical industry, beverage producers, and producers of electrical appliances and equipment the most. The depreciation of the rouble and deterioration in the purchasing power of Russian households decreased the number of Russian tourists by more than one-third. And we should not forget sanctions, which had a negative impact on agricultural producers and the food industry. Although exports to many European countries have increased, there are still several other countries in that market that have contributed negatively (primarily because of the decline in exports of shale oil products). The major impact of the drop in total exports came from electronic, chemical, and shale oil products, electricity, ferrous metals, dairy products and beverages (about one-fourth of the total exports of goods). The drop in exports of these goods cannot be linked to the possible worsening of competitiveness, but to external factors, like low oil prices, sanctions from Russia and its worsened demand, and, in the case of electronics, specific corporate decisions. If we exclude these goods, exports from Estonia would have increased last year.

Weakened demand, falling prices, and increased labor costs have contracted business sector profits

In addition to the weakened demand, business sector turnover decreased due to the drop in producer and export prices. Robust wage growth, deflation, and reduced labour taxation improved households' purchasing power and contributed positively to domestic trade and other activities related to domestic consumption. Although the Estonian business sector has proved its flexibility by reacting to the fall in turnover with a decrease in production costs, labour costs are still growing. Eventually, the business sector has not been successful in preventing a contraction of profits and profitability.

European markets are expected to provide more export possibilities in 2016-2017

The economies of Estonia's main trading partners are expected to improve in 2016. This should offer more possibilities to expand exports for enterprises dependent on foreign demand. However, we expect only a modest recovery of Estonian exports. This year should offer better possibilities to export more to the European and the US markets, while enterprises dependent on the Russian market and on global oil prices should not expect considerable improvement. The economic recession in Russia is receding gradually, but its demand continues to be weak, at least in 2016. In Estonia, the recovery of producer prices, and especially of export prices, will be very sluggish and slower than the recovery of import prices, as the euro is expected to stay weak this year. This could put additional pressure on business sector profits. However, as enterprises have integrated more with the global value chains, changes in currency exchange rates should have less impact on prices than they did years ago.

Wage growth will remain fast, but private consumption will slow a bit

Wage growth will remain fast as the lack of suitable labour remains a concern. An agreed 10% increase in the minimum wage in 2016 and again in 2017 will lift the average wage level by around 0.5% each year. The growth of wages in real terms will slow in 2016 compared with 2015, as prices will start growing and labour taxes will be lowered less than in 2015. Labour taxes will be reduced by a higher nontaxable threshold in 2016 and 2017, and by a lower social tax rate in 2017. Although the latter will probably not affect net wages, it will provide some relief for enterprises struggling with a fast growth in labour costs. We expect the robust growth of private consumption to slow gradually, and this will set some limits to growth in retail trade, as well as in other domestic services. However, the financial situation of households remains relatively strong. A rise in pensions, children's allowances, and other social benefits will further support private consumption, especially of those with lower earnings, and prevent it from slowing drastically. According to the confidence indicator, expectations of Estonian consumers (their financial situation, savings, major purchases, and expectations about the general economic situation) for the next 12 months are improving.

The expected improvement of foreign demand will increase the need for more investments

Although, the drop in gross fixed capital formation deepened considerably last year, investments have already passed the trough and the decrease slowed gradually in the second half of last year. As the growth of import of capital goods has accelerated, we expect the improvement of investments in the beginning of 2016. The business sector credit portfolio has been growing at a moderate pace for more than three years already. The business sector has deleveraged its peak debt of 2009-2010, and its debt-to-GDP ratio has been relatively constant in the past three years. Despite the drop in turnover and contraction of profits, the share of nonfinancial corporations' nonperforming loans in the total credit portfolio is decreasing, thus confirming their financial strength. Unfortunately, together with the increased labour costs, the investment ratio has gradually been falling. We expect that the very low interest rate environment will persist in 2016-2017, supporting lending for investments. However, improved demand, as well as an increase in prices, is a precondition for a recovery of investments without a decrease in business sector profits and profitability. In 2016 and 2017, the government is expected to use more EU funds in its investments, while household investments in dwellings should continue its moderate pace.

Prices will rise again in 2016

Modest inflation is expected in 2016. Prices of energy have decreased more than expected, caused by an oversupply of commodities globally. Changes in tax policy will push prices higher by an estimated 0.7 percentage point, as the excise tax on alcohol, tobacco, and fuels will be lifted and the value-added tax (VAT) exemptions reduced. Services, excluding transport services, will also become more expensive as strong wage growth will continue. In 2017, price growth will accelerate as prices of commodities in the world markets will recover somewhat and excise tax rates will be lifted again.

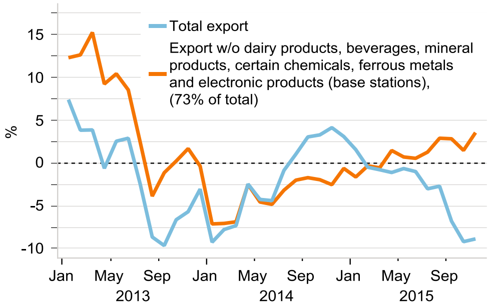
Labour market might loosen up somewhat

In 2016-2017, employment is expected to fall because of a lower supply and demand of labour (due to investments in machinery). Employment is expected to decline in a few export-related sectors that have been struggling with low demand and/or export prices. A state reform will reduce the number employed in the public sector. A cutback in the number of public workers and the reorganisation of the social benefits system for the disabled (forcing them to find jobs) will lift the number of unemployed, at least temporarily. Registered unemployment figures have exceeded last year's level since September 2015.

The major downside risk is related to Russia, while the upside risk could come from the European market

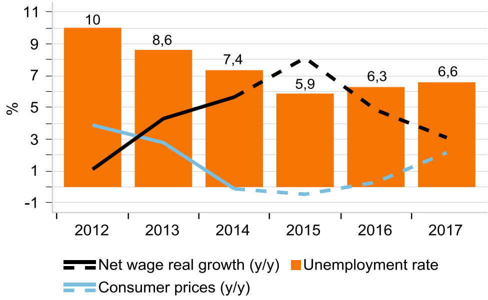
Helped primarily by the recovery of exports and investments, GDP growth in Estonia is expected to accelerate from last year's 1.2% to 2.3% this year and to 2.6% in 2017. GDP will be below potential during the forecast period, while the expected decline in employment, as well as the reduced investments and labour productivity over the last few years, will afford less capacity to grow in the medium term. There are both upside and downside risks to the forecast. The upside risk comes from the European market, where the delayed effect of the ECB expansionary monetary policy on the real economy could have a stronger-than-expected positive effect on economic activity. This, in turn, could offer more export possibilities for Estonian business sector. Also, the more sluggish recovery of global oil prices could have a stronger-than-expected positive effect on consumption and business sector costs. The major negative risk is related to uncertainties about the recovery of the Russian economy and unpredictability of its political decisions. More-sluggish-than-expected--or even fall- in -foreign demand and prices could have a negative impact on business sector finances, and this, in turn, could have a negative impact on both investments and labour market.

Estonia: Export annual growth, 3m MA



Sources: Swedbank Research & Macrobond

Estonia: Labour market indicators & inflation



Sources: Swedbank Research & Macrobond

Swedbank

Latvia: Cyclical upswing

We expect broad-based growth of about 3% to continue in 2016-2017. Although this is decent, at about potential, it keeps policymakers complacent. Yet, despite relatively good growth, income convergence with the euro area average has slowed. At the same time, a tightening labour market and recovery of credit growth might briefly boost spending and GDP growth to over 4%; this possibility has risen recently.

Key economic indicators, 2014-2017 [1/]

	2014	2015e		2016f		2017f	
Real GDP growth, %	2.4	3.0	(2.4)	3.3	(3.3)	3.0	(3.0)
Consumer price growth, %	0.6	0.2	(0.3)	0.8	(1.5)	2.3	(2.3)
Unemployment rate, % [2/]	10.8	9.8	(9.9)	9.2	(9.2)	8.3	(8.3)
Real net monthly wage growth, %	7.9	7.3	(6.7)	5.2	(4.1)	3.6	(3.6)
Current account balance, % of GDP	-2.0	-1.4	(-1.4)	-2.3	(-2.7)	-3.8	(-4.1)
General government budget balance, % of GDP [3/]	-1.6	-1.5	(-1.6)	-1.2	(-1.2)	-0.9	(-0.9)

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

Sources: CSBL and Swedbank.

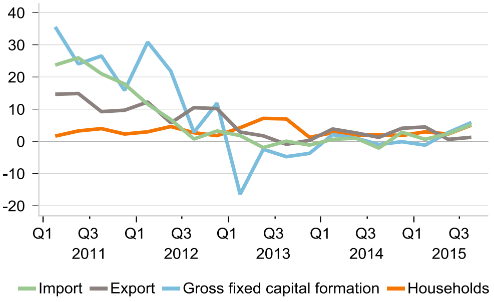
Broad-based consumer-driven growth in 2015

In 2015, we estimate GDP growth to have been at 3% (2.7% in the first three quarters). Although exports to Russia fell by the anticipated 25-30%, export and investment growth has been stronger than was expected a year ago. Exporters have been more agile in shifting to other markets, while the weak investments in the first half of the year seem to have picked up since then. Growth in 2015 thus was broad based, but the largest contribution still came from household consumption, driven by income growth and zero inflation.

About 3% growth in the coming couple of years

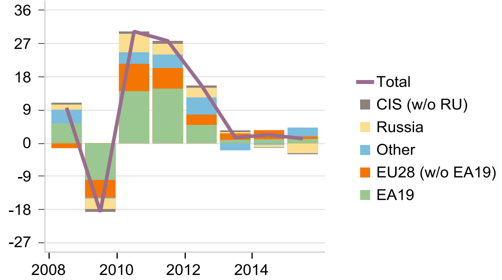
In 2016-2017, growth is forecast at about 3% per annum, i.e., close to potential. We expect growth to be broad based and the contribution from exports and investments to rise. Trade integration with Russia has declined and will continue to do so; as a result, the negative effect from a further Russian downturn will be minor, although (geo)political risks remain. Globally, possibly lower external demand growth is also a risk. On the other hand, upside risks to short-term growth have increased locally – with the business cycle maturing, a swifter heating up of the labour market, a recovery of credit growth, and improving optimism might cause stronger consumption and boost GDP growth to over 4% in the short term.

Latvia: Annual growth of GDP components (%)



Sources: Swedbank Research & Macrobond

Latvia: Contribution to goods' export annual growth (11M for 2015), pp



Sources: Swedbank Research & Macrobond

Exports to pick up, but labour costs raise pressure on competitiveness

Export growth is set to accelerate in 2016-2017, with the Russian effect fading away and external demand strengthening somewhat. In the first 11 months of 2015, goods exports to Russia fell by 25% and to other CIS markets by 7%. However, this was more than outweighed by exports to other countries – up by 2.3% to the euro area, up by 3% to other EU countries outside the euro area, and by 19% to other countries (including farther markets in Africa, Asia, and the Americas). As a result, nominal goods exports were still 1.2% higher than a year ago. The share of Russia in goods exports fell below 8%, the lowest since 2005. The performance of services exports was even better than that of goods – transportation services suffered due to Russia, but tourism and other commercial services grew notably (especially IT, intellectual property, financial, and insurance). The flexibility of Latvian exporters is encouraging, but rising labour costs are gradually biting into competitiveness, as seen in flat or inching-down export market shares in the EU. Productivity growth keeps lagging behind that of wages.

Investments to pick up gradually, but EU funding support will still be small

This makes investment growth crucially important, both to reduce competitiveness risks and to promote future growth. On the positive side, businesses understand this, and their investments picked up in the second half of the year, most of the contribution coming from machinery and equipment. On the negative side, the distribution of EU funds from the 2014-2020 period is still delayed. Two years have passed, but out of the EUR 4.4 billion allocated to Latvia from the Cohesion Fund, ESF, and ERAF, contracts have been signed only for EUR 285 million (6% of total), of which the largest part has been assigned for road maintenance and State Employment Agency programmes (e.g., improving skills of unemployed). Authorities have been very slow in setting up an administrative framework, so programmes for businesses are expected to become available only towards the end of this year, supporting investment growth in 2017. This year, government budget financing for education and science, which has been mostly from EU funds, is planned to be substantially lower than in 2015. Construction of residential buildings and road maintenance in 2016 is likely to remain at levels similar to 2015; however, there is a big shortfall in public (e.g., infrastructure) projects. Meanwhile, the Rural Development Programme was finally launched at the end of last year (EUR 1.1 billion to be allocated in the 2014-2020 period), so we expect larger investments in agriculture this year. We also anticipate businesses to continue investing in machinery and equipment, even without EU funds. We forecast GFCF to continue picking up in 2016-17.

Inflation driven by administrative measures in 2016, but still very moderate

Global oil prices have kept falling and we now forecast substantially lower prices also this year (yet another fall of about 25-30% in euro terms). Global food prices are expected to grow only marginally in euro terms. As a result, we anticipate consumer price inflation to remain very weak, at 0.8%, of which about 0.5 percentage point is due to excise tax hikes for fuel and alcohol, and the introduction of a value-added tax for housing management services. We anticipate consumer price growth to pick up to about 2% in 2017, owing to recovering commodity prices and domestic price pressures (due to rising labour costs).

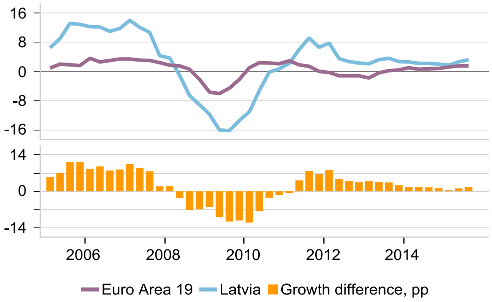
Strong wage growth to continue…

The labour market outlook remains largely the same as before – labour supply will continue falling, and employment growth will be marginal. Unemployment will continue declining, to about 8% in 2017. Finding employees is becoming more and more challenging, and, thus, wage growth is to remain strong, at about 6% for nominal gross wages. There was another minimum wage hike of 3% as of January 2016, but this is much smaller than in 2014-2015. With inflation rising, purchasing power growth will decelerate gradually but remain robust.

… supporting household spending

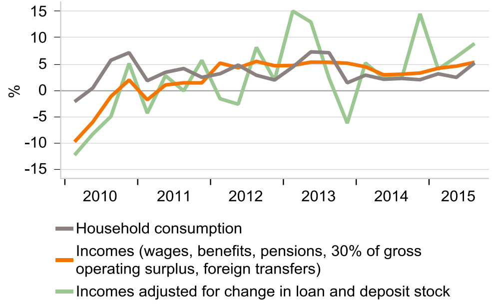
Household consumption remained rather cautious last year, that is, somewhat slower than income growth. There was a pickup in spending growth in the third quarter of 2015, but retail data do not suggest a turnaround yet. The fourth quarter seems to be weaker than the third one – annual growth of retail volumes, excluding fuel, decelerated to 2.6% in October-November from 4.8% in the third quarter (4.4% in 11 months). Household deposits keep growing. New lending for households grew by over 20% in the first nine months of 2015, but the loan portfolio was still down by 5%. We forecast household spending to pick up a bit this year, owing to continuous strong income growth, weak inflation, growing new lending, and robust consumer confidence. With inflation increasing, household consumption growth is expected to decelerate in 2017 but still remain above 3%.

Latvia: GDP annual growth, %



Sources: Swedbank Research & Macrobond

Latvia: Income & consumption annual real growth



Sources: Swedbank Research & Macrobond

Growth at about potential, but income convergence has slowed

The government budget deficit has been largely in line with the plan in 2015. Economic growth has been somewhat stronger than in Estonia and Lithuania and is still more rapid than in the euro area. Public finances are in reasonable shape for now. Politicians remain quite complacent, and, sadly, we do not expect any major reforms going forward, especially given the muddle with forming the new government (the previous government resigned in December, although it is still acting until the new one is elected). At the same time, we do not expect major change in economic policy direction, as the government will most likely be created of the same parties, and some of the previous ministers will continue. Without a will for reforms, income convergence will be rather slow. The growth differential between Latvia and the euro area has diminished to about 1.2 percentage points in 2014-2015. Converging by 1 percentage point per year would bring Latvian incomes to the euro area's average by about 2050. This "progress" is clearly too slow to reduce emigration risks.

Lithuania: Investments sizzling, finally

After last year's seismic shifts – exports of Lithuanian goods to Russia shrank by 50% – GDP growth is set to double in 2016, before cooling off somewhat in 2017. This is due not only to increasing purchasing power and confidence of consumers, but also to a long-awaited pickup in business investments. Upcoming parliamentary elections have encouraged the government to embark on a spending spree, further stimulating growth, but at the cost of a larger budget deficit.

Key economic indicators, 2014-2017 1/

	2014	2015f		2016f		2017f	
Real GDP growth, %	3.0	1.7	(1.8)	3.3	(3.3)	3.0	(3.0)
Consumer price growth, %	0.1	-0.9	(-0.8)	2.0	(2.5)	3.0	(3.0)
Unemployment rate, % 2/	10.7	9.2	(9.3)	8.1	(8.1)	7.4	(7.5)
Real net monthly wage growth, %	5.1	5.6	(5.5)	4.8	(4.3)	2.8	(2.8)
Current account balance, % of GDP	3.6	-1.9	(-2.6)	-2.3	(-2.8)	-3.0	(-3.5)
General government budget balance, % of GDP 3/	-0.7	-1.0	(-1.0)	-1.5	(-1.5)	-0.5	(-0.2)

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

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

In the third quarter of last year, annual GDP growth accelerated to 1.7% and probably was above 2% in the final quarter. Despite a negative global sentiment at the beginning of this year, we see little reason to be worried about the prospects for the Lithuanian economy. We keep our forecast for 2016 and 2017 unchanged at 3.3% and 3.0%, respectively.

Growth bottomed out in 2015, but trade deficit will continue widening

Last year was slightly better in one aspect – trade remained balanced and managed to avoid slipping into deficit. This was due to the strong growth of exports of goods to the European Union—these were up by 6.1% during the first 11 months of last year (in nominal terms). Despite challenging times for the transport sector, exports of services increased by 4.8%. All in all, exports of goods and services avoided contraction and, in real terms, were 0.6% higher last year, compared with 2014.

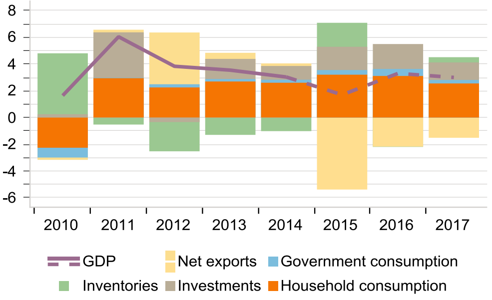
We expect a normalisation of the growth of exports (but not to Russia or other CIS countries) – it is expected to accelerate to 4.0% and 5.0% this year and the next, respectively. However, robust consumption and investment growth will boost imports, and the trade deficit is set to widen to 2.3% in 2017. Due to smaller remittances and investment income, the current account was already in deficit last year, and the gap is projected to widen from 1.9% of GDP in 2015 to 3.0% in 2017. The current and capital accounts, however, will be close to balance throughout the forecast period.

Poland has been implementing iffy policies, with costs and benefits for the Lithuanian economy

The new Polish government has embraced very iffy economic and social policies, which in some cases have even been borderline destructive. The consequences were quick – the European Commission has started to investigate whether Poland has undermined the rule of law and the principles of democracy, Standard & Poor's has cut Poland's rating by one notch and assigned a negative outlook, and its long-term debt costs have soared; meanwhile, the zloty has fallen to its lowest level in almost five years.

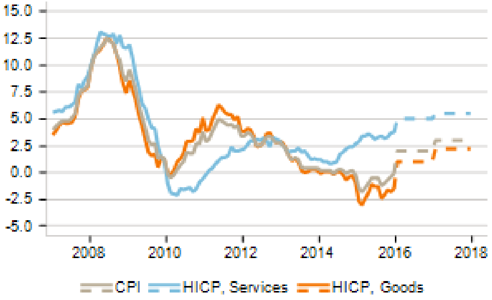
Poland is the second-largest export market for Lithuanian manufacturers (behind only Germany), so nobody wants this market to become unpredictable and protectionist – one Russia is plenty, thank you. The bad news is that the cheaper zloty may encourage some Lithuanians to go shopping in Poland – the practice was quite widespread during the crisis in 2009. On the other hand, in the ongoing competition for foreign direct investment inflows, Lithuania and the other Baltic countries have a big boost – Poland will probably be off the list for many foreign investors.

Lithuania: Contribution to annual GDP growth



Sources: Swedbank Research & Macrobond

Consumer prices, annual change



Source: Swedbank Research & Macrobond

Despite oil slump, inflation will pick up in 2016, but so will wage growth

Oil prices fell more and will stay lower than previously expected; thus, we adjust our inflation forecast from 2.5% to 2.0% in 2016 but keep it unchanged at 3.0% in 2017. After last year's deflation, this may seem like an unwelcome drag on household consumption, but fast price growth is expected, mainly due increasing wages and, consequently, prices of services (a long-overdue process, let's admit). Wage growth is being accelerated by the somewhat unsustainable hikes in the minimum wage – it will increase by 17% this year. But the lack of skilled labour translates into a more broad-based wage growth across many sectors.

In the short term, this is good news for households-- consumption is expected to grow by 4.7% in 2016 and has plenty of potential to surprise on the upside. Wage growth is expected to accelerate to 6.5% this year and remain robust in 2017. Part of the 2016 spurt is related to the 17% increase in the minimum wage, which will add 1.4 percentage points to the average wage. Many public sector employees will also, for the first time since the crisis, enjoy rising wages. So far, consumption has grown on the back of increasing wages and employment, but households are reacquiring their taste for credit. The consumer loan portfolio started growing only in the summer of last year and in November it was 3.9% higher than a year ago. The trend is likely to continue this year – credit is cheap and confidence is improving.

But, amidst the accelerating wage growth, one needs to keep an eye on productivity and the potential loss of competitiveness. Since 2013, wage growth has been exceeding gains in productivity, and the trend will continue this year. However, employment growth will stall in 2017 (mainly due to the aging society), and output per employee is expected to grow slightly faster than real wages.

Investments seem to be recovering and will provide much-needed boost to productivity

A pleasant surprise last year was the accelerated growth in investments. Despite geopolitical uncertainties and collapsing trade with Russia, investments in fixed tangible assets during the first three quarters of last year were 10% higher than a year ago. Growth accelerated in the third quarter and, we expect, will stay strong this year. Growth was driven by the private sector. Productive investments – acquisition of equipment, machinery, and transport vehicles – increased by 16%.

Companies are well positioned to increase their financial leverage and invest

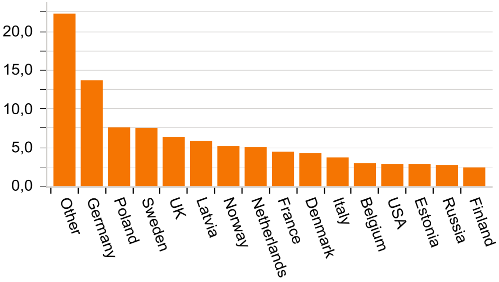
This year and the next, investments will be supported not only by the favourable lending conditions and low interest rates, but also by the rising inflows of EU structural funds and the very healthy corporate balance sheets. In general, companies are well positioned to take risks – the debt-to-equity ratio is just above 70% and is close to the all-time lows. Retained earnings increased to EUR 12 billion (one third of GDP) in the third quarter of last year and are well above pre-crisis highs. Profits in 2015 were slightly below pre-crisis highs, but cash on balance has already reached record highs and is ready to be invested.

Budget deficit will probably miss the target this year, but no cause for worry

Government consumption is expected to increase by 3.0% this year, and the budget deficit will most likely rise to 1.4% of GDP, a bit higher than the forecast of the Ministry of Finance (1.2% GDP). Last year, national budget revenues were 2.3% higher than expected, partly due to a smaller shadow economy and less smuggling. Value-added tax (VAT) revenues were still 3.1% behind the plan, which appeared to be too ambitious, but revenues from other main taxes exceeded the plan.

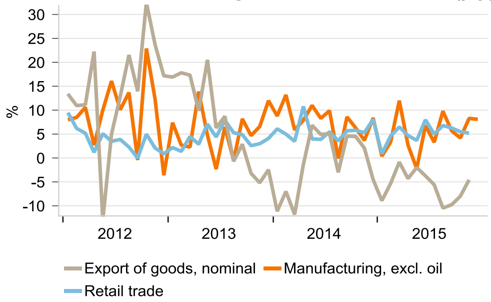
The government assumes that tax administration will continue to improve this year; however, this is not a certainty. Incentives for illegal trade are likely to increase as excise duties for tobacco and alcohol will rise this year. The National Audit Office of Lithuania expressed doubts about the assumptions behind the revenue plans, including the dividends from state-owned enterprises. Next year, the budget deficit should decrease by 1 percentage point of GDP; however, we do not expect a balanced budget during the forecast horizon. We do not think that the current state of public finances is unsustainable – even if the risk scenario materialises and growth falls well behind the forecast. More worrisome is the complacency with the status quo and chronic lack of structural reforms. Nothing new here.

Lithuania: Share of LT-origin goods export (without oil)



Sources: Swedbank Research & Macrobond

Lithuania: Manufacturing, retail trade & export (y/y)



Sources: Swedbank Research & Macrobond

Appendices

I. The Estonian outlook

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

	2014	2015f		2016f		2017f	
Real GDP growth, %	2.9	1.2	(1.6)	2.3	(2.6)	2.6	(2.8)
Household consumption	3.6	5.0	(5.2)	3.8	(4.0)	3.0	(3.5)
Government consumption	3.0	1.5	(1.5)	1.5	(1.5)	2.5	(2.5)
Gross fixed capital formation	-1.8	-5.8	-(3.5)	2.0	(3.0)	5.0	(5.0)
Exports of goods and services	1.8	-1.5	-(1.5)	2.0	(2.5)	4.0	(4.0)
Imports of goods and services	1.4	-2.4	-(2.0)	2.6	(3.5)	5.0	(5.0)
Consumer price growth, %	-0.1	-0.5	-(0.4)	0.3	(1.6)	2.2	(2.5)
Unemployment rate, % [2/]	7.4	5.9	(6.6)	6.3	(6.9)	6.6	(6.8)
Real net monthly wage growth, %	5.7	8.1	(7.4)	4.9	(4.3)	3.1	(3.7)
Nominal GDP, billion euro	20.0	20.4	(20.6)	21.3	(21.6)	22.5	(22.9)
Exports of goods and services (nominal), % growth	1.4	-3.0	-(3.0)	1.4	(1.9)	4.6	(4.4)
Imports of goods and services (nominal), % growth	0.0	-3.7	-(3.4)	2.1	(3.0)	5.7	(5.5)
Balance of goods and services, % of GDP	3.4	3.8	(3.4)	3.2	(2.5)	2.4	(1.7)
Current account balance, % of GDP	1.0	2.4	(2.2)	0.8	(0.7)	0.0	-(0.2)
Current and capital account balance, % of GDP	3.1	6.5	(5.6)	3.4	(2.8)	1.8	(0.9)
FDI inflow, % of GDP	5.9	0.0	-(1.9)	3.3	(4.6)	4.0	(4.4)
Gross external debt, % of GDP	94.7	90.0	(89.7)	85.4	(84.5)	81.0	(80.1)
General government budget balance, % of GDP [3/]	0.7	0.7	(0.3)	-0.2	-(0.2)	0.0	(0.0)
General government debt, % of GDP	10.4	9.9	(10.0)	9.6	(9.7)	9.4	(9.4)

1/ November 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	2015		2016f		2017f	
Real GDP growth, %	2.4	3.0	(2.4)	3.3	(3.3)	3.0	(3.0)
Household consumption	2.3	3.4	(2.8)	4.2	(4.0)	3.5	(3.5)
Government consumption	4.9	2.6	(2.1)	1.6	(1.6)	2.3	(2.3)
Gross fixed capital formation	0.5	2.7	(1.5)	7.0	(7.0)	10.0	(10.0)
Exports of goods and services	3.1	1.8	(1.8)	4.0	(4.0)	4.0	(4.0)
Imports of goods and services	0.8	2.5	(2.3)	6.2	(6.0)	7.0	(6.8)
Consumer price growth, %	0.6	0.2	(0.3)	0.8	(1.5)	2.3	(2.3)
Unemployment rate, % [2/]	10.8	9.8	(9.9)	9.2	(9.2)	8.3	(8.3)
Real net monthly wage growth, %	7.9	7.3	(6.7)	5.2	(4.1)	3.6	(3.6)
Nominal GDP, billion euro	23.6	24.5	(24.5)	25.8	(25.8)	27.3	(27.3)
Exports of goods and services (nominal), % growth	2.3	2.3	(2.5)	5.1	(5.7)	5.5	(5.0)
Imports of goods and services (nominal), % growth	0.6	1.6	(2.3)	6.9	(7.6)	8.4	(7.9)
Balance of goods and services, % of GDP	-2.2	-1.8	(-2.1)	-2.8	(-3.2)	-4.5	(-4.9)
Current account balance, % of GDP	-2.0	-1.4	(-1.4)	-2.3	(-2.7)	-3.8	(-4.1)
Current and capital account balance, % of GDP	1.2	1.8	(1.7)	0.3	(-0.1)	-1.0	(-1.4)
FDI inflow, % of GDP	1.9	2.9	(2.9)	3.1	(3.1)	3.1	(3.1)
Gross external debt, % of GDP	141.5	142.1	(139.1)	138.6	(135.3)	136.3	(132.4)
General government budget balance, % of GDP [3/]	-1.6	-1.5	(-1.6)	-1.2	(-1.2)	-0.9	(-0.9)
General government debt, % of GDP	40.8	36.2	(37.5)	38.3	(37.1)	37.7	(36.4)

1/ November 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	2015		2016f		2017f	
Real GDP growth, %	3.0	1.7	(1.8)	3.3	(3.3)	3.0	(3.0)
Household consumption	4.2	5.0	(5.0)	4.7	(4.5)	3.8	(3.8)
Government consumption	0.4	2.0	(1.5)	3.0	(2.5)	1.5	(1.5)
Gross fixed capital formation	7.0	9.0	(6.5)	9.0	(7.0)	6.0	(6.0)
Exports of goods and services	3.3	0.6	(0.0)	4.0	(4.0)	5.0	(5.0)
Imports of goods and services	3.2	7.5	(6.0)	6.5	(5.5)	6.5	(6.5)
Consumer price growth, %	0.1	-0.9	(-0.8)	2.0	(2.5)	3.0	(3.0)
Unemployment rate, % [2/]	10.7	9.2	(9.3)	8.1	(8.1)	7.4	(7.5)
Real net monthly wage growth, %	5.1	5.6	(5.5)	4.8	(4.3)	2.8	(2.8)
Nominal GDP, billion euro	36.4	36.9	(37.0)	38.8	(39.1)	41.1	(41.5)
Exports of goods and services (nominal), % growth	0.7	-3.3	(-3.0)	3.0	(7.0)	9.0	(8.0)
Imports of goods and services (nominal), % growth	-0.2	-0.9	(1.0)	5.0	(8.0)	10.0	(9.0)
Balance of goods and services, % of GDP	1.9	0.0	(-1.3)	-1.5	(-2.0)	-2.3	(-2.8)
Current account balance, % of GDP	3.6	-1.9	(-2.6)	-2.3	(-2.8)	-3.0	(-3.5)
Current and capital account balance, % of GDP	6.3	0.2	(-0.2)	0.3	(-0.3)	-0.2	(-0.8)
FDI inflow, % of GDP	0.7	1.0	(1.0)	1.5	(1.5)	2.0	(2.0)
Gross external debt, % of GDP	70.6	77.3	(71.3)	74.6	(68.7)	71.1	(66.0)
General government budget balance, % of GDP [3/]	-0.7	-1.0	(-1.0)	-1.4	(-1.5)	-0.4	(-0.2)
General government debt, % of GDP	40.7	42.9	(43.0)	41.0	(40.7)	42.9	(42.0)

1/ November 2015 forecast in parenthesis

2/ According to Labour force survey.

3/ According to Maastricht criterion.

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