Swedbank Economic Outlook

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Swedbank Economic Outlook presents the latest economic forecasts for Sweden, the Baltics and the major global economies. In a series of indepths, current issues that have a bearing on the economic developments are analysed.

Swedbank Economic Outlook is a product made by Swedbank Macro Research.

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Cover image: Getty Images

Good growth, poor policies

Ten years after the financial crisis, the global economy is back on track. Unfortunately, politics is off the rails. The contrast between decent economic growth and an uncertain political environment remains the main theme in the outlook for the coming years. Populism and poor economic policies are harmful, but, as the case of Venezuela and Turkey shows, the time lag between the introduction of poor policies and the emergence of a full-blown crisis can be long.

Risks are abundant, but the global economy is likely to perform well in the near term

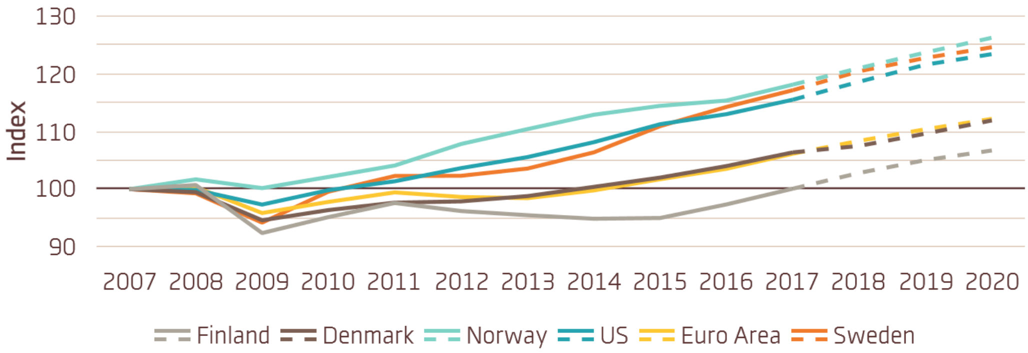
This autumn marks the 10–year anniversary since the Lehman crash in September 2008. The global financial market froze, causing a sharp recession that, in many countries, resulted in the deepest recession since the Great Depression in the 1930s. The subsequent recovery has been painful and slow.

At present, both the US and euro area economies are in much better shape than they have been in the past 10 years. In the US, the expansion is entering its 10th year; if it continues past the summer of 2019, this will be the longest expansion since the 1850s (earliest available data). Europe is lagging the US in terms of recovery, but growth is back and unemployment is getting closer to the levels seen before the financial crisis hit. As a result, central banks have begun normalising monetary policy, led by the Federal Reserve. Overall, economic fundamentals are looking stronger than they were in 2008. Households have deleveraged, firms are investing, and government debt, albeit at high levels, is stabilising in many countries.

Yet, the outlook is far from rosy. There is a political backlash from years of economic hardship. Populism has been on the rise in Europe and in the US, and, in several emerging markets, autocratic leadership has tightened its grip on political and economic power. The economic outlook is, therefore, dependent on how quickly and to what extent poor economic policies, such as the rise in protectionism, will affect the economy. Our view is that growth will stay at decent levels in the near term and show resilience to political turmoil. Importantly, this does not imply that poor policies will not have an impact. These policies do harm long-run growth prospects and elevate the short-term risks to the otherwise rather benign outlook.

Large differences in recovery after the financial crisis

Real GDP, annual, local currency. Index: 2007=100



Note: Calendar adjusted series used for EMU, Finland
Sources: Swedbank Research & Macrobond

The next crisis is likely to come from somewhere unexpected

There are some risks in the near term that warrant attention. The Brexit negotiations are not progressing well. If there is no deal between the UK and the EU in October, financial market turmoil is a likely effect, harming growth prospects. In emerging markets, vulnerabilities have been building in the past 10 years. Low interest rates and abundant liquidity have caused high levels of dollar-denominated debt in countries such as Turkey, South Africa, and Argentina. As the Federal Reserve keeps raising rates and local currencies weaken, the debt situation could easily become unmanageable. A weak Italian government could cause renewed concern regarding the future of the euro. And, of course, an escalation of trade or geopolitical tensions could cause market havoc, with falling stock markets, risk-off sentiment, and households and firms deciding to reduce consumption and investments enough to cause a new recession.

However, all these risks are known. And known risks are less dangerous, as investors, regulators, and governments tend to be prepared and try to mitigate these risks. The next crisis may come from somewhere less expected, such as escalating costs of climate change. This summer has put the cost of inaction on climate change front and center. More frequent extreme weather events are likely in coming years. Hurricanes, draughts, and wildfires all cause economic damage. Changing farming landscapes and lack of water could cause climate refugees and economic hardships in more countries than previously thought. Overinvestment in fossil fuels and old technologies could cause financial stability risks, as costs of renewable energy are falling and global energy markets are transforming.

Investment to counteract climate change can boost growth

The Nordic and Baltic economies are always vulnerable to global risks: turmoil in financial markets, weaker exports following trade tensions, and, systemic risks such as climate change. In the near term, however, growth prospects are looking healthy in all these countries. The economic fundamentals and fiscal positions are strong enough to handle a downturn in the global economy. However, the time to prepare for worst times is when the sun is shining. As our in-depth on sustainability shows (see page 22), all Nordic and Baltic countries have homework to do to strengthen medium-term growth. All countries can also invest more in fostering a more sustainable future.

A transition to a more climate-friendly environment is not only good for the planet, but it also involves a lot of business opportunities for those willing to develop new technologies and lead the way. In a global economy characterised by risk on the downside, the transformation to a more energy- and resource-effective future involves investments that can help boost economic growth. An increase in such investments, therefore, poses a welcome upside risk to the economic outlook.

Swedbank's global GDP forecast[1/]

Percentage change	2017	2018F		2019F		2020F
USA	2.2	2.7	(2.6)	2.5	(2.2)	1.5
EMU countries [2/]	2.5	2.1	(2.2)	1.9	(1.8)	1.6
Germany	2.5	2.0	(2.3)	1.9	(1.9)	1.6
France	2.3	1.7	(2.0)	1.8	(1.9)	1.6
Italy	1.6	1.1	(1.3)	1.0	(1.1)	0.9
Spain	3.1	2.7	(2.8)	2.2	(2.2)	1.8
Finland	2.8	2.7	(2.5)	2.2	(2.2)	1.8
UK	1.7	1.4	(1.6)	1.7	(1.7)	1.6
Denmark	2.3	1.1	(1.5)	2.0	(2.0)	2.0
Norway (mainland)	2.4	2.4	(2.5)	2.3	(2.2)	2.1
Japan	1.7	1.0	(1.5)	1.1	(1.0)	0.6
China	6.9	6.6	(6.4)	6.4	(6.2)	6.2
India	6.2	7.0	(6.9)	7.2	(7.3)	7.8
Brazil	1.0	1.6	(2.2)	2.1	(2.0)	2.3
Russia	1.5	1.9	(2.0)	1.8	(2.0)	1.8
Global GDP in PPP [3/]	**3.8**	**3.8**	**(3.8)**	**3.7**	**(3.6)**	**3.5**

[1/] Previous forecast in parentheses
[2/] Calendar adjusted
[3/] IMF PPP weights (revised April 2018)

Sources: IMF and Swedbank Research

US – What happens around the corner?

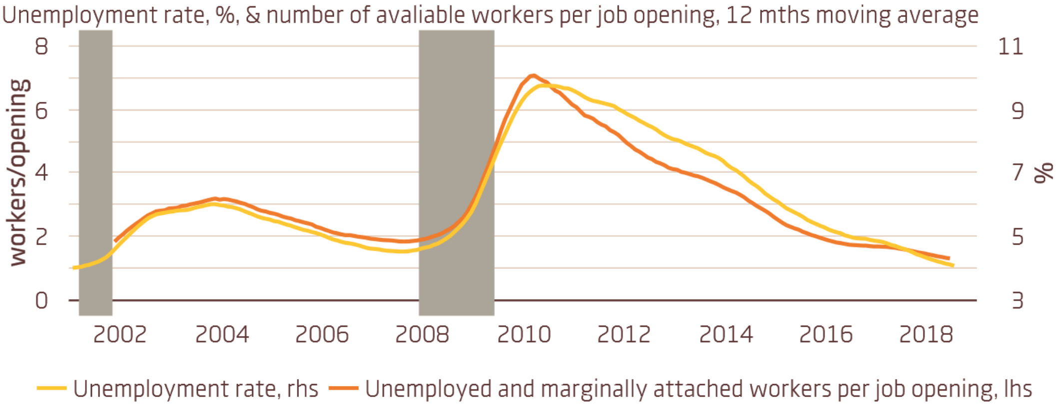
The short-term outlook for the US economy continues to be strong, but looking ahead to 2020 many factors suggest notably slower growth. Politics and tension regarding trade remain the most significant factors shaping the risks to the economic outlook.

The strong outlook continues, but numerous factors point to a slowdown in 2020

The US economy is growing rapidly at present, and we expect these strong cyclical tendencies to continue for at least a year. Consumption growth is seen at about the present pace ahead, supported by a strong labour market, confident households, and individual tax cuts. The recent upswing for investments continues despite an uncertain trade policy. The agreement to increase federal spending also boosts economic growth. The labour market is tight; shortages are pronounced and will increase ahead. Nominal wage growth, however, remains fairly muted, and overheating is therefore unlikely this year. Cost pressures are rising more broadly and will be reinforced by added import tariffs on half of all US imports from China. Inflation is near 2% and likely to remain at or slightly above this level. Against this backdrop, the Federal Reserve will continue hiking the policy rate at a once-per-quarter pace until next autumn.

The US labour market is very tight and labour shortages are pronounced

Unemployment rate, %, & number of avaliable workers per job opening, 12 mths moving average



Sources: Swedbank Research & Macrobond

While the timing of a recession is hard to pinpoint, several factors suggest a 2020 slowdown. By then, exacerbated labour shortages, a tighter monetary policy, higher cost pressures, and the full effect of added trade barriers suggest businesses' ability to grow will be limited, with a reduced willingness to investment. Before then, however, this expansion, which began in mid-2009, will become the longest on record.

Politics and trade policy have large bearing on the outlook

Beyond economic fundamentals, the chief factors affecting the US outlook are politics and trade policy. We assume that all US-China trade barriers currently set in motion will become applicable, while we believe NAFTA renegotiations will be concluded without causing major disruptions to cross-border trade. President Trump seems to have agreed to a détente with EC President Juncker. Our base case is thus that the US and the EU will refrain from imposing major additional trade barriers. However, tension will remain. Politics also colours the outlook. Midterm elections will be held November 6. Opinion polls indicate that Republicans will retain the Senate, while Democrats will take the House of Representatives. In an environment already fraught with political division, a split Congress could lead to further turmoil and an inability to make necessary reforms. This also heightens the risk of a renewed debt ceiling debacle. The limit on the US government's ability to borrow is suspended only through March 1, 2019.

Europe – Irregular around the margins

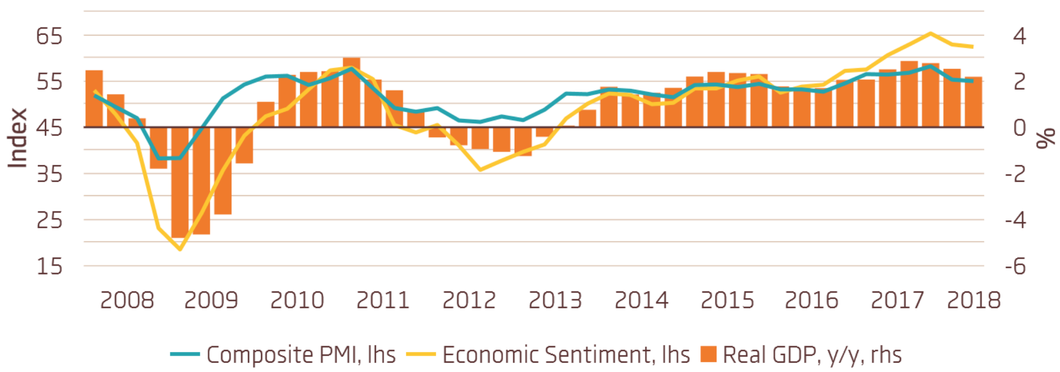
Europe is facing a number of political challenges in the near term. Not only has the risk of a Brexit no deal increased, but the long-term prospects for Italian populist politics have soured, and Turkey is at the brink of a financial meltdown, with potentially nasty spillovers into some euro area banks. Nevertheless, despite weaker-than-expected economic performance in the first half of 2018, the EMU economy is likely to grow healthily this year and the next. However, with global growth easing, the ECB turning to monetary tightening, and the economy facing more pronounced capacity constraints, we expect EMU growth to decelerate to 1.6% in 2020.

Euro area

The euphoria related to the strong and broad-based cyclical upswing in the EMU dominated the news and the markets last year. But rising trade tensions, increased political uncertainty, and weaker-than-expected economic data quickly soured the mood in the first half of this year. Spring and summer marked a rapid deterioration in US-EU trade relations. The US imposed tariffs on steel and aluminum and threatened to impose additional tariffs on cars coming from the block. The EU retaliated by imposing tariffs on politically sensitive American consumer goods. The domestic political developments provided little room for respite, either. The prospect of unsustainable policies by the populist Italian government sent shivers through the market, while the German government found itself on the brink of collapse over the summer.

Euro area sentiment has deteriorated recently

Markit PMI survey; EC survey; SA



Sources: Swedbank Research & Macrobond

As if the political mess was not enough, the economic data also provided little reason to cheer. Annual GDP growth eased to 2.2% in the second quarter, which was the slowest growth rate since the first quarter of 2017 (seasonally adjusted). Meanwhile, the economic sentiment indicators deteriorated considerably. The European Commission Economic Sentiment Indicator (ESI) slipped to a 11-month low in July, while the composite PMI deteriorated from 58.8 in January to 54.4 in August. However, despite these numbers, there is little reason for excessive gloom - the EMU economy is still on a strong footing (see page 24).

Keep in mind that some of the recent slowdown was caused by temporary factors (e.g., flu outbreaks, extreme weather, strikes), and growth should pick up in the second half of this year. The short-term indicators, such as the ESI and the PMI, are still above their long-term averages and point to continued solid expansion this year. Although growth has most likely already peaked, the economy is still expected to continue growing at above-potential rates for the next few years. A continued pickup in domestic demand will be the main driver of growth over the forecast horizon. A shortage of workers, as well as the sectoral wage agreements reached in Germany and other countries, are already contributing to faster wage growth in the EMU. This trend is expected to continue and, together with further increases in the number of employed, will support consumer confidence and encourage households to open up their wallets. Business investment will be supported by rising capacity constraints, as well as still-cheap and easily available credit. Given the increased US pressure on European NATO allies to spend more on military defense, government investment is expected to pick up as well.

However, weaker global growth, trade tensions, deteriorating competitiveness, and rising capacity constraints will most likely limit EMU export growth. Although the trade tensions between the US and the EU have eased recently, further escalation of the trade war on other fronts (especially, between the US and China), as well as the returning threat of higher US tariffs on European cars, could weaken the EMU economy and is thus considered to be one of the main negative risks to our economic outlook.

In general, the risks to the EMU outlook are tilted to the downside. The populist Italian government could still provide unpleasant surprises by implementing unsustainable fiscal policies, sending jitters through the markets and prompting bond yields to soar in the EMU periphery. Such developments could bring back discussions about the prospects of the euro's survival and weaken economic sentiment and investment in the EMU. The financial meltdown in Turkey could destabilise some EMU banks, increase tensions in Italy, and create a new wave of refugees. The increasing likelihood of a no-deal Brexit would also send shock waves across the EMU and UK economies. Such developments, as well as a more rapid than expected slowdown in global growth with the exhaustion of the ECB arsenal of conventional and unconventional monetary policy tools, would not bode well for the EMU economy.

United Kingdom – Brexit negotiations at their crescendo

The economy is muddling through, with no impressive growth numbers. The weak start of this year, caused by adverse weather, was temporary, and second-quarter numbers reversed on the back of warm weather and the World Cup celebrations. Despite a declining trend in real GDP, the Bank of England (BoE) found enough reasons to hike for a second time after the Brexit referendum. The future policy response and economic outlook, however, remain highly uncertain as the Brexit date (March 29, 2019) is approaching. The odds for a no-deal Brexit have increased after the government's White Paper, setting out the British preferences, failed to unite the Cabinet. Instead, the cabinet was engulfed in serious political turmoil, ending in certain members leaving. Although the spectrum of possible outcomes remains wide, our base scenario is a deal where the UK keeps its close ties to the EU and has to give more concessions to the EU than suggested by the White Paper. However, even if a UK-EU package deal is agreed upon in October, there is a risk that the British Parliament will reject it without a proper back-up plan. In that event, a minister will have less than a month to say what the government should do next. To hold a new referendum or an early election is likely not topping that agenda, since opinion polls show that Britons are not especially regretful about the referendum outcome and the parliament is strongly divided.

Of course, the financial markets, economic outlook, and BoE have reacted to this information. Financial markets have and will keep a lid on the sterling, and the BoE, in conjunction with European institutions, is working on ensuring financial stability no matter the March outcome. Further rate hikes by the BoE will be gradual and modest despite an inflation rate likely to stay above the target in the near term. The high inflation rate has and will keep affecting households' purchasing power negatively. Although the labour market is very tight and there are signs of increasing wage pressure, this will not be enough to massively boost private consumption. At the same time, business investments will remain subdued in light of Brexit-related uncertainties, while public spending is expected to increase in order to maintain the quality of public services ahead.

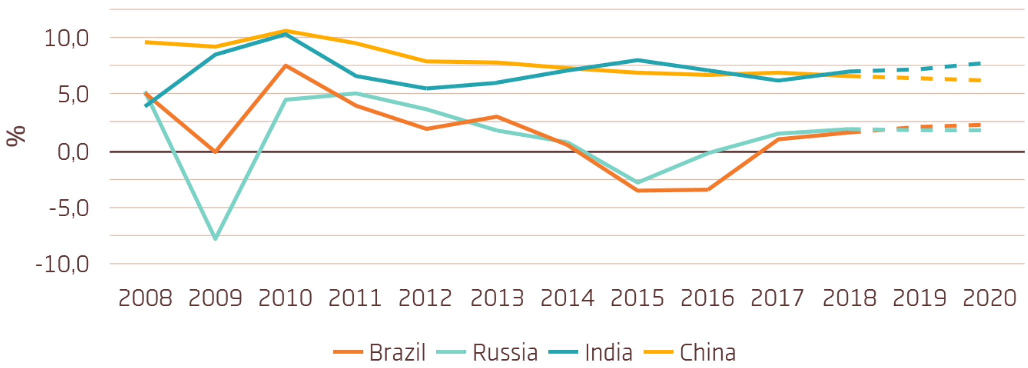
Emerging Markets – Risk for turbulence

The evolving global trade conflict – with falling commodity prices, a stronger US dollar, and capital outflows from emerging markets – has led to volatility in financial markets. The recently deteriorated US-Turkey relations, with a falling Turkish lira, led to broader EM contagion. However, the volatility in the financial markets has not yet significantly affected the real economies of the larger EM countries. Overall, these countries' contribution to global growth is projected to remain steady, though downside risks are substantial.

Turkey

The recent fall in the Turkish lira, sparked by deteriorated US-Turkey relations, has led to a broad contagion in emerging markets (EM), with currencies depreciating and stock markets falling as investors have turned to safer havens. At the moment, Turkey is a larger cause for concern than the larger EM economies, as its economy is particularly imbalanced. The current account balance has deteriorated significantly in the past couple of years. With accelerated high levels of external debt, alongside an insufficient foreign exchange reserve, import coverage is low. A balance of payments constrained growth is, therefore, a likely scenario, despite the recently promised Qatari direct investment. At the same time, the policy rate was doubled in June to curb accelerating inflation. More rate hikes will likely be necessary, which will further hurt households and corporates with already high debt-service ratios. US-Turkey relations will be important to follow as they will continue to affect the overall outlook for EM.

Growth remains steady in several EM-countries though risks are on the downside
Real GDP growth, national currency, y/y, %



Sources: IMF, Swedbank Research & Macrobond

China

Growth was slightly stronger than expected in 2017 and somewhat higher than in 2016. In the first half of 2018, growth averaged 6.9%. In the second half of 2018, we expect that growth moderates somewhat, while remaining well above the 2018 government target of 6.5%. In 2019-2020, we expect that growth moderates further. Net exports, which in recent years have contributed marginally to growth, fell back in the first half of 2018, but a rise in household and government consumption compensated and investment remained steady. The trade conflict with the US, with no clear end in sight, as well as changes in the geopolitical outlook, looming in the near to distant future, pose significant downside risks to the growth outlook. Incoming data will be key in determining these risks and signs of real effects on the economy. The trade conflict has led to a depreciated renminbi, as well as a fall in Chinese stock markets. China still aims to increase the global use of the renminbi and attract capital inflows, and with the Fed raising Fed funds and the US dollar appreciating, it is unlikely that China will devalue the renminbi. Inflation has been moderate, at 2.1% in July, which is below the 3.0% target and an increased stimulus of the economy is expected. In July, China's top decision-making body, the Politburo, announced that China would apply fiscal stimulus as needed, claiming that, the external environment had 'significantly changed', referring to the trade conflict. It also claimed that it would continue the key deleveraging process, though at a measured pace, which is partly an effort to redirect high levels of non-financial corporate and local governments' debt to more productive sectors. Shadow banking has seen a sharp fall in lending in the first half of 2018 and total credit growth is stable. Supply-side reforms have increased profits in the industry and will continue, including in infrastructure construction. House prices, sales, and starts are rising again, and investment in real estate is still high.

India

Growth in 2017 was held back by reforms but has returned in 2018, as evidenced by the unexpectedly strong growth in the first quarter. In 2019-2020, we expect that growth picks up and nears its potential in the latter part of the period. Inflation, which dipped in 2017, has returned in 2018; this led the Reserve Bank of India to increase the policy rate, the repo rate, for the first time since February 2014, by a total of 50 basis points from June to August. It appears the government's plan to recapitalise the banking sector has boosted economic activity, with a visible pickup in credit growth in 2018. At the same time, a rising repo rate will leave less room for fiscal stimulus. A higher oil price and a weakened rupee have worsened the current account and the terms of trade. With growth driven by public spending and rising public debt, the upcoming general election in 2019 poses a risk on the downside as the government appears to be losing support and policy missteps may emerge. As an example, the latest import tariffs, as part of the "Make in India" campaign, may do more to reduce export competitiveness than to build it as they may harm India's own import-using producers more than they boost its export-producing manufacturing sector.

Brazil

Brazil began its recovery in 2017, as higher global commodity prices drove up exports and low inflation raised real wages, and in turn, household consumption. In the first half of 2018, growth was lower than expected, as Brazil, a commodity net exporter, was hurt by falling overall commodity prices on the back of the global trade conflict and falling external demand. Confidence indicators, the PMI, IFO, and FGV, have been declining in 2018. Unemployment is still high and real wages have been falling. Inflation is back on target, as the Bank of Brazil has lowered the policy rate, the Selic rate, in multiple steps beginning in 2016. In the near term, risks are on the downside due to the trade conflict, falling commodity prices and external demand. The coming general election in October, in particular, poses substantial political uncertainty. The currently unpopular incumbent president, Michel Temer, has not succeeded in passing budgetary reforms, such as the pension reform, or in implementing the fiscal cuts needed to bring down the growing public debt. With significant short-term external debt, a depreciating real against a strengthening dollar, and tighter US liquidity, a potential balance of payments constraint adds to the downside risk.

Russia

Growth has picked up this year, partly boosted by the World Cup, the impact of which will wane soon. The high oil price helps as well. Despite weak investment, economic recovery has spilled over into retail, driven by an improving labour market (unemployment down to 4.7% in June, a post-2008 low), real incomes (up by 2% in the second quarter), and historically low inflation (2.5% in July). The Russian government approved a set of reforms to hike VAT, raise the retirement age, reform oil sector taxes, and establish a new fund to finance increased spending on education, health care, and infrastructure. The first two proposals have met broad public opposition, but (especially the retirement age raise) are needed. The reforms are growth positive overall but will be partly outweighed by new sanctions against Russia from the US. The risks are on the downside, with even more sanctions possibly following. On a positive note, Russia has sufficient international reserves, low debt levels, and a current account surplus. The VAT hike and weaker rouble will temporarily push inflation above its 4% target, and the central bank will be slow in easing. The rouble will gradually strengthen. We forecast GDP growth at 1.9% in 2018, and 1.8% in 2019 and 2020.

The Swedish economy – Resilient or vulnerable?

Swedish growth is robust despite a slowdown in the housing market and concerns about global trade policy. In the years to come, an important question will come to the forefront – is the economy truly resilient, or is it vulnerable? The risks include slowing construction and lower export growth, as well as the costs associated with this summer's extreme weather and uncertainty surrounding the upcoming election.

Good growth persists but vulnerability is high

Sweden is in its fifth year of growth of nearly 3%, though this will gradually drop toward 2% in 2019 and 2020. This is a solid rate from both an international and historical perspective. Neither the slow-down in the housing market nor the risk of tariffs and a trade war had much impact on the growth numbers. Domestic short-comings, such as a poorly functioning housing market, a polarised labour market, and neglected infrastructure, have not prevented the economy and employment from growing, either.

The main reason for this resilience is that the global growth is still performing well and Swedish employment continues to rise. Forward-looking indicators, which are used to predict global economic developments, suggest that the major economies will continue to grow, even if growth rates will come down from relatively high levels due to US tariffs and countermeasures by China and the EU. So far, the trade barriers have not been high enough to create a new global recession, and the escalation of trade barriers between the EU and the US is, at least temporarily, on ice. This suggests that Swedish exports will continue to contribute to jobs and investment at home.

As a result, business investment, especially in manufacturing, should increase, since demand is solid and resource utilisation is high. The outlook, however, could worsen if the US introduces auto tariffs. This would hurt Swedish export growth as autos (more than 6% of Swedish goods exports) have accounted for a significant share of export growth in recent years. Despite a gradually stronger krona, rising unit labour costs and slowing growth in the euro area, we expect export growth to remain decent. This, coupled with lower import demand, will mean a positive contribution from foreign trade in 2018 through 2020.

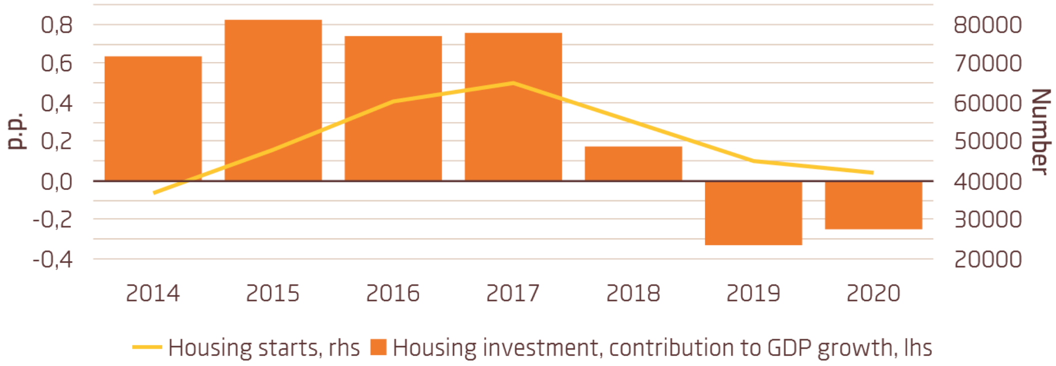
Housing construction is slowing and will dampen growth in 2019 and 2020

The housing market has, in addition to increased protectionism, been the other major concern for the Swedish economy. House prices have stabilised, however, and the price drop we have seen has not affected the entire country in any substantial way, mostly only the Stockholm and Gothenburg regions. Prices have largely been stable this spring and summer. A large supply of new construction and the tighter mortgage amortisation requirement could still lead to falling prices this autumn, especially for single-family homes and tenant-owned flats in Gothenburg and Stockholm. For the country as a whole, we believe the decline is largely over and that outside metropolitan areas and the regional focus cities single-family home prices are likely to continue to rise.

The housing market will have a moderating influence on growth in coming years, however. New flats construction will drop off significantly in the major metropolitan areas. Housing investment, which since 2012 has consistently contributed to Swedish growth, is expected to slow the economy by a few tenths of a percentage points in the next two years. It is mainly investment in multi-family housing, especially tenant-owned flats, that will contribute negatively and have the biggest impact on housing investment. The decline in housing investment will partly be compensated for by a substantial increase in public investment that we expect to see in coming years. Construction workers should have a fairly easy time finding work, given the major investments that will be made in both maintenance and new infrastructure such as railways, subways, and roadways. Renovations and new investment in schools, hospitals, elderly care, and childcare will also contribute to employment and growth. In demographic terms Sweden has both many young and many old people, and both these groups will grow in the years ahead.

Decline in housing starts lowers investments in housing

Housing starts and contribution to GDP from housing investment, incl. Swedbank's forecasts



Sources: Swedbank Research & Macrobond

A strong labour market keeps consumers confident

In coming years, the Swedish economy is expected to enter a calmer stage, which, coupled with an aging population, should slow the labour market. Unemployment is likely to stabilise at around 6% in the next few years. Though the labour market has some vulnerabilities, such as mismatch problems, low productivity, and polarisation, the overriding trend in employment growth has been surprisingly positive.

Households have benefitted the most from rising employment. They have seen steadily growing disposable income, which, in the near term, is expected to continue. Due to declining activity in the housing market, it is likely that the rate of increase in debt-to-income ratios will slow in the forecast period. If this happens, it would be a welcome development for the Riksbank and the Swedish Financial Supervisory Authority (SFSA).

The SFSA's amortisation requirement has gradually begun to have an impact, and the latest requirement affects an estimated 15% of buyers in the housing market, with the corresponding figures for Stockholm and Gothenburg 30% and 19%. Aside from amortisation, which for accounting purposes counts as a form of savings, savings are driven by contractual factors and demographic changes. A large percentage of the workforce is namely between the ages of 50 and 65, a group that tends to save more. Taken together, we therefore assess that savings will remain high while spending will decline somewhat – especially on durable goods such as cars and home furnishings.

Stimulative fiscal policy both before and after the election

In the past few years, fiscal policy has been stimulative and included reforms such as increased welfare initiatives and lower pension taxes. Future policy is expected to remain stimulative for two reasons. First, Sweden's public finances are very strong. Second, the complicated negotiations to form a new government may entail both increased government spending and tax cuts in order to achieve a stable base for a government coalition. In addition, the government is likely to continue to support municipalities and county councils facing rising costs. In particular, substantially higher demographically driven costs will kick in towards the end of the forecast horizon. From 2020 onwards, the costs will increase, driven by both large cohorts of young and old people and the fiscal challenges they create. The risk is that labour shortages will limit the sector's growth potential. In the next two years, however, tax revenues are expected to be buoyed by good growth and a strong labour market, which will help to keep the public sector's financial savings above the new surplus target taking effect next year.

The Riksbank hikes the repo rate cautiously at the end of the year

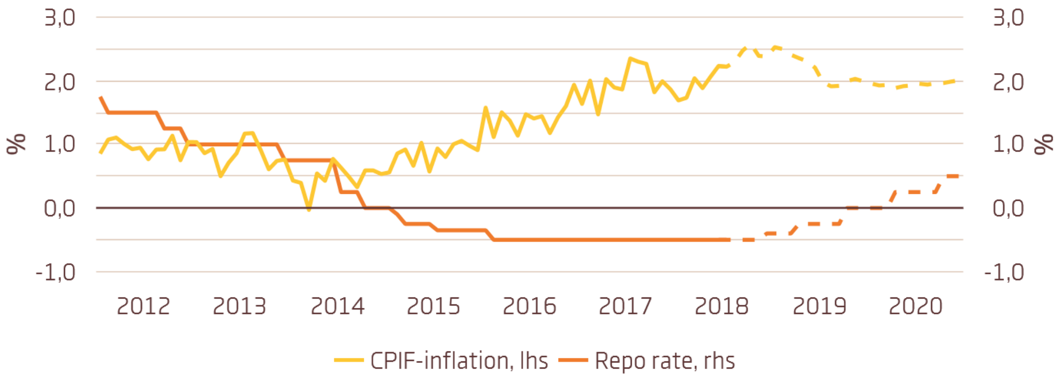
From the Riksbank's perspective, inflation data have been hard to decipher since last spring. On the one hand, the inflation according to CPI with a fixed mortgage rate (CPIF) has been above the Riksbank forecast, but, on the other, underlying price pressure (CPIF excluding energy) has been weaker than expected.

The crucial factor has been energy prices, which also explains the discrepancy between these two measures. The summer drought and record-low water reservoir levels are expected to lead to higher energy prices in the near term. In addition, higher grain prices in connection with poor harvests in Sweden and globally will raise food prices. This means that the CPIF inflation rate, with the support of the extreme summer heat, will remain above the Riksbank's inflation target this autumn.

After about a year and a half, during which most the CPIF inflation outcomes have stayed around or above its target, the Riksbank is now expected to take small, cautious steps towards normalising monetary policy. Extraordinary measures in the form of bond purchases have already ended, and the Riksbank's balance sheet is expected to shrink in 2020. The next step will be to raise the repo rate, starting with what we expect will be a 10-basis-point-hike in December. Next year, the repo rate is expected to be raised twice more with the support of rising underlying inflation to end 2019 at 0 %.

Cautious repo rate hikes as infation increases

CPIF-inflation, repo rate and Swedbank's forecasts, y/y



Sources: Swedbank Research & Macrobond

Nordic economies keep improving

The economies of the Nordic countries continue to improve. Growth in the Norwegian economy is likely to accelerate as oil investments pick up. Household demand and a tightening labour market are bolstering the Danish economy. The Finnish economy is continuing to enjoy robust and broad-based growth this year, but the cyclical downturn will slow this down.

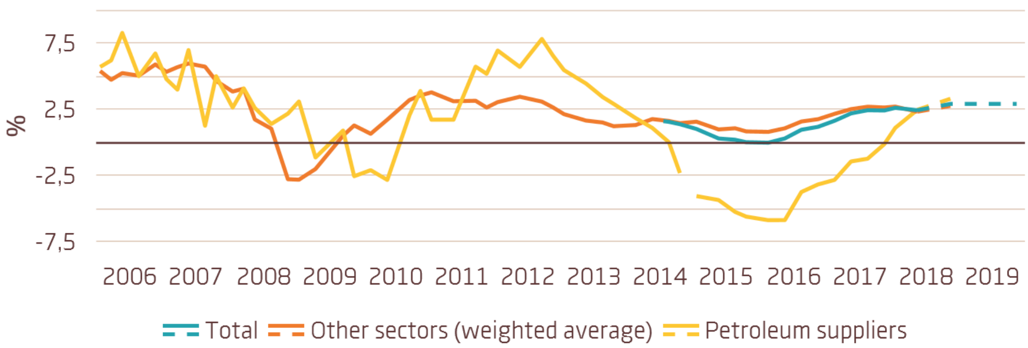
Norway

The overall situation in the Norwegian economy has continued to improve. Unemployment is declining everywhere, and Norges Bank's Regional Network indicates almost 3.0% growth in GDP going forward. The downturn in oil is turning into a new expansion. Global growth is solid, while the Norwegian krone remains weak. Manufacturing surveys indicate growth ahead. House prices have resumed a rising trend. Against this background, we expect Norges Bank to start raising the policy interest rate in September even if inflation remains below the inflation target.

House prices have recovered to equal their all-time high. In July, the temporary mortgage credit regulation was extended with only minor changes. This regulation should over the longer run dampen household credit growth and, thus, also dampen house price growth. However, over the coming months, house prices are expected to continue to increase gradually. Recent data show that both existing home sales and credit growth are staying well up, indicating strong demand.

Norway: Regional network indicates strong growth ahead

Implied growth from survey respondents, % change q/q, ann.rate



Note: Break in the series to due change in statistics
Sources: Swedbank Research & Macrobond

We judge the longer-term fundamental factors as sound and supported by improving macroeconomic developments. The next leg in the Norwegian business cycle is likely to be an expansion in investments. For investments in the oil sector, this is already becoming a reality. This will certainly be very favourable for the overall Norwegian economy, and, as a consequence, we expect growth to accelerate further. Additionally, because the recovery in the housing market makes lower housing investment less of a drag on overall growth than previously assumed, overall GDP growth will keep up quite well.

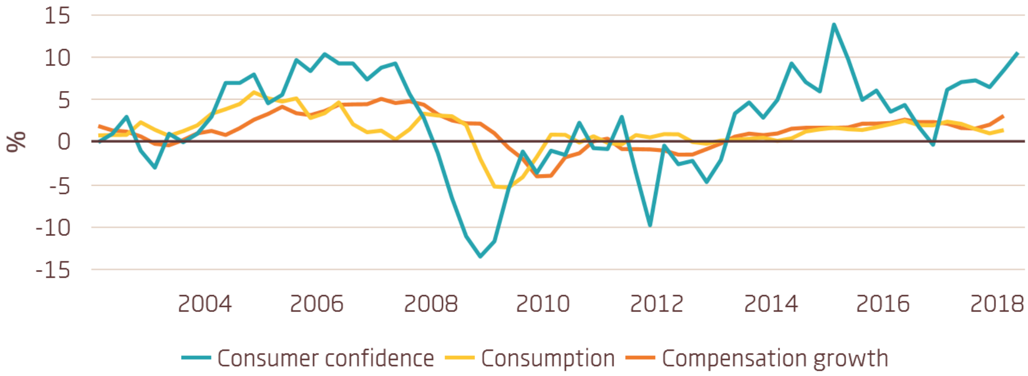
Denmark

The Danish economy has enjoyed robust growth in recent years due to stronger business investments, and growing exports and household spending. Consumer confidence has improved steadily through the last 18 months, pointing to continued increases in spending ahead. Employment growth has exceeded 1.7% over the past year, and unemployment has fallen to the relatively low level of 4%, suggesting increasing capacity utilisation. There are no clear signs of overheating, but the labour supply shortage, coupled with low productivity growth, represents a risk in the short term. Real wage and income growth has been decent, in part thanks to subdued inflation. Inflation is expected to be sustained by gradually tighter conditions in both the product and labour markets as resources become increasingly scarce.

Business investments have started to pick up after several weak post-crisis years; they will be strengthened going forward by low interest rates and the need for capacity expansion in several sectors. Since the end of the euro crisis, most sectors in the economy have contributed to growth. Most notably, the construction sector has picked up since house prices started to rise again in 2013. Business barometers for the industrial sector improved markedly last year but have stabilised recently. The export outlook is good on account of solid growth in the euro area and in the neighbouring Nordic countries. The Danish economy looks set to continue to expand, and growth is expected to remain at 2% in the years ahead.

Denmark: Rising real income will support consumption

Real income and consumption, 2m MA, y/y (%)



Sources: Swedbank Research & Macrobond

In the medium term, one of the main risks to the Danish economy is related to continued house price growth. Since the beginning of 2017, one-family house prices have increased by 5%, while those of owner-occupied flats have risen by nearly 9%. Household indebtedness has declined steadily since the end of the financial crisis; however, the level is still quite high, also relative to comparable countries. Coupled with growing housing prices, this raises concerns for financial stability. The government has in response enacted several measures to dampen house price growth and reduce vulnerabilities.

Finland

2018 is another year with robust economic growth in Finland. We forecast that GDP will grow 2.7% this year - considerably above Finnish potential output growth. Due to the cyclical downturn, economic growth is expected to slow to 2.2% in 2019 and 1.8% in 2020.

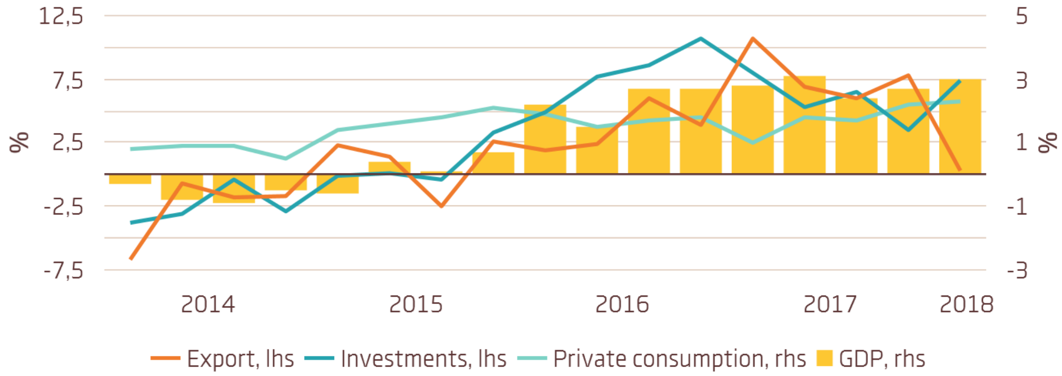
The positive economic outlook, business sector's improved turnover, and profitability have contributed to investment growth. Increased investments in capital stock have improved productivity and created a stronger base for output growth. However, the majority of investments (58%) are made in construction, the impact of which on growth will ease gradually. We expect that the growth of investments will slow in 2019-2020.

Increased demand for labour has considerably reduced unemployment and lifted the employment rate. Although this trend is expected to continue during the forecast period, the high degree of mismatch of skills and location of labour inhibit the reduction of unemployment. The subdued growth of earnings has helped improve the cost competitiveness of Finnish enterprises. However, the shortage of labour, a limiting factor of production, has intensified and has caused wage pressures. Even though wage growth is accelerating, Finnish cost competitiveness is expected to improve against its major trading partners in the next few years.

The improving situation on the labour market and faster growth of total wages are raising households' purchasing power and increasing private consumption. Finnish consumers' confidence has likely already peaked, but it is still historically at its highest level. The expected pickup in inflation towards the end of the forecast period (to a relatively moderate pace) will limit consumption growth. At the same time, the saving rate of households is decreasing and their debt is rising. This increases their sensitivity to higher interest rates and makes them more vulnerable to possible economic shocks.

Finland: Rapid growth supported by consumption and investments

Real annual GDP growth and components, CSA, %



Sources: Swedbank Research & Macrobond

The favourable external environment and improved cost competitiveness have enabled Finnish enterprises to increase their exports. However, export growth has slowed this year, whereas industrial enterprises' export expectations have moderated. Turnover growth in both manufacturing output and the service sector has slowed this year, as well. One of the main downward risks for Finnish exports, and output growth, is a greater-than-expected weakening of foreign demand. The possible rise in protectionism would have a negative effect on the Finnish economic outlook.

Increasing tax revenues and the Finnish government's decisions to curb public sector expenditures are improving general government finances. However, the buffers for expenditure pressures will remain modest, and the public sector contribution to economic growth will be limited.

Baltic countries – Hot in the city

Hot in the city tonight, tonight – cheerfully sang Billy Idol 36 years ago, but it could also have been many households and companies in the Baltics this summer. Not only was it literally hot, GDP growth figures in all three Baltic countries remained well above their potential, while labour markets have continued heating up. Nevertheless, inflation remains tame, debt is low, and foreign trade and public finances are balanced, indicating that we will see only a gradual cool down, not an overheating and collapse.

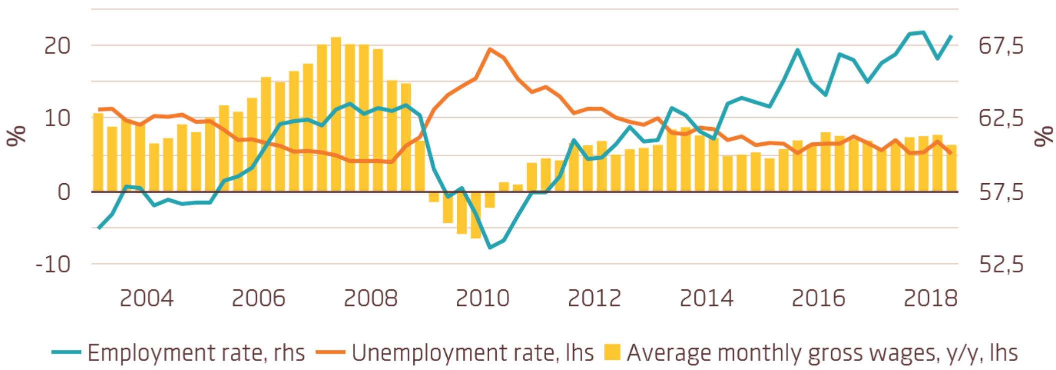
Estonia

Economic growth in Estonia has decelerated somewhat, and we forecast that it will continue to slow in the next two years. However, growth rates of 3.5% this year, 3.2% next year, and 2.7% in 2020 are still decent. In general, the economy is well balanced and resilient – according to our baseline scenario, the current account will remain in surplus and public finances strong. Estonian households have been able to save and are better protected against unexpected economic shocks. At the same time, the labour market has become very tight.

Robust economic growth has increased demand for labour. Unemployment has dropped to the level seen before the financial crisis, while the employment rate has increased to a record high. The labour shortage has, increasingly, become the factor for enterprises that most limits their business activity. We forecast that the unemployment rate will continue to decrease in the short term and stay close to 5% in 2020. The labour market will remain very tight because of Estonia's current immigration policy. This situation is hiding a major downside risk – it is contributing to the excessive growth of labour costs and, thereby, worsening price competitiveness, and limiting business sector profits and output.

Estonia: Labour market has become very tight

Labour market indicators, %



Sources: Swedbank Research & Macrobond

The growth in demand for imports from Estonia's major trade partners has slowed in 2018. We forecast that foreign demand will offer fewer export possibilities in 2019 and 2020, which could decelerate growth of Estonian export volumes. Estonian exports have climbed up the value-added chain and thus, exporters can ask for higher prices – this partly compensates the negative effect of higher labour costs. One of the main risks to the export outlook is an unexpected worsening of foreign demand – Estonia, as a very open economy, would take a substantial hit from the spread of protectionism.

The share of investments in GDP has decreased almost to the lowest level of the last 23 years, reducing potential output growth. Business sector investments decreased in the beginning of this year. We expect that this was temporary, as the main reason was the base effect from the unusually robust investments in the first half of 2017. The growth of foreign and domestic demand has peaked, but it should remain strong, and the business sector needs more investments to raise productive capital. Although public sector investment growth is expected to slow this year and the next, the surge in investments in 2017 has shifted investments up and the sector investments' share in GDP will increase. In 2020, construction of Rail Baltica will boost investments both in the public and business sector.

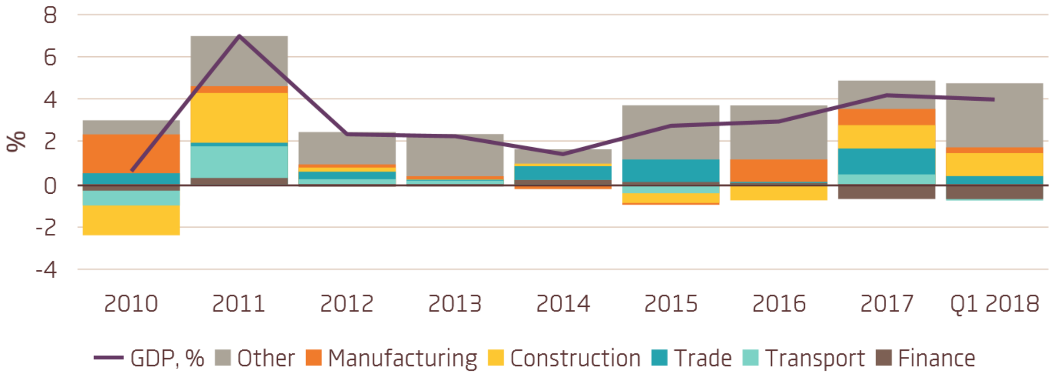
Latvia

Growth reached a whopping 5.1% in annual terms in the second quarter, beating expectations. While growth is broad based, two sectors stand out. First is the booming construction, with growth rates exceeding 30%, partly supported by EU funds. Nonresidential buildings and civil engineering contribute the most (both public and private investment), but construction of residential buildings is also on the rise. Thus, investment growth is also at elevated levels. Clearly, these are not sustainable growth rates, and, with base effects waning, construction and investment growth will slow. The second sector is falling financial services – nonresident business is unfolding more slowly and gradually than claimed by the authorities earlier this year, but it will keep negatively influencing export and GDP. For now, though, the growth in the construction sector more than outweighs the decline in the financial sector..

The boom in construction is likely to exacerbate labour shortages and wage pressures elsewhere in the economy, as the labour market is already quite tight. The unemployment rate fell to 7.7% in the second quarter, the lowest in 10 years. Annual wage growth is at about 9%, partly driven also by the minimum wage hike and income legalisation. The unemployment rate will continue falling, but more gradually. The currently observed employment growth is to fade away next year, however, as the working-age population keeps falling and the participation rate is at historically high levels. Purchasing power is rising swifter than last year, but household consumption growth is rather stable. The stock of household loans is still falling in annual terms, but the interest in taking mortgages is increasing as confidence is robust and incomes rise. This will support consumption, but its growth will still decelerate as wage growth slows gradually.

Latvia: Boom in construction compensates for a fall in financial sector

Contribution to annual GDP growth, %



Sources: Swedbank Research & Macrobond

Export performance improved in the second quarter, but growth is expected to decelerate, with competitiveness pressures increasing, capacity and labour constraints intensifying, and trading partners' growth slowing. Slower growth in manufacturing is the first sign of this. The dry and hot weather is likely to lower food export numbers this year, although higher prices will counteract this somewhat.

As the business cycle matures, we expect economic growth to slow from 4% this year to 3% next year and 2.5% in 2020. Risks are plentiful. While EU funds support growth, they pose overheating risks in the construction and labour markets. Productivity growth, although rather steady at about 3%, is lagging behind wage growth and will continue to do so, increasing competitiveness pressures. The transport sector is vulnerable, and the second-quarter recovery is likely to be temporary. The parliamentary election results are highly uncertain, although we do not expect any major change in economic policy. Risks are tilted to the downside also for global growth, which could also negatively affect Latvian exports.

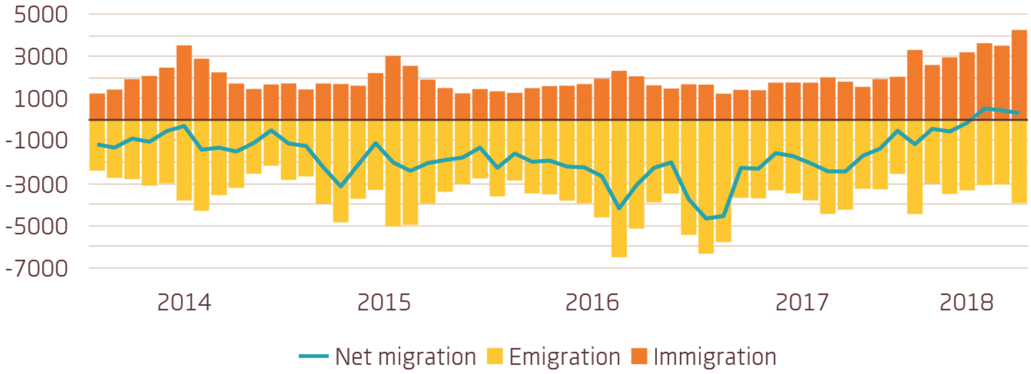
Lithuania

The economy sustained its growth momentum in the second quarter of this year, expanding by 3.7% in annual terms. As indicated by the booming construction sector, the long-awaited pickup in investment seems to have finally arrived. Thanks to the buoyant economy and the EU funds, construction volumes increased by 17.5% in the second quarter, compared with the same period a year ago, with double-digit growth figures recorded for residential and nonresidential buildings, as well as civil engineering structures. Meanwhile, annual growth in the corporate loan stock picked up to 8.4% in June – the fastest growth rate in more than a year. Investments this year are expected to grow at the fastest pace in seven years before easing gradually in 2019-2020 as the investment cycle matures.

Household consumption, also, did not retreat this year. Supported by rapid growth in the wage bill, higher pensions and social benefits, and consumer confidence at an 11-year-high, as well as unusually warm weather, annual growth in retail trade volumes picked up to 6.7% in the second quarter. Meanwhile, the labour market continued to tighten, with unemployment dropping to 5.9% in the second quarter as employers finally tapped into the vast pool of previously unemployed. Shifting migration trends must have also contributed to growing employment – net migration has been positive recently. In 2019-2020, consumer purchasing power will be boosted by reduced income taxes for low- and middle-income earners, but the room for above-productivity wage growth is shrinking and growth in employment is expected stall due to the ageing population. As a result, we expect growth in household consumption to ease gradually towards 2020.

Lithuania: More people are arriving than leaving

Number of people per month



Sources: Swedbank Research & Macrobond

On the back of decelerating growth in the main export markets, deteriorating competitiveness, and the high export base of last year, annual nominal export growth continued easing in the second quarter. The above-mentioned factors will continue to limit export expansion over the next few years. So far, Lithuanian firms and consumers have not expressed much concern over the recent trade spats – the EC Economic Sentiment Indicator stood at a 10-year high in July. However, as small and open economies tend to be particularly vulnerable to rising protectionism, a continuing escalation of trade tensions could harm Lithuanian export prospects. If adverse global economic events were to occur, the Lithuanian economy would be considerably better placed to withstand them than a decade ago. Unlike the situation before the 2008 recession, the Lithuanian economy has been running a balanced current account, its public finances are in surplus, there are no signs of overheating in the housing market, both households and companies have low debt levels, some important structural reforms have been passed, and more are under way.

Exchange and Interest Rates

Normalisation of monetary policy continues, affecting both interest and exchange rates. Interest rates will rise gradually, and the Swedish krona will appreciate mildly. Fed policy will support the US dollar in the near term. The oil price is expected to stabilise at around USD 70/barrel.

Central banks at various speed

The US central bank, the Federal Reserve, has come relatively far in its normalisation of monetary policy by raising its key interest rate to the interval 1.75 – 2.00%, while the bank continues to reduce its bond holdings. At the back of a relatively high growth rate and a strong labour market, we expect this development to continue until the second half of next year. However, since the Fed's interest rate decision committee (FOMC) has become somewhat more "hawkish," we estimate that interest rate hikes will be slightly more aggressive in the coming year.

The continued strong and broad-based euro area growth, in combination with a gradually higher inflation rate, will make the European Central Bank, ECB, take a first cautious step towards normalizing monetary policy in 2019 by discontinuing bond purchases. However, monetary policy will remain expansive in the euro area throughout the forecast period, with a first refi rate hike during the third quarter of 2019, followed by two further hikes in 2020. Inflation developments, the strength of the recovery, and the euro will be in the focus of the ECB.

The Riksbank will similarly continue to focus on inflation developments, not least with respect to the different underlying measures. Furthermore, the Swedish krona remains a key factor, and we anticipate an appreciation, though at a relatively slow pace. We expect inflation to stabilise around the target in the medium term, which opens for a first cautious repo rate hike, 10 bps, is expected towards the end of the year. Over the coming two years, we expect that the Riksbank will hike the repo rate only gradually and the repo rate is expected to be at 0.5% at the end of the forecast period.

Monetary policy normalisation sets the tone for interest rates

Over the next few years, the development of long-term interest rates will primarily be determined by the speed at which the major central banks normalise monetary policy. Not least, central banks' actions regarding their balance sheets will be crucial, mainly for long-term bonds.

In the short term, we expect steeper interest rate curves in Europe and Sweden, as only gradual hikes in key policy rates will dampen the rate increase in bonds with shorter maturity. When these eventually are raised, we expect the interest rate curves to flatten again. The various time schedules the central banks follow for normalizing monetary policy, notably the reduction of the bond purchases, will play a major role in developments in long-term interest rates and interest rate curves in the various markets.

However, long-term interest rates will remain low throughout the forecast period, as inflationary pressures will remain subdued and demand for secure assets high. In addition, the Swedish bond yields will be held back by the fact that the government's borrowing requirement is very low and the turnover of bonds is limited. Political risks in Europe have risen again this year, which, together with an escalating trade war and an approaching Brexit decision, could lead to higher interest rate volatility and rising interest rate spreads, especially in peripheral markets.

Monetary policy and geopolitics key to FX rates

Monetary policy and geopolitics remain the most important factors for foreign exchange developments. In the near term, the interest rate differential will support the dollar, but continued, relatively good, developments in the euro area and a gradual more hawkish stance from the ECB will limit the downside of the euro's exchange rate against the dollar. The Riksbank's imminent beginning of a gradual tightening of monetary policy, in combination with a strong economy, will strengthen the Swedish krona, even though at a relatively slow pace. The Norwegian krone will stabilise in the near future, supported by a higher oil price and the continuing stabilisation of the housing market. The uncertainty surrounding the Brexit negotiations still suppresses the outlook for the British pound sterling, and periodically, the sterling foreign exchange rate could be more volatile. A somewhat tighter monetary policy from the Fed, alongside a sideways development of commodity prices, may intermittently cause greater volatility and uncertainty for EM currencies.

OPEC raises output in an effort to stabilise the market. We think it will succeed

The oil market balance is currently quite tight. The oil price has risen materially since last summer, driven by strong demand growth and high OPEC production cuts, resulting in declining crude inventories. In June, OPEC+ announced its aim to lower the compliance level to closer to 100% going forward (from about 120% currently). In order to mitigate the risk of overheating the market, the countries' total output will have to increase. We believe the result of this strategy will be more stable prices, at around USD 70/barrel. We now expect the oil price average for 2018 to come in at USD 72/barrel. We have revised up our estimate for 2019 to USD 70/barrel and forecast USD 67.5/barrel for 2020.

Interest and exchange rate forecasts

	Outcome	Forecast				
	2018 27.AUG	2018 31.DEC	2019 30.JUN	2019 31.DEC	2020 30.JUN	2020 31.DEC
Policy rates (%)						
Federal Reserve, USA [1/]	2.00	2.50	3.00	3.25	3.25	3.25
European Central Bank [2/]	0.00	0.00	0.00	0.25	0.50	0.75
Bank of England	0.75	0.75	1.00	1.00	1.00	1.25
Riksbank	-0.50	-0.40	-0.25	0.00	0.25	0.50
Norges Bank	0.50	0.75	1.00	1.25	1.50	1.75
Bank of Japan	-0.10	-0.10	-0.10	-0.10	0.00	0.00
Government bond rates (%)						
Sweden 2y	-0.53	-0.35	0.10	0.60	0.80	1.00
Sweden 5y	-0.05	0.20	0.85	1.30	1.65	1.80
Sweden 10y	0.49	0.80	1.25	1.75	2.05	2.25
Germany 2y	-0.61	-0.45	-0.15	0.30	0.75	0.90
Germany 5y	-0.20	0.00	0.60	1.10	1.40	1.70
Germany 10y	0.37	0.60	1.00	1.50	1.80	2.00
US 2y	2.64	2.90	3.05	3.20	3.40	3.45
US 5y	2.74	3.15	3.20	3.30	3.50	3.55
US 10y	2.85	3.20	3.30	3.40	3.55	3.65
Exchange rates						
EUR/USD	1.16	1.15	1.16	1.17	1.18	1.20
EUR/SEK	10.61	10.15	9.90	9.55	9.50	9.40
USD/SEK	9.14	8.83	8.53	8.16	8.05	7.83
KIX (SEK) [3/]	121.0	119.7	117.3	113.0	112.5	110.3
EUR/NOK	9.70	9.31	9.08	8.84	8.80	8.79
NOK/SEK	1.09	1.09	1.09	1.08	1.08	1.07
EUR/GBP	0.90	0.91	0.87	0.88	0.89	0.89
USD/CNY	6.85	6.75	6.65	6.55	6.50	6.40
USD/JPY	111.4	108.0	105.0	105.0	105.0	105.0
USD/RUB	67.4	67.0	64.7	62.4	60.2	58.3

[1/] Upper Bound
[2/] Refi Rate
[3/] Trade-weighted exchange rate index for SEK. A higher value of the index means that SEK has depreciated

Sources: Macrobond and Swedbank Research

Cost of inaction on climate change is rising

Extreme weather conditions this summer put focus on the cost of inaction on climate change. The business community and the financial sector are gearing up to advance sustainable investments. Yet, the Swedbank's Sustainability Indicators show a lot of unused potential in the Baltics and the Nordics in their transition to cleaner and more energy-efficient economies.

This summer, we have seen droughts affecting farmers across Europe and wildfires causing severe material damage to individuals and to the forest industry, especially in the Nordics. The prices of agricultural production will rise in the coming months, adding to consumer price inflation. Extreme temperatures negatively affect people's health conditions. This very hot and dry summer has focussed the attention of the public, policymakers, and the business community in the Nordics and the Baltics on climate change. Due to climate change, it is likely that extreme weather will be recurring more often. The economic and humanitarian effects of climate change are huge, highlighting the need to invest more in a sustainable future. Recent data show that global greenhouse gas (GHG) emissions continue to rise, implying that current efforts to combat climate change are not sufficient.

The Swedbank Sustainability Indicators (SSI) monitor the progress of Nordic and Baltic countries towards the UN Sustainable Development Goals (SDGs). Our analysis shows that environmental protection is the area in which the most progress needs to be done in the Nordics to meet the 2030 Agenda targets. The progress in the Baltics lags even more. It is clear that there is still a lot of unused business potential in the Nordics and the Baltics that could foster their transition towards a cleaner and more energy-efficient economy.

Vast business potential in environmental protection

The SSI serve to identify areas in which we need and can expect both public and business investment in coming years. As a benchmark or target for 2030, we use the top performers in the EU28 in 2015. Depending on how far the countries are from the 2030 targets, we assign them traffic light colours (a bit different ranges for the Baltics and the Nordics to account for different preconditions and the pace of improvements in recent years). We have chosen 41 indicators, grouped into four sustainability pillars: environmental protection, social inclusion, governance, and sustainable medium-term growth.

NORDICS: Progress towards UN SDGs, % of benchmark*

	Sweden	Denmark	Finland	Norway
E: Environmental protection (SDGs # 6, 7, 11, 12, 13)	83	79	68	72
S: Social inclusion (SDGs # 1, 3, 5, 10)	89 ↓	81	91	91
G: Governance and institutions (SDGs # 16, 17)	97 ↓	94 ↓	91 ↓	99
G: Sustainable medium-term growth (SDGs #4, 8, 9)	87 ↓	91	83 ↓	88

↓ – Downward/stable trend during last 5 years (4 years for governance) ↓

* Benchmark is 90/10th percentile of EU28 in 2015. In total 41 indicators covering 14 from 17 SDGs, aggregated to four pillars. Cut-off points for traffic lights: >90% for green, 70-90% for yellow.

Source: Swedbank Macro Research

The SSI show that a lot of work remains to be done in **Sweden, Denmark, Finland**, and **Norway** to meet the ambitious environment goals. In fact, the largest business potential lies in the environmental protection pillar. Sweden scores the best but is still at only 83% of the target. Finland lags, at 68% of the benchmark, mostly owing to still-high energy intensity, low resource productivity, and high waste generation. Yet, all the countries still have a long way to go to reduce greenhouse gas emissions to fulfil the ambitious national targets. The levels of waste generation and air pollution (except in Sweden) also require action, both from policymakers and corporates. On a positive note, performance in environmental protection has been improving in recent years (although less so in Norway).

The Baltics have even more work to do, as they reach only 58-70% of the benchmark in environmental protection. Estonia scores worst on many indicators due to its polluting shale oil industry. Energy intensity and resource productivity scores are in the red for all three countries. The levels of air pollution are also too high, and more action is required in waste recycling.

BALTICS: Progress towards UN SDGs, % of benchmark*

	Estonia	Latvia	Lithuania
E: Environmental protection (SDGs # 6, 7, 11, 12, 13)	58	73	70
S: Social inclusion (SDGs # 1, 3, 5, 10)	56 ↓	56	55
G: Governance and institutions (SDGs # 16, 17)	70	51	62
G: Sustainable medium-term growth (SDGs #4, 8, 9)	69	63	66

↓ – Downward/stable trend during last 5 years (4 years for governance) ↓

* Benchmark is 90/10th percentile of EU28 in 2015. In total 41 indicators covering 14 from 17 SDGs, aggregated to four pillars. Cut-off points for traffic lights: >90% for green, 70-90% for yellow.

Source: Swedbank Macro Research

Promoting sustainable growth and improving social inclusion also requires action

The Nordics are global leaders in many areas of sustainable development. However, the SSI show that a lot remains to be done. For instance, in social inclusion, Denmark lags the most, primarily due to a higher maternal mortality ratio than in the other Nordic countries. Sweden lags in such areas as poverty risk and the income gap between the 20% richest and 20% poorest. The gender pay gap is still sizeable in all Nordic countries. Preconditions for sustainable medium-term growth are a challenge for the Nordics, with only Denmark assigned a green light. For all the countries, the share of early leavers from education and training is a problem. Youth NEET (not in education, employment, or training) rates are still at elevated levels in Finland, while Norway lags in R&D expenditure. Governance has historically been the strong side for the Nordics. However, complacency is dangerous – results have been worsening during recent years, except for Norway.

While the improvements in SSI in the **Baltics** over the past five years, partly driven by economic recoveries, have been remarkable (except for social inclusion), there is a lot of catching up to do in many areas. The largest differences between countries are in the governance pillar, with Latvia scoring worst on all indicators; it reached only 51% of the benchmark on average. Estonia leads with 70%. The smallest differences between the countries and the lowest scores are in the social inclusion pillar. Although the gender pay gap is "in the red" for all three countries, gender inequality seems to be a larger challenge for Estonia than the other Baltic countries; meanwhile, Latvia and Lithuania are struggling the most with higher severe material deprivation rates. All poverty indicators are in the red for all three countries, as is maternal mortality. As for the sustainable medium-term growth pillar, Latvia scores worst, with 63%, while Estonia reaches 69%. Within this pillar, innovations (patents per capita and R&D expenditure) and lifelong learning for adults constitute the most pressing problems for both Latvia and Lithuania; meanwhile, in Estonia, the number of patents is very small despite higher R&D spending.

The detailed methodology and results for SSI can be found here (January 2018) and here (June 2018, including updated detailed tables for both Nordic and Baltic countries).

ECB will move later than it should

Three-and-a-half years after the ECB started its Asset Purchase Programmes, the end of quantitative easing (QE) is in sight. But even though economic growth is healthy and broad based, and headline inflation is hovering around 2%, the ECB has been very cautious and reluctant to normalise monetary policy. Is this a mistake, and what can we expect going forward?

Economic fundamentals justify policy normalisation

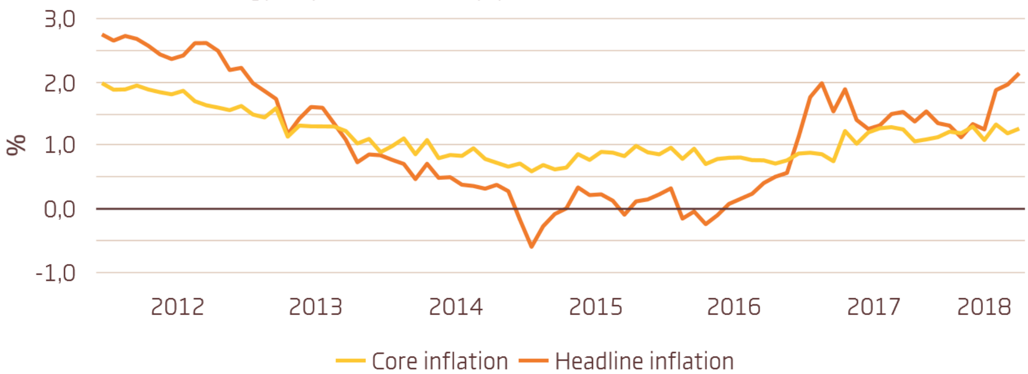
Euro area GDP growth accelerated above 2% at the end of 2016 and, on the back of health global trade, continued accelerating in 2017. Although growth has eased this year, it remains at or above potential in most euro area countries. Steady economic growth is well reflected in the labour market – employment is increasing and unemployment is shrinking steadily. Unemployment is down to 8.3% and is already below the natural level of unemployment and 1 percentage point below the average level since the beginning of this century.

The low level of unemployment naturally leads to labour shortages, which are becoming very obvious in most euro area countries. In Germany, France, and Spain, a record number of manufacturing companies are saying that the labour shortage is the most pressing issue. In the euro area as a whole, almost one in five companies report that the labour force shortage is the major factor limiting their production. Inevitably, this is going to lead to higher wage growth.

And it is already doing so: labour costs were growing at 2.1% in the first quarter of this year – the fastest pace since 2012. Furthermore, the Duke CFO survey points to wage growth acceleration towards 3%. The public sector and the largest trade unions have also ensured faster wage growth in the coming two years. All these factors indicate that core inflation will also pick up. Price growth expectations in the construction, industry, and services sectors, as well as households, are at the highest level since 2013. All this suggest that the ECB should be seriously considering or beginning policy normalisation. Yet...

Core inflation is about to pick up in EMU

HICP, total and w/o energy, unprocessed food, y/y



Sources: Swedbank Research & Macrobond

It is not only about inflation

Would you be able to guess the start of ECB quantitative easing (QE) by looking at the above chart of euro area core inflation? For the past five years, it has been stuck in a very narrow band around 1%, and no particular moment seemed to justify the unprecedented easing of monetary policy – negative interest rates and asset purchases. Yes, due to the collapse of oil prices, headline inflation turned negative in mid-2014 and fluctuated around zero for another year. This was the main argument, at least officially, to start QE. Yet now, when—again due to oil prices—headline inflation is hovering around 2%, the ECB is willing to dismiss this development as a temporary blip and is focussing on core inflation. This strikes us as a somewhat asymmetric reaction to price developments and underlying factors.

But it is not hard to see why the ECB is so reluctant to talk about policy normalisation. It started easing when US was already talking about tightening. The ECB made the mistake of premature policy tightening in 2011, which may have contributed to the second recession in the euro area. The ECB does not seem to be willing to risk making that mistake again – some overheating is perceived as a smaller problem than a stronger euro, weaker growth, and possibly destabilising higher sovereign yields. The ECB has come very late to the party and is willing to be the last one to leave. And those who share the ride (e.g., the Riksbank) have to stick around for longer than they otherwise would.

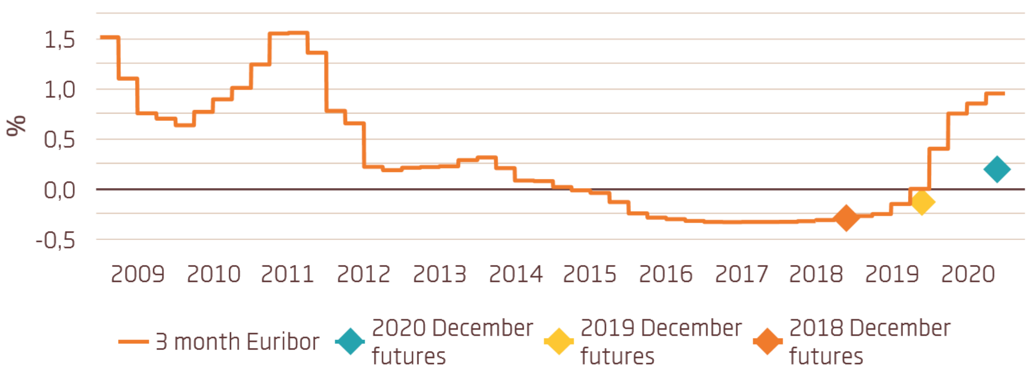
Mario Draghi will not turn hawkish, but his successor might

Mario Draghi has proved to be more dovish than analysts and markets have expected. But his term ends in the autumn of 2019, and his successor may yield to the pressure from some Governing Council members to start normalising monetary policy. For now, Euribor futures are pricing in all possible worst-case scenarios: escalation of trade wars, financial meltdown in Turkey, political missteps in Italy, and the approaching peak of the US and global economic cycle. Currently, markets see the three-month Euribor above zero only in 2021 and still below 1 percent at the end of 2023.

We think that Mario Draghi will honour his commitment to keep interest rates unchanged "throughout the summer" of next year, and that the ECB will raise interest rates in September 2019. Yet, we forecast that, once it begins the process, the ECB will normalise its policy faster than is currently expected. Economic fundamentals are likely to support this, unless, of course, trade wars, Italian politics, or other "unknown unknowns" will spoil the party. In that case, unfortunately, all bets are off and we would start another decade of zero or negative interest rate policy, with all its negative side effects.

The ECB may turn more hawkish than currently expected

3m Euribor, Swedbank forecasts and futures



Sources: Swedbank Research & Macrobond

Big challenges await the next government

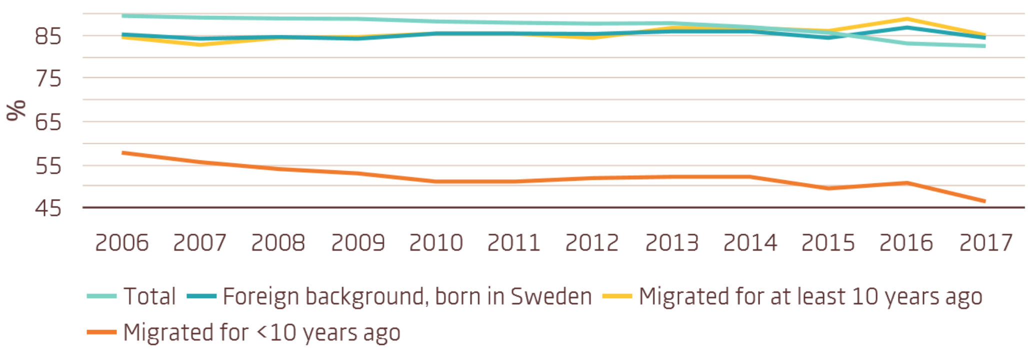
Uncertainty hangs over the Swedish parliamentary election on September 9. The risk of complex and protracted negotiations to form a new government is significant. Uncertainty surrounding the process could affect the currency and fixed-income markets. However, since Sweden's finances are strong, we expect it will mostly be the currency market affected and that the effects will be short term. Economic policy in the near term could be hampered by difficulty in forming a coalition and enacting reforms, however. This could prove costly in fiscal terms and reduce the likelihood of implementation of the reforms necessary to strengthen the Swedish economy.

Risk of a politically complex and costly political term ahead

A new government, depending on who is in it and what coalitions are formed, could mean a more expansionary fiscal policy than normal, post-election, to satisfy all the parties involved. The risk of a future government crisis and threat of a snap election can not be overlooked, either. Sweden's public finances have been a positive surprise in recent years. According to our forecast, this year's public sector financial savings are expected to reach 0.7% of GDP in 2018 and 0.5% in 2019. The budget has been benefitting for several years from the strong economy and low interest rates. This is not sustainable, and there is a risk that a too-expansionary fiscal policy after the election could, in the event of a slowdown, make the economy more vulnerable.

Immigrant background has little effect on school results 10 years after migration

Share of ninth-graders qualified for upper secondary school (%)



Note: Newly immigrated students migrated during the last four years and have two foreign born parents.
Sources: Swedish National Agency for Education, Swedbank Research & Macrobond

Sweden's dysfunctional housing market, polarised labour market, lack of a functioning integration policy, and neglected infrastructure are among the vulnerabilities hiding behind high-growth numbers and strong public finances. Reforms in these areas work best if they are long term and have support across blocs. Below, we cover some of the areas that we feel the new government and parliament must address: the labour market, with a focus on integration and education, the housing market, infrastructure, and the environment.

Immigration and integration are voters' most important issues

Immigration and integration rank highest in several surveys of voters' most important issues. The statistics can be used to paint an alarming picture of social exclusion. They can also be used to stress the contribution to job growth of foreign-born workers in the last decade. Our analysis shows that integration in the labour market is positive for broad groups of foreign-born residents, who account for 70% of job growth in the last 10 years. Employment rates have also risen in the last 10 years, and workforce participation is as high for foreign-born workers as for natives.

At the same time, unemployment among foreign-born workers is still high, at 15%, while the corresponding figure for native Swedes is 3.6%. The challenges are concentrated among those born abroad with a low education. Declining test scores for first- and second-generation foreign-born workers are the single most serious trend we see in the data. Over 30% of all students with foreign backgrounds (born abroad or with two foreign-born parents), and nearly 36% of boys with foreign backgrounds, do not achieve grades qualifying them for high school. For students with a Swedish background, the corresponding figures are 9% and 10%. Implementing comprehensive reforms to alleviate this trend should, therefore, be the highest priority in order to address long-term social isolation and better integrate foreign-born workers into the Swedish labour market.

Extreme weather turns attention to maintenance and infrastructure investment

Infrastructure is not an issue that rates highly among voters, but it is important to increase flexibility in the housing and labour markets, and to achieve the goal of a fossil-fuel free society by 2045. The railways are a key concern, since capacity utilisation is high and maintenance is lagging. Based on the Swedish Transport Administration's scenario, passenger and freight traffic will surge in coming decades in the wake of a rapidly growing population and expanding trade. This increases the need for new investments and maintenance of existing infrastructure. The question is not whether investments are needed, but where, and how they will be financed. Our calculations show that new investments in high-speed rail could boost GDP by an average of nearly 0.3% per year by 2040-2045.

These investments will create a fiscal burden for years to come, however, and if undertaken we expect a temporary deviation from the surplus target as demographic costs rise due to the aging population. Comprehensive investments in high-speed rail could also squeeze out other important investments and, eventually, entail significantly higher and hard-to-calculate costs. Given the rapid developments in technology, there is also a risk that the benefits of high-speed rail will fade.

The housing market is in desperate need of reforms – young people are hurt the most

The housing market is dysfunctional, and household debt has outpaced disposable household income for years. Those hardest hit by the lack of reforms to create a functioning housing market are the young. Our analysis shows that young people trail other groups in income growth. When house prices markedly rise, debt grows much more among the youngsters than other groups. The mortgage cap and amortisation requirement mostly affect young households as well. The number of young people still living at home has increased 60% since 1997. More of them need support from their family to buy a home. The consequences are already evident in the mobility patterns of young people as the influx to large cities has slowed. The continued growth of large cities is rather an effect of foreign migration and births, not an influx from other regions in Sweden.

We assess, therefore, that more comprehensive reforms are needed to address the current situation. A renewed debate on housing policy is necessary after the election. A broad tax reform that encompasses housing policy is essential to create long-term prospects of a better-functioning housing market. In addition, measures should be taken immediately to counteract the negative effects of the amortisation requirement and mortgage cap on young households. Subsidised housing savings, coupled with a lower mortgage cap for young buyers, could give young people a better opportunity to move to take advantage of new jobs and educations.

Appendices

SWEDEN: Key economic indicators, 2017–2020 [1/]

	2017	2018F		2019F		2020F
Real GDP growth (calendar adjusted), %	2.5	2.8	(2.7)	1.9	(1.8)	1.5
Real GDP growth, %	2.3	2.7	(2.6)	1.9	(1.8)	1.8
Household consumption	2.2	2.7	(2.6)	2.2	(2.0)	1.6
Government consumption	0.4	0.8	(1.5)	1.1	(1.1)	1.3
Gross fixed capital formation	5.9	3.9	(3.1)	1.6	(2.3)	1.8
Change in inventories, contribution to GDP growth	0.1	0.1	(-0.1)	0.0	(0.0)	0.0
Exports of goods and services	3.6	3.4	(5.7)	4.3	(4.4)	3.9
Imports of goods and services	4.8	3.3	(5.5)	4.0	(4.6)	3.7
Industrial production (calendar adjusted), %	3.8	4.2	(5.4)	3.9	(4.0)	3.2
CPI, % (average)	1.8	2.1	(1.8)	2.5	(2.6)	2.7
CPI, % (end of period)	1.7	2.4	(2.1)	2.6	(2.7)	2.8
CPIF, % (average) [2/]	2.0	2.2	(1.8)	2.2	(1.9)	2.0
CPIF, % (end of period) [2/]	1.9	2.4	(1.7)	2.0	(1.9)	2.0
Riksbank policy rate, end of period	-0.50	-0.4	(-0.25)	0.00	(0.25)	0.5
Unemployment rate (15–74), %	6.7	6.2	(6.3)	6.1	(6.3)	6.0
Change in labour force (15–74), %	2.0	1.2	(1.2)	0.8	(0.8)	0.6
Change in employment (15–74), %	2.3	1.7	(1.6)	0.9	(0.8)	0.7
Nominal hourly wage (NMO), whole economy, %	2.4	2.7	(2.8)	3.1	(3.2)	3.5
Household savings ratio, %	16.0	16.6	(16.6)	16.6	(16.5)	16.5
Household real disposable income, %	2.3	2.5	(2.6)	2.3	(2.0)	1.4
Current account balance, % of GDP	4.2	4.4	(4.9)	4.7	(5.0)	4.8
General government budget balance, % of GDP [3/]	1.3	0.7	(0.5)	0.4	(0.0)	0.3
General government debt, % of GDP [3/]	40.7	36.9	(37.6)	35.1	(36.3)	34.9

[1/] Previous forecast in parenthesis
[2/] CPI with fixed interest rates
[3/] According to Maastricht definition

Sources: National statistics and Swedbank Research

ESTONIA: Key economic indicators, 2017–2020 [1/]

	2017	2018F		2019F		2020F
Real GDP growth, %	4.9	3.5	(3.9)	3.2	(3.0)	2.7
Household consumption	2.2	3.5	(4.5)	3.5	(2.7)	3.0
Government consumption	0.8	2.0	(2.0)	2.0	(2.0)	2.0
Gross fixed capital formation	13.1	1.0	(6.0)	6.0	(4.5)	5.5
Exports of goods and services	2.9	5.0	(4.5)	4.0	(4.0)	3.5
Imports of goods and services	3.5	5.5	(5.0)	4.5	(4.0)	4.0
Consumer price growth, %	3.4	3.4	(3.0)	3.0	(2.5)	2.5
Unemployment rate, % [2/]	5.8	5.5	(6.2)	5.1	(6.3)	5.3
Change in employment, % [2/]	2.2	0.8	(0.5)	0.5	(0.3)	0.0
Gross monthly wage growth, %	6.5	6.6	(6.0)	6.0	(5.5)	5.5
Nominal GDP, billion euro	23.0	24.8	(24.8)	26.5	(26.4)	28.1
Exports of goods and services (nominal), % growth	7.1	7.7	(8.3)	7.1	(6.6)	6.6
Imports of goods and services (nominal), % growth	6.4	8.7	(7.7)	7.7	(6.6)	7.1
Balance of goods and services, % of GDP	4.5	3.8	(4.4)	3.4	(4.4)	3.1
Current account balance, % of GDP	3.1	2.5	(2.8)	1.6	(2.7)	1.4
Current and capital account balance, % of GDP	7.2	6.1	(6.7)	4.3	(6.3)	3.8
FDI inflow, % of GDP	3.2	3.0	(3.0)	3.0	(3.0)	3.0
General government budget balance, % of GDP [3/]	-0.3	-0.5	(-0.3)	-0.3	(-0.3)	-0.2
General government debt, % of GDP [3/]	9.0	8.6	(8.6)	8.0	(8.5)	7.6

[1/] Previous forecast in parenthesis
[2/] According to Labour Force Survey
[3/] According to Maastricht definition

Sources: National statistics and Swedbank Research

LATVIA: Key economic indicators, 2017–2020 [1/]

	2017	2018F		2019F		2020F
Real GDP growth, %	4.5	4.0	(3.0)	3.0	(3.2)	2.5
Household consumption	5.1	5.7	(6.0)	5.0	(5.0)	3.3
Government consumption	4.1	3.5	(3.0)	3.0	(3.0)	2.9
Gross fixed capital formation	16.0	15.0	(12.0)	8.0	(11.5)	5.5
Exports of goods and services	4.8	4.0	(3.0)	3.5	(3.5)	3.7
Imports of goods and services	9.5	6.8	(7.2)	6.0	(6.6)	4.6
Consumer price growth, %	2.9	2.6	(3.3)	2.5	(2.5)	2.3
Unemployment rate, % [2/]	8.7	7.6	(8.1)	7.1	(7.5)	6.9
Change in employment, % [2/]	0.2	1.5	(0.1)	0.2	(0.1)	-0.3
Gross monthly wage growth, %	7.8	9.0	(9.0)	7.0	(7.0)	5.5
Nominal GDP, billion euro	26.9	29.1	(28.7)	31.1	(30.5)	32.9
Exports of goods and services (nominal), % growth	8.5	7.5	(5.6)	5.4	(5.3)	5.6
Imports of goods and services (nominal), % growth	12.6	7.9	(8.8)	7.3	(8.2)	5.9
Balance of goods and services, % of GDP	-1.3	-1.5	(-3.2)	-2.6	(-4.9)	-2.8
Current account balance, % of GDP	-0.8	-0.8	(-2.5)	-2.0	(-4.2)	-2.2
Current and capital account balance, % of GDP	0.0	0.9	(-0.2)	-0.2	(-1.6)	-0.3
FDI inflow, % of GDP	3.7	1.0	(2.3)	2.1	(2.1)	2.0
General government budget balance, % of GDP [3/]	-0.5	-0.8	(-1.0)	-0.8	(-0.9)	-0.7
General government debt, % of GDP [3/]	40.1	38.1	(34.8)	36.4	(34.1)	37.2

[1/] Previous forecast in parenthesis
[2/] According to Labour Force Survey
[3/] According to Maastricht definition

Sources: National statistics and Swedbank Research

LITHUANIA: Key economic indicators, 2017–2020 [1/]

	2017	2018F		2019F		2020F
Real GDP growth, %	3.9	3.6	(3.2)	2.5	(2.5)	2.0
Household consumption	3.8	3.8	(3.8)	3.5	(3.5)	2.5
Government consumption	1.0	1.5	(1.5)	1.5	(1.0)	1.0
Gross fixed capital formation	7.3	9.0	(9.0)	7.0	(7.0)	5.0
Exports of goods and services	13.6	4.5	(5.0)	3.0	(3.0)	2.0
Imports of goods and services	12.8	6.0	(6.5)	4.0	(4.0)	3.0
Consumer price growth, %	3.7	2.7	(3.0)	2.5	(2.5)	2.5
Unemployment rate, % [2/]	7.1	6.4	(6.9)	6.5	(6.9)	6.6
Change in employment, % [2/]	-0.5	0.2	(-0.3)	-0.1	(-0.3)	0.0
Gross monthly wage growth, %	8.5	8.7	(7.5)	7.0	(6.0)	4.0
Nominal GDP, billion euro	41.9	44.9	(44.9)	47.3	(47.3)	49.4
Exports of goods and services (nominal), % growth	18.6	8.0	(8.0)	5.0	(5.0)	3.0
Imports of goods and services (nominal), % growth	17.3	9.0	(10.0)	6.0	(6.0)	4.0
Balance of goods and services, % of GDP	2.2	1.5	(0.2)	0.7	(-0.6)	-0.1
Current account balance, % of GDP	0.8	-0.3	(-0.9)	0.1	(-1.2)	-0.3
Current and capital account balance, % of GDP	2.0	1.1	(0.9)	1.6	(0.7)	1.2
FDI inflow, % of GDP	2.2	2.5	(1.5)	2.0	(1.5)	2.0
General government budget balance, % of GDP [3/]	0.5	0.6	(0.5)	0.3	(0.2)	0.1
General government debt, % of GDP [3/]	39.7	35.3	(36.5)	37.8	(36.7)	36.4

[1/] Previous forecast in parenthesis
[2/] According to Labour Force Survey
[3/] According to Maastricht definition

Sources: National statistics and Swedbank Research

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