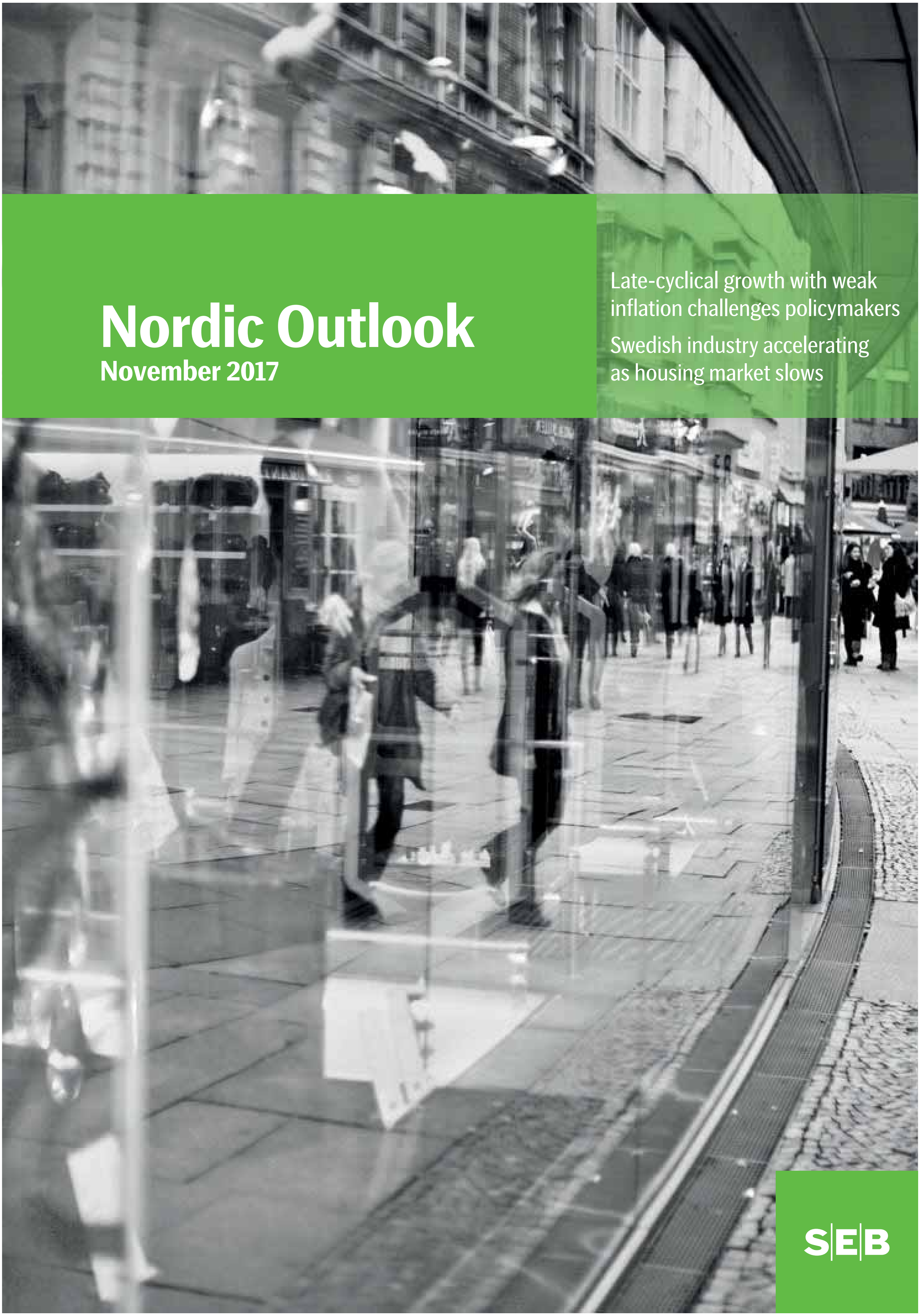
Nordic Outlook

November 2017

Late-cyclical growth with weak inflation challenges policymakers

Swedish industry accelerating as housing market slows



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Broadened global growth despite cyclical and political threats

- **Late-cyclical growth and weak wage response test economic policy framework**
- **Delay in interest rate normalisation, but Phillips curve is alive despite low inflation**
- **Euro zone political and economic tailwind will eventually push EUR/USD up to 1.25**
- **Rising profits sustain share prices despite stretched valuations**
- **Industrial growth will keep Swedish GDP up but weaker housing market poses dilemma**

The broad-based positive trend in the world economy has continued this autumn. In the **United States**, third quarter 2017 GDP growth surprised on the upside. The Japanese economy is now growing faster than for a long time. In the **euro zone**, **Germany** and **Spain** remain impressive, but the situation has also improved in France and Italy. The Brexit process is noticeably hampering the **British economy**, yet to a slightly lesser extent than feared. In the emerging market (EM) economies, too, bright spots have predominated. For example, the **Chinese economy** continued to operate at full throttle before the Communist Party congress, which took place in October. **India** is an important exception, however, with a sharper slowdown than expected. **The Nordic economies** are continuing their above-trend growth. In **Sweden**, GDP and employment are continuing to increase rapidly, but the composition of growth is changing as residential construction slows while exports and industrial production accelerate.

Throughout 2017 we have been more optimistic than the consensus of analysts, yet we have had to make continuous upward revisions in small steps. Because of strong signals, we are again making **cautious upward revisions in our GDP forecast for most countries**. At the global level, however, the effect is only about a tenth of a percentage point per year, but GDP growth of close to 4 per cent yearly in 2017-2019 reflects a favourable world economic trend. We are now generally seeing a growth dynamic that is rather typical of a mature expansion period. Robust labour markets and increasing wealth are contributing to optimism in the household sector, while capacity utilisation is reaching levels that will drive new capital spending on a more widespread basis. This dynamic is usually quite powerful even late in an economic cycle.

However, there are both political and cyclical risks in this forecast picture. The past few years have provided much more political drama than usual. Last year's Brexit referendum in the United Kingdom and Donald Trump's victory in the US presidential election led to worries about major setbacks in international cooperation, free trade and transparency. Meanwhile various geopolitical sources of concern have appeared one after another, for example the Russia-Ukraine conflict, the overheated rhetoric surrounding North Korea's relations with other countries and, most recently, new tensions in the Middle East including Saudi Arabia. The Catalan crisis has also focused attention on regional separatism as a means of expressing dissatisfaction in Western Europe. Some of these political crises have had a very short-term dominant influence on financial markets, but such effects have quickly faded. We cannot rule out that some political events may change world economic conditions in ways that may have long-term consequences. Yet developments in recent years have shown that – in their consumption and investment decisions – households and businesses are normally rather insensitive to political uncertainty. A more **uncertain political landscape is thus in itself no obstacle to a positive economic forecast**.

Global GDP growth

Year-on-year percentage change

	2016	2017	2018	2019
United States	1.5	2.3	2.6	2.0
Japan	1.0	1.5	1.2	1.0
Germany	1.9	2.2	2.2	2.0
China	6.7	6.9	6.6	6.2
United Kingdom	1.8	1.5	1.3	1.1
Euro zone	1.8	2.3	2.3	2.1
Nordic countries	2.2	2.7	2.3	2.2
Baltic countries	2.2	4.0	3.4	3.1
OECD	1.8	2.4	2.3	2.0
Emerging markets	4.3	4.9	5.1	5.1
World, PPP*	**3.2**	**3.8**	**3.9**	**3.8**

Source: OECD, SEB * Purchasing power parities

With unemployment in many countries today down to levels not achieved for decades, **cyclical downside risks are more evident than political ones in a slightly longer perspective**. In the last *Nordic Outlook*, we discussed various types of recession risks that decision makers must always bear in mind. One conclusion was that the most serious consequences would occur if inflation suddenly surged like a "ketchup effect", forcing central banks to make sizeable key interest rate hikes. In a number of countries, the US in particular, resource utilisation has also reached such high levels that a degree of supply side-driven slowing of GDP growth is likely in 2019. But for example in the euro zone and many EM economies, which are on their way towards recovery after a slump in recent years, there is continued expansionary potential. We are thus sticking to our forecast that supply side restrictions will generally not stop the upturn during our forecast period.

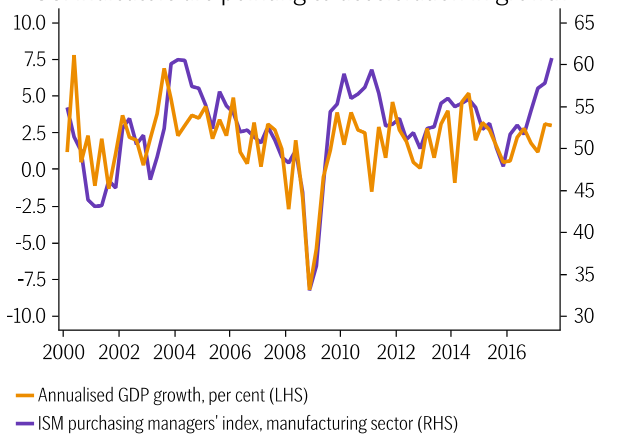
Inflation has continued to surprise on the downside. Our inflation analysis indicates that central banks will continue to have relatively large manoeuvring room when it comes to shaping the normalisation of their monetary policies. This will not prevent them from having to face **difficult trade-offs between the risks of building up financial imbalances and the possibility of pushing down unemployment further** (see the theme article entitled "Inflation targeting in crisis?"). Although most central banks are increasingly signalling that strong economic growth is making it natural to soon begin reversing loose policies, in most regions such a shift is quite far away in time. We are reiterating our forecast that after a December rate hike, **the US Federal Reserve will carry out three more hikes during 2018 and one in 2019**, bringing its key rate to 2.50 per cent at the end of 2019. But the Fed will have to move ahead with little company. We believe that the Bank of England, which has now delivered a one-off rate hike reversing the rate cut it implemented directly after the Brexit referendum, will wait until 2019 before taking the next step. The European Central Bank has announced an extension of its asset purchases, and no rate hikes are likely before 2019. In our forecast, we have also **postponed the first rate hike in Sweden until September 2018**, since the Riksbank has signalled that high growth, an increasingly hot labour market and inflation close to target do not justify any rate hike soon.

Subdued inflation has put a lid on global interest rates this year. Looking ahead, we expect a slow upturn as the Fed delivers key rate hikes somewhat faster than the market is discounting, and later when the ECB tapers its bond purchases and finally also raises its key rates. The upturn will be only to 50 and 70 basis points, respectively, bringing 10-year government bond yields to **2.90 per cent in the US and just above 1.10 per cent in Germany at the end of 2019**. The dollar has some room to appreciate in the short term but will weaken later as other central banks begin policy normalisation. Increased exposure to the euro in the currency portfolios of global asset managers – once euro zone economic growth has speeded up and political risk premiums have faded – will also push the euro higher. **At end-2019, the EUR/USD rate will be 1.25.** A bright macroeconomic picture and favourable interest rates will drive stock markets upward. We are now approaching valuation levels that are stretched, but **as long as growth remains strong we expect share prices to keep climbing about as fast as earnings**.

US: Growth rebound resolving uncertainties

American economic growth has rebounded solidly after a weak beginning of the year. After a strong second quarter, hurricanes Harvey and Irma caused material devastation but also a degree of uncertainty about the macroeconomic picture as job growth plunged in September. But a look at the third quarter as a whole brought another upside surprise: annualised GDP growth of 3.0 per cent. The Trump administration continues to have problems pushing its policies through Congress. As for tax policies, internal Republican conflicts have created the main obstacles, with the fiscally conservative branch of the party opposing unfunded solutions. Yet we believe that Congress will eventually **enact tax cuts that will provide a stimulus effect equivalent to one quarter per cent of GDP**. So far the administration has not carried out any of the protectionist measures announced during last year's presidential election campaign. Although there is some risk that Trump will choose to withdraw from the slow-moving negotiations with Canada and Mexico on the North American Free Trade Agreement (NAFTA), the most likely outcome is still that the three countries will achieve a renegotiated agreement.

US: Indicators are pointing to acceleration in growth



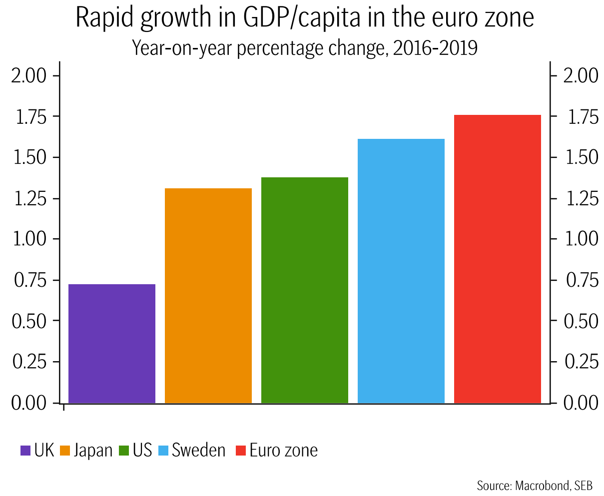
Source: U.S. Bureau of Economic Analysis (BEA), Institute for Supply Management (ISM)

Now that various demand-side uncertainties have been resolved, the labour market situation will be even more crucial to the long-term US growth outlook. Unemployment has now fallen to 4.2 per cent, its lowest level since 2000. Other indicators also show that businesses have increasing problems in recruiting suitable labour, but broader labour market metrics suggest that the resource situation is not quite so tight. Involuntary partial unemployment is high, while labour force participation is well below the levels that prevailed in the early 2000s. This means there is potential for some expansion in the labour supply, although demographic factors such as social exclusion mechanisms due to drug abuse and long-term unemployment suggest that we will not revert to earlier peak levels. Partly due to the brighter economic outlook, **we have revised our GDP growth forecast for 2018 upward to 2.6 per cent**, but due to labour market bottlenecks we still believe that growth will slow to 2.0 per cent in 2019.

Euro zone: Growth-induced euphoria?

The euro zone economy continues to surprise on the upside. **Third quarter GDP growth was 2.5 per cent year-on-year: the highest since 2011**. The labour market is improving. Despite low pay hikes, household optimism is record-strong. Exports and industrial production are accelerating. This helps boost capacity utilisation and thus capital spending. We are revising our forecast upward to **2.3 per cent GDP 2017 and 2018**; even our 2019 forecast of 2.1 per cent represents an expansion well above trend. Since the euro zone has substantially slower population growth than the US, for example, its upturn in GDP per capita is even more impressive.

Because of the strong economy and relief that the euro zone's super-election year 2017 did not lead to especially major success for anti-European Union forces, there are **hopes of a fresh start for EU integration and cooperation efforts**. After Brexit the UK will no longer be able to block such ambitions, and this has also strengthened hopes. The initiatives are coming mainly from Brussels and Paris. For example, French President Emmanuel Macron has proposed creating an EU-level finance minister post, a European monetary fund and more resources for joint crisis management in the region. Partly due to ongoing government coalition talks in Germany, leading politicians there have not yet revealed their views on these issues. The liberal party FDP may stand in the way of such plans due to its sceptical attitude towards supra-nationalism and new commitments that might burden German taxpayers.



We foresee a decent chance that a strategy that gives member countries clear choices as part of a "multi-speed Europe" may achieve some success, since the task of deepening **EU and euro zone cooperation will enjoy a tailwind over the next couple of years** due to better economic conditions and looser fiscal policies. But many tensions remain. Anti-EU and populist parties have gained ground in national parliaments. If EU political leaders should behave in excessively tone-deaf fashion, opposition would certainly increase both at the grassroots level around Europe and among sceptical member countries. Dissatisfaction has recently also manifested itself in the form of regional separatism. This has assumed its most dramatic form in Catalonia but also enjoys fertile soil in northern Italy, Scotland, Belgium and elsewhere.

Sluggish, asymmetric Brexit negotiations

Uncertainty about the future relationship between the United Kingdom and the EU is hampering British economic growth, but indicators have recently rebounded a bit partly due to the weak pound and robust international economic conditions. This picture is divided, however, and optimism among domestic service sector companies has fallen. We have adjusted our 2018 GDP growth forecast for the UK somewhat higher but predict a gradual deceleration from 1.5 per cent in 2017 to 1.1 per cent in 2019. Despite below-trend growth, so far unemployment has fallen. It is now at its lowest since 1975, but we foresee a slight upturn ahead. **Yet our forecast assumes that negotiated solutions can be achieved that will ensure an orderly withdrawal from the EU**.

So far the Brexit talks have moved at a sluggish pace, which may be part of the negotiating game and thus not yet so worrisome. But the asymmetry between the two sides is starting to become increasingly clear, with EU negotiators defending the fundamental principles of the Union and knowing that time is the worst enemy of the British. UK negotiators are eager to eliminate financial uncertainty as quickly as possible but are meanwhile feeling the pressure from EU-sceptical public opinion. The tensions in the UK political system are also tending to grow, with increasing divisions in Parliament and declining confidence in Prime Minister Theresa May. Yet it is not possible to discern any political opening to re-assess Brexit and remain in the EU.

Nordics, GDP growth

Year-on-year percentage change

	2016	2017	2018	2019
Sweden	3.3	3.2	2.6	2.4
Norway	1.1	2.0	1.6	1.8
Denmark	2.0	2.3	2.3	2.3
Finland	1.9	2.9	2.5	2.3

Source: OECD, SEB

Broadly based, above-trend Nordic growth

The acceleration in global growth is clearly benefiting the Nordic economies. **In Sweden the economic expansion has gained strength, but a weakening of the housing market** will slow down growth, mainly due to lower construction. This will be offset to some extent by accelerating exports and industrial capital spending, among other things due to the weak krona. GDP will grow by 3.2 per cent in 2017 and about 2.5 per cent yearly in 2018-2019. After three weak years, **Norway is now on the right path. Mainland GDP growth has climbed above trend**: in 2017-2019, growth will increase from 1.7 to1.9 per cent. Expansionary fiscal and monetary policies and strong construction activity have contributed. When these drivers weaken a bit, private consumption and exports will strengthen instead. **The biggest upturn has occurred in Finland**, which has left behind a long period of weak growth. Exports and capital spending are accelerating, while households are very optimistic. The economy will grow by 2.5-3 per cent yearly in 2017-2019: the fastest in more than five years. The **Danish economy is gradually improving**, too. GDP will grow by nearly 2.5 per cent yearly, as exports and capital spending supplement household consumption.

EM economies rebounding after slump

The growth rate of emerging market (EM) economies has gradually strengthened since 2015, and positive signals have predominated in the past few months as well. We expect GDP growth in SEB's aggregate EM index to climb **from 4.3 per cent in 2016 to 4.9 per cent this year and to 5.1 per cent in 2018 and 2019**. Growth in China has recently surprised on the upside; we have adjusted our forecast a bit higher but still believe the economy faces a minor slowdown. Now that the Communist Party leadership reshuffle has been approved, political stability will increase. President Xi Jinping will thus have a better chance to speed the pace of reform efforts, including greater willingness to accept a slower short-term growth rate so as to bring about a shift in economic drivers, but heavy debt – especially among companies – poses a risk if international demand slows while credit supply is tightened.

GDP growth, BRIC countries and EM sphere
Year-on-year percentage change

	2016	2017	2018	2019
China	6.7	6.9	6.6	6.2
India	7.9	6.6	7.5	7.8
Brazil	-3.6	0.7	2.2	2.3
Russia	-0.2	1.8	2.0	1.9
Emerging markets, total	**4.3**	**4.9**	**5.1**	**5.1**

Source: OECD, SEB

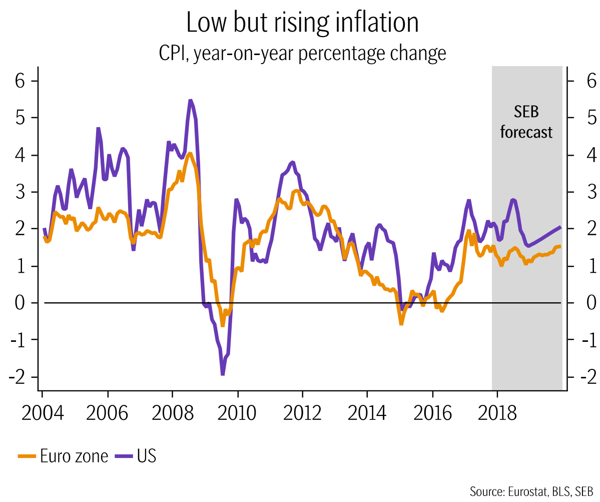
The slowdown in **India** has been sharper than expected. The currency ("demonetisation") reform late in 2016 and the tax reform in mid-2017 have probably hampered economic activity temporarily. We expect growth to rebound to about 7.5-8 per cent in 2018, even though reform efforts appear set to be put on the back burner until the 2019 election. **Brazil** is climbing out of its deepest economic crisis in modern times. GDP growth will be weakly positive this year, then climb to above 2 per cent in 2018 and 2019. But the economic turnaround has also contributed to weaker crisis awareness and reform ambitions; Brazil's important pension reform now looks likely to fail. **Russia** has also left its recession behind. The oil price recovery will help maintain GDP growth of around 2 per cent yearly in 2017-2019.The March 2018 presidential election is hardly likely to result in to any change in the political climate. Relations with the EU and the US will thus remain frosty.

The EM economies now account for 57 per cent of the world economy in terms of purchasing power parities (PPP), which means they provide a dominant contribution to global GDP growth. Yet the label "economic engine of the world" is a bit dubious, since their share measured in nominal terms is more relevant to their influence on the global system. This share is far lower than their PPP share. Even more important is that the EM economies are still highly vulnerable to changes in the financial climate of more advanced economies, especially the US. We have seen repeated examples of this; the EM slowdown in 2013-2015 occurred in the wake of the Fed's signal that it would soon shift to a less expansionary QE policy (tapering). More recently, the Fed's clear signal of a December 2017 key rate hike has led to a widespread depreciation in EM currencies. **The negative effects of future Fed rate hikes thus pose a downside risk**, but our main forecast is that the EM economies will perform well as long as the Fed's tightening actions occur gradually and in an environment of strong global economic growth.

A more balanced oil market

The sharp price decline of 2014-2015 clearly illustrated some new characteristics of the oil market. The price drop quickly triggered pressure for change in the industry, and break-even costs for world oil production fell sharply. Meanwhile the US emerged as a "marginal" producer, since shale oil was profitable at a relatively low price of just above USD 50 per barrel. The market thus perceived an implicit oil price ceiling around this level. **During 2017, however, the situation changed in several respects**. 1) Russia and other major producers have finally agreed on an output ceiling. 2) Break-even levels in the US for shale and other oil rose, which is one reason why the number of active US rigs has not risen despite the recent upturn in oil prices. 3) Geopolitical risks and internal political conflicts in Saudi Arabia have help drive the upturn we have seen during October and November.

The price upturn of the past month has not had an impact on longer-dated oil futures, which are instead trading at below spot prices. Speculators have also built up record-sized positions since Brent crude oil soared 45 per cent from its low in June of below USD 45/barrel. Meanwhile we seem to be moving towards a more balanced oil market, with the supply surplus of recent years gradually becoming a deficit. Oil prices will probably fall somewhat, but there are still conditions that will enable prices to remain a bit higher for a long period than we have seen in recent years. **Our forecast is that the average price of Brent crude will be USD 55/barrel in 2018 and USD 60/barrel in 2019, with upside risks in both years**.



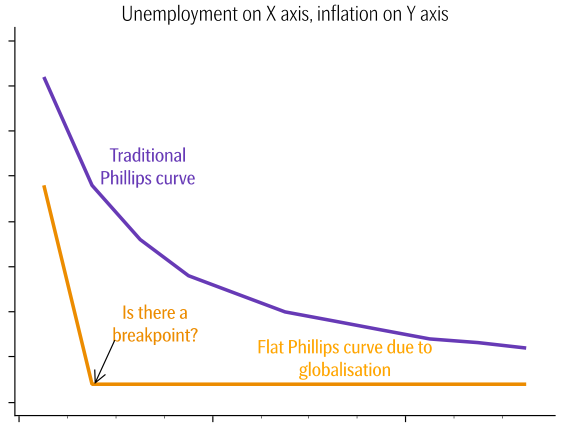
A lack of clear inflation signals

Inflation remains subdued. Impulses from energy prices or other volatile components have occasionally pushed up consumer price index (CPI) inflation to 2 per cent, for example in the euro zone early in 2017 and in the US and Sweden during the second half. But **underlying wage pressure still seems too low to keep inflation so close to central bank targets**. In the euro zone, inflation according to the harmonised index of consumer prices (HICP) has fallen to 1.4 per cent; core inflation has been very stable for a long time at close to 1 per cent. In the US, wages and salaries seem unwilling to take off despite historically low unemployment. This is one reason why the Fed's main metric – the personal consumption expenditures deflator (core PCE) – has fallen as low as 1.3 per cent. Core PCE is now being pushed down by temporary effects such as a mobile phone price war, but its level will remain worryingly low for the Fed for a rather long time.

Our inflation forecasts are generally providing about the same picture as they have done recently. Deflation risks have declined sharply, and the short-term inflation pattern remains rather heavily influenced by volatile components, especially energy prices. But even though unemployment has fallen to historically low levels, underlying price and wage pressures are not high enough to make central banks feel comfortable. **The theme article entitled "Crisis for inflation targeting?"** discusses several competing approaches to understanding the inflation process. These can be summarised as various shapes for the Phillips curve, i.e. the relationship between the labour market and the rate of price and wage increases.

Shape of Phillips curve is one focus of policy debate

Unemployment on X axis, inflation on Y axis



Source: Macrobond, SEB

One thesis is that globalisation forces and an ongoing technological revolution, which will make jobs disappear on a large scale, are so powerful that **inflation will remain low regardless of the resource situation** and attempts by central banks to push up inflation are thus futile. If the Phillips curve is horizontal in this way, ultra-loose monetary policy will create financial imbalances and inefficient allocation of financial resources. Yet it is also conceivable that there is a **critical level of unemployment at which inflation lets loose** in a way that may force central banks to abruptly slam on the brakes, but that we have not yet reached this critical "knee" in the Phillips curve. Our view is a combination of the above views. Sooner or later, higher resource utilisation will affect price and wage formation, but the relationship has weakened and the effects arrive after a significant delay. Partly due to greater openness, national resource gaps have become less important to the inflation process. Individual economies, especially small ones, **thus benefit greatly from synchronised high international resource utilisation** when it comes to their ability to push up inflation. Since inflation is determined by interaction between national and global factors, we should not be so hopeful about the potential for finding a stable Phillips curve where domestic unemployment is related to inflation and wage increases.

CB framework questionable, but still there

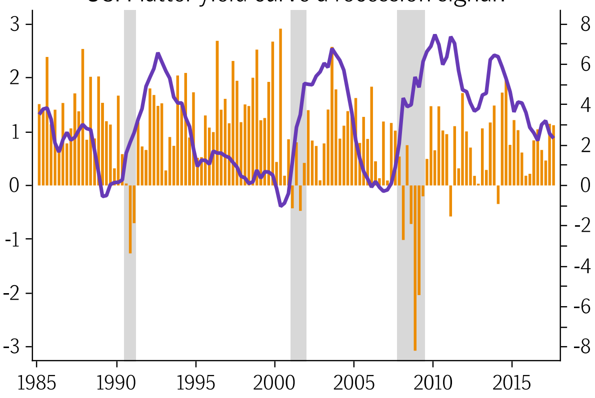
How central banks (CBs) interpret the inflation dynamic will be crucial to the shape of future monetary policy. Without any relationship between inflation and resource utilisation, it is hard to see how inflation targeting can serve in the long run as the main instrument of stabilisation policy. The risk of constantly pumping up financial bubbles or making pro-cyclical interest rate changes and actually reinforcing cyclical fluctuations would be too great. Central banks have thus been biased towards communicating that they fundamentally believe in some sort of Phillips curve relationship. This autumn we have also seen analyses that try to explain the feeble price and wage response in a traditional way. The International Monetary Fund (IMF) has pointed to weak productivity growth as an important partial explanation for low pay increases. In addition, a high proportion of part-time unemployment may signify that low unemployment figures in the US and elsewhere exaggerate the degree of tightness in the labour market. Such an interpretation suggests that central banks can rely on forecast models and that they have the option of proceeding cautiously when they withdraw stimulus measures.

But very recently, **increased humility and openness about the inflation dynamic has been discernible**: declarations from decision makers that they do not really know so much about today's inflation process and that forecasting methods may be out-of-date. Such declarations have come from the Bank for International Settlements (BIS) as well as the heads of the Federal Reserve (Janet Yellen) and the Bank of England (Mark Carney). New inflation drivers such as globalisation, uncertain new forms of employment (the "gig economy") and automation are also cited in analyses by the IMF and especially the BIS. If the inflation process is dominated by lasting forces beyond the control of national central banks, there is reason to question today's inflation targeting regime. But at present, it is clear that radical ideas about abandoning the existing framework enjoy little support among central banks and other decision makers. In order to bring about a change, **we probably need a new international crisis in which a dysfunctional framework is singled out as the scapegoat**.

Fed hikes will continue despite low inflation

Despite uncertainty about what drives inflation, **most central banks now seem to be preparing to begin a cautious normalisation**. In spite of unexpectedly low inflation, this autumn the Fed began a gradual reduction in its balance sheet and also clearly signalled that this year's third key interest rate hike will occur in December. So far, Fed rate hikes have not led to any major tightening in general US financial conditions, among other things because stock markets have continued to climb and credit spreads have remained narrow. We believe that this – combined with above-trend GDP growth, a tighter labour market and gradually higher pay increases – will help bring about three more Fed rate hikes in 2018 and one in 2019. **This implies a federal funds rate of 2.50 per cent at the end of 2019**, which is a bit lower than the Fed's own forecasts. Long-term yields have not risen significantly so far in response to the key rate hikes, which is a mixed blessing since a flatter yield curve – for example, measured as the spread between 10- and 2-year Treasury yields – has historically been a clear signal of an oncoming recession (see theme article). The flattening of the curve may thus be regarded as an alarm clock for the Fed. But the curve still has a positive slope, and we believe that long-term yields will also climb once the fixed income market starts pricing in slightly little more aggressive Fed behaviour.

US: Flatter yield curve a recession signal?



10-year Treasury yield minus 2-year yield (LHS)
Annualised change in GDP, per cent (RHS)

Source: U.S. Bureau of Economic Analysis (BEA), Macrobond Financial AB, Macrobond, SEB

Even though euro zone resource utilisation remains relatively low, economic strength is beginning to create impatience among some ECB officials to soon begin rolling back portions of their exceptionally stimulative monetary policies. This led to a compromise decision late in October, which included halving the central bank's monthly bond purchases to EUR 30 billion but extending their horizon until at least September 2018. Our main forecast is that the ECB will in fact stop these purchases in September, although there is some likelihood that they will again be trimmed and prolonged until December. After that we expect the ECB to raise its deposit rate for banks to -0.25 per cent in March 2019 and then hike the repo rate in June and December to **0.50 per cent at the end of 2019**. Prime Minister Shinzo Abe's re-election will mean continued government support for the **Bank of Japan's** policy of purchasing about JPY 90 billion worth of securities per year, keeping the 10-year government bond yield around zero and maintaining a key interest rate of -0.10 per cent in an effort to achieve a still-distant inflation target. In November the **Bank of England** reversed the crisis rate cut it carried out right after the Brexit referendum, but we expect no further hikes in the near term. An orderly withdrawal from the EU will, however, be followed by two BoE hikes to **1.00 per cent in the second half of 2019**.

Despite economic growth far above the Riksbank's forecast early in 2017 and inflation/inflation expectations close to target, the Riksbank continues to reject the thought of policy normalisation. In our forecast, we are postponing an initial rate hike until September 2018. Three additional hikes during 2019 will bring **the repo rate to 0.50 per cent by year-end**. Bond purchases will probably end in December 2017, although an extension for signalling purposes cannot be ruled out. In any event, the Riksbank will continue to re-invest distributions and maturing bonds, thereby retaining a high percentage of the outstanding bond supply. The Riksbank might face a dilemma if **a weaker housing market leads to gloomier growth prospects at the same time as greater scepticism about the Swedish economy weakens the krona, thereby creating an inflation impulse**. Previous experience shows that Swedish inflation generally occurs late in an economic cycle, which may amplify such an impulse. On previous occasions, such as in 2008, the Riksbank has hiked its key rate in a late-cyclical inflation environment amid a deteriorating economic situation. Although this is not our main scenario, economic policymakers are obviously facing new dilemmas, largely as a consequence of previous failures.

Central bank key interest rates

Per cent

	Today	Dec 2017	Dec 2018	Dec 2019
Federal Reserve (Fed)	1.25	1.50	2.25	2.50
ECB (refi rate)	0.00	0.00	0.00	0.50
Bank of England (BoE)	0.50	0.50	0.50	1.00
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.60	5.10
Riksbank (Sweden)	-0.50	-0.50	-0.25	0.50
Norges Bank (Norway)	0.50	0.50	0.75	1.25

Source: Central banks and SEB

Thanks to a robust economic recovery and subdued inflation, **Norges Bank will postpone any rate hike until late 2018, followed by new hikes to 1.25 per cent by end- 2019**. A weak krone will allow it greater freedom to diverge from other central banks. Meanwhile it will maintain its focus on the risks of household debt, despite the ongoing home price downturn.

Yield upturn is on hold, but not over

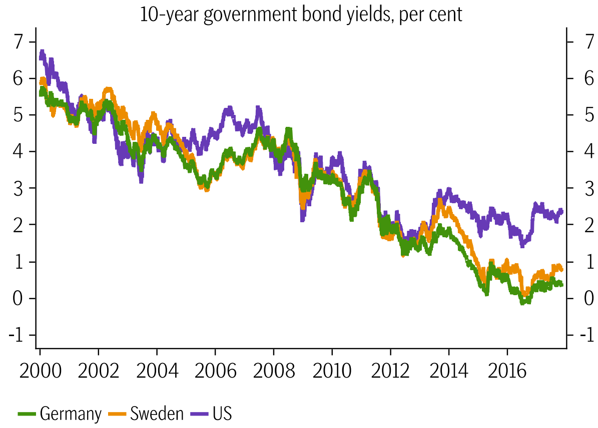
Last year's US presidential election pushed bond yields upward in both the US and Europe, but during 2017 long-term yields have not shown any clear trend. At present, 10-year US Treasury yields are somewhat below their levels early in the year, despite Fed interest rate hikes, among other things because of lower inflation expectations. After inflation repeatedly surprised on the downside, break-even inflation as measured in the inflation-indexed bond market has fallen after a rapid upturn late in 2016. Lower expectations about the Trump administration's reform agenda have probably also played a role. In addition, continued loose monetary policies elsewhere in the world have a downward effect on US yields.

Coming key rate hikes – which are only partly discounted by the market – and gradual reduction in the Fed's balance sheet suggest that **long-term US yields will start moving slowly upward**. The euro zone economy is growing rapidly, but as long as accelerating inflation appears distant and the ECB keeps expanding its balance sheet, it is difficult to foresee any clear upward trend for euro zone bond yields in the near term. But tapered bond-buying and increased expectations of ECB hikes will eventually put some upward pressure on bond yields.

Our forecast implies that 10-year US Treasury yields will reach 2.80 per cent by the end of 2018 and 2.90 at the end of 2019. The yield curve will thus remain relatively flat but positive throughout our forecast period; at the end of 2019 the spread between the 10-year yield and the key interest rate will be 40 basis points. **Ten-year German yields will climb to 0.75 per cent at the end of next year and to 1.10 at the end of 2019**: an upturn of 70 points from today's level. This implies that the 10-year yield spread against the US will remain historically wide, but down from its peak of nearly 240 points at the end of 2016. Compared to the September issue of *Nordic Outlook*, our forecasts for the end of 2019 have been revised downward by 20 points for the both the US and Germany.

How much can US yields decouple from Europe?

10-year government bond yields, per cent



Source: Macrobond

Swedish government bond yields have climbed weakly in 2017 due to high economic growth, rising inflation expectations and inflation that has at least temporarily moved above target. A bond shortage, due to strong government finances and speculation that the Riksbank will again decide to extent its bond purchases will cause the 10-year yield spread between Sweden and Germany to bottom out at around 25 basis points during the first half of 2018. After that, as the Riksbank moves closer to a rate hike in September, the spread is again expected to widen. By the end of 2019, we expect the yield spread against Germany to have widened to 60 basis points. **Ten-year government yields will thus increase from 0.70 per cent today to 1.70 per cent in 2019.** A wide yield spread against Germany and the prospect of a stronger krone will make **Norwegian** government bonds attractive to investors searching for returns. **The 10-year spread will shrink to 80 points by the end of 2018. It will later widen once Norges Bank has begun its rate hikes**.

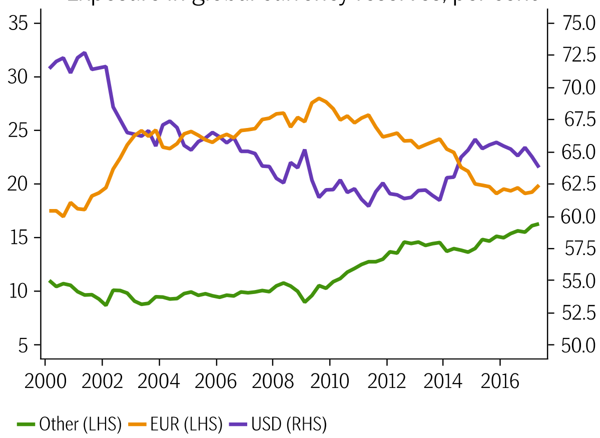
Krona appreciation to be further postponed

The global foreign exchange (FX) market currently lacks a clear common theme. In the absence of lasting trends and obvious mispricing, the drivers for different currencies vary. Monetary policy has dominated exchange rate movements for a long time, but central bank magic has apparently begun to fade. One reason may be that relatively small policy adjustments are expected in the near term, in an environment where various central banks are struggling to push up inflation.

After a sizeable euro appreciation last spring and summer, the EUR/USD exchange rate has fallen this autumn and is now approaching the upper end of the range (1.05-1.15) that has mainly prevailed since early 2015. A rise in the dollar, as perceptions of Fed policy were re-evaluated, is also completely consistent with our forecast in the last *Nordic Outlook*. There is some remaining room for dollar appreciation, but in a longer perspective **the dollar is more likely to weaken once again as other central banks begin their normalisation** and as differences in monetary policies begin to shrink.

USD exposure in the currency portfolios of central banks and other global managers increased noticeably between 2013 and 2016 (see chart below). The corresponding downturn in euro exposure has been under way since 2010 and has presumably been connected to increased political and economic uncertainty in the euro zone and questions about the future of the common currency project. However, the recent trend towards stronger euro zone economic growth and reassuring election outcomes has contributed to a re-evaluation of the risk picture in a favourable direction. It is thus likely that the euro will regain lost ground and that we will see outflows from the dollar, especially considering the political problems of the US itself after the last presidential election. Although the timing has been delayed, we still believe that **the EUR/USD exchange rate will eventually move higher, reaching 1.20 at the end of 2018 and 1.25 at the end of 2019**.

Exposure in global currency reserves, per cent



Source: International Monetary Fund (IMF), Macrobond, SEB

The British pound (GBP) remains at a historically weak level due to the uncertainty surrounding the Brexit process. The pound gained temporary support when the Bank of England raised its key interest rate by 0.25 percentage points to 0.50 per cent in November. Yet we view this as a one-off rate hike aimed at taking back the rate cut that was implemented soon after the referendum on EU membership, when the BoE feared a substantially bigger negative impact on the British economy than later turned out to be the case. Brexit negotiation results will probably remain the most important driver of pound exchange rate movements. Although the negotiations will probably be difficult and time-consuming, our main forecast is that the two sides will finally arrive at a solution that will result in a fairly orderly withdrawal from the EU. We thus expect the GBP risk premium to shrink eventually, with the **EUR/GBP exchange rate falling from 0.92 at the end of 2017 to 0.88 at the end of 2018 and 0.84 at the end of 2019**.

This autumn the krona has depreciated as the Riksbank has again dashed expectations that it will normalise its interest rate policy during the first half of 2018. In addition, uncertainty about the Swedish housing market has helped weaken the krona. We have now changed our forecast of the Riksbank's first key interest rate hike to September 2018, which means **we now believe in a longer period of krona weakness, with the EUR/SEK rate at 9.70 mid-2018**. Not until the second half of 2018 will the krona appreciate a bit more clearly, but even at the end of 2019 we now believe the EUR/SEK level will be slightly above 9.00. At the same time, we may be misled by a lopsided focus on the krona's trend against the euro. So far in 2017, the krona has actually strengthened against most currencies, especially the US dollar. Looking further ahead, the krona will also find it hard to climb further against the euro in a global environment where the role of the euro is strengthening. Yet in a broader perspective, krona appreciation will be relatively large. **USD/SEK will fall as far as 7.35, while the KIX trade-weighted index will reach 105.9 late in 2019**.

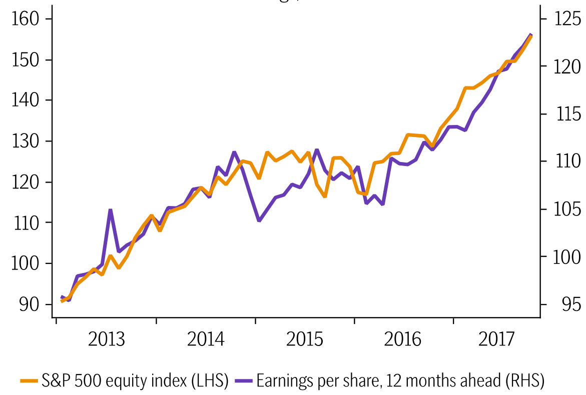
The oil price recovery does not seem to have been enough to significantly strengthen the Norwegian krone. Although Norway's economy has recovered from the slowdown that followed the oil price decline of 2014-2015, during the past year inflation has fallen to levels far below target. As in Sweden, this contributes to uncertainty about monetary policy and the possibility of diverging greatly from the ECB and thereby risking krone appreciation. The weakness of the Norwegian housing market is probably also a negative factor, but given an undervalued NOK and the larger inflows created when the government supplements its budget with large-scale oil revenues, appreciation is likely. We thus expect **a cautious downturn in the EUR/NOK exchange rate to 9.20 at the end of 2018 and a slight further movement to 9.00 by the end of our forecast period**.

Growth and low interest rates drive equities

Global stock markets have continued to perform strongly this autumn. The improving macroeconomic picture and an interest rate scenario beneficial to equities have driven up share prices to levels where valuations appear stretched. But as long as growth remains strong – fuelling higher corporate earnings – there is little probability of major reversals. Instead the most likely outcome is that **the upward trend can continue, but with recurring pauses for breath when optimism has climbed too far**. Third quarter company reports largely lived up to expectations. In the US, these reports surprised on the upside. Historically strong margins were again the main factor. **The most positive development was that earnings are now also being driven by increased sales**, providing hopes of future profits. In Europe, a strong euro was one factor behind a more restrained earnings picture. Because this year's stock market upturns have been accompanied by rising profits, valuations have largely remained flat. Regional differences are evident, though. US equities are being valued around their historical peak, while those in Europe and Japan are trading within the range that has applied in recent years. In EM economies, valuations have admittedly crept higher, but the EM discount to the rest of the world is still relatively large, while the earnings outlook appears attractive. Given the maturity of the economic cycle, we do not anticipate any further upturn in valuations. **But as long as the positive growth picture lasts, stock markets should be largely capable of rising at the pace of earnings**. Aggregate estimates in the US point to earnings increases of more than 12 per cent this year and around 10 per cent in 2018 and 2019, while European estimates are a percentage point or so lower.

US: Stock market upturn is supported by rising profits

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



Source: Standard & Poor's, Macrobond, SEB

Nordic stock markets have not really kept pace with the rest of the world; **their upturn since the last *Nordic Outlook* is 6 per cent, compared to more than 8 per cent for the world index**. The Oslo exchange has been the strongest performer, supported by rising oil prices, but the industrials-oriented Stockholm exchange has also risen. The Finnish stock market has performed more sedately, while Danish listed equities have been essentially unchanged. The upturn has been fairly broad at the sectoral level, with only three out of ten sectors in the red. The previous super-strong transport sector (including shipping) has lost some ground, along with telecoms – strongly influenced by Nokia and Ericsson – but the worst performer has been construction and real estate, whose high valuations were based on previously record-high margins but are now being challenged by increased uncertainty in the more speculative segments of the housing market.

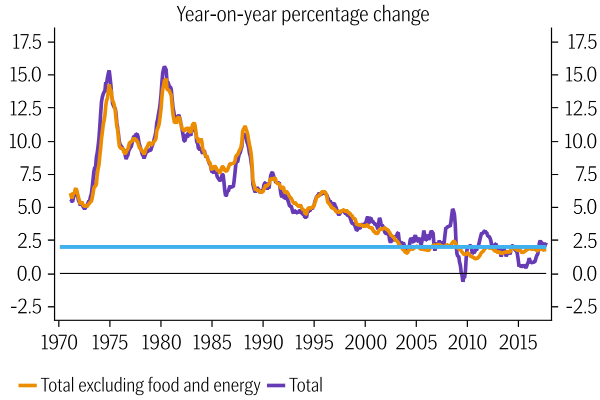
So far this year, Nordic equities have shown total returns of around 15 per cent including dividends. The good earnings trend of the first half was followed by positive surprises in the third quarter as well. Macroeconomic indicators, and in many cases also company commentaries, suggest that the positive trend has continued during the final quarter of 2017. Looking ahead, this is an important parameter for our view of Nordic equities. Although stock market valuations may be regarded as high, given the global growth outlook and still low interest rates, valuations are in line with a justifiable long-term equilibrium level. **We expect this year's predicted earnings growth of more than 8 per cent to rise to nearly 13 per cent in 2018, followed by 10 per cent during 2019**. Assuming that market valuations will remain close to the long-term equilibrium, Nordic stock markets should be able to provide total returns of around 10 per cent in 2018, and the Stockholm exchange by itself 8 per cent. Our forecast is sensitive to revised earnings projections, both on the upside and downside.

- **Different interpretations of the inflation dynamic give central banks some flexibility**
- **Globalised inflation creates blurry national Phillips curves**
- **Crucial test for inflation targeting, but major consequences from regime change**

In recent issues of *Nordic Outlook*, we have discussed the potential for predicting the outbreak of the next recession. Analysis of the resource situation in various economies should be the most important tool, but such metrics as equilibrium unemployment and output gaps are uncertain and rather theoretical concepts. The weak price and wage response opens the way to different interpretations of the inflation dynamic, and therefore of the need for key interest rate hikes. The following is a discussion of how this may influence monetary policy and thus also the length of the economic recovery.

OECD: Core inflation close to 2 per cent

Year-on-year percentage change



Source: OECD (Organisation for Economic Co-operation & Development), Macrobond, SEB

A bit schematically, we can distinguish three different approaches to inflation processes:

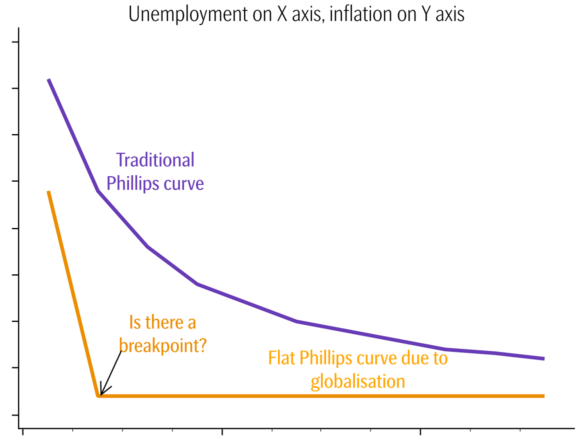
1**) Disinflationary forces are irresistibly strong**. Due to globalisation and robotisation, price and wage hikes will remain depressed regardless of economic conditions. A bigger global labour supply and the option to shift production to low-wage countries weaken the negotiating position of employees even when the local labour market is hot. We are now facing a radical technological leap, with automation and robotisation eliminating jobs on a large scale. Central banks thus risk beating their heads against a wall, merely generating asset price inflation in a desperate attempt to meet inflation targets.

2**) The Phillips curve has a trick knee**. Although inflation has so far proved surprisingly insensitive to the resource situation, there is a critical unemployment level where inflation lets loose like a "ketchup effect". We can argue that this trick knee has not been observable in recent decades, since burst bubbles – due to severe imbalances in the economy – have triggered recessions before we have pushed unemployment far enough down. This is true of the real estate market around 1990, the information and communications technology (ICT) sector around the turn of the millennium and the credit and mortgage markets at the time of the Lehman Brothers crash.

3) Blurry Phillips curve and delayed inflation response
The third approach, partly a mixture of 1) and 2), is that sooner or later, bottleneck problems increase the ability of businesses and employees to raise prices and wages. But it is hardly possible for us to determine with any precision how the Phillips curve actually looks, especially in light of the small cyclical variations in inflation we have seen in recent decades. Furthermore, inflation impulses often seem to arrive after significant delays. For example, businesses often hold off on price increases as long as they can boost their sales by increasing volume. In addition, there are key elements of wage formation in many countries where employer and employee organisations can agree to hold back wage increases for a while, in order to promote their country's employment.

Shape of Phillips curve is one focus of policy debate

Unemployment on X axis, inflation on Y axis



Source: Macrobond, SEB

Approach 1) has gained ground as inflation has repeatedly surprised on the downside and due to increasingly intensive debate about how we now face a technological revolution in which jobs will disappear on a large scale. Changes in the drivers of inflation such as globalisation, uncertain forms of employment (the "gig economy") and automation are cited by organisations like the IMF and especially the BIS. But since employment actually keeps increasing faster than expected, and productivity growth has instead been unexpectedly weak, it still remains unproven why technological advances should generally lead to a job shortage, unlike previously in history. In spite of everything, inflation is close to 2 per cent in most countries, contradicting any suggestion that inflation is dead.

We lean towards viewing the third approach as the most relevant, especially when it comes to analysing individual countries. Because of greater openness, inflation is determined by global conditions to a greater extent than before, making national resource gaps less important to the inflation process. Individual economies, especially small ones, **thus benefit greatly from synchronised high international resource utilisation** when it comes to their ability to push up inflation. **Contributions from commodity prices also seem to be important**. These are often driven by factors that are independent of the general economic cycle, such as technological developments and the cooperation climate among producer countries (OPEC etc.). Because inflation is determined by interaction between national and global factors, plus sector-specific factors, we should not be so hopeful about the potential for finding a stable Phillips curve where domestic unemployment is related to inflation and wage increases.

Bias towards belief in the Phillips curve

The question is how decision makers cope with the prevailing uncertainty. Without any relationship between inflation and resource utilisation, it is hard to see how inflation targeting can serve in the long run as the main instrument of stabilisation policy. The risks of pumping up financial bubbles or making pro-cyclical interest rate changes and actually reinforcing cyclical fluctuations would be too great. Central banks are thus biased towards communicating that they fundamentally believe in some form of Phillips curve relationship. But recently, **increased humility and openness about the inflation dynamic has been discernible**. There have been declarations from the BIS as well as the heads of the Federal Reserve (Janet Yellen) and the Bank of England (Mark Carney) that they actually do not know so much about today's inflation process, and that forecasting methods may be out-of-date.

There are two formal ways of justifying key rate hikes in the absence of distinct inflation arguments. Central banks can **"lean against the wind"**, weighing risks of excesses related to debt and asset prices into their interest rate policies. Central banks can also be given **"dual mandates"** for inflation and the labour market. Risks of harmful overheating symptoms in the labour market can then justify a hike even if the inflation target is threatened. But it is worth noting that the dual mandate originally had the opposite point of departure: to give central banks a better chance to push unemployment lower.

Riksbank assuming an extreme position

Different countries have varying potential for distancing themselves from a lopsided focus on inflation, with the Fed having the clearest dual mandate. But more decisive is how central banks actually evaluate the risks and opportunities of sticking to ultra-loose monetary policy despite relatively high resource utilisation. On the minus side, for example, are **risks of increased financial instability** via pumped-up balance sheets and asset prices. Another risk is that low pressure for change and **inefficient capital allocation** when the price of money is kept artificially low will hamper productivity growth. On the plus side is the **chance to push down unemployment** as far as possible. In this way, central banks hope they can lower structural unemployment – something that is normally the responsibility of governments – by giving people an opportunity to re-join the labour market after a long absence. Accepting some overshooting of inflation targets after a long period of falling short is one way to create extra room for this.

Yet the predominant view among central banks **now seems to be to underscore the risks of sticking to ultra-loose policies** and thus take advantage of the available motives for cautious normalisation. This involves using somewhat different strategies; some central banks focus on "leaning against the wind" arguments (for example in Canada and Norway) while others use the Phillips curve and an extended inflation forecast horizon. Meanwhile there is clearly a limit on how low inflation central banks can tolerate, without being accused of violating their mandate or appearing to be old-fashioned and incompetent about understanding the inflation dynamic.

The Riksbank's position has increasingly diverged from the mainstream. Although Sweden, compared to most countries, has an inflation rate close to target, tight resource utilisation and high asset prices, the Riksbank has shown no interest in taking the opportunity to pursue a less extreme monetary policy. We can see different motives for this that have varied in strength over time: **1) an ambition to help bring down unemployment** when possible, 2) **an exceptional fear that inflation expectations** will diverge from target, and 3) **a strict interpretation of the allocation of responsibility between different political bodies**, with interest rate policymakers completely relinquishing responsibility for financial stability. The Riksbank is thus testing the limits of how reasonable its inflation policy is. This poses major long-term risks.

Crisis may be needed for regime change

Whether inflation targeting survives in its present form will depend both on how the underlying inflation process actually looks and how skilfully central banks operate in the prevailing uncertain situation. Despite the lack of clear empirical support, central banks have relied on the Phillips curve. So far this has **enabled inflation targeting to survive in an environment of small variations in actual inflation**. The question now is whether they can continue this strategy in a credible way or whether the system must be reformed.

Since the financial crisis, we have seen various proposals for changes. Some have been implemented, such as introducing macroprudential supervision. The IMF secretariat's proposal to raise the inflation target from 2 to 4 per cent in order to create more flexibility is still controversial, and perhaps not so relevant to the current situation. The general lack of change is probably due to there being a lot at stake. The job of stabilising inflation can be separated and distinguished from other goals, creating an opportunity to draw a sharp line between central banks and the political system. The more unclear the goals are, the harder it is to preserve the independence of central banks. But taking independence away from central banks would have rather major consequences. It will probably be **necessary for inflation targeting to be singled out as the scapegoat for the next international economic crisis before far-reaching change will actually be realised**. This has also been the case earlier when there have been major changes at the global level.

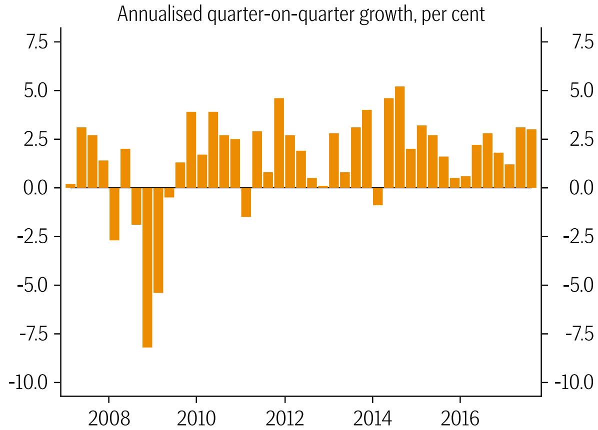
Above-trend growth, but continued low inflation

- **Surprisingly strong third quarter**
- **Continued above-trend economic growth**
- **Tax cuts are expected in 2018**
- **Inflation will speed up next year**
- **New Fed Chair Powell will continue hikes**

In the second quarter of 2017, GDP growth rebounded vigorously after a weak first quarter. Late in the third quarter, portions of the United States were hit by hurricanes Harvey and Irma, which left behind large-scale material devastation in some regions. Certain economic statistics were also affected, including September job growth, but in practice the national economic impact was small. The third quarter was an upside surprise, with annualised GDP growth slowing only marginally to 3.0 per cent compared to 3.1 per cent in the second quarter. Growth was broad-based, with positive contributions from consumption, capital spending and net exports. GDP growth is expected to remain above trend in the final quarter as well. Our forecast is that **GDP will grow by 2.3 per cent in 2017 and by 2.6 per cent in 2018. In 2019** we expect a gentle deceleration to **2.0 per cent** due to higher interest rates and the beginning of bottleneck symptoms.

Growth was resilient to Q3 hurricane effects

Annualised quarter-on-quarter growth, per cent



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

The Federal Reserve will continue its monetary policy normalisation. We are sticking to our main scenario that the Fed will **hike its key interest rate in December and carry out three more hikes in 2018**. During **2019** the Fed will be content with **one hike**, bringing the key rate to 2.5 per cent, which is close to the long-term equilibrium level. We expect the shrinking of the Fed's balance sheet that began in October to continue as planned.

Tax cuts will have little growth impact

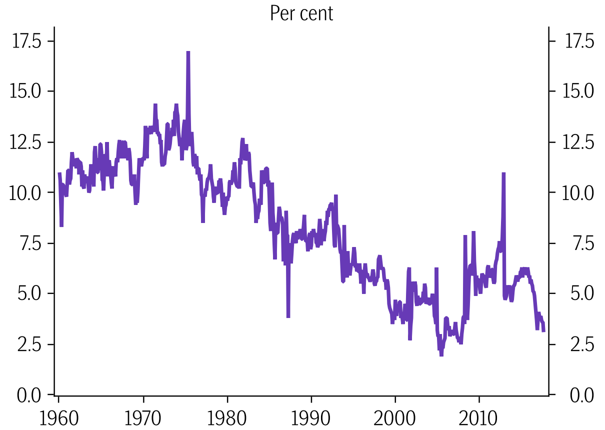
Donald Trump's administration remains determined to pilot tax cuts through Congress this autumn, but these plans face major problems. The president's failure to replace the Affordable Care Act (Obamacare) has reinforced the impression that Trump will have a hard time enacting his political programmes. The administration's tax reform efforts are being hampered by various legal manoeuvres resulting from Russia's involvement in the 2016 presidential election, rapid turnover among key individuals in the administration and political polarisation. Another factor is divisions within the Republican Party; most Republicans have a fundamentally positive attitude towards lowering taxes, but meanwhile there is opposition among conservative politicians to unfunded cuts. This creates problems even though the Republicans are not dependent on support from the Democrats. **The most likely outcome is that a package of limited tax cuts will be implemented during the first quarter of 2018.** This would include slashing the corporate tax from 35 to 20 per cent and cutting income taxes. **We believe the growth impact of these measures will be limited, totalling 0.2-0.3 per cent of GDP in 2018.** Companies are expected to use their gains to boost dividends to shareholders, instead of for capital spending. Income tax cuts will primarily benefit the wealthiest households, which tend to save a large percentage of their disposable income.

We have previously discussed the risk that Trump's inability to achieve success in other fields will increase his inclination to carry out **protectionist actions**. Although he has refrained from calling China a currency manipulator and from introducing import tariffs, ongoing US **negotiations with Mexico and Canada on the North American Free Trade Agreement (NAFTA) will be the big test**. The ambition was to complete these talks before year-end, but the US has unveiled several proposals that Mexico and Canada cannot accept. The timetable has thus been extended to include the first quarter of 2018. The longer negotiations drag on, the bigger the risk that Trump will tire of them and initiate a US withdrawal process. **Although this risk has increased, our main scenario is still that a renegotiated agreement will be achieved.**

Good conditions for consumption

Private consumption continued to increase at a decent pace in the third quarter, despite a minor deceleration compared to the preceding very expansionary quarter. Several factors typical of a mature economic expansion are continuing to provide support. The **labour market** is strengthening further and will contribute to rising demand as employment increases. Meanwhile stock market indices are setting new records, and **home prices** are continuing their recovery. In addition, **tax cuts** in 2018 are expected to provide an extra stimulus and still-low interest rates will squeeze household borrowing costs. In this favourable consumption environment, household confidence indicators maintained by the Conference Board and the University of Michigan are close to record-high levels.

Low savings ratio slowing increase in consumption



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, SEB

The savings ratio was revised sharply downward in the latest yearly review of the US national accounts. In recent months the **savings ratio** has fallen further. It stood at 3.1 per cent in September, the **lowest level since 2007**. Although this level can be explained by rapidly increasing wealth and low interest rates, it is a restraining factor that will contribute to relatively moderate consumption increases ahead. **Our overall forecast is that household consumption will increase by 2.7 per cent in 2017 and by 2.9 per cent in 2018.** During **2019** the consumption increase will slow to **2.1 per cent**, driven by a stagnating labour market and rising interest rates.

Decent capital spending ahead

The ever-tighter labour market is creating fertile soil for capital spending. In some sectors, mounting difficulties in recruiting employees are providing incentives for companies to expand their capital spending instead. Meanwhile capacity utilisation is rising only slowly, despite a healthy rate of increase in industrial production. It stands at **77 per cent, or less than the 80 per cent level at which business investments usually accelerate**. Capital spending rose sharply in the oil and mining sectors during the first half of 2017 but cooled sharply in the third quarter and is expected to remain relatively weak in the near term. Construction investments have stabilised but are rising at a slower pace than early this year. Overall increases in capital spending will be decent ahead. Our estimate is that **investments will increase by 3.7 per cent in 2017** and **3.3 per cent in 2018**. **In 2019** we expect an increase of **3.1 per cent**. The risks to our forecast are in the form of a stronger dollar and a breakdown in NAFTA negotiations, which would hurt industrial production.

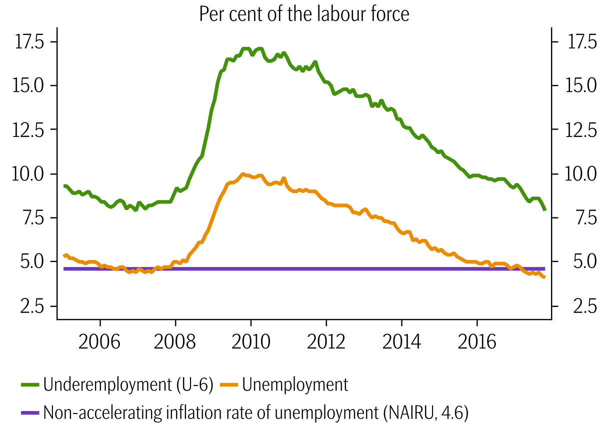
Exports have taken off during 2017, with net exports providing a clear positive contribution to GDP growth during the first three quarters. The reasons are a weaker US dollar than in 2016 and an improvement in global economic conditions. **We forecast exports will increase by slightly more than four per cent in 2018 and a little bit less in 2019.**

Tightening labour market

Aside from a temporary hurricane-driven dip in September, **employment growth has continued** at a healthy pace. During 2017 job growth has exceeded 168,000 per month, well above what is needed to keep pace with population increases. Unemployment has thus continued to fall, even though it is already below estimated long-term equilibrium. In October, it fell to 4.1 per cent, which is the lowest since 2000. Our forecast is that the jobless rate will continue downward, dropping below 4 per cent early in 2018.

Several other labour market indicators are also showing a continued decline in idle resources. But the picture is ambiguous: unlike the ordinary jobless rate, the broadest unemployment metric (U-6) remains somewhat above its level when the financial crisis broke out. Labour force participation fell to 62.7 per cent in October, marginally higher than its latest low in November 2016. This is well below the peak of 67.3 per cent in 2000. **The participation rate** can probably continue climbing a bit but **will hardly get anywhere near the level at the turn of the millennium**. There are several reasons for this. Widespread long-term unemployment in the wake of the Lehman Brothers recession led to permanent exclusion of many people from the labour force. Drug abuse, especially the "opioid epidemic", has also increased to such size that it affects the total labour supply. Probably the most important explanation, however, is that a large share of employees retired relatively early over the past decade. But there are also factors that will lift the participation rate ahead. The negative impact of the epidemic now seems to be easing, while the percentage of people in the higher education system is decreasing.

Unemployment is below the Fed's NAIRU metric



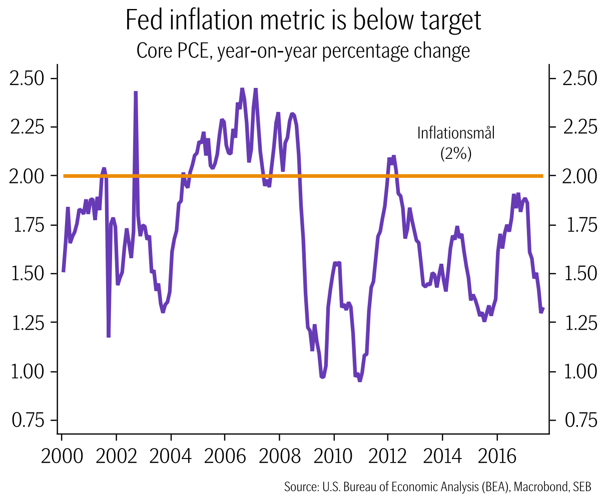
Source: U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

Inflation will accelerate in 2018

Even though the labour market has become increasingly tight, the wage and salary response remains weak. Pay increases accelerated in September, but this was largely driven by the temporary elimination of a large number of low-paid restaurant industry jobs due to the hurricanes. In October the year-on-year rate of hourly earnings increases again fell to a low 2.4 per cent, but we still believe that continued labour market strengthening will lead to accelerating wages and salaries as recruitment opportunities worsen. Portions of the labour market are also beginning to show **signs of bottleneck problems**. These are clearest in the construction sector but are also apparent in manufacturing and agriculture, where labour recruitment is beginning to be difficult. Such problems are still largely manageable but are expected to build up over time and contribute to a slight deceleration in the economic growth rate during 2019.

CPI inflation has accelerated a bit in recent months, 2.0 per cent in October – partly driven by rising petrol (gasoline) prices causes by the hurricanes. Measured as full-year averages, **we expect inflation to end up at 2.1 per cent in 2017 and 2018**. In **2019** inflation will decelerate a bit to **1.8 per cent**.

The Fed's main core inflation metric, which uses the personal consumption expenditures (PCE) deflator, was 1.3 per cent in September: **well below its 2 per cent target**. Yet there are many indications that the downturn is temporary, driven among other things by a mobile phone price war. We thus expect accelerating inflation in 2018. According to the Fed's latest forecast in June, core PCE is expected to be close to the 2 per cent target by the end of 2018. Our own full-year forecasts are that **core PCE will increase by 1.5 per cent this year, by 1.7 per cent in 2018 and by 1.9 per cent in 2019**.



Inflation expectations in a one-year perspective, as measured by the University of Michigan survey, have been relatively stable in 2017 at around 2.5 per cent. Measured as break-even inflation, five-year expectations have recovered from their low of a few months ago. In its communications, the Fed has expressed concern about the risk that falling inflation expectations will make it harder to achieve its inflation target, but recent developments indicate that this risk has diminished.

Fed will continue gradual tightening

The Fed's dilemma is still that above-trend economic growth and an ever-tightening labour market are now combined with inflation that is well below target. The Fed has left its key interest rate unchanged since hiking it in June, but a majority of Federal Open Market Committee (FOMC) members have communicated that a further hike during 2017 is reasonable. The Fed's inflation metric – core PCE – is well below target but the central bank expects an acceleration during 2018, with core PCE reaching just below 2 per cent. This is enough to persuade a majority of FOMC members to advocate continued rate hikes. Our forecast is thus that **the Fed will hike its key rate for the fifth time in December**. **During 2018** we continue to expect **three additional rate hikes**. **In 2019** we expect only **one hike**, which means a federal funds rate of **2.5 per cent at the end of our forecast period**. During 2017, US financial conditions have continued their expansionary trend despite the Fed's rate hikes. At present this is no problem, since it offsets the adverse effects of rate hikes on growth and enables the Fed to continue tightening its monetary policy.

In October the Fed began to shrink its balance sheet. After having carefully prepared the market, it did so without drama. At first the tightening effect will be very small, and as long as the economy or the financial markets are not disrupted to any great extent we expect the Fed to follow the plans it unveiled in June. During 2018 the tightening effect may be roughly equivalent to one key interest rate hike. Reinvestments of maturing securities are being reduced gradually according to predetermined maximum amounts (thresholds). The initial thresholds are USD 6 billion in Treasury bonds and USD 4 billion in mortgage-backed securities (MBS). These thresholds will then be increased gradually every three months until they reach a maximum of USD 30 billion for Treasuries and USD 20 billion for MBS. The only remaining question concerns the **long-term size of the balance sheet**, with the Fed not announcing any exact target. However, in a September speech New York Fed President William Dudley indicated a range of USD 2.4-3.5 trillion. This suggests that the Fed will eventually end up with a balance sheet well below the current USD 4.5 trillion but significantly above its pre-crisis starting point of less than USD 1 trillion. Depending on the choice of final level, the Fed is likely to complete its balance sheet reduction process sometime around 2020-2021.

Early in November, President Trump nominated **Jerome "Jay" Powell as the new Fed chairman**. Powell will succeed Janet Yellen, whose term as Fed chair expires on February 3. Powell has been a member of the Fed's seven-strong Board of Governors since 2012. Our assessment is that **Powell will support continued gradual key rate hikes**. His monetary policy views are similar to Yellen's and his appointment will thus not greatly affect our view of Fed monetary policy. Aside from Powell, Randal Quarles has also been appointed to the Board. Quarles is believed to have a somewhat more hawkish monetary policy stance. The four regional Fed presidents who will vote on the FOMC in 2018 are believed to be more hawkish than their predecessors. **This would make the 2018 Fed monetary policy team somewhat more hawkish overall**, supporting our forecast of continued key rate hikes.

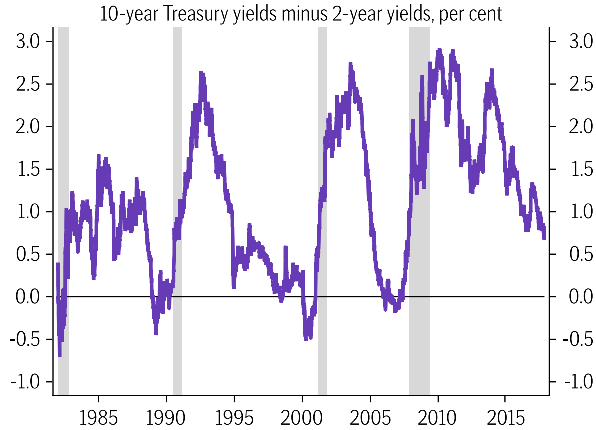
Theme: Yield curve the best recession indicator

- **Risk of economic downturn is increasing**
- **Will the yield curve invert in 2018?**
- **Widespread artificially low long-term yields**

Interest in identifying early indications of when the next recession will occur will increase the longer the current economic recovery continues. The yield curve has proved to be a good instrument for predicting post-war American cyclical downturns. Investors normally earn higher yields on government securities with longer maturities, since the risk is greater; the yield curve thus usually has a positive slope. From the standpoint of economic cycles, the critical time is when the curve flattens and eventually inverts – in other words, when short-term yields are higher than long-term ones. Since the 1950s, the US economy has had 13 interest rate hiking cycles and 10 recessions. **All recessions were preceded by an inversion in the yield curve**. During the three hiking cycles not followed by recessions, the US Federal Reserve stopped its rate hikes in time, that is, before the yield curve had inverted.

The yield curve is getting flatter

10-year Treasury yields minus 2-year yields, per cent

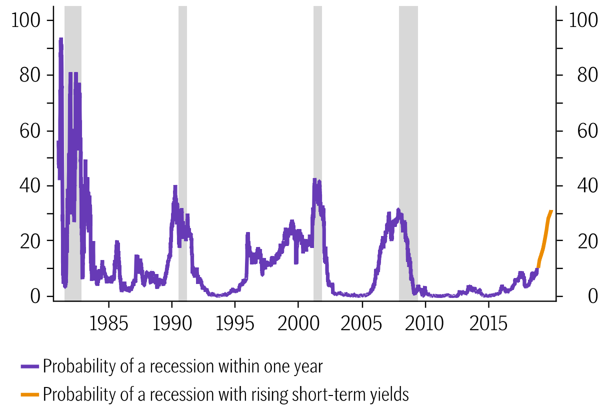


Source: Macrobond, SEB

The yield curve, measured as the difference between the yield on 10-year and 2-year Treasury securities, has flattened significantly due to the Fed's rate hikes. The recession signal is not yet critical, but the trend is beginning to look a bit worrisome. **The probability of a US recession within one year is just over 10 per cent, according to our model**. That hardly sounds scary, but the trend is upward and this is the highest reading measured during the current recovery. Secondly, it should be viewed **in relation to the levels that have triggered earlier recessions**. It turns out that when the model's recession probability rises to 21 per cent or higher, the US economy has entered a downturn no more than 1.5 years later – **a 21 per cent level thus appears to be critical**. The Fed is also in the midst of a rate hiking cycle, where the curve is already rather flat at present. Today's 10-year Treasury yield is at about the same as just before the Fed began hiking its key interest rate in December 2015. Shorter-term yields have simultaneously risen. If long-term yields remain unchanged while the Fed is delivering hikes according to current forecasts, **the yield curve may thus invert within one year**. Although this is not our main scenario, it may be interesting to note a trend in which planned interest rate hikes push up two-year yields but not 10-year yields. This would signal **a US economic downturn in 2019 or possibly 2020**, according to our model. The usual pattern is that a US recession spreads around the world, with a lag of a few quarters.

Rising probability of an economic downturn

Per cent



Source: Macrobond, SEB

However, there are **reasons not to interpret the yield curve so literally in this economic cycle**. Although the Fed has ended its asset purchases and has also begun a cautious reduction of its balance sheet, it is still the dominant player in the fixed income market. The Fed's own analyses indicate that earlier quantitative easing pushed down long-term yields by about 100 basis points until 2016. At present, the yield level is estimated at 50-60 points below where it would otherwise have been. Furthermore, other central banks are continuing their asset purchases, which may also contribute to some downward pressure on US long-term yields in today's global fixed income market. **Artificially low long-term yields will thus drive up the probability of a recession in our analysis**.

This discussion is a bit reminiscent of the situation around 2005, when then-Fed Chairman Alan Greenspan started a debate on whether long-term yields were artificially low: a "conundrum", he called them. Large Chinese purchases of US Treasury securities – partly driven by gigantic trade imbalances – were cited then as a reason for depressed yields and as an argument why a flat yield curve did not need to be interpreted as a recession signal. **Both the "conundrum" debate and today's situation show that it is not so easy for central banks to interpret the significance of yield curve slopes**.

Falling unemployment not enough to lift inflation

- **Abe aiming at record-long period as PM**
- **Strong growth by Japanese standards**
- **Low inflation continues to frustrate BoJ**

There are many reasons to be optimistic about Japanese growth. A combination of economic stimulus measures and a general regional trade upswing will **lift GDP growth to 1.5 per cent this year**: the strongest since 2013 and even more impressive on a per capita basis. Looking ahead, exports and business investments **– the Tankan survey shows the highest business confidence levels** since the early 1990s – will be key engines. Growth will cool to 1.2 per cent in 2018 and 1.0 per cent in 2019 but remain well above the average since 1990. Given potential growth in the 0.5-1.0 per cent range, this suggests that **unemployment will keep falling, reaching 2.0 per cent in 2019**: the lowest since 1990. A super-strong labour market and loose monetary policy will help **push inflation up a bit, to a yearly average of 0.9 per cent in 2018 and 2019**.

In recent years, **the economy has been unusually stable** by Japanese standards. On a quarterly basis, GDP has climbed seven quarters in a row for the first time since 2000. The probability of a recession in the coming year is 20 per cent according to analysts, but our own model indicates a probability of only around 12 per cent. Japan's public debt, 240 per cent of GDP, is the highest ever recorded for an OECD country. Continued large budget deficits will boost long-term vulnerability but do not affect our estimate of short-term recession risk.

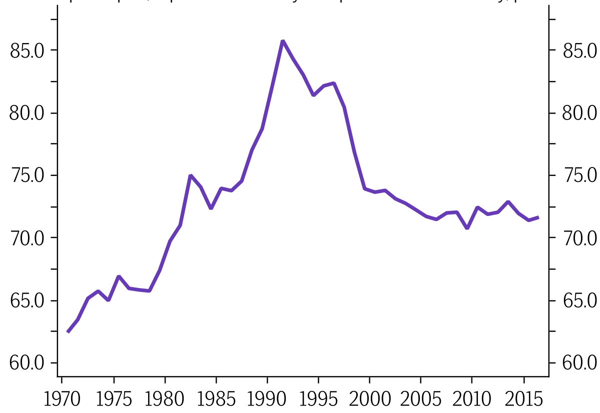
As a result of the October parliamentary election, Shinzo Abe appears set to become Japan's longest-serving prime minister. His Liberal Democratic Party and its coalition partner Komeito won about two thirds of lower house seats. This resounding victory will have an impact; despite great global political uncertainty, Japanese policies will remain in place for at least another four years, with a **green light for various growth-promoting reforms**. The outcome also implies continuity at the Bank of Japan (BoJ); Governor Haruhiko Kuroda will probably be re-appointed when his term expires in April 2018.

"Abenomics", now celebrating its fifth birthday, will keep on rolling. Despite its mixed record to date, we will probably see further measures to boost female labour market participation and open the way for limited labour immigration. The tense military situation in the region, including North Korea's push towards nuclear-armed missiles, will make the pacifist clauses in Japan's constitution increasingly problematic. With the blessings of the Trump administration, Abe will probably take steps to amend the constitution to **make a military build-up easier**. This will give Japan a more important role in helping **slow China's efforts to becoming the increasingly dominant regional power**.

Ultra-loose monetary policy will continue. At its October policy meeting, the BoJ lowered its short-term inflation forecast but insisted that the 2 per cent target will be achieved in 2019. Despite falling unemployment and a closed output gap, pay increases remain low. Although our analysis shows that **the Phillips curve is not entirely dead in Japan**, the association between unemployment and wages/prices is still too weak for us to believe that inflation will reach the BoJ target during our forecast period. Our main scenario is thus that the BoJ will **continue its massive securities purchases, totalling about JPY 90 trillion per year**, in order to try to keep 10-year government bond yields close to zero per cent. Meanwhile we expect the key interest rate to remain at -0.1 per cent throughout our forecast period.

Japan has almost kept up with the US since 1999

GDP per capita, Japanese economy compared to US economy, per cent



Source: OECD, Macrobond, SEB

A weak currency, a squeeze on yields and interest rates and rising asset values are consequences of BoJ policies. **Japan's Nikkei 225 share price index has climbed to its highest level since July 1996** but remains around 45 per cent below its peak during the bubble in the late 1980s. Looking ahead, Fed actions and geopolitical developments will be important drivers of yen exchange rate movements. **Continued Fed rate hikes suggest that the yen will weaken in the near term.** Our forecast is a USD/JPY rate of 110 at the end of 2018 and 105 at the end of 2019. An escalation of the North Korea crisis would probably lead to a stronger yen, since the Japanese currency normally appreciates in troubled times.

Deceleration in China is offset by global acceleration

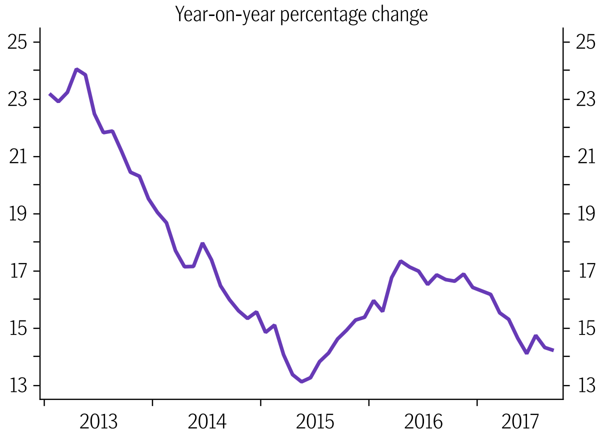
- **China: Mild slowdown at a sensitive time**
- **India: Unexpectedly weak growth is past**
- **Russia: Another six years with Putin**
- **Brazil: Climbing out of a deep hole**

China: Rising CNY to attract foreign capital

China's economy has accelerated in 2017. **GDP growth during the first three quarters rose to 6.9 per cent**, from 6.7 per cent in the same period of 2016. It is thus likely to end up near the top of the government's 6.5-7.0 per cent full-year 2017 target range, driven by two forces. First, exports have benefited from stronger global demand. For example, year-on-year export growth to the US and Europe is 10 per cent, compared to a decline in 2016. Second, easier credit conditions have fuelled an acceleration in mortgage loans and higher real estate prices, which in turn have stimulated residential construction and private consumption via wealth effects. Stronger economic growth has strengthened the yuan in 2017.

Total debt growth

Year-on-year percentage change



Source: SEB

Looking ahead, we predict a moderate deceleration in GDP growth to 6.6 per cent in 2018 and 6.2 per cent in 2019. The government has shifted to tighter economic policies, with export growth providing room for a domestic slowdown. President Xi Jinping now views rising debt as a risk to political stability. Total debt growth has been slowing, and the government will take steps to cool the debt build-up further. Despite higher GDP growth, **inflation has eased because food prices have dropped due to favourable weather**. CPI inflation will fall to 1.7 per cent in 2017 from 2.0 per cent in 2016. But given China's above-trend growth, underlying inflation pressures are building. We thus foresee an inflation rebound to 2.5 per cent in 2018 and 2.8 per cent in 2019.

Policy adjustments will drive the economy during 2018. In October, President Xi completed a reshuffle in the Communist Party leadership, which occurs every five years. He consolidated his power base, opening the way for more concerted reform efforts in 2018. Xi will probably shift the policy focus from GDP targets per se to the quality of growth. Increased readiness to endure short-term pain for long-term gain will add some downside risks to 2018 GDP growth. Most of the policy shift will take place in March as the Party leadership reshuffle is carried out and GDP targets are set.

President Xi's focus areas

The president's policy statement, "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era" was incorporated into the Communist Party Constitution in October. But what does it actually say? His thoughts are formulated in 14 points, of which we regard the following four areas as the most important: 1) The anti-corruption campaign initiated by Xi will become more rules-based and institutionalised. 2) China will protect its national sovereignty, which means upgrading the military and taking a hard line against separatist movements (such as in Taiwan and Hong Kong). 3) Economic reforms will deepen and continue; for example, we believe reform of state-owned enterprise will accelerate. 4) China will defend the "public interest", which means reducing inequality – for example by fighting poverty and boosting efforts to create jobs for university graduates and migrant workers.

Economic policy will probably be fairly neutral, though with a certain tightening bias. Fiscal policy in 2018 will be similar to that of 2017, with a budget deficit of roughly 3-4 per cent of GDP. However, taking into account the local authorities' indebtedness, the deficit is significantly greater. The People's Bank of China (PBoC) is maintaining a neutral stance. Inflation is still below the informal 3 per cent CPI target, but the government's decision to prevent continued debt growth will block monetary easing. We expect the key interest rate to remain at 4.35 per cent until the second half of 2018, when a gradual hiking cycle will start, with the key rate reaching 4.60 per cent by year-end and 5.10 by end-2019.

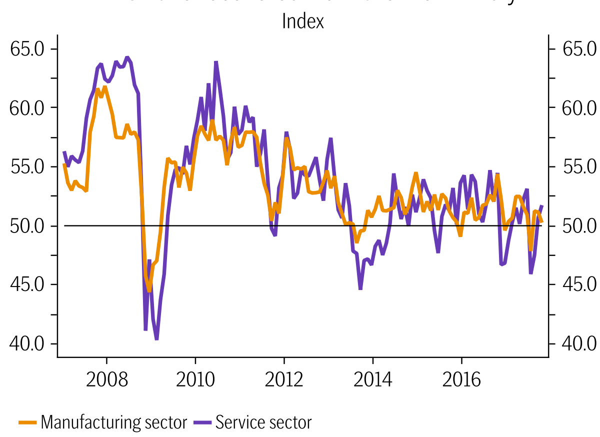
The **yuan** will continue to appreciate slowly. We expect the USD/CNY exchange rate to be 6.70 at the end of 2017, 6.30 by the close of 2018 and 6.10 at end-2019. The PBoC has adjusted its monetary policy to keep the currency stable, with a small bias towards appreciation. In this way, the PBoC wants to attract foreign capital that can help sustain China's domestic stock and bond markets. Strong demand from the US and Europe will also stimulate exports and thereby help the trade balance. Exporters can withstand a mild appreciation, as long as volume is supported by strong international demand.

The main risk to China is still an acceleration in global inflation that drives up domestic inflation and interest rates. The Chinese economy is still grappling with a debt level of around 250 per cent of GDP. A rising interest rate environment would thus be very painful, with borrowers being squeezed by negative cash flow and rising default risks.

India: Unexpectedly weak GDP figures

Second quarter growth was only **5.7 per cent year-on-year**: a continued deceleration and well below 2016's GDP increase of nearly 8 per cent. In the first quarter, economic activity was hampered by the currency ("demonetisation") reform launched in November 2016. The weak second quarter figure is harder to explain, but uncertainty related to the launch of India's national goods and services tax in July plus weaker net exports may have contributed. **Most signs are that the growth rate has now bottomed out.** Purchasing managers' indices (PMIs) have recovered from their July low. Industrial production and car sales have also improved. Despite an expected acceleration ahead, due to the weak first half we again need to revise our GDP forecast downward. **We expect GDP to climb by 6.6 per cent in 2017, 7.5 per cent in 2018 and 7.8 per cent in 2019.**

PMIs have recovered from their low in July



Source: IHS Markit, Macrobond, SEB

In October the Narendra Modi government unveiled a **plan to recapitalise the banking sector**. As described in earlier issues of *Nordic Outlook*, a high proportion of bad loans are holding back lending by the dominant state-owned banks, which in turn is harming business investments. The banks have already received some fresh capital, but the new programme is far bigger (about 1.3 per cent of GDP) and is expected to have **a clearly positive long-term impact on bank lending**. Meanwhile the government also announced a five-year plan for **increased infrastructure spending**. In order to finance these investments, the government will probably have to relinquish its goal of reducing the budget deficit from 3.5 to 3.2 per cent of GDP. There is also a sizeable risk that the central government budget will be weighed down further because the government will be forced to aid a number of states that have weakened their finances by granting large-scale loan concessions to farmers. In the two most important reform areas – the labour market and land purchase laws – we expect no major initiatives before the 2019 parliamentary election.

In recent months, inflation has climbed significantly from a low of 1.5 per cent in June. CPI inflation was 3.6 per cent in October, but this is still below the 4 per cent target. Most indications are that inflation will continue upward, driven by surplus liquidity in the banking sector and more expansionary fiscal policies. Measured as annual averages, we expect **inflation** to end up at **3.3 per cent in 2017 and around 4.5 per cent in both 2018 and 2019**.

Partly due to low inflation, the Reserve Bank of India lowered its key interest rate in August for the second time in 2017 to the current 6.0 per cent. But the RBI announced at the same time that there is little room for further cuts and expressed concern about the inflation and fiscal policy outlook. Our forecast is that **the key rate will be left unchanged until the second half of 2018**, when the RBI will **hike it to 6.25 per cent**. **In 2019 we expect a further hike to 6.50 per cent at year-end.**

During the spring, the **rupee** appreciated against the US dollar, but it weakened again in August due to concerns about weaker government finances. In a slightly longer perspective, the rupee is one of the best-performing emerging market currencies. We expect accelerating economic activity combined with a more hawkish RBI to help strengthen the rupee a bit in 2018. **At the end of 2018 the USD /INR rate will be 62.0. At the end of 2019 it will stand at 60.0.**

Russia: Economic upturn will help Putin

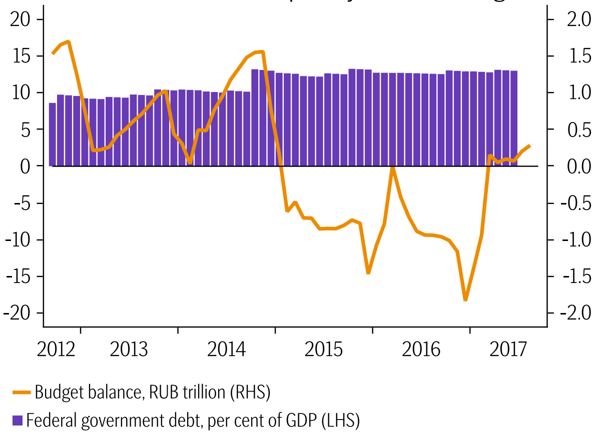
Russia has emerged from the recession that swept the economy after the major oil price decline of 2014 and 2015. GDP grew at 1.6 per cent year-on-year in the first nine months of 2017. **The recovery has mainly been driven by capital spending and private consumption**, helped by rising real incomes and falling unemployment. As domestic demand has climbed and the rouble has appreciated, net exports have become a drag on growth despite gradually rising oil prices in 2017. The industrial segments that have recovered fastest are autos and other vehicles along with food and agriculture. The Russian finance ministry is now somewhat concerned about the strong rouble, which risks making imports cheaper and stunting the growth of domestic production.

The dominant oil and gas sector accounts for about one fifth of GDP, one third of federal budget revenue and nearly half of Russia's exports. We consider it unlikely that oil prices (Brent) will remain at their current high levels during all of 2018, but there is also little risk of a sharp price decline since global demand is beginning to catch up with production. Relatively high oil prices will help sustain the economy during the next couple of years. **We expect GDP growth of 1.8 per cent in 2017, 2.0 per cent in 2018 and 1.9 per cent in 2019.**

October inflation fell to 2.7 per cent year-on-year, far below the Central Bank of Russia (CBR) target of 4.0 per cent by the end of 2017, but is likely to bottom out in the next few months and rebound slightly. As an annual average, we believe that **inflation will end up at 3.7 per cent this year, then climb to 4.0 per cent in 2018 and to 4.5 per cent in 2019**. The central bank has been worried that increased domestic demand and continued high inflation expectations will drive up inflation again. CBR interest rate cuts have thus been very cautious but will continue. We believe the **key rate will be 8.00 per cent at the end of this year, 6.50 per cent at the end of 2018 and 7.00 per cent at the end of 2019**.

Russia's 2017 federal budget deficit looks set to end up around 2 per cent of GDP thanks to restrained spending policies and unexpectedly high oil prices. **Fiscal consolidation has occurred faster than the Kremlin expected.** Since oil prices seem likely to turn out well above budget forecasts, we predict that the budget deficit will shrink to around 1 per cent of GDP in 2018 and that the budget will achieve balance in 2019.

Government finances helped by oil and GDP growth



Source: Russian Ministry of Finance, Macrobond, SEB

Capital inflows to the Russian bond and stock markets are one reason why the rouble has not weakened during the second half of 2017 at the pace we had predicted, but as the finance ministry has pointed out, the strength of the rouble is a threat to the economic recovery. Foreign exchange market interventions will thus grow in size and decrease the correlation between oil prices and the rouble. We expect the rouble to weaken slightly to **59.0 per USD by the end of 2017, then to 61.0 at the end of 2018 and 64.5 at the end of 2019**.

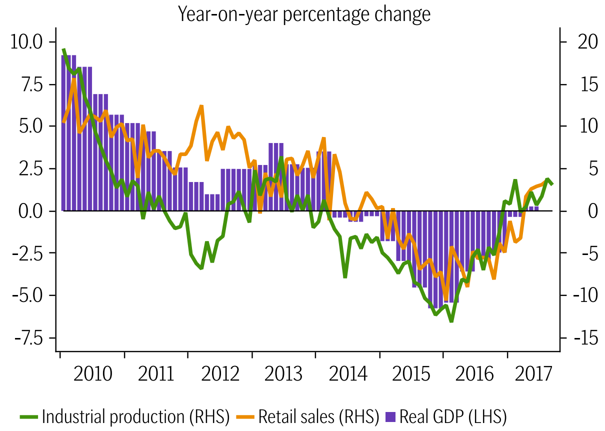
President Vladimir **Putin will win the March 2018 presidential election**. Low inflation and unemployment, as well as a muzzled opposition, suggest that his victory will be overwhelming. Urgent reforms of state-owned companies and of the legal system will be implemented, but at a very slow pace. At present there are no indications that either the US or EU has any plans to ease their sanctions against Russia.

Brazil: Climbing out of a deep hole

In the second quarter, GDP rose year-on-year for the first time since 2014. Although its pace was a modest 0.3 per cent, there are clear signs that Brazil is on its way out of its deepest economic crisis in modern times. To put the recession in perspective, the size of Brazil's GDP today is about the same as at the end of 2010. Net exports are still an important driver, but their contribution has decreased as private consumption and imports have risen. Unemployment fell to 12.4 per cent in September from 13.7 per cent in March, since the number of jobs increased faster than labour force participation – a trend that looks set to continue. The recovery in private consumption is important, but growth will be held back by continued weak capital spending and the need for major cost-cutting in the central government budget. The public sector budget deficit was 8.7 per cent of GDP in September and will gradually decrease. We believe that **GDP will grow by 0.7 per cent this year, 2.2 per cent in 2018 and 2.3 per cent in 2019**.

Monthly data are pointing to continued recovery

Year-on-year percentage change



Source: Brazilian Institute of Geography & Statistics (IBGE), Macrobond, SEB

Year-on-year inflation bottomed out in August and remained a low 2.7 per cent in October, the lowest level since 1999 and the result of weak domestic demand and currency appreciation. The government will raise certain officially controlled prices to strengthen its budget. This will **lift inflation to 4.0 per cent in 2018 and 4.3 per cent in 2019**, which is close to the new 4.25 per cent target that the central bank set in June. Looking ahead, the key interest rate (SELIC) will be cut at a slower pace from its current 7.50 per cent to 7.00 in December 2017. We expect SELIC to be cut to a record-low 6.75 per cent in 2018 before being hiked again late in the year or early in 2019.

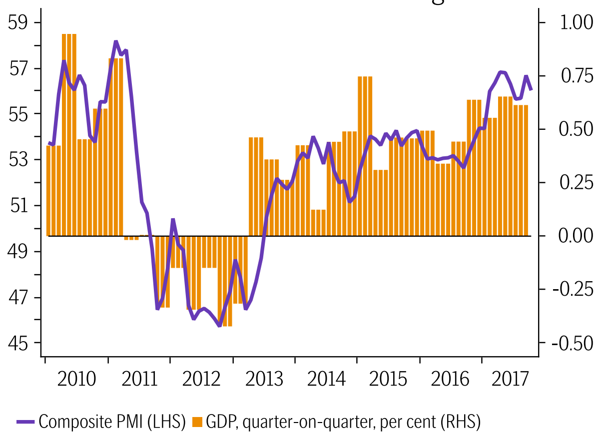
In February the real reached its highest level since the 2014-2016 crisis. Since then the currency has remain fairly flat, within a broad range. We believe there is now a larger risk that the real will gradually weaken than that it will revert to an appreciating trend. Monetary policy easing and a gradual increase in inflation will be the main driving forces for the currency, but the political situation will also play a major role. President Michel Temer's reform ambitions have been an important factor behind the optimistic view of the real, but his support base in Congress is beginning to shrink. Important reforms in the pension system now look set to fail or will be watered down too much and the uncertain political situation ahead of next year's election will weigh on the real. **We expect the real to weaken, reaching 3.30 per dollar by the end of 2017, 3.45 at the end of 2018 and 3.60 at the end of 2019.**

Broad-based acceleration of economic activity

- **EU cooperation taking small steps forward, despite continued tensions**
- **Shrinking budget deficits will make fiscal stimulus measures possible**
- **Household confidence at record levels**
- **Low inflation postponing ECB normalisation**

The euro zone economy continues to surprise on the upside. **Third quarter GDP growth was 2.5 per cent year-on-year: the highest since 2011**. The labour market is improving. Despite low pay hikes, household optimism is record-strong. Exports and industrial production are accelerating. This contributes to rising capacity utilisation and thus to greater capital spending. We are revising our forecast upward to **2.3 per cent GDP per year in 2017 and 2018**; even our 2019 forecast of 2.1 per cent represents an expansion well above trend. Since the euro zone has far slower population growth than the US, for example, the upturn in GDP per capita is even more impressive. The European Central Bank (ECB)'s October announcement that it will extend its bond purchases until September 2018 will probably be the last, but continued low inflation will make the normalisation process happen very slowly. Only in March 2019 do we expect the ECB deposit rate for banks to be raised by 15 basis points, followed by refi rate hikes in June and December to 0.5 per cent by the end of 2019.

Stable acceleration in economic growth



Source: Markit, Eurostat

Exaggerated optimism about EU re-set?

Because the euro zone's super-election year 2017 did not lead to major successes for anti-EU forces, there are **hopes of a fresh start for EU integration and cooperation efforts**. After Brexit the UK can no longer hold back such ambitions, and this has strengthened such hopes. Brussels and Paris are driving developments. French President Emmanuel Macron has for example proposed creating an EU-level finance minister post, a European monetary fund and more resources for joint crisis management in the region. Germany's views will be crucial, but so far Chancellor Angela Merkel has kept a low profile. This is probably due to her hesitation, prior to the completion of post-election coalition talks, to express strong views on supra-nationalism and new commitments to southern Europe that might burden German taxpayers. Despite the difficulties, we foresee a decent chance that a strategy that gives member countries clear choices as part of a "multi-speed Europe" may achieve some success. The task of deepening **EU/euro zone cooperation during 2017-2019 will enjoy a tailwind** from better economic conditions and looser fiscal policies, enabling pro-EU politicians to more convincingly portray such cooperation as successful. Meanwhile there will be less room for anti-EU forces to benefit from discontent among voters who feel marginalised. The Italian election (spring 2018) may lead to renewed political and euro uncertainty but our overall assessment is that the regional recovery is strong enough to withstand such pressure.

GDP forecasts
Year-on-year percentage change

	2016	2017	2018	2019
Germany	1.9	2.2	2.2	2.0
France	1.2	1.8	2.0	2.0
Italy	0.9	1.5	1.6	1.6
Spain	3.2	3.1	3.1	3.0
Euro zone	**1.8**	**2.3**	**2.3**	**2.1**

Source: Eurostat, SEB

Regional separatism an explosive issue

Many political storm clouds remain. Despite the lack of a decisive breakthrough, anti-EU and populist parties achieved gains in national parliaments. If the EU establishment should act in an excessively tone-deaf fashion, opposition would certainly increase both at the grassroots level and among sceptical member countries. In recent months, discontent has also been reflected in the shape of regional separatism. This has assumed its most dramatic form in Catalonia but has also found fertile ground in such places as northern Italy, Scotland and Belgium. Even in countries without actual secession threats, **major regional gaps create discontent and a breeding ground for nationalist, separatist or populist parties**.

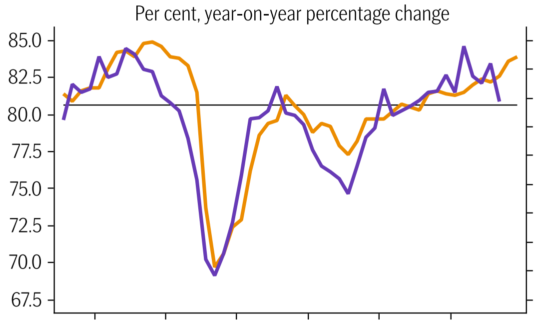
For years, EU institutions have encouraged regional distinctions. As part of the "Europe of Regions" concept, for example, the EU launched various programmes and activities with a more or less explicit undertone of **encouraging a strengthening of the supra-national EU level and the regional level at the expense of nation-states**. This may have helped create false hopes among separatist forces, because now that the issue is in the spotlight it is obvious that EU cooperation is based on mutual recognition of nation-states and borders. The EU and its member countries have clearly emphasised that the Catalan conflict is an internal Spanish issue. This is based on the view that **accepting unilateral regional independence movements would have unmanageable consequences**.

Fiscal policy becoming more expansionary

Last year public deficits fell to 1.5 per cent of GDP, down nearly 5 percentage points since 2009. Although some countries still have unhealthy weakness in their public finances, austerity programmers have had a clear impact. It is now likely that fiscal policies will shift in an expansionary direction during the next couple of years. After years of focusing on cost-cutting, governments are under pressure to help sustain the economic upturn and ease the situation of groups that were hard hit by earlier austerity. Meanwhile regulatory pressure from Brussels is easing, since most countries have pushed their deficits to less than 3 per cent of GDP. The current German government (pre coalition) exploratory consultation talks may also lead to a more expansionary direction if Merkel's CDU/CSU offers the FDP and Greens significant influence over fiscal policy. Despite stimulus measures, the strong economy will enable the euro zone to **continue reducing its overall deficit from 1.5 per cent of GDP in 2016 to 0.9 per cent in 2019**. Gross public debt will fall slowly, to just above 85 per cent of GDP in 2019.

High capacity utilisation helps sustain capital spending

Per cent, year-on-year percentage change



Fixed investments (RHS) — Capacity utilisation in manufacturing (LHS) — Average capacity utilisation in manufacturing (LHS)

Source: Eurostat

Indicators foresee continued strength

Strong sentiment indicator levels help support our positive economic forecast. Purchasing managers' indices (PMIs) and the European Commission's Economic Sentiment Indicator (ESI) are close to earlier record levels in some cases. During the past six months, PMIs in the four biggest euro zone countries have been above the expansion threshold of 50 in all sectors that are measured (manufacturing, services, construction and retail). In particular, **manufacturers are very optimistic about the situation**. Although PMIs fell a bit in October, they remain around a historically high 55 in the big four. The PMI is now higher in France than in Germany – a clear sign that more countries are now contributing to the favourable trend.

Strong order bookings point to continued output and export upturns. Industrial production accelerated in the third quarter and is now rising by 3.5-4.0 per cent year-on-year. Although export growth has slowed in recent months, due to improved competitiveness and strong global demand **we believe the expansion will stabilise at around 4.5 per cent yearly in 2017-2019**. Rising capacity utilisation and solid order bookings suggest rising investments ahead. As early as 2016, rising investment was observed, but so far this year the pace has been more sluggish than expected. We believe this is a temporary slowdown and that capital spending will increase by an average of just above 4 per cent yearly in 2017-2019.

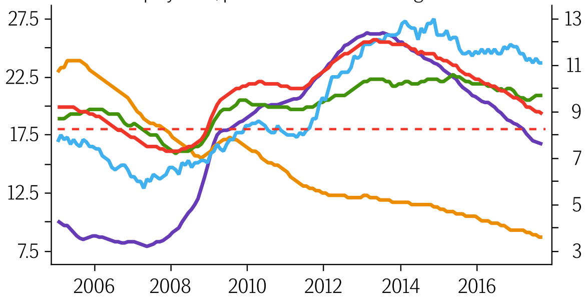
The strong economy is also leading to higher imports, which at present are actually growing faster than exports. The region's current account surplus will thus fall from 4 per cent of GDP in 2016 to 3 per cent in 2019. Germany's large surplus, which remains one of the most important global imbalances, will be around 8 per cent of GDP throughout our forecast period.

High consumer confidence squeezes saving

The upturn in consumption during 2016 was the strongest in 10 years – a clear sign that the recovery has reached the point where households are feeling more comfortable. In October, consumer confidence reached its highest level since 2000 – driven by strong labour markets, low interest rates and rising wealth via continued home and share price increases. Although savings ratios have fallen in recent years, it is difficult to foresee any acute need for households to boost their saving during our forecast period. **We thus expect consumption to increase by about 2 per cent yearly in 2017-2019**.

Broad-based decline in unemployment

Unemployment, per cent of labour force aged 15-74



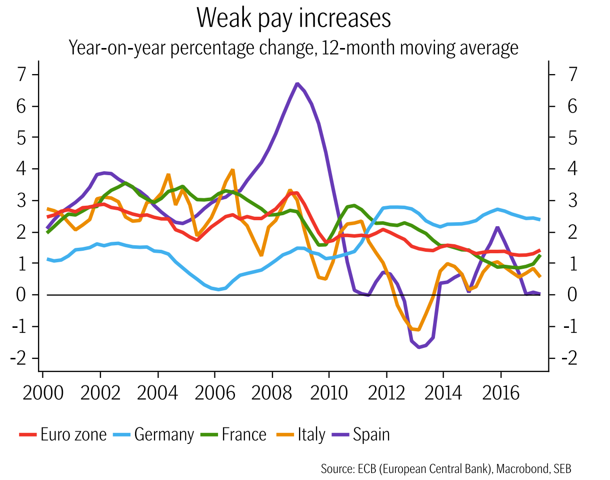
Euro zone equilibrium unemployment (RHS) — Euro zone (RHS) — Italy (RHS) — France (RHS) — Germany (RHS) — Spain (LHS)

Source: Eurostat

Strong job growth, but low pay increases

Euro zone unemployment is now 8.9 per cent: the lowest since January 2009, and more than 3 percentage points below the peak during the crisis. Job growth in the past year has exceeded 2 million. Spain has contributed a fourth of new jobs, while employment in Germany rose by nearly 400,000 and in France by more than 300,000. Total employment has now climbed above the pre-crisis peak. The outlook remains good, and company hiring plans point to continued job growth.

According to PMIs, these plans indicate an employment upturn of around 1.5 per cent. This is in line with final figures from recent months. Partly due to stronger labour markets, more people have re-entered the work force, slowing the decline in the jobless rate. Measured as annual averages, unemployment will continue falling from **9.1 per cent this year to 8.5 per cent in 2018 and 8.2 per cent in 2019**. Towards the end of our forecast period, it will thus be close to equilibrium, which we estimate at 8 per cent. Compared to other leading industrial regions, the euro zone is thus a few years behind in the economic cycle, contributing to continued low pay increases.

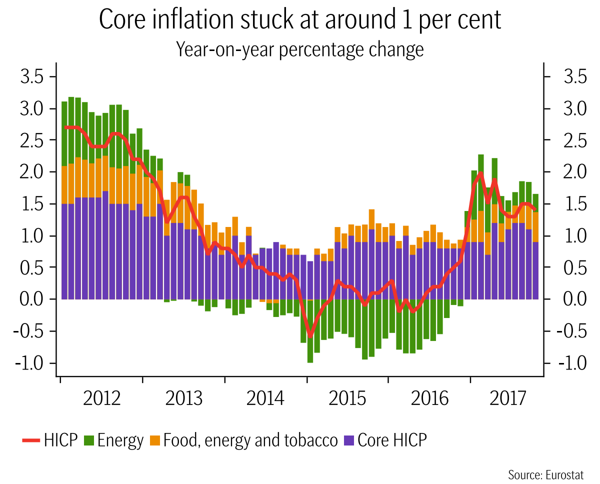


Inflation upswing will be delayed

Despite higher economic growth and falling unemployment, **inflation pressure remains low**. Early in 2017 the harmonised index of consumer prices (HICP) temporarily rose to 2 per cent, but since then it has fallen. In October it was 1.4 per cent. We expect a further decline to less than 1 per cent early in 2018, driven by negative base effects of food and energy prices. In recent years, core inflation has been around 1 per cent, and not until 2019 will we see a slight upturn. Continued idle resources in the labour market and the need for improved competitiveness will hamper pay increases, contributing to low inflation pressure for a long period. The pattern of recent years also indicates that inflation will have difficulty reaching the ECB's target of just below 2 per cent unless there are commodity price increases. Our oil price forecast does not indicate that energy prices will help to drive up inflation especially much. The euro has depreciated somewhat against the US dollar in recent weeks, but this will have only a marginal effect on inflation. A bit further ahead, we expect the opposite exchange rate trend, making it even harder for the ECB to achieve its target.

ECB will proceed slowly and cautiously

Although GDP growth rates in different countries now tend towards convergence, big differences in unemployment and resource utilisation make it difficult for the ECB to **pursue a monetary policy that is suitable for everyone**. For example, in Germany the unemployment rate is now probably below equilibrium, while the situation is completely different in Spain and Italy. This has an impact on price and wage trends. In the four biggest euro zone countries, inflation varies from 1.1 per cent in Italy to 1.8 per cent in Germany. Meanwhile average wages and salaries are increasing by 2.5 per cent yearly in Germany but remain largely unchanged in Italy and Spain. The ECB's dilemma is heightened by differences in the principles followed by different countries concerning their views about how various instruments should be used to speed up inflation. Even though the euro common currency has now existed for nearly 20 years, German representatives still express a substantially more hawkish view than southern European ones.



Nearly a decade after the first crisis-combating policies were launched, central banks led by the US Federal Reserve are trying to **navigate towards less expansionary monetary policies**. The ECB is also part of this shift, but due to additional near-term stimulus needs and continued low inflation pressure, **the normalisation process will be more drawn-out and cautious than that of other leading central banks**. At its October policy meeting, the ECB and President Mario Draghi provided a dovish signal but launching the **"less but longer"** strategy (bond purchases of EUR 30 billion per month for 9 months) instead of **"more but shorter"** (EUR 40 billion for 6 months), while keeping key interest rates unchanged.

Although inflation is not yet high enough, the ECB and Draghi confirmed stronger euro zone economic growth. The October announcement means monetary policy is set for most of 2018. The ECB is maintaining its forward guidance on the sequencing of policy measures according to which bond-buying will be phased out first, and interest rates hiked only thereafter. Since bond-buying will now continue for (at least) 9 months in 2018, the probability of rate hikes next year is close to zero. Time is thus becoming short for the **ECB to hike rates before Draghi's term of office expires** in October 2019. Our main forecast is that bond purchases will end in September 2018, but there is chance that short 3-month tapering phase, will push the end of QE to December. After that, the first step will be to raise the deposit rate for banks by 15 basis points to -0.25 per cent in March 2019. This will again make the corridor between the various key rates symmetric again, with the refi rate in the middle at 0 per cent. Then the entire policy rate corridor could be hiked in June and perhaps again in December, bringing the refi rate to 0.50 per cent at the end of our forecast period.

- **Two Banking Union cornerstones in place, but deposit guarantee a source of divisions**
- **Bail-in principle may lead to dramatic changes in banking sector ownership**
- **Swedish membership might lead to lower capital requirements and expanded lending**
- **Competitive neutrality requires adapting to ECB norms, even without membership**

Nordea's recent declaration that it is moving its head office from Sweden to Finland has thrown a spotlight on the consequences of Sweden's current non-participation in the European Banking Union. The United Kingdom's decision to leave the EU also means Sweden will be increasingly alone in having no voice in the Banking Union, especially if Denmark joins. Last summer the Swedish government announced it would study the pluses and minuses of membership, with a report due by November 2019. This theme article discusses various aspects of the Banking Union and the consequences for Sweden and Swedish banks of being an outsider.

Banking Union's awkward implementation

The financial crisis exposed regulatory and supervisory weaknesses in the EU banking sector. Regulatory frameworks had been implemented differently by national authorities and governed by outdated legislation that did not take into account that banking activities were no longer limited to one homeland. The EU thus decided to create a banking union aimed at achieving a more uniform system. The banking union is based on three cornerstones: **common supervision, resolution** (crisis management) **and deposit guarantee systems**.

Because Germany and various southern European countries were unable to reach a consensus, the third cornerstone is still missing. But common banking supervision was implemented in 2014 when the European Central Bank (ECB) took over responsibility for the 123 biggest banks in the euro zone. The creation of this **Single Supervisory Mechanism (SSM)** has led to harmonised supervision and more uniform capital requirement levels. The long-term objective is for harmonised regulation and supervision to **promote a sound banking system, prevent financial crises and support macroeconomic stability**. If a bank nevertheless ends up in a crisis, the **Single Resolution Mechanism (SRM)** – via the Single Resolution Board (SRB) – is entrusted with ensuring its orderly winding-down or restructuring ("resolution"). Meanwhile any cost to taxpayers and damage to the real economy are to be minimised.

Bail-in processes challenge traditional ownership structures

EU member countries that choose to remain outside the Banking Union will probably **need to impose stricter regulatory requirements on their banks than those applied to banks in the union**. This is especially true of small countries with large banking systems. While large countries can possibly afford to resolve a failing bank on their own, small countries face the choice of either joining the Banking Union and its burden sharing or introducing stricter regulatory requirements aimed at preventing large banks from ever ending up in a crisis. **The question of competitive neutrality may thus become a delicate problem for those remaining outside the union**. Stricter rules for domestic banks imply distorted competition that might pave the way for foreign players to take over a larger share of the market. In an economic crisis, this means greater vulnerability, since one cannot know to what extent foreign banks will survive and ensure lending that will facilitate economic recovery.

As for the winding down and restructuring of banks in the union, it is the SRB – not national regulators – that decides when a bank is about to fail. The SRB has also declared that the "bail-in" tool shall be used in case of winding-down in order to minimise the cost to taxpayers. A bail-in means that the bank's creditors are forced to accept losses in exchange for a shareholding in the bank. This is very different from a bail-out, in which **supplying government funds has often ultimately led to the preservation of existing ownership and control**. A bail-in process may thus lead to a kind of owner revolution, in which large pension funds, for example, take over from traditional ownership groups. This new form of crisis management has already created some friction between member countries. Last summer SRB thus forced Spain to follow EU legislation when dealing with the crisis facing the Banco Popular. Meanwhile two small Italian banks in the Veneto region were allowed to wind down in accordance with Italian insolvency law. It will be interesting to see the political implications of this exception in case of a severe crisis where major national "values" are at risk.

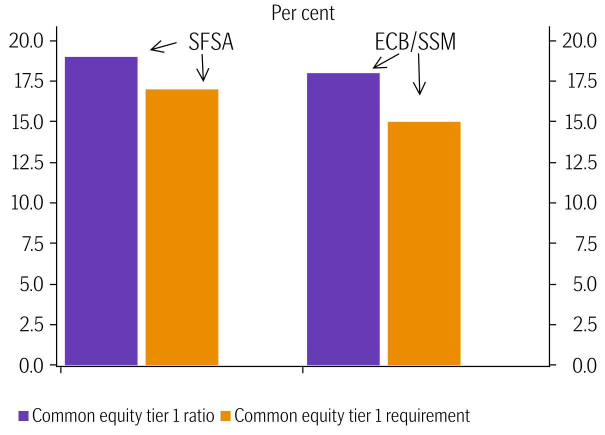
If Sweden joined the Banking Union, the ECB – through the SSM and SRB – would take over supervision and crisis management of major banks from the Swedish Financial Supervisory Authority (FSA) and National Debt Office, respectively. Swedish authorities would still participate in supervision, **but the ECB would be in the driver's seat and have the last word**. Swedish authorities could thus not control decisions based on national interests to the same extent as before. This change is obvious when the SRM resolution procedure is contrasted with typically Swedish solutions that include an element of government aid.

Lower capital requirements for members

Swedish membership would probably mean that capital and other regulations would become less strict and certain regulatory fees could be lowered. Swedish capital requirements today are very high compared to the rest of the EU. This has limited capital surpluses and dividend-paying potential. The Swedish FSA has introduced higher requirements to ensure that banks build up sufficient capital buffers in case of a major systemic crisis. By means of more flexible capital requirements, the FSA aims at maintaining a well-functioning banking system even under difficult circumstances. The ECB has a more rigid, streamlined view of capital requirements, for example attaching less importance to internal models for risk-adjusted credit exposure ("risk weighting"), which provide the basis for banks' capital requirements. The effect is lower buffer requirements, while minimum requirements have a greater impact and breaches have bigger consequences. To summarise, the net effect would still be lower capital requirements for Swedish banks if the ECB and SSM took over from the FSA. The chart below illustrates the size of the difference between Swedish FSA and ECB/SSM requirements.

Capital ratios under different regimes

Per cent



Source: Swedish FSA, ECB, SEB

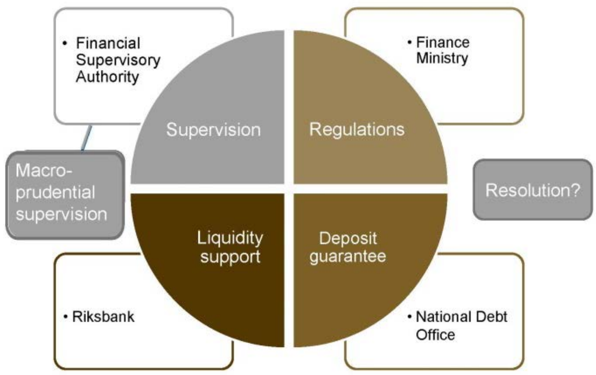
The profitability and competitiveness of Swedish banks would thus probably improve in case of membership. These **banks would thus have room for expanded lending**, which would help stimulate the economy. **The banks would also have greater room for paying dividends to shareholders**, although high ambitions in terms of credit ratings would remain a restriction. Operating in a European banking system under ECB supervision would give Swedish banks a better overview of existing regulations and guarantees of competitive neutrality through the uniform application of rules etc.

Membership would mean that Swedish government finances might be burdened by banking crises elsewhere in the Banking Union. Sweden would share the common costs of supervision and bank crisis management. This would include contributing its share to the fund that will be used for dealing with problem banks in the union that are subject to resolution. By extension, Sweden might be forced (through bank fees or even guarantee commitments) to help finance the resolution of southern European banks, for example, where there are lingering risks and unanswered questions. As for the last piece of the Banking Union puzzle – a common deposit guarantee system – Sweden faces the same dilemma as Germany. Will voters/taxpayers accept the risks of perhaps being forced to finance deposit guarantees for southern Europe?

Would joining pave the way for the euro?

It is difficult to foresee how the various arguments will ultimately be assessed by political leaders. Both the Riksbank governor and the finance minister have previously declared that Sweden's large banking sector, compared to its GDP, might be one reason for joining the Banking Union in order to reduce national exposure. But Nordea's move to Finland changes that picture greatly. When Nordea was included, Sweden led the EU (alongside the Netherlands and Cyprus) with total banking assets equivalent to about 340 per cent of GDP. **But without Nordea, Sweden is roughly at the EU average: 190 per cent of GDP**. Instead Finland soars to the top in the EU because of Nordea, with only Switzerland ahead of it in Europe as a whole. A smaller banking sector perhaps weakens the arguments for Swedish membership in the Banking Union, but on the other hand the issue of competitive neutrality becomes even more acute with Nordea in the union and other Swedish banks outside of it. Such a situation would probably **force Swedish authorities to move closer to European standards in practice**. The effects of being outside the Banking Union would thus not be so great.

Sweden's post-financial crisis allocation of responsibility



Source: National Debt Office

In a broader perspective, this question can also be connected to a general convergence trend in the EU and the euro zone. All euro zone countries already belong to the Banking Union. Other EU countries can join relatively easily. It seems likely that membership would lead to **a convergence process that, in various respects, would also make a later transition to the euro easier**. In the Banking Union, the Riksbank would play a clearly subordinate role compared to the ECB when it comes to financial stability, which could also make it more natural to link its interest rate policy more closely to a dominant peer. In practice, Banking Union membership would be a step closer to the euro zone, which euro-friendly parties such as the Social Democrats and Moderates might view as a positive step. But Swedish public opinion still overwhelmingly favours retaining the krona. It may thus be considered provocative if political leaders take steps that can be interpreted as attempts to move closer to a gradual transition to the euro.

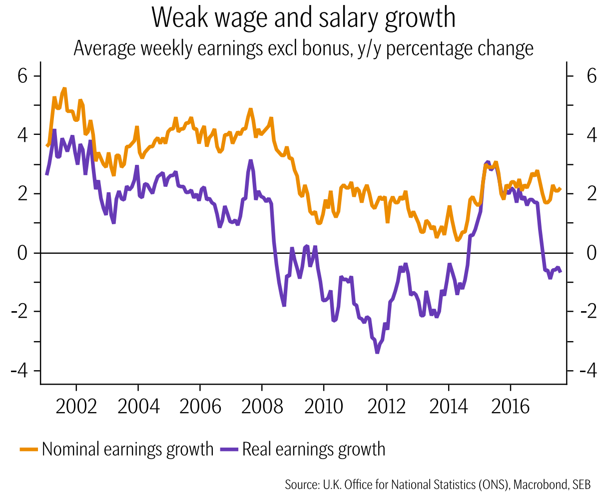
Underlying strength, but negotiating game poses risks

- **2018 economic growth revised upward**
- **Inflation has peaked and will decline**

Negotiations on British withdrawal from the EU are going sluggishly. Despite several rounds, no apparent progress has been made. Brexit is being negotiated in two stages – terms of the divorce and the future UK-EU relationship. "Divorce" refers, for example, to how much the UK should pay for its future obligations within the union. Only after sufficient progress is achieved will the talks broaden to include future relations, with a new trade agreement as one key element. **Hopefully this will be possible at this December's EU summit**. If so, negotiators would then have 9-10 months to reach a new agreement. This is a short period, but we expect an agreement to be achieved. One danger, though, is British disunity. The UK government is weak and Brexit negotiations are associated with personal prestige and fault-lines within both the government and Parliament. **There is thus a major risk of new political crises emerging during our forecast period**.

Brexit-related uncertainty led to a minor economic slowdown in the first half of 2017, but during the year several indicators have rebounded due to such factors as the continued weak pound and stronger global conditions. Political and economic uncertainty created by the EU withdrawal process is probably hampering British growth, but not really to the extent we had previously expected. **GDP growth will end up at 1.5 per cent this year – slightly below trend – but we are revising our 2018 forecast upward to 1.3 per cent. In conjunction with EU withdrawal we expect 2019 growth to fall a bit further, to 1.1 per cent**. If negotiations fail, however, there is a risk of a more dramatic slowdown, especially during 2019.

British households will probably continue to behave cautiously. Saving is at historical lows, while **weak nominal pay increases and high inflation are squeezing real incomes**. The improvement in household wealth, mainly driven by rising home prices, has also eased. Retail sales growth is the weakest since 2013, and car sales are falling. **The labour market remains strong, with rising employment in nearly all sectors** and there are few apparent signs of an imminent deceleration. Such indicators as hiring plans also point to continued job creation. **Unemployment stood at 4.3 per cent in July, the lowest since 1975**. We now anticipate a levelling out, with the jobless rate remaining at 4.3 per cent by the end of 2017 and then rising to 4.8 per cent at the close of 2019. Low unemployment has not triggered upward pressure on wages and salaries. One reason may be that low productivity growth is hampering the ability of companies to pay more. Meanwhile it is difficult to assess what effects EU withdrawal will have on future labour supply. If EU citizens leave the UK as a consequence, labour shortages might arise that risk hampering growth.



Among companies the situation is increasingly divergent, with **widening gaps between different sectors**. The weak pound mainly benefits the manufacturing sector, where confidence remains at very high levels. Meanwhile confidence has fallen this year in the more domestically oriented service sector, while **construction sector confidence has dropped sharply** since the second quarter and reflects a gloomy trend.

The pound's depreciation in recent years is now having an impact, pushing inflation well above the Bank of England (BoE) inflation target, but this upturn is temporary. **By the end of 2018 we expect that inflation will have fallen to 1.7 per cent, where it will stabilise in 2019**. The BoE raised the key interest rate by 0.25 percentage points at its November policy meeting. We view this rate hike as an effort to recoup the crisis rate cut it implemented soon after the June 2016 Brexit referendum, when there were fears of an impending UK recession. **No further hikes appear likely in the near term, given our inflation forecast, but if withdrawal from the EU occurs in controlled fashion we expect two further hikes during the second half of 2019.** This would bring the key rate to 1.00 per cent at the end of our forecast period.

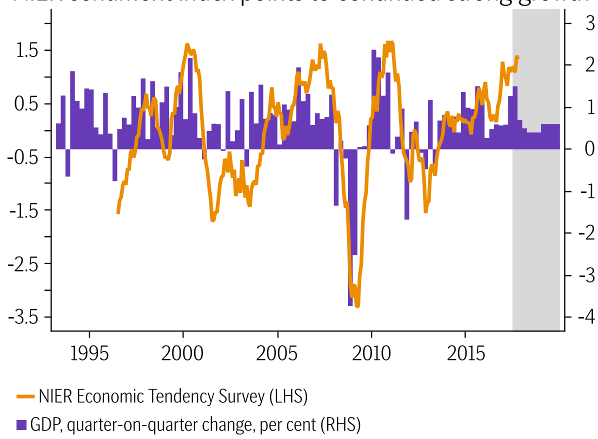
The weakness of the pound mainly reflects the uncertainty that the process of withdrawal from the EU creates. Assuming successful Brexit negotiations, we predict that **the risk premium that is now part of the pound exchange rate will gradually disappear, which should lead to a stronger pound during our forecast period**. We foresee a GBP/SEK rate of 10.75 at the end of 2018 and 10.95 at the end of 2019.

Continued boom, but worries about the housing market

- **Broad-based upturn in industrial activity**
- **Housing investments will fall**
- **Lower unemployment, despite rising supply**
- **Home prices are levelling, will fall slightly**
- **Riksbank will hold off on key interest rate hike, despite signs of overheating**

Recently **most indicators have continued to improve**, but due to clear signs that home prices are levelling out, we have adjusted our GDP growth forecast for next year slightly lower. **We now expect GDP to increase by 3.2 per cent in 2017, by 2.6 per cent in 2018 and 2.4 per cent in 2019**. The composition of growth has shifted a bit compared to earlier forecasts, however, since exports and industrial capital spending will increase more strongly while the slowdown in residential construction will become clearer. Sharply **falling home prices are a downside risk to our forecast**, but given generally strong economic conditions and a large underlying need for housing, we believe that a price decline at the national level would be limited to 5-10 per cent (see theme article).

NIER sentiment index points to continued strong growth



Source: Swedish National Institute of Economic Research (Konjunkturinstitutet, KI), Macrobond, SEB

The labour market has strengthened further since summer. Although the downturn in unemployment remains sluggish, various indicators are signalling that **the resource situation is tight**. This has finally begun to have an impact on wage and salary increases, but the three-year collective pay hike agreements signed early in 2017 at relatively low levels will have a restraining effect throughout our forecast period. The inflation rate, which was above the Riksbank's 2 per cent target in the summer, is partly driven by temporary factors that will gradually fade in the next six months. Underlying inflation pressure will now gradually rise, but **CPIF (CPI less interest rate changes) will still fall short of target even late in 2019**. Despite strong economic growth, the Riksbank has signalled continued extremely low key interest rates. In our forecast, we have thus postponed the first rate hike until September 2018. We believe that **three further hikes will occur during 2019, bringing the repo rate to 0.50 per cent late in the year**.

The Riksbank's ultra-loose monetary policy, combined with an expansionary fiscal policy for the election year 2018, represent **a powerful dose of stimulus** to the Swedish economy. This is further accentuated by the recent depreciation of the krona. We believe the EUR/SEK exchange rate will remain around 9.70 during the first half of 2018 as well (see theme article). **Strong GDP growth and an increasingly hot labour market – along with signs of weakness in the housing market – are now creating a new economic policy dilemma**, due among other things to a previously unclear allocation of roles. The Riksbank has clearly declared that monetary policy will not take into account the risks of rising home prices and household sector indebtedness. Meanwhile putting macroprudential rules in place has taken time. Ideological battles and a lack of political will have blocked taxation and housing policy measures.

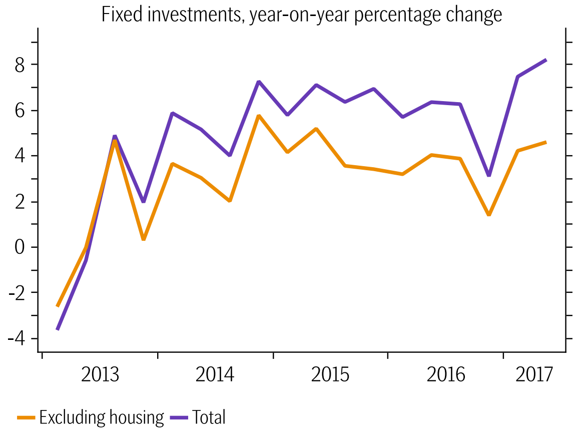
There is now a risk that such measures will arrive too late and amplify a home price downturn. We consider it extremely likely that the government – despite the political risks – will approve the new proposal by the Swedish Financial Supervisory Authority (FSA) for an income-related mortgage loan principal requirement. The Riksbank might face a dilemma **if a weaker housing market leads to gloomier growth prospects at the same time as greater scepticism about the Swedish economy weakens the krona, thereby creating an inflation impulse.** Previous experience shows that Swedish inflation generally occurs late in an economic cycle, which may amplify such an impulse. We also have previous experience, notably in 2008, of the Riksbank not hesitating to hike its key rate in a late-cyclical inflation environment amid a deteriorating economic situation. The governor of the Riksbank has declared that rate hikes may again become necessary in such a situation. Although this is not our main scenario, economic policymakers are obviously facing new dilemmas, largely as a consequence of previous failures.

Industrial activity is taking off at last

A synchronised global economic upturn, with new positive surprises in the most important European export markets, has **lifted Swedish sentiment indicators to historical highs**. Hard data such as merchandise exports and industrial production are also accelerating, although the growth rate is still relatively moderate. **We expect exports to increase by 5.3 per cent this year and 7.2 per cent in 2018**, far stronger than in our last *Nordic Outlook*. This upturn is fairly broad-based, although the acceleration in the past six months has been especially evident for input goods, with a strong upturn for the wood product, paper and metal sectors. The situation has also improved in the investment goods sector, while the outlook for consumer goods is more mixed. Rising exports will also push up industrial capital spending, which has been largely unchanged for a couple of years. We also still believe that public sector investments will accelerate, though the trend of the past year has been volatile and hard to interpret.

Housing construction has raised investments

Fixed investments, year-on-year percentage change



Source: Statistics Sweden (SCB), Macrobond, SEB

The number of housing starts rose to about 70,000 yearly during the first half of 2017. The level remained high during the third quarter, despite signals of weaker demand for newly constructed homes in certain major urban areas. **Uncertainty has increased in the housing market** (see theme article), but because of strong underlying demand pressure we still expect a high level of residential construction. However, the number of housing starts will probably decline somewhat during 2018. This implies that home construction will fall by about 10-15 per cent. The contribution of residential investments to GDP growth will gradually fall from just above one percentage point in the first half of 2017 to nearly -0.5 point for 2019 as a whole. As a share of GDP, housing construction will peak at more than 6.5 per cent in the first half of 2019, then decline somewhat. Because of accelerating industrial capital spending and public sector investments, **the overall growth rate in capital spending will remain high. Overall investments will fall from about 8 per cent this year to 6.5 per cent next year**, then to about 5 per cent in 2019.

Subdued public consumption despite record-strong employment

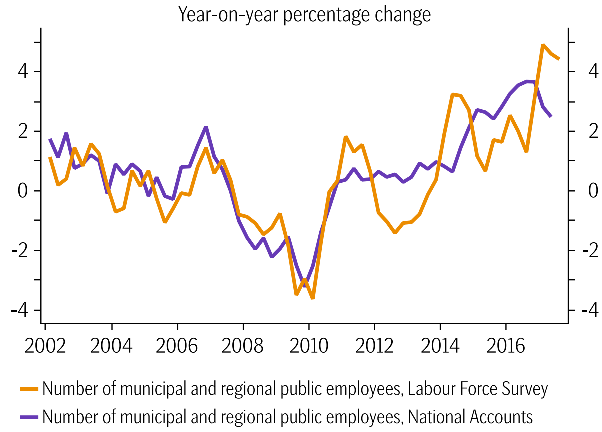
Public sector employment continued to grow at nearly 3 per cent year-on-year in the third quarter, and there are many indications of continued rapid expansion. In the last *Nordic Outlook*, we pointed out that estimates of public consumption in constant prices in the national accounts indicate that productivity is trending downward. This diverges from the pattern elsewhere in Europe. Although a rebound is likely after a very weak first half, productivity growth will probably remain weak. We continue to maintain that **employment is a better indicator of the public sector's impact on demand and resource utilisation** and that the new measuring methods understate Swedish GDP by about one quarter of a percentage point compared to other countries. Looking ahead, the rate of increase in public employment will be determined by the ability of public authorities to find suitable employees. The very large staff shortages now being reported indicate that a slowdown in the pace of recruitment is inevitable.

Surprisingly cautious households

Private consumption indicators have not kept pace with rising incomes, wealth and employment. This caution is also reflected in the continued slight increase in household saving. **Our forecast that consumption will increase by about 2.0-2.5 per cent yearly is unchanged**. Considering that the population is increasing by 1-1.5 per cent a year, this rate of increase is moderate. A major decline in home prices is also a downside risk. The historical correlation between home prices and consumption is relatively high. Above all, consumption has tended to be weak when home prices are falling, but the reason for this strong association may be that home price declines have coincided with generally shaky economic conditions. In that case, a weak labour market is probably the main factor pushing down consumption, not the home price decline as such. Although there is an association between home prices and consumption, this is probably rather weak as long as the price declines are small. The household savings ratio has increased even as home prices have risen in recent years, which supports the thesis that the association between home prices and consumption is, in itself, not so strong.

Local government employment is continuing to increase

Year-on-year percentage change



Source: Statistics Sweden (SCB), Macrobond, SEB

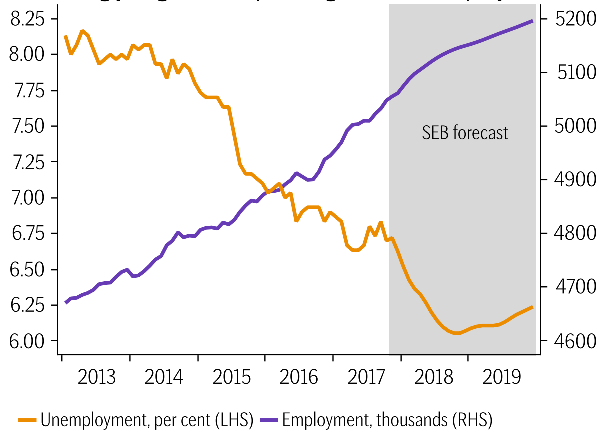
Rapid job growth, lower unemployment

The upturn in employment indicators has strengthened this autumn. **Employment rose by nearly 3 per cent in the third quarter**. We have adjusted our already optimistic 2018 fore-cast upward and now foresee job growth of 2.5 per cent; business sector hiring plans suggest that upside risks also predominate. Despite very strong job growth, **unemployment has remained unexpectedly high, with almost no move-**

ment so far this year. Rising labour force participation in most age categories is the reason for this, and in the past six months an increase in the number of gainfully employed individuals over 65 has become especially evident.

The rising participation rate is especially impressive in light of recent large-scale immigration of people with extensive educational and training needs. Yet the large-scale education and training programmes in the 2018 central government budget suggest that labour force participation will be falling in the near term. Our forecast remains that **unemployment will fall below 6 per cent, but we now believe this will not happen until mid-2019**. With yearly job growth of more than 2 per cent, unemployment is likely to fall even if labour force participation remains unchanged. Towards the end of 2019, unemployment will climb a bit as recent immigrants increasingly join the labour market.

Strong job growth is pushing down unemployment

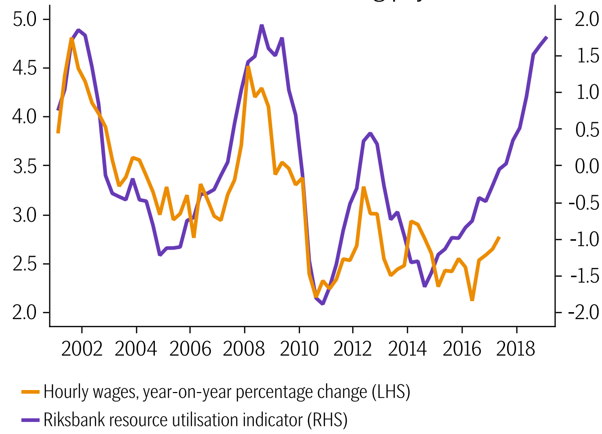


Source: Macrobond, SEB

Tight labour market, but sluggish pay hikes

The Riksbank's resource utilisation (RU) indicator has climbed to historical highs, a sign that the labour market is tight even though unemployment is relatively high. Employment Service statistics meanwhile show that more and more unemployed people have little formal education and/or weak ties to the labour market. As in other countries, the question is now to what extent the tight labour market situation will spill over into pay increases. Sweden generally has less slack than other countries. The rate of pay increases has accelerated in the public sector, which has the biggest staff shortages. But the correlation between resource utilisation and pay/inflation has been relatively weak since the mid-1990s, when the Riksbank's inflation target was established and wage formation was reformed. Looking ahead, pay hikes will be held back by the 3-year collective agreements in place during 2017-2019, with increases of just over 2 per cent yearly. Because the Swedish labour market is relatively open, imported labour – especially from EU countries with weaker labour markets – also holds back pay increases. Overall, we are sticking to our assessment that **pay increases will gradually accelerate from just over 2.5 per cent this year to 3.5 per cent during 2019**. Since wages and salaries according to the National Accounts are increasing a little faster than in more official pay statistics, there is a certain upside risk to our pay forecast.

Hot labour market, but no big pay increases



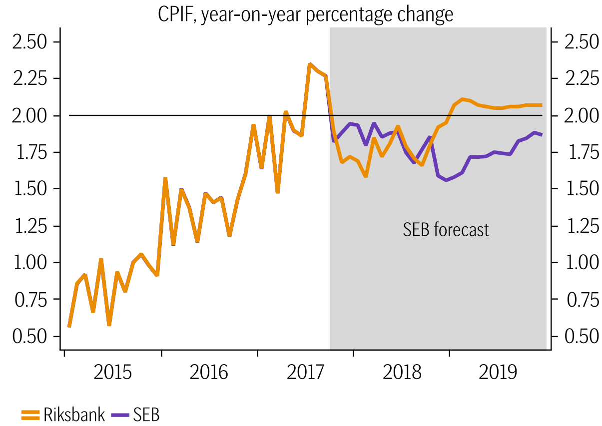
Source: Riksbank, Swedish National Mediation Office, SEB

Inflation moving below target again

Inflation was unexpectedly high during the summer, with CPIF exceeding 2 per cent for several months. Since then, CPIF inflation has slowed. In October it stood at 1.8 per cent. Some of the volatility during the past few months is explained by changes in methodology that have led to stronger seasonal patterns for charter holidays. This will continue to affect yearly figures in the first half of 2018 too. But service price hikes also reflect generally higher inflation pressure. In the past three months, CPIF excluding energy and package holidays has stood at 1.8 per cent. The service price upturn is relatively broad, but with especially large hikes for domestic travel, banking and health care. These price hikes will probably not be repeated, nor will they be reversed. Service inflation will remain high during the next 6-18 months, suggesting that **CPIF inflation will remain close to target during much of 2018**.

Inflation below target again

CPIF, year-on-year percentage change



Source: Riksbank, Macrobond, SEB

Yet service prices will not increase enough for the Riksbank to be on solid ground in terms of meeting its target in a world of generally weak inflation pressure. Falling international food prices, for example, will help slow inflation early in 2018. Final September and October figures also show that upward pressure on CPI due to the weak krona of recent years is gradually fading. Yet slightly higher contributions from indirect taxes, via an energy tax hike and a new air travel tax, will push inflation 0.2-0.3 percentage points higher in January, contributing to our forecast that CPIF inflation in 2018 will be unchanged compared to August. **Because of gradual pay hikes, we expect inflation to remain relatively high during 2019**, but the increase will not be enough to push inflation all the way up to target even at the end of our forecast period.

Loose monetary policy despite high growth

Even though GDP growth has been far stronger than the Riksbank expected early in 2017 – while both inflation and inflation expectations have been close to target – the Executive Board has **rejected the idea of starting to normalise the bank's extremely loose monetary policy**. Since the Riksbank seems totally focused on spot inflation and on countering a krona appreciation, we are postponing our forecast of the first key interest rate hike to September 2018, which is in line with the Riksbank's latest repo rate path. During 2019 we foresee three further hikes, bringing the repo rate to 0.5 per cent at year-end.

It cannot be ruled out that the Riksbank will choose to extend its quantitative easing (QE) programme beyond year-end 2017, carrying out smaller bond purchases during the first half of 2018 in order to send a clear signal to the market. Since three out of six Executive Board members dissented from the decision to extend bond-buying to the second half of 2017, our main forecast is that purchases will end in December, but the Riksbank is very likely to continue reinvesting its distributions and, in some form, also maturing bonds (see below).

Shrinking government bond supply

Swedish government bond yields have remained low, and the spread against equivalent German bonds has narrowed despite falling yields in the euro zone. Downward adjustments in repo rate expectations are one driver, but the combination of continued Riksbank purchases of government bonds and a decreased supply due to Sweden's strong government finances is quite important. In October the National Debt Office (NDO) decreased its planned supply of both nominal and inflation-indexed government bonds, but above all it reduced the supply of Treasury bills to levels far below what was previously considered a minimum for a smoothly functioning market. **The NDO thus seems ready to sacrifice Treasury bill market maintenance so it can preserve bond issuance volume**.

The imbalance between supply and demand will persist during the coming year, but how large it will be depends on how the Riksbank manages its nearly SEK 50 billion holding of the bond that matures in March 2019. In the past, the Riksbank has chosen to reinvest before the maturity date. If it should follow the same pattern this time, it will own 50 per cent of the outstanding nominal bond supply. In order not to hurt market liquidity too much, we believe the Riksbank will be content to reinvest half the total before the bond matures, but this is still **not enough to prevent the problem of supply shortages in the Swedish fixed income market** from worsening in the coming year. We expect this to be one reason why the 10-year yield spread against Germany will **narrow to 25 basis points in mid-2018**. Further ahead, Riksbank key rate hikes will be more important, and **the spread will widen to 60 bps late in 2019**. Ten-year Swedish yields will thus climb to 1.70 per cent in 2019 from 0.70 per cent today.

Strong finances despite stimulus measures

The rapid upturn in GDP and employment will generate **strong public finances even though the government has unveiled a highly expansionary election year 2018 budget**. The dose of stimulus was somewhat higher than we had anticipated and is equivalent to about 1 per cent of GDP. Swedish public finances are cyclically very sensitive. Largely due to a rapid increase in such important tax bases as personal incomes (employment), consumption and construction, we now foresee a stable budget surplus of about 1 per cent of GDP throughout our forecast period. Cyclically adjusted, the surplus will be just above the 1/3 per cent of GDP that is the target level in the new fiscal policy framework that goes into effect in 2019. Public sector debt will fall towards 35 per cent of GDP in 2019, so by the end of our forecast period it will be close to the new "debt anchor". **We expect the central government budget surplus to be around SEK 40 billion per year in 2017-2019**.

Public finances

Per cent of GDP

	2016	2017	2018	2019
Net lending	1.1	1.0	0.7	1.0
Borrowing req., SEK bn	-85	-41	-25	-40
Gen. gov't gross debt	42.2	39.9	37.8	35.7

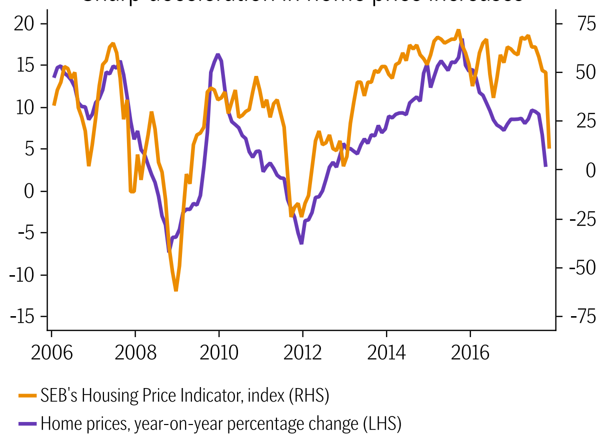
Source: Statistics Sweden, SEB

Political parties have now begun to focus mainly on the September 2018 election. We do not expect disruptive battles during parliamentary consideration of the budget. The opposition will criticise the government for pursuing an irresponsibly expansionary fiscal policy, considering Sweden's strong economic situation. For its part, the government can maintain that it is largely following the fiscal framework and that the Riksbank ultimately bears the main responsibility for ensuring reasonably balanced overall economic policy. Regardless of the election outcome, we will probably see continued expansionary fiscal policy in 2019, though not on a par with that of 2018.

- **Price correction of 5-10 per cent likely after long upturn**
- **Strong economy, low interest rates and continued housing shortage will limit dip**
- **Nationwide price downturn of 15-20 per cent would be dangerous to economy**

Signs of a slowdown in Sweden's housing market have become more evident. For example, SEB's Housing Price Indicator fell in October to its lowest since 2012, but its level is still compatible with flattening rather than falling prices. Some metrics, such as Valueguard's HOX housing index, are already showing a minor price decline. Anecdotal information, mainly from Stockholm, also points to price declines and increasing market imbalance, with sellers not accepting lower prices. Although the situation varies sharply between different parts of Sweden, most signs are that we are now facing some price downturns.

Sharp deceleration in home price increases



Source: Valueguard, SEB

Our main forecast is that **in mid-2018 the Valueguard HOX housing price index will be 5-10 per cent below the peak recorded in August 2017**. After that, we predict a levelling out late in 2018, followed by slightly rising prices during 2019. The price downturn will be relatively mild and short-lived, among other things because the underlying imbalance in the housing market will persist – including rapid population growth and actually rather modest residential construction in a long-term perspective. It is very **unusual for a single country to record a home price decline of more than 10-15 per cent in a strong global economy**. Some of the key factors affecting Swedish housing market developments are discussed below.

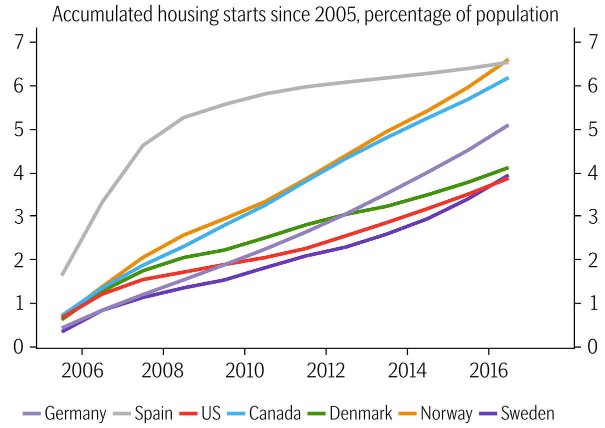
Continued long-term housing deficit, despite accelerated pace of construction

Sweden was one of the few countries that did not record any major home price declines due to the financial crisis. Prices quickly resumed their upward path when central banks began their interest rate cuts and continued higher as interest rates fell further. Canada, Australia and Norway are countries with similar patterns, where prices have tripled since 2000 and doubled since the financial crisis. Prices of tenant-owned cooperative units (mainly flats) in Sweden have increased much faster than for single-family homes. **Faster population growth, little construction and especially the downward interest rate trend have been behind the price increases**.

Although the underlying forces driving the upturn are intact, the housing market is slowing. One explanation for the price decline is **excess supply and speculative elements in certain market segments with large-scale new construction**. However, there are no indications that the rapid increase in construction over the past few years has led to a general surplus of housing. The National Board of Housing, Building and Planning estimates that 80,000 new homes per year are needed until 2020 to meet rapid population growth, which is partly due to earlier large-scale immigration of refugees. It is possible that this estimate somewhat overstates housing needs. For example, new arrivals from non-European countries tend to average more individuals per household, thereby reducing the required housing area per person.

Few new homes in Sweden despite sharp upturn

Accumulated housing starts since 2005, percentage of population



Source: Macrobond, SEB

Yet because Swedish residential construction has been low in a historical perspective for a long time, it is **unlikely that several years of high-intensity construction will eliminate the underlying shortage of housing**. Due to the rapid acceleration in home-building over the past few years, we will probably reach a level of around 70,000 new units in 2017 as a whole. In relation to population size, this is on a par with the peak levels recorded in Norway and Canada, for example. But these countries maintained high construction levels for longer. Accumulated over a 10-year period, their construction as a percentage of population has been about 50 per cent higher than in Sweden.

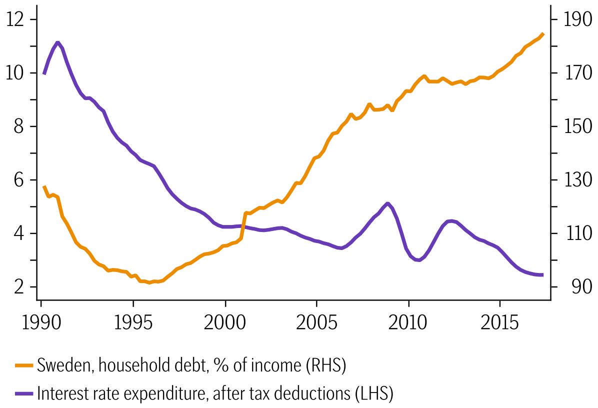
Construction is not adapted to demand, but groups joining the "property ladder" help

Today's home construction is obviously not adapted to the demand picture. Most new units are in high-end projects that most home buyers cannot afford. This will eventually require adjustments in construction processes and discounts on rents and purchase prices. But there are also other mechanisms, for example related to the many new immigrants who are unlikely to be able to buy a home in the foreseeable future. Municipal governments are currently required to supply a certain number of refugees with homes, and a common way of doing this is to give them priority in municipal waiting lists for rental housing. This makes it harder for other groups to find rental units within a reasonable time, **forcing many households – especially among younger people – to buy a home, which helps stabilise prices**. Although this municipal requirement is temporary, the political system will probably be compelled to devise new measures for helping new arrivals find housing.

We are also seeing some adjustment to this new situation, since construction of rental units is rising faster than for tenant-owner units. Although newly built rental units will be substantially more expensive to rent than existing units, **because of the housing shortage it is unlikely that these new units will stand empty**. A large proportion of new construction has occurred in major urban areas or in regional centres, where underlying population growth provides a stable demand situation and thus also reduces the risk that units will remain unoccupied.

Rising debts, but record-low interest expenditures

Per cent of income



Source: Statistics Sweden, SEB

Strong household balance sheets should also be factored into assessments of the risks of a major home price decline. Although debt levels have risen in a way that is calls for reflection, household saving has been very high for a long time, contributing to strong balance sheets. **Interest expenditures represent a record-low percentage of household incomes**. This situation will hardly change in the foreseeable future. The Riksbank has declared that it will not use interest rate policy to cool off the housing market, since it views this as a task for the government, for example via taxation, or the Swedish Financial Supervisory Authority (FSA) via macroprudential policy.

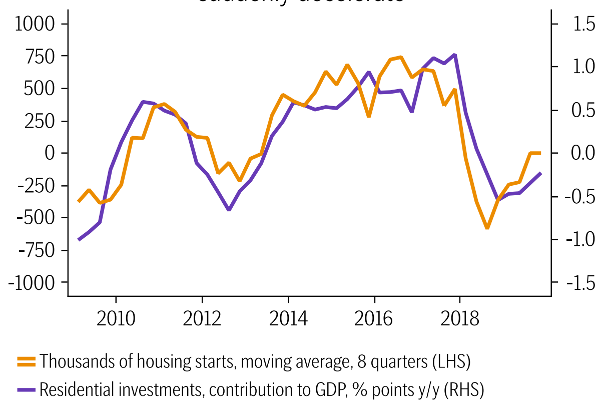
Slowdown creates various policy dilemmas

The weaker housing market now raises the question of whether cooling-down measures are already too late. The FSA recently unveiled a proposal for limiting debt by increasing the principal repayment ("amortisation") requirements for highly leveraged households. This proposal is likely to be accepted in some form by the government, even though it implies taking political risks ahead of the September 2018 election. If the government simply refuses, however, it risks undermining the FSA's macroprudential role. Capital gains taxation on housing units may be another hot potato. Such taxes tend to block movements up the property ladder, which will probably become more important for the smooth functioning of the housing market. So far, the Riksbank has sent out ambiguous signals about how it will react to any home price decline, yet it is **unlikely to carry out sizeable interest rate hikes** if housing market weaknesses impede the growth outlook.

Pain threshold: a 15-20 per cent price drop

The housing market slowdown is now very likely to cool off construction. The contribution of home construction to GDP growth will fall from about 1 percentage point today to zero in 2018 and -0.5 points in 2019. We have lowered our 2018 estimate by half a point. Private consumption will also be hurt to some extent. But since Swedish industrial production and exports are accelerating, GDP growth will probably remain at levels that will lead to a continued strong labour market. Along with strong international conditions, we thus see **good potential for Sweden to avoid a negative spiral** that would cause even sharper price declines, especially considering low interest rates and a continued structural housing shortage.

Contribution of residential construction to growth will suddenly decelerate



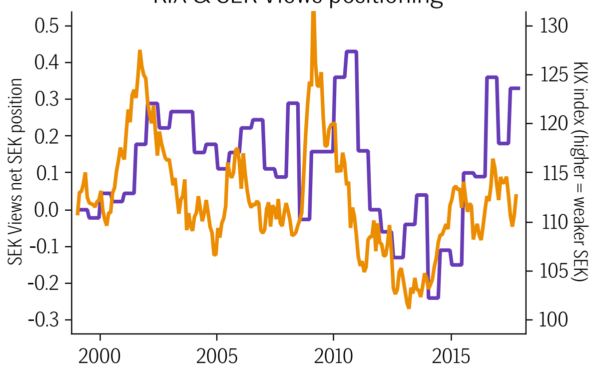
Source: Statistics Sweden, SEB

However, if the price decline should approach 15-20 per cent at the national level, the secondary effects on the rest of the economy would probably be so large as to change our macro scenario more fundamentally. Such a major nationwide price decline is unlikely, though, since much of the country would probably be little affected. A downturn of this magnitude in Sweden as a whole would probably be equivalent to a price decline of around 40 per cent in the most price-sensitive sub-markets, especially tenant-owner units in major cities.

- **Negative interest, positioning and seasonal effects will keep SEK down in short term**
- **Housing market worries may accentuate negative SEK spiral**
- **EUR/SEK exchange rate will start falling in mid-2018 as key rate hike approaches**

For some time we have forecast a strong Swedish krona 6-24 months ahead, though we have sometimes seen reasons to be more cautious. In mid-October, for example, we adjusted our 1 to 6-month krona forecasts downward **since the SEK had reached a relatively strong level while our *SEK Views* survey revealed a nearly record-long krona position in the Swedish market** (chart below). We have now exceeded the EUR/SEK levels around 9.80 we predicted. Today's krona levels are thus attractive in a longer perspective, but the question is whether the period of krona weakness is already over.

KIX & SEK Views positioning



Sveriges Riksbank Kronindex, KIX (RHS)
SEK Views Market positioning, + = market overweight (LHS)

Source: Macrobond, SEB

Riksbank policy is working as intended

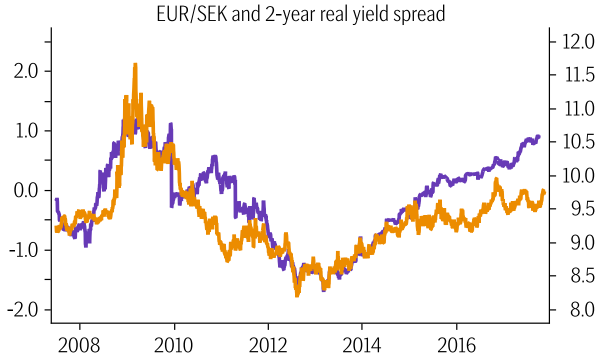
At present there are not many indications that the krona will recover quickly. Swedish interest rates are extremely low, especially in real terms, and the Swedish banking system has sizeable surplus liquidity. Along with year-end effects, this may help push Swedish short-term interest rates even deeper into negative territory. The Riksbank is showing no signs of stepping back from negative key interest rates and QE near term. In the immediate future, the krona will also be hampered by the annual allocation of about SEK 35-40 billion by the Pension Authority of which a majority is invested in foreign assets. This normally occurs in the second week of December and is preceded by a weakening of the krona.

How sensitive is SEK to lower home prices?

We believe that a major decline in Swedish home prices can be avoided and that the downturn in prices at the national level will be limited to 5-10 per cent. Although continued dramatic media reports of the housing market situation may push down the krona in the short term, the exchange rate **should not be affected significantly by such a mild price decline**. But if home prices should fall by 15-20 per cent at the national level, the consequences would be far greater. In that case, foreign investors would probably unwind speculative krona positions and decrease their exposure to Swedish mortgage-backed bonds as well as to banking/financial service and consumption-related equities. Although foreign ownership is now below the historical average, such a development would probably **lead to a krona depreciation of up to 10 per cent**.

Loose interest rate policy keeping krona weak

EUR/SEK and 2-year real yield spread



EUR/SEK exchange rate (RHS)
2-year real yield spread, Germany vs Sweden (LHS)

Source: Macrobond, SEB

Krona will remain weak for quite some time

Overall, we expect the krona to continue trading at weak levels for another while and to be worth 10.00 per EUR at year-end. In addition, there is a short-term risk of an even weaker SEK. The Riksbank holds the key to letting the krona appreciate towards 9.20 per EUR (our equilibrium estimate), but as long as the ECB is the anchor of Swedish monetary policy there is not enough support to attract buyers again. We have delayed our forecast date for the Riksbank's first key interest rate hike to September 2018, which thus also means that **we now expect a longer period of krona weakness, with the EUR/SEK exchange rate at 9.70 on June 30, 2018**. Not until H2 2018 will the krona appreciate more clearly, but even at the end of 2019 we now believe EUR/SEK will be a bit above 9.00. At the same time, a lopsided focus on the krona's trend against the euro may be misleading. So far during 2017, the krona has actually strengthened against most currencies, especially the US dollar. Looking further ahead, the krona will also find it difficult to gain further ground against the euro in a global environment where the role of the euro as a reserve currency is strengthening. Yet in a broader perspective, krona appreciation will be relatively large. **The USD/SEK rate will fall as far as 7.35, while the KIX will reach 105.9 late in 2019**.

Healthy economic recovery

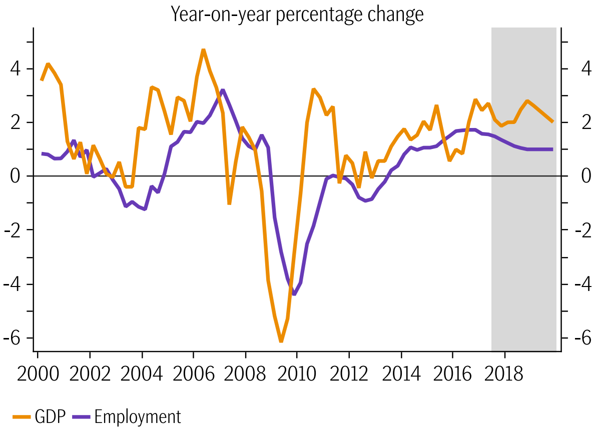
- **Strongest GDP growth since the crisis**
- **Exports, investments fuel continued growth**
- **Debt creation remains muted**

Danish GDP growth posted solid gains of 0.7 per cent in the second quarter, but short-term headwinds are likely to hold back Q3; Statistics Denmark's GDP indicator suggests Q3 may even have seen a small drop. We expect a rebound in Q4. Our GDP growth forecast remains **above trend** and largely unchanged at **2.3 per cent in 2017, 2018 and 2019:** highest since the double-dip recession of 2011 and for the period as a whole a pace not seen since before the financial crisis.

The continuous upswing is primarily driven by strong global demand and increasing employment, the latter with a growth rate of just below 2 per cent. Furthermore, high levels of consumer confidence and rising home prices underpin demand. However, the household savings rate has been rising, reaching a historically high level of 11 per cent. More recently, weak retail sales and a considerable drop in purchases of new passenger cars, due to policy uncertainty, have restrained consumption growth.

Strongest growth momentum since the crisis

Year-on-year percentage change



Source: Statistics Denmark, SEB

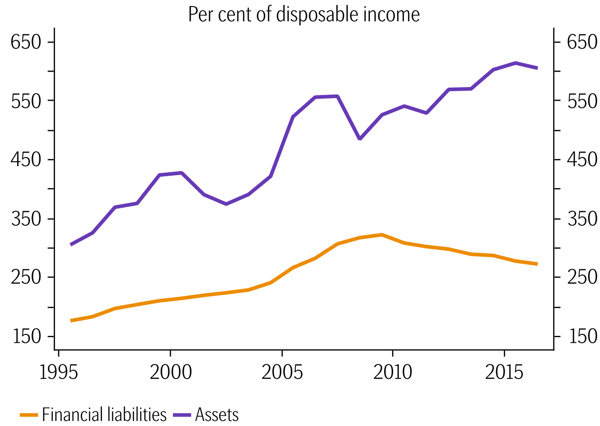
Looking ahead, we believe that private consumption will rebound, continuing to rise as disposable income increases. The current upswing differs from the one in the 2000s, as **strong income driven growth is now accompanied by a reduction in household debt**. Going forward, easing credit conditions will have a positive impact on private consumption, contributing to faster growth. However, we still expect income to be the primary driver for consumer spending.

Export growth has been strong in 2017, supported by **accelerating demand in European export markets**. Net exports are likely to level off as domestic demand picks up. We continue to expect accelerating capital spending activity over the next few years, with **business investment supported by rising capacity utilisation and residential investment getting a lift from higher home prices**.

Fiscal policy is likely to remain broadly supportive. Public consumption is expected to pick up, and the **government's plans to cut taxes are likely to be under-financed**. Combined with low interest rates and a positive global story, this creates a strong backdrop for growth. Overall, economic conditions remain solid, likely to facilitate the most positive outlook for the Danish economy in years.

Households reduce debt while assets grow

Per cent of disposable income



Source: Eurostat Database, Macrobond, SEB

The special factors (package holiday and hotel prices) that contributed to a temporary 'summer surge' in Danish CPI have been normalised, but overall core CPI has not fully retreated yet. **Harmonised CPI inflation will increase to 1.2 per cent on average in 2017 followed by 1.4 per cent in 2018 and 2019.** However, with wage and salary increases running at less than 2 per cent, inflation does not appear to be a serious risk. A gradual tightening of the labour market is likely to lead to a slow increase in private sector wage inflation.

With the current account surplus set to reach a record 9 per cent of GDP, the Danish krone is likely to stay strong, and rates will likely remain low during our forecast period in order to defend the currency's peg against the euro.

Risks are balanced. Rising home prices may eventually create overheating risks, but this is not a problem right now. Downside risks to growth are even less prominent and mainly related to international assumptions.

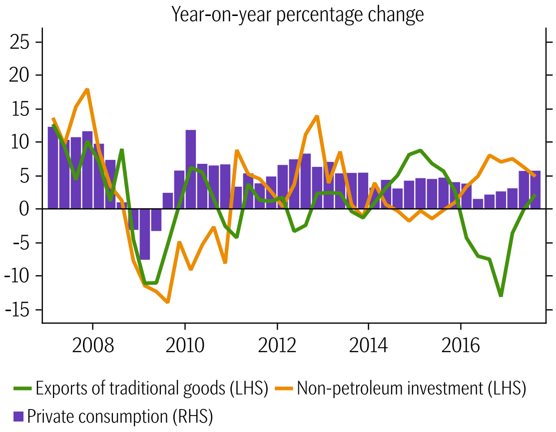
Recovery with a broader base

- **Mainland GDP growing above trend**
- **A modest correction in home prices**
- **Norges Bank hikes, despite low inflation**

After almost three years of weak growth, mainland economic activity picked up in early 2016. The recovery has gained a firmer footing this year, with growth in mainland GDP (excluding petroleum and shipping) accelerating to above trend in the first three quarters. Expansionary fiscal and monetary policies and strong growth in housing construction have supported the recovery. While the growth contribution from these factors will gradually diminish, the recovery is meanwhile becoming more broad-based. Private consumption is supported by solid improvements in household real disposable income. Exports of traditional goods are benefiting from strong foreign demand and the weak krone exchange rate. In addition, the capital spending cycle is turning around; the impulses from petroleum investment will turn from being strongly negative during the past three years to positive in 2018. We maintain our above-consensus forecast, expecting **mainland GDP to accelerate** from 1.9 per cent in 2017 **to 2.4 per cent in 2018 (2.3 per cent in 2019)**. Overall GDP should grow by 1.6 and 1.8 per cent in 2018 and 2019, respectively. The housing market remains a downside risk to the outlook.

Recovery is becoming more broadly based

Year-on-year percentage change



Source: Statistics Norway, Macrobond, SEB

The government's budget proposal for 2018 implies that fiscal policy is turning neutral, which is reasonable given the recovery in economic growth and labour markets. We assume **no contribution to mainland GDP from fiscal policy** in coming years, in line with expenditures implied by the fiscal policy rule.

Capital spending will lift growth

The capital spending cycle within oil and gas extraction turned around last winter, but the initial recovery has been fragile. Oil investment declined a hefty 5.1 per cent in the third quarter and negative back-revisions lowered the trajectory in 2017. While this suggests a minor **2.0 per cent decline in 2017,** investment should pick up in the next couple of years. Oil companies are likely to raise their forecast for planned investment for 2018 in Statistics Norway's next oil investment survey (due in late November). First, several projects are expected to be submitted to the government in late 2017 which will then be included in the survey. Second, the survey should show any additional uplifting effect from higher oil prices this autumn. Oil investment is expected to **climb by 2.8 per cent and 5.5 per cent in 2018 and 2019, respectively**.

Despite higher activity in the petroleum sector, the recovery in manufacturing remains sluggish. The positive trend which started in early 2017 was halted in Q3 when production declined. This is surprising, considering that manufacturing sentiment remains at levels consistent with trend-like growth in production. We expect the recovery to resume, underpinned by a pick-up in the petroleum-heavy capital goods sector. Moreover, improving conditions in Norway's main export markets in Europe should stimulate industrial production in the medium term. Shipments of traditional goods have rebounded strongly in 2017 and were up 2.2 per cent in Q3 from a year earlier. The manufacturing Business Tendency Survey suggests a larger increase is in store, since expectations about foreign orders have picked up notable this year. We expect a further rebound **of 3.1 per cent in exports of traditional goods in 2018**. Net exports will be broadly neutral in 2018 and 2019.

Business investment turned around in 2016 and gained 8.2 per cent in the third quarter after a setback in the spring. While notoriously volatile on a quarterly basis, the underlying trend is positive. Norges Bank's latest lending survey reported rising loan demand from companies and lending to the sector has surged during 2017. Capacity utilisation in manufacturing is still depressed, but manufacturers have lifted their investment plans to a level not seen since before the financial crisis. We expect **business investment to accelerate in 2018**. Residential investment has continued to grow steadily in 2017, but a slowing is inevitable. Declining new home sales have put a lid on housing starts after the solid increase of the past two years. However, there is a noticeable time lag before it will affect completions. **Residential investment will not make a prominent negative contribution to growth until 2019**.

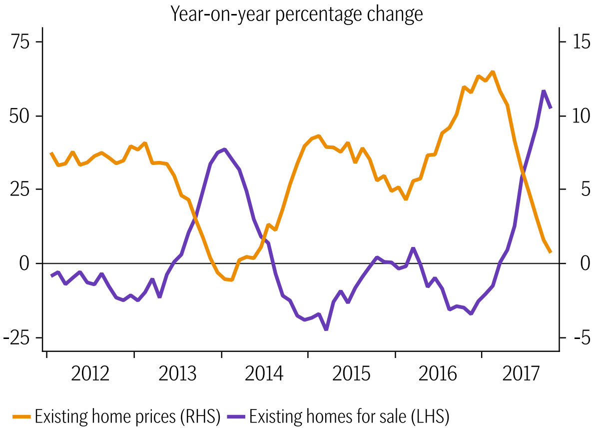
Lower home prices, but no collapse

The housing market has seen a distinct slowing so far in 2017. After peaking in March, existing home prices (seasonally adjusted) declined in six of the seven months to October. A large supply of existing and new homes has been the main driver behind the correction. With completions expected to grow further in 2018, the negative demand-supply imbalance is likely to persist. Tighter lending standards, in particular the new debt-to-income cap, have also helped push down home prices. The mortgage regulation framework is set to expire next summer. Revoking or amending it would support the market, but given high household debt and expectations of a modest correction, the Finance Ministry is likely to extend it.

We expect a modest price correction in the housing market, since demand is likely to remain healthy. Households' fundamentals are expected to improve further, and the risk of higher interest rates undermining affordability markedly in the coming years is small. Annual growth in existing home prices will slow to 5 per cent in 2017 from 8 per cent in 2016. We expect a **decline of 4-6 per cent in 2018, with home prices then stabilising in 2019**. The forecast implies that prices will decline on a month-to-month basis until next summer.

Surging supply pressures home prices

Year-on-year percentage change



Source: Real Estate Norway (Eiendom Norge), Macrobond, SEB

Absent a more severe correction, private consumption should withstand lower home prices. Household spending has picked up notably in 2017 and will continue to benefit from rising real disposable income, higher job growth and very low interest rates. We expect **private consumption growth of 2.6 per cent in both 2018 and 2019**. The household savings ratio has dropped to a seven-year low, suggests **downside risks to consumption should home price decline substantially**.

Solid labour market improvements

Unemployment has continued its downward trend, signalling a robust recovery in labour markets. Job growth as measured in the Labour Force Survey (LFS) has, however, been slower than anticipated. This may reflect that companies are trying to improve productivity, implying a longer-than-normal lag from the GDP turnaround. However, broader national accounts data, including employees not registered as residents of Norway, paints a better picture – with employment rising 1.2 per cent in Q3 from a year earlier. Signs of stronger labour demand have showed up in a faster inflow of new vacancies. Job expectations are positive, according to sentiment surveys. We expect job growth to increase slightly faster than the labour force in the coming year. **The LFS unemployment rate will average 3.9 per cent in 2018 and 3.7 per cent in 2019**.

Inflation stabilising below target

After declining rapidly since summer, inflation has stabilised and even rebounded slightly in the last quarter. The driving force was almost exclusively the weaker-trending exchange rate between 2012 and 2015. Krone stabilisation over the past two years has led to diminishing upward pressure on prices for imported goods. Domestic inflationary pressures are low. Pay hikes continue to be modest and show a slight declining trend. Generally low international price pressure is also helping suppress inflation. Food prices, which have fallen since summer, will push inflation somewhat higher in the coming six months. CPI-ATE inflation (excluding taxes and energy) will rise from 1.1 per cent in October to nearly 1.5 per cent early next year, and we expect inflation to remain at this level until the end of the forecast period. **CPI-ATE will increase by 1.4 per cent in both 2018 and 2019**. CPI inflation will be somewhat higher: 1.5 per cent in both 2018 and 2019.

Rate hikes despite low inflation

Norges Bank has kept its key rate stable at 0.50 per cent since March 2016. The robust economic recovery justifies a less expansionary policy, but inflation remains subdued. Our CPI-ATE trajectory is below Norges Bank's forecast for 2018 and 2019, but it is uncertain to what extent the current low inflation rate will affect the bank's deliberation at at its next policy meeting in December. Norges Bank seems rather relaxed about forecasting below-target inflation, since it emphasises rising capacity utilisation, which should result in inflation picking up over the medium term. A continued improvement in economic growth and decreasing labour market slack should thus justify an earlier start to the hiking cycle than envisaged by Norges Bank. Moreover, household debt growth remains high and it will take time for household vulnerabilities to recede despite the ongoing correction in home prices. We reiterate our expectation of a **first rate hike in December 2018** and a key rate of **1.25 per cent by end-2019**. While the krone is still an important consideration, current weak levels suggest Norges Bank can hike independently of neighbouring central banks.

NOK outlook supports NGBs

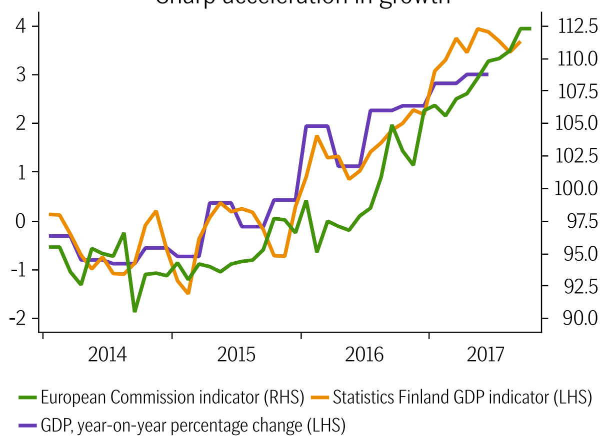
The krone has weakened this autumn, which is somewhat surprising given higher oil prices, accelerating economic growth and a balanced Norges Bank. We expect the krone to reconnect to its solid fundamentals. The long-term fair value of the NOK supports this view. We expect **the EUR/NOK exchange rate to reach 9.20 by the end of 2018**. Ongoing ECB asset purchases are likely to maintain Norwegian yield spreads against Germany at historically wide levels in 2018. Norwegian government bonds (NGBs) are nonetheless attractive from a yield-seeking perspective and the outlook for the krone is supportive. We expect **the 10-year yield spread against Germany to tighten to 80 bps in 2018.**

Finally rebounding from a long slump

- **Indicators close to previous highs**
- **Accelerating exports and capital spending**
- **Record-high household optimism**

Finland's economic recovery is on increasingly solid ground. **First half 2017 growth was the highest in more than 5 years** and indicators are pointing to even stronger expansion ahead. Compared to recent years, accelerating **capital spending and exports stand out** especially. Meanwhile household confidence is at a historically high level, but low pay increases are limiting the room for consumption. **We are revising our GDP growth forecast a few tenths higher to 2.9 per cent in 2017, 2.5 per cent next year and 2.3 per cent in 2019**. But despite its brighter outlook, the Finnish economy is still scarred by earlier recurrent recessions: **only in late 2018 will it reach the same GDP level as 10 years ago**.

Sharp acceleration in growth



Source: Statistics Finland, Macrobond, SEB

Indicators are strong, with the European Commission's Economic Sentiment Indicator (ESI) at its highest since early 2011. The mood is especially good in the service sector, but the recent upturn is relatively broad-based. It has been nearly 10 years since manufacturers have been so pleased with their order books as today, and production is currently increasing by about 6.5 per cent year-on-year. Meanwhile there is a long way to go; despite its upturn in the past two years, manufacturing output is about 20 per cent below its peak before the global financial crisis. Rapidly rising capacity utilisation in the overall economy will help drive a continued upturn in capital spending.

The export upswing is an important reason why companies are more optimistic. Global demand is rising and economic developments are moving in the right direction in key Finnish export markets. The euro zone and the Nordic countries are doing well, and Russia – which has now emerged from its slump – is also making a positive contribution. The 2016 Competitiveness Pact between the government, employer organisations and labour unions is slowly but surely helping, since Finnish export prices are increasing more slowly than those of competing countries. **Exports will increase by 7 per cent in 2017 and 4-5 per cent yearly in 2018 and 2019**. With exports rising faster than imports, the current account balance is improving even though it still shows a deficit.

Household optimism is record-high. Consumer confidence has not been so stable for so long since measurements began in 1995. Sentiment is driven by the economic turnaround and the fastest job growth in five years, but due to stagnating wages and salaries along with continued tight fiscal policy, the room for consumption is limited. The household savings ratio is already historically low, but low interest rates are allowing households to boost their debt level. **Consumption will increase by about 2 per cent yearly in 2018-2019**.

Unemployment has been a disappointment, even though the economy has otherwise moved in the right direction. The downturn has stopped and the jobless rate has been largely unchanged at 8.7-8.8 per cent during the past year. Although **employment rose** by about 1 per cent in the first half, it remains lower than in 2008. Yet we believe **unemployment will slowly shrink, reaching 8.2 per cent in 2018 and 7.9 per cent in 2019**. The Competitiveness Pact will help **keep wage and salary increases low**; in 2017, contractual pay levels are expected to be largely unchanged. Wage drift will contribute to somewhat higher increases in 2018-2019. The risk is on the upside, with employees wishing to share the benefits of improved growth, while employers emphasise Finland's continued weak position and competitiveness aspects. Inflation has been stable at just below 1 per cent for much of 2017. It will climb a bit, to 1.1 per cent in 2018 and 1.4 per cent in 2019, but will remain below the euro zone average.

Continued high unemployment and an ageing population will put pressure on government expenditures, contributing to a **persistent public sector deficit in spite of the improved economic situation**. There is thus no room for fiscal stimulus measures. Policymakers will instead maintain their focus on budget consolidation and improved competitiveness. **The budget deficit will gradually fall from 1.7 to 1.0 per cent of GDP** between 2016 and 2019. Government debt will shrink marginally to 61 per cent of GDP in 2019.

Capital spending to play a greater role for growth

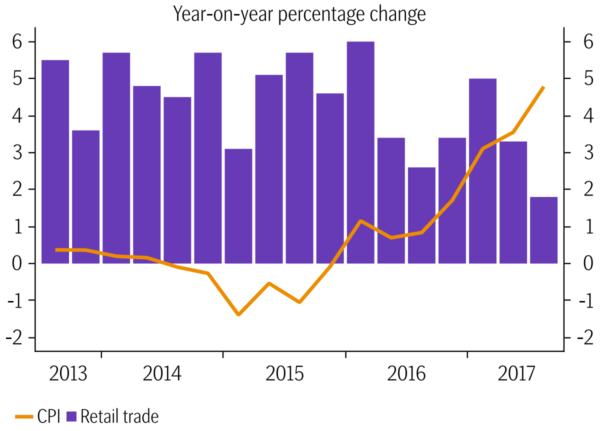
- **High inflation contributing to deceleration in private consumption**
- **Sluggish increase in capital spending despite record-high capacity utilisation**

Economic expansion slowed in the third quarter of 2017, partly due to weaker private consumption. Despite this, GDP grew by a healthy 3.8 per cent year-on-year during the first nine months of 2017, driven by strong merchandise and service exports. We expect capital spending to become a more important growth factor ahead. **Lithuania's GDP will climb by 3.2 per cent next year and by 3.0 per cent in 2019**.

Retail sales figures have confirmed earlier signals of a slowdown in private consumption. Partly due to rising inflation, more consumers are seeking lower-priced alternatives such as shopping in Poland or via foreign internet retailers. Although emigration has been stabilising and immigration has risen since summer, the number of consumers is still falling. **Consumer confidence is now below last year's level, due to scepticism about the economic outlook**.

Retail trade growth decelerates as inflation rises

Year-on-year percentage change



Source: Statistics Lithuania

Debts of non-financial corporations are increasing at a slower pace than GDP this year. Meanwhile household debt is rising in tandem with disposable income, which indicates a balanced overall trend in the Lithuanian credit market. The growth in residential prices will be slower next year due to an increased supply of unsold properties – especially in the capital, Vilnius.

Public investments have been unchanged compared to last year, held down by slow utilisation of EU structural funds. So far, private sector investments have increased at a limited pace despite record-high capacity utilisation, but we expect capital spending to be a more important growth engine in 2018. Efficiency-raising investments will be unavoidable in response to high capacity utilisation, recruitment problems and rising labour costs.

Companies are continuing to exploit favourable conditions in export markets. Exports of plastics, dairy products, furniture, steel and electronics are among the largest contributors to the export upturn. **In addition, re-exports to Russia and other CIS markets are increasing rapidly as economic conditions improve in those countries.**

The labour market situation is increasingly tight, and businesses keep complaining about the shortage of skilled workers. The labour force and the number of employed persons are shrinking and these trends are likely to persist if net migration remains negative. One offsetting factor is that it is becoming **more common to hire people from other countries**. The number of them working in the transport, construction and real estate sectors is clearly increasing. **We forecast that unemployment will drop from 7.3 per cent this year to 7.0 per cent in 2018 and 6.8 per cent in 2019**.

Average wage and salary growth slowed from 9 per cent in the first half of 2017 to around 7 per cent so far in the second half as the effect of the previous increase in the minimum monthly wage (MMW) faded. However, the MMW will be raised again by 20 euros to 400 euros from January 1. In 2018, **pensions will also be increased by 10 per cent and the maximum non-taxable income threshold will be raised from 310 to 380 euros**, which will help support struggling consumer spending.

A sharp **labour cost increase** has been the main factor fuelling **inflation that is among the highest in the EU this year**. Wage and price inflation has gained momentum and is one factor behind higher service prices. An increase in excise duties for alcoholic beverages has also contributed to inflation. We forecast that consumer prices will increase by 2.8 per cent next year and by 2.5 per cent in 2019. **Inflation will thus be lower than the expected average of 3.7 per cent for this year, but it will remain well above the EU average**.

The government is planning a budget surplus in 2018 – totalling 0.3 per cent of GDP, we believe – and says it expects the economy to expand faster than the potential growth rate and thus a deficit cannot be tolerated. The budget will pay particular attention to measures for increasing the income of low earners and reducing poverty.

Accelerating growth, but mounting labour shortages

- **Construction sector is the most expansive**
- **Tight labour market creating reform needs**
- **Pay is surging, despite low productivity**

Latvian economic growth has been speeding up. GDP rose by 5.8 per cent year-on-year in the third quarter of 2017: the fastest pace in six years and well above the expectations of most analysts. Growth was driven by an 8 per cent increase in industrial output, a 23 per cent jump in construction and a 4 per cent upturn in services.

The euro zone recovery will continue to support an expansion of Latvia's exports and manufacturing sector. Exports look set to climb by some 10 per cent this year and 6-7 per cent in 2018. Now that EU structural funds have again started pouring into Latvia, construction activity has surged. Such capital flows will drive this sector and will continue to stimulate capital spending after the 17.5 per cent upturn recorded in the first half of 2017. **Overall, we expect GDP to grow by 4.5 per cent this year, followed by 3.7 per cent in 2018 and 3.5 per cent in 2019.**

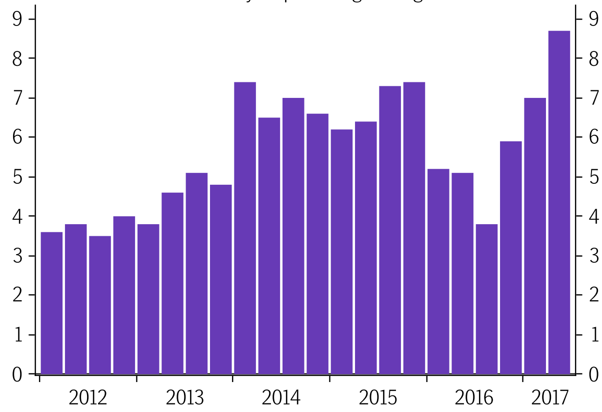
Retail sales have also showed signs of greater activity in recent months. In September, sales climbed by 4.9 per cent year-on-year. We expect private consumption to increase further next year, thanks to higher pay and planned tax cuts. The real estate sector, which so far has not really kept up with the acceleration in the rest of the economy, will probably gain strength. There is great uncertainty in the transit sector, which may be a source of concern further ahead.

Whether the current growth rate can be maintained will depend on the ability of economic policymakers to resolve **such problems as labour shortages and construction sector bottlenecks**. In the latest "Doing Business" report from the World Bank, Latvia fell by five positions to 19th place, underscoring the need to revive the reform process, for example by reducing bureaucracy.

The labour market has heated up and the employment rate is close to its pre-crisis level, but unemployment is relatively high at close to 9 per cent. Over the next two years the jobless rate will decrease, since there will be a demand for labour in most sectors, especially construction. By the end of 2017, we expect unemployment to have fallen to **8.6 per cent, decreasing further to 7.4 per cent in 2018 and 6.8 per cent in 2019**. This will further accentuate labour shortages, underlining the need for reforms in education and other fields. Because the labour force is ageing, recruitment opportunities are worsening and there is upward pressure on pay and prices. Labour immigration would be one way to deal with the situation, but this is unlikely to be on the agenda before the 2018 election.

Rising wages and salaries

Year-on-year percentage change



Source: Statistics Latvia

In the second quarter of 2017 wage and salary growth accelerated further, reaching 8.7 per cent year-on-year. Because of rising wage pressure, weak productivity growth is becoming an increasingly acute issue. **Yet it is unlikely that pre-crisis excesses will be repeated.** Entrepreneurs will continue to focus on holding down costs, and their assessments of their companies' profit opportunities will determine their willingness to go along with pay increases. Thanks to the good growth outlook, we have adjusted our forecast of pay increases to 7.6 per cent this year and more than 8 per cent in 2018, followed by a minor slowdown in 2019.

Despite high pay increases, inflation is relatively subdued and stood at 2.9 per cent in September. Major contributors to inflation have been higher fuel and heating costs as well as price hikes on various food categories. **Our forecast is that CPI inflation will end up at 3 per cent in 2017.** Next year, price pressure will remain strong as economic activity accelerates and certain excise taxes are raised. Yet we expect inflation to slow to **2.7 per cent in 2018** and **2.3 per cent in 2019** due to lower contributions from energy costs.

The government has adopted its 2018 budget. The deficit next year is projected at 1 per cent of GDP, about the same as the likely outcome in 2017. Considering the strong economic situation, **a tighter fiscal policy aimed at balancing the 2018 budget would be appropriate**.

Economy at full throttle

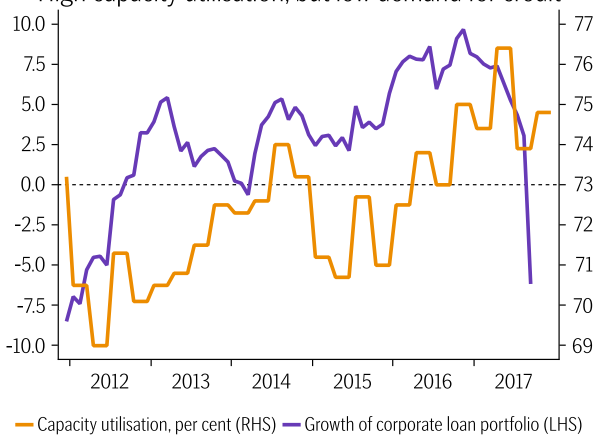
- **First half GDP growth accelerated to 5.2%**
- **Capital spending is boosting growth**
- **Construction sector benefiting from higher public sector spending and demography**

During the first half of 2017, Estonia's GDP grew by a **remarkable 5.2 per cent** in real terms. Last time growth reached such levels was in 2011 when the economy was recovering from a severe recession. We expect **GDP to increase by 4.1 per cent** this year and also show decent growth of **3.3 per cent in 2018 and 3.0 per cent in 2019**.

The most important driver of GDP growth this year has been capital spending, which surged 17 per cent in the first half of 2017. However, this growth was not very broad-based; nearly half came from increased upgrading of the transport sector. Construction also contributed, **soaring by 22 per cent in the first half**. Aside from extensive residential and commercial real estate construction, public investments almost doubled in H1. Estonia's public investments rely heavily on **EU structural funds** and the money for the 2014-2020 programming period has only now started to flow into the economy. In the business sector, the capital spending outlook remains unclear. After peaking in the second quarter, capacity utilisation in manufacturing has been somewhat lower, though remaining at a historically high level. The growth in corporate lending, however, has been decelerating since the end of 2016. In September, the total lending portfolio even declined year-on-year. One reason may be improved profitability, enabling smaller investments to be financed without credit. **We expect capital spending to increase by 14.5 per cent in 2017 and 3.6 and 4.0 per cent in 2018 and 2019, respectively**.

Housing demand has benefited from the **strong labour market**. Estonia's labour force participation has achieved its highest level in modern history; nearly 68.3 per cent of people aged 15 to 74 years were employed in the second quarter of 2017. Wage and salary growth is high and shows few signs of slowing, averaging 6.3 per cent in H1. **High pay increases** must be taken into account also when looking at real estate prices. While in EU home price index has on average increased a modest 10 per cent since 2010 according to one metric, in Estonia it has surged by 70 per cent in the same period, but adjusted for wage and salary growth, home buying remains affordable. In addition, demography has supported demand, since the number of 25- to 34-year-olds – who are the most likely homebuyers – is currently growing at its the fastest level.

High capacity utilisation, but low demand for credit



Source: Bank of Estonia (Eesti Pank), European Commission (DG ECFIN), SEB

Estonia's previously record-high industrial production growth has decelerated. During the first half of 2017, output surged by double digits, but the increase slowed to 3 per cent in Q3. This slowdown was fairly broad-based. The outlook for the Swedish construction sector is also important to Estonia, since for many years the most successful manufacturing sector has been wood processing, which has benefited from the boom in Sweden. Wood products and prefabricated houses now account for more than 20 per cent of total merchandise exports. A slowdown in Swedish construction would greatly impact Estonian growth figures, but so far the economic forecasts for Estonia's main trading partners is generally optimistic, so **we expect exports to increase by 4.2 per cent in 2017, 4.5 per cent in 2018 and 4.0 per cent in 2019**.

Along with GDP growth inflation has returned. According to the harmonised index of consumer prices (HICP), inflation rose to 3.5 per cent during first nine months of 2017. The only EU country to exceed Estonia in that respect was Lithuania, while Latvia takes third place. With fuel and food prices rising sharply, it is no surprise that the three Baltic countries are topping the inflation charts, since basic goods make up a large proportion of total expenditures in relatively poor households. Domestic factors have also contributed. The Estonian government has carried out large increases in excise duties for alcohol and fuels. In addition strong wage and salary pressure has pushed up service prices. Many of the above-mentioned factors will persist during our forecast period. **We are thus predicting that HICP inflation will be 3.6 per cent this year, 3.0 per cent in 2018 and 2.5 per cent in 2019**.

GLOBAL KEY INDICATORS

Yearly change in per cent

	2016	2017	2018	2019
GDP OECD	1.8	2.4	2.3	2.0
GDP world (PPP)	3.2	3.8	3.9	3.8
CPI OECD	1.1	2.2	1.9	1.8
Export market OECD	2.5	4.1	3.8	3.4
Oil price, Brent (USD/barrel)	45.2	54.7	55.0	60.0

US

Yearly change in per cent

	2016 level, USD bn	2016	2017	2018	2019
Gross domestic product	18,906	1.5	2.3	2.6	2.0
Private consumption	13,057	2.7	2.7	2.9	2.1
Public consumption	3,287	0.8	-0.1	0.7	0.7
Gross fixed investment	3,126	0.6	3.7	3.3	3.1
Stock building (change as % of GDP)		-0.4	-0.1	0.0	0.0
Exports	2,241	-0.3	3.3	4.2	3.9
Imports	2,806	1.3	3.3	4.0	4.2
Unemployment (%)		4.9	4.3	3.9	4.1
Consumer prices		1.3	2.1	2.1	1.8
Household savings ratio (%)		4.9	3.8	3.2	3.3

EURO ZONE

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	10,515	1.8	2.3	2.3	2.1
Private consumption	5,754	2.0	2.1	2.2	2.0
Public consumption	2,169	1.8	1.2	1.0	1.0
Gross fixed investment	2,078	4.5	4.5	4.3	4.0
Stock building (change as % of GDP)	0	-0.1	0.0	0.0	0.0
Exports	4,847	3.3	4.4	4.5	4.5
Imports	4,362	4.7	4.8	5.0	5.0
Unemployment (%)		10.0	9.1	8.5	8.2
Consumer prices		0.2	1.5	1.0	1.4
Household savings ratio (%)		6.2	6.3	6.2	6.0

OTHER LARGE COUNTRIES

Yearly change in per cent

	2016	2017	2018	2019
GDP				
United Kingdom	1.8	1.5	1.3	1.1
Japan	1.0	1.5	1.2	1.0
Germany	1.9	2.2	2.2	2.0
France	1.2	1.8	2.0	2.0
Italy	0.9	1.5	1.6	1.6
China	6.7	6.9	6.6	6.2
India	7.9	6.6	7.5	7.8
Brazil	-3.6	0.7	2.2	2.3
Russia	-0.2	1.8	2.0	1.9
Poland	2.7	4.0	3.5	3.2
Inflation				
United Kingdom	0.6	2.7	2.3	1.7
Japan	-0.1	0.4	0.5	1.2
Germany	1.7	1.7	1.4	1.7
France	0.8	1.2	1.3	1.5
Italy	-0.1	1.4	1.3	1.5
China	2.0	1.7	2.5	2.8
India	5.0	3.3	4.5	4.5
Brazil	8.8	3.4	4.0	4.3
Russia	7.1	3.7	4.0	4.5
Poland	-0.6	2.1	2.7	2.5
Unemployment (%)				
United Kingdom	4.9	4.4	4.3	4.6
Japan	3.1	2.9	2.5	2.3
Germany	4.1	3.7	3.7	3.8
France	9.9	9.5	9.2	8.9
Italy	11.7	11.5	11.2	11.0

FINANCIAL FORECASTS

Official interest rates		15-Nov	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19
US	Fed funds	1.25	1.50	1.75	2.25	2.50	2.50
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Euro zone	Refi rate	0.00	0.00	0.00	0.00	0.25	0.50
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	1.00
Bond yields							
US	10 years	2.35	2.45	2.60	2.80	2.90	2.90
Japan	10 years	0.04	0.05	0.05	0.05	0.05	0.05
Germany	10 years	0.38	0.50	0.55	0.75	1.00	1.10
United Kingdom	10 years	1.29	1.40	1.45	1.60	1.85	2.10
Exchange rate							
USD/JPY		113	114	115	110	108	105
EUR/USD		1.18	1.14	1.17	1.20	1.23	1.25
EUR/JPY		133	130	135	132	133	131
EUR/GBP		0.90	0.92	0.90	0.88	0.86	0.84
GBP/USD		1.32	1.24	1.30	1.36	1.43	1.49

SWEDEN

Yearly change in per cent

	2016 level, SEK bn	2016	2017	2018	2019
Gross domestic product	4,405	3.3	3.2	2.6	2.4
Gross domestic product, working day adjustment		3.1	3.5	2.7	2.5
Private consumption	1,950	2.2	2.4	2.2	2.2
Public consumption	1,152	3.4	1.6	0.8	0.5
Gross fixed investment	1,059	5.6	7.7	6.3	4.7
Stock building (change as % of GDP)	31	0.0	0.0	0.0	0.0
Exports	1,950	3.3	5.3	7.2	3.0
Imports	1,737	3.4	6.3	8.4	3.2
Unemployment, (%)		6.9	6.7	6.2	6.2
Employment		1.5	2.3	2.0	1.1
Industrial production		2.8	4.5	6.0	5.0
CPI		1.0	1.8	1.8	2.1
CPIF		1.4	2.0	1.8	1.8
Hourly wage increases		2.4	2.7	3.1	3.5
Household savings ratio (%)		15.8	15.5	15.8	15.7
Real disposable income		2.3	2.4	3.1	2.5
Current account, % of GDP		4.5	4.5	4.3	3.8
Central government borrowing, SEK bn		-85	-41	-25	-40
Public sector financial balance, % of GDP		1.1	1.0	0.7	1.0
Public sector debt, % of GDP		42.2	39.9	37.8	35.5

FINANCIAL FORECASTS	15-Nov	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19
Repo rate	-0.50	-0.50	-0.50	-0.25	0.00	0.50
3-month interest rate, STIBOR	-0.61	-0.55	-0.45	-0.27	0.10	0.55
10-year bond yield	0.70	0.75	0.95	1.35	1.60	1.70
10-year spread to Germany, bp	32	25	40	60	60	60
USD/SEK	8.45	8.77	8.29	7.88	7.56	7.36
EUR/SEK	9.97	10.00	9.70	9.45	9.30	9.20
KIX	114.1	114.9	111.3	108.6	106.8	105.9

FINLAND

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	218	1.9	2.9	2.5	2.3
Private consumption	119	1.8	1.8	2.0	2.0
Public consumption	52	1.2	0.5	0.5	0.5
Gross fixed investment	46	7.2	7.0	3.8	4.0
Stock building (change as % of GDP)		0.4	0.0	0.0	0.0
Exports	76	1.3	7.0	5.3	4.0
Imports	79	4.4	6.0	4.0	3.5
Unemployment, OECD harmonised (%)		8.9	8.7	8.2	7.9
CPI, harmonised		0.4	0.9	1.1	1.4
Hourly wage increases		1.5	1.5	2.0	2.0
Current account, % of GDP		-1.4	-0.9	-1.0	-1.0
Public sector financial balance, % of GDP		-1.7	-1.5	-1.3	-1.0
Public sector debt, % of GDP		63.1	62.5	62.0	61.0

NORWAY

Yearly change in per cent

	2016 level, NOK bn	2016	2017	2018	2019
Gross domestic product	3,152	1.1	2.0	1.6	1.8
Gross domestic product (Mainland)	2,646	1.0	1.9	2.4	2.3
Private consumption	1,311	1.5	2.5	2.6	2.6
Public consumption	706	2.1	1.8	1.6	1.6
Gross fixed investment	711	-0.2	4.0	2.0	2.1
Stock building (change as % of GDP)		1.4	-0.2	0.0	0.0
Exports	1,266	-1.8	2.3	1.4	1.6
Imports	956	2.3	3.1	2.9	2.3
Unemployment (%)		4.7	4.2	3.9	3.7
CPI		3.6	1.8	1.5	1.5
CPI-ATE		3.0	1.4	1.4	1.4
Annual wage increases		1.7	2.4	2.8	3.1

FINANCIAL FORECASTS	**15-Nov**	**Dec-17**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Deposit rate	0.50	0.50	0.50	0.75	1.00	1.25
10-year bond yield	1.51	1.50	1.45	1.55	1.85	2.05
10-year spread to Germany, bp	113	100	90	80	85	95
USD/NOK	8.26	8.33	7.95	7.67	7.40	7.20
EUR/NOK	9.75	9.50	9.30	9.20	9.10	9.00

DENMARK

Yearly change in per cent

	2016 level, DKK bn	2016	2017	2018	2019
Gross domestic product	2,065	2.0	2.3	2.3	2.3
Private consumption	987	2.1	2.3	2.6	2.5
Public consumption	525	0.3	0.8	0.9	1.2
Gross fixed investment	414	6.0	2.8	4.2	3.6
Stock building (change as % of GDP)		-0.2	-0.1	-0.1	0.0
Exports	1,102	2.8	5.5	4.6	3.6
Imports	963	3.8	5.2	4.9	4.1
Unemployment, OECD harmonised (%)		6.5	5.7	5.3	4.9
CPI, harmonised		0.0	1.2	1.4	1.4
Hourly wage increases		1.8	1.7	1.9	2.1
Current account, % of GDP		8.1	8.5	8.6	8.6
Public sector financial balance, % of GDP		-0.6	0.0	0.5	1.0
Public sector debt, % of GDP		37.7	37.0	36.0	35.0

FINANCIAL FORECASTS	**15-Nov**	**Dec-17**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Lending rate	0.05	0.05	0.05	0.05	0.30	0.55
10-year bond yield	0.46	0.60	0.65	0.85	1.10	1.20
10-year spread to Germany, bp	8	10	10	10	10	10
USD/DKK	6.31	6.53	6.36	6.20	6.05	5.95
EUR/DKK	7.44	7.44	7.44	7.44	7.44	7.44

LITHUANIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	39	2.3	3.7	3.2	3.0
Private consumption	25	5.0	4.2	3.6	3.5
Public consumption	7	1.3	1.5	1.3	1.3
Gross fixed investment	7	-0.5	7.0	8.0	5.0
Exports	29	3.5	7.0	4.9	3.7
Imports	28	3.5	7.6	5.8	4.3
Unemployment (%)		7.9	7.3	7.0	6.8
Consumer prices		0.7	3.7	2.8	2.5
Public sector financial balance, % of GDP		0.3	0.0	0.3	0.2
Public sector debt, % of GDP		40.2	41.0	36.5	37.5

LATVIA

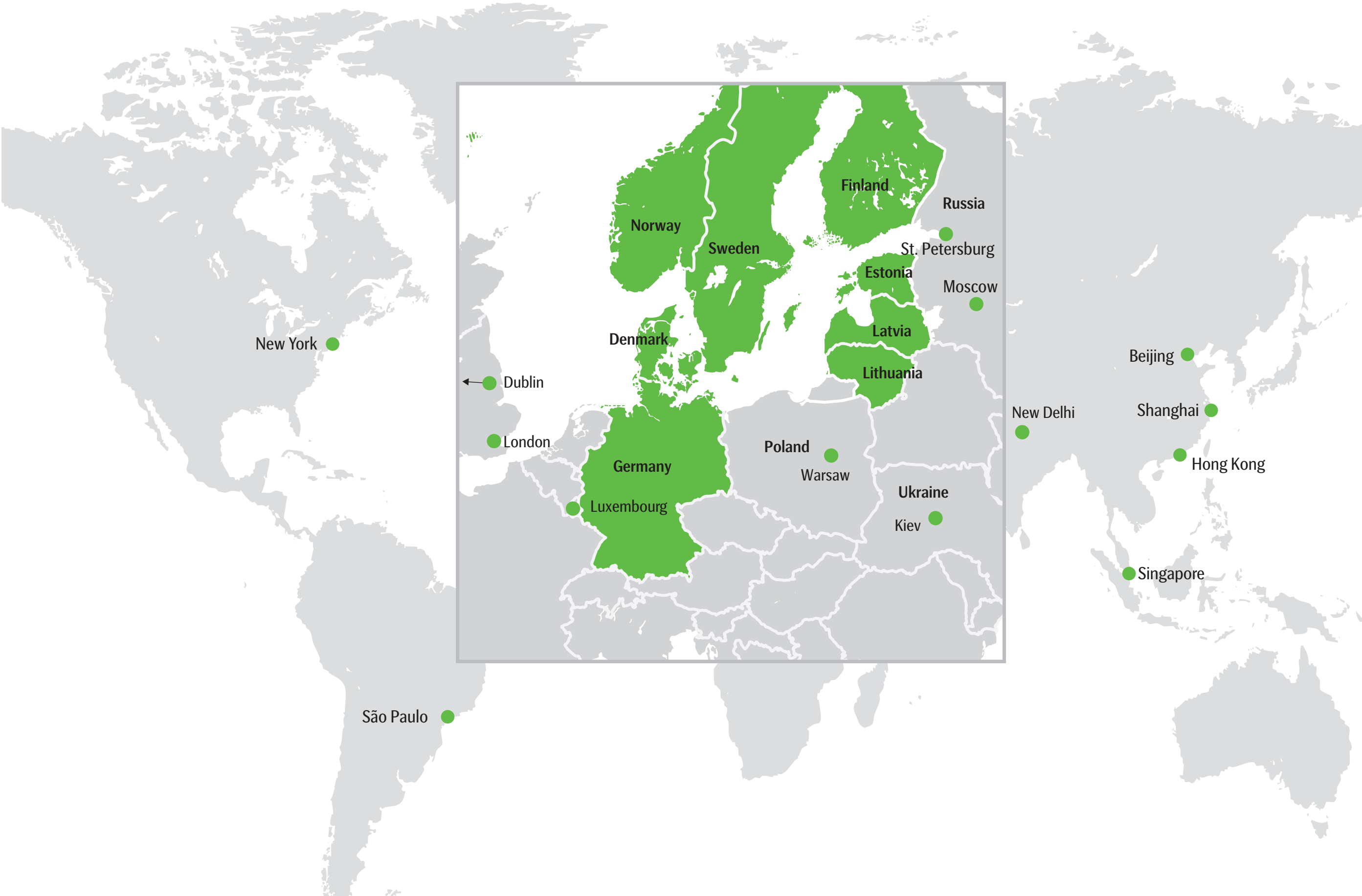
Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	25	2.0	4.5	3.7	3.5
Private consumption	15	3.5	5.2	5.7	4.1
Public consumption	4	2.7	3.4	2.2	1.8
Gross fixed investment	5	-11.7	16.0	9.0	7.5
Exports	15	2.8	7.2	6.5	5.5
Imports	14	4.6	8.0	8.0	6.0
Unemployment (%)		9.6	8.9	8.1	7.2
Consumer prices		0.1	3.0	2.7	2.3
Public sector financial balance, % of GDP		0.0	-0.6	-1.2	-1.1
Public sector debt, % of GDP		40.1	38.6	37.3	36.5

ESTONIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	21	2.1	4.1	3.3	3.0
Private consumption	10	4.4	2.0	4.2	2.6
Public consumption	4	1.9	1.2	1.8	2.2
Gross fixed investment	5	-1.2	14.5	3.6	4.0
Exports	17	4.1	4.2	4.5	4.0
Imports	16	5.3	4.6	4.0	3.7
Unemployment (%)		6.8	6.2	6.8	7.2
Consumer prices		0.8	3.6	3.0	2.5
Public sector financial balance, % of GDP		-0.3	0.0	-0.2	-0.4
Public sector debt, % of GDP		9.4	9.3	9.0	9.0



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