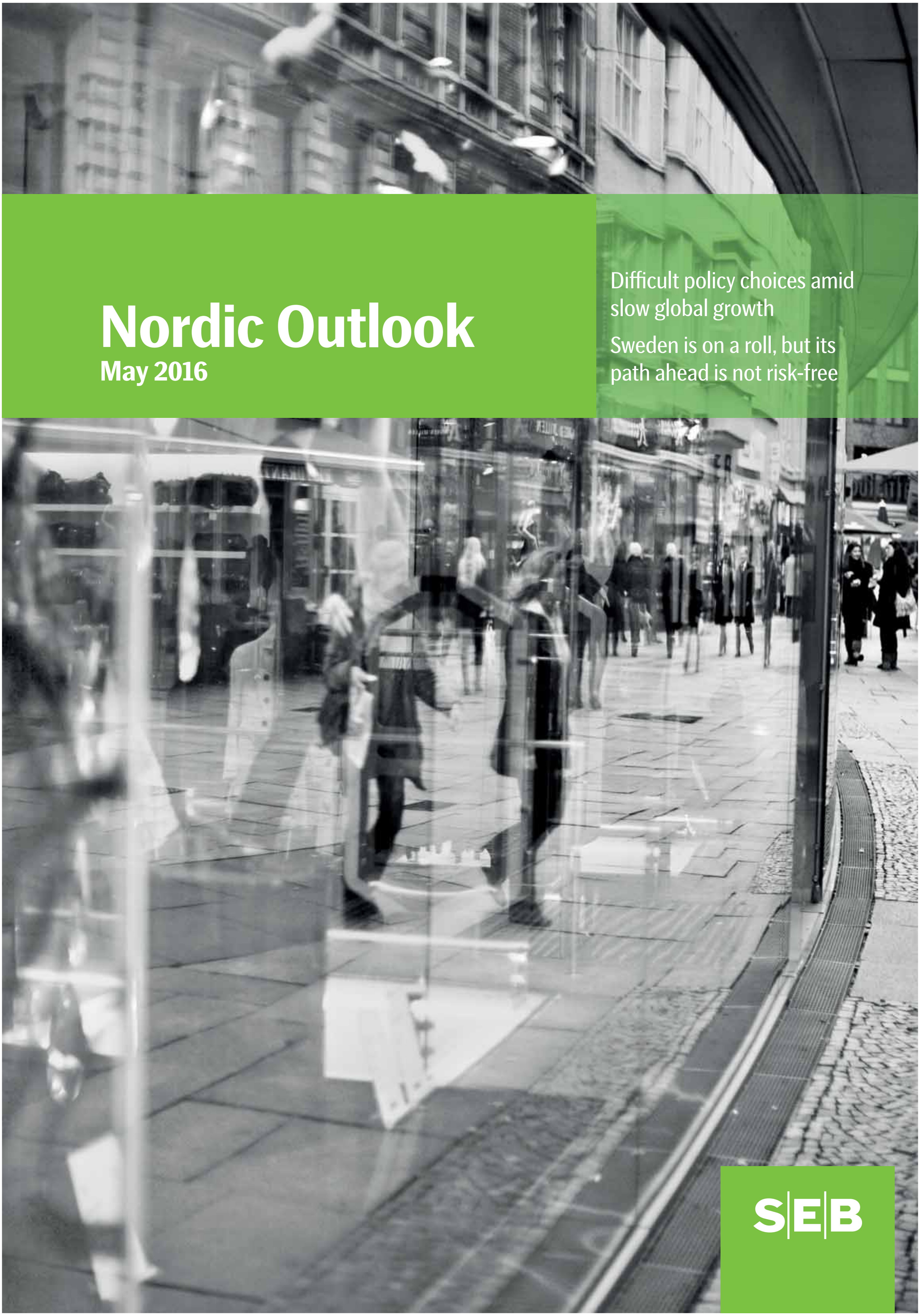
Nordic Outlook

May 2016

Difficult policy choices amid slow global growth

Sweden is on a roll, but its path ahead is not risk-free



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Difficult policy choice due to sluggish global growth

- **Growth outlook for 2016 revised downward**
- **Commodity rebound easing downside risks**
- **Monetary policy near the end of the road**
- **Cautious Fed rate hikes to 1.25 per cent**
- **Limited potential for stronger US dollar**
- **Riksbank hike in 2017 due to strong growth**

So far this year, global economic performance has been mixed. A slump in manufacturing had an impact on first quarter gross domestic product (GDP) figures, which were generally disappointing. This was especially true in the **United States**, where the pattern of a weak start to the year was repeated. In the **United Kingdom**, weakness may also be connected to uncertainty ahead of the June 23 referendum on continued European Union membership. Meanwhile **euro zone** GDP growth surprised on the upside. The **Chinese** economy is being squeezed by low capacity utilisation and housing market imbalances, but its deceleration is following forecasts rather closely. Many emerging market (EM) economies are hampered by low commodity prices and structural weaknesses. The **Swedish** economy has shown continued strong growth, driven by rising residential construction and extra public spending on refugee resettlement, and to some extent by the weak krona.

We have lowered our global GDP growth **forecast for 2016 to 3.1 per cent, compared to 3.4 in February's *Nordic Outlook***. This means we no longer expect growth to be higher than in 2015. But at the same time as we have adjusted our forecasts downward, **various sources of concern from early this year have at least partly diminished**. Oil prices have rebounded somewhat from exceptionally low levels early this year, contributing to a general reduction in financial market volatility and a recovery for many stock markets and currencies in emerging economies. Industrial activity has stabilised recently, and fears of a manufacturing-led US recession have dwindled. Worries about a global downturn initiated by China, for example due to a sharp devaluation, have also faded. These are among the reasons why we are sticking to our forecast that global growth will accelerate to 3.7 per cent in 2017.

The world economy thus still seems to be in a situation where central banks can repeatedly **calm outbursts of financial market turmoil and avert direct recession threats**, but where **growth remains troublingly anaemic and fragile**. Given such sluggishness, there are especially good reasons to discuss the problems underlying the state of the world economy – for example, risks of "secular stagnation" due to ineffective monetary policies or changes in the ability of central banks to influence inflation. There are also long-term risks associated with zero or negative key interest rates, including those due to swollen balance sheets and widening wealth gaps. This *Nordic Outlook* will thus focus extra attention on these issues, among other things in several theme articles.

Global GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
United States	2.4	2.4	1.9	2.5
Japan	0.0	0.6	0.5	0.5
Germany	1.6	1.7	1.7	1.8
China	7.3	6.9	6.5	6.3
United Kingdom	2.9	2.2	1.9	2.3
Euro zone	0.9	1.6	1.7	1.8
Nordic countries	1.6	2.2	2.2	2.0
Baltic countries	2.8	1.8	2.6	3.1
OECD	1.9	2.1	1.9	2.3
Emerging markets	4.7	3.9	4.1	4.7
World, PPP*	**3.4**	**3.1**	**3.1**	**3.7**

Source: OECD, SEB * Purchasing power parities

Multi-dimensional policy challenges

Looking ahead, the concrete formulation of central bank normalisation policies will be dependent on an analysis of the response of the economy in three different stages:

- In the first stage, the question is how serious the short-term recession risks are, and **whether it is suitable at all to begin a monetary policy normalisation** that risks interrupting the recovery.
- Then the main question will be whether inflation reacts in a way that makes key rate hikes urgent. Most important is **how strong the link between resource utilisation and inflation is**, and to what extent globalisation, digitisation and other forces have made it harder to manage inflation.
- In a slightly longer time perspective, the path of rate hikes will be determined by **how the interest rate sensitivity of economies has been changed** by lengthy periods of exceptional stimulus measures, which among other things have led to swollen household, corporate and government balance sheets.

Definitive answers to such big questions are hardly likely to emerge during the next few years, yet the way that central banks and other actors approach these questions will be crucial to policy decisions. Our fundamental view is that in many respects, economic associations have changed and weakened, but predictions of major systemic shifts still often prove premature. Certain changes in the analytical framework of central banks are probably on their way, for example when it comes to their view of the need for international coordination (see the theme article “A new International Monetary System?” on p. 14) and the potential for influencing the inflation process. But it is difficult to detect any trend towards far-reaching reforms of the economic policy framework. **This also means that we do not see any strong reasons to** change the main features of our forecasts of central bank actions and financial market developments. **The US Federal Reserve will resume key interest rate hikes in September, and its federal funds rate will reach 1.25 per cent by the end of 2017**: 50 basis points (bp) lower than we had previously expected. The Bank of England and Sweden’s Riksbank will begin key rate hikes during the first half of 2017. Other central banks will deliver some additional stimulus measures, including a rate cut by Norges Bank in Norway and one by the Bank of Japan, as well as an extension of the European Central Bank (ECB)’s quantitative easing (QE) programme.

Government bond yields will slowly move upward from today’s levels. By the end of 2017, 10-year yields will be about 70 bp higher than today, **which means levels of about 2.40 per cent in the US and 0.80 per cent in Germany**. Lowered expectations about the Fed will decrease the potential for a stronger US dollar. **We predict that the EUR/USD exchange rate will move downward to 1.10 by late 2016.** After that, long-term valuation aspects will play a larger role, which will lead to a weak upswing during 2017. The krona will also appreciate slowly against the euro as rising resource utilisation in the Swedish economy has a larger impact on monetary policy; by the end of 2017 the EUR/SEK rate will stand at 8.70. Stock markets are now being depressed by economic uncertainty and by rapid downward adjustments in corporate earnings estimates, but our forecast of slightly stronger global economic performance – especially in 2017 – and continued very low interest rates again creates the potential for a cautious upturn.

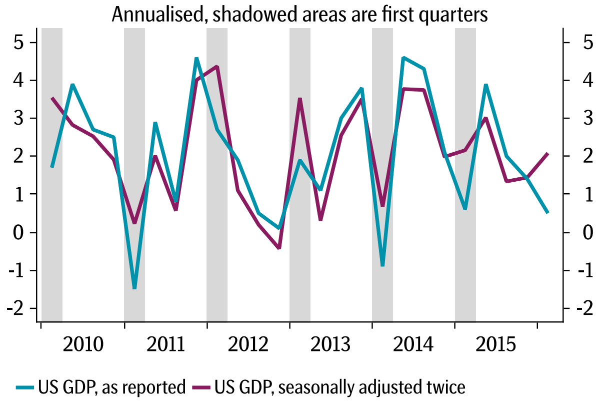
Meanwhile there are also growing questions about the long-term sustainability of the economic policy system. A little paradoxically, decades of economic and financial deregulation seem to have led to a situation in which the market economy’s dependence on policy decisions is greater than ever. Enormous central bank stimulus programmes have led to **increased difficulty in interpreting price signals in financial markets**. This not only applies to their general effects on asset prices, but monetary policy also seems to be increasingly formulated to address specific problems, for example in the lending system. In practice, central banks are thus taking over responsibility for decisions that normally occur in a decentralised way in the market, with **obvious risks of poorer resource allocation**. The boundaries between central banks and the political system also tend to become more fluid when monetary policy has such clear consequences in various fields. For example, monetary stimulus programmes have led to increased economic gaps that are hard to address by using traditional reallocation policies. Negative interest rates can be interpreted as a new type of wealth tax, which admittedly works in the opposite direction, but this further illustrates how the tasks of central banks and popularly elected political leaders are overlapping. Ultimately this may lead to greater difficulty in **gaining legitimacy for the principle of independent central banks with clearly defined areas of responsibility**.

Temporary US slowdown

GDP growth in the United States during the first quarter (Q1) was a mere 0.5 per cent at an annualised rate, raising the question of whether the US economy is facing a serious deceleration. This time around, it is difficult to single out any specific disruption, for example in the form of extreme winter weather or strikes, as an explanation. **Yet we still do not believe that this weak growth reflects the underlying status of the US economy**. For example, it is reasonable to ask how the seasonal adjustment system actually works, after seeing repeated Q1 disappointments. One method is to seasonally adjust the adjusted series as well (see the box in the US section). Using such a double adjustment, average annualised Q1 growth during the period 2010-2016 is 2.4 per cent, compared to 0.7 per cent in the official statistics. The corresponding 2016 figures are 2.1 and 0.5 per cent, respectively.

Is "residual seasonality" depressing Q1 growth?

Annualised, shadowed areas are first quarters



Source: Bloomberg, SEB

This indication that quarterly fluctuations are actually less dramatic is also consistent with our other analysis. Worries about a manufacturing-led recession have faded, and financial conditions have again eased as a consequence of the weaker dollar, among other factors. We thus expect growth to accelerate to 2.5 per cent during the second half of 2016, mainly due to a strong labour market and increasing wealth, which promise a stable upturn in consumption. But because of the weak first quarter, **we have revised our full-year GDP growth forecast down from 2.5 to 1.9 per cent**. We are also making a slightly more cautious estimate for 2017 and now foresee GDP growth of 2.5 per cent. Our forecast assumes that Hillary Clinton will win the November presidential election and that no major shift in economic policy will occur. In a theme article, we analyse various aspects of Donald Trump’s spectacular challenge to the established political system.

Brexit - bigger political than economic effect

In recent months the British economy has felt the impact of market worries about possible withdrawal from the EU – especially in the foreign exchange (FX) market. This spring, various actors have presented analyses of the consequences of Brexit. A box in February's *Nordic Outlook* presented our overall political analysis. We later illustrated various outcomes in three different scenarios. Here is a summary of our main conclusions:

We believe that the Remain side has a **65 per cent probability of winning** the June 23 referendum. If the Leave side wins, a scenario in which renegotiations persuade the country to stay in the EU is rather likely. Such a "soft Leave" scenario is relatively close to repeating the same pattern as in EU-related referendums in other countries over the past few decades and carries a **25 per cent probability**. This means that the probability of a "hard Leave" scenario, in which the UK actually withdraws from the EU, is only **10 per cent**.

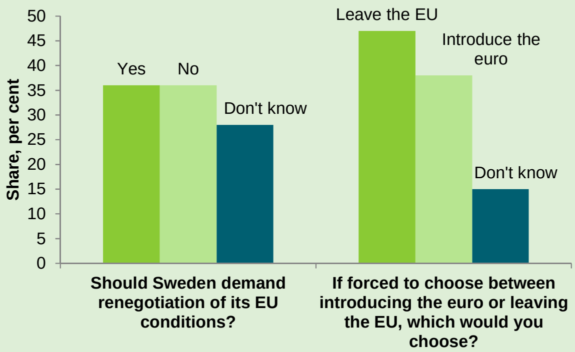
The economic consequences of a Leave outcome would probably be noticeable, though not dramatic. Right now many participants in the debate have adopted a strident tone. There is often **a temptation to dramatise the economic consequences of major political decisions**. Even in case of a "hard Leave", negotiations on new trade agreements would probably be pursued in a pragmatic spirit, reducing the risks of disaster. Looking ahead two years, we believe that a "hard Leave" would result in **nearly 2 per cent point lower GDP** in the UK and that the effect on the Nordic countries and the euro zone would be about half as large. This is consistent with the UK Exchequer's estimate of 6 per cent lower GDP in a 15-year perspective.

The financial consequences of a Leave outcome would also be obvious, and we have already seen a decline in the pound due to greater uncertainty. In case of a "hard Leave", the GBP would fall a further 5 per cent against the euro, whereas a relief rally would follow a Remain victory. The US dollar would be the winner against all European currencies in case of a Leave outcome. We believe that the krona would appreciate against the pound but weaken against the euro, due to greater uncertainty. We also estimate that **share prices on the London Stock Exchange at the end of 2017 would be about 20 per cent lower** in this scenario than in the Remain scenario. The corresponding difference elsewhere in Europe would be an estimated 10 per cent.

There would be major political consequences if the UK left the EU at a time of numerous other big challenges. The balance of power would shift in various ways. The EU would revolve much more around the euro zone, and other countries would be marginalised. Another consequence would be a weakening of the Northern European bloc (now including the UK, Germany, the Netherlands and Nordic EU members). This bloc fairly often acts jointly to defend various forms of liberalisation, but without the UK it would not have the critical level of 35 per cent of EU population required to block majority decisions. If the British leave the EU, the risks of internal divisions would increase. In Scotland, there is probably an overwhelming majority that favours remaining in the EU, and **separatism would gain new energy**. The situation in Northern Ireland would also be complicated, with an EU border dividing the island.

It is difficult to say whether British withdrawal would be the beginning of a collapse of the EU or whether the other member countries would close ranks. Regardless of the referendum outcome, however, the situation has already changed since the UK no longer embraces the EU's strategy of "ever closer union". This is a formal confirmation that **we no longer have European integration in two speeds, but also in two different directions**. For Sweden and Denmark, the conditions of EU membership would change. They would lose an important ally and role model when it comes to adopting a sceptical and cautious attitude towards the European project in general and its federalist, idealistic visions in particular.

Public opinion on the EU is divided



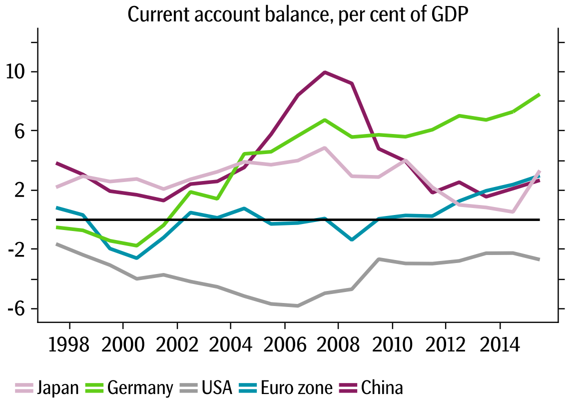
Unlike Denmark, Sweden has no formal right to stay outside the euro zone. We thus cannot rule out the possibility that we may be forced to choose between either introducing the euro currency or completely leaving the EU. According to a public opinion survey commissioned by SEB and carried out by Demoskop, 47 per cent of respondents state that in such a situation they would choose to leave the EU completely, while 38 per cent would prefer to introduce the euro. Since only 14 per cent of Swedes wanted to introduce the euro as their currency according to Statistics Sweden's latest euro sympathy survey in November 2015, we interpret these responses as meaning that **a relatively large number of Swedes think the euro is the price they are willing to pay in order to remain in the EU**. On the question of whether Sweden, like the UK, should demand renegotiation of its EU conditions, the Yes and No sides are even (36 per cent each), which may be interpreted as meaning that Swedes are not especially inclined to start a fight about the country's relations with the EU.

Recovery in Western Europe despite fears

Western Europe's economic performance has been relatively stable recently, and first quarter GDP growth in the euro zone was a surprisingly high 0.5 percent compared to Q4 2015 (equivalent to an annualised growth slightly above 2 per cent). Spain and Germany are growing at a relatively healthy pace, while France and especially Italy are lagging behind. Looking ahead, the economy will continue to grow somewhat above trend, with **GDP increasing to 1.7 per cent in 2016 and 1.8 per cent in 2017**. However, this represents a slight downward revision compared to our previous forecast. The ECB's expansionary policies are making a positive contribution, and low interest rates are benefiting both households and businesses. Meanwhile the banking sector, especially in southern Europe, is being weighed down by bad loans. This has a restraining effect on economic activity.

German surpluses illustrate global imbalances

Current account balance, per cent of GDP



Source: IMF

Political developments seem more worrying. The refugee crisis has illustrated the European Union's inability to jointly deal successfully with acute issues. Combined with economic austerity policies, this has paved the way for populist and EU-critical political forces and may, in the long term, further undermine the ability of the EU to act. There is also uncertainty about the UK's choice of European policy and possible contagion in case of a British exit from the EU ("Brexit"). But we are sticking to our view that the short-term **economic effects of a breakdown in the Schengen system of borderless travel are relatively small**, since they do not actually affect the fundamental principle of free mobility within the EU.

There is a clear trend towards greater tensions between Germany and other euro zone countries and institutions in their views on economic policy. These are rooted in the fundamental problems that a currency union always struggles with – accentuated by the fact that today's interest rates and exchange rates are not suitable for German conditions. Although they stimulate growth, adverse effects such as rising home prices and a financial squeeze on the pension industry are becoming more apparent. Negative interest rates are also considered especially exasperating in an economy with a strong tradition of bank savings. Germany's criticisms of the ECB's actions are becoming increasingly loud: something of a historical paradox, since it was Germany that stubbornly advocated ECB independence. The country's current account surplus has now reached 8 per cent of GDP. This also has global dimensions, since the US Treasury has now put Germany on its watch list for potential currency manipulators. This also fits into Donald Trump's rhetoric about how the US economy suffers from the unfair practices of other countries.

Pressures on EM sphere easing somewhat

Emerging market (EM) economies played a key role in global financial market turbulence early this year, and the downturn in foreign exchange and stock markets was especially apparent in the EM sphere. Commodity-exporting economies were particularly hard hit, and falling oil prices forced many oil-producing countries to sell off risky assets, with repercussions on global stock markets and currencies as well. Since bottoming out late in January, EM currencies and stock markets have recovered nicely as commodity prices have risen and as worries about developments in China have eased. **For example, SEB's weighted emerging markets foreign exchange index has gained about 8 per cent** since its low in January. In our view, this recovery is fairly stable, but there is still a risk that downward pressure on EM currencies will resume if commodity prices fall again, or if expectations of more aggressive US Federal Reserve policies return.

EM currencies are recovering

SEB Emerging Markets FX Index, Jan 2013 = 100

Source: Macrobond, SEB

The EM economic outlook is highly divergent. **India is continuing to benefit from low commodity prices and will show GDP growth of about 7.5 per cent both this year and next**. The slow pace of reforms will prevent even faster growth. **Our forecast of a gentle deceleration in China has been confirmed** by development in recent months. Fiscal and monetary policy easing has yielded results, and the situation in the housing sector has improved. We are sticking to our GDP growth forecast of 6.5 per cent this year and have revised our 2017 forecast upward to 6.3 per cent. In the short term there is room for upside surprises, although there are still structural downside risks connected to high indebtedness and low capacity utilisation. Among the other BRIC countries, we are now seeing a deep recession in **Brazil**, where GDP will fall by 3.5 per cent this year, whereas the GDP decline in **Russia** will slow to 0.8 per cent in 2016. But in various small and medium-sized EM economies such as Argentina, Mexico, the Philippines, Vietnam and Poland, growth is decent.

Risk situation somewhat more symmetric

Our view in February's *Nordic Outlook* that traditional recession risks were relatively small is supported by the latest statistics. This is especially true of the Chinese economy's response to looser economic policies and signals of improvement in the real estate sector. A global stabilisation in manufacturing activity has also lowered the probability of an industrial-led downturn, while rising commodity prices have helped decrease geopolitical risk.

Yet some elements of financial market pricing still indicate worries about recession, and **we believe that downside risks remain dominant**. Analysts' corporate earnings adjustments have occurred so quickly this year that they resemble recession behaviour. The political realm is weighed down by Brexit risk and uncertainty about the future global role of the US – both in terms of economic and security policies – due to the successes of Donald Trump. There are also lingering long-term questions about the Chinese economy. Finally, there are general downside risks connected to the low effectiveness and manoeuvring room of economic policies, as well as generally high global indebtedness.

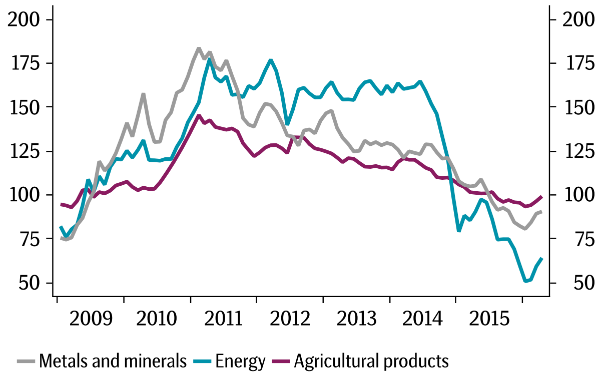
Upside potential is relatively small. In the US, our estimates indicate that saving is very high compared to underlying household financial strength, underscoring the potential for faster consumption growth. If elections follow our main forecast, relief rallies may be larger than we have predicted. Meanwhile it is also possible that pessimism about GDP trend growth and productivity growth has gone too far and that we will see a medium-term "ketchup effect" as digital advances are increasingly commercialised. Our overall assessment today is that the risk of worse economic performance than in our main scenario is 20 per cent, while the probability of a high-growth scenario is 15 per cent. In our February issue, the corresponding figures were 25 and 10 per cent.

Oil market is better-balanced

Partly due to diminished worries about a Chinese hard landing and a weaker USD, commodity prices have climbed on a broad front. Brent crude oil prices have rebounded to about USD 45 per barrel, compared to a low of USD 27/barrel in January. **The balance in the oil market has improved as production has reacted to the low price level.** In the first quarter of 2016, global oil production shrank for the first time in three years, mainly due to steadily falling output in the US. This trend has largely followed our analysis in February's *Nordic Outlook*, but balance has been restored somewhat faster than we expected. One reason may be that US shale oil producers have faced greater difficulties in attracting capital. This is also reflected in the number of active oil rigs in the US, which has not increased in recent months despite a steady price upturn.

Commodity prices are rebounding from lows

Index 2009=100

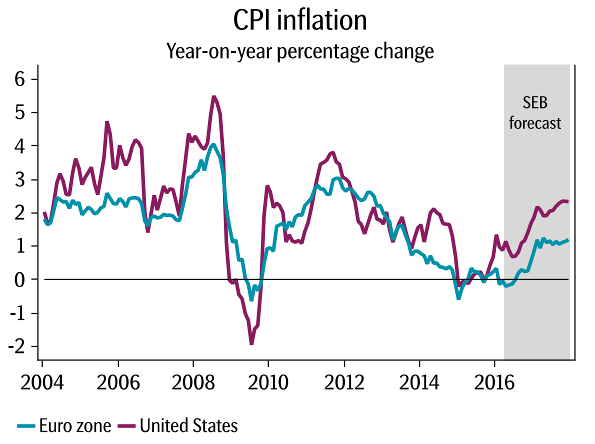


Source: The World Bank

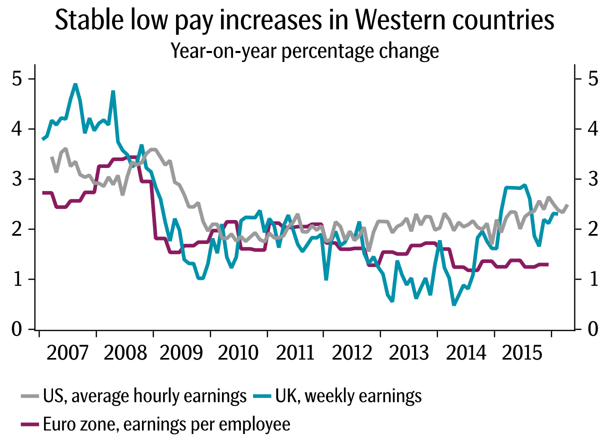
During the summer months, we are likely to see continued upward oil price pressure, driven by the seasonal upturn in automobile use: forward prices indicate that this effect will be unusually large in 2016. During the second half, there is potential for a relatively good balance in the oil market, although the pace of production is difficult to predict, especially in Iraq, Iran and Saudi Arabia. Global oil stockpiles are still far above normal, so **the potential for further price increases is small**. Shale oil output in the US would revive and cut short any rising price trend. We also believe that it will be difficult for oil producers to reach agreement on coordinated production cutbacks, either in the Organisation of the Petroleum Exporting Countries (OPEC) or in other producer constellations, for example including Russia. The long-term trend towards increased substitution opportunities for fossil fuels will also continue. Overall, we are sticking to our forecast that crude oil will be priced at USD 45 per barrel at the end of this year. We have slightly raised our forecast for the average 2016 price, from USD 40.0 to **USD 42.5/barrel, while our corresponding forecast for 2017 remains at USD 50**.

Weak wage response to tight labour market

In recent months, inflation signals have been mixed. Core inflation has surprised on the upside in the US and Sweden, while coming in somewhat lower than expected in the euro zone. Looking ahead, the oil price rebound will mean a short-term upward push in the total consumer price index (CPI). Food prices also rose early in 2016, which will eventually have an impact on consumer prices. We expect US inflation to become entrenched at slightly higher levels, among other things because service prices are now rising at around 3 per cent yearly and the labour market will become increasingly tight. Euro zone inflation will remain depressed and stay close to zero throughout 2016; the ECB will probably need to lower its inflation forecast further. Total CPI in the US will increase by **an average of 1.1 per cent in 2016 and 2.1 per cent in 2017**, while core inflation will be somewhat higher. Euro zone core inflation will be rather stable at around 1 per cent throughout our forecast period, while the annual **average for total CPI will increase from 0.1 per cent in 2016 to 1.1 per cent in 2017**.



Source: Eurostat, BLS, SEB



Source: Macrobond

The big question for the long-term inflation outlook is **whether tighter labour markets will contribute to higher wage and salary increases**, or whether this association (the Phillips curve) has broken down as a result of globalisation, digitisation or other factors. There are undoubtedly signs that the association has weakened when we review the situation in various countries. The clearest example is **Japan**, where the rate of annual pay increases is now below ½ per cent even though unemployment is at a low 3 per cent. Nor is any obvious wage and salary acceleration discernible in the Western world. **German** pay increases have sped up somewhat as a response to strained resource utilisation, but at less than 3 per cent the rate is uncomfortably low considering Germany's strong competitiveness and its ever-widening current account surplus. In the **UK** the rate of pay increases has fallen, after an upturn in mid-2015. In **Sweden**, unemployment is higher than in the large economies, yet labour market bottleneck problems are beginning to crop up. The just-completed national wage round confirms the perception that wage formation is relatively insensitive to variations in resource utilisation and that the response to these variations comes after a substantial delay.

But developments in the US will probably determine whether the economic policy framework will change as a consequence of new wage formation patterns. At present, our model-based estimates indicate that the labour market situation is still important. We thus believe that pay increases will accelerate to 3.5 per cent next year. Although there is considerable uncertainty about this, the Fed has time to wait and see. The central bank is unlikely to be especially eager to experiment with new approaches concerning the inflation process. Yet it is generally apparent that for various reasons, decision makers **view low pay increases as a problem**. Attempts by central banks, especially in Japan and Western Europe, to appeal to employee and employer organisations to speed up pay hikes have not borne fruit. We are instead seeing a growing trend towards **boosting legal minimum wages**, especially in English-speaking countries. The effect on average pay increases is unlikely to be very large, but this serves as another example of weakening confidence in the ability of market forces to create equilibrium and balance.

Negative rates with political dimensions

As expected, global monetary policy has become more expansionary in 2016, especially through the actions of the ECB. About **20 per cent of the world economy is operating under negative key interest rates**. Although inflation is rising as resource utilisation increases and energy prices stabilise, more central banks are having difficulty achieving their inflation targets within a reasonable period. **The interest rate normalisation process will thus move very slowly** – especially because the Fed, given the USD's role as a reserve currency – must take global conditions into account (see the theme article *"A new International Monetary System?"* on p. 14).

As ECB President Mario Draghi described the situation on May 2, 2016: *"Very low rates are not innocuous… There is a temptation to conclude that… very low rates… are the problem. But they are not the problem. They are the **symptom** of an underlying problem."*

It is obvious that **the "secular stagnation" concept**, which has been a recurrent theme in *Nordic Outlook*, has now reached the meeting rooms of monetary policymakers and is high up on the Group of 20 (G20) agenda. High global savings and a low inclination to invest are pushing down real interest rates and forcing central banks to adjust their nominal key rates downward. Given this interpretation, interest rate policy is **actually accommodative rather than proactive in the prevailing environment**. It is also becoming clear that fiscal policymakers have a major role to play in order to ease the burden on monetary policy.

Six countries or regions – Denmark, the euro zone, Japan, Switzerland, Sweden and Hungary **– have some form of negative key interest rate today**. As a result, a total government bond supply of about USD 10 trillion is being traded at negative rates. The unfavourable side effects of this are attracting a higher degree of attention. The consequences for the business models and profitability of financial institutions may, for example, hamper growth in countries where banks and pension companies are already being squeezed by demographics, regulation and continued debt restructuring.

Negative interest rates also have major political dimensions. In countries where interest-bearing savings accounts are more common than shareholdings, such as Germany, **negative interest rates may be interpreted as a "hidden tax on savings**". Negative interest rates are thus a slow method of bringing down excessive public debt by creating a transfer of capital from the private (mainly pension company) sector to the public sector. One positive effect may be that **economic inequality decreases**. Households with worse financial situations are not as hard hit by this form of capital transfer, while as consumers they can benefit from low interest rates and low inflation. But the method is not harmless. One important risk is that it provokes increased compensatory saving and thus leads to lower growth and fewer jobs.

Monetary policy is near the end of the road

Today the question is how much monetary policy ammunition is left. Technically, many central banks have not reached their lower limit for the key interest rate or their upper limit for expanding quantitative easing (QE). According to IMF estimates, there is room for further interest rate cuts; the IMF believes that the pain threshold for negative interest rates is in the range of -0.75/-2.00 per cent. But the IMF also points to existing problems which suggest that the limit of -0.50 per cent that many individual central banks have specified appears more likely. Central banks also seem increasingly worried about a weakened transmission mechanism. The final impact on growth and inflation via financial channels seems to have decreased. This indicates that most central banks have now reached the end of the road in terms of interest rate cuts, whereas the **technical pain threshold for new asset purchases** has probably not yet been reached.

Central bank key interest rates
Per cent

	Today	Dec 2016	Dec 2017
Federal Reserve (Fed)	0.50	0.75	1.25
European Central Bank	0.00	0.00	0.00
Bank of England (BoE)	0.50	0.50	1.00
Bank of Japan (BoJ)	-0.10	-0.30	-0.30
People's Bank of China	4.35	3.85	3.85
Riksbank (Sweden)	-0.50	-0.50	0.25
Norges Bank (Norway)	0.50	0.25	0.25

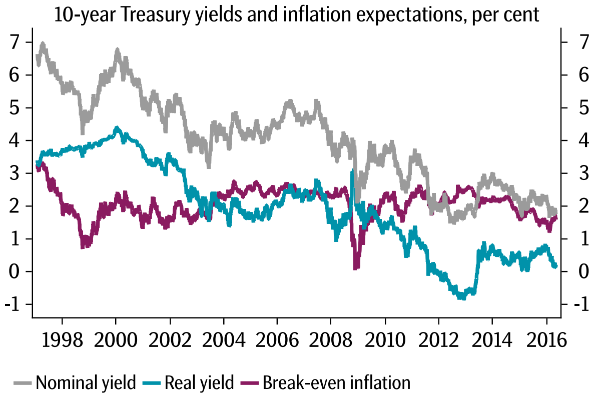
Source: Central banks and SEB

Looking ahead, we believe that the **Fed will hike its key rate in September** after a nine-month pause. Financial conditions have eased again. Meanwhile the labour market is becoming increasingly tight and inflation is on its way up. Next year the Fed will raise its key rate two more times, to 1.25 per cent late in 2017. This forecast carries a downside risk, since the burden may be too great in an environment where other central banks are expanding their stimulus programmes. **We expect the Bank of Japan to cut its key rate from -0.10 to -0.30 per cent during 2016**, while troublingly low inflation will continue to put pressure on the ECB. We believe the ECB will abstain from further rate cuts but extend its bond purchases past March 2017, though at a lower level. If its second round of cheap loans to euro zone banks (targeted long-term refinancing operations, TLTRO II) proves successful, however, soft loans may eventually play a larger policy role than QE. The **Riksbank** and **Bank of England will also carry out their first rate hikes during the spring of 2017**, while **Norges Bank will cut its key rate to 0.25 per cent** and then maintain this rate throughout our forecast period.

Yields will climb in fragile macro landscape

Long-term international bond yields have remained depressed. In the US, 10-year Treasury yields are about the same as before the "taper tantrum" in the spring of 2013, when the market first began to discount a phase-out ("tapering") of Fed stimulus policy. German 10-year government bond yields approached last year's historical lows just above zero when the ECB launched its QE programme. In Japan, 10-year government bonds are trading at negative yields.

US: Real yields stuck at around zero
10-year Treasury yields and inflation expectations, per cent



Source: Macrobond

The oil price rebound has helped push US break-even inflation a bit higher. Yields have nevertheless continued to fall since the beginning of 2016, illustrating **the strong downward pressure on real yields, which are now approaching zero again.** New economic growth reversals have reinforced an image of persistent central bank laxity and are putting continued downward pressure on bond yields. The market is expecting only one Fed rate hike before the end of 2017, and in Europe and Japan there are expectations of further stimulus measures; for example, the market is discounting one more small ECB rate cut by early 2017. In the euro zone, 10-year real yields are well below zero, reflecting expectations that interest rate policy must remain very expansionary for a long time.

We share the view that central banks will need to move very cautiously in an environment characterised by uncertainty about both the sustainability of the recovery and the interest rate sensitivity of economies. However, we believe that to some extent, the market is underestimating growth as well as the inflation outlook in the US, and thus **also the pace of future Fed rate hikes**. Long-term US yields will probably move cautiously upward as the next Fed rate hike in September approaches. We do not expect more rate cuts by the ECB but believe it will expand its QE programme until the end of 2017, though in a scaled-down version.

Our central bank analysis suggests that the spread between US and German 10-year government bond yields could widen further. But because of exceptionally depressed German yields, the current spread is historically wide. We thus foresee a high probability that German long-term yields will follow American yields upward, so that **the spread will remain around 160-170 basis points until the end of 2017**. In terms of levels, we predict that 10-year US Treasury yields will reach 2.00 per cent by the end of 2016 and then gradually rise to 2.40 per cent by year-end 2017. The corresponding German bond yields will be 0.30 and 0.80 per cent. Compared to *Nordic Outlook* in February, we have **revised our long-term yield path downward by 0.4-0.5 percentage points**.

Over the past six months, the yield spread between Swedish and German 10-year government bonds has widened to 60-70 basis points, on a par with the highest levels since the early 2000s. But during those periods, the Riksbank's repo rate was 75-100 basis points above the ECB's key rate, which indicates room for a narrowing margin in the short term. Late in 2016, however, it will be reasonable for the spread to begin widening again as the focus of attention shifts to future Swedish rate hikes. Given low Swedish bond liquidity, due to the Riksbank's purchases, it is also likely that Swedish yields will begin trading with a premium. Swedish 10-year bond yields will **thus climb from 0.85 per cent at the end of 2016 to 1.60 at the end of 2017. This is 55 and 80 basis points above the corresponding German yields, respectively**.

Nordics, GDP growth

Year-on-year percentage change

	2014	2015	2016	2017
Sweden	2.3	4.1	4.0	2.8
Norway	2.2	1.6	1.2	1.5
Denmark	1.3	1.2	1.5	2.2
Finland	-0.7	0.5	0.7	1.1

Source: OECD, SEB

In Norway, a front-loading of government bond issues has led to a supply-driven steepening of the yield curve. Norwegian 10-year yields are thus historically high compared to their German equivalents. Given the positive outlook for the krone – due to higher oil prices, a dovish bias by Norges Bank and falling bond supply – we believe that demand for Norwegian government bonds will increase ahead. We thus expect the 10-year yield spread against Germany to tighten **from around 120 bps today to 70 by the end of 2017, for a yield of 1.50 per cent**.

Currencies less central bank-driven

For decades, there has been a consensus among the world's major central banks that they should not directly try to influence exchange rates for the purpose of achieving competitive advantages. Yet aggressive stimulus measures in recent years by the ECB, the Bank of Japan and others have had as their clear secondary purpose to push up inflation and growth via the exchange rate, which has ultimately resulted in an increasingly strong US dollar. The negative side effects of dollar appreciation – such as downward pressure on commodity prices and higher costs for global USD-denominated borrowing, have become increasingly evident. **But since the G20 meeting in February, we are seeing signs that central banks are again moving towards a more cautious approach** and are trying to avoid escalating currency wars. In such an environment, long-term equilibrium exchange rates should play a larger part in events. The role of monetary policy as a dominant economic driver is weakening, as reflected in the smaller impact of recent stimulus measures on exchange rates than we were previously accustomed to. Looking ahead, however, major central bank policy moves are still likely to play an important role.

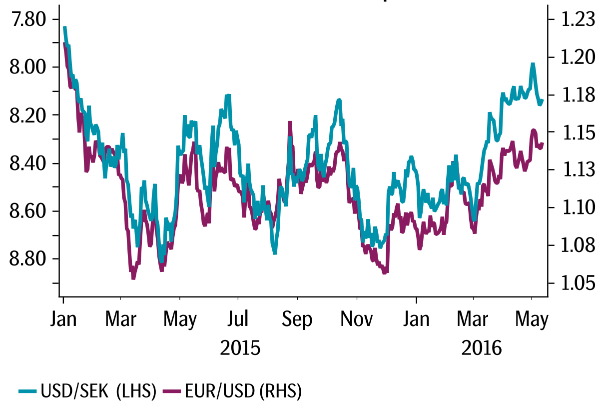
Because of limited room for further stimulus measures by the ECB, the EUR/USD exchange rate will be driven by expectations about the Fed as well as changes in global risk appetite. Our toned-down Fed forecast, including only one rate hike during the second half of 2016, means that the divergence between the Fed and other central banks will be less pronounced. We have thus lowered our forecast of the dollar's upturn. In the very short term, the EUR/USD exchange rate may continue to rise a bit: a movement also supported by repositioning among speculative market players. Looking a bit further ahead, however, we believe that a combination of a Fed rate hike, **somewhat stronger US economic growth and slightly better global risk appetite will drive the EUR/USD rate down to 1.10 by the end of 2016**. The dollar may possibly appreciate somewhat further early in 2017 before the EUR/USD rate rebounds towards its long-term equilibrium level, which we estimate at 1.20. But continued widening of divergences in monetary policies will restrain this movement, and the rate will reach no higher than 1.12 at the end of 2017.

Worries about a victory for Brexit supporters in the coming UK referendum have pushed down the pound since late 2015. Given our main forecast that the referendum will approve continued EU membership, there is thus room for a rebound in the British currency during the second half of 2016. The long-term outlook will be largely determined by the actions of the Bank of England. British unemployment is now at levels that have historically led to rising cost pressures and tighter monetary policy. If the country remains a member of the EU, there will thus probably be a cautious normalisation of monetary policy during 2017, which should benefit the pound further. **We expect the EUR/GBP exchange rate to be 0.75 at the end of 2016**, followed by a bit more pound appreciation during 2017. If the British vote in favour of leaving the EU, the pound will weaken both in the short and medium term. Although the scope of this downturn is difficult to predict, we regard levels around 0.82 to 0.85 as reasonable during the second half of 2016 given such a scenario.

The contradictory forces affecting the movements of the Swedish krona are growing in strength. Robust economic growth, a favourable flow situation and market positioning as well as long-term undervaluation suggest a stronger krona ahead. Offsetting this is the Riksbank's continued firm ambition to resist a krona appreciation by means of escalating monetary policy easing and by threatening FX market intervention. The direction is clear, but the timing and speed of the krona appreciation will depend on future Riksbank actions. At its April policy meeting, the Riksbank chose to expand its bond purchases, but we believe that a shift towards a more flexible interpretation of inflation policy is under way and will be made easier by continued strong growth and rising resource utilisation. Although there are many indications of small changes in the near term, we still believe that **the EUR/SEK**

rate will move towards 9.00 by the end of 2016. Next year a slow krona appreciation will continue, enabling the **EUR/SEK exchange rate to reach 8.70 by the end of 2017**.

Persistent correlation pattern



Source: Macrobond

Sharply lower oil prices in recent years have had a major impact on the Norwegian economy. Norges Bank has been forced to lower its key interest rate a number of times, and we expect further rate cuts during 2016. The Norwegian krone has weakened to the lowest levels we have seen in several decades, and the currency is now clearly undervalued. Given a stabilisation in both oil prices and the Norwegian economy, the krone will gradually recover. In addition, the flow situation has become increasingly favourable in recent years. The oil-adjusted deficit in the government budget totals more than NOK 200 million this year, which is being partly funded by petroleum revenue, but also by making use of the Government Pension Fund. This will result in net inflows that will benefit the NOK. We thus **expect the EUR/NOK exchange rate to fall to 9.10 by the close of 2016** and predict that the krone will continue appreciating to 8.50 per euro at the end of 2017.

Gloomy earnings outlook squeezes equities

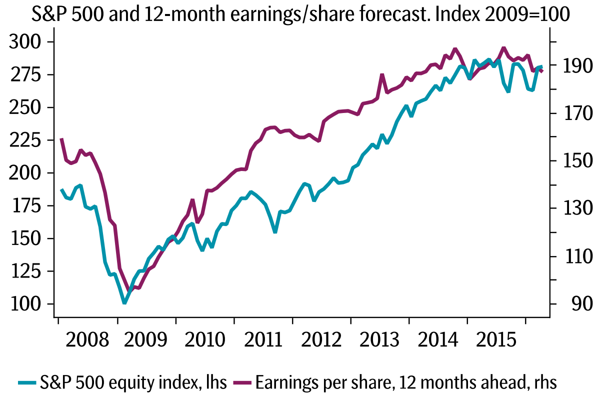
In recent years, falling oil prices and worries about Chinese economic growth have created recurring unrest on the world's stock exchanges. Although market reactions have sometimes seemed exaggerated, the stock market climate still reflects a generally more challenging environment **as the economic recovery has entered a more mature phase, while global valuations have climbed to more stretched levels**. In addition, central banks are unlikely to have much more room to sustain risk appetite with new stimulus measures. The Fed has begun its rate hiking cycle, though at an extremely slow pace. This also implies that any further stock market upturn from today's share price levels must occur primarily as a result of rising corporate earnings, and not through higher valuations. In this respect, early 2016 has been difficult; the pace of downward earnings revisions in the US has been unusually rapid and is more in line with what usually occurs during recessions.

In the short term, we believe that stock markets will remain mostly stagnant, while awaiting further evidence that the economy will continue to strengthen. **Disappointing growth figures and political events will create a risk of new reversals.** The upturn in world sentiment indicators ended in April, which is one reason why there are lingering questions about global manufacturing activity. A vote in favour of Brexit in the UK's June referendum might potentially lead to large stock market movements. So might an increase in the probability that Donald Trump will become the next president of the United States.

If our forecast that the US economy will regain momentum this year and that the global economy will accelerate in 2017 proves correct, **the corporate earnings outlook can again be expected to be revised upward, laying the groundwork for a renewed cautious upturn in share prices**. Because of low debt in large corporations and cheap loan financing, share buy-backs can be expected to continue making a positive contribution, but higher pay increases in the US – which will exert downward pressure on corporate margins – will be a limiting factor. Looking at the EM sphere, as earlier we foresee the best outlook in Asia, which will benefit from both better earnings prospects and lower political risk.

US: Downward earnings revisions hurting equities

S&P 500 and 12-month earnings/share forecast. Index 2009=100



Source: S&P 500

Nordic equities have a high exposure to oil and other commodity prices as well as to the global economic situation in general, both directly through oil companies and indirectly through suppliers of investment goods. We can thus expect a renewed acceleration in the world economy to be especially beneficial to Nordic equities. Meanwhile their valuations are in line with valuations elsewhere in Europe. Nordic equities are neither expensive nor cheap in a long-term perspective. Our forecasts imply that the MSCI Nordic index will reach 240 and the OMX30 index in Stockholm 1520 by the end of 2016, **equivalent to an upturn of 12 and 14 per cent**, respectively. If this potential upturn is to become a reality, markets will have to begin discounting our more optimistic scenario for 2017. Expected corporate earnings growth during 2016 is moderate: a total of 4 per cent in the Nordic countries and about 5 per cent in Sweden. A Nordic stock market rally will thus mainly be a theme for the latter part of 2016, while the short-term outlook is more modest.

Theme: A new International Monetary System?

- **Global monetary system now being re-assessed, in light of empty policy toolkits**
- **G20/G7 want to end unilateral FX market interventions and reduce dependence on US**

What happened at the **late February G20 meeting** of finance ministers and central bank governors in Shanghai? The communiqué revealed nothing new, yet based on speeches and actions before and after the meeting, the **G20/G7** seem to agree on **key conclusions** that influence the outlook for, and interaction between, global monetary and currency policies:
1. Secular stagnation is highly likely: today more countries share the same risks and large, growing policy challenges.
2. Monetary policy is at the **end of the road**. The transmission mechanism has weakened and **currency policy is not the solution** to global problems: the focus is now on fiscal policy.
3. Policy coordination is needed between major central banks; **global considerations** must be taken into account.

This consensus coincides with the launch this February – together with the G20/G7 – of an IMF research project to develop, improve and deepen the International Monetary System (IMS). A recent US Treasury report on potential currency manipulators also ties together the G20's conclusions with the need to renew the IMS. In 2016 the IMF will present conclusions on what needs to be done. Decisions are possible as early as the G20's September 4-5 summit in China.

What is the International Monetary System?

The IMS has three parts: **1. Rules/conventions** governing relations between countries, **2. mechanisms** that address and manage imbalances in case of crisis, and **3. institutions** that ensure that rules are followed and mechanisms work. The aim of the system is to support international trade and investments and reduce the risks of protectionism and financial instability. Since the **Bretton Woods system** collapsed in 1971, the contours of the IMS have weakened, although the US and the dollar have played dominant roles. The role of the IMF has varied over time but strengthened due to the 2008-2009 crisis.

Globalisation and financial integration have changed the monetary system, creating new dependence relationships and shifting the balance of power. The various countries whose **currencies enjoy global reserve status** also intend to either expand or reverse **unconventional monetary policies**. This raises the risk of global contagion via the IMS and otherwise limits the economic policies of smaller, vulnerable countries, especially if they are in different phases of the economic cycle.

The IMF and G20 have identified three main areas that may lead to changes in the IMS: 1. Management of **global capital flows** and potential for individual countries to **use foreign exchange (FX) market interventions** as a policy tool; 2. Ensuring the stability of the **financial safety net**; and 3. **the new role of Special Drawing Rights (SDRs)** in the IMS. Here are some thoughts about how these changes may look.

1. Volatile capital flows and interventions
Global imbalances remain large, and debt is troublingly high in many parts of the world. Asset prices are pumped up. This increases the risk of destabilising capital flows. A country whose currency enjoys global **reserve status** – today the dollar, euro, yen, pound and yuan – thus needs to take global considerations into account in implementing their monetary policies. These systemically important economies can expect especially **close monitoring** to ensure that they do not undermine the system. **In practice, the IMF already has such a framework in place but currently lacks real opportunities to influence the policies of individual countries**. The US has asked the G20 to establish a data-driven, objective analysis of national currency policies and their impact on other economies, especially since monetary policy is now at the end of the road. We expect it to become much harder for countries to use currencies as a tool, other than in exceptional cases (structural capital flows). One emerging principle is that countries should pledge to orient **fiscal/monetary policy towards domestic purposes by using domestic tools – not their currency**.

2. A stronger global financial safety net
In recent years, the IMF has gained stronger financial resources. Meanwhile the BRICS countries have built up funds that can be used to ensure both short- and long-term stability, and central banks have developed mutual liquidity "swap line" systems. More capital may perhaps be needed, but of greater importance is that various global institutions – the IMF but also the World Bank, BIS, WTO and FSB – can ensure effective **coordination** of their actions if stabilisation needs arise.

3. An enlarged role for SDRs in the IMS
SDRs, the IMF's currency basket – which will also include the Chinese yuan starting in October – may become **a new reserve currency** and anchor in a new IMS through expanded use. This could also enable countries to establish **currency systems** that relate to the SDR in a more objective way.

Today's IMS **is not well-adapted** to the dramatic events of the past 20 years or today's unconventional monetary policies – which include zero or negative interest rates and monetary expansion – due to concerns about national **economic policy sovereignty**. This worsens the outlook for far-reaching changes in the IMS.

- **Central banks accept secular stagnation but need more help from fiscal policymakers**
- **Supply side or credit market problem focus leads to different policy conclusions**
- **Competing theories force decision makers to make difficult choices**

With growth refusing to take off despite years of extremely loose monetary policy, some people are asking whether the economy has fundamentally changed. One increasingly accepted explanation is "secular stagnation" – an ambiguous concept that usually describes a situation in which not even zero interest rates are enough to generate full employment and the economy therefore runs the risk of becoming stuck in a rut. For some years, the IMF's recommendations have reflected fears of such a scenario. This thinking is now more explicitly starting to influence communication from central banks, as seen in speeches this year by both Fed Chair Janet Yellen and ECB President Mario Draghi – suggesting that these ideas may also have a more direct impact on their actions. But secular stagnation is not uncontroversial; other explanations for weak growth are based instead on problems on the supply side of the economy or on the role of the financial sector. There is thus reason to look more closely at these various schools.

Demand crisis with lessons from the 30s

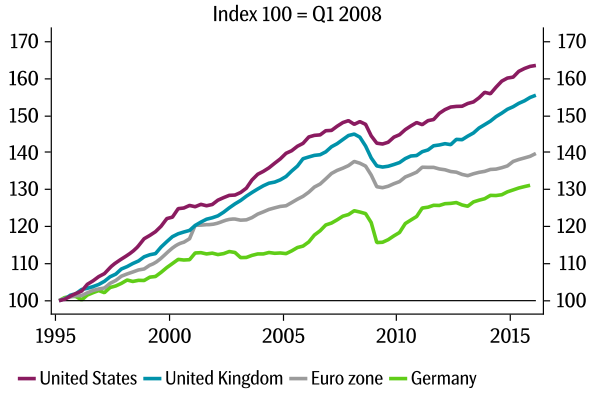
The secular stagnation concept is rooted in the 1930s but underwent a renaissance when former US Treasury Secretary Lawrence Summers used it in a speech at an IMF forum in late 2013. His analysis focuses mainly on the falling trend in real interest rates from high 1980s levels to the zero interest rates of today. This trend is clear and long-lasting ("secular"), not driven by cyclical factors related to the economy and central banks. Instead it reflects a **growing structural imbalance between excessive savings and insufficient investments**. Ageing populations in Western countries, falling confidence in the sustainability of welfare systems, growing income and wealth gaps and high household saving in EM economies have helped boost global propensity to save. Declining willingness to invest is explained by such factors as lower population growth in the West, which has reduced the need for housing construction, and a general decline in investment goods prices.

One outcome of equilibrium – or neutral – real interest rates around zero is that **conventional monetary policy cannot cope with fluctuations in the economy**, in any case **without building up new financial bubbles**, as occurred before the financial crisis. The economy also has little chance of pulling out of a slump on its own power. Given this interpretation of secular stagnation, the current situation resembles the Keynesian liquidity traps of the 1930s that Paul Krugman and other economists have described. **The policy solution is also 30s-like**, with expansionary fiscal policy as the most effective tool. Public infrastructure spending is a classic example, but another method is to boost the income of households with a high propensity to consume (often low income earners), for example by raising minimum wages. Measures that stimulate business activity – like corporate tax cuts or looser regulations – are other recipes, while structural reforms that push down household incomes and prices further are counterproductive.

Monetary policy may still have a role to play, roughly as we are now seeing with negative interest rates (according to Summers) or attempts to narrow credit spreads by purchasing private assets and lending to the banking sector, as the ECB is doing. An alternative method advocated by Krugman is to raise inflation targets, since the 2 per cent or so that central banks now aim for is not enough to push down real interest rates sufficiently low. Unless inflation targets are raised, concludes Krugman, even unconventional policy (QE) will be ineffective.

Wide gap to earlier growth trend

Index 100 = Q1 2008



Source: Eurostat, BEA

The supply side as a problem area

Another interpretation – represented by US economist Robert J. Gordon – is that the root of the problems lies on the supply side. Growth has decelerated because the working-age population is growing more slowly. Hopes that growth might be higher are based on **unrealistic assumptions about the underlying productivity trend**. US unemployment keeps falling despite a relatively modest GDP growth rate of around 2 per cent, a fact that supports this idea. As an example, Gordon cites disappointing productivity gains from the IT revolution, saying that such growth faded much faster than was the case during the industrial revolutions of the 19th century and early 20th century. In Gordon's view, rapid productivity growth during the period 1920-1970 was the exception, not the rule. After a temporary productivity growth peak in the late 1990s and early 2000s, the third digital revolution is now essentially over. If the problems lie on the supply side, the policy conclusions will be different. There is no easy short-term cure.

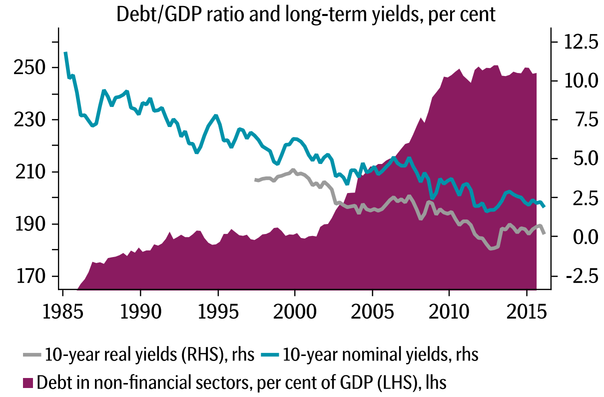
Instead it is necessary to invest in measures that can boost the labour supply and the underlying productivity growth trend. Key areas may include training programmes that raise the level of skills and reduce social exclusion, or measures that help increase actual retirement age or boost labour immigration.

The financial sector and monetary policy

A third school of analysis focuses on the role of the financial sector and the lingering harmful effects of the financial crisis. Harvard economist Kenneth Rogoff, for example, maintains that the slow recovery of recent years largely follows historical patterns after financial crises. This interpretation is optimistic in the sense that **once debt restructuring has been completed, there is good potential to revert to a higher growth trend**. In the wake of a debt-driven recession, policy-makers must strengthen banking sector balance sheets to make a recovery possible and to speed up the process. Without orderly balance sheets in the banking sector, monetary policy is rather ineffective. But according to this view, fiscal policy also has an important role to play in compensating for low private sector demand while debt restructuring is under way.

US: Falling long-term yields, rising debts

Debt/GDP ratio and long-term yields, per cent



Source: BIS, Macrobond

The dynamic between monetary policy and the financial sector is also analysed by the Bank for International Settlements, but BIS is more inclined to conclude that loose monetary policy itself is the villain. Pre-crisis financial excesses are behind slow growth both before and after the crisis, since excessively low interest rates have led to weak pressure for change and led to excessive allocation of financial resources to less productive economic sectors. As in Rogoff's analysis, monetary policy is ineffective as a crisis solution in an environment of debt overhangs and traumatised banking systems. The BIS' policy recommendation is to prevent credit excesses by means of high interest rates, a "leaning against the wall" policy, instead of cleaning up after bubbles have burst. The BIS' world view is notably different from secular stagnation. The supply side, not the demand side, should be supported by means of structural reforms. **Interest rates have trended lower due to recurring periods of monetary easing, which have caused indebtedness to trend higher in a similar way**. Since high debts are an obstacle to growth, both private and public sector balance sheets need to be trimmed, not pumped up further. Thus neither monetary nor fiscal policy offers a solution.

Is there actually any growth problem?

Finally a fourth school of economists is not at all worried about growth. Digitisation and technological innovations will boost the economy. Right now we are seeing rather mediocre growth, either because **statistics are not showing all improvements** or because **it takes time before new advances have a full commercial impact and thus become drivers of growth**. Policy challenges include risks of wider income gaps due to technological progress or higher unemployment, because the economy cannot create new jobs as fast as old ones disappear. The link between productivity growth and technological advances is discussed in our theme article on page 21 and is yet another question that may create headaches for policymakers. The Fed seems to have adopted a wait-and-see attitude towards this question, but Fed Vice Chair Stanley Fischer has said that available research does not support the contention that statistical problems explain falling productivity growth to any great extent. So far, the Fed is thus apparently not prepared to adopt a more optimistic view.

Difficult choices between growth risks

It is rather natural for economists to advance different theories about the state of the economy, but in a situation where the stabilisation policy toolkit is starting to run out, it is especially important to choose the right map and compass. The need for stronger banking sector balance sheets is uncontroversial and is something that even the ECB has finally come to grips with, but there is apparently no meeting of minds about how active official economic policies should be otherwise. So far, such policies have mainly been proactive, dominated by **worries that an unnecessarily long period of low resource utilisation will cause lasting damage to the economy** by pushing people out of the labour market and depressing the capital spending level, hampering future productivity growth. But meanwhile there is growing concern that measures which provide short-term relief may cause long-term problems. **BIS is not alone in warning about the downsides of low interest rate policy** and the importance of avoiding new credit bubbles.

If central banks are listening to secular stagnation ideas, it also means that they consider it important to continue helping sustain demand in the economy. Yet the ambivalence between different ways of thinking is reflected in the advice coming from the IMF this year. Countries are being urged to make structural reforms to support the supply side, but not ones that may lead to unfavourable short-term effects on demand or the inflation outlook. But most observers – except BIS – see a need to **expand the role of fiscal policy**. This is reflected in somewhat higher tolerance for deficits in countries with weak economies, but especially in calls for stimulus measures in countries with strong public finances such as Germany. Mario Draghi's appeal to Germany to choose between monetary or fiscal stimulus measures – but not to rule out both – is in this spirit. If low real interest rates are a symptom of weak demand, rather than a reflection of policy, this meanwhile implies that central banks should be **cautious about withdrawing stimulates programmes** before they are sure that inflation is moving their way. This also supports the slow pace of the Fed's rate hikes.

The slowdown is temporary

- **Strong consumption, but no boom**
- **An ever-tighter labour market**
- **Inflation is approaching Fed target**
- **Key interest rate will rise slowly**

The pattern keeps repeating itself. The first quarter was again disappointing in the US economy. But this year, the slump again has a good chance of being short-lived. Financial conditions, which tightened sharply early in 2016, are now as expansionary as they were before China's yuan devaluations triggered a market panic in August 2015. Business confidence indicators, led by the ISM manufacturing index, are pointing upward, also helping to calm the market's recession worries. Yet we are lowering our full-year forecasts, especially for 2016; **the economy will grow by 1.9 per cent in 2016 and 2.5 per cent in 2017**. Job growth has continued, but unemployment has remained fairly stable over the past six months. We do not believe that the trend towards rising labour force participation is sustainable, however. We are thus forecasting that **unemployment will fall to 4.4 per cent by the end of 2017**.

Inflation is moving higher. We expect core inflation to match the Federal Reserve's 2 per cent target in 2017. Even though the Fed will thus achieve its targets for both the labour market and inflation, we expect the central bank to hike its interest rates at a more leisurely pace than in our earlier forecasts. **The most important key rate will reach the 1.00-1.25 per cent range by the end of 2017**, which is equivalent to three rate hikes from today's level. The Fed's reaction function seems to be allowing a larger role for international developments and financial market stability. Meanwhile the Fed wants to avoid excessively sharp dollar appreciation. Other major central banks are continuing to loosen their monetary policies, which also justifies more cautious normalisation by the Fed.

Households are saving for a rainy day

By virtue of its size, household consumption remains the most important growth engine. A strong labour market is lifting incomes. As a net importer of oil, the US benefits from lower oil prices. Households are the biggest winners; **lower petrol (gasoline) prices represented a 1,000 dollar windfall for the average household in 2015**. But the much-anticipated consumption boom remains elusive, since households are continuing to sock away this extra budget supplement. The household savings ratio has climbed by half a percentage point during the past six months and stands at a three-year high. A model-based estimate – in which the savings level is determined by net wealth and household confidence – indicates that the savings ratio ought to be 2.5 percentage points lower than its actual level. This implies that there is major potential for higher consumption growth, for example if households start becoming confident that oil prices will permanently remain at lower levels.

Meanwhile both car sales and petrol consumption indicate that **lower oil prices have already had an impact on consumption patterns**. Car sales were record-setting last year, and large SUVs were among the winners. There consequently appear to be other factors that are holding back household spending. Earlier, we highlighted structural reasons. At an aggregate level, **net household wealth is at record levels. But its distribution is strikingly uneven**, which the Fed's research illustrates. The net wealth of the median household fell steeply during the Great Recession and has not recovered this loss; in 2013, the latest year covered in the Fed's study, the net wealth of the median household was at the same level as in the early 1990s. In terms of pay increases, the median household was also losing ground; between 2010 and 2013, median earnings shrank by 5 per cent to a 20-year low in real terms. The consequences of this long-term trend towards increasingly skewed wealth distribution, combined with the lingering scars of the 2007-2009 recession, are among the reasons why we are dialling down our consumption forecast a bit. **We estimate that household consumption will increase by 2.6 per cent in 2016 and 2.7 per cent in 2017.**

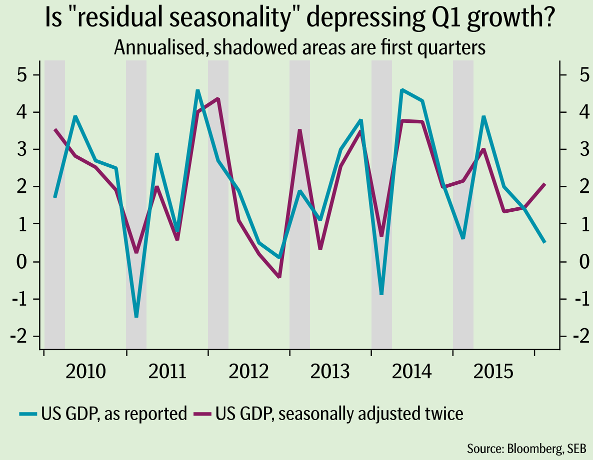
Rising inventories are a source of concern

Business confidence indicators are suggesting expansion even though the purchasing managers' index published by the Institute for Supply Management (ISM) eased somewhat in April. Both the new orders and export sub-indices show rising optimism, but this is not yet reflected in actual order statistics, which are still hampered by weak capital spending. **One source of concern is that business inventories are rising sharply in relation to sales**. This marks the end of the long-term trend towards leaner inventories. One explanation is that sales have fallen short of expectations due to weaker international demand. As indicated above, companies now seem to be undergoing a **classic inventory cycle, which has reduced growth in recent quarters and may also hamper growth in the near term**. According to business confidence indicators, however, a shift is under way. This is one reason why we do not regard the threat as so serious. American demand looks robust, as confirmed by the opinions of domestically oriented small businesses, which instead view taxes and regulations as their main reasons for pessimism.

Weak first quarter a statistical illusion?

In order to interpret short-term economic statistics, adjustments for normal seasonal and calendar variations are necessary. But in recent years, one recurring pattern has been that American GDP growth has been weakest in the first quarter and has then recovered. Such tendencies existed as early as the 1990s and 2000s, but the effect became much clearer in the 2010s. One explanation might be that the deep 2008-2009 recession left its mark on normal seasonal patterns. Other possible explanations may be weather-related effects and the ever-larger role of China in the world economy, considering that the Chinese New Year leads to massive disruptions in that country's Q1 statistics every year. One method is to seasonally adjust even seasonally adjusted time series. Using such double seasonal adjustments, GDP growth is clearly higher. Q1 averages for the past seven years are thus **2.4 per cent, compared to the official 0.7 per cent**. In 2016, **GDP growth in Q1 is an annualised 2.1 per cent** compared to the recently published **GDP figure of 0.5 per cent**.

Because the Fed is well aware of this problem, it is not paying so much attention to the year's growth slump, as the press release after its April policy meeting indicates.



Underlying near-trend growth is also a better match for the continued strength of the US labour market, implying that productivity is probably a bit stronger than the official statistics show.

Another worrisome indicator is that corporate earnings measured as a percentage of GDP have fallen in recent quarters. But last year's fall in energy prices, combined with earlier USD appreciation, seems to explain most of the decline. We do not believe this trend signals that a new recession is under way. Looking ahead, however, a continued squeeze on corporate earnings is likely to occur as higher pay increases redistribute income from employers to employees. Overall, **business investments will remain weak according to our forecasts, increasing by an annual average of 4.3 per cent in 2016-2017**. This is a clear downward revision compared to our earlier capital spending forecasts.

An ever-tighter labour market

The demand for labour remains strong. Job growth has averaged more than 192,000 per month this year, which is slightly below last year's average of 229,000. The number of job openings is close to record levels, and companies are doing everything they can to hold on to their existing workforce.

Earlier this spring, new applications for unemployment benefits fell to their lowest level since 1973. As the labour market becomes tighter, it is also becoming more difficult for companies to fill their vacancies. **Job growth will thus slow to an average of 180,000 in 2016 and 160,000 in 2017**, according to our forecasts.

Despite continued robust job growth, unemployment has fallen only marginally in the past six months. Instead, many people have been persuaded to re-join the labour market, and the participation rate has climbed appreciably. If participation had instead remained flat, unemployment would have stood at 4 per cent today. **A rising participation rate is good news for the Fed** and will decrease the pressure to hike interest rates, but the potential for a continued cyclical upturn in the participation rate is limited. Meanwhile downward pressure due to the ageing population is continuing. We thus believe that **unemployment will fall gradually to 4.4 per cent by the end of 2017**.

Fast pay increases in the pipeline

Rising wages and salaries in the future are still one reason why we believe that the Fed will move a bit faster than market pricing indicates. The recent bump in labour force participation has increased the competition for jobs, which in turn is helping to hold back pay increases. **Demographic factors are also helping restrain average hourly earnings**. Older, more highly paid individuals are leaving the labour force and are being replaced by younger, lower paid talents. Because of this structural effect, average hourly earnings normally show more modest pay increases than metrics that follow the same sample of employees over time (as the Atlanta Fed does). Today the difference between these metrics may well be a little bigger than normal, considering that rather large annual cohorts are now leaving the labour force.

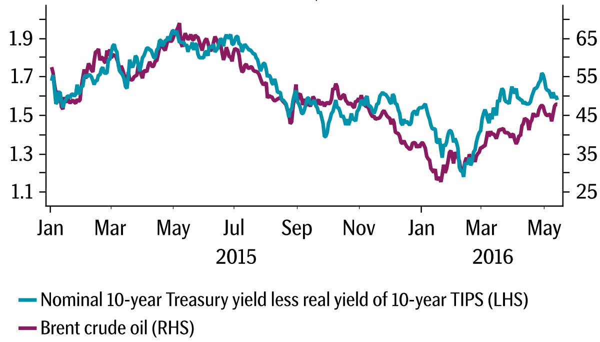
Average hourly earnings are the metric that is most relevant for the inflation process and are thus one focus of market attention. We also expect average hourly earnings to accelerate noticeably compared to current levels; **at the end of 2017 the yearly pace of increase will be 3.5 per cent, according to our indicator-based forecasts**. The upturn may possibly be even higher; if the acceleration prevailing so far during 2016 persists, the rate of increase will reach 3.5 per cent as early as December this year. Higher minimum wages are in the process of being introduced in many states; this will also contribute marginally to faster pay increases. Earlier this spring, for example, the state of New York decided to raise its minimum wage from today's USD 9 to USD 15 by 2018 in many cases. California has also decided to raise its minimum wage to USD 15, but at a slower pace and ending the process by 2022.

Inflation curves pointing upward

Both headline and core inflation has climbed steeply since last autumn. Unlike temporary inflationary impulses a few years ago, there are many indications that the **upturn will be more sustained this time around**. In the service sector, where domestic factors dominate pricing, the upturn is broad-based and shows 3 per cent increases. Since wages and salaries are expected to rise more rapidly in the future, a slowdown in service inflation is not in the cards. Meanwhile prices are flat in the goods sector, which is influenced more by subdued international demand and delayed USD appreciation effects. The price index according to the ISM manufacturing index has reflected increases in recent months, which supports this picture. **CPI inflation will average 1.1 per cent this year and 2.1 per cent in 2017 according to our forecasts**. CPI core inflation rates will be 2.1 per cent both years.

US inflation expectations rising more than justified by oil alone

Per cent, USD



Source: Bloomberg, SEB

Meanwhile core inflation using the personal consumption expenditure (PCE) deflator is the Fed's main focus. After having flat-lined last year, core PCE inflation also climbed, reaching a year-on-year rate of 1.6 per cent in March. Even though core inflation is thus approaching its target, the **Fed is still sceptical about the upturn**. We see several conceivable reasons for the Fed's caution; its inflation forecasts have been too optimistic in the past, while certain metrics of inflation expectations are still at excessively low levels. The inflation expectations of households remain stable, according to the University of Michigan survey. Meanwhile pricing in the Treasury inflation-protected securities (TIPS) market indicates that inflation expectations have climbed since February more than the oil price upturn justifies. This indicates rising expectations for core inflation as well. **Year-on-year PCE core inflation will reach 1.5 per cent at the end of 2016 and 2.0 per cent at the end of 2017**, which is also relatively well in line with the Fed's forecasts.

Fed will proceed cautiously

After having begun its interest rate hiking cycle in December 2015, **the Fed chose to send more gentle signals and to scale down the pace of its expected rate hikes** as a response to global economic worries – mainly related to China – and the tightening of financial conditions caused by last winter's financial market turbulence. In the past month or two, however, worries about the Chinese economy have eased, while financial conditions are back at very expansionary levels. The Fed also noted this trend at its latest policy meeting, opening the door slightly to a rate hike as early as its policy meetings in the next few months. In order to hike interest rates at its next meeting in June, however, the Fed would require positive economic signals across the board. The meeting will take place before the UK's "Brexit" referendum, another reason why a June rate hike is unlikely. We are thus sticking to our forecast that **the next rate hike will occur in September**.

Although the Fed is already close to fulfilling its official monetary policy targets with regard to inflation and employment, we believe that **its rate hiking cycle will be even flatter than in our earlier forecasts**. The trend of financial conditions is important to the timing and pace of the rate hikes. One the one hand, monetary policy tightening is needed in order to reduce overheating risks in the labour market. On the other hand, this spring's experiences show how sensitive global financial markets are even to minor changes in Fed policy. Our main scenario is **that the Fed will successfully communicate and gain market support for its September rate hike** and thereby manage to deflect a new wave of market turbulence. But after that, the Fed will abstain from further rate hikes during 2016. It is clear that nowadays, international conditions and financial market stability also play a self-evident role in the Fed's reaction function. For various reasons, the Fed also wants to **avoid major USD appreciation**, which may occur automatically if the monetary policy divergence between the world's leading central banks becomes too wide. A strong dollar hampers American exports and slows inflation, but perhaps even more importantly it increases devaluation pressure on the Chinese yuan and squeezes emerging market countries that have USD-denominated debts. Our forecast is thus that **the federal funds rate will end up in the 0.50-0.75 per cent range at the end of 2016 and 1.00-1.25 per cent at the end of 2017**. Although the market is only pricing in one rate hikes by the end of 2017, we still believe that the risks in our interest rate forecast are on the upside.

Theme: Trump victory risks trade wars and recession

- **Clinton favoured, but Trump has a chance**
- **A handful of states will decide the election**
- **Unrealistic economic policy programme**
- **Blurry boundary between ideology and populist rhetoric**

When the candidates began campaigning last year, it was hard to foresee that real estate magnate Donald Trump would win the Republican primary battle. But by painting a dark picture of today's United States and offering drastic solutions, Trump has managed to formulate a protectionist message that many Americans find attractive. Among betting firms, Democrat Hillary Clinton is a clear favourite in the November presidential election, but Trump's chance of winning seems to be rising.

We also regard Clinton as the clear favourite, yet we estimate Trump's chances at 35-40 per cent. Opinion polls usually become fairly reliable only after the party conventions. The principle that the biggest vote-getter in a state wins all its electoral votes also means that national surveys may be misleading. In most states, one party traditionally enjoys a large majority; the outcome often ends up the same regardless of the candidates. A handful of states are thus crucial to the election result. Right now the polls indicate an even match in certain "swing states", making the outcome more uncertain. Florida and Ohio, for example, are likely to hold the balance.

Trump's economic proposals seem both dramatic and out of touch with reality. He wants to simplify the tax system and cut taxes by USD 12 trillion over a 10-year period. He argues that higher economic growth and closed loopholes will make these tax cuts self-funding, but this type of dynamic effects is usually overestimated. The federal deficit would probably soar. Trump's campaign promise to pay off the entire national debt within eight years, while protecting the social insurance system, makes his programme even more unrealistic. One example of Trump's budgetary logic is that he would cut defence spending, at the same time as the defence system would become stronger. He would achieve this by forcing US allies to shoulder greater responsibility, including paying the costs of American troops stationed abroad. Continued United Nations membership and the general global role of the US should also be re-assessed and changed, according to Trump.

Protectionist currents are strong in both major parties today, but **for Trump this has been an especially powerful source of votes. China and Mexico have been his main whipping boys**. He proposes 45 per cent tariffs on Chinese goods and 35 per cent on Mexican ones; if these countries responded with tariffs on US goods, **the consequences would be trade wars and a high recession risk**. Trump's anti-free trade rhetoric is partly a populist tactic, but it is also rooted in his ideological convictions. Today he is aggressively attacking the North American Free Trade Agreement (NAFTA), but he was already loudly criticising it when it was signed in 1992. Instead of new free trade pacts, his model would be short-term bilateral agreements on a more ad hoc basis. Trump's mantra is that his deal-making skills would result in more advantageous trade treaties. The power of a US president is substantially greater in such fields as trade and foreign policy than in areas like fiscal policy. This is worth noting when assessing the probability that various elements of his policies might be implemented.

Having nailed down the Republican nomination, Trump is likely to try to **appear more presidential in order to attract new voter categories**. Today 80-85 per cent of blacks and Hispanics have a negative view of Trump. In the population as a whole, the figure is 66 per cent. Yet a widespread distaste for the US political establishment and a clear majority of people who also have a negative view of Clinton imply that Trump's chances are far from hopeless. Also benefiting him is that voters tend to prefer a change of parties in the White House.

Trump's success has taken the Republican establishment by surprise. At worst, internal disagreements and divisions may **hand the presidency to the Democrats on a silver platter for years to come**. The party convention in Cleveland this July may be raucous; many people find it hard to see Trump as an ideological Republican. Yet the latest indications are that more and more people are prepared to tolerate him as a candidate, despite not giving him their explicit support. By continuing to trim away his roughest edges, Trump may also make it harder for his opponents within the party to actively work against him.

We can also take a broader view of how a candidate like Trump could get so close to the White House. In modern times, there have been two similar Republican challenges to the establishment. Barry Goldwater's arch-conservative campaign in 1964 proved disastrous, amid the triumphs of the American civil rights movement. In 1980, when Ronald Reagan campaigned against high taxes, growing bureaucracy and clumsy economic policies, he was widely perceived as an extremist – especially in Europe – but his policies eventually had a global impact lasting for decades. Trump's extremist programme is unprecedented, but his success is definitely based on having tapped into important underlying popular currents. Events in Iraq, Syria and elsewhere have increased public distrust of the interventionist US foreign policy model. Trump can also benefit from the inability of the political establishment to address the side-effects of globalisation, in the form of trade imbalances and political disorientation among its losers. Looking ahead, if these currents were channelled into more rational political programmes, they would be more difficult to dismiss as pure populism.

- **Low productivity growth has several conceivable contributing causes**
- **There is little risk that we are in a permanent state of low productivity growth**

Productivity is one of the most central concepts in economics. It has been said that *"productivity matters little in the short run, but in the long run it is the only thing that matters."*

Having high productivity – getting as much GDP as possible out of the production factors applied – is important to a country, since it allows the freeing up of resources that can raise people's living standards. **High productivity and increased human welfare thus almost go hand in hand.** What is usually defined as a country's productivity is the labour productivity, i.e. production (GDP) per unit of labour that is used. Labour productivity can then be broken down into a factor measuring human capital development (competences and skills), the amount of productive capital (so called capital deepening) plus a common factor: total factor productivity, which measures technological progress. The latter cannot be measured directly but can only be estimated as a residual. Aside from measuring productivity to get an idea of the pace at which our living standard improves, productivity estimates also provide vital information for assessing capacity utilisation in the economy, which in turn can be used to estimate inflation pressure.

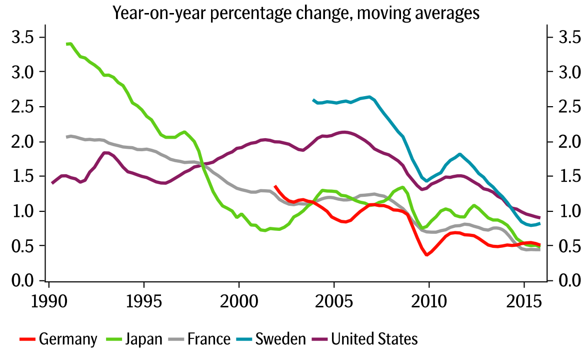
In the long run, productivity is closely connected to technological development and innovations, but in the short run it is also a key component of economic performance. Productivity normally surges early in a cyclical upturn when idle capacity is placed in service, enabling production to increase without the need for new hiring or machinery purchases. Similarly, productivity falls during a cyclical downturn, since businesses do not cut back their workforce and capital stock as fast as they cut production. To obtain an accurate picture of the underlying trend, we must therefore study how productivity changes over a longer time period.

Downward trend in productivity growth

Since productivity over time is usually regarded as an overall indication of the degree of technological development and innovations, it is a mystery why the information technology (IT) and internet revolution that we have seen in the past 10-20 years is not reflected in the form of rapidly rising productivity. On the contrary, the trend of productivity growth in many advanced economies – such as the United States, Europe and Japan – is rather discouraging.

Lower productivity growth in recent years

Year-on-year percentage change, moving averages



Source: OECD

Is low productivity growth here to stay?

One of the biggest pessimists when it comes to the future outlook for productivity and growth is the American economic researcher Robert J. Gordon. He views the slowdown in productivity growth since the mid-1970s as a reversion to a more normal situation. In fact the rapid economic growth and productivity improvements of the 19th and 20th centuries are the anomaly. In addition, many advanced economies are now struggling against a kind of structural headwind because of such factors as high indebtedness, unfavourable demographics and wider income gaps that deter growth. Hoping that high productivity growth will offset this is too optimistic. The rapid technological progress of the past 200 years has probably been driven by a number of lucky one-off events that are unlikely to be repeatable in the future. Nor can the IT and internet revolution measure up to such earlier game-changing innovations as electricity and the steam engine. In a historical perspective, this revolution appears to be of minor importance since it only managed to accelerate economic and productivity growth for less than 10 years starting in the mid-1990s.

Although Gordon's opinion is far from mainstream, similar arguments are gaining the attention of more and more economists. In particular, the theory of "secular stagnation" has picked up many adherents in recent years. For those who are not persuaded by the above arguments, another possible explanation for low productivity growth – especially during the years after the financial crisis – is that capital spending growth has been low. Employees who are not able to benefit from the latest technology by means of sufficiently fast growth in capital stock have trouble maintaining high productivity growth.

Productivity a problematic welfare metric

Despite low productivity growth statistics, many people still think this is inconsistent with their own perception of how productivity has changed, both at work and elsewhere. One explanation for this discrepancy may be that our way of measuring productivity is simply incapable of capturing what is actually happening in the economy. One classic objection traditional productivity metrics (especially when they are being used to measure whether things have improved for us) is that they only record paid work. Only production that has a market price is captured in GDP, and only what is included in GDP can influence productivity. If a stay-at-home parent washes, cooks, cleans and takes care of the children, this is not included in GDP. Meanwhile it is undeniable that enormous productivity increases have occurred in our homes – everything from piped-in water, clothes washers and dishwashers for earlier generations to ready-made food and robot vacuum cleaners for today's parents of small children. Since the mid-20th century, all this has dramatically decreased the working time required to manage a household (from the rough equivalent of a full-time job for our grandmothers to perhaps 15 hours a week today). **A large percentage of the population has thus experienced a significant improvement in living standard without this being visible in the statistics.**

Measuring the internet

A more recent critique on the same theme has been presented by Google's chief economist, Hal Varian, and others. It is based on the fact that many of the new services that have appeared as a result of the internet revolution are free, or in any case nearly free. For example, in the pre-internet era everyone who wanted to send a letter had to pay postage to have it delivered. Today, everyone who wants free e-mail has access to it. This is also superior to traditional letters in terms of both speed and environmental impact. Although it is easy to grasp that this is a major productivity increase for written communication, because e-mail is free it is not recorded in GDP and is thus not captured in productivity metrics. The same can be said about myriad other services that we use daily, which have made us more productive and have helped to make our everyday lives much easier. Although some of these services are included in GDP because we pay for them by watching advertising – whose revenue is then included in GDP – it is reasonable to believe that aside from this advertising revenue the true value of all the free services consumed today is vastly underrepresented.

Another dimension of the above is that over time, many of these new services eliminate existing solutions. When e-mail out-competes traditional letters, when web-based news replaces physical newspapers and when GPS technology takes away the jobs of physical map makers, the out-competed businesses leave large holes in GDP. **More efficient free services replace them and improve their functionality, but do not fill these holes in GDP.**

Another possible source of error based on internet services is that these may lead to overestimates of the number of hours worked (which has the same effect on productivity as underestimating production). To the extent that our smartphones and job computers enable us to do other things besides our jobs during working hours, the number of working hours actually used for production will be overestimated, thus also contributing to lower productivity. At the same time, we can justifiably argue that this is offset by the ability of smartphones to achieve the opposite, by enabling us to work during our leisure hours.

Parallel solutions consume more resources

The technological changes currently under way in many industries may also, in themselves, reduce productivity. This is because during a technological change, businesses are forced to keep using the old technology while investing large sums in the new one in order to ensure their own long-term survival. A newspaper company that has to distribute both physical newspapers and web-based news must spend unnecessarily large resources to perform its task of supplying news. The same can be said of numerous industries that have one foot in the old economy and one foot in the new one: retailers that must invest both in new web shops and in their old brick-and-mortar shops, telecom operators that must maintain old land-based telephone networks while investing in mobile expansion, or banks that still have many branches and old systems while investing large resources in the development of new and more efficient digital solutions. **The extra resources required to maintain such overlapping production systems lead to lower productivity during the transition period.** There are also numerous other explanations as to why productivity growth is so low, for example that low interest rates have made it too easy for unproductive businesses to stay alive. Regardless of the underlying reasons, the big question is what we should believe about the future.

Hoping for better times

There are many people who believe that productivity growth will begin accelerating again, and that all the positive effects of the internet revolution will soon start showing up in the statistics. Nor is it news that productivity improvements may occur after a time lag. The invisible productivity increase in homes mentioned above contributed, after a certain time lag, to higher production in the economy since it enabled more housewives to get an education and then join the labour market. **Looking ahead, one way of making internet-based services visible in GDP statistics is of course to begin charging for them.** Although many people are still opposed to paying for internet-based services, a rapid shift in attitude is under way. Paying to listen to streamed music or to read news is becoming more common. Here such innovations as micropayments – enabling consumers to pay a very small sum to read an article, for example – may cause more and more of what is free today beginning to be included in GDP. Even to the extent that insufficient capital spending growth is behind weak productivity increases, there is real hope of improvement since periods of underinvestment are normally followed by periods of investment-led growth – which would now also benefit from historically low interest rates that make borrowing cheap. The costs of the ongoing technology shift are also temporary, and once completed they will begin to be reflected in higher productivity. **Technological advances also indicate that large, important segments of the economy have the potential to show enormous productivity increases during the next decade.** One example is the transport sector, where self-driving cars and trucks will greatly reduce the need for labour and also boost the capacity of our roads, since they do not need to eat or sleep. So there is good potential to boost productivity, and perhaps all we need is a little patience.

Abenomics is not bearing fruit

- **Weak short- and long-term growth outlook: meagre pay hikes despite high employment**
- **Bank of Japan doing more, but impact is marginal – fiscal stimulus expected**
- **Political restart for Abe a forlorn hope...**

Japan's medium- and long-term growth outlook is grim, mainly due to its ageing population. In the short term, Prime Minister Shinzo Abe's "Abenomics" has failed to provide sustainable growth and inflation. Economic activity is hampered by weak domestic and global demand. Corporate earnings are climbing to record levels, but investments and pay hikes are meagre. **GDP will grow by 0.5 per cent both in 2016 and 2017. Downside risks dominate**, especially in 2017 if consumption tax is raised. Slow growth and a strong yen have **worsened the inflation outlook**.

Weak growth will be driven by higher consumption, helped by further fiscal stimulus, and cautious capital spending. **The Bank of Japan (BoJ) estimates potential growth at only 0-0.5 per cent**. The need for structural reforms, particularly in the labour market, is thus enormous if Japan is to achieve higher long-term GDP growth. The Abe government's **reform agenda remains both unclear and uncertain**.

We expect Mr Abe to try to use the **G7 meeting** on May 26-27 and **new fiscal stimulus measures** to boost his popularity and pave the way for potential upper and lower house elections in early July. His tactics are clear: to win the election and prolong his mandate to implement reform policies. This raises hopes of a restart, but low expectations are appropriate.

Japan 6th country with a negative key rate

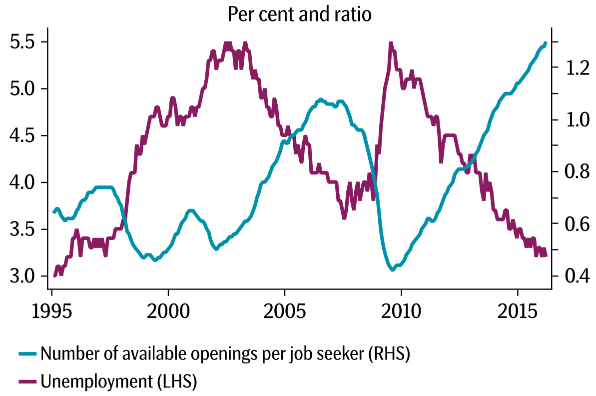
Economic policy is hobbled. In practice, monetary policy has reached the end of the road; the introduction of negative interest rates in January (-0.10 per cent) was an obvious attempt to weaken the yen, but the outcome was the opposite. Meanwhile the country is under **pressure from the G20 not to depreciate the yen** and to stick to its target of stabilising public sector debt at close to 250 per cent of GDP.

The G20 countries fear that credibility problems related to Japanese public finances will have negative effects on both Japan and the global economy. Abe is thus under heavy pressure to **fully or partly implement the long-anticipated consumption tax hike** from 8 to 10 per cent in April 2017, despite a clear risk of renewed recession. But by proposing **new fiscal stimulus measures** while "front-loading" his record-sized and expanded 2016 budget, Abe hopes the economy will be strong enough to handle the 2017 tax hike.

Private consumption and business investments are the key to achieving a short-term growth surge and the BoJ's 2 per cent inflation target. But despite strong political pressure both in 2015 and 2016, the new negative key interest rate and a strong labour market, this year's wage round was **a major setback for inflation targeting**. We expect nominal yearly pay hikes to reach 0.3-0.4 per cent in 2016-2017, even though **unemployment will be 3.2 per cent this year and 3.1 per cent in 2017**. Such meagre wage and salary growth is not enough to help Japan achieve its inflation target, but it is a positive achievement that pay levels are climbing at all.

Increasingly strong Japanese labour market

Per cent and ratio



Source: Macrobond

We expect inflation to stay close to zero in 2016 and then climb to nearly 1.5 per cent in 2017 (assuming the consumption tax is raised). The market's inflation expectations remain in a downward trend close to zero. Despite the fading effects of monetary policy on growth and inflation, we believe that **the BoJ will cut its key rate further to -0.30 per cent** in 2016 to weaken the currency indirectly and, like the ECB, enable the banking system to borrow at negative rates. Meanwhile the BoJ is well prepared to expand its already large QE programme of JPY 80 trillion in yearly asset purchases.

The current account surplus – 3.5-4 per cent of GDP per year – implies exporting capital to other countries. Japan's foreign assets now exceed its debts by a huge USD 3.5 trillion. This risks strengthening the yen in the event of heightened global market turbulence; more capital will return home than leave Japan. **We expect the USD/JPY exchange rate to be 116 at the end of 2016 and 114 at the end of 2017**.

Growth will bottom out in 2016

- **China: Market turbulence has faded**
- **India: Not much room for acceleration**
- **Russia: Worst downturn has passed**
- **Brazil: Sharp recession and political crisis**

China: Soft landing despite imbalances

The worst market turbulence due to China's growth slowdown, currency policy and capital outflows has faded, confirming our previous assessment that **financial markets over-reacted early in 2016**. Although it is possible to point to a number of risks, we are **sticking to our forecast that China will avoid both an economic hard landing and a financial crisis**. In the first quarter of 2016, GDP growth slowed by one tenth of a percentage point to 6.7 per cent year-on-year. Early in 2016, economic figures were especially hard to interpret due to the Chinese New Year, which shifts between January and February. March statistics, which are less influenced by seasonal effects, indicated an improvement in economic activity towards the end of Q1, when purchasing managers' indices, exports, industrial production and retail sales provided upside surprises. However, most of the April statistics were weaker than expected.

An **improvement** is also discernible in the **housing market**. Prices are climbing month-on-month and now also year-on-year. The number of home sales has also accelerated and is well above the year-ago figure. Recently the supply of unsold homes has thus decreased somewhat, which in turn has had a positive impact on housing construction. But the question is how long-lasting this upturn will be. Despite a certain decrease, the overhang of unsold homes remains massive. The housing market is fragmented, and the oversupply is mainly found in small and medium-sized cities. A persistent upturn in home sales will be needed in these cities to bring supply down to a level where construction can more permanently contribute to GDP growth. This is not expected to happen until late 2016.

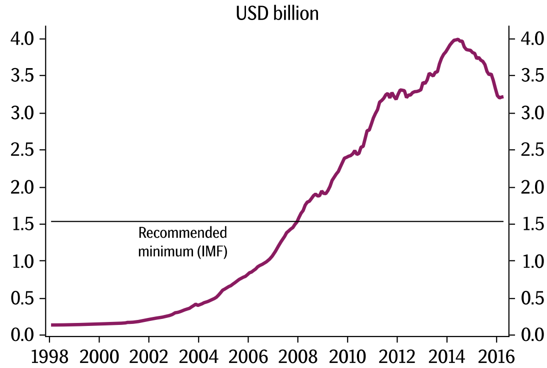
Monetary and fiscal policy easing has provided key support to economic growth. Lending was very strong in March but dampened in April. Most easing of the monetary policy has probably already occurred, but the effects of measures already taken will continue to stimulate the economy during the rest of 2016. Accelerating government infrastructure investments continue to provide support; during the next three years there will be infrastructure investments representing slightly less than 7 per cent of GDP. We expect a continued slowdown in overall GDP growth, which was 6.9 per cent in 2015. Our forecast is that **GDP will increase by 6.5 per cent in 2016** and by **6.3 per cent in 2017**. Beyond our forecast horizon, the deceleration will continue – driven by China's rebalancing from growth that is driven by industry and capital spending to service- and consumption-based growth.

Inflation has totalled 2.3 per cent in April for the third straight month. The earlier upturn was largely driven by food prices, which may climb somewhat further. The official inflation target of 3.0 per cent is not in danger, however. **We expect inflation to average 2.3 per cent in 2016 and 2.5 per cent in 2017.**

After the unexpected yuan devaluation in August 2015, we have seen several periods of foreign exchange market turbulence, and China's competitiveness remains in question. In our view, the risks of renewed turbulence (like that of August 2015 and early 2016) are not so large. We believe that market worries about a major devaluation are exaggerated and that the People's Bank of China wants to avoid recurrent volatility during the process of transitioning to a freely floating currency. Inclusion of the CNY in IMF's SDR in October will make it difficult to devalue the currency. In 2016 we expect the PBoC to gradually allow depreciation against the dollar, while keeping the yuan stable against the currency basket. We expect the **USD/CNY** exchange rate to be **6.90 at the end of 2016 and 6.60 at the end of 2017**.

China's currency reserve

USD billion



Source: China State Administration of Foreign Exchange, SEB

Market turbulence related to capital outflows and the shrinking currency reserve (see the theme article in *Nordic Outlook*, February 2016) has faded in recent months. The outflows have slowed, but it is too early to declare that they are over. The currency reserve increased a bit in March and April, but the reason was exchange rate shifts. There is a risk that capital outflows will again start growing, driven by expected USD appreciation in 2016. But although the currency reserve has decreased it remains far above the IMF's recommended minimum level. Looking ahead, pressure on the yuan and outflows should diminish.

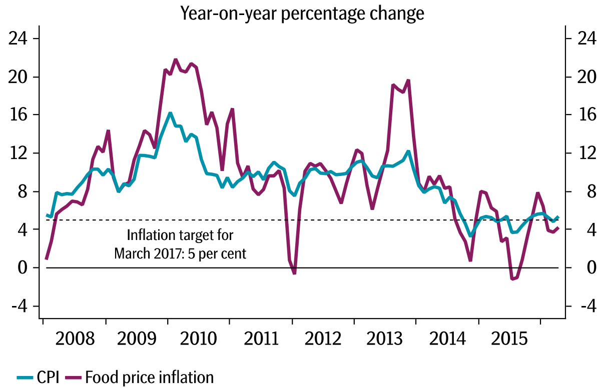
China's debt level has again attracted attention due to the rapid growth in lending. The total debt level is nearly impossible to determine, but estimates by the Bank for International Settlements (BIS) indicate around 250 per cent of GDP, which is well above the 175 per cent average for emerging economies. **The increase in debt has also occurred very rapidly** in recent years. China has implemented a number of reforms, among other things in the management of local government debt, which have lowered the risk of an acute financial crisis. Yet there is an overhanging risk that the PBoC will supply large quantities of capital in order to support the banks, which in the long term may result in a Japanese-style scenario of deflationary tendencies and slower growth.

India: Not much room for acceleration

India is still a bright spot among emerging market countries, but GDP growth slowed a bit in the final quarter of 2015. Most indications are that the potential for renewed acceleration is highly limited. Other economic data also provide a weaker picture of the GDP trend. Earlier signs of recovery in manufacturing have weakened, exports and imports remain sluggish. Although government investments have increased, this upturn has not spread to private capital spending. The banking sector is dominated by highly indebted state-owned banks. This means that lending will remain cautious. The corporate sector is also highly indebted, which will hamper future capital spending. The Reserve Bank of India (RBI) has put pressure on banks and companies to clean up their balance sheets and reduce the volume of problem loans. New bankruptcy legislation will make this process easier, but it will take time before it has an impact on lending. Because of efforts to shrink the budget deficit and the RBI's ambition to achieve its inflation target, there is little potential for stimulus measures. Overall, we believe that GDP growth will remain at around current levels. GDP rose by 7.3 per cent in 2015. Looking ahead, **we expect a cautious acceleration to 7.5 per cent in 2016 and 7.6 per cent in 2017**.

Indian inflation close to the official target

Year-on-year percentage change



Source: Indian Ministry of Statistics and Programme Implementation

As expected, the RBI managed to fulfil its 6.0 per cent inflation target for January 2016. The bank's targets for the end of March 2017 and 2018 are 5 and 4 per cent, respectively. It looks as if the 2017 target can be achieved, but in 2018 it will be difficult to meet the RBI's higher level of ambition. We expect **average full-year inflation of 5.0 per cent in 2016 and 4.7 per cent in 2017**. The risks are on the upside, since a third unfavourable monsoon year would push up food prices. In April the RBI cut its key interest rate by 25 basis points to 6.5 per cent. At the same time, it carried out a number of **steps to strengthen the monetary policy transmission mechanism**, thereby amplifying the impact of earlier rate cuts. We believe that the RBI is now largely finished lowering interest rates and will wait until early 2017, when we expect a 25 point cut.

Prime Minister Narendra Modi's government is continuing its reform efforts but has **not yet succeeded in pushing through the most important reforms**. The delayed national sales tax will probably be implemented in 2016, but efforts to reform the labour market and land purchase laws are moving sluggishly. Most reform proposals face resistance and protests. One example is the government's initiative to open the e-commerce sector to foreign investors, which lobbyists view as a threat to the retail sector. The governing Bharatiya Janata Party's poor results in local elections appear likely to continue, adding to the difficulties of pushing through the reforms that are needed in order to speed up economic growth further.

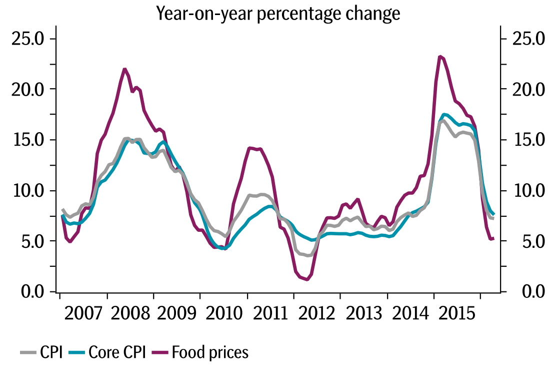
The **rupee** weakened early in 2016 but has recovered to about the same level as last December 31. Reductions in India's current account and budget deficits are helping sustain the currency, but the commodity price recovery is having the opposite effect since India is a net importer that benefits from low prices. The Fed's expected rate hikes will lead to only minor depreciation. **We expect an INR/USD exchange rate of 69.0 at the end of 2016 and 64.0 at the end of 2017.**

Russia: Worst downturn has passed

The renewed oil price decline late in 2015 and early in 2016 led to greater uncertainty about the Russian economy, but after falling below 30 dollars per barrel, oil prices recovered this spring. Our forecast of a gradual moderate upturn to an average price of USD 50/barrel provides some breathing room for the Russian economy, but **government finances will remain squeezed** even at this price level. We expect the federal budget deficit to end up close to 4 per cent of GDP this year, even though the weak rouble helps to push up oil revenue in national currency terms. The necessary cost-cutting will mainly impact public sector investments, but the Reserve Fund will also be used in order to cover the government budget deficit. In addition, state-owned companies will be required to boost their dividends. We expect the government to avoid major cuts in social spending, so as not to squeeze households ahead of the September parliamentary election. Meanwhile Western sanctions will continue to hamper capital spending, especially in the energy sector. Developments are difficult to anticipate, but our forecast is that the **EU will begin a cautious softening of its sanctions after this summer**, while US sanctions will continue throughout 2016.

Because of the oil price recovery and improved prospects for the real economy, the worst economic downturn has now passed. Most economic data are pointing towards continued decline year-on-year, but the downturn has decelerated and GDP decreased by 1.2 per cent in the first quarter; a smaller fall than expected. Another positive factor is that inflation has fallen faster than expected, easing the pressure on real wages. **In 2016 we expect inflation to slow to 7.3 per cent and in 2017 to 6.0 per cent**, measured as full-year averages. The downturn in inflation will eventually allow room for key interest rate cuts, even though inflation is currently far above the official 4 per cent target. The central bank has left its key rate unchanged at 11 per cent since August 2015. We expect it to begin rate cuts in the second half of 2016, and the **key interest rate will stand at 9 per cent at the end of 2016**.

Russia: Inflation has fallen faster than expected



Source: Russian Federal State Statistics Service

Overall, the recession will continue for another while, but towards the end of 2016 we expect positive growth to resume. We have revised the forecast for **2016** upward and now estimate that **GDP will fall by 0.8 per cent.** There is potential for a recovery in 2017 based on somewhat higher oil prices and an easing of EU sanctions. **We expect GDP to increase by 1.0 per cent in 2017.**

The correlation between the rouble and oil prices has weakened somewhat but remains strong. The rouble was one of the currencies that fell the most early in 2016, but it has now recovered impressively. Its appreciation has occurred faster than expected, and we believe that there is little room for further gains by year-end from the current level. **We expect the RUB/USD exchange rate to be 63.0 at the end of 2016 and 66.0 at the end of 2017.**

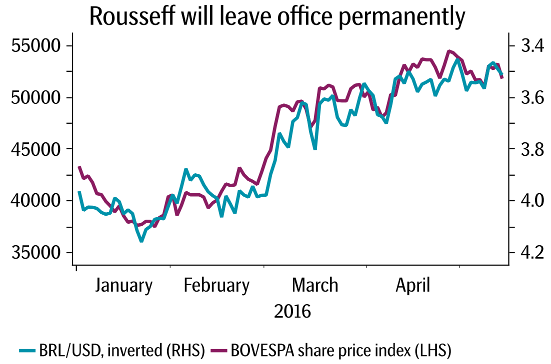
Domestic political risk is limited. President Vladimir Putin still enjoys strong popular support despite Russia's sharp economic downturn. Although his United Russia political party is substantially less popular than he is, it is difficult to see how the divided and weakened opposition could pose a genuine threat in the September parliamentary election.

Brazil: Sharp recession and political crisis

Brazil's **economic and political crisis is continuing**. In 2015, GDP declined by 3.8 per cent. In the fourth quarter, GDP fell 6 per cent year on year. The downturn is broad-based; the decline in capital spending is now accompanied by a drastic downturn in private consumption, which is squeezed by sharply falling real wages. But there are **some signs of improvements**. The current account deficit has decreased rapidly, driven by falling imports, and is now close to balance. Exports have begun a cautious recovery, thanks to last year's sharp currency depreciation. Inflation is slowing, since earlier hikes in regulated prices are now disappearing from the statistics. Yet the inflation rate remains above 9 per cent, and we believe that as an annual average, **inflation will end up at 8.0 per cent in 2016 –** far above the 4.5 per cent target. Inflation will fall to **6.0 per cent in 2017**. There is thus little chance of stimulating the economy with a more expansionary monetary policy. Because of a **budget deficit of more than 10 per cent of GDP**, fiscal policy cannot be used to help sustain the economy either. Although we expect Brazil's recession to continue **in 2016, the decline in GDP will slow to 3.5 per cent. In 2017, we expect GDP to increase by 0.5 per cent.**

Despite the powerful recession and great political uncertainty, **financial markets have recovered** since January and both the currency and the stock market have climbed steeply. The central bank has intervened to counter an appreciation of the real. This recovery has been connected in part to the general shift in sentiment about EM economies and commodity prices, but market optimism has gained extra impetus from **expectations that President Dilma Rousseff will be forced to step down permanently** as a result of the ongoing impeachment process. Vice President Michel Temer has temporarily taken over the presidency.

Stronger stock market and currency on hopes that Rousseff will leave office permanently



Source: BM&F BOVESPA, Macrobond

Although our main scenario is that Rousseff will leave office, we believe that the **markets are too optimistic about what will come after her**. This optimism is being driven by hopes that a Temer government will pursue more reform-oriented policies. But Temer has been implicated in corruption charges, and it cannot be ruled out that he may be forced to step down as well. A new government must also manage Brazil's very difficult economic situation. Parliament is fragmented, which will make important reform efforts harder. The most urgent matter is the large government budget deficit. It will be a tough challenge to carry out the necessary cost-cutting. Even assuming a positive scenario, government debt will increase dramatically. In our judgement, the optimism surrounding the expected departure of Rousseff will change to pessimism and the real will again weaken from its current level. **At the end of 2016 we expect the USD /BRL exchange rate to be 3.75, and at the end of 2017 it will be 4.00.**

A hesitant economy surrounded by political uncertainty

- **Political risks having little economic impact**
- **Capital spending will help to drive recovery**
- **Zero inflation during much of 2016**
- **ECB holding off, but further action possible**

The economy keeps moving in the right direction. First quarter GDP was surprisingly positive: up 0.5 per cent on the previous quarter. Spain and Germany are growing at a healthy pace, but as long as France and Italy lag behind, overall euro zone GDP growth will not surge. **Households continue to set the pace**. Although pay increases are small, rising employment and low inflation will mean higher purchasing power. Capital spending, which has remained low for some years, is cautiously starting to accelerate. Demand for loans and total lending are rising, though slowly. The European Central Bank (ECB)'s expansionary policy is making a positive contribution, with low interest rates benefiting both households and businesses. On the other hand the euro has regained lost ground against the US dollar, which is holding back exports. Meanwhile the banking sector, especially in southern Europe, is weighed down by bad loans. This is restraining economic activity. **Overall GDP growth will be 1.7 per cent in 2016 and 1.8 per cent in 2017**: a downward revision by 0.2 percentage points in both years, compared to the last *Nordic Outlook*.

GDP forecasts
Year-on-year percentage change

	2014	2015	2016	2017
Germany	1.6	1.7	1.7	1.8
France	0.2	1.2	1.2	1.5
Italy	-0.3	0.8	1.2	1.3
Spain	1.4	3.2	3.0	2.9
Greece	0.7	-0.2	-1.0	3.0
Portugal	0.9	1.5	1.7	1.8
Ireland	5.2	7.8	4.5	3.5
GIPS countries	1.7	3.2	2.6	2.9
Euro zone	**0.9**	**1.6**	**1.7**	**1.8**

Source: Eurostat, SEB

EU and euro zone face political headwinds

The European project is now being tested on several fronts. The **"Grexit" issue** is quietly hanging over the European Union, although our main forecast is that Greece and its fellow EU members will reach a solution on its bail-out programme. The refugee crisis has illustrated the EU's inability to jointly deal with acute issues in a resolute fashion. Combined with austerity packages and high unemployment, this has paved the way to success for various types of EU-critical protest parties. Yet in the short term, **we do not believe that the economic consequences of increased political uncertainty will be especially large**. Border controls are now threatening the Schengen system of borderless travel – creating problems for commuters and goods shipments, but not actually affecting fundamental principles of free mobility within the EU.

Further ahead, however, political developments may have a substantially larger negative impact. If anti-EU parties achieve enough success to gain major political influence in some countries, this will greatly impede the ability of the EU to make decisions, since many such decisions require acceptance by all member states. June elections in Spain, which has been unable to form a government, and elections in France and Germany next year are creating some uncertainty. The "Brexit" issue will also be important. **Regardless of whether the United Kingdom stays in the EU or not, the playing field will change**. A British vote to leave the EU would trigger a withdrawal process in which the EU must strike a balance between trying to retain good relations with the UK, while preventing other countries from being encouraged to follow the same path. Even in our main forecast – that the British will remain in the EU – the playing field will change. The country's opt-outs clearly show that we have a dual-track EU, not a two-speed EU as before. It is not unlikely that other countries would like similar opt-outs, which would further divide member countries into one group that would like to deepen their cooperation towards greater federalism and another that would like to move in the opposite direction. This line of conflict will also exist within the euro zone.

Because of falling unemployment and cost-cutting, **public finances are improving**. In 2015 the ratio of euro zone public debt to GDP fell to 90.7 per cent: the first downturn since 2008. Budget deficits are shrinking but remain above 3 per cent of GDP in such countries as Greece, Spain and France. A number of international bodies, including the ECB and the International Monetary Fund (IMF), are now advocating more **expansionary fiscal policies in order to ease the burden on monetary policy**, but budget deficits limit the room for manoeuvre in most countries. Nor is it so easy to follow the advice of the IMF and ECB and implement structural reforms that will create more dynamic growth, even if they are funded. For example, reforming tax systems, labour laws or social insurance systems is politically difficult, takes time and risks fuelling further support for protest parties. We thus do not expect any quick results or effects in the near term, although greater **tolerance of deficits will make overall fiscal**

policies in the euro zone weakly expansionary. Budget deficits will slowly improve, shrinking to 1.6 per cent of GDP in 2017, while public debt will reach 90 per cent of GDP.

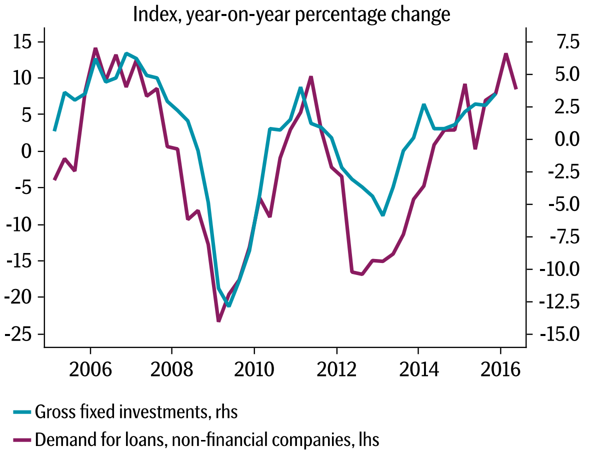
Indicators are pointing to modest growth

So far this year, sentiment indicators have generally weakened somewhat. Purchasing managers' indices (PMIs) for the region as a whole fell in April to 53.0. All four of the largest euro zone economies are above the expansion threshold of 50, with somewhat higher levels in Germany and Spain than in France and Italy. Decreased concern about the global economic situation and developments in China **are expected to stabilise the outlook ahead**. Order bookings are decent, especially for domestically oriented sectors. In manufacturing, producers of consumer goods are showing stronger figures than investment goods and intermediate goods sectors, a trend also reflected in recent production statistics. Looking ahead, this divergence will ease somewhat; improved exports and capital spending are expected to broaden the growth base.

Industrial production grew in a decent pace in early 2016, and some further improvement is expected ahead. There has been a positive trend in the past year, led by Spain. The latest monthly figures show that manufacturing output is now also growing faster in France and Italy than in Germany. **We expect total industrial production to increase by 2 per cent both in 2016 and 2017**. Exports have accelerated, rising by 5 per cent in 2015. In recent months, however, the rate of increase has slowed, but our forecast that the euro currency will weaken again – combined with a somewhat stronger world economy – will benefit exports. We expect upturns of about **4.0 to 4.5 per cent yearly in 2016 and 2017 for the euro zone as a whole**.

Increased demand for loans, rising investments

Index, year-on-year percentage change



Source: ECB, Eurostat

Capital spending recovery under way

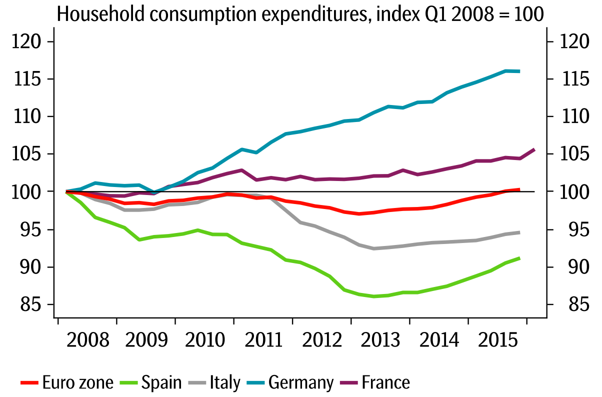
A long period of weak demand has pushed capital spending down to a level than is now 4 per cent of GDP lower than before the crisis. We see potential for a modest recovery in the next couple of years. Despite shaky economic growth in recent years, capacity utilisation is surprisingly high, an indication that the low investments of recent years are beginning to hamper the production potential of companies. Future business expectations are now at decent levels, and in such an environment we believe that companies will respond more than previously to rising demand by investing in expansion. **We thus expect capital spending to increase by 3 per cent yearly in 2016 and 2017**.

Employment is sustaining consumption

Consumption has been an important driver of demand and growth this past year. Although consumer confidence has fallen somewhat, its level is high enough to be compatible with continued expansion. Falling unemployment and a growing number of jobs are helping maintain confidence and buying power. Retail sales are decent according to the latest statistics, and cyclically sensitive car sales showed 10 per cent year-on-year growth this past quarter. Overall, **consumption increases by just over 1.5 per cent yearly in 2016 and 2017**.

Consumption: Major differences within the euro zone

Household consumption expenditures, index Q1 2008 = 100



Source: Eurostat

Continued labour market improvement

The labour market is continuing its gradual positive trend, but there are still major challenges. **Unemployment fell to 10.2 per cent in March**: 1 percentage point lower than a year earlier. The decline is broad-based but is occurring at different speeds in different countries. Job creation is the main factor driving down unemployment. Spain stands out in this respect, too, with an upturn of nearly 3 per cent on a year earlier. **The positive labour market trend will persist**. Domestic demand, not export-oriented manufacturers, will continue to drive growth. This will have a marginally bigger impact on employment. **As annual averages, unemployment will fall to 10.1 per cent in 2016 and 9.6 per cent in 2017.**

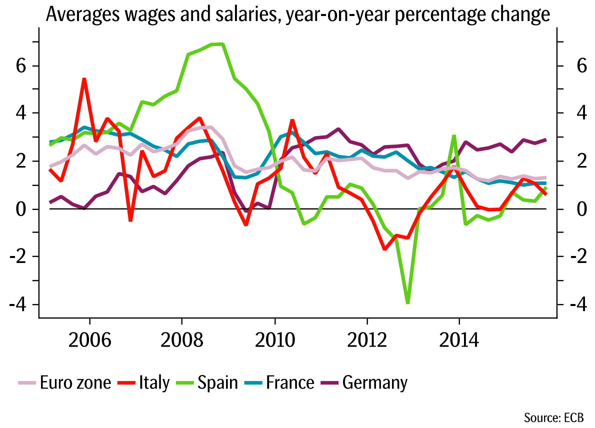
Structural problems and rigidities as well as the dramatically deep downturn in certain parts of the economy such as the construction sector, have contributed to the increase in the equilibrium unemployment level during the past few years. We believe that it is around 9 per cent today. This means that there will be **idle resources throughout our forecast period and that upward wage pressure will be weak**. Meanwhile the high equilibrium level implies that continued structural reforms will be needed to prevent unemployment from stabilising at a level clearly higher than before the crisis. This applies especially to crisis-plagued countries. In Spain, for example, the jobless rate is 20 per cent today and we estimate that equilibrium unemployment is about 15 per cent: a level that will create both social and public finance problems.

Continued low inflation for a long time

High unemployment is keeping wage and salary rises at about 1 per cent in many countries, while Germany stands out with 3 per cent increases. We expect this pattern to persist over the next couple of years. Competitiveness has improved most clearly in Ireland, Greece and Spain in recent years but there is a need to continue this process.

German wages growing faster than average

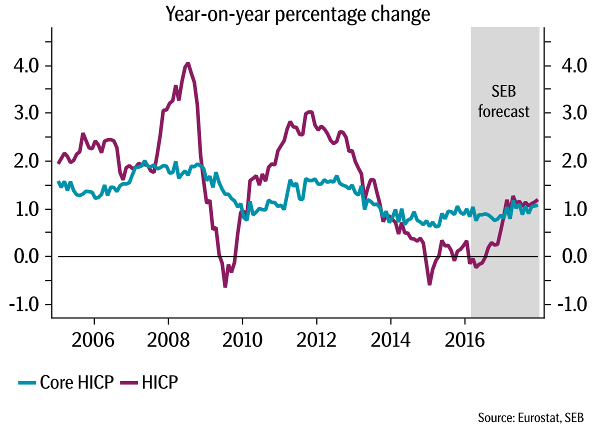
Averages wages and salaries, year-on-year percentage change



Price pressure is, and will remain, low. Inflation prospects are largely unchanged since the last *Nordic Outlook*. Although the differences have narrowed, our forecast remains lower than consensus and ECB projections. Low energy, commodity and food prices are continuing to keep prices down. Other factors are low international price pressures and weak pay increases, which are also restraining core inflation and the medium-term inflation outlook. We believe that **inflation according to the EU's harmonised index of consumer prices (HICP) will be close to zero until the end of 2016** and that base effects from earlier oil price declines will then lift inflation to about 1 per cent. **Core inflation will remain largely unchanged at its current 1 per cent level throughout our forecast period**.

Zero inflation during much of 2016

Year-on-year percentage change



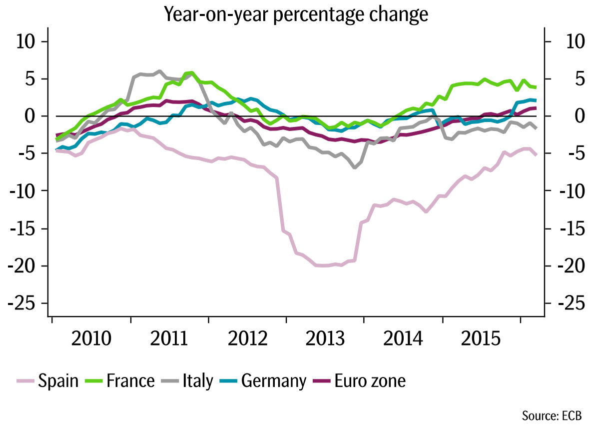
ECB on hold, but further actions may come

Having surprised the market in March with a broad package of measures consisting of interest rate cuts, expanded asset purchases including corporate bonds and a second round of loans to banks (TLTRO II), in April the ECB left monetary policy unchanged. **The focus is now on implementing these measures**; we do not expect new measures in the near term. The ECB's bond purchasing programme will run until March 2017 or for as long as needed, and TLTRO II will run for the same period. As a result, monetary stimulus will increase gradually during the coming year.

The ECB remains squeezed by low inflation and inflation expectations. Another restraining factor is **fragmented monetary policy effectiveness in the banking system**. The IMF estimates total bad loans in the euro zone at 900 billion euro. Although Italy, for example, has made progress by creating a mechanism to remove bad loans from bank balance sheets, banks are still struggling with a large quantity of bad loans which constrain their lending to companies. Because the banking sector accounts about 85 per cent of financing in the euro zone, this issue is especially important. The ECB is now trying to deal with the problem in various ways. TLTRO II (loans priced as low as -0.4 per cent) enables banks to provide corporate loans at generally lower interest rates. In addition, companies that raise funds directly via credit markets can benefit from the ECB's corporate bond purchases.

An increase in lending, but not everywhere

Year-on-year percentage change



If our inflation forecast is correct, the ECB faces further downward forecast revisions. This, combined with the unlikelihood that the ECB will end its bond purchases completely in March 2017, makes us believe that asset purchases will continue – though at a slower pace – throughout 2017. If TLTRO II loans are successful, the ECB will probably choose to expand them after March 2017 at the same time as bond purchases are reduced or even terminated. Credit easing will then become more important at the expense of QE. Further interest rate cuts are not our main scenario. The ECB chose various other forms of unconventional monetary policy this spring, a sign that it views further rate cuts as a less effective weapon, due in part to the problems it creates. Furthermore, global monetary policy discourse indicates that we are near **the end of the interest rate policy road** and that fiscal policy must instead provide more help. It is increasingly evident that euro zone-wide monetary policy is creating tensions – due to interest rates but also exchange rates. The German economy is performing well, partly due to an artificially weak euro by German standards and low interest rates that are driving up home prices and creating problems for the pension industry, among others.

Remain side will emerge victorious in Brexit referendum

- **Temporary dip in economic growth**
- **Inflation slowly moving towards BoE target**
- **Leisurely key interest rate normalisation**

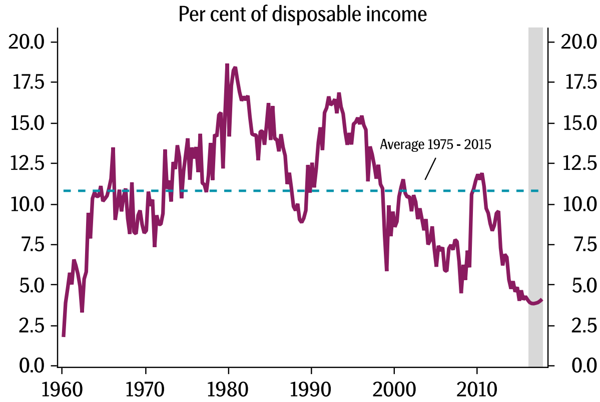
Most news about the British economy today centres on Brexit. Next month's referendum on continued EU membership was one reason why first quarter GDP growth was the weakest since 2012. Although we view this slowdown as temporary and expect the Remain side to win, we have lowered our forecast: **GDP will grow by 1.9 per cent this year and 2.3 per cent next year**. After last year's zero inflation, prices will climb, but without signalling that a key interest rate normalisation is imminent; **inflation will average a low 0.6 per cent this year and 1.7 per cent in 2017**. As earlier, we believe that **the first key rate hike will occur in February 2017** and that the key rate will be 1.00 per cent at the end of our forecast period. Market pricing, which has quickly moved higher recently, is still pointing to a somewhat more leisurely rate hiking pace. **Unemployment**, which has already declined to its equilibrium level, **will fall slowly to 4.7 per cent by the end of 2017**, matching the low achieved during the last economic cycle.

A deceleration in the British economy benefits the Remain side, which advocates continued EU membership. Chancellor of the Exchequer George Osborne has taken the opportunity to issue a stern warning about what consequences a withdrawal from the EU may bring. Sagging household and business confidence indicators in recent months suggest that second quarter growth may be disappointing as well. There are also signs that **investment and hiring decisions are being postponed** in anticipation of the June 23 referendum outcome. For example, job creation has decelerated noticeably, but another possible explanation may be that employers have become cautious because a **national living wage** was introduced in April.

While opinion polls indicate a relatively even match, betting firms show an overwhelming probability that the UK will choose to stay in the EU – which is our main scenario. The "Panama Papers" scandal thus appears to have boosted the Leave side's chances only temporarily; Prime Minister David Cameron's damage control efforts seem to have succeeded. Meanwhile the British economy is fundamentally in rather good shape. **There is a good chance that household consumption will continue to be the chief driver of growth** despite a record-low savings ratio of 3.8 per cent at the end of 2015. Changes in statistical measuring methods have been largely instrumental in pushing down the savings ratio, so we do not view the low savings level as an especially strong threat to consumption. On the contrary, a combination of lower unemployment and rising home and share prices suggests that the savings ratio may fall further. **We thus expect household consumption to climb by 1.9 per cent in 2016 and 2.6 per cent in 2017 –** in line with real disposable income growth and thus also with an unchanged savings ratio.

Household savings ratio is low

Per cent of disposable income



Source: OECD, SEB

At the end of 2015, the current account deficit was 7 per cent of GDP, a record level for the post-war period. Based on the rule of thumb that a 3 per cent deficit is sustainable in the long term, this situation may seem alarming and negative for the pound. However, one mitigating factor is that the deficit is largely driven by foreign direct investments in the UK, which are increasing faster and providing better returns than British direct investments abroad.

Inflation will not reach 2 per cent until early 2018, according to both our own forecasts and those of the Bank of England (BoE). The BoE would like to see faster growth as well as higher domestic cost pressure and core inflation before initiating key rate hikes. The slowdown in pay increases is another indication that such action is not imminent. We thus do not expect the first rate hike until February 2017. **At the end of 2017, the most important key rate will stand at 1.00 per cent**. The public opinion situation has nevertheless pushed up market pricing somewhat. The market foresees a key rate of 0.73 per cent at the end of 2017. A decrease in political risks has also strengthened the pound this spring, especially against the US dollar. The Remain outcome we predict in the referendum will strengthen the pound further. After the referendum, the real economic outlook will take over the main driver of monetary policy. The pound will gain against the euro and stay flat against the dollar. **The EUR/GBP exchange rate will be 0.75 and the GBP/USD rate will be 1.47 at the end of 2016**.

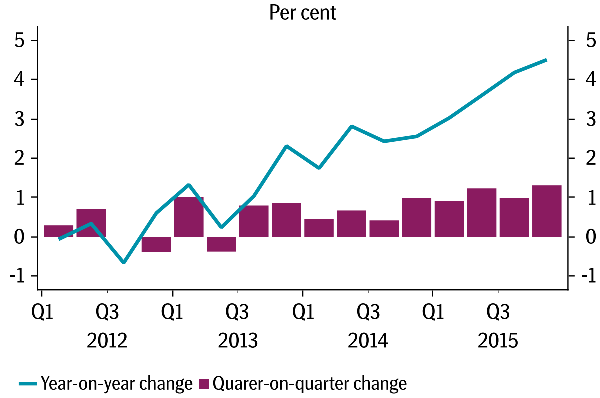
Continued above-trend growth but increasing imbalances

- **GDP growth is strong but is about to peak**
- **Record expansion in public consumption**
- **Resource utilisation is near historical highs**
- **Rising NAIRU due to integration problems**
- **Higher inflation, but still below target**

Swedish growth has gradually accelerated over the past three years, reaching 4.5 per cent year-on-year in the fourth quarter of 2015. Looking ahead, GDP will slow a bit but the economy will still expand faster than its long-term trend. **We expect GDP to grow by 4.0 per cent this year and 2.8 per cent in 2017**. The upturn is mainly driven by strong domestic demand, with greater resources for refugee settlement contributing to record-high increases in public sector consumption this year. The increase in housing construction will be somewhat slower than in 2015, but it remains an important driver of growth. Exports are being helped by a relatively weak krona due to the Riksbank's stimulus measures, but this effect is hampered by weak international demand and the fact that many companies do not regard this exchange rate effect as long-lasting.

GDP growth is about to culminate

Per cent



Source: Statistics Sweden

To a relatively high degree, GDP growth is being driven by refugee-related public spending increases at the same time as labour market imbalances are increasing. Looking ahead, this is a source of risk. **If integration of new arrivals** into Swedish society and the labour market **fails, major social problems will arise while tax hikes will eventually be necessary**. This, in turn, might undermine Sweden's ability to compete with other countries for attractive workers. However, the forecast of the number of future asylum seekers has been lowered substantially, in light of domestic policy shifts and the situation in Europe. This gives the Swedish government greater fiscal manoeuvring room. Good economic conditions will continue to improve public finances generally, and we expect fiscal policy to become more expansionary the closer we come to the September 2018 elections (see theme article).

Because of low international price increases and significant lead times between rising resource utilisation and inflation impulses, CPIF (CPI minus interest rate changes) will remain below 2 per cent in 2016-2017. The Riksbank will probably need to lower its inflation forecast further. This implies a risk of further stimulus measures, but we believe that the Governing Board will gradually shift focus towards rising resource utilisation and become a bit more tolerant about when its 2 per cent inflation target is achieved. Our main scenario is thus that **the Riksbank will not implement any further stimulus measures and that its first key interest rate hike will occur in April 2017**: somewhat later than we had predicted before.

Also likely is that the Riksbank will be somewhat more inclined to start "leaning against the wind": taking into account the risks of excessive home prices and household debts when shaping monetary policy. But the macroprudential measures about to be enacted – or the concrete proposals presented in the current housing policy talks – are not sufficient to halt the upturn in home prices. The housing shortage is worsening despite increased construction, which is one reason why we foresee a 10 per cent price surge this year, after which prices will level out in 2017. **Yet a sharp downturn in home prices remains the most important downside risk in our forecast**.

Industrial firms hold back new investments

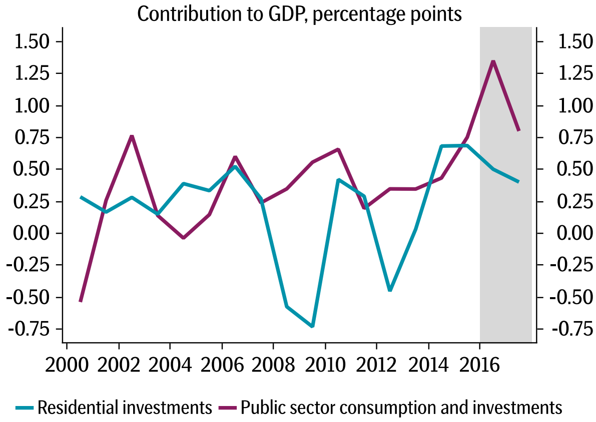
Despite headwinds due to tepid international economic conditions, merchandise exports have performed relatively strongly since mid-2015. Actual export and industrial production figures are thus more in phase with the PMI and the National Institute of Economic Research (NIER)'s Economic Tendency Survey, which are signalling growth roughly in line with the historical average. Our relatively optimistic 2016 forecast, however, assumes that global industrial conditions will recover in the near future. Sweden's service exports will continue to grow rapidly, although at a somewhat slower pace than in 2015. This will contribute to **expected total export growth of 5.8 per cent in 2016 and 4.6 per cent in 2017**.

According to Statistics Sweden's investment survey, industrial companies plan to cut their capital spending this year. This is a warning signal for industrial conditions, but plans that companies report early in a year can usually be adjusted significantly. Given our forecast of continued expansion in exports and production, **we expect capital spending to be unchanged this year compared to 2015**. Spending plans in the domestically oriented business sector are more expansionary, and public sector investments will also probably begin rising faster this year after levelling out in 2015.

Residential construction has risen by 15-20 per cent in the past two years. The number of housing starts in 2015 was the highest since the early 1990s. The upturn will continue this year, but a slight levelling late in 2015 suggests a slower growth rate in 2016. Yet as a percentage of GDP, housing construction remains modest; today's volume is not even half of the 100,000 homes per year that the National Board of Housing, Building and Planning believes will be needed until 2020. Looking ahead, a sluggish construction process and ideological disagreements between political parties on suitable stimulus methods will lower the pace of growth. Today's high resource utilisation in the construction sector also limits potential growth. This is reflected in our own forecast that the contribution of residential investments to GDP growth will fall from 0.75 points in 2015 to 0.4 points in 2016 and 2017. **The yearly increase in overall capital spending will also slow from 7.3 per cent in 2015 to 6-6½ per cent in 2016-2017**.

The public sector is growing at a record pace

Contribution to GDP, percentage points



Record-high public sector expansion

Public sector consumption rose by 2.5 per cent in 2015: the fastest pace since the late 1990s. This upturn is mainly driven by housing, health care and living expenses for asylum seekers; during 2015 and 2016 more than 200,000 people are expected to seek asylum in Sweden. Later in the asylum and integration process, the costs of education and training as well as more permanent housing will affect forecasts. Altogether, public sector consumption will increase by nearly 4 per cent this year, contributing nearly 1 percentage point to GDP growth. Adding in public sector investments, **the contribution to growth will be nearly 1.5 points, which is the highest since the 1980s**.

Our forecast is based on the main scenario of the Swedish Migration Agency, which has lowered its projected number of asylum seekers per year to 60,000 in 2016 and 2017. This is 40,000 fewer per year than in the Agency's earlier scenario. In view of current border controls and the situation elsewhere in Europe, **there are many indications that this forecast will be adjusted even lower**, although there is great uncertainty. Spending pressure in 2016 will not be affected so much by the number of asylum seekers this year; the consequences will be greater in a longer time perspective. Lower direct refugee-related costs will also be partly offset by increasing pressure for spending on settlement and integration into society.

Consumption up, despite wary households

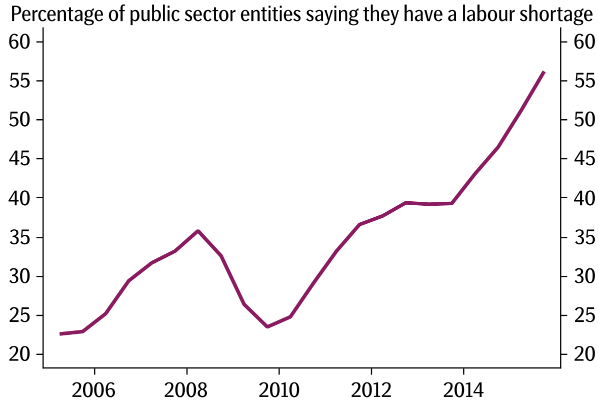
Household consumption is being sustained by continued good growth in purchasing power and rising employment. Low inflation, partly due to falling energy prices, will enable real household incomes to grow by more than 3 per cent in 2016, for the second year. **We expect private consumption to rise almost as fast both in 2016 and 2017** (2.9 and 2.8 per cent, respectively). Household saving is now very high in historical terms, indicating potential for even faster consumption growth. But the high savings ratio probably reflects lingering uncertainty about both international and domestic economic stability, especially with regard to home price trends.

Sticky unemployment despite job growth

Due to strong GDP growth, the employment upturn will accelerate to nearly 2 per cent in 2016 after gains of about 1½ per cent yearly in 2014 and 2015. Despite rapid job growth, rising labour force participation has kept unemployment higher than expected so far this year. In the short term, **we expect the jobless rate to fall towards 6 per cent**, since the labour supply can hardly keep up with such rapid job growth. But late in our forecast period, the unemployment curve will rebound as the numerous refugees who have arrived in recent years begin to join the labour market. The upswing in unemployment may possibly be delayed by a year or so, considering the long lead times before new arrivals are ready to apply for jobs.

Overheated labour market in the public sector

Percentage of public sector entities saying they have a labour shortage



Source: Statistics Sweden

Increasingly strained resource utilisation

Today there is unusually great uncertainty about the actual slack in the labour market. The number of unemployed people with little or no formal education is now growing rapidly, and this upturn is very likely to continue. Indicators of resource utilisation – such as the percentage of companies in the NIER's Economic Tendency Survey stating that they are having difficulty finding suitable job applicants – have climbed during the past two years and are now a bit above their historical averages. The Riksbank's resource utilisation indicator, which summarises a large number of similar indicators, confirms that **the resource situation is now tighter than the historical average** (see the chart in the monetary policy section). The Employment Service's survey also shows that as early as the second half of 2015, the resource situation in the public sector is substantially tighter than it has been at any time since measurements started in 2005. A surge in public sector employment suggests that resource utilisation will continue to rise this year. There are signs that this has begun to influence wage formation in such areas as health care and education.

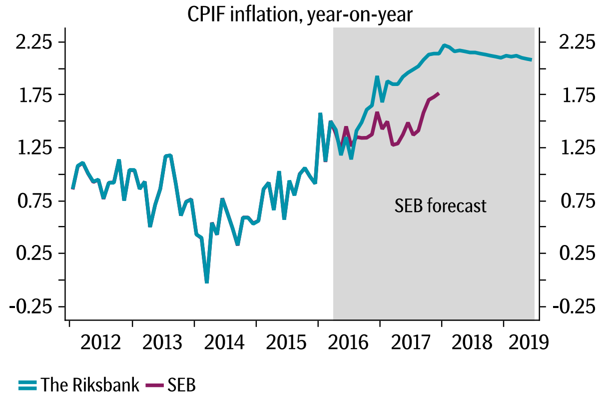
We believe that resource utilisation is close to its normal level and that **equilibrium unemployment (non-accelerating inflation rate of unemployment, or NAIRU) is between 6½ and 7 per cent**. An increasing proportion of the foreign-born people now on their way into the labour market have little or no formal education, posing major economic policy challenges. At present, it is hard to detect any political consensus on what needs to be done. The Social Democratic-led government will probably keep focusing on education, training and subsidised jobs, but this will probably not be enough to keep NAIRU from rising. This would imply that the Swedish jobless rate will get stuck at levels far above those prevailing in countries like the US, Japan and Germany and that **the government's target of achieving the lowest unemployment in Europe by 2020 appears distant**. Yet Sweden's labour force participation rate is very high in an international perspective, which moderates this negative picture of the unemployment situation.

Low pay hikes, but new wage round soon

The 2016 wage round is now largely completed. Although the Trade Union Confederation (LO) failed to coordinate the demands of its member unions and strike notices came thick and fast in March, **domestically oriented sectors followed the 2.2 per cent benchmark set by the industrial sector**. Average pay hikes in the resulting collective agreements thus ended up a few tenths of a percentage point lower than we had predicted. Incoming overall pay statistics so far in 2016 have also brought downside surprises, which follows the pattern from the past three years. We have thus adjusted our 2016 pay hike forecast downward from 3.1 to 2.7 per cent. Since one-year agreements were dominant this year, the next wage round will soon begin. It will take place in a tighter labour market situation. **We thus expect both contractual pay increases and wage drift to accelerate, with overall pay rising by 3.5 per cent**, which is also in line with the Riksbank's assessment.

Riksbank too optimistic about inflation

CPIF inflation, year-on-year



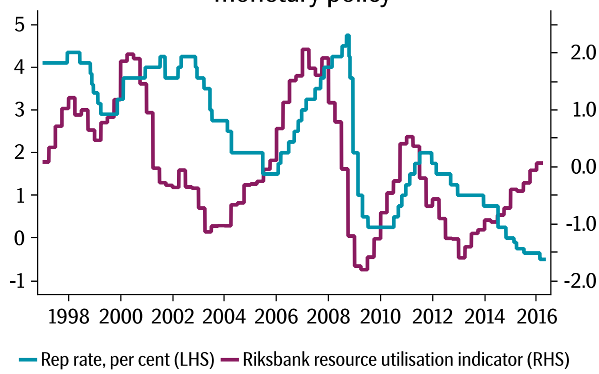
Source: The Riksbank, SEB

Core inflation below target in 2016- 2017

Inflation has surprised on the upside so far during 2016 and is now high in an international perspective. CPIF stood at 1.4 per cent in April, and underlying inflation (CPIF excluding energy) was 1.8 per cent. But this represented a slight downturn compared to March figures, which were driven up by a seasonal peak for travel costs and by temporary price hikes on vegetables. Because of fading upward pressure from the earlier krona depreciation plus unusually large indirect tax hikes in 2015, underlying inflation will continue to fall during 2016 and early 2017, while the **CPIF metric will flat-line at around 1.5 per cent**. Meanwhile there are signs that domestic inflation pressure is building up, especially because service prices are increasingly significantly faster than they have in recent years.

Yet our main scenario is that **rising resource utilisation will affect price and wage formation after a significant lag**. In addition, parts of the CPI basket are hardly affected at all by market forces. Rents, accounting for 12 per cent of the basket, are an important example; they will rise by only 0.7 per cent despite the acute housing shortage. Low international price increases and the indirect effects of falling oil and other commodity prices will also help to keep CPIF below 2 per cent throughout 2017. CPI inflation will reach 2 per cent in late 2017 when Riksbank rate hikes push mortgage interest costs higher.

Record gap between resource utilisation and monetary policy



Source: The Riksbank, Macrobond

Gradual reassessment of Riksbank policies

Our main scenario implies that the Riksbank will not carry out any more stimulus measures during this cycle and that **its first rate hike will occur in April 2017**, somewhat earlier than the Riksbank's own rate path indicates. After that, we expect two more rate hikes in the second half, resulting in a repo rate of +0.25 per cent at the end of 2017. The main reason is that resource utilisation will climb to stressed levels and that this will gradually become more important to the bank's Governing Board. Even now, we can already see signs that some Board members are more prepared to accept the fact that it will take longer to bring inflation up to the 2 per cent target, among other things due to strong economic growth. Looking ahead, we also believe that the recent King-Goodfriend (K-G) review's recommendation that the Riksbank should be more tolerant of divergences from its inflation target will influence the Board's thinking. K-G concluded that the Riksbank cannot entirely relinquish responsibility for preventing excesses in the housing market and household borrowing that threatens financial stability, a view that may also have an impact further ahead.

However, it cannot be ruled out that the Executive Board may feel compelled to deliver further stimulus measures during the next six months. One trigger might be that **the Riksbank will probably have to revise its inflation forecast downward one more time** during the next six months. But the greatest risk is connected to ECB actions. If the ECB should expand its stimulus measures significantly, upward pressure on the krona may be perceived as too strong.

Riksbank Act and monetary policy reassessed

Last winter's evaluation of the Riksbank by leading economists Mervyn King and Marvin Goodfriend is now entering its next phase: 1. A review of the **Sveriges Riksbank Act** and 2. possible effects on the **monetary policy formulation**. The current review of the Act is expected to take several years and cover such issues as the Riksbank's responsibility for financial stability and currency policy. But we believe there will be no change in the earlier decision to hand the main responsibility for macroprudential supervision to the Financial Supervisory Authority. We also regard the allocation of currency policy roles between government and Riksbank as sufficiently clear; more important to the Riksbank's krona management is global opinions about currency interventions and similar actions.

The K-G report and the review of the Riksbank Act are **not expected to trigger any dramatic change in the framework of Swedish monetary and currency policy**. There are many indications that the future **inflation target** may be based on a different metric (such as HICP or CPIF) and will be made more flexible by introducing a tolerance interval and/or greater acceptance that it may take more time to achieve the target. Under current conditions, such changes would ease pressure on the Riksbank to adopt more expansionary policies. We consider it unlikely that the Riksbank will also adopt a labour market related target; the K-G report also rejected this. In our view, after this summer the Riksbank may clarify minor modifications in its monetary policy framework once inflation has reached slightly higher and more stable levels.

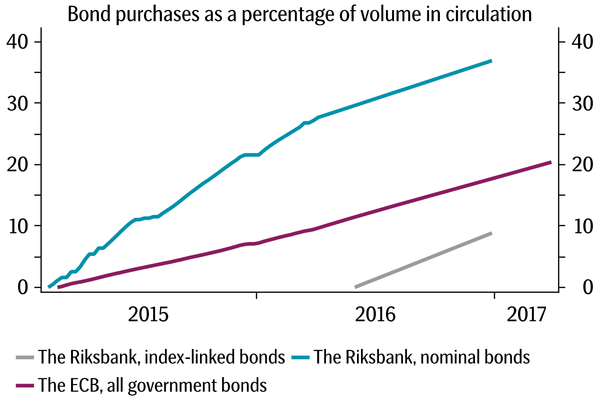
Wider yield spreads by late 2017

Over the past six months, the yield spread between Swedish and German 10-year government bonds has widened to 60-70 basis points, on a par with the highest levels in 15 years. The ECB's large-scale bond purchases have again pushed German yields down to their spring 2015 lows. Comparing the scale of ECB and Riksbank bond purchases, we note that the ECB's are larger as a percentage of GDP, but due to Sweden's relatively low government debt the Riksbank's holdings still represent a far higher percentage of the bond supply. By the end of 2017, the Riksbank's holdings will be equivalent to 37 per cent of the bond supply, while the ECB's will represent less than 20 per cent of supply. So far, Riksbank purchases have not pushed down yields to the same extent, while market disruptions have been limited. This is mainly because foreign investors have reduced their holdings. However, we believe that the Riksbank will gradually have greater difficulty finding sellers, which would **push down Swedish yields and thus narrow the spread against Germany** during the next six months.

But during 2017, it is reasonable to assume that the spread will widen again as the Riksbank begins to deliver rate hikes. It is also likely that because of low liquidity, Swedish bonds will begin trading with a premium. Taken together, this means that we are expecting the yield spread against Germany to widen to 90 basis points towards the end of 2017, which would be the highest level since the mid-1990s. In absolute terms, **the yield on a 10-year government bond will climb to 1.60 per cent**, which is still very low in a historical perspective.

Riksbank buying a larger proportion of bond supply

Bond purchases as a percentage of volume in circulation



Source: The Riksbank, ECB

Bumpy path towards a stronger krona

Divestment of Swedish financial assets – fixed-income securities and equities – by central banks and sovereign wealth funds has helped to keep the krona weak against the euro and other currencies over the past 1-2 years. But according to the KIX currency index, the krona is trading at its strongest level since 2014 – mainly due to a weaker US dollar and depreciating emerging market currencies. The krona continues to confirm the pattern of being pushed downward against the euro and other currencies in times of financial market turbulence.

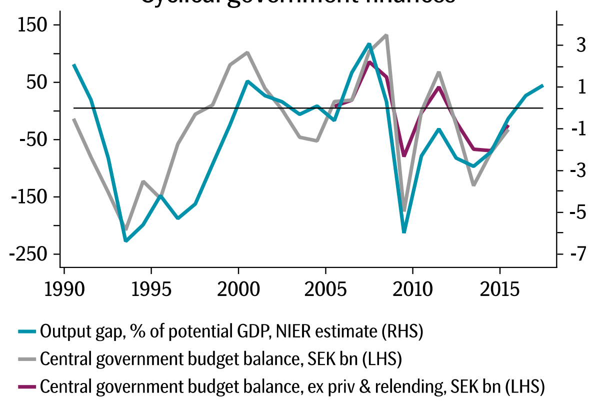
Foreign interest in the krona has gradually increased, since the Riksbank's monetary policy is viewed as increasingly unsynchronised with current trends of economic growth, inflation and household debt. As expectations of a reversal in Riksbank policy in 2017 increase, we also believe that the krona will appreciate. But the market is also unlikely to ignore the Riksbank's repeated assurances that krona appreciation jeopardises its own inflation forecasts. The G20 and G7 have clearly criticised countries that use monetary policy tools to weaken their currencies. We and the market believe this will reduce the risk of interventions involving the Swedish krona.

Our forecast is that the **EUR/SEK** exchange rate will be **9.00 and 8.70 at the end of 2016 and 2017 respectively**. This implies that **the krona will be trading closer to its equilibrium rate against the euro**. Because of a gradually stronger trade weighted dollar, as the Fed continues its rate hiking cycle, the krona in trade weighted terms (KIX) will appreciate to a lesser extent, to 103.6 at the end of 2017, which implies that the Swedish currency's entire depreciation since 2013 will have been reversed.

- **Strong economy improving budget balance**
- **Risky underlying public spending pressures**
- **Government faces a difficult balancing act**

Due to strong economic growth, Sweden's public finances will improve in 2016 and 2017. The historical pattern of cyclically sensitive government finances is being reconfirmed again. The impact on tax revenue will be especially large, since **GDP growth is employment-heavy** and is driven by **highly taxed demand segments such as construction and private consumption**. Despite rapidly rising migration-related costs and spending pressure in other areas, total spending is being revised downward from earlier forecasts. The official **expenditure ceiling for 2016 thus no longer seems to be in jeopardy**. Forecasts of the number of asylum seekers have been lowered. There are many indications that the Swedish Migration Agency must revise its forecasts further downward from the 60,000 asylum seekers in its current main scenario.

Cyclical government finances



Source: NIER, ESV, Statistics Sweden

Our forecast implies that **the public balance will stay at just above zero in 2016 and 2017.** Government debt will continue falling to 40 per cent of GDP at the end of 2017. The budget balance is expected to show a small surplus in 2016 and 2017, despite a more extensive reform agenda in the Budget Bill for 2017. Overall fiscal policy is expansionary in 2016, mainly due to the increase in unfunded spending in the wake of the refugee crisis. We estimate that **increased public spending will contribute just below 1.5 percentage points to GDP in 2016**.

More manoeuvring room creates quandary

Given its growing degree of freedom, the government will eventually face choices between different principles for crafting its fiscal policy, especially since the fiscal framework created in the 1990s has become less clear in recent years. **The surplus target** (1 per cent of GDP over an economic cycle) **is being played down**, while **the definition of the "krona-by-krona principle"** (full funding for new spending) **has become increasingly vague**. Also important to note is that standard calculations of the structural budget balance are based on deviations from normal resource utilisation related to output and/or unemployment. Most estimates indicate that resource utilisation today is fairly normal, which means that the actual and structural budget balance are roughly the same. In that sense, it cannot be maintained that high growth will make the budget situation artificially strong.

Public finances

Per cent of GDP

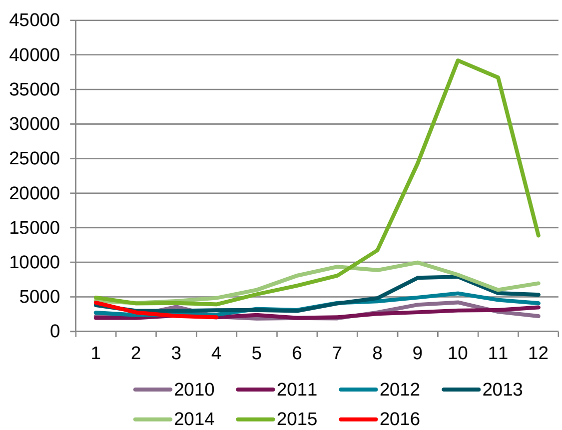
	2014	2015	2016	2017
Net lending	-1.6	0.0	0.4	0.1
Borrowing req., SEK bn	72	33	-18	-9
Gen. gov't gross debt	44.8	43.4	42.0	40.0

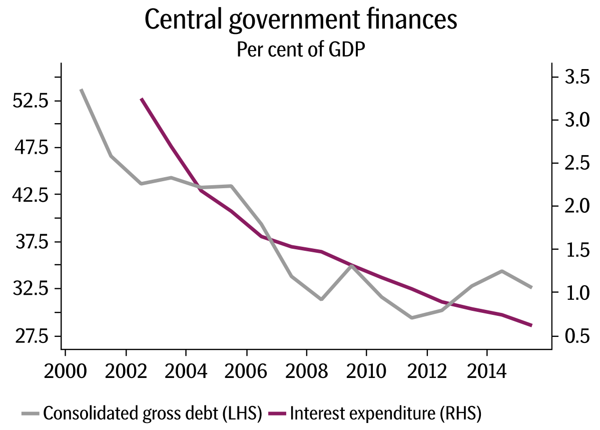
Source: Statistics Sweden, SEB

Another argument in favour of unfunded spending hikes is that extraordinary programmes to integrate migrants into society and the labour market after an exceptional wave of **refugee immigration is comparable to other major investments in the future, such as infrastructure**. But such an interpretation assumes that these investments are temporary and not a permanent increase in the spending level. Last autumn's tightening of migration policy may suggest this direction, although it is hard to draw conclusions about future refugee flows. Finally, one can argue that a more expansionary fiscal policy would also be compatible with recommendations by the IMF and other organisations that fiscal manoeuvring room should be used as much as possible to ease the burden on monetary policy. Given low government debt and large current account surpluses, this advice is undoubtedly applicable to Sweden.

Migration into Sweden has slowed appreciably

Refugee arrivals, monthly data





Source: Macrobond

Worrisome underlying spending pressure

In practice, there are also important arguments in favour of a continued cautious fiscal policy. Although an output gap approach at macro level leads to reassuring conclusions about the structural budget balance, we can identify **a number of individual public finance items that are now at stressed levels**. Government debt interest payments are one example; sensitivity analyses show that a 1 percentage point rate hike will be equivalent to SEK 13 billion in increased spending. But more importantly, many parts of the public sector are under heavy pressure. A combination of low pay levels and over-burdened working conditions has led to recruitment problems and large-scale resignations by experienced staff. This applies to important fields like the police, health care and schools. Increased resources are likely to be needed to avoid a drastic decline in quality. The local government sector is also generally signalling that costs per asylum seeker are probably being underestimated and that **municipal and county council income taxes will need to be raised dramatically, unless the central government supplies more funds**.

Labour market programmes may also require sizeable extra funding, partly because many new arrivals in Sweden risk getting stuck for long periods in subsidised employment. This is especially true if **the government is not prepared to open up a labour market for unskilled, low-paying jobs**. Sick leave spending has been pushed down and is thus an uncertain area. Sick pay costs will rise from SEK 32 billion in 2014 to SEK 51 billion in 2019, according to the 2016 budget bill. Growing geopolitical tensions in northern Europe may also require increased defence funds, after a long period of cutbacks.

Cyclical risks are also important. Resource utilisation in the economy does not suggest overheating, but this is no guarantee of continued rapid growth. There have been various examples of economic downturns before the GDP gap has closed. In such cases, the cyclical sensitivity of Swedish government finances becomes a threat. One rule of thumb is that a 1 per cent drop in GDP growth weakens the budget by nearly SEK 20 billion. International worries about highly inflated home prices in Sweden may also be good reason for caution. These concerns have not led to demands for a higher Swedish risk premium, in part because of strong underlying government finances. Bold fiscal experiments would thus increase vulnerability by weakening the potential for easing the consequences of a possible decline in home prices.

Government is pondering alternatives

At present, it is difficult to determine how the government will act. When there are economic arguments in both directions, political risk assessments will be decisive. In the 2014 election campaign, it was important for the future Social Democratic finance minister, Magdalena Andersson, to successfully neutralise her Moderate Party predecessor, Anders Borg, in projecting an image of fiscal responsibility. Now in opposition, the Moderates seem to be picking a fight on the issue of fiscal discipline. If the Social Democrats lose such a debate, they risk a further decline in public confidence concerning their suitability for office. On the other hand, the government may become more desperate about its ambition to reverse its decline in public support before the 2018 election. A large proportion of the labour movement probably favours the idea that a generous dose of economic stimulus is worth a try, all else aside. The Trade Union Confederation (LO), for example, has advocated such a policy for a long time. The idea also enjoys heavy support from labour movement newspapers and think tanks, which generally seem to have moved in a more radical, idealistic direction over the past decade.

The government will probably be forced to try to find a compromise between the various strategies. **It will gradually adopt a more expansionary fiscal policy**, but not in a dramatic way, enabling the finance minister to argue that **government finances are under control** and that deficits are smaller than when the government took office in 2014. After a cautious spring budget bill, in which the most important signal was that the local government sector will be granted an extra SEK 10 billion starting in 2017, we will probably see a more aggressive autumn budget bill. It is likely to prioritise classical Social Democratic areas such as social welfare and housing construction, as well as investments in skills, for example an adult education package for the growing category of people with little formal education. Altogether, we expect a fiscal stimulus effect equivalent to 0.5 per cent of GDP in 2017. The last budget before the election, to be submitted in September 2018, will probably be even more expansionary.

Despite the Social Democratic-led government's weak public opinion figures and the deep crisis affecting its junior coalition partner, the Green Party, the opposition Alliance has continued to refrain from new initiatives. Alliance party leaders are clearly focused on winning the 2018 election and do not want to assume the risk of taking over the reins of power given their current weak political situation. If the government actually succeeds in re-igniting its political fortunes with the help of a strong economy and aggressive fiscal policy, the situation may change. Internal criticism of a passive strategy that allows a minority government to regain the political initiative may then become louder. We still believe that Alliance leaders will avoid bringing down the government as long as they can. A tactic of blocking some parts of government policies to show the limits of the minority government's authority is more probable.

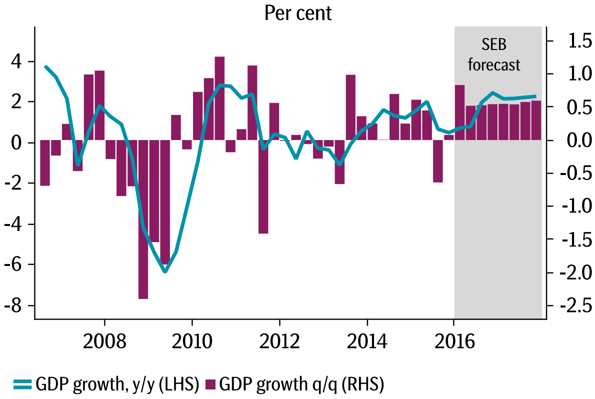
Growth expected to recover in 2016

- **2015 growth slump without obvious drivers**
- **Growth back on track in 2016**
- **Only moderate FX inflow in Brexit scenario**

The Danish economy did not deliver as expected in 2015. After a solid start in 2015, growth turned south in the second half with a drop in GDP of 0.6 per cent in the third quarter followed by more or less unchanged GDP in Q4. **This brought annual growth in 2015 as a whole to 1.2 per cent – a negligible acceleration from the 1.1 per cent recorded in 2014** and much weaker than had been expected entering 2015.

Denmark not in a recession

Per cent



Source: Statistics Denmark, SEB

Last year's economic performance raises the question of whether **Denmark is in a recession**. But it is currently hard to see any of the patterns normally associated with recession. Employment is growing at a healthy clip while the country's main export destinations are seeing no significant economic slowdown. Thus, we expect quarterly growth in 2016 to bounce back to the levels seen in late 2014 and early 2015, i.e. around half a per cent each quarter. Still, carry-over effects from the 2015 slump are spilling into this year, which is why **we expect growth of 1.5 per cent in 2016, accelerating to 2.2 percent in 2017** (a downgrade of 0.3 percentage points in 2016).

One key explanation for this weakness is disappointing capital spending. Volatile large single items contributed negatively in Q3, while construction suffered in both Q3 and Q4. However, looking at home sales and prices, the Danish housing market seems to be in solid shape – and geographically the recovery seems to be broadening. Strangely, the sudden weakness in construction is occurring while building permits are improving. Such a gap is unusual and it does not seem to be due to weather-related effects. Just short of post-crisis highs, construction sector sentiment is signalling no trouble either, so we expect capital spending growth to reach 2.4 per cent during 2016 (up from 1.2 in 2015).

On the final demand side, fundamentals among households are generally improving. Job growth is picking up speed and wages are growing steadily. This combination is bringing a further improvement in aggregate income and spending power – the latter also supported by extremely low inflation. Last year also saw an increase in financial savings among households. A partial reversal in 2016 might provide additional support for consumption. One cause of concern is sliding confidence, but current levels have historically corresponded to around 2 per cent growth in spending. As we move into 2017, consumers are expected to benefit from higher compensation as the labour market gradually becomes tighter. In 2016 we expect consumption growth to remain just above 2 per cent, accelerating to 2.6 per cent in 2017.

Exports fell in 2015, but we expect better foreign trade dynamics ahead. The key is the ongoing recovery in northern Europe, since half of Danish exports end up there. Medical products are important for non-European trade but tend to be less cyclical. We foresee moderate recovery in exports with growth of 1.5 per cent in 2016, rising above 4 per cent in 2017.

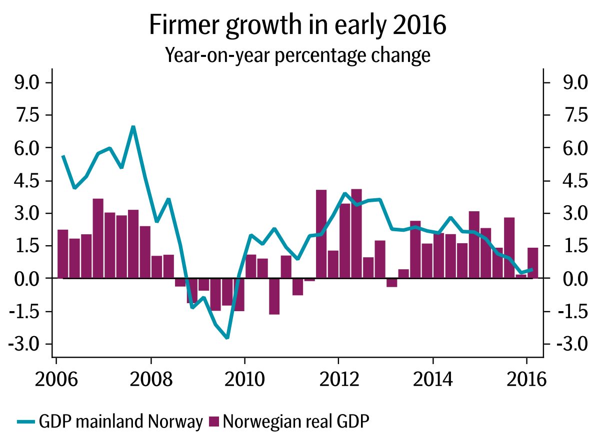
Sluggish exports only led to a slight deterioration in the current account, since imports had a feeble 2015. Still, Denmark retains a solid external position, with a surplus of 6 per cent of GDP. We expect only a moderate worsening during our forecast period. Inflation dynamics are still extremely moderate. The inflation rate was flat in April, with core inflation at 0.4 per cent. This puts the core rate in Denmark below that of the euro zone, but we still expect Danish inflation to outpace that of the euro zone slightly, since labour market slack is smaller in Denmark. The Danish inflation rate is expected to come in at 0.3 and 1.2 per cent in 2016 and 2017 respectively.

One key short-term monetary policy issue is changes in capital flows ahead of the British EU referendum. This theme has gained the attention of markets lately, but so far there is no evidence of changing flows. The question is whether a Leave outcome in the UK could again bring "safe haven flows" to Denmark, spurring a need for central bank intervention in the foreign exchange market. However, significant flows seem unlikely. It was more obvious that Denmark should see such inflows when troubles were centred in the euro zone, against which the Danes peg their currency.

The gloom is slowly fading

- **GDP forecast lowered**
- **But growth recovering in early 2016, non-oil domestic demand better than expected**
- **Fiscal expansion makes rate cut uncertain**

Expectations about the Norwegian economy have long been depressed in the wake of the ongoing pullback in the petroleum sector. The decline in capital spending in the sector is far from over and will continue to pull down demand in the economy. However, developments over the winter were not weaker than expected. Any sense of a broader-based crisis with risks of more severe secondary effects is slowly lifting, and spring has brought some green shoots. Recent indicators for the labour market and manufacturing – the sector hit the hardest by the sharp pullback within petroleum – portend stabilisation and fit with our expectation that the low point in terms of economic momentum is now past.



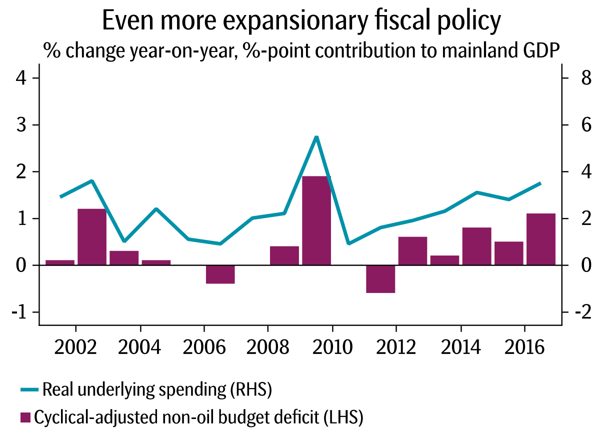
Source: Statistics Norway

Mainland GDP – excluding oil/gas and shipping – was very weak throughout 2015 and actually slipped in the second half, but the 0.3 per cent sequential gain in the first quarter of 2016 was reassuring. While still soft, it was encouraging that non-oil domestic demand showed broad-based improvement and is running ahead of the forecast.

Our forecasts have nonetheless been lowered. First, negative revisions to the national accounts since the February issue of *Nordic Outlook* have left a weaker momentum going into 2016. Second, exports of non-oil goods dropped more than 5 per cent in the first quarter, along with a whopping 38 per cent plunge for refined petroleum products. While a rebound is looming, the very low starting point weighs heavily on our full-year forecast. As a result, **we have lowered our forecast for growth in mainland GDP to 1.1 per cent in 2016** (from 1.5 per cent in the February *Nordic Outlook*) and to **2.0 per cent in 2017**. Meanwhile, capital spending in the petroleum sector has dropped by a third over the past ten quarters and slightly more than previously suggested, suggesting that the decline should be 14.5 per cent in the current year. In sum, **overall GDP should be up 1.2 per cent in 2016 and 1.5 per cent in 2017**.

Fiscal policy even more expansionary

Sharply lower oil prices have more than halved the government's net petroleum income between 2014 and 2016, according to the spring budget bill, but this substantial shortfall has not led to any belt-tightening. On the contrary, expenditures continue rising more than non-oil revenues, for example as the government increases its efforts to stem unemployment. Norway is benefitting from the introduction of a "fiscal policy rule" 15 years ago, which ties budget spending to the size of the Government Pension Fund Global (the sovereign wealth fund) and shields spending from variations in oil prices.



Source: Ministry of Finance

In fact, the **fiscal thrust is rising** from 0.5 percentage points of mainland GDP in 2015 to 1.1 percentage points in the current year, the most since 2009. The non-oil budget deficit is swelling by NOK 30 billion to NOK 216 billion according to the revised budget, equivalent to 8 per cent of mainland GDP, the highest ratio since 1993. The deficit exceeds net petroleum revenues by NOK 84 billion which is covered by transferring an equal amount of the interest and dividend income from the GPFG. Including such income, the consolidated budget for the central government is still in surplus: while the smallest in many years, it corresponds to a healthy 3.7 per cent of GDP. In addition to ongoing stimuli from lower interest rates and previous currency depreciation (still having an effect despite some reversal since the end of 2015), fiscal policy will be important in mitigating still-strong headwinds from the petroleum sector.

Depressed but spending nonetheless

We have previously singled out private consumption, not oil, as the main uncertainty factor in our forecast to the extent consumers started acting as very depressed sentiment would suggest. Spending on goods stabilised in the first quarter after declining over the second half of 2015, but as the trend in services held up, sequential growth in household consumption actually firmed and the level was 2.0 per cent higher than a year earlier: far better than still-negative confidence indices indicate. While other segments of private consumption have been a drag – such as spending by non-profit organisations and higher spending by foreigners which is subtracted – **we have raised our forecast for 2016 aggregate spending to 1.8 per cent** but **kept it at 2.3 per cent for 2017**. Slower wage growth and higher overall inflation are squeezing purchasing power, but employment is holding up better than feared, putting a floor under aggregate income.

Stabilising labour markets

Recent labour market indicators suggest that weakness has stopped feeding on itself. The biggest surprise is reaccelerating job growth: following the decline over the second half of 2015, employment using the Labour Force Survey metric rose 0.5 per cent in the first quarter from the previous one. The gain seems a bit exaggerated, but the 10 per cent increase in new vacancies year-to-date shows underlying demand.

The LFS unemployment rate was up half a percentage point in the year to the first quarter but, at 4.6 per cent, was unchanged from the previous two quarters. Meanwhile, the number of people registered as unemployed, generally seen as a more reliable measure, declined over the first four months of the year. The five counties along the southern and western coast most affected by the pullback in petroleum have seen a further increase so far in 2016, but net registered unemployment in the rest of the country has declined year-on-year in every month but two since the start of 2015.

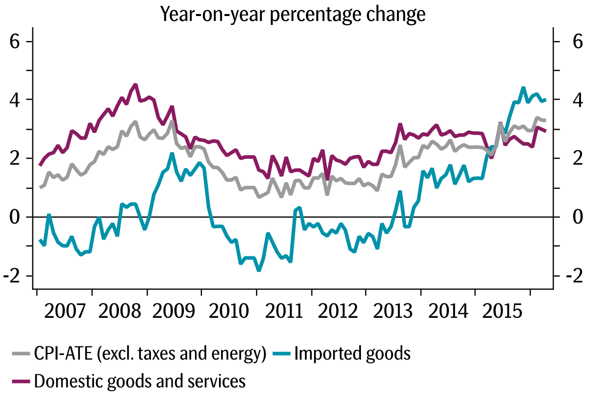
These developments suggest that weakness is not spreading. Combined with better-than-expected job growth, this would suggest lowering our unemployment forecast. However, since temporary layoffs have continued increasing rapidly in recent months, we are only nudging our forecasts **for LFS unemployment** lower to **4.8 per cent in 2016 and 2017**, but the risk no longer seems squarely to the upside. Registered unemployment should increase a bit more from the April level of 3.0 per cent (seasonally adjusted).

Sticky fingers

Core inflation as measured by the CPI-ATE measure (excluding taxes and energy) remained sticky over the winter. The annual rate was 3.3 per cent in April and has stayed above Norges Bank's 2.5 per cent target for 11 consecutive months. One common explanation for elevated inflation is the sharp upturn in prices for imported goods, a by-product of the sharp currency depreciation the central bank has aimed at to support overall activity. This explanation is certainly valid, since imported inflation on the core measure has turned sharply higher and was up 4.0 per cent in the year to April. Changes to the NOK import-weighted index suggest that imported inflation should slow considerably this summer.

It's not all about the currency

Year-on-year percentage change



Source: Statistics Norway, SEB

More surprising is that core domestic inflation is near 3 per cent. There are some secondary effects from the exchange rate, but at the same time rent inflation – almost a third of the domestic basket – has eased quite a bit over the past couple of years. Continued moderate wage growth should ease service inflation. Combined with a currency effect in reverse, this should **slow core inflation from 2.9 per cent in 2016 to 2.2 per cent in 2017**. **Overall CPI should be up 3.1 per cent and 2.2 per cent** this year and next.

The trough is near

Norges Bank kept the key interest rate at 0.5 per cent at its May meeting. The bank refrained from giving any explicit guidance, though the rate path in its March *Monetary Policy Report*, which implied one or two further rate cuts, seems obsolete. Higher oil prices and the more expansionary spring budget bill have eased downside risks to growth and the **need for even lower key rates has thus been reduced**.

In our view, keeping the NOK weak is the central bank's main objective. Norges Bank will thus be on guard for an excessively rapid oil-driven rally in the krone until growth momentum improves. Soft growth, rising unemployment and a stronger NOK may thus persuade Norges Bank to deliver one final 25 basis point cut in September.

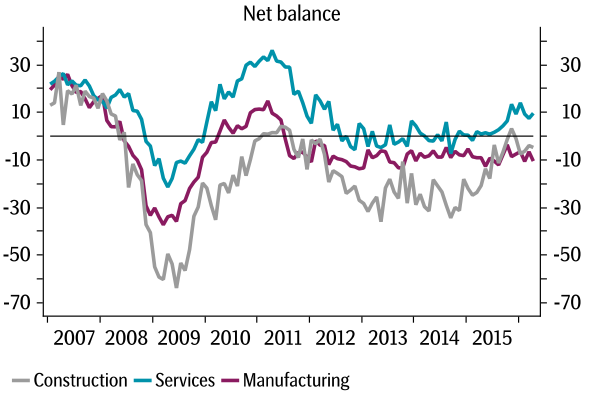
The NOK exchange rate is benefiting from higher oil prices and less dovish monetary policy. The krone's valuation suggests that the currency remains very cheap against most other G10 equivalents. Moreover, the flow outlook will continue to support the krone as the government is using more of the returns from the Government Pension Fund Global to cover its non-oil budget deficit. We expect **the EUR/NOK exchange rate to reach 9.10 and 8.50 by the end of 2016 and 2017, respectively**.

Growth is back, but a long uphill struggle remains

- **Exports are slowly reviving**
- **Households are being squeezed from several directions...**
- **...but low inflation will allow some room for increased consumption**
- **Continued public sector austerity**

An unexpectedly strong finish in 2015 saved Finland from its fifth recession since 2008. Early 2016 statistics have also provided upside surprises, but the Finnish economy continues to face adversities. The manufacturing sector and exporters are having a tough time, although we foresee some improvement. Households are being squeezed by high unemployment and public sector cost-cutting as the government struggles to bring down budget deficits and improve Finland's competitiveness. Despite these problems, there are certain signs of recovery, and **GDP will grow by 0.7 per cent in 2016 and 1.1 per cent in 2017**. This forecast is somewhat higher than in the February issue of *Nordic Outlook*.

Sentiment indicators are looking somewhat brighter



Source: European Commission

Indicators are at decent levels compared to recent years, but the situation remains a bit less upbeat in manufacturing and construction. Industrial production is still falling, but a turnaround is under way. Production in the forest product industry seems to have stabilised after a 25 per cent downturn since 2008. Meanwhile the trend in the electronics industry is still negative after a halving of production since 2008. Yet exports have seen some improvement and are now contributing positively to economic growth. Merchandise exports remain weak, but service exports are growing. A weaker euro, improved competitiveness and a certain stabilisation in Russia are helping. **Exports will increase by 1.5 per cent in 2016 and 2.8 per cent in 2017**. Low capacity utilisation is holding back capital spending. After a four-year downturn, we expect **unchanged capital spending in 2016 and then a weak increase in 2017**.

High unemployment, low pay increases and public sector cost-cutting are **continuing to squeeze households**. The jobless rate has fallen slowly. It stood at 9.2 per cent in March – a bit above equilibrium, which we estimate at 8 per cent. Because of weak economic growth, the downturn in **unemployment** will be sluggish. We expect annual averages of **9.1 per cent in 2016 and 8.8 per cent in 2017**. Pay increases have slowed, and today they total about 1.5 per cent annually in the private sector. We expect continued low upward pressure on wages and salaries, in light of high unemployment and the need to restore competitiveness.

The housing market has been a source of concern, but after falling slightly in recent years, home prices have now stabilised. Retail sales increased steadily in 2015, and despite a weak January figure this upturn appears to have continued during the first quarter of 2016. There is limited room for consumption, though, given labour market developments and public sector austerity. The household savings ratio fell in 2015 and is in the lower part of the 5.5-8 per cent interval that has prevailed during the past decade, which indicates that the potential for a further decline is small. Very low inflation – close to zero this year and 1 per cent in 2017 – will enable a slight upturn in purchasing power. **Consumption will increase by about 1 per cent yearly in 2016 and 2017**, which is slower than in 2015.

The years of economic crisis have squeezed Finnish public finances. Public debt climbed above 60 per cent of GDP in 2015, although the budget deficit fell to somewhat less than 3 per cent of GDP. The government previously unveiled far-reaching plans to bring down its deficit and improve the country's competitiveness (see *Nordic Outlook*, February 2016). This includes an effort to improve the public sector balance by EUR 4 billion over several years. Meanwhile the government is trying to persuade unions and employers to agree on steps to improve competitiveness. These negotiations are moving sluggishly, which is one reason why the government is dangling a carrot by promising certain tax cuts if the two sides reach an agreement. Already approved and future measures are expected to have a positive impact on public finances, and we predict that the budget deficit will fall to 2.4 per cent of GDP in 2017.

Waiting for exports to improve

- **Growth hampered by weak exports and capital spending**
- **Labour market has reached the ceiling**

According to first estimates, **Estonia's GDP grew only by 1.1 per cent last year**, much less than expected at the beginning of 2015. GDP growth for 2014 was revised from 2.1 to 2.9 per cent, and an upward revision is also likely for 2015. Yet the second half of 2015 and the first quarter of 2016 have given few reasons for contentment. Euro zone growth forecasts have been trimmed, curtailing the growth potential of Estonian exporters. Low demand and an uncertain environment are hindering investments. **We have thus lowered our GDP forecast** to **2.0 per cent in 2016** and **2.4 per cent in 2017**.

Estonia has one of the most open economies in Europe, with **exports equivalent to 80 per cent of GDP**. Recent years have not been kind to export-oriented countries as global trade has slowed. In 2015, exports shrank by 1.1 per cent, mainly due to the recession in Russia, which reduced bilateral trade by 35 per cent. The contraction was mainly caused by the recession in Russia, which reduced trade by 35 per cent. The drop was more significant to transportation and storage sector, as 70 per cent of the trade to Russia is re-export. Estonia's top export destinations continue to be Sweden and Finland. Although Finland's total imports declined in 2015, Estonia managed to increase its sales and gain market share. Exports to Sweden are dominated by a single electronics manufacturer, which decreased its production last year. Without it, exports would have increased by 10 per cent thanks to increased sales of furniture and prefabricated houses. Fast growth in Sweden and Germany, together with improved prospects in Finland, give reasons for more optimism this year.

The most significant factor behind last year's slow GDP growth was a **4.5 per cent drop in gross capital formation**. Even though private investment in housing has increased, business sector investments remain weak because of dwindling exports and surging labour costs. In prior years, major projects in the energy and chemistry industry kept the numbers up, but now there are few sectors that can fill the gap. The public sector has been modest in its investments because of the transition from one EU Structural Funds period to another. We expect a moderate upturn in capital spending this year, fuelled by improved exports and public sector investments.

Although the **labour market** performed strongly in 2015, with unemployment falling to 6.2 per cent, **this positive trend seems to have reversed**. Unemployment, on the wane for five consecutive years, has started to increase year-on-year. Business revenues declined in 2015, and **companies need to cut costs**. At the same time, **average wages and salaries rose by 6 per cent** last year, as firms struggled to recruit new employees. Since the labour market responds to changes in demand with a delay, companies may begin to cut employee numbers. Structural changes are needed in the economy, and there will be no better time to move labour from low value-added sectors to ones with better growth potential.

Labour costs keep rising

Year-on-year percentage change

Source: Statistics Estonia

The strong labour market has boosted household spending. Private consumption rose by 4.8 per cent in 2015. In addition to the surge in average pay, disposable income increased thanks to a 1 per cent cut in income tax and an increase in social benefits. Households also benefited from deflation; CPI fell by 0.5 per cent, thanks to lower energy and food prices. This year **HICP** inflation will be only **0.9 per cent, followed by acceleration to 2.7 per cent in 2017**. Inflation and a **more moderate upturn in disposable income** will trim the growth of private consumption compared to 2015.

To smooth the economic cycle, the government has decided to pursue a **more expansionary fiscal policy** by increasing spending and reducing reserves. Estonia's public finances will remain conservative, with a budget deficit of about 0.5 per cent and public debt of less than 10 per cent of GDP. Concerns have been raised that Estonia is not benefiting from low interest rates and could take on more debt to finance capital spending. There is surely room for more investments, but the tight labour market and good growth in private spending make any further need to stimulate domestic demand debatable.

Consumption will accelerate growth in 2017

- **Strong labour market and pay hikes lift purchasing power amid growing challenges**
- **Demographic weaknesses are increasing the need for structural reforms**

Latvia is in a **growth slump**, in line with global trends, but the outlook for increased economic activity during the rest of 2016 and in 2017 is relatively good. **We expect GDP to climb by 2.7 per cent in 2016** – the same as in 2015 – and **then accelerate to a 3.5 per cent rate in 2017**. Potential growth is estimated at 2.5-3 per cent. The main drivers behind this acceleration will be higher private consumption as well as capital spending and a cautious improvement in external demand, but **downside risks predominate** – among other things due to continued economic and political uncertainty related to Russia.

First quarter 2016 GDP figures indicate low economic activity. Construction declined sharply and will continue to be squeezed by the absence of major projects and decreased access to EU funds. Yet industrial production is increasing, and the outlook for important sectors – such as fabricated metal products, food processing and forest products – is relatively good.

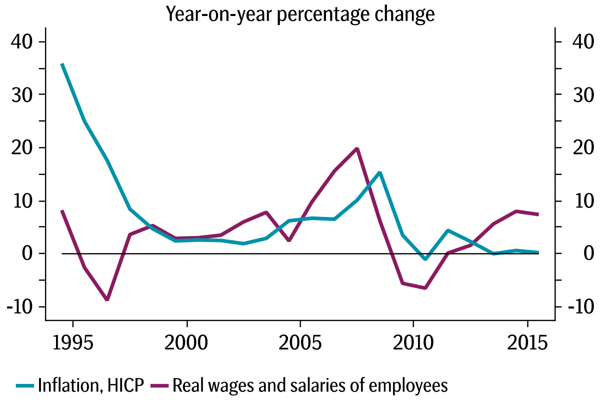
Private consumption will remain the primary growth engine, among other things due to pent-up consumption needs. During the past six months, consumption growth has been weak because of international uncertainty. **But real wages will climb by 5-6 per cent both in 2016 and 2017** after increasing by 7.4 per cent in 2015. As a result, we believe that **private consumption will grow by 3.3 per cent this year and 4.2 per cent in 2017**. The European Central Bank's stimulus policies will also benefit domestically oriented sectors, but to ensure more broad-based and stable growth, Latvia needs higher business investments. The short-term export outlook will be hampered by a stronger euro, but looking ahead we believe that efforts to reduce dependence on Russia and diversify exports will make a volume upturn possible.

Unemployment will continue to fall gradually. **At the end of 2017, the jobless rate will be 7.7 per cent**. We thus expect the output gap to close. Good growth, but especially a shrinking labour force due to demographic factors and emigration, will pose major structural challenges to the economy. Nominal pay hikes must decelerate to ensure that Latvia does not lose the competitiveness it regained earlier.

As in most of the euro zone, inflation is very low. Since January 2016, prices have actually been falling. A number of economic sectors are currently reporting price declines, for example transport, alcoholic beverages and tobacco, health care and the hotel and restaurant sector. Looking ahead, fluctuations in energy prices will play a major role in monthly figures, but the underlying trend will be a gradually rise in inflation pressure. Late in 2016 inflation will again become positive. **Inflation will average 0.2 per cent in 2016, rising to 2.1 per cent in 2017**.

Robust real wage growth

Year-on-year percentage change



Source: Central Statistical Bureau of Latvia

The Latvian economy rests on a **relatively strong fundamental base**. The current account deficit is about 2 per cent of GDP, and the budget deficit barely exceeds 1 per cent – both sustainable levels. We expect government debt to remain below 40 per cent of GDP during our forecast period. Private non-financial sector debt totals about 100 per cent of GDP: well below the 160 per cent that international organisations have identified as a critical level. **Excessive debt will thus not hamper medium-term growth**.

The long-term growth outlook will depend on reforms that enable to **achieve higher productivity and strengthen its competitiveness**. This spring, Latvia concluded technical negotiations with the OECD to become its 35th member country, but the government in Riga must now implement the structural reforms discussed during the OECD accession talks. So far, the government has made only **limited progress in implementing these reforms**.

Despite strong public finances, with deficits well below the euro zone's thresholds, we expect Latvia to ask the European Commission for permission to increase its 2017 budget deficit marginally. The background is the government's need to carry out reforms in the health care sector. Looking ahead, **the government will need to create fiscal room that can be used for productivity-raising policies**. The government's efforts – and its success – in boosting the efficiency of tax collection will improve its chances of creating this fiscal room.

On the road to economic recovery

- **Economic growth is improving**
- **Unemployment is falling**
- **Inflation has started to pick up**

Economic growth has regained momentum, based on recovering exports and relatively solid private consumption growth, and supported by the fall in unemployment rate and higher gains in average wages. Despite uncertainties about the global economy, **we are sticking to our GDP growth forecast: 2.8 per cent in 2016**, up from 1.6 per cent last year, **and 3.2 per cent in 2017.**

Recent industrial confidence figures reveal caution linked to worries about the economic situation of major export partners. However, we expect merchandise exports to climb in 2016 due to base effects and higher sales to EU countries. Meanwhile, confidence in the service and distributive sectors has already rebounded to pre-crisis levels. In the construction sector, residential builders are seeing expansion while civil engineering business is shrinking. **The residential property market in Lithuania remains balanced** and the prices of apartments are still rising at a healthy pace this year.

The labour market is tightening. **The unemployment rate will drop to an average of 8.0 per cent in 2016**, down from 9.1 per cent last year, **and 7.7 per cent in 2017**. Economic growth is stimulating the creation of new jobs, but the labour force remains generally stagnant due to large-scale emigration. The resulting shortages of skilled labour will slow the expansion of businesses and have a negative impact on the economy in longer term. The so-called Social Model proposal, which would make labour relations more flexible, is still stuck in the Parliament. The probability that the model will finally be approved this year has been diminishing.

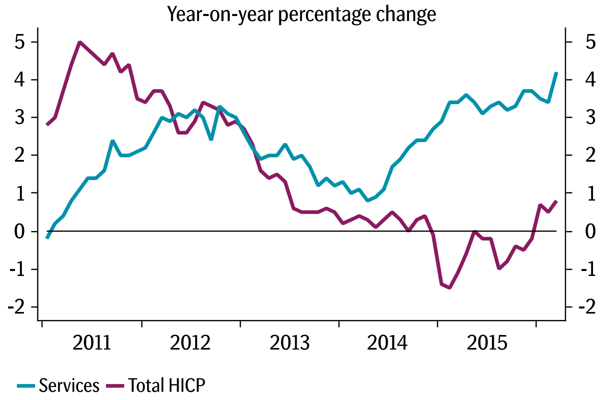
The increase in the minimum monthly wage has contributed to faster growth in **average nominal pay, which looks set to go up by 7 per cent in 2016 and 6 per cent in 2017.** This threatens competitiveness, since the growth in average wages has been outpacing the increase in productivity. Although businesses are still slow to innovate, initiatives by the government and a growing perception of the need for change lead us to believe that the situation will gradually improve. In 2015, gross fixed capital formation jumped by 10.3 per cent on higher investments by energy and manufacturing companies. Investments will increase more slowly in 2016, but will still contribute to the growth of bank loan portfolios.

Although average annual HICP changes are still showing deflation, we expect an **inflation rate of 0.3 per cent this year**, up from -0.7 per cent in 2015, **and 1.2 per cent in 2017.** The fastest growth is occurring in the prices of services, because businesses are naturally passing on the increase in average wages to end-users. The effect of low energy prices is fading, opening the way for higher labour costs to drive inflation.

Early in 2016, the NordBalt power cable between Sweden and Lithuania started operating. Although disruptions are still frequent, the favourable effect of the cable on average wholesale electricity prices in Lithuania is evident. The price of electricity to residential end-users will be probably fall by as much as 5 per cent by mid-2016.

The growth of service prices is accelerating

Year-on-year percentage change



Source: Eurostat

Public finances have improved in the recent years. In 2015 the general government budget deficit was 0.2 per cent of GDP. This improved balance was mainly achieved due to better tax revenue – a consequence of strong growth in wages and consumption. Expenditure growth was limited, despite increased funding for the defence sector. This year we expect a **budget deficit of 1.0 per cent of GDP** due to faster increases in expenditures for defence, pensions and public sector wages.

The political scene is heating up ahead of the **October 9 parliamentary election**. The idea of reducing the value-added tax (VAT) rate on food – which is currently the same as on other goods – is getting a lot of public attention, although an increased tax exemption would be more helpful to the lowest-income households. We do not expect any drastic changes in economic and social policies after the elections.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2014	2015	2016	2017
GDP OECD	1.9	2.1	1.9	2.3
GDP world (PPP)	3.4	3.1	3.1	3.7
CPI OECD	1.7	0.6	0.7	1.7
Export market OECD	4.0	3.4	2.7	4.4
Oil price, Brent (USD/barrel)	99.5	53.4	42.5	50.0

US

Yearly change in per cent

	2015 level, USD bn	2014	2015	2016	2017
Gross domestic product	18,165	2.4	2.4	1.9	2.5
Private consumption	12,445	2.7	3.1	2.6	2.7
Public consumption	3,204	-0.6	0.7	0.7	0.0
Gross fixed investment	3,031	5.3	4.0	2.7	5.8
Stock building (change as % of GDP)		0.0	0.2	-0.2	0.0
Exports	2,217	3.4	1.1	1.2	5.7
Imports	2,731	3.8	4.9	2.5	6.8
Unemployment (%)		6.2	5.3	4.8	4.5
Consumer prices		1.6	0.1	1.1	2.1
Household savings ratio (%)		4.8	5.1	5.4	6.0

EURO ZONE

Yearly change in per cent

	2015 level, EUR bn	2014	2015	2016	2017
Gross domestic product	10,400	0.9	1.6	1.7	1.8
Private consumption	5,738	0.8	1.7	1.8	1.8
Public consumption	2,169	0.8	1.3	1.4	1.3
Gross fixed investment		1.3	2.7	3.1	3.0
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	4,751	4.1	5.0	4.3	4.0
Imports	4,291	4.5	5.7	5.1	4.6
Unemployment (%)		11.6	10.9	10.1	9.6
Consumer prices		0.4	0.0	0.1	1.1
Household savings ratio (%)		6.5	6.5	6.7	6.8

OTHER LARGE COUNTRIES

Yearly change in per cent

	2014	2015	2016	2017
GDP				
United Kingdom	2.9	2.3	1.9	2.3
Japan	0.0	0.6	0.5	0.5
Germany	1.6	1.7	1.7	1.8
France	0.2	1.2	1.2	1.5
Italy	-0.3	0.8	1.2	1.3
China	7.3	6.9	6.5	6.3
India	7.1	7.3	7.5	7.6
Brazil	0.1	-3.8	-3.5	0.5
Russia	0.6	-3.7	-0.8	1.0
Poland	3.4	3.6	3.6	3.8
Inflation				
United Kingdom	1.5	0.0	0.6	1.7
Japan	2.7	0.8	0.0	1.5
Germany	0.0	0.2	0.4	1.7
France	0.1	1.4	0.2	0.7
Italy	0.2	0.0	0.1	0.7
China	2.0	1.4	2.3	2.5
India	7.3	4.9	5.0	4.7
Brazil	6.3	9.0	8.0	6.0
Russia	7.8	15.6	7.3	6.0
Poland	0.0	-0.9	0.8	2.0
Unemployment (%)				
United Kingdom	6.2	5.5	4.9	4.7
Japan	3.6	3.4	3.2	3.1
Germany	5.0	4.6	4.6	4.8
France	10.3	10.2	10.1	10
Italy	12.7	12.4	12.2	12.0

THE BALTICS

	2014	2015	2016	2017
GDP, yearly change in per cent				
Estonia	2.9	1.1	2.0	2.4
Latvia	2.4	2.7	2.7	3.5
Lithuania	3.0	1.6	2.8	3.2
Inflation, yearly change in per cent				
Estonia	0.5	0.1	0.9	2.7
Latvia	0.7	0.2	0.2	2.1
Lithuania	0.2	-0.7	0.3	1.2

FINANCIAL FORECASTS

		11-May	Sep-16	Dec-16	Jun-17	Dec-17
Official interest rates						
US	Fed funds	0.50	0.75	0.75	1.00	1.25
Japan	Call money rate	-0.10	-0.20	-0.30	-0.30	-0.30
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.50	0.50	0.50	0.75	1.00
Bond yields						
US	10 years	1.73	1.85	2.00	2.10	2.40
Japan	10 years	-0.11	-0.20	-0.10	0.00	0.15
Germany	10 years	0.12	0.20	0.30	0.50	0.80
United Kingdom	10 years	1.52	1.50	1.65	2.00	2.30
Exchange rate						
USD/JPY		109	114	116	117	114
EUR/USD		1.14	1.14	1.10	1.10	1.12
EUR/JPY		124	130	128	129	128
GBP/USD		1.45	1.50	1.47	1.49	1.53
EUR/GBP		0.79	0.76	0.75	0.74	0.73

SWEDEN

Yearly change in per cent

	2015 level, SEK bn	2014	2015	2016	2017
Gross domestic product	4,155	2.3	4.1	4.0	2.8
Gross domestic product, working day adjustment		2.3	3.9	3.8	3.0
Private consumption	1,878	2.2	2.6	2.9	2.8
Public consumption	1,083	1.3	2.5	3.8	2.5
Gross fixed investment	1,007	7.5	7.3	6.2	6.0
Stock building (change as % of GDP)	10	0.1	0.1	0.1	0.0
Exports	1,878	3.5	5.9	5.8	4.6
Imports	1,701	6.3	5.4	6.1	6.4
Unemployment (%)		7.9	7.4	6.9	6.5
Employment		1.4	1.4	1.6	1.5
Industrial production		-2.3	2.9	3.0	3.5
CPI		-0.2	0.0	0.9	1.4
CPIF		0.5	0.9	1.4	1.5
Hourly wage increases		2.7	2.6	2.7	3.4
Household savings ratio (%)		15.2	16.0	16.1	15.3
Real disposable income		2.2	3.4	3.6	1.9
Current account, % of GDP		5.4	5.9	5.5	5.2
Central government borrowing, SEK bn		72	33	-18	-9
Public sector financial balance, % of GDP		-1.6	0.0	0.4	0.1
Public sector debt, % of GDP		44.8	43.4	42.0	40.0

FINANCIAL FORECASTS	11-May	Sep-16	Dec-16	Jun-17	Dec-17
Repo rate	-0.50	-0.50	-0.50	-0.25	0.25
3-month interest rate, STIBOR	-0.44	-0.50	-0.55	-0.20	0.20
10-year bond yield	0.71	0.70	0.85	1.20	1.60
10-year spread to Germany, bp	59	50	55	70	80
USD/SEK	8.13	7.98	8.18	8.00	7.77
EUR/SEK	9.30	9.10	9,00	8.80	8.70
KIX	108.8	107.0	106.7	104.6	103.6

NORWAY

Yearly change in per cent

	2015 level, NOK bn	2014	2015	2016	2017
Gross domestic product	3,189	2.2	1.6	1.2	1.5
Gross domestic product (Mainland)	2,498	2.3	1.0	1.1	2.0
Private consumption	1,279	1.7	2.0	1.8	2.3
Public consumption	684	2.9	1.9	2.8	2.5
Gross fixed investment	687	0.0	-4.2	-1.5	1.1
Stock building (change as % of GDP)		0.4	0.3	0.0	0.0
Exports	1,273	2.2	3.4	0.8	1.4
Imports	898	1.5	1.1	0.3	2.8
Unemployment (%)		3.5	4.4	4.8	4.8
CPI		2.0	2.2	3.1	2.2
CPI-ATE		2.4	2.7	2.9	2.2
Annual wage increases		3.1	2.8	2.5	2.6

FINANCIAL FORECASTS	**11-May**	**Sep-16**	**Dec-16**	**Jun-17**	**Dec-17**
Deposit rate	0.50	0.25	0.25	0.25	0.25
10-year bond yield	1.30	1.30	1.30	1.35	1.50
10-year spread to Germany, bp	117	110	100	85	70
USD/NOK	8.16	8.07	8.27	8.00	7.59
EUR/NOK	9.33	9.20	9.10	8.80	8.50

DENMARK

Yearly change in per cent

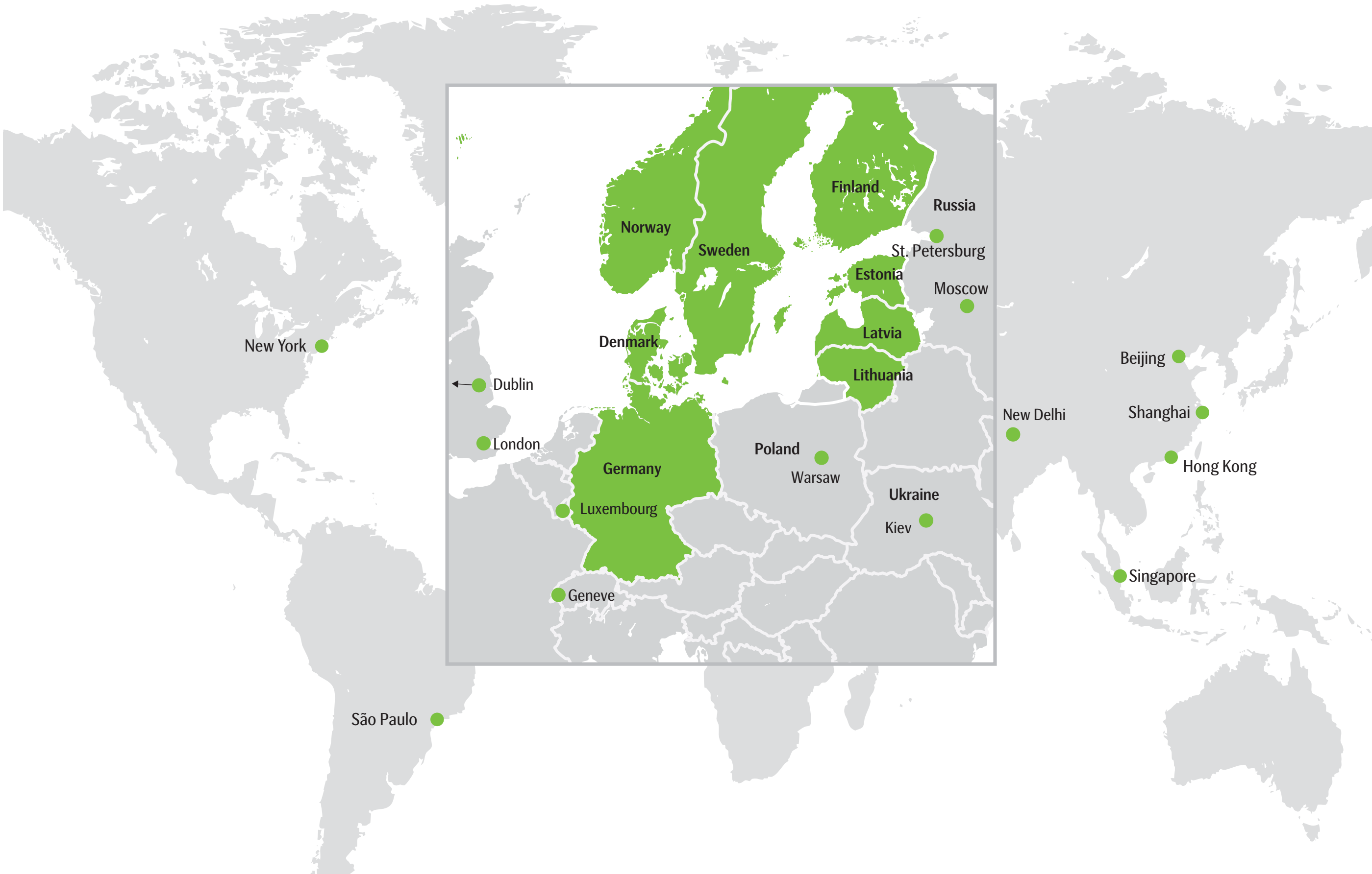
	2015 level, DKK bn	2014	2015	2016	2017
Gross domestic product	1,986	1.1	1.2	1.5	2.2
Private consumption	958	0.9	2.1	2.1	2.6
Public consumption	520	0.2	0.6	0.6	0.9
Gross fixed investment	388	4.0	1.2	2.4	4.0
Stock building (change as % of GDP)		0.3	-0.3	0.0	0.0
Exports	1,058	2.6	-1.0	1.5	4.3
Imports	932	3.8	-1.4	2.0	4.9
Unemployment (%)		5.0	4.6	4.2	3.8
Unemployment, OECD harmonised (%)		6.5	6.2	5.4	4.8
CPI, harmonised		0.6	0.5	0.3	1.2
Hourly wage increases		1.3	1.5	1.8	2.3
Current account, % of GDP		7.6	7.1	6.8	6.3
Public sector financial balance, % of GDP		0.0	-2.1	-2.0	-1.0
Public sector debt, % of GDP		44.8	40.1	40.0	40.0

FINANCIAL FORECASTS	**11-May**	**Sep-16**	**Dec-16**	**Jun-17**	**Dec-17**
Lending rate	0.05	0.05	0.05	0.05	0.05
10-year bond yield	0.45	0.45	0.50	0.65	0.90
10-year spread to Germany, bp	33	25	20	15	10
USD/DKK	6.51	6.54	6.77	6.77	6.65
EUR/DKK	7.44	7.45	7.45	7.45	7.45

FINLAND

Yearly change in per cent

	2015 level, EUR bn	2014	2015	2016	2017
Gross domestic product	211	-0.7	0.5	0.7	1.1
Private consumption	116	0.6	1.4	0.9	1.1
Public consumption	51	-0.3	-0.9	-0.5	-0.2
Gross fixed investment	42	-2.6	-1.1	0.0	1.0
Stock building (change as % of GDP)		0.0	-0.2	0.0	0.0
Exports	77	-0.9	0.6	1.5	2.8
Imports	77	0.0	-0.4	0.6	2.0
Unemployment (%)		8.7	9.3	9.1	8.8
CPI, harmonised		1.2	-0.2	0.1	1.0
Hourly wage increases		1.5	1.5	1.5	1.8
Current account, % of GDP		-0.9	-1.0	-0.9	-0.9
Public sector financial balance, % of GDP		-3.2	-2.7	-2.5	-2.4
Public sector debt, % of GDP		59.3	63.1	64.5	65.0



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